



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

### **Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives**

*Banking Act 1959*

*Insurance Act 1973*

*Life Insurance Act 1995*

*Superannuation Industry (Supervision) Act 1993*

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I, Wayne Byres, delegate of APRA:

- (a) under subsection 11AF(1) of the *Banking Act 1959* DETERMINE *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* in the form set out in the Schedule, to the extent that it applies to all ADIs and authorised banking NOHCs;
- (b) under subsection 32(1) of the *Insurance Act 1973* DETERMINE *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* in the form set out in the Schedule, to the extent that it applies to all general insurers, authorised insurance NOHCs, and subsidiaries of general insurers and authorised insurance NOHCs;
- (c) under subsection 230A(1) of the *Life Insurance Act 1995* DETERMINE *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* in the form set out in the Schedule, to the extent that it applies to all life companies, friendly societies, and registered life NOHCs; and
- (d) under subsection 34C(1) of the *Superannuation Industry (Supervision) Act 1993* DETERMINE *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* in the form set out in the Schedule, to the extent that it applies to RSE licensees.

This instrument commences on 1 March 2017.

Dated: 6 December 2016

[Signed]

Wayne Byres  
Chairman

### **Interpretation**

In this Determination:

*ADI* has the meaning given in section 5 of the *Banking Act 1959*.

*APRA* means the Australian Prudential Regulation Authority.

*authorised banking NOHC* has the meaning given to the expression authorised NOHC in section 5 of the *Banking Act 1959*.

*authorised insurance NOHC* has the meaning given to the expression authorised NOHC in subsection 3(1) of the *Insurance Act 1973*.

*friendly society* has the meaning given in section 16C of the *Life Insurance Act 1995*.

*general insurer* has the meaning given in section 11 of the *Insurance Act 1973*.

*life company* has the meaning given in the Schedule to the *Life Insurance Act 1995*.

*registered life NOHC* has the meaning given to the expression registered NOHC in the Schedule to the *Life Insurance Act 1995*.

*RSE licensee* has the meaning given in section 10(1) of the *Superannuation Industry (Supervision) Act 1993*.

### **Schedule**

*Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* comprises the 26 pages commencing on the following page.



## **Prudential Standard CPS 226**

### **Margining and risk mitigation for non-centrally cleared derivatives**

#### **Objectives and key requirements of this Prudential Standard**

This Prudential Standard requires an APRA covered entity to have appropriate margining practices in relation to non-centrally cleared derivatives. An APRA covered entity must exchange variation margin and post and collect initial margin with a covered counterparty, subject to certain criteria.

The key requirements of this Prudential Standard are that an APRA covered entity must:

- exchange variation margin and post and collect initial margin in transactions with a covered counterparty subject to certain criteria and the implementation timetables;
- use a zero threshold in the exchange of variation margin;
- post and collect initial margin on a gross basis calculated by either the 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; and
- collect eligible collateral to satisfy margin requirements and apply appropriate risk-sensitive haircuts to collateral collected.

This Prudential Standard also requires an APRA covered entity to apply risk mitigation practices in the areas of trading relationship documentation, trade confirmation, portfolio reconciliation, portfolio compression, valuation processes and dispute resolution processes.

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## Authority

1. This Prudential Standard is made under:
  - (a) section 11AF of the *Banking Act 1959* (Banking Act);
  - (b) section 32 of the *Insurance Act 1973* (Insurance Act);
  - (c) section 230A of the *Life Insurance Act 1995* (Life Insurance Act); and
  - (d) section 34C of the *Superannuation Industry (Supervision) Act 1993* (SIS Act).

## Application

2. This Prudential Standard applies to all:
  - (a) authorised deposit-taking institutions (**ADIs**), including **foreign ADIs**, and **non-operating holding companies** authorised under the Banking Act (authorised banking NOHCs);
  - (b) **general insurers**, including **Category C insurers**, **non-operating holding companies** authorised under the Insurance Act (authorised insurance NOHCs), and **parent entities of Level 2 insurance groups**;
  - (c) **life companies** including **friendly societies** and **eligible foreign life insurance companies** (EFLICs), and **non-operating holding companies** registered under the Life Insurance Act (registered life NOHCs); and
  - (d) RSE licensees under the SIS Act in respect of their business operations.<sup>1</sup>
3. The requirements in this Prudential Standard apply in respect of each ‘APRA covered entity’, defined as:
  - (a) an ADI, including a foreign ADI, and an authorised banking NOHC;
  - (b) a general insurer, including a Category C insurer, an authorised insurance NOHC and a parent entity of a Level 2 insurance group;
  - (c) a life company, including a friendly society and an EFLIC, and a registered life NOHC; and
  - (d) a registrable superannuation entity under the SIS Act (RSE).
4. A requirement imposed on an APRA covered entity that is also the Head of a Level 2 group is to be read as requiring that APRA covered entity to ensure that each member of the Level 2 group that is a covered counterparty complies with

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<sup>1</sup> For the purposes of this Prudential Standard, an ‘RSE licensee’s business operations’ includes all activities as an RSE licensee (including the activities of each RSE of which it is the licensee), and all other activities of the RSE licensee to the extent that they are relevant to, or may impact on, its activities as an RSE licensee.

the requirements of this Prudential Standard as if it were itself an APRA covered entity.<sup>2</sup>

5. The requirements in this Prudential Standard apply to transactions which are booked in the accounts of an APRA covered entity. For a foreign ADI, Category C insurer or EFLIC, the requirements in this Prudential Standard apply only to transactions booked in accounts of the Australian branch of that entity.
6. This Prudential Standard commences on 1 March 2017.

### Interpretation

7. Terms that are defined in *Prudential Standard APS 001 Definitions* (APS 001), *Prudential Standard GPS 001 Definitions* (GPS 001) or *Prudential Standard LPS 001 Definitions* appear in bold the first time they are used in this Prudential Standard.
8. Where this Prudential Standard provides for APRA to exercise a power or discretion, this power or discretion is to be exercised in writing. In this Prudential Standard, unless the contrary intention appears, a reference to a provision of an Act, Regulations or Prudential Standard is a reference to the provision as in force from time to time.

