The Final Version Of Guideline E-22 — Margin Requirements For Non-Centrally Cleared Derivatives — What's New?

March 21, 2016

The OSFI published the final version of Guideline E-22 — Margin Requirements for Non-Centrally Cleared Derivatives

On February 29, 2016, the Office of the Superintendent of Financial Institutions (OSFI) published the final version of Guideline E-22 — Margin Requirements for Non-Centrally Cleared Derivatives. The purpose of the Guideline is to provide clear and comprehensive guidance to all federally-regulated financial institutions1 (FRFIs) on the variation and initial margin requirements that will take effect starting September 1, 2016, consistent with the timing required by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) framework.

This final version of the Guideline is the result of a public consultation that commenced with the issuance of a draft Guideline on October 19, 2015. The final Guideline incorporates several revisions resulting from comments received by OSFI during this period. Consistent with the draft Guideline, the final form of the Guideline requires the exchange of margin to secure the performance of non-centrally cleared derivatives (NCCD) transactions, which are derivative transactions that are not cleared through a central counterparty, between Covered Entities (as defined in the Guideline). This final Guideline is available here.

As recognized by OSFI in its Guideline Impact Analysis Statement, NCCDs contribute significantly to systemic risk in the financial sector. By requiring that collateral be available to offset losses caused by the default of a derivatives counterparty, margin can mitigate this systemic risk and offer heightened protection against counterparty credit risk. In addition, OSFI expects that implementing margin requirements will promote central clearing of derivatives where practicable.

Background

In September 2013, the BCBS and IOSCO released an initial draft of a framework setting out the minimum standards for margin requirements for NCCDs. Canada, as a member of BCBS, participated in the development of this framework. Revised in March

2015, this framework now requires the mandatory exchange of initial and variation margin for NCCDs beginning on September 1, 2016.

By and large, the final version of the Guideline does not differ substantially from the draft published in October 2015. However, OSFI has incorporated certain revisions to the Guideline as a result of comments made during the consultation period in order to clarify, expand upon, or change certain provisions of the Guideline.

One of the questions raised by OSFI at the outset of the public consultation period last October was how margin requirements should be regulated in the context of NCCD transactions in Canada. OSFI sought feedback on whether it should opt to create its own guideline that would provide domestic margin requirements or alternatively whether it should rely on the BCBS/IOSCO framework to communicate these requirements. In line with its stated preference for the former approach in the draft Guideline, OSFI has concluded, with the release of the final Guideline, that a comprehensive domestic margin requirements guideline is the most appropriate option for ensuring that institutions understand and apply the guidance correctly.

Consistent with the draft Guideline, this final Guideline is based on the BCBS/IOSCO framework. According to OSFI, the Guideline is both consistent with the provisions of the BCBS/IOSCO framework, and supports the BCBS' financial stability objectives, while "giving due recognition to the constraints imposed by Canada's place in the global market." Given the cross-border nature of the derivatives market, OSFI notes that the Guideline may also support "equivalency or comparability assessments of Canadian derivatives regulatory requirements by other jurisdictions."

The Requirements

Who is Covered?

The Guideline applies to all FRFIs and their Covered Counterparties, i.e. non-FRFI counterparties that meet the definition of a Covered Entity. A Covered Entity is defined in the Guideline 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 2016 and any year thereafter exceeds $12 billion. Prior to entering into a transaction, FRFIs are expected to self-declare themselves as Covered Entities (assuming they meet the requirements) and are responsible for confirming whether their counterparties are Covered Entities as well.

In contrast to the draft Guideline, non-financial entities are excluded altogether from the definition of Covered Entity in the final Guideline. As stated by OSFI, this exclusion was accepted after several commenters argued that non-financial entities are typically end users who use derivatives solely for hedging purposes and are excluded from the definition of a Covered Entity in the margin rules of most foreign jurisdictions.

