AUTORITÉ DES MARCHÉS FINANCIERS

GUIDELINE ON MARGINS FOR OVER-THE-COUNTER DERIVATIVES NOT CLEARED BY A CENTRAL COUNTERPARTY

Updated November 2021

TABLE OF CONTENTS

Introduction....3
1. Scope....4
2. Appropriate margining practices....7
3. Collateral....12
4. Haircuts....12
5. Dispute resolution....15
6. Implementation of expectations for the exchange of variation margin and initial margin....16
Annex 1....17
Annex 2....18
Annex 3....19

DRAFT

Introduction

The G20 provided guidance on margining for over-the-counter (OTC) derivatives[1] not cleared by a central counterparty[2] (“non-centrally cleared OTC derivatives”) as part of its ongoing financial markets reform program. It had been agreed that improved transparency in the OTC derivatives markets and further regulation of OTC derivatives and market participants would be necessary to mitigate the systemic risk posed by OTC derivatives transactions.

A global framework aimed at reducing risk caused by the potential default of an OTC derivatives counterparty was therefore published jointly by the Basel Committee on Banking Supervision (the “BCBS”) and the International Organization of Securities Commissions (”IOSCO”) in March 2015.[3]

This guideline is in response to the invitation by the BCBS and IOSCO for jurisdictions to communicate their expectations regarding best practices in respect of the exchange of margin for non-centrally cleared OTC derivatives. It incorporates the adjustments made to the implementation phases by the BCBS and IOSCO in July 2019 and March 2020.

DRAFT

1 The terms “derivative” and “over-the-counter derivative” are as defined in section 3 of the *Derivatives Act*, CQLR, c. I-14.01.

2 The term “central counterparty” refers to the definition of “clearing house” in section 3 of the *Derivatives Act*.

3 *Margin requirements for non-centrally cleared derivatives,* Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions, March 2015.

1. Scope

The *Guideline on margins for over-the-counter derivatives not cleared by a central counterparty* (the "guideline") sets out the expectations of the Autorité des marchés financiers (the "AMF") regarding the exchange of margin for non-centrally cleared OTC derivatives ("covered derivatives"). This guideline applies to a **covered institution** that trades covered derivatives with a **covered counterparty**.

Within the meaning of this guideline, a financial institution is a **covered institution** for a period from September 1 of a given year to August 31 of the following year, if both of the following apply:

1. It is governed by one of the following laws:

   - *Insurers Act*, CQLR, c. A-32.1;
   - *Act respecting financial services cooperatives*, CQLR, c. C-67.3;
   - *Deposit Institutions and Deposit Protection Act*, CQLR, c. I-13.2.2;
   - *Trust Companies and Savings Companies Act*, CQLR, c. S-29.02;

2. It belongs to a **financial group** whose aggregate month-end average gross notional amount of outstanding covered derivatives for the months of March, April and May of that same year, excluding derivative traded between entities of the same **financial group**, exceeds $12 billion.

For the purposes of this guideline, an entity (the "first entity") is an affiliated entity of another entity (the "second entity") within the same **financial group** if any of the following apply:

a. the first entity and the second entity are consolidated in consolidated financial statements prepared in accordance with:

   (i) IFRS; or

   (ii) generally accepted accounting principles in the United States of America;

b. all of the following apply:

   (i) neither the first entity's nor the second entity's financial statements, nor the financial statements of another entity, were prepared in accordance with the principles or standards specified in the above subparagraphs a*(i)* or *(ii)*;

   (ii) the first entity and the second entity would have been, at the relevant time, required to be consolidated in consolidated financial statements prepared by the first entity, the second entity or the other entity, if the consolidated financial statements were prepared in accordance with the principles or standards specified in the above subparagraphs a*(i)* or *(ii)*;

DRAFT

c. both entities are prudentially regulated entities supervised together on a consolidated basis.

Moreover, covered derivatives traded between a **covered institution** and an entity of the same **financial group** are not covered by this guideline if all of the following apply:

a. both counterparties to the covered derivatives agree to exempt them from the application of this guideline;

b. both counterparties are subject to a centralized risk management program reasonably designed to assist in monitoring and managing the risks associated with all derivatives between the counterparties through evaluation, measurement and control procedures;

c. the terms of the covered derivatives between the two counterparties are documented in an appropriate format.