### Definitions

9. The following definitions are used in this Prudential Standard:
  - (a) aggregate month-end average notional amount — is the simple average of the total notional amount<sup>3</sup> of outstanding non-centrally cleared derivative transactions as at the end of each month in the reference period. The total notional amount is the aggregate of all outstanding non-centrally cleared derivative transactions across all entities within the margining group. Intra-group transactions (transactions between two counterparties within the same margining group) are excluded from the calculation unless otherwise required by APRA;
  - (b) asset class — for the purposes of this Prudential Standard, the asset classes are (1) currency/rates, (2) equity, (3) credit, and (4) commodities. The asset class ‘currency/rates’ includes currency, interest rate and inflation derivatives. The asset class ‘commodities’ includes gold, silver and platinum;
  - (c) BCBS-IOSCO framework — is the margin requirements for non-centrally cleared derivatives as set out by the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of

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<sup>2</sup> For the avoidance of doubt, a reference to an ‘APRA covered entity’ in this Prudential Standard is to be read, for the purposes of paragraph 4 of this Prudential Standard, as a reference to the entity and also all members of an APRA covered entity’s Level 2 group that are covered counterparties.

<sup>3</sup> The calculation of the notional amounts must include physically settled foreign exchange forwards and swaps.

Securities Commissions (IOSCO) in *Margin requirements for non-centrally cleared derivatives* as it exists at 18 March 2015;

- (d) central counterparty (CCP) — is a clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer. A CCP becomes counterparty to trades with market participants through novation, an open offer system, or another legally binding arrangement;
- (e) covered bond special purpose vehicle — has the same meaning as in the Banking Act;
- (f) covered counterparty — is an entity that is a financial institution with the following exclusions:
  - (i) sovereigns, central banks, multilateral development banks, public sector entities and the Bank for International Settlements;
  - (ii) a covered bond special purpose vehicle that enters into derivative transactions for the sole purpose of hedging;
  - (iii) a securitisation special purpose vehicle in a traditional securitisation that enters into derivative transactions for the sole purpose of hedging; and
  - (iv) a special purpose vehicle or collective investment vehicle established for the sole purpose of acquiring and holding or investing in real estate or infrastructure assets, that enters into derivative transactions for the sole purpose of hedging;
- (g) derivative — is either of the following:
  - (i) a derivative (within the meaning of Chapter 7 of the *Corporations Act 2001*); or
  - (ii) an arrangement that is a forward, swap or option, or any combination of those things, in relation to one or more commodities;

but does not include any arrangement that is of a kind mentioned in subregulation 6(2) of the *Payment Systems and Netting Regulations 2001*;<sup>4</sup>
- (h) exchange traded derivative — is a derivative that is transacted directly through an organised, licensed and regulated exchange;
- (i) financial institution — includes, but is not limited to, any institution engaged substantively in one or more of the following activities

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<sup>4</sup> Subregulation 6(2) of the *Payment Systems and Netting Regulations 2001* identifies obligations that are not eligible obligations in relation to a close out netting contract. The arrangements mentioned include credit facilities, reciprocal purchase agreements (otherwise known as repurchase agreements), sell buyback arrangements, securities loan arrangements, contracts of insurance and managed investment schemes.

(domestically or overseas) – banking; leasing; issuing credit cards; portfolio management<sup>5</sup> (including asset management and funds management); management of securitisation schemes; equity and/or debt securities, futures and commodity trading and broking; custodial and safekeeping services; insurance and similar activities that are ancillary to the conduct of these activities. An **authorised NOHC**, a registered life NOHC, or any overseas equivalent is considered a financial institution. For the avoidance of doubt, hedge funds, trading firms, and foreign deposit-taking institutions are considered to be financial institutions;

- (j) Head of a Level 2 group — is each of the following:
  - (i) where an ADI that is a member of a Level 2 group is not a subsidiary of an authorised banking NOHC or another ADI, that ADI;
  - (ii) where an ADI that is a member of a Level 2 group is a subsidiary of an authorised banking NOHC, that authorised banking NOHC;
  - (iii) the parent entity of a Level 2 insurance group as defined in GPS 001;
- (k) initial margin — is collateral that is collected to cover the potential future exposure that could arise from future changes in the market value of a derivative over the close-out period in the event of a counterparty default;
- (l) IOSCO’s Risk Mitigation Standards — are the risk mitigation standards for non-centrally cleared over-the-counter (OTC) derivatives as set out by the Board of IOSCO in *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives* as it exists at 28 January 2015;
- (m) Level 2 group — means the entities that comprise:
  - (i) **Level 2** as defined in APS 001; or
  - (ii) a **Level 2 insurance group** as defined in GPS 001;
- (n) margining group — is a group, comprising one or more entities, within the meaning of Australian Accounting Standard AASB 10 *Consolidated Financial Statements* as in force from time to time; however, an APRA covered entity may elect to apply equivalent foreign accounting standards that apply to the consolidated financial statements of the APRA covered entity or covered counterparty, as relevant;
- (o) margining period — is the period of time during which margin must be exchanged for all new transactions entered into within that period (see Tables 1 and 2);

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<sup>5</sup> For clarity, the definition does not apply where a portfolio manager is acting as an agent.