Certain financial entities remain excluded from the definition of a Covered Entity. OSFI has provided an exemption to small and medium-sized financial entities (i.e. entities who do not belong to a consolidated group and whose notional amount of non-centrally cleared derivatives for a year does not exceed $12 billion) that would only face a low degree of risk in virtue of their non-material exposure to NCCDs. Significantly, in this connection OSFI has provided that investment funds that are managed by an

investment advisor are considered distinct entities that are treated separately when applying the monetary threshold for determining whether it is a Covered Entity as long as the funds are distinct legal entities that are not collateralised by or are otherwise guaranteed or supported by other investment funds or the investment advisor in the event of fund insolvency or bankruptcy.

However, the final Guideline also expands the list of entities which are excluded from the definition of Covered Entity. This list now includes : (i) sovereigns, (ii) public sector entities,2 (iii) multilateral development banks eligible for a zero risk weight in the Capital Adequacy Requirements (CAR) Guideline, (iv) the Bank for International Settlements, (v) central counterparties, (vi) treasury affiliates that undertake risk management activities on behalf of affiliates within a corporate group, (vii) 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), (viii) 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, (ix) any SPE established for the purpose of acquiring or investing in real estate and (x) any collective investment vehicle established for the purpose of investing in real estate or other physical assets.

In addition, intra-group trades (i.e. non-centrally cleared derivatives between a Covered FRFI and its affiliates) and trades with certain specified multilateral development banks such as the European Investment Bank (EIB), the Asian Development Bank (ADB), the African Development Bank (AfDB) and International Finance Corporation (IFC), among others, are explicitly stated to exempt from the margin requirements.

After several commenters requested that OSFI provide further deference to foreign rules when FRFIs trade with foreign counterparties, OSFI established in the final Guideline a process for achieving substituted compliance for foreign rules.

In this connection, to avoid duplicative or conflicting margin requirements on a single set of transactions, the Guideline provides rules that will allow a foreign bank branch or foreign insurance company operating in Canada that is a Covered Entity as well as a Covered FRFI trading with a foreign Covered Counterparty to be deemed in compliance with OSFI's margin requirements if certain requirements are met.

OSFI has also addressed situations where the FRFI and the counterparty are located in different jurisdictions and has provided rules for determining when a counterparty's home jurisdiction can be deferred to for the purposes of determining whether the counterparty is a Covered Entity.

What Type of Transactions are Covered?

In general, the margin requirements outlined in the Guideline apply to all NCCDs with the exception of physically settled foreign exchange (FX) forwards and FX swaps. However, NCCDs between a FRFI that is a Covered Entity and its affiliates (i.e. intra-group trades) are not subject to the margin requirements of the Guideline.

What type of Collateral is Permitted?

The following types of collateral are eligible to satisfy both variation and initial margin requirements: (a) cash (in the form of money credited to an account or similar claims for the repayment of money, such as certificates of deposit or comparable instruments issued by a Covered Entity); (b) gold; (c) debt securities rated by a rating agency that meet certain defined threshold rating levels; (d) debt securities not rated by a rating agency if they are issued by a bank, listed on a recognized exchange, classified as senior debt, all rated issues of the same seniority by the issuing bank meet certain defined threshold rating levels and the institution holding the securities as collateral has no information to suggest that the issue justifies a rating below such rating; (e) equities (including convertible bonds) that are included in a main index; (f) equities (including convertible bonds) which are not included in a main index but which are listed on a recognized exchange; and (g) Undertakings for Collective Investments in Transferable Securities (UCITS) and mutual funds if a price for the units is publicly quoted daily and the UCITS/mutual fund is limited to investing in the instruments listed above. Securities issues by the posting counterparty are not eligible collateral.

Any margin exchanged must be subject to a haircut to account for potential changes in the value of the collateral. Haircuts may be computed using an internal model if the internal model meets the requirements set out in the Guideline.

Margin not subject to the additional haircut includes cash variation margin and initial margin exchanged in a currency other than the termination currency that the posting party has designated in the relevant contract when the currency of the asset differs from the currency of collateral and non-cash variation margin other than the type described below.

In contrast, margins subject to the additional haircut include all other initial margin other than the type described above and non-cash variation margin exchanged in a currency other than the ones agreed in the relevant contract are subject to the additional haircut when the currency of the asset differs from the currency of the collateral. How the haircuts are calculated is described in detail in the Guideline.

How is Margin Posted?