Within the meaning of this guideline, a **covered counterparty** is a financial entity that meets the second condition on page 4 for consideration as a **covered institution**. However, an entity is not a **covered counterparty** if the entity is any of the following:

a. the Government of Canada, the government of a jurisdiction of Canada or the government of a foreign jurisdiction;

b. a crown corporation for which the government of the jurisdiction where the crown corporation was constituted is liable for all or substantially all the liabilities of the crown corporation;

c. a person or company wholly owned by a government referred to in paragraph *a* if the government is liable for all or substantially all the liabilities of the person or company;

d. a municipality, school board, university or social service program that receives regular government financial support;

e. a special purpose entity that operates solely as a pass-through funding vehicle through the issuance of securities for which a government referred to in paragraph *a* is responsible for all or substantially all the liabilities;

f. the Bank of Canada or a central bank of a foreign jurisdiction;

g. the Bank for International Settlements;

h. a multilateral development bank.[4]

Any entity, commonly known as a special purpose entity, belonging to the same **financial group** as a **covered institution** or a **covered counterparty** is not considered a **covered institution** or a **covered counterparty** if both of the following apply:

a. its primary objective is one of the following:

---

[4] See Annex 2.

DRAFT

(i) finance one or more asset pools;

(ii) provide investors with exposure to a specific set of risks;

(iii) acquire or invest in real estate or physical assets;

b. if its primary objective is the one referred to in subparagraph a(i) or (ii), all of its indebtedness, including obligations owing to its derivative counterparty, is secured solely by its assets.

For the purposes of this guideline, a **bilateral netting agreement** is an agreement that requires the **covered institution** and its **covered counterparty** to:

a. net the calculated amounts of variation margin for the covered derivatives that are subject to the **bilateral netting agreement**, and

b. exchange variation margin by delivering collateral, even if the **covered institution** or the **covered counterparty** is in default of an obligation under another derivative that is subject to the **bilateral netting agreement**.

In respect of a **bilateral netting agreement**, the AMF expects a **covered institution** to have a reasonable basis to believe that, in the event of a legal challenge, the relevant courts or administrative authorities would find the exposure under the netting agreement to be the net amount under the laws of the relevant jurisdictions.

DRAFT

2. Appropriate margining practices

The AMF expects all **covered institutions** to have appropriate margining practices in place for all covered derivatives traded with a **covered counterparty**, with the exception of:

- physically settled foreign exchange forwards;
- cross-currency swaps; and
- fixed physically settled foreign exchange transactions associated with the exchange of principal of cross-currency swaps.

When a financial institution becomes a **covered institution**, the expectations set out in this guideline will apply to all new covered derivatives traded as of that time with a **covered counterparty**. However, the AMF does not expect initial margin expectations to be met for existing covered derivatives.[5]

Conversely, should a **covered institution** cease to be a **covered institution**, the expectations set out in this guideline will no longer apply in respect of any covered derivative involving the institution, regardless of the date on which the derivative was traded, until such time as the institution has recovered its status as a **covered institution**.

The same holds true for a **covered counterparty**.

The AMF expects a **covered institution** to adequately declare its status, or any change thereto, to its counterparty and obtain the counterparty's status before trading a covered derivative in order to determine whether the guideline should apply.

The expectations with respect to initial margin and variation margin for a covered derivative do not have to be met if all of the following apply:

a. the derivative is traded as a result of counterparties changing or terminating and replacing derivatives submitted to either of the following:

   (i) a multilateral portfolio compression exercise conducted by an independent third party; or

   (ii) a bilateral portfolio compression exercise;

b. the portfolio compression exercise referred to in subparagraph a*(i)* or *(ii)* involves both counterparties to the covered derivative;

[5] In this regard, it should be noted that any material amendment to an existing covered derivative qualifies as a new derivative. For example, any amendment that is intended to extend an existing covered derivative will be considered a new derivative. However, amendments made to existing derivatives solely to reflect the interest rate benchmark reform do not create new derivatives.

DRAFT

c. the derivatives submitted to the portfolio compression exercise referred to in subparagraph a*(i)* or *(ii)* do not include a covered derivative.

The AMF permits **covered institutions** to comply with the margin exchange requirements applicable to their **covered counterparties** rather than the expectations set out in this guideline, insofar as the **covered institutions** deem those requirements to be equivalent. Although the AMF does not intend to validate the equivalence beforehand, it reserves the right to conduct an in-depth equivalence review as part of its supervisory actions. Therefore, the AMF expects **covered institutions** to document the requirements applicable to their counterparties where the **covered institutions** choose to comply with them.

The AMF expects a **covered institution** that trades covered derivatives to exchange initial margin, which is based on potential future exposure, and variation margin, which is based on current exposure.