- (p) minimum transfer amount — is the amount specified in a margin agreement that sets the minimum amount of collateral required to be transferred between the two counterparties as part of a collateral call;
- (q) netting agreement — is an ‘eligible bilateral netting agreement’ within the meaning of *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112), except that all references to ‘ADI’ are replaced with ‘APRA covered entity’;
- (r) non-centrally cleared derivative — is a derivative that is not cleared by a CCP. This does not include exchange traded derivatives, securities financing transactions and indirectly cleared derivatives that are intermediated through a clearing member on behalf of a non-member client where the client is subject to the margin requirements of the CCP, or where the client provides margin consistent with the CCP’s margin requirements;
- (s) qualifying level — is the level of aggregate month-end average notional amount for a reference period, in relation to the margining group of an APRA covered entity and the margining group of a covered counterparty, above which an APRA covered entity is subject to variation margin or initial margin requirements in the corresponding margining period (see Tables 1 and 2);
- (t) reference period — is the period of time in respect of which month-end totals must be used to calculate the aggregate month-end average notional amount (see Tables 1 and 2);
- (u) RSE — is a ‘registrable superannuation entity’ as defined in the SIS Act;
- (v) RSE licensee — has the same meaning as in the SIS Act;
- (w) securities financing transactions (SFTs) — are transactions such as repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions where the value of the transactions depends on the market valuation of securities and the transactions are typically subject to margin agreements;
- (x) securitisation special purpose vehicle — a special purpose vehicle that purchases and holds, or otherwise holds directly in its name, the pool for the purpose of a securitisation. The special purpose vehicle’s acquisition of exposures held in the pool is typically funded by debt issued by the SPV, including through the issue of securities or units by the special purpose vehicle;
- (y) senior securitisation exposure — is a securitisation exposure effectively backed or secured by a first claim on the entire amount of the assets in the underlying pool. Securitisation exposures with different maturities that share *pro rata* loss allocation with senior securitisation exposures so that they benefit from the same level of credit enhancement, are themselves senior securitisation exposures;

- (z) threshold — is the amount specified in a margin agreement that defines the level of exposure above which margin will be posted. The threshold represents the amount of uncollateralised exposure allowed under the margin agreement;
- (aa) traditional securitisation — a securitisation where the pool is transferred (or assigned) to, and held by, or otherwise held directly in its name by, a special purpose vehicle; and
- (ab) variation margin — is collateral that is collected or paid to reflect the current mark-to-market exposure resulting from changes in the market value of a derivative.

### **Assets in Australia**

10. For the purposes of paragraph 13A(4)(a) of the Banking Act and paragraph 28(a) of the Insurance Act, cash or non-cash collateral given to secure any obligation under a non-centrally cleared derivative transaction is excluded from being assets in Australia.

### **Exchange of variation margin for non-centrally cleared derivatives**

11. An APRA covered entity must exchange variation margin with a covered counterparty<sup>6</sup> during a margining period in the third column of Table 1 where:
  - (a) the APRA covered entity belongs to a margining group whose aggregate month-end average notional amount of non-centrally cleared derivatives for the relevant reference period in the first column of Table 1 exceeded the corresponding qualifying level in the second column of Table 1; and
  - (b) the covered counterparty belongs to a margining group whose aggregate month-end average notional amount of non-centrally cleared derivatives for the relevant reference period in the first column of Table 1 exceeded the corresponding qualifying level in the second column of Table 1.
12. Variation margin must be exchanged for all new<sup>7</sup> non-centrally cleared derivative transactions, with the exception of physically settled foreign exchange (FX) forwards and swaps,<sup>8,9</sup> entered into during the relevant

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<sup>6</sup> Refer to paragraphs 57 to 61 for the treatment of intra-group transactions.

<sup>7</sup> Genuine amendments to existing derivative transactions do not qualify as a new derivative transaction. Any amendment that extends an existing derivative transaction for the purpose of avoiding margin requirements must be considered a new derivative transaction. The novation of a grandfathered transaction, or a transaction that results from portfolio compression of grandfathered transactions, does not qualify as a new derivative transaction. However, a transaction resulting from compression of both grandfathered transactions and transactions which are subject to mandatory margin requirements is subject to the margin requirements in this Prudential Standard.

<sup>8</sup> For clarity, physically settled FX forwards and swaps must be included in the calculation of aggregate month-end average notional amount for the purposes of determining whether qualifying levels are exceeded, but may be excluded from the calculation of variation margin and initial margin to be exchanged.

<sup>9</sup> For clarity, the fixed physically settled FX transactions associated with the exchange of principal in cross-currency swaps may also be excluded from the calculation of variation margin

margin period in the third column of Table 1.<sup>10</sup>

Table 1: Implementation timetable for variation margin requirements

Reference period	Qualifying level	Margining period
March, April and May 2016	AUD 3 billion	1 March 2017 to 31 August 2017
March, April and May 2017	AUD 3 billion	1 September 2017 to 31 August 2018
March, April and May of each subsequent calendar year	AUD 3 billion	1 September of the year referred to in the first column of this row to 31 August of the next calendar year

13. Where a non-centrally cleared derivative transaction is subject to variation margin requirements at inception, these requirements apply for the life of that transaction.
14. Variation margin must be calculated and called on a daily basis. Settlement of variation margin amounts must be conducted promptly.
15. Variation margin must be exchanged using a zero threshold so that the mark-to-market exposure of the non-centrally cleared derivative transactions is fully collateralised. In the event of a dispute, the undisputed amount must be exchanged between the two counterparties until the dispute is resolved.
16. Transactions that are not subject to the same legally enforceable netting agreement must not be considered in the same variation margin calculation.

### Post and collect of initial margin for non-centrally cleared derivatives

17. An APRA covered entity must post and collect initial margin with a covered counterparty<sup>11</sup> during a margining period in the third column of Table 1 where:
  - (a) the APRA covered entity belongs to a margining group whose aggregate month-end average notional amount of non-centrally cleared derivatives for the relevant reference period in the first column of Table 2 exceeded the corresponding qualifying level in the second column of Table 2; and

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to be exchanged. All other risks associated with cross-currency swaps must be included in the calculation of variation margin to be exchanged.

<sup>10</sup> If an APRA covered entity enters into a new non-centrally cleared derivative transaction, with the exception of a physically settled FX forward or swap, with a covered counterparty during the margining period 1 March 2017 to 31 August 2017, the APRA covered entity will be taken to comply with paragraphs 11 and 12 of this Prudential Standard if it uses its best endeavours to exchange variation margin with the covered counterparty during that period. If the transaction remains open on 1 September 2017, the APRA covered entity must exchange variation margin for the transaction from 1 September 2017.

<sup>11</sup> Refer to paragraphs 57 to 61 for the treatment of intra-group transactions.