Collateral must be posted for both variation margin and initial margin. The Guideline contains a number of requirements in this connection, including the required amount to be exchanged, how and when margin should be calculated and called as well as the manner in which margin should be exchanged. F or both variation margin and initial margin, parties must have "rigorous and robust" dispute resolution procedures in place with their counterparty before entering into a NCCD transaction.

For initial margin requirements, the required amount may be calculated by reference either to (i) an internal quantitative portfolio margin model; or (ii) a standardized margin schedule. The specific method and parameters used by each party must be agreed upon prior to a transaction, and this choice must be consistent for all transactions within the same asset class, unless a counterparty otherwise requires. Moreover, a party may only use the internal model if it meets certain criteria set out by OSFI in the Guideline, such as the establishment of internal governance and validation processes, modelling and documentation requirements, and mandatory periodic reviews and escalation procedures.

OSFI took into account commenters' concerns regarding the practical achievability of having to calculate and call the first initial margin on a daily basis by allowing for the first initial margin call to occur within two business days of the execution of the trade and on a daily basis thereafter.

With respect to variation margin, OSFI has stated that the full amount necessary to fully collateralize the mark-to-market exposure of the NCCDs must be exchanged, subject to the minimum transfer amount for all margin transfers (which is not to exceed $750,000). In addition, to reduce adverse liquidity shocks and in order to effectively mitigate counterparty credit risk, OSFI has required that variation margin should be calculated and exchanged for NCCDs subject to a single, legally enforceable netting agreement, which would include an ISDA Master Agreement. At the request of commenters, who requested clarification on how to deal with "non-netting" counterparties where bankruptcy regimes or legal systems may make the enforceability of netting agreements difficult to verify, OSFI provided conditions for a netting agreement to be deemed legally enforceable. When a Covered FRFI enters into a netting agreement with a Covered Entity that is not legally enforceable, Covered FRFIs must collect variation margin amounts on a gross basis.

The amount of initial margin and variation margin required must be calculated and called within two business days of the execution of a trade, and thereafter on a daily basis, and it must be exchanged (posted/received) on or before the second business day following each call for initial margin or variation margin, as applicable.

When are the Requirements in Effect?

The requirement to exchange variation margin will be phased-in for certain FRFIs from September 1, 2016 to February 28, 2017. On a permanent basis thereafter, all Covered FRFIs will be subject to the requirements when transacting with another Covered Entity.

The requirement to exchange two-way initial margin with a threshold of up to $75 million will be phased-in from September 1, 2016 to August 31, 2020. On a permanent basis thereafter, all Covered FRFIs (subject to certain exceptions) will be subject to the initial margin requirements when transacting with another Covered Entity.

Initial margin and variation margin requirements will apply to all new contracts entered into during the phase-in periods. In this connection, genuine amendments to existing derivatives contracts as well as novations of grandfathered trades and "new" non-centrally cleared derivatives that result from portfolio compression of grandfathered trades will not qualify as new derivatives contracts. However, OSFI has stated that any amendment that is intended to extend an existing derivatives contract for the purpose of avoiding margin requirements, as well as new non-centrally cleared transactions resulting from compressions of both grandfathered transactions and transactions which are subject to mandatory margin requirements will be considered new derivatives contracts and will be subject to the margin requirements of this Guideline. Applying the initial margin and variation margin requirements to existing derivatives contracts is not required. Of course, a Covered FRFI may choose to do so as long as this is bilaterally agreed upon with the counterparty. A Covered FRFI cannot alternate between applying the margin requirements to all NCCDs and only apply them to new NCCDs to reduce margin requirements. OSFI has stated that this choice should be made consistently over time on a counterparty by counterparty basis.

Contact Us

If you would like further information or would like to discuss or comment on the Guideline, please contact the authors of this alert or any other member of the BLG Derivatives Group.

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[1] For the purposes of the Guideline, federally-regulated financial institution refers to banks, foreign bank branches, bank holding companies, trust and loan companies, cooperative credit associations, cooperative retail associations, life insurance companies, property and casualty insurance companies and insurance holding companies.

[2] Public sector entities are defined as (i) entities directly or wholly-owned by a government, (ii) school boards, hospitals, universities and social service programs that receive regular government financial support and (iii) municipalities.

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