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 initial margin with a covered counterparty, subject to certain criteria.

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

- post and collect variation margin and 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 such as trading relationship documentation, trade confirmation, valuation processes and dispute resolution processes. An APRA covered entity must conduct portfolio reconciliation and portfolio compression with a scope and frequency that reflects the APRA covered entity's level of non-centrally cleared derivative activity, the risks faced by the entity, global regulatory standards, industry protocols and market practice.

Authority

1. This Prudential Standard is made under:

   (a) section 11AF of the *Banking Act 1959* (Banking Act) in relation to authorised deposit-taking institutions (**ADIs**) and **non-operating holding companies** authorised under the Banking Act (authorised banking NOHCs);

   (b) section 32 of the *Insurance Act 1973* (Insurance Act) in relation to **general insurers** and **non-operating holding companies** authorised under the Insurance Act (authorised insurance NOHCs) and **parent entities** of **Level 2 insurance groups**;

   (c) section 230A of the *Life Insurance Act 1995* (Life Insurance Act) in relation to **life companies**, including **friendly societies**, and **non-operating holding companies** registered under the Life Insurance Act (registered life NOHCs); and

   (d) section 34C of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) in relation to registrable superannuation entity (RSE) licensees (RSE licensees) under the SIS Act.

Application

2. This Prudential Standard applies to all ADIs, authorised banking NOHCs, general insurers, authorised insurance NOHCs, life companies, registered life NOHCs and RSE licensees in respect of their business operations[1].

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**, and an authorised insurance NOHC;

   (c) a life company, including a friendly society and an **eligible foreign life insurance company** (EFLIC)**,** and a registered life NOHC; and

   (d) an 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, other than an entity referred to in paragraph 5, complies with the requirements of this Prudential Standard as if it were itself an APRA covered entity.

[1] 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.

5. A member of a Level 2 group that is a covered bond special purpose vehicle that enters into derivative transactions for the sole purpose of hedging or a securitisation special purpose vehicle in a traditional securitisation that enters into derivative transactions for the sole purpose of hedging is not required to comply with this Prudential Standard.

6. The margin requirements apply to transactions which are booked in the accounts of an APRA covered entity or a member of the Level 2 group, other than an entity referred to in paragraph 5.

7. This Prudential Standard commences on 1 September 2016.

Interpretation

8. 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.

9. Where this Prudential Standard provides for APRA to exercise a power or discretion, this power or discretion is to be exercised in writing.

Definitions

10. The following definitions are used in this Prudential Standard:

    (a) aggregate month-end average notional amount - the simple average of the total notional amount[2] 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;

    (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;

    (c) BCBS-IOSCO framework - the margin requirements for non-centrally cleared derivatives as set out in the March 2015 paper by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), *Margin requirements for non-centrally cleared derivatives*;

    (d) central counterparty (CCP) - 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;

[2] All non-centrally cleared derivatives must be included in the calculation of the notional amounts, including physically settled foreign exchange forwards and swaps. Intra-group transactions (transactions between two counterparties within the same margining group) are excluded from the calculation unless otherwise advised by APRA.

(e) covered bond special purpose vehicle - has the same meaning as in the Banking Act;

(f) covered counterparty - an entity that is a financial institution or a systemically important non-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; and

  (iii) a securitisation special purpose vehicle in a traditional securitisation that enters into derivative transactions for the sole purpose of hedging;

(g) derivative - has the same meaning as in the *Payment Systems and Netting Act 1998*;

(h) exchange traded derivative - 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 (domestically or overseas) – banking; leasing; issuing credit cards; portfolio management (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 - 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 - 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) 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;

(m) margining group - a group, comprising one or more entities, within the meaning of Australian Accounting Standard AASB 10 *Consolidated Financial Statements*;

(n) margining period - the period of time during which margin must be exchanged for all new transactions entered into within that period;

