HKMA consults on revisions to margin and risk mitigation standards for non-centrally cleared derivatives

2 June 2020

On 25 May 2020, the Hong Kong Monetary Authority published a revised Module CR-G-14 of the Supervisory Policy Manual (the “HKMA Margin and RMS Module”) which contains the HKMA’s margin requirements and other risk mitigation standards for non-centrally cleared derivatives transactions. The market is invited to respond to the proposed revisions by 25 June 2020.

We set out the key proposals in this Bulletin.

Substituted compliance

The HKMA is proposing to add certain conditions to the application of substituted compliance for both margin requirements and risk mitigation standards (RMS).

An authorized institution (AI) incorporated outside Hong Kong who wishes to comply with its home rules using substituted compliance can continue to do so as long as the home jurisdiction is one of the WGMR member jurisdictions¹ deemed as comparable or one for which the HKMA has issued a comparability determination (and the AI should follow its home rules in their entirety). However, under the HKMA’s proposed revisions, if the home rules cover a different product scope, the home rules should at least be applied to the product scope in the HKMA Margin and RMS Module.

With respect to all AIs (whether Hong Kong-incorporated or overseas-incorporated), it is proposed that in applying substituted compliance, they are still required to comply with certain requirements under the HKMA Margin and RMS Module. These are detailed in a new paragraph 2.3.12 in the HKMA Margin and RMS Module and include the requirement to seek formal approval from or notify the HKMA on the use of initial margin (IM) models, and certain RMS requirements on retaining trading relationship documentation, maintaining records for unconfirmed transactions and reporting to the HKMA on unresolved disputes.

¹ WGMR member jurisdictions comprise Australia, Brazil, Canada, the European Union, Hong Kong, India, Japan, Republic of Korea, Russia, Singapore, Switzerland, the United Kingdom and the United States. Brazil and the United Kingdom are two new jurisdictions proposed to be added. Mexico was on the list and now proposed to be removed.

Contents

| Substituted compliance | 1 |
| Phase-in schedule for initial margin (IM) and risk mitigation standards (RMS) | 2 |
| Single stock equity options, equity basket options and equity index options | 2 |
| Benchmark reform | 2 |
| Hedging exemption | 2 |
| Risk mitigation standards | 3 |
The HKMA is also proposing to amend the phase-in schedule for RMS as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase 4: 1/9/2019 to 31/8/2020 &amp; 1/9/2020 to 31/8/2021</td>
<td>HK$6 trillion</td>
</tr>
<tr>
<td>Phase 5: 1/9/2021 to 31/8/2022</td>
<td>HK$375 billion</td>
</tr>
<tr>
<td>From 1/9/2022 onwards</td>
<td>zero</td>
</tr>
</tbody>
</table>

AIs should note that a different threshold applies to IM and RMS requirements in the period from 1 September 2021 to 31 August 2022 (Phase 5). The HKMA indicated that for AIs that have not yet been subject to IM requirements by 1 Sept 2021, they should comply with the RMS requirements except for those elements that would only be applicable upon the implementation of IM requirements. AIs which may not reach the IM threshold for Phase 5 should nonetheless monitor their thresholds and prepare for RMS implementation if required.

Phase-in schedule for initial margin and risk mitigation standards

Amendments to the phase-in schedule for IM will now be formally included in the HKMA Margin and RMS Module once the module becomes effective following the consultation process. As confirmed by the HKMA in its circular to AIs on 25 May 2020 (Additional measures to alleviate the impact of Covid-19), the final two implementation phases of margin requirements for non-centrally cleared OTC derivatives will be deferred by an additional year as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase 4: 1/9/2019 to 31/8/2020 &amp; 1/9/2020 to 31/8/2021</td>
<td>HK$6 trillion</td>
</tr>
<tr>
<td>Phase 5: 1/9/2021 to 31/8/2022</td>
<td>HK$60 billion</td>
</tr>
</tbody>
</table>

Single stock equity options, equity basket options and equity index options

Consistent with the treatment of these products under the European Market Infrastructure Regulation (EMIR) and the margin rules of the Securities and Futures Commission (SFC), margin requirements for non-centrally cleared single stock equity options, equity basket options and equity index options will be deferred to 4 January 2021.

Benchmark reform

Genuine and non-material amendments to legacy contracts will not result in such legacy contracts being considered as new contracts subject to margin requirements. The HKMA gave an example that genuine amendments to existing derivatives contracts which are made to give effect to interest rate benchmark reforms will not be considered new contracts. It would be helpful if the HKMA can clarify that amendments to include fallback provisions for other types of benchmarks are also covered. This would be consistent with the SFC’s approach.

Hedging exemption

The HKMA proposes to add a new exemption for counterparties which use non-centrally cleared derivatives for hedging purposes. Under this new exemption, an AI may elect not to exchange IM or VM with a covered entity that primarily provides financing to facilitate the purchase or lease of products manufactured by the entity’s parent company or fellow subsidiaries and predominantly uses non-centrally cleared derivatives.
transactions for hedging purposes, provided that the AI has put in place internal risk management policies and procedures in accordance with the requirements set out in the HKMA Margin and RMS Module and has obtained a declaration from the counterparty that it predominantly uses the non-centrally cleared derivatives for hedging purposes.

