November 24, 2015

Office of the Superintendent of Financial Institutions Canada
255 Albert Street
Ottawa, Ontario
K1A 0H2
Canada

Attention: Patrick Tobin - Capital Specialist, Bank Capital

Re: OSFI Consultation on Draft Guideline E-22 – Margin Requirements for Non-Centrally Cleared Derivatives

Ladies and Gentlemen,

The International Swaps and Derivatives Association, Inc.[1] ("**ISDA**") appreciates this opportunity to submit comments on the draft version of Guideline E-22 (the "**Draft Guideline**") on margin requirements for non-centrally cleared derivatives transactions published by the Office of the Superintendent of Financial Institutions Canada ("**OSFI**") on October 19, 2015.

ISDA and its members strongly support the goals of strengthening resiliency in the non-centrally cleared derivatives markets by establishing margin requirements for those transactions. We outline below a number of practical concerns and risks we have identified with the Draft Guideline and make a number of suggested improvements. Among other things, we feel it is important that the Draft Guideline accommodate transactions with counterparties that are not eligible for netting and promote harmonization with other margin regimes that are based on the BCBS-IOSCO margin framework. It is also important that the timeframes for the call and collection of both initial and variation margin are adjusted as appropriate to reflect the practical realities of transacting across multiple regions.

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 68 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Where appropriate, we suggest specific changes to the text of the Draft Guideline. For ease of reference, we have repeated the section and paragraph headings from the Draft Guideline below and organized our comments and feedback accordingly. Capitalized terms used herein that are not defined herein have the meanings given to such terms in the Draft Guideline.

We hope our comments in this submission will assist OSFI in finalizing the Draft Guideline.

Draft Guideline Section 1 – Scope of coverage

*1.1 – **Scope of applicability***

Non-Financial Entities Should Be Out of Scope

Under the Draft Guideline, FRFIs are required to exchange margin with non-financial entities that qualify as Covered Entities under paragraph 2. ISDA would urge OSFI to exclude all non-financial entities from the scope of the Draft Guideline. We submit that the policy rationale for mandatory margin requirements is not applicable in the case of end users who generally enter into derivatives for hedging purposes and who are not systemically important. In their final joint rule released on October 22, 2015 (the "**US PR Margin Rule**"), the US prudential regulators decided not to apply mandatory margin requirements to transactions with non-financial end users and other end users that are exempt from US mandatory clearing requirements.[2] A similar approach applies in Europe under Regulation (EU) (No 648/2012) ("**EMIR**"), where non-financial counterparties below applicable clearing thresholds are also not subject to mandatory margin requirements.[3] If OSFI is not prepared to completely exclude non-financial entities from the Draft Guideline, we would submit that hedging transactions should be excluded from the notional threshold calculation under paragraph 2 in relation to non-financial entities.

Timelines in Paragraph 2 Should Be Clarified

There are two references to "implementation date" in paragraph 2 but it is unclear what date these are referring to. It is also unclear why, once an entity becomes a Covered Entity, the requirement to exchange applicable margin only applies during "the one-year period from September 1 of that year to August 31 of the following year". ISDA assumes that OSFI intends for the requirements to apply for as long as the entity remains a Covered Entity. We have proposed some suggested drafting changes below to address both of these points.

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[2] The US PR Margin Rule exempts transactions with commercial end users, qualifying small banks (generally insured depository institutions and credit unions with less than $10 billion in assets), qualifying captive finance companies, treasury affiliates acting as agents and certain cooperative entities from the margin requirements where the transaction would qualify for a clearing exemption. For counterparties that do not qualify as a financial end user, the margin requirements are not mandatory and the only obligation on the covered swap entity is to collect initial margin or variation margin as they determine appropriate.

[3] Under EMIR, a non-financial entity is considered below the clearing threshold when its rolling average of notional positions in OTC derivatives (excluding 'hedging' derivatives) over 30 working days (measured on a group basis) does not exceed the clearing thresholds applicable to each derivatives asset class. In other words, a non-financial entity is only subject to margin requirements when its non-hedging activity exceeds the applicable thresholds for clearing.

<u>Suggested Language</u>:

> "A Covered Entity is defined as
>
> • A financial entity belonging to a consolidated group whose aggregate month-end average notional amount of non-centrally cleared derivatives for March, April, and May ~~of any~~ <u>of the previous</u> year ~~following the implementation date~~ exceeds $12 billion; or
>
> • A non-financial entity belonging to a consolidated group whose aggregate month-end average notional amount of non-centrally cleared derivatives for March, April, and May ~~of any~~ <u>of the previous</u> year ~~following the implementation date~~ exceeds $50 billion.
>
> Once a counterparty becomes a Covered Entity, Covered FRFIs must exchange any applicable margin with that counterparty <u>in accordance with this guideline</u> ~~during the one-year period from September 1 of that year to August 31 of the following year~~."