(o) minimum transfer amount - the amount specified in a margining agreement that sets the minimum amount of collateral required to be transferred between the two counterparties as part of a collateral call;

(p) netting agreement - a legally binding agreement that is in writing and that creates a single legal obligation covering all transactions and collateral included in the netting agreement, such that the parties to the agreement would have the right to:

    (i) terminate and close-out, in a timely manner, all transactions under the netting agreement;

    (ii) net gains and losses on transactions, including the value of any collateral, terminated and closed out under the netting agreement so that the parties to the agreement would have either a claim to receive or an obligation to pay only the net sum of the close-out values of individual transactions. For forwards, swaps, options and similar derivative contracts, this will include the positive and negative mark-to-market values of individual transactions; and

    (iii) liquidate or set-off collateral

    in the event that either party fails to perform due to default, liquidation or bankruptcy or other similar circumstances;

(q) non-centrally cleared derivative - is a derivative that is not cleared by a CCP. This does not include exchange traded derivatives, securities financing transactions (SFTs) 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;

(r) qualifying level - 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;

(s) reference period - the period of time in respect of which month-end totals must be used to calculate the aggregate month-end average notional amount;

(t) RSE - a 'registrable superannuation entity' as defined in the SIS Act;

(u) RSE licensee - has the same meaning as in the SIS Act;

(v) securities financing transactions (SFTs) - transactions such as repurchase agreements, reverse repurchase agreements, and security 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;

(w) securitisation special purpose vehicle - an 'SPV' as defined in *Prudential Standard APS 120 Securitisation* (APS 120);

(x) senior securitisation exposure - 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;

(y) systemically important non-financial institution - an entity that is not a financial institution and that belongs to a margining group whose aggregate month-end average notional amount of non-centrally cleared derivatives for the preceding March, April and May exceeded AUD 50 billion;

(z) threshold - the amount specified in a margining agreement that defines the level of exposure above which margin will be posted. The threshold represents the amount of uncollateralised exposure allowed under the margining agreement;

(aa) traditional securitisation - 'traditional securitisation' as defined in APS 120; and

(bb) variation margin - collateral that is collected to reflect the current mark-to-market exposure resulting from changes in the market value of a derivative.

Assets in Australia

11. 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 contract is excluded from being assets in Australia.

Exchange of variation margin for non-centrally cleared derivatives

12. An APRA covered entity must exchange variation margin with a covered counterparty during a margining period 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.

13. Variation margin must be exchanged for all new[3] non-centrally cleared derivatives contracts entered into during the relevant margining period in the third column of Table 1.

Table 1: Implementation timetable for variation margin requirements

Reference period	**Qualifying level**	**Margining period**
March, April and May 2016	AUD 4.5 trillion	1 September 2016 to 28 February 2017
September, October and November 2016	AUD 12 billion	1 March 2017 to 31 August 2017
From March 2017, March, April and May of each year	AUD 3 billion	1 September of each year to 31 August of the next calendar year.

14. Where a non-centrally cleared derivative transaction is subject to variation margin requirements at inception, these requirements apply for the life of that transaction.

15. Variation margin must be calculated and called on a daily basis. Settlement of variation margin amounts must be conducted promptly.

16. 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.

17. Transactions that are not subject to the same legally enforceable netting agreement must not be considered in the same variation margin calculation. Variation margin amounts must be calculated separately for each netting agreement.

Exchange of initial margin for non-centrally cleared derivatives

18. An APRA covered entity must post and collect initial margin with a covered counterparty during a margining period 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

    (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.

[3] Genuine amendments to existing derivative contracts do not qualify as a new derivatives contract. Any amendment that extends an existing derivatives contract for the purpose of avoiding margin requirements must be considered a new derivatives contract.

19. Initial margin must be posted and collected for all new[4] non-centrally cleared derivatives contracts, with the exception of physically settled foreign exchange (FX) forwards and swaps[5], 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 September 2016 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
From March 2020, March, April and May of each year	AUD 12 billion	1 September of each year to 31 August of the next calendar year

20. Where a non-centrally cleared derivative transaction is subject to initial margin requirements at inception, these requirements apply for the life of that transaction.