Since a similar hedging exemption is currently provided under the HKMA Margin and RMS Module for significant non-financial counterparties that predominantly uses non-centrally cleared derivatives transactions for hedging purposes, the proposed expansion would appear to be most relevant to group financing entities which may be financial counterparties. Note that both the existing hedging exemption for significant non-financial counterparties and the proposed new hedging exemption as described above do not affect how AANA is to be calculated for a counterparty: hedging transactions are to be included in the AANA calculation in accordance with paragraph 2.4.9 of the HKMA Margin and RMS Module.

**Risk mitigation standards**

More prescriptive requirements are proposed to be added to the portfolio reconciliation requirement and the dispute resolution requirement. AIs are advised to ensure that documentation and procedures are set up properly to comply with these requirements.

**Portfolio reconciliation**

Counterparties are required under the current rules to reconcile any discrepancy in valuation that is more than 10 per cent. of the higher valuation. The HKMA now specifies in the proposed revisions that the valuation reconciliation threshold of 10% could be applied at the netting set level. Once the 10% threshold is exceeded, all the transactions in the netting set portfolio need to be reconciled. An AI may also apply a reconciliation threshold at the transaction level which is agreed with its counterparty taking into account the risk profile of the portfolio. As to the material terms of outstanding transactions in a non-centrally cleared derivatives portfolio, they should be reconciled at the transaction level.

**Dispute resolution**

An AI should report to the HKMA any material disputes in excess of HK$100 million (or its equivalent in any other currency) if not resolved within 15 business days. The HKMA now prescribes that with respect to the exchange of margin, the HK$100 million threshold is applied to the AI’s disputes with its counterparty on VM and IM respectively.

The above highlights the key proposals in the HKMA’s consultation and is not meant to be an exhaustive discussion. Linklaters has extensive experience in assisting clients with margin implementation projects and would be delighted to assist you with working through the HKMA’s proposed changes.
Contacts

Hong Kong SAR

Chin-Chong Liew
Partner
Tel: (+852) 2842 4857
Mob: (+852) 9303 8928
chin-chong.liew@linklaters.com

Victor Wan
Partner
Tel: (+852) 2901 5338
Mob: (+852) 9861 1399
victor.wan@linklaters.com

Stephen Song
Partner
Tel: (+852) 2901 5440
Mob: (+852) 6111 4837
stephen.song@linklaters.com

Karen Lam
Partner
Tel: (+852) 2842 4871
Mob: (+852) 6279 0124
karen.lam@linklaters.com

I-Ping Soong
Counsel
Tel: (+852) 2901 5181
Mob: (+852) 6343 0315
i-ping.soong@linklaters.com

Simon Zhang
Counsel
Tel: (+852) 2842 4844
Mob: (+852) 6407 4324
simon.zhang@linklaters.com

Jenny Wong
Senior PSL
Tel: (+852) 2901 5560
Mob: (+852) 6500 3566
jenny.wong@linklaters.com

Ying Zhou
Managing Associate
Tel: (+852) 2842 4153
Mob: (+852) 6117 2183
ying.zhou@linklaters.com

Simon Kwan
Associate
Tel: (+852) 2901 5341
Mob: (+852) 6316 0933
simon.kwan@linklaters.com

Carmen Yam
Legal Assistant
Tel: (+852) 2901 5313
Mob: (+852) 6316 9816
carmen.yam@linklaters.com
This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

© Linklaters. All Rights reserved 2020

Linklaters operates in the Hong Kong Special Administrative Region (SAR) through the Hong Kong SAR branch of an English law partnership under the name of Linklaters. Linklaters is affiliated with Linklaters LLP, a limited liability partnership registered in England and Wales with registered number OC326345. Linklaters LLP is a law firm authorised and regulated by the Solicitors Regulation Authority. The term partner in relation to Linklaters LLP is used to refer to a member of the Linklaters LLP or an employee or consultant of Linklaters LLP or any of its affiliated firms or entities with equivalent standing and qualifications. A list of the names of the members of Linklaters LLP and of the non-members who are designated as partners and their professional qualifications is open to inspection at its registered office, One Silk Street, London EC2Y 8HQ, England or on www.linklaters.com. This document contains confidential and proprietary information. It is provided on condition that its contents are kept confidential and are not disclosed to any third party without the prior written consent of Linklaters. Please refer to www.linklaters.com/regulation for important information on our regulatory position.

We process your data in line with our Global Privacy Notice. You can view this at www.linklaters.com/en/legal-notices/privacy-notice.

To opt-out of receiving any marketing emails from us, or to manage your email preferences and the personal details we hold for you, please contact: marketing.database@linklaters.com.

Author: Jenny Wong