<u>Impact of a Change in Covered Entity Status Should be Clarified</u>

ISDA requests that OSFI clarify the impact of a change in a party's Covered Entity status on the obligation to exchange margin. ISDA submits that a party's Covered Entity status should be evaluated when the parties first enter into a transaction and that a change in that status should not result in stricter margin requirements applying to any pre-existing transactions (whether those transactions are grandfathered under paragraph 61 of the Draft Guideline or not). If a change in Covered Entity status were to alter the margin requirements applicable to legacy transactions, the economics of those impacted transactions could change significantly. Therefore it is important that pre-existing transactions are not affected by such changes.

If a change in status would result in less strict margin requirements applying (for example, a party ceases to be a Covered Entity), the parties should be permitted to agree on a bilateral basis to comply with less strict standards for all transactions. This approach is consistent with the position under the US PR Margin Rule.

<u>All Central Counterparties Should be Excluded from Definition of Covered Entity</u>

Under paragraph 2, qualifying central counterparties are excluded from the definition of Covered Entity. ISDA submits that all central counterparties, not just qualifying central counterparties, should be excluded from the definition of Covered Entity. Central counterparties, regardless of whether they are qualifying, do not post initial margin to clearing participants. If non-qualifying central counterparties are not exempt from the definition of Covered Entity, this will effectively prohibit FRFIs from clearing derivatives with central counterparties that are not qualifying.

<u>Definition of Financial Entity Should be Narrowed</u>

The proposed definition of financial entity would encompass a wide range of entities, some of which do not pose systemic risk and are not structurally set up to comply with prescriptive

margin requirements such as the ones contained in the Draft Guideline. For example, treasury affiliates that undertake hedging activities on behalf of affiliates within a corporate group could be caught within the broad definition of "financial entity" in paragraph 2; however, such entities are not considered systemically important and generally enter into derivatives to hedge commercial risk.

The definition of "financial entity" would also encompass special purpose entities ("**SPEs**") used in structured finance transactions. In such transactions, the SPE is either secured by a senior claim on pledged collateral held by the SPE or is otherwise entitled to a senior priority claim on the assets of the SPE. Those arrangements protect swap counterparties without requiring an exchange of variation and initial margin as contemplated under the Draft Guideline. SPEs do not have access to liquid collateral that can be transferred back and forth to a counterparty in the manner contemplated under the Draft Guideline. Unless such entities are treated as out of scope, it is possible that market participants will no longer be able to execute certain types of transactions with FRFIs as a result of the Draft Guideline.

ISDA submits that OSFI should explicitly exclude treasury affiliates and SPEs from the definition of Covered Entity.[4] ISDA also submits that OSFI should exclude FRFIs with $10 billion or less in total assets that enter into non-centrally cleared derivatives for hedging purposes from the definition of Covered Entity. This would be consistent with the approach under the US PR Margin Rule, where financial institutions with less than $10 billion in total assets that enter into transactions for hedging purposes are excluded from margin requirements (tracking a similar exemption available to those institutions under US rules from mandatory clearing requirements).

Greater Deference to other Margin Regimes Based on BCBS-IOSCO

ISDA strongly supports a harmonized and consistent set of margin rules across jurisdictions that are consistent with the BCBS-IOSCO guidelines for margin. We ask OSFI to reconsider the approach to cross-border harmonization in the Draft Guideline. We submit that the approach is too narrow in that it only allows FRFIs to defer to other sets of regulatory requirements for the narrow purpose of determining if its counterparty is a Covered Entity. While paragraphs 12 and 24 would allow the FRFI to use the minimum transfer amount and the initial margin threshold of the counterparty in certain circumstances, the Draft Guideline would still determine all other aspects of the margin requirements applicable to the transaction. In addition to creating complexity from an implementation perspective, we believe this hybrid approach does not allow sufficient deference to other comparable margin regimes.

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[4] One suggested approach would be to add language in the Draft Guideline along the following lines: "A Covered Entity will not include (i) treasury affiliates that undertake hedging activities on behalf of affiliates within a corporate group; (ii) any special purpose entity ("**SPE**") established for the purpose of financing a specific pool or pools of assets or underwriting a specific set of risk exposures, in each case, by incurring indebtedness; provided that the indebtedness of the SPE, including obligations owing to the SPE's swap counterparties, is secured by the specific pool or pools of financed assets; (iii) any SPE established by an investment fund for the purpose of acquiring and holding real estate or other physical assets on behalf of or at the direction of the investment fund; (iv) any SPE established for the purpose of acquiring or investing in real estate; and (v) any collective investment vehicle established for the purpose of investing in real estate or other physical assets."

