

**Banking, Insurance, Life Insurance and Superannuation (prudential standard)  
determination No. 1 of 2016**

**EXPLANATORY STATEMENT**

**Prepared by the Australian Prudential Regulation Authority (APRA)**

*Banking Act 1959*, section 11AF

*Insurance Act 1973*, section 32

*Life Insurance Act 1995*, section 230A

*Superannuation Industry (Supervision) Act 1993*, section 34C

APRA may, in writing, determine, vary or revoke a prudential standard that applies to an institution regulated by APRA under:

- (1) section 11AF of the *Banking Act 1959* (Banking Act), in relation to authorised deposit-taking institutions (ADIs) and authorised non-operating holding companies (authorised banking NOHCs);
- (2) section 32 of the *Insurance Act 1973* (Insurance Act), in relation to general insurers, authorised non-operating holding companies (authorised insurance NOHCs), and subsidiaries of general insurers and authorised insurance NOHCs;
- (3) section 230A of the *Life Insurance Act 1995* (Life Insurance Act), in relation to life companies, friendly societies, registered non-operating holding companies (registered life NOHCs), and subsidiaries of life companies and registered life NOHCs; and
- (4) section 34C of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) in relation to RSE licensees under the SIS Act.

On 6 December 2016, APRA made Banking, Insurance, Life Insurance and Superannuation (prudential standard) determination No. 1 of 2016 (the instrument), which determines *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (CPS 226).<sup>1</sup> The instrument commences on 1 March 2017.

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<sup>1</sup> CPS 226 incorporates by reference certain provisions of Acts, Regulations and prudential standards, as well as Australian Accounting Standard AASB 10. All of these references are references to the provisions as in force from time to time, and are available on the Federal Register of Legislation at [www.legislation.gov.au](http://www.legislation.gov.au). CPS 226 also incorporates by reference the BCBS-IOSCO framework as it exists at 18 March 2015 and the IOSCO Risk Mitigation Standards as they exist at 28 January 2015. These documents are available at: BCBS-IOSCO framework: <http://www.bis.org/bcbs/publ/d317.pdf>; and IOSCO Risk Mitigation Standards: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf>.

## **1. Background**

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors, policyholders and fund members within a stable, efficient and competitive financial system.

In response to the global financial crisis, the Group of Twenty (G20) initiated a series of reforms to the over-the-counter (OTC) derivatives market. The G20's initial reform comprised three key commitments:

- to improve transparency by requiring transaction information on all OTC derivatives to be reported to trade repositories;
- to improve market efficiency and risk management by requiring all standardised OTC derivatives to be cleared through central counterparties; and
- to improve market efficiency and integrity by requiring the execution of all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate.

In 2011, the G20 added to its reform programme a fourth commitment to introduce margin requirements for non-centrally cleared derivatives and called on the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) to develop recommendations for consistent global standards in this area.

Counterparty exposures on bilaterally transacted derivatives contributed to the depth of the global financial crisis. Many of these exposures were uncollateralised or undercollateralised, meaning insufficient collateral was available to offset losses caused by counterparty defaults and such losses were subsequently borne by the surviving counterparties. The build-up of uncollateralised exposures led to contagion and spillover effects on wider financial markets and the real economy.

The problems associated with insufficient collateral were exacerbated by inadequate risk management practices. Weaknesses in areas including trading relationship documentation, trade confirmation, portfolio reconciliation and compression, valuation processes and dispute resolution created a lack of certainty and transparency over the terms of non-centrally cleared transactions and aggravated the problems observed in the non-centrally cleared derivatives market.

In 2015, the BCBS and IOSCO finalised minimum standards for margin requirements for non-centrally cleared derivative transactions ('the BCBS-IOSCO framework'). The BCBS-IOSCO framework requires the exchange of both variation margin and initial margin. Variation margin is collateral that is collected to reflect the current mark-to-market exposure resulting from changes in the market value of a non-centrally cleared derivative. Initial margin protects against the potential future exposure that may arise from future changes in the mark-to-market value of a non-centrally cleared derivative during the period of time that is assumed to be required to close-out and replace the position following a counterparty default.

To complement the margin requirements, IOSCO in 2015 released *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives*, which sets out additional qualitative risk mitigation practices to reduce risk in the non-centrally cleared derivatives market ('the IOSCO risk mitigation standards'). These standards require covered entities to adopt appropriate risk mitigation standards in the areas of trading

relationship documentation, trade confirmation, valuation processes, portfolio reconciliation, portfolio compression and dispute resolution.