- (b) the covered counterparty belongs to a margining group whose aggregate month-end average notional amount of non-centrally cleared derivatives for the relevant reference period in the first column of Table 2 exceeded the corresponding qualifying level in the second column of Table 2.
18. Initial margin must be posted and collected for all new<sup>12</sup> non-centrally cleared derivative transactions, with the exception of physically settled FX forwards and swaps,<sup>13</sup> entered into during the relevant margining period in the third column of Table 2.

Table 2: Implementation timetable for initial margin requirements

Reference period	Qualifying level	Margining period
March, April and May 2016	AUD 4.5 trillion	1 March 2017 to 31 August 2017
March, April and May 2017	AUD 3.375 trillion	1 September 2017 to 31 August 2018
March, April and May 2018	AUD 2.25 trillion	1 September 2018 to 31 August 2019
March, April and May 2019	AUD 1.125 trillion	1 September 2019 to 31 August 2020
March, April and May of each subsequent calendar year	AUD 12 billion	1 September of the year referred to in the first column of this row to 31 August of the next calendar year

19. Where a non-centrally cleared derivative transaction is subject to initial margin requirements at inception, these requirements apply for the life of that transaction.
20. Initial margin must be posted and collected on a gross basis.
21. Initial margin must be calculated and called both at the outset of a transaction and on a regular and consistent basis upon changes in the measured potential future exposure. Settlement of initial margin amounts must be conducted promptly.
22. The threshold applicable to the initial margin for each margining group must not be greater than AUD 75 million. The threshold is applied bilaterally at the aggregate level of the margining group and is based on all non-centrally cleared derivative transactions between the two margining groups. In the event of a dispute, the undisputed amount must be posted and collected by the two counterparties until the dispute is resolved.
23. For the purposes of applying the initial margin threshold in paragraph 22, an investment fund, RSE, trust or managed investment scheme (MIS) may be

<sup>12</sup> Refer to footnote 7.

<sup>13</sup> Refer to footnote 8.

treated separately from both (i) the investment advisor, RSE licensee, trustee and/or responsible entity for that investment vehicle; and (ii) any other investment vehicle, as long as the fund, RSE, trust or MIS represents a segregated pool of assets that is not collateralised by or otherwise guaranteed or supported by other funds or an advisor in the event of insolvency or bankruptcy.

24. The specific method and parameters that will be used by an APRA covered entity and a covered counterparty to calculate initial margin must be agreed and recorded at or prior to the onset of a transaction.
25. Initial margin must be held so as to ensure that:
  - (a) the margin collected is promptly available to the collecting party in the event of the posting party's default; and
  - (b) the collected margin must be subject to arrangements that protect the posting party to the extent possible under applicable law in the event that the collecting party enters insolvency or bankruptcy.
26. Initial margin must not be re-hypothecated, re-pledged or re-used but cash initial margin may be held in a demand deposit account with a third-party custodian in the name of the posting counterparty. The third-party custodian must not be affiliated with either counterparty. Contractual arrangements providing for the posting and collection of initial margin must provide for initial margin to be held in a manner that satisfies this requirement.
27. Initial margin collected must be segregated from the collector's proprietary assets. The initial margin collector must also segregate initial margin provided in respect of one or more counterparties from the assets of other parties if requested by the relevant counterparty or counterparties.

### **Minimum transfer amount**

28. The combined variation margin and initial margin amount required to be posted or collected under this Prudential Standard must be subject to a *de minimis* minimum transfer amount that must not exceed AUD 750,000.

### **Due diligence**

29. An APRA covered entity must undertake a reasonable level of due diligence to assess:
  - (a) whether a counterparty is a covered counterparty; and if so
  - (b) whether, for variation margin requirements, the covered counterparty belongs to a margining group whose aggregate month-end average notional amount of non-centrally cleared derivatives for the relevant reference period in the first column of Table 1 exceeded the corresponding qualifying level in the second column of Table 1; and
  - (c) whether, for initial margin requirements, the covered counterparty belongs to a margining group whose aggregate month-end average notional

amount of non-centrally cleared derivatives for the relevant reference period in the first column of Table 2 exceeded the corresponding qualifying level in the second column of Table 2.

A self-declaration or public disclosure from a counterparty is an acceptable way to verify that the counterparty is a covered counterparty whose non-centrally cleared derivatives activity exceeded the applicable variation margin and initial margin qualifying levels. Where an APRA covered entity is of the preliminary view that a counterparty is not a covered counterparty or did not exceed the applicable qualifying levels, the APRA covered entity is required to undertake a reasonable level of due diligence to ensure that there is no reason to believe otherwise.

### **Calculation of initial margin for non-centrally cleared derivatives**

30. The required amount of initial margin posted and collected must be calculated by either a model approach approved by APRA or the standardised schedule set out in Attachment A.
31. Derivative transactions for which an APRA covered entity faces no counterparty risk require no initial margin to be collected and may be excluded from the initial margin calculation under both a model approach and the standardised schedule.
32. The calculation of initial margin for cross-currency swaps differs depending on whether a model approach or the standardised schedule is adopted:
  - (a) If a model approach is adopted, then the model does not need to incorporate the risk associated with the fixed physically settled FX transactions associated with the exchange of principal. All other risks of the cross-currency swap must be considered in the calculation.<sup>14</sup>
  - (b) If the standardised schedule is adopted, then the initial margin only needs to be calculated with reference to the relevant row in the interest rates section of the standardised schedule outlined in Attachment A.

### **Model approach to initial margin for non-centrally cleared derivatives**

33. An APRA covered entity may apply to APRA for approval to use a model for the calculation of initial margin for some or all of its portfolio. An APRA covered entity need not restrict itself to a model approach or the standardised schedule for its whole portfolio. APRA may approve an application made under this paragraph.
34. The initial margin calculated by the model approach must be sufficiently conservative even during periods of low market volatility. Calculation of the initial margin amount must be consistent with at least a one-tailed 99 per cent

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<sup>14</sup> For avoidance of doubt, the only payments that may be excluded from initial margin requirements for a cross-currency swap are the fixed physically settled FX transactions associated with the exchange of principal. All other payments or cash flows that occur during the life of the swap must be subject to initial margin requirements.

confidence interval over a 10-day time horizon,<sup>15</sup> based on historical data that includes a period of significant financial stress and does not exceed an historical period of five years. The historical data must be equally weighted for calibration purposes.