ISDA submits that FRFIs should be able to satisfy the requirements of the Draft Guideline by complying with any other margin requirements applicable to a transaction where those other requirements are based on the BCBS-IOSCO framework. We believe that should include any margin requirements promulgated under the legislative authority of the provinces to the extent they are based on the BCBS-IOSCO framework. We also submit that when FRFIs are transacting with non-Canadian entities that are not FRFIs, the FRFI should only be required to collect margin and not be required to post margin. Given that the Draft Guideline is intended to protect Canadian markets against systemic risk, we believe it is appropriate for OSFI to regulate margin being posted to a FRFI but not require that FRFIs post collateral to non-Canadian entities that are not regulated by OSFI. Of course, it may be that non-Canadian counterparties will be required under rules applicable in their own jurisdiction to collect collateral from FRFIs but we do not believe that a separate requirement by OSFI that FRFIs post collateral in those circumstances is warranted.

Products in Scope Should be Clarified

We request that OSFI clarify that "financial contract" as used in paragraph 9 means cash settled contracts only. We also suggest that the reference to "fluctuations" in paragraph 9 be amended to instead read "fluctuations in the price, value or level".

Given the various definitions of derivatives that are used in proposed margin rules across jurisdictions, ISDA submits that the Draft Guideline should permit parties to choose a broader product set than the one set forth in paragraph 9. Netting within the broader product set should be permitted to the same extent, and under the same conditions, that would apply to netting of products within scope of the Draft Guideline. The broader product set should be eligible to be used to determine both initial margin and variation margin and may include derivatives as defined by rules applicable to each counterparty in their respective jurisdiction.

Verification of Covered Entity Status

Paragraph 11 of the Draft Guideline provides that Covered FRFIs should verify whether or not their counterparties are Covered Entities prior to entering into a transaction. ISDA requests that OSFI clarify in footnote 4 that, once it has received verification from a counterparty as to its Covered Entity status, a FRFI can assume such entity continues to have such status until the Covered Entity informs the FRFI otherwise.

Minimum Transfer Amount

Paragraph 12 of the Draft Guideline contemplates a minimum transfer amount of $750,000 to apply to all margin transfers (combined variation and initial margin). ISDA requests that OSFI amend the Draft Guideline to provide that the minimum transfer amount applies to variation margin and initial margin separately.

*1.2 – **Instruments covered***

Credit Intermediation Swaps Associated with the CMB Program Should be Excluded

OSFI has asked whether credit intermediation swaps entered into in connection with issuances under the Canada Mortgage Bond (CMB) program should be treated as in scope for the Draft Guideline. ISDA's understanding is that, in applicable cases, the Canada Housing Trust (as issuer of the underlying bonds) ("**CHT**") enters into a swap with a highly rated counterparty ("**CHT Counterparty**") to manage the reinvestment and interest rate risks associated with the relevant assets held by CHT. The CHT Counterparty will typically enter into a back-to-back credit intermediation swap and, in certain cases, related hedging transactions (together, "**CMB Seller Transactions**") with the market lender that is utilizing the CMB programme to raise financing.

In light of the question posed by OSFI, we assume OSFI's position is that non-centrally cleared derivatives entered into between CHT and a FRFI (acting as a CHT Counterparty) would be out of scope of the Draft Guideline on the basis CHT is a public sector entity (and therefore excluded from the definition of Covered Entity). On that basis, our comments are focused on the position of FRFIs acting as counterparties under the CMB Seller Transactions. Given that FRFIs will not receive collateral when transacting with CHT, ISDA believes that FRFIs should not be required to post collateral in connection with any CMB Seller Transaction. If FRFIs are required to post collateral to counterparties under CMB Seller Transactions, it will raise costs for lenders under the CMB program and ultimately increase costs for retail mortgage borrowers. Given the strict eligibility criteria to be a CHT Counterparty under the CMB program, ISDA does not believe the Draft Guideline should require FRFIs to post collateral under CMB Seller Transactions.