The AMF expects any daily amount of two-way margin exchanged (sum of initial and variation margin owing) exceeding the minimum transfer amount ("MTA") previously set by both counterparties to be transferred. The applicable MTA may not exceed $750,000. If a **covered institution** trades a covered derivative with a foreign **covered counterparty**, the **covered institution** may use the MTA applicable in the jurisdiction of the **covered counterparty**.

2.1 Variation margin

The AMF expects variation margin to be exchanged, subject to the MTA, on a bilateral basis and to fully collateralize the mark-to-market exposure. It also expects variation margin to be calculated and called within two business days of the date the covered derivative was traded. Thereafter, variation margin must be calculated and called on a daily basis.

The AMF expects variation margin for covered derivatives subject to a single legally enforceable **bilateral netting agreement** to be exchanged on a net basis. Where such an agreement is not in place, variation margin must be exchanged on a gross basis.

2.2 Initial margin

A **covered institution** should exchange initial margin with its **covered counterparty**, subject to an amount in excess of an initial margin threshold ("IMT") previously set by both parties and not exceeding $75 million. The IMT, which is applied at the level of the **covered institution's** financial group, applies to all covered derivatives with the **financial group** to which the **covered counterparty** belongs.

The AMF expects initial margin to be exchanged, subject to the MTA and IMT, on a gross basis. It also expects initial margin to be calculated and called within two business days of the date the covered derivative was traded. Thereafter, initial margin must be calculated and called on a daily basis until the maturity, expiration or termination date of the covered

DRAFT

derivative. The **covered institution** therefore has two business days to receive the collateral corresponding to the amount of initial margin called.

The exchanged amount of initial margin may be calculated using one of the following methods:

- the standardized initial margin schedule in Annex 1;
- a quantitative initial margin model.

The choice between the two methods should be made consistently for all covered derivatives within the same asset class traded with the same **covered counterparty**.

A **covered institution** may rely on its **covered counterparty** to calculate the amount of initial margin to be called if the **covered institution** is a party to a legally enforceable written agreement with its **covered counterparty** under which the latter must calculate initial margin for all covered derivatives within the same asset class traded between them.

2.2.1 Use of the standardized initial margin schedule

The initial margin amount to be called is calculated in two steps:

1. for each covered derivative in a portfolio subject to a legally enforceable **bilateral netting agreement**, the margin rate corresponding to its asset class indicated in the schedule in Annex 1 is multiplied by its gross notional amount. The aggregate results obtained are referred to as the portfolio's "gross initial margin".
2. the gross initial margin amount is adjusted using the following formula:

*Net standardized initial margin = 0.4 * Gross initial margin + 0.6 * NGR * Gross initial margin*

Where NGR (or "net-to-gross ratio") is defined as the net replacement cost over the gross replacement cost for covered derivatives in a portfolio subject to a legally enforceable **bilateral netting agreement**.

Therefore, the amount of initial margin to be called on a portfolio according to the standardized margin schedule is the net standardized initial margin amount.

A **covered institution** is not required to calculate and call initial margin for a covered derivative for which the institution faces no counterparty risk.

2.2.2 Use of a quantitative initial margin model

Using a quantitative initial margin model requires meeting several prerequisite conditions. Although the AMF does not intend to systematically pre-approve (prior to use) or approve (during use) the models used to determine the amounts of initial margin, it reserves the right to conduct an in-depth review of the models as part of its supervisory actions.

DRAFT

However, the AMF expects the **covered institution** to have its internal quantitative initial margin model reviewed by a reasonably qualified person who is independent of the person who developed the model to ensure that it meets the expectations relating to model development outlined below.

The AMF also expects a quantitative initial margin model to be subject to an internal governance process that regularly tests the model's output against recent market data based on the type and complexity of the derivatives for which the model is being used.

Furthermore, the AMF expects a quantitative initial margin model to not permit any initial margin amount that may be collected by the **covered institution** to be offset by, or otherwise take into account, any initial margin that may be provided to the **covered counterparty**.

A **covered institution** should have a rigorous and well-defined process for re-estimating, re-evaluating and updating any quantitative initial margin model it develops to ensure continued applicability and relevance for the various types of covered derivatives. If it is using a model developed by a third party vendor, including its **covered counterparty**, the **covered institution** should have reasonable assurance that the vendor's processes ensure the model's continued applicability and relevance.

The AMF expects **covered institutions** to review and revise the data used to calibrate any internal quantitative initial margin model at least annually, and more frequently as market conditions warrant.