35. The period of financial stress used for calibration must be identified and applied separately for each asset class.
36. Transactions that are not subject to the same legally enforceable netting agreement must not be considered in the same initial margin model calculation.
37. A model may allow for diversification, hedging and risk offsets within an asset class provided these transactions are covered by the same legally enforceable netting agreement. Any such allowance requires approval by APRA as part of an initial margin model approval.
38. Initial margin calculations by a model for derivatives in distinct asset classes must be performed without regard to derivatives in other asset classes. That is, initial margin amounts calculated for each asset class must not account for diversification benefits across asset classes<sup>16</sup> and must be summed to calculate the initial margin amount for a netting agreement.
39. A model used for initial margin calculations must be subject to an independent internal governance process that:
  - (a) continuously monitors and assesses the value of the model's risk assessments;
  - (b) tests the model against realised data and experience;
  - (c) validates the applicability of the model to the derivatives for which it is used;
  - (d) regularly reviews the model in line with developments in global industry standards for initial margin models; and
  - (e) accounts for the complexity of the products covered.
40. An APRA covered entity must ensure that an independent review of the initial margin model and risk measurement system is carried out initially (i.e. at the time when model approval is sought) and then regularly as part of the internal audit process. This review must be conducted by functionally independent, appropriately trained and competent personnel, and must take place at least once every three years or when a material change is made to the model or the risk measurement system.

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<sup>15</sup> The 10-day requirement applies in the case that variation margin is exchanged on a daily basis. If variation margin is exchanged at less than daily frequency, the minimum time horizon must be set equal to 10 days plus the number of days in between variation margin exchanges.

<sup>16</sup> This applies to all products including those which have risk exposures in multiple asset classes (e.g. quantos).

41. Once an APRA covered entity has obtained approval to use a model for the calculation of initial margin for an asset class, it must continue to employ that model for that asset class on an ongoing basis unless, or except to the extent that, the model approval is varied, revoked or suspended by APRA.
42. APRA may, at any time, vary, revoke or suspend a model approval for the calculation of initial margin, or impose additional conditions on a model approval.
43. Where a model approval has been varied, revoked or suspended, APRA may require an APRA covered entity to revert to the standardised schedule for the calculation of initial margin.
44. Prior notification to APRA is required for any material changes to an initial margin model or risk measurement system. APRA's prior written approval is required for any material changes to an initial margin model which are not consistent with global industry standards for initial margin models.

### **Eligible collateral for margining**

45. Subject to the conditions set out in this Prudential Standard, an APRA covered entity must collect margin only in the following forms of eligible collateral and, where relevant, **credit rating grades** must be determined in accordance with Attachment C of this Prudential Standard:<sup>17</sup>
  - (a) cash collateral;
  - (b) debt securities rated by an **External Credit Assessment Institution (ECAI)** with a credit rating grade of either four (or better) for securities issued by: Commonwealth, State and Territory governments in Australia (including State and Territory central borrowing authorities); central, state and regional governments in other countries; the Reserve Bank of Australia; central banks in other countries; and the international banking agencies and multilateral development banks;
  - (c) debt securities rated by an ECAI with a credit rating grade of either three (or better) for securities issued by: ADIs, overseas banks, Australian and international local governments and corporates;
  - (d) debt securities not rated by an ECAI where these securities are issued by an ADI or overseas bank as senior debt and are listed on a recognised exchange. This is subject to the condition that all rated issues of the same seniority by the issuing ADI or overseas bank have a long-term or short-term credit rating grade of at least three and the APRA covered entity holding the security has no information suggesting that the security justifies a rating below this level;
  - (e) covered bonds rated by an ECAI with a credit rating grade of either three (or better);

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<sup>17</sup> For the avoidance of doubt, eligible collateral for margining purposes is distinct from the eligible collateral under APS 112 that can be used to reduce the credit risk capital requirement.



- (f) senior securitisation exposures rated by an ECAI with a credit rating grade of one;
  - (g) equities included in a major stock index; and
  - (h) gold bullion.
46. Resecuritisation exposures, irrespective of credit ratings, are not eligible collateral for margining purposes.
  47. Collateral in the form of securities issued by a counterparty to the transaction (or by any person or entity related or associated with the counterparty) is considered to have a material positive correlation with the credit quality of the counterparty and is therefore not eligible collateral for margining purposes.
  48. An APRA covered entity must have appropriate controls in place to ensure that the collateral collected does not exhibit significant wrong-way risk<sup>18</sup> or significant concentration risk. The controls must consider concentrations in terms of an individual issuer, issuer type and asset type.
  49. Eligible collateral that was originally posted or collected may be substituted provided that:
    - (a) both parties agree to the substitution;
    - (b) the substitution is made on the terms applicable to their agreement; and
    - (c) the substituted eligible collateral meets all the requirements of this Prudential Standard and the value of the substituted eligible collateral, after the application of risk-sensitive haircuts, is sufficient to meet the margin requirement.

### **Collateral haircuts**

50. Risk-sensitive haircuts appropriately reflecting the credit, market and FX risk must be applied to the collected collateral. The risk-sensitive haircuts must be calculated using either a model approach approved by APRA or the standardised schedule set out in Attachment B.
51. APRA may, upon written request by an APRA covered entity, approve the use of a model approach for the calculation of risk-sensitive haircuts.<sup>19</sup> The model used must be subject to appropriate internal governance standards.
52. For the model approach, an APRA covered entity must ensure that an independent review of the risk-sensitive haircut model and risk measurement

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<sup>18</sup> Wrong-way risk occurs when the value of the collateral collected exhibits a significant correlation with the creditworthiness of the counterparty or the value of the underlying non-centrally cleared derivatives portfolio in a way that undermines the effectiveness of the protection offered by the collateral collected.