Draft Guideline Section 2 – Variation Margin Requirements

Margin Requirements Should not Apply to Counterparties that Lack Enforceable Netting

Paragraph 15 provides that non-centrally cleared derivatives must be subject to a single, legally enforceable netting agreement. For certain counterparty types and for counterparties in certain jurisdictions, satisfactory netting opinions cannot be obtained. In those instances, market participants do not typically exchange collateral due to the risk of an insolvency official cherry-picking among transactions and seeking to retain posted collateral that, had the exposures been netted, should have been returned. If OSFI does not fully remove the obligation on FRFIs to post collateral to non-Canadian counterparties as suggested above, ISDA submits that Covered FRFIs should not be required to exchange collateral with counterparties located in jurisdictions that lack enforceable netting or with specific counterparties for whom enforceable netting is not available. If OSFI is not prepared to fully exempt all transactions with such non-netting eligible counterparties, ISDA requests that OSFI consider exempting transactions with non-netting eligible counterparties for up to 5% of the FRFI's total non-centrally cleared derivatives (measured by notional amount). This would allow FRFIs to continue to transact with such counterparties in non-centrally cleared derivatives on an uncollateralised basis but subject to a reasonable cap.

More Flexible Timing for Calling and Collecting Initial and Variation Margin

The Draft Guideline requires both variation margin and initial margin to be calculated and called on a daily basis. It provides that variation margin must be exchanged on or before the business day following the calculation of the variation margin amount and that initial margin should be exchanged within two business days of the calculation of the initial margin amount.

ISDA requests greater flexibility around these timing requirements. We note that the timing of the first margin call for a new transaction can depend on several factors, including the time of execution of the transaction, the location of the parties, whether the parties are in different calendar days at the time of execution and whether the day of execution is a business day for both parties. We therefore propose timelines that will accommodate the variety of factors that can impact the call and settlement timeframes. In all cases, we request that the obligation to calculate, call and exchange margin be within the timelines outlined below "or as soon as reasonably practicable thereafter."

Variation Margin:

We propose that the initial calculation and call of variation margin should occur either on or before the business day following the day of execution or the second business day following the day of execution if Asian operations are involved. Thereafter, variation margin should be calculated and called on a daily basis as contemplated in paragraph 16 of the Draft Guideline.

For counterparties that are also subject to a requirement to exchange initial margin, the exchange of variation margin should be operationally possible within one day following the calculation and call, or within two days following the calculation and call if European or Asian operations (including custodians or sub-custodians) are involved. For counterparties that are not subject to initial margin (and who therefore are unlikely to have the same developed infrastructure), the settlement of variation margin may require up to three business days following the calculation and call.

Initial Margin:

We propose that the initial calculation and call of initial margin should occur no later than the second business day following the day of execution. Thereafter, initial margin should be calculated and called on a daily basis as contemplated in paragraph 22 of the Draft Guideline. The exchange of initial margin should be within two business days following the calculation and call (as contemplated in paragraph 23).

Draft Guideline Section 3 – Initial margin requirements

*3.1 – **Overview***

No requirement to agree on the margin calculation method and quantitative model

Paragraph 25 of the Draft Guideline proposes that the specific method and parameters that will be used by each party to calculate initial margin should be agreed in advance. It also provides that parties may agree to use a single model for the purposes of model margin calculations. It is unclear how these pre-trade requirements would significantly benefit market participants and ISDA is of the view that it would impose an unnecessary administrative burden. We request that OSFI amend paragraph 25 to remove these requirements.

*3.2 – **Internal Model Approach***

*3.2.1 – **Overview and Governance***

Model Requirements Should only Apply to Covered FRFIs

In various places in Section 3.2 of the Draft Guideline the obligations related to internal models are stated as applying to "covered entities" (as opposed to the defined term Covered Entity). It is unclear therefore if the obligations related to models are applicable only to Covered FRFIs or Covered Entities generally. ISDA requests that OSFI clarify that the obligations in Section 3.2 should only apply directly to Covered FRFIs.

Covered FRFIs Need Flexibility to Calibrate Initial Margin Models.

In order to qualify to use an internal model to calculate initial margin requirements, the Draft Guideline states that Covered Entities must "review and, as necessary, revise the data used to calibrate the initial margin model at least monthly, and more frequently as market conditions warrant, to ensure that the data incorporate a period of significant financial stress" (paragraph 33). We believe this requirement is excessive and potentially pro-cyclical. ISDA submits that an annual review with consideration of recalibration at that time is sufficient and consistent with the requirement for transparent and predictable procedures. We note that the US prudential regulator in the US PR Margin Rule amended the corresponding provision in that rule to make the review requirement annual as opposed to monthly.

*3.2.2 – **Modeling Requirements***

Timeline for Calculating Potential Future Exposure

The Draft Guideline (in paragraph 34, second bullet) provides that potential future exposure should reflect an estimate of an increase in value over a minimum horizon of 10 days. ISDA requests that this reference to "a minimum horizon of 10 days" be replaced with a reference to "a

minimum horizon equal to the shortest of ten business days or the maturity of the non-centrally cleared derivative”.