21. Initial margin must be posted and collected on a gross basis.

22. 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.

23. The threshold used for initial margin on a margining group basis 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 derivatives between the two margining groups.

24. An investment fund or RSE that is managed by an investment advisor is considered a distinct entity that may be treated separately when applying the initial margin threshold as long as the fund or RSE is a distinct legal entity that is not collateralised by or otherwise guaranteed or supported by other funds or an advisor in the event of insolvency or bankruptcy.

25. An APRA covered entity must avoid wherever practicable triggers that may lead to a

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[4] See footnote 3.

[5] 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 initial margin to be exchanged.

large discrete call for additional initial margin and would have a pro-cyclical effect. Any such triggers must be subject to appropriate internal controls and limits.

26. 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.

27. Initial margin must be held so as to ensure that:

    (a) the margin collected is immediately 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.

28. Initial margin must not be re-hypothecated, re-pledged or re-used. Contractual arrangements providing for the posting and collection of initial margin must provide for this outcome.

Minimum transfer amount

29. 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

30. An APRA covered entity must undertake a reasonable level of due diligence to assess:

    (a) whether a counterparty is 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.

Calculation of initial margin for non-centrally cleared derivatives

31. 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.

32. Derivatives 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.

33. 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[6].

    (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

34. 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.

35. 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 confidence interval over a 10-day time horizon[7], 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.

36. The period of financial stress used for calibration must be identified and applied separately for each asset class.

37. Transactions that are not subject to the same legally enforceable netting agreement must not be considered in the same initial margin model calculation. That is, the initial margin amounts must be calculated separately for each netting agreement.

38. 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.

39. 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

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[6] 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.

[7] 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.

across asset classes[8] and must be summed to calculate the initial margin amount for a netting agreement.

40. A model used for initial margin calculations must be subject to an 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.

41. 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.

42. 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.

43. 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.

44. 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.

45. Prior notification to APRA is required for any material changes to a model or risk measurement system. APRA's prior written approval is required for any material changes to a model which are not consistent with global industry standards for initial margin models.

Eligible collateral for margining

46. 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[9]:

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[8] This applies to all products including those which have risk exposures in multiple asset classes (e.g. quantos).

[9] For the avoidance of doubt, eligible collateral for margining purposes is distinct to the eligible collateral under *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* that can be used to reduce the credit risk capital requirement.

(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);

(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.

47. Resecuritisation exposures, irrespective of credit ratings, are not eligible collateral for margining purposes.

48. 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.

49. An APRA covered entity must have appropriate controls in place to ensure that the collateral collected does not exhibit significant wrong-way risk[10] or significant concentration risk. The controls must consider concentrations in terms of an individual issuer, issuer type and asset type.

50. Eligible collateral that was originally posted or collected may be substituted provided that:

[10] 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.

(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

51. 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.

52. An APRA covered entity may apply to APRA for approval to use a model approach for the calculation of risk-sensitive haircuts[11]. The use of a model approach for the calculation of risk-sensitive haircuts must be approved by APRA. The model used must be subject to appropriate internal governance standards.

53. For the model approach, an APRA covered entity must ensure that an independent review of the risk-sensitive haircut 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.

54. 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[12]. 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.

55. 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.

56. 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.

57. APRA's prior written approval is required for any material changes to a model.

[11] 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.

[12] Classes of collateral must be consistent with the categories in Table 4 of Attachment B and include (1) cash, (2) debt securities under paragraph 46(b), (3) debt securities under paragraphs 46(c), 46(d), 46(e) and 46(f), (4) equities, and (5) gold. Foreign exchange haircuts must be modelled consistently for all collateral classes.