<sup>19</sup> For clarity, while an APRA covered entity may have approval to use a model to calculate haircuts on collateral for the purpose of calculating regulatory capital, a separate approval by APRA is required for the use of a model in calculating haircuts for margining collateral.

system is carried out initially (i.e. at the time when model approval is sought) and then regularly as part of the internal audit process. This review must be conducted by functionally independent, appropriately trained and competent personnel, and must take place at least once every three years or when a material change is made to the model or the risk measurement system.

53. An APRA covered entity must consistently adopt either the standardised schedule or a model approach for the calculation of risk-sensitive haircuts for all of the collateral within the same collateral class.<sup>20</sup> Once an APRA covered entity has obtained approval to use a model for the calculation of risk-sensitive haircuts for a collateral class, it must continue to employ that model for that collateral class on an ongoing basis unless, or except to the extent that, the model approval is varied, revoked or suspended.
54. APRA may, at any time, vary, revoke or suspend a model approval for the calculation of risk-sensitive haircuts, or impose additional conditions on a model approval.
55. Where a model approval has been varied, revoked or suspended, APRA may require an APRA covered entity to revert to the standardised schedule for the calculation of risk-sensitive haircuts.
56. APRA's prior written approval is required for any material changes to a risk-sensitive haircut model.

### **Treatment of intra-group transactions**

57. An APRA covered entity is not subject to the initial margin requirements in this Prudential Standard for a non-centrally cleared derivative transaction with a covered counterparty that is a member of the APRA covered entity's margining group.
58. The variation margin requirements in this Prudential Standard do not apply to a non-centrally cleared derivative transaction between an APRA covered entity that is a foreign ADI, Category C insurer or EFLIC and a covered counterparty that is a member of the APRA covered entity's margining group.
59. An APRA covered entity is not subject to the variation margin requirements in this Prudential Standard for a non-centrally cleared derivative transaction with a covered counterparty that is a member of the APRA covered entity's margining group where that covered counterparty is also a member of the APRA covered entity's Level 2 group.<sup>21</sup>

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<sup>20</sup> Classes of collateral must be consistent with the categories in Table 4 of Attachment B and include (1) cash; (2) debt securities under paragraph 45(b); (3) debt securities under paragraphs 45(c), 45(d), 45(e) and 45(f); (4) equities; and (5) gold. Foreign exchange haircuts must be modelled consistently for all collateral classes.

<sup>21</sup> For a life company or a friendly society, non-centrally cleared derivative transactions between any of its funds (e.g. statutory fund, benefit fund, management fund or shareholder fund) are not in the same Level 2 group and are therefore subject to the variation margin requirements.

60. APRA may, upon written request by an APRA covered entity, exclude one or more intra-group transactions from the variation margin requirements applicable to the entity under this Prudential Standard.
61. APRA may require an APRA covered entity to exchange variation margin and/or post and collect initial margin with any other entity within the APRA covered entity's margining group where APRA deems appropriate to do so.

### **Cross border application of margin and risk mitigation requirements**

62. APRA may approve substituted compliance in relation to the margin requirements of a foreign jurisdiction where those requirements are comparable in outcomes with the BCBS-IOSCO framework and the requirements in this Prudential Standard.
63. Where APRA approves substituted compliance in relation to the margin requirements of a foreign jurisdiction, an APRA covered entity will be deemed to be compliant with the margin requirements in this Prudential Standard for transactions in which it complies with the relevant foreign margin requirements in their entirety. APRA may limit the scope of or impose conditions on recognised substituted compliance.
64. An APRA covered entity may only substitute compliance with the margin requirements in this Prudential Standard for compliance with the margin requirements (in their entirety) of a foreign jurisdiction approved under paragraph 62 of this Prudential Standard in a transaction where:
  - (a) the APRA covered entity is transacting with a covered counterparty that is subject to the margin requirements of the relevant foreign jurisdiction; and/or
  - (b) the APRA covered entity is directly subject to the margin requirements of relevant foreign jurisdiction.
65. Where a foreign ADI, Category C insurer or EFLIC is directly subject to:
  - (a) margin requirements that are substantially similar to the BCBS-IOSCO framework by its home jurisdiction; or
  - (b) risk mitigation requirements that are substantially similar to IOSCO's Risk Mitigation Standards by its home jurisdiction,

it may comply in their entirety with its home jurisdiction's margin or risk mitigation requirements (as the case may be) or those of a jurisdiction deemed equivalent by its home jurisdiction in lieu of complying with the relevant requirements in this Prudential Standard where the APRA covered entity has completed an internal assessment that positively demonstrates: (i) how it is directly subject to requirements of the foreign jurisdiction; (ii) how the requirements of the foreign jurisdiction are substantially similar to the BCBS-IOSCO framework or IOSCO's Risk Mitigation Standards (as the case may be); and (iii) how it complies with those requirements. The APRA covered entity's

internal assessment, and any additional requested information, must be made available to APRA upon request.

66. Where a member of an APRA covered entity's Level 2 group that is incorporated outside of Australia is directly subject to:
- (a) margin requirements of a foreign jurisdiction that are substantially similar to the BCBS-IOSCO framework; or
  - (b) risk mitigation requirements of a foreign jurisdiction that are substantially similar to IOSCO's Risk Mitigation Standards,

the APRA covered entity may apply for approval by APRA to comply, in respect of that member, with the foreign jurisdiction's requirements in lieu of complying with the relevant requirements in this Prudential Standard.

67. An APRA covered entity is not required to post or collect initial margin where either it or its counterparty to the transaction is incorporated, and operating, in a legal jurisdiction that does not permit it or its counterparty to satisfy the requirements in paragraph 25 in relation to that transaction.
68. An APRA covered entity is not required to exchange variation margin or post or collect initial margin if there is any doubt as to the enforceability of the netting agreement upon insolvency or bankruptcy of the counterparty. An APRA covered entity must monitor such exposures and set appropriate internal limits and controls to manage its exposure to such counterparties.
69. An APRA covered entity is not required to exchange variation margin or post or collect initial margin where collateral arrangements are questionable or not legally enforceable upon default of the counterparty. An APRA covered entity must monitor such exposures and set appropriate internal limits and controls to manage its exposure to such counterparties.
70. Applicable netting agreements and collateral arrangements must be supported by regularly updated legal opinions consistent with the requirements set out in Attachment J of APS 112.