Risk Factors Should be Permitted in Lieu of Asset Classification

The Draft Guideline does not permit initial margin models to account for diversification, hedging and risk offsets across asset classes (paragraph 34, bullet 6). ISDA submits that Covered Entities should be permitted to use initial margin models that account for diversification, hedging and risk offsets both within and across asset classes. The Draft Guideline should be amended to permit parties to include non-derivative assets in the model.

3.2.4 – Control, oversight, and validation mechanism

Outcomes Control Analysis Should Acknowledge Challenges Inherent in Backtesting

With respect to the outcomes analysis process contemplated in paragraph 36, which includes backtesting the initial margin model, ISDA suggests adding a sentence after the second bullet which says “This analysis must recognize and compensate for the challenges inherent in back-testing over periods that do not contain significant financial stress.”.

Section 4 – Collateral

4.1 Eligible Collateral

Proposed Amendment to Definition of Eligible Collateral

Under paragraph 44(d) of the Draft Guideline, eligible collateral includes certain debt securities not rated by a recognized external credit assessment institution that meet enumerated criteria. One of the criteria which must be met is that “OSFI is sufficiently confident about the market liquidity of the security”. ISDA believe that such an open-ended requirement will not be workable for market participants. It would require FRFIs to include a unilateral right in their underlying collateral documentation to declare such debt securities ineligible whenever OSFI declares it is no longer sufficiently confident in the liquidity of such securities. Such uncertainty will make it difficult for market participants to price transactions and will likely mean that such debt securities will never be considered eligible collateral. ISDA submits that this limb of paragraph 44(d) is not necessary given the other eligibility criteria in paragraph 44(d) and requests that it be deleted.

4.2 Haircuts

4.2.2 Model Based Haircuts

Incorporate FX Risk of IM in IM Model as Opposed to Proposed 8% Haircut

The standard supervisory haircuts in the table in paragraph 57 include an additional 8% haircut on assets where the currency of the derivative differs from the currency of the collateral. While paragraph 46 provides that this additional 8% haircut does not apply to variation margin, the 8% haircut does apply to initial margin. ISDA submits that Covered FRFIs should be permitted to incorporate the foreign exchange risk into the initial margin model calculations in lieu of applying the proposed 8% haircut. Any application of the haircut should be against the termination currency of the derivatives netting contract rather than the currency of the derivative transaction, provided that consistent with the U.S. PR Margin Rule, each counterparty should be permitted to designate a different termination currency. ISDA also believes there should be no haircut applied to cash collateral for either initial margin or variation margin.

Section 5 – Phase-in of requirements

Certain Amendments and Clarifications Should be Made to the Phase-In Requirements

Paragraph 60 of the Draft Guideline provides that for purposes of calculating the aggregate month-end average notional amounts used to determine the phase-in of initial margin and variation margin requirements, all non-centrally cleared derivatives, including physically settled foreign exchange forwards and foreign exchange swaps ("**Excluded FX**"), should be included.

ISDA submits that OSFI should amend this paragraph to omit Excluded FX from the calculation of month-end average notional amounts. Excluded FX has unique characteristics which distinguish them from other derivatives. The same characteristics that justify excluding these transactions from the requirement to exchange variation margin and initial margin also justify excluding them for purposes of determining phase-in timing. We also submit that inter-affiliate transactions should be excluded for purposes of calculating average month-end notional amounts in Section 5.

ISDA also requests that OSFI clarify that Excluded FX and inter-affiliate transactions should be excluded when determining aggregate month-end average notional amounts for purposes of the Covered Entity definition in paragraph 2.

Clarifications to Scope of Excluded Transactions

Paragraph 61 provides (in footnote 11) that genuine amendments to existing derivatives contracts do not qualify as a new derivatives contract for purposes of the grandfathering provisions of the Draft Guideline. ISDA supports that position and requests that OSFI also carve-out from the scope of the Draft Guideline (i) novations of grandfathered transactions and (ii) new non-centrally cleared transactions resulting from portfolio compressions of grandfathered transactions.

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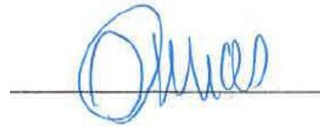
ISDA appreciate the opportunity to submit feedback on the Draft Guideline to OSFI. We would welcome the opportunity to further discuss with OSFI any of the points raised in this letter. Please feel free to contact the undersigned at 212-901-6031 if you have any questions.

Yours sincerely,



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