Treatment of intra-group transactions

58. An APRA covered entity is subject to the variation margin requirements in this Prudential Standard for a non-centrally cleared derivative with a covered counterparty that is a member of the same margining group[13] in a margining period where:

    (a) the covered counterparty is not part of the APRA covered entity's Level 2 group; and

    (b) the margining group's aggregate month-end average notional amount of non-centrally cleared derivatives for the relevant reference period exceeded the corresponding qualifying level for variation margin.

59. An APRA covered entity is not subject to the initial margin requirements in this Prudential Standard for a non-centrally cleared derivative with a covered counterparty that is a member of the same margining group.

60. The intra-group variation margin requirements in paragraph 58 of this Prudential Standard do not apply to an APRA covered entity that is a foreign ADI, Category C insurer or EFLIC.

61. APRA may exempt certain intra-group transactions from the variation margin requirements in paragraph 58 of this Prudential Standard. APRA may also impose any conditions on an exemption and may revoke an exemption at any time.

62. APRA may require an APRA covered entity to exchange variation margin and/or initial margin with any other entity within the same margining group where APRA deems appropriate to do so.

Cross border application of margin requirements

63. APRA may approve substituted compliance in relation to a foreign margining regime where the regime is comparable in its outcomes with the BCBS-IOSCO framework and the requirements in this Prudential Standard.

64. Where APRA recognises substituted compliance in relation to a foreign margining regime, an APRA covered entity will be deemed to be compliant with the margin requirements in this Prudential Standard to the extent that it complies with the relevant foreign margining regime. APRA may limit the scope of or impose conditions on recognised substituted compliance.

65. An APRA covered entity may only substitute compliance with the margin requirements in this Prudential Standard with compliance with a foreign margining regime deemed equivalent by APRA 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 margining regime;

[13] For life companies and friendly societies, non-centrally cleared derivative transactions between any of its funds (e.g. statutory fund, benefit fund, management fund or shareholder fund) are also subject to the variation margin requirements outlined in this paragraph.

and/or

(b) the APRA covered entity is directly subject to the margin requirements of the relevant foreign margining regime.

66. Where a foreign ADI, Category C insurer or EFLIC is directly subject to margin requirements that are substantially similar to the BCBS-IOSCO framework[14] by its home jurisdiction, it may comply with its home jurisdiction's margin requirements in lieu of complying with the margin requirements in this Prudential Standard.

67. Where a foreign-incorporated APRA covered entity that is not a foreign ADI, Category C insurer or EFLIC is directly subject to margin requirements that are substantially similar to the BCBS-IOSCO framework[15] by a foreign jurisdiction, it may apply for approval by APRA to comply with the relevant foreign jurisdiction's margin requirements in lieu of complying with the margin requirements in this Prudential Standard.

68. An APRA covered entity is not required to post or collect variation margin or initial margin where netting of derivatives is not enforceable 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 post or collect variation margin or 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.

Risk mitigation standards for non-centrally cleared derivative transactions

70. An APRA covered entity entering into a non-centrally cleared derivative transaction must adhere to the risk mitigation standards outlined in paragraphs 71 to 91 of this Prudential Standard.

Trading relationship documentation

71. An APRA covered entity must establish and implement policies and procedures to execute written trading relationship documentation with its counterparties prior to or contemporaneously with executing a non-centrally cleared derivative transaction.

72. The trading relationship documentation must:

(a) provide legal certainty for non-centrally cleared derivative transactions;

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[14] The foreign ADI, Category C insurer or EFLIC must be able to demonstrate (i) how it is directly subject to margin requirements of a foreign regime and (ii) how it meets margin requirements which are substantially similar to the BCBS-IOSCO framework. This information must be made available to APRA upon request.

[15] The foreign incorporated subsidiary must be able to demonstrate (i) how it is directly subject to margin requirements of a foreign regime and (ii) how it meets margin requirements which are substantially similar to the BCBS-IOSCO framework.

(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.

73. 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 counterparty and such documentation must be made available to APRA upon request.