### **Risk mitigation requirements for non-centrally cleared derivative transactions**

71. An APRA covered entity that transacts in non-centrally cleared derivatives must establish and implement policies and procedures for risk mitigation standards for non-centrally cleared derivative transactions with all of its counterparties (including counterparties that are in the same margining group). Subject to the requirements in paragraph 72, these policies and procedures may consider the nature of the risks and transaction type, as well as size, complexity, and operating environment of both the APRA covered entity and its counterparty in establishing an appropriate framework.
72. An APRA covered entity entering into a non-centrally cleared derivative transaction with a covered counterparty must, at a minimum, apply the risk mitigation standards outlined in paragraphs 74 to 94 of this Prudential Standard.

73. The risk mitigation requirements in paragraphs 74 to 94 of this Prudential Standard commence on 1 March 2018.

### **Trading relationship documentation**

74. An APRA covered entity must establish and implement policies and procedures to execute written trading relationship documentation<sup>22</sup> with a covered counterparty prior to or contemporaneously with executing a non-centrally cleared derivative transaction.
75. The trading relationship documentation must:
- (a) promote legal certainty for non-centrally cleared derivative transactions;
  - (b) include all material rights and obligations of the counterparties concerning the non-centrally cleared derivative trading relationship that have been agreed between them; and
  - (c) be executed in writing or through equivalent non-rewritable, non-erasable electronic means.
76. An APRA covered entity must have policies and procedures to maintain trading relationship documentation for a reasonable period of time after the maturity of any outstanding transactions with a covered counterparty and such documentation must be made available to APRA upon request.

### **Trade confirmation**

77. An APRA covered entity must establish and implement policies and procedures designed to ensure the material terms of all non-centrally cleared derivative transactions<sup>23</sup> with a covered counterparty are confirmed as soon as practicable after execution of the transaction. Material terms must include terms necessary to promote legal certainty to the transaction including incorporating by reference the trading relationship documentation.
78. An APRA covered entity must establish and implement policies and procedures designed to confirm material changes to the legal terms or the rights and obligations under transactions.
79. Confirmations must be executed in writing through non-rewritable, non-erasable automated methods where it is reasonably practicable for the relevant counterparties to the transaction to do so. In all other cases, confirmation must be executed in writing via non-rewritable, non-erasable electronic or manual means.

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<sup>22</sup> A long form confirmation that meets the conditions in paragraph 75 and is received as soon as practicable after the execution of a transaction is considered to satisfy the requirement for trading relationship documentation.

<sup>23</sup> This requirement applies to all transactions including transactions entered into from novation.

### **Portfolio reconciliation**

80. An APRA covered entity must establish and implement policies and procedures designed to ensure that the material terms and valuations of all transactions in a non-centrally cleared derivatives portfolio are reconciled with covered counterparties at regular intervals.
81. The policies and procedures must be designed to ensure the process or method of portfolio reconciliation is agreed upon with its counterparties and designed to:
  - (a) ensure an accurate record of material terms and valuations of the non-centrally cleared derivatives transactions in the portfolio; and
  - (b) identify and resolve discrepancies in the material terms and valuations in a timely manner.
82. An APRA covered entity must conduct portfolio reconciliation with a scope and frequency that reflects:
  - (a) the nature and extent of its non-centrally cleared derivative activity;
  - (b) the materiality and complexity of the risks it faces;
  - (c) global regulatory standards imposed on similar institutions for similar transactions; and
  - (d) market practice and industry protocols in the relevant derivative markets.

### **Portfolio compression**

83. An APRA covered entity must establish and implement policies and procedures to regularly assess and, to the extent appropriate, conduct portfolio compression.
84. On either a bilateral or multilateral basis, portfolio compression must seek to replace economically-equivalent transactions by decreasing the number of transactions and/or the notional value of a portfolio.
85. An APRA covered entity must conduct portfolio compression with a scope and frequency that reflects:
  - (a) the nature and extent of its non-centrally cleared derivative activity;
  - (b) the materiality and complexity of the risks it faces;
  - (c) global regulatory standards imposed on similar institutions for similar transactions; and
  - (d) market practice and industry protocols in the relevant derivative markets.

## Valuation processes

86. An APRA covered entity must agree with its covered counterparties and clearly document the process for determining the value of each non-centrally cleared derivative transaction at any time from the execution of the transaction to the termination, maturity, or expiration thereof, for the purpose of exchanging margin. Valuation processes must be reasonably designed to minimise the likelihood of disputes.
87. All agreements on valuation process must be documented in the trading relationship documentation or trade confirmation.
88. Valuation determinations must be based on economically similar transactions or other objective criteria. Documentation must include an alternative process or approach by which counterparties will determine the value of the non-centrally cleared derivative transaction in the event of the unavailability or other failure of any inputs required to value the transaction.
89. An APRA covered entity must perform periodic review of the agreed upon valuation process to take into account changes in market conditions. An APRA covered entity must establish and implement policies and procedures for updating any such changes as a result of a review.

## Dispute resolution

90. An APRA covered entity must establish and implement policies and procedures designed to ensure rigorous and robust dispute resolution procedures are agreed with its covered counterparties prior to or contemporaneously with executing a non-centrally cleared derivative transaction. The dispute resolution procedures must address the mechanism or process for determining when discrepancies in material terms or valuations should be considered disputes as well as how such disputes should be resolved as soon as practicable.
91. The dispute resolution mechanism or process must include the escalation of material disputes to senior management. The dispute resolution mechanism or process must include escalation to the Board where the dispute is considered material to the APRA covered entity.
92. An APRA covered entity must have policies and procedures to document disputes and such documentation must be made available to APRA upon request.
93. In the event that a margin dispute arises, an APRA covered entity must make all necessary and appropriate efforts, including timely initiation of dispute resolution protocols, to resolve the dispute with its counterparty and exchange the required amount of margin in a timely manner.
94. An APRA covered entity must notify APRA of disputes that are material either in dollar value or period of time outstanding. An APRA covered entity must clearly document and regularly review the criteria used to determine when a dispute is reported to APRA.