A **covered institution** should adequately document material aspects of any internal quantitative initial margin model, including the management and valuation of the covered derivatives to which it applies, the control, oversight, and validation of the initial margin model, any review processes and the results of such processes.

2.2.3 Expectations relating to the development of an internal quantitative initial margin model

Covered institutions wishing to use an internal quantitative initial margin model should meet the following conditions:

a. Initial margin requirements are based on an estimate of potential future exposure of covered derivatives;

b. The potential future exposure of a covered derivative reflects an estimate of the one-tailed 99% confidence interval for a change in value of a covered derivative or a portfolio of covered derivatives over a minimum close-out period of 10 days;

c. All data used to calibrate the model are based on an equally weighted historical observation period of at least one year and not more than five years that incorporates a period of financial stress for each broad asset class to which the model is applied;

d. The model must account for the material risks inherent in the covered derivatives for which initial margin is being calculated. The risk categories should include, but

DRAFT

should not be limited to, foreign exchange risk, interest rate risk, credit risk, equity risk and commodity risk, as appropriate;

e. The model may apply to a portfolio of covered derivatives, in which case it should only consider the covered derivatives to which it applies and that are subject to a single legally enforceable **bilateral netting agreement**;

f. The model may account for diversification, hedging and risk offsets of the portfolio of covered derivatives to which it applies provided the derivatives are within the same asset class and are subject to the same legally enforceable **bilateral netting agreement**.

DRAFT

3. Collateral

Any collateral delivered by a **covered institution** as initial margin should not be re-used by its **covered counterparty**.

The following collateral instruments are eligible for the exchange of margin (both variation and initial margin):

a. cash;

b. gold;

c. debt securities rated by a recognized rating agency where these are either:

  - at least BB- when issued by or guaranteed by the Government of Canada, the Bank of Canada or the government of a province or territory of Canada;
  - at least BB- when issued by a foreign government with a credit rating of at least BB-;
  - at least BBB- when issued by a corporate entity;
  - at least A-3/P-3 for short-term debt instruments.

d. equities listed on a recognized exchange; and

e. securities of an investment fund if:

  (i) a price for the securities is publicly quoted daily, and

  (ii) the investment fund is limited to investing in the above listed instruments.

Securities issued by the **covered counterparty** or by any entity within the same **financial group** are not considered eligible collateral.

The AMF expects collateral received as margin to be held in such a way as to ensure that it is available in a timely manner to the **covered institution** in the event of the **covered counterparty**'s default.

All collateral deposited as initial margin by a **covered institution** must be held in one or more accounts at a permitted depository that are clearly identified as holding collateral and that are segregated from the **covered counterparty**'s collateral and property.

The **covered institution** may require a further level of segregation, i.e., segregation from the collateral deposited as initial margin by other **covered counterparties**.

4. Haircuts

Any collateral received as margin should be haircutted to account for potential changes in its value.

DRAFT

In addition to this haircut, the AMF expects a **covered institution** to apply an additional haircut where the collateral received is denominated in a currency other than the currency of settlement for the covered derivative for which the collateral is received.

The AMF does not expect a **covered institution** to apply an additional haircut where the collateral received is any of the following:

a. cash posted for variation margin;

b. an asset other than cash that is:

   (i) posted for variation margin, and

   (ii) denominated in the currency agreed upon in the legally enforceable **bilateral netting agreement** that applies to the covered derivative for which the collateral is received;

c. any asset that is:

   (i) posted for initial margin, and

   (ii) denominated in the currency for which payments will be made upon the termination of the covered derivative for which the collateral is received as agreed upon in writing between the **covered institution** and its **covered counterparty**.

The AMF expects a **covered institution** that wants to calculate the haircut and, if applicable, the additional haircut on the collateral, to use either of the following:

a. a haircut model that is:

   (i) reasonably designed to cover an estimate of the one-tailed 99% confidence interval for a change in value of the collateral over a 10-day holding period, and

   (ii) calibrated using historical data of not less than one year obtained from an independent and reliable source;

b. the standardized haircut schedule in Annex 3.

Where a **covered institution** uses the haircut model of a third party vendor, including its **covered counterparty**, the AMF expects the **covered institution** to have reasonable assurance that the third party vendor's processes ensure the haircut model's continued relevance and efficiency.