Trade confirmation

74. An APRA covered entity must establish and implement policies and procedures to ensure the material terms of all non-centrally cleared derivative transactions[16] are confirmed as soon as practicable after execution of the transaction. Material terms confirmed must include terms necessary to promote legal certainty to the transaction including incorporating by reference the trading relationship documentation.

75. An APRA covered entity must adopt policies and procedures to confirm material changes to the legal terms or the rights and obligations under transactions.

76. 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.

Portfolio Reconciliation

77. An APRA covered entity must establish and implement policies and procedures to ensure that the material terms and valuations of all transactions in a non-centrally cleared derivatives portfolio are reconciled with counterparties at regular intervals.

78. The process or method of portfolio reconciliation for the institution must be agreed upon with its counterparties. The reconciliation process must be designed:

(a) to ensure an accurate record of material terms and valuations of the non-centrally cleared derivatives transactions in the portfolio; and

(b) to identify and resolve discrepancies in the material terms and valuations in a timely manner.

79. An APRA covered entity must conduct portfolio reconciliation with a scope and frequency that reflects the:

(a) nature and extent of its non-centrally cleared derivative activity;

(b) materiality and complexity of the risks it faces;

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16 This requirement applies to all transactions including transactions entered into from novation.

(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

80. An APRA covered entity must establish and implement policies and procedures to regularly assess and, to the extent appropriate, conduct portfolio compression.

81. 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.

82. An APRA covered entity must conduct portfolio compression with a scope and frequency that reflects the:

    (a) nature and extent of its non-centrally cleared derivative activity;

    (b) 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

83. An APRA covered entity must agree with its 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.

84. All agreements on valuation process must be documented in the trading relationship documentation or trade confirmation.

85. 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.

86. An APRA covered entity must perform periodic review of the agreed upon valuation process to take into account changes in market conditions. The relevant documentation must be updated for any changes as a result of the review.

Dispute resolution

87. An APRA covered entity must have rigorous and robust dispute resolution procedures in place with its counterparties prior to or contemporaneously with executing a non-centrally cleared derivative transaction. An APRA covered entity must agree with its

counterparties and document the mechanism or process for:

(a) determining when discrepancies in material terms or valuations should be considered disputes; and

(b) how such disputes should be resolved as soon as practicable.

88. 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.

89. An APRA covered entity must have policies and procedures to document disputes and such documentation must be made available to APRA upon request.

90. 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.

91. 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

92. APRA may, by providing notice in writing, adjust or exclude any requirement in this Prudential Standard in relation to a particular APRA covered entity.

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. The 'net standardised initial margin amount' for an APRA covered entity may also be calculated 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. The use of such an alternative schedule for the 'net standardised initial margin amount' must be approved by APRA.

3. For each particular netting agreement:

   (a) Net standardised initial margin amount = 0.4 x gross standardised initial margin amount + 0.6 x net-to-gross ratio x 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[17].

[17] 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

Asset Class	**Initial margin rate (% of notional amount)**
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. The risk-sensitive haircut for an APRA covered entity may also be calculated 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. The use of such an alternative schedule for the risk-sensitive haircut must be approved by APRA.

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 termination currency [18].

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.

Table 4: Standardised schedule of risk-sensitive haircuts

Collateral Class	**Haircut (% of market value)**
Cash	0%
Debt securities under paragraph 46(b):	
residual maturity less than 1 year	0.5%
residual maturity from 1 year to less than 5 years	2%
residual maturity 5 years or longer	4%
Debt securities under paragraphs 46(c), 46(d), 46(e),46(f):	
residual maturity less than 1 year	1%
residual maturity from 1 year to less than 5 years	4%
residual maturity 5 years or longer	8%
Equities included in a major stock index	15%
Gold	15%

[18] That is, the collateral is posted in a currency other than that agreed as the termination currency in the relevant contract (either in an individual derivatives contract or a governing qualifying master netting agreement/Credit Support Annex).