## **Adjustments and exclusions**

95. APRA may adjust or exclude any requirement in this Prudential Standard in relation to a particular APRA covered entity.<sup>24</sup>

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<sup>24</sup> Refer to subsection 11AF(2) of the Banking Act, subsection 32(3D) of the Insurance Act, subsection 230A(4) of the Life Insurance Act and subsection 34C(5) of the SIS Act.



## Attachment A — Standardised schedule for initial margin

1. Initial margin calculated according to the standardised schedule equals the sum of the ‘net standardised initial margin amount’ calculated separately for each netting agreement.
2. APRA may, upon the request of an APRA covered entity, approve the entity to calculate the ‘net standardised initial margin amount’ using a schedule already in use for regulatory capital purposes prior to the application of this Prudential Standard, provided that such a schedule is at least as conservative as that outlined below.
3. For each particular netting agreement:
  - (a) Net standardised initial margin amount =  $0.4 \times$  gross standardised initial margin amount +  $0.6 \times$  net-to-gross ratio  $\times$  gross standardised initial margin amount. The net-to-gross ratio (NGR) is the ratio of the net current credit exposure (NCCE) of all transactions included in a netting agreement to the gross current credit exposure (GCCE) of the same transactions. That is,  $NGR = NCCE/GCCE$ .
  - (b) NCCE is the sum of all positive and negative mark-to-market values of all individual contracts covered by a netting agreement (i.e. positive mark-to-market values of transactions may be offset against negative mark-to-market values on other transactions covered by the same netting agreement). If the net sum of individual mark-to-market values is positive, the NCCE is equal to that sum. If the sum of mark-to-market values is zero or negative, the NCCE is set equal to zero.
  - (c) GCCE is the sum of the mark-to-market values of all transactions covered by a netting agreement with a positive mark to-market value with no offsetting against contracts with a negative mark-to-market value.
  - (d) The ‘gross standardised initial margin amount’ is the sum over all derivative contracts in the netting agreement of the gross notional size of each derivative contract multiplied by the relevant initial margin rate provided in the standardised schedule in Table 3. Simple netting of notional amounts where contracts are matched by the same underlying and maturity is allowed.<sup>25</sup>

<sup>25</sup> For example, a pay-fixed AUD interest rate swap with maturity of three years and notional of AUD 100 million could be netted against a pay-floating AUD interest rate swap with maturity of three years and notional of AUD 50 million to arrive at a single notional of AUD 50 million to which the appropriate initial margin rate would be applied. Derivatives with different fundamental characteristics such as the underlying, maturity etc. may not be netted against each other.

Table 3: Standardised schedule of initial margin rates

<b>Asset class</b>	<b>Initial margin rate (% of notional amount)</b>
Credit: Duration less than 2 years	2%
Credit: Duration from 2 years to less than 5 years	5%
Credit: Duration 5 years or longer	10%
Commodity	15%
Equity	15%
Foreign exchange	6%
Interest rate: Duration less than 2 years	1%
Interest rate: Duration from 2 years to less than 5 years	2%
Interest rate: Duration 5 years or longer	4%
Other	15%

## Attachment B — Standardised schedule of risk-sensitive haircuts

1. The risk-sensitive haircut percentage under the standardised schedule is calculated as the sum of the collateral class haircut percentage in Table 4 and the FX haircut percentage outlined in paragraphs 3 and 4 of this Attachment.
2. APRA may, upon the request of an APRA covered entity, approve the entity to calculate the risk-sensitive haircut using a schedule already in use for regulatory capital purposes prior to the application of this Prudential Standard. Such a schedule must be at least as conservative as that outlined below.
3. For the purposes of variation margin, an additional FX haircut of eight per cent of market value applies to all non-cash collateral in which the currency of the collateral asset differs from the currency agreed in an individual derivative contract, the relevant governing master netting agreement or the relevant credit support annex.
4. For the purposes of initial margin, an additional FX haircut of eight per cent of market value applies to all cash and non-cash collateral in which the currency of the collateral asset differs from the termination currency. Each counterparty may specify only one termination currency.

Table 4: Standardised schedule of risk-sensitive haircuts

Collateral class	Residual maturity	Haircut (% of market value)
Cash		0%
Debt securities under paragraph 45(b) of this Prudential Standard	≤1 year	0.5%
	>1 year, ≤5 years	2%
	>5 years	4%
Debt securities under paragraphs 45(c), 45(d), 45(e) and 45(f) of this Prudential Standard	≤1 year	1%
	>1 year, ≤5 years	4%
	>5 years	8%
Equities included in a major stock index		15%
Gold		15%

## Attachment C — Credit rating grades

- For the purposes of this Prudential Standard, an APRA covered entity must use the credit rating grades in Table 5 and Table 6 below.

Table 5: Recognised long-term ratings and equivalent credit rating grades

<b>Credit rating grade</b>	<b>Standard &amp; Poor's Corporation</b>	<b>Moody's Investors Services</b>	<b>Fitch Ratings</b>
1	AAA AA+ AA AA-	Aaa Aa1 Aa2 Aa3	AAA AA+ AA AA-
2	A+ A A-	A1 A2 A3	A+ A A-
3	BBB+ BBB BBB-	Baa1 Baa2 Baa3	BBB+ BBB BBB-
4	BB+ BB BB-	Ba1 Ba2 Ba3	BB+ BB BB-

Table 6: Recognised short-term ratings and equivalent credit rating grades

<b>Credit rating grade</b>	<b>Standard &amp; Poor's Corporation</b>	<b>Moody's Investors Services</b>	<b>Fitch Ratings</b>
1	A-1	P-1	F-1
2	A-2	P-2	F-2
3	A-3	P-3	F-3