The purpose of the BCBS-IOSCO reforms is to reduce systemic risk and limit contagion by ensuring the availability of collateral to offset losses caused by the default of a derivative counterparty and to improve risk management practices in order to promote legal certainty, transparency and timely dispute resolution. By requiring collateral to be posted against both current and potential future counterparty exposures for non-centrally cleared derivatives, as required for centrally cleared exposures, these reforms are also intended to promote central clearing.

CPS 226 incorporates margin requirements for non-centrally cleared derivatives based on the BCBS-IOSCO framework, and additional risk mitigation requirements for non-cleared transactions based on the IOSCO risk mitigation standards.

## **2. Purpose and operation of the instruments**

The purpose of the instrument is to determine CPS 226. CPS 226 requires an entity covered by the rules to have appropriate margining and risk mitigation practices in relation to non-centrally cleared derivatives. CPS 226 applies to institutions in the banking, general insurance, life insurance and superannuation industries, subject to certain thresholds.

Through the introduction of margin requirements for non-centrally cleared derivatives in Australia, CPS 226 implements a key component of the G20's post-crisis derivatives market reform package. The margin requirements are intended to improve prudential safety, reduce systemic risk and promote central clearing of derivatives. The margin requirements in CPS 226 take effect from 1 March 2017, subject to a phase-in period extending to September 2020.

CPS 226 also establishes minimum risk mitigation requirements for non-centrally cleared derivatives. These requirements are aimed at promoting legal certainty and facilitating the timely resolution of disputes in non-centrally cleared derivatives. The risk mitigation requirements in CPS 226 come into force from 1 March 2018.

The key requirements of CPS 226 are that an entity must:

- exchange variation margin and post and collect initial margin in transactions subject to certain criteria and the implementation timetables;
- post and collect initial margin on a gross basis calculated by either a standardised schedule or an approved model approach;
- ensure that initial margin is held in a manner that provides legal certainty to both counterparties in the event of insolvency or bankruptcy;
- collect eligible collateral to satisfy margin requirements and apply appropriate risk-sensitive haircuts to collateral collected; and

- apply risk mitigation practices in the areas of trading relationship documentation, trade confirmation, portfolio reconciliation, portfolio compression, valuation processes and dispute resolution processes.

### **3. Consultation**

APRA undertook consultation on the proposed introduction of margining and risk mitigation requirements for non-centrally cleared derivatives from June 2015 to October 2016. In February 2016, APRA commenced formal consultation through the public release of a discussion paper and a draft of CPS 226, which set out the proposed framework for margining and risk mitigation for non-centrally cleared derivatives.

Twenty-two submissions were received in response to the February 2016 consultation. APRA considered all issues raised in submissions and made several amendments to the framework in response. In particular, APRA excluded physically settled foreign exchange forward contracts and swaps from the scope of the variation margin requirements in CPS 226 in recognition of the widespread use of these products for genuine hedging purposes, as well as for international harmonisation. APRA may revisit this exclusion if there are changes to the global regulatory environment or material risk in the Australian financial system. The exchange of variation margin for these transactions is common practice between larger counterparties. APRA expects this practice to continue in the interbank market and will issue guidance to this effect.

The final form of CPS 226 and a response to submissions paper were released on APRA's website on 17 October 2016. At that time, APRA did not include an implementation timetable for the requirements, pending further information on international implementation timeframes.

On 6 December 2016, APRA announced the implementation timetable for CPS 226. CPS 226 will be effective from 1 March 2017. The initial margin requirements will be phased in from March 2017 to September 2020 in a manner consistent with the BCBS-IOSCO phase-in timetable for dates from September 2017 to September 2020. The variation margin requirements will commence on 1 March 2017, with a six-month implementation period during which institutions subject to the requirements may finalise and transition to full compliance for all qualifying transactions entered into on or after 1 March 2017. The risk mitigation requirements in CPS 226 will take effect on 1 March 2018.

### **4. Regulation Impact Statement**

APRA prepared a Regulation Impact Statement which has been lodged as supporting material.

**5. Statement of compatibility prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011**

A Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* is provided at Attachment A to this Explanatory Statement.

## **Statement of Compatibility with Human Rights**

*Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011*

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This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* (HRPS Act).

### **Overview of the Legislative Instrument**

This legislative instrument makes Banking, Insurance, Life Insurance and Superannuation (prudential standard) determination No. 1 of 2016, which determines *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (CPS 226). CPS 226 applies to institutions in the banking, general insurance, life insurance and superannuation industries. Under CPS 226, an entity that actively transacts in non-centrally cleared derivatives is required to exchange collateral as appropriate to those transactions to manage the risk of counterparty default, and to have policies and procedures to manage its risks in undertaking that derivatives activity.

### **Human rights implications**

APRA has assessed this Legislative Instrument and is of the view that it does not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the HRPS Act. Accordingly, in APRA's assessment, the instrument is compatible with human rights.

### **Conclusion**

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.