However, if the **covered institution** uses an internal haircut model, the AMF expects it to:

DRAFT

a. establish, implement and maintain policies and procedures reasonably designed to ensure that the haircut model is tested regularly against historical data that includes stressed market conditions;

b. at least annually and more frequently as market conditions warrant, revise the test data used to calibrate the haircut model and, if appropriate, recalibrate the model;

c. on a reasonably frequent basis, conduct an independent review of the haircut model;

d. at least annually and more frequently as market conditions warrant, conduct an assessment on the integrity and reliability of the data used in the model, including the accuracy and appropriateness of the test data used;

e. as soon as practicable, rectify any material deficiencies identified in the haircut model;

f. at least once every three months, update the data and recalculate the applicable haircut for each asset that is held as collateral in respect of an outstanding covered derivative and for which a haircut was calculated using the haircut model;

g. as market conditions warrant, for collateral received as margin in respect of an outstanding covered derivative for which a haircut was calculated using the haircut model, update the data using a shorter observation period and recalculate the applicable haircut.

DRAFT

5. Dispute resolution

The AMF expects a **covered institution** to have a written agreement with each **covered counterparty** that sets out sound and rigorous procedures for identifying, processing and, as soon as practicable after identifying, resolving a dispute between the **covered institution** and the **covered counterparty** relating to initial margin, variation margin or the applied haircut.

The AMF expects the dispute resolution procedures to establish all of the following:

a. how to determine what is considered a dispute;

b. how to settle a disagreement on the amount of initial margin or variation margin to be provided;

c. how to settle a disagreement on the valuation of a covered derivative;

d. how to settle a disagreement on the valuation of the collateral;

e. how to settle a disagreement in relation to a haircut on collateral received as margin.

The AMF also expects a **covered institution** to notify its decision-making bodies of a dispute with a **covered counterparty** relating to initial margin, variation margin or an applied haircut that has not been resolved within a reasonable period of time, if any of the following apply:

a. the dispute is material;

b. the **covered institution** has more than one dispute with its **covered counterparty** and, together, those disputes are material;

c. the dispute is part of a pattern of disputes involving one or more **covered counterparties**.

The AMF further expects a **covered institution** to notify it of any dispute that has not been resolved within a reasonable period of time after the **covered institution** escalated the dispute to its decision-making bodies.

DRAFT

6. Implementation of expectations for the exchange of variation margin and initial margin

The AMF's expectations in respect of the exchange of variation margin have been in effect since March 1, 2020.

The expectations in respect of the exchange of initial margin are effective:

- September 1, 2021 for any **covered institution** belonging to a **financial group** whose aggregate month-end average gross notional amount of outstanding covered derivatives for the months of March, April and May 2021, excluding derivatives traded between entities of the same **financial group**, exceeds $75 billion;

- September 1, 2022 for any other **covered institution**.

DRAFT

Annex 1

Standardized initial margin schedule

Asset class	Initial margin (% of notional exposure)
Credit: residual maturity of 0–2 years	2
Credit: residual maturity of 2–5 years	5
Credit: residual maturity of 5+ years	10
Commodity	15
Equity	15
Foreign exchange	6
Interest rate: residual maturity of 0–2 years	1
Interest rate: residual maturity of 2–5 years	2
Interest rate: residual maturity of 5+ years	4
Other	15

DRAFT

Annex 2

List of multilateral development banks

- International Bank for Reconstruction and Development (IBRD)
- International Finance Corporation (IFC)
- Asian Development Bank (ADB)
- African Development Bank (AfDB)
- European Bank for Reconstruction and Development (EBRD)
- Inter-American Development Bank (IADB)
- European Investment Bank (EIB)
- European Investment Fund (EIF)
- Nordic Investment Bank (NIB)
- Caribbean Development Bank (CDB)
- Islamic Development Bank (IDB)
- Council of Europe Development Bank (CEDB)

DRAFT

Annex 3

Standardized haircut schedule

Asset class	Haircut (% of market value)
Cash in the same currency	0
Debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada or a foreign government or a foreign central bank: residual maturity of one year or less	0.5
Debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada or a foreign government or a foreign central bank: residual maturity of greater than one year and less than five years	2
Debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada or a foreign government or a foreign central bank: residual maturity of greater than five years	4
High-quality corporate/covered bonds: residual maturity of one year or less	1
High-quality corporate/covered bonds: residual maturity of greater than one year and less than five years	4
High-quality corporate/covered bonds: residual maturity greater than five years	8
Equities listed on a recognized exchange	15
Gold	15
Additional haircut on assets in which the currency of the covered derivatives differs from the currency of the collateral	8

DRAFT