Letter

Title	Derivatives Sound Practices – Letter (2015)
Category	Sound Business and Financial Practices
Date	January 30, 2015
Sector	Banks Foreign Bank Branches Life Insurance and Fraternal Companies Property and Casualty Companies Trust and Loan Companies

To: Banks, Foreign Bank Branches, Bank Holding Companies , Federally Regulated Trust and Loan Companies, Co-operative Credit and Co-operative Retail Associations, Federally Regulated Insurers and Insurance Holding Companies

OSFI is issuing the final version of the Guideline, which replaces the 1995 Guideline B-7 Derivatives Best Practices that first outlined expectations for federally-regulated financial institutions (FRFIs) with respect to derivative activities. The Guideline reflects the over-the-counter (OTC) derivatives market reforms initiated by G-20 leaders and communicates OSFI's expectations for central clearing of standardized OTC derivatives and reporting derivatives data to a trade repository. It also reflects current practices with respect to the risk management of derivatives activities. OSFI expects that the sophistication of an institution's risk management practices and measurement techniques will depend on the nature, size, and complexity of its derivatives activities, and the Guideline therefore recognizes the distinction between the requirements for dealers versus FRFIs that are primarily end-users of derivatives. The Guideline complements OSFI's Supervisory Framework and Assessment Criteria and other relevant OSFI guidance.

In the Guideline, reference may be made to rules promulgated by other regulators, including provincial securities regulators, which are considered to be applicable to FRFIs by virtue of this Guideline. OSFI will monitor FRFIs' compliance with these requirements. OSFI is also monitoring changes to federal legislation, including the *Bank Act*,

where an explicit regulation-making authority has been added regarding the OTC derivatives activities of banks. OSFI is planning the application to FRFIs of an international policy framework establishing initial and variation margin requirements for non-centrally cleared derivatives at a future date to be communicated in 2015. Future revisions to OSFI guidance will be considered, where appropriate, to ensure that a consistent and comprehensive set of rules continue to apply to the OTC derivatives activities of banks and other FRFIs.

The Guideline incorporates several revisions resulting from comments received during the public consultation process, which began in October 2014. The attached table (Annex 1) summarizes material comments received from industry stakeholders and provides an explanation of how they have been addressed. We thank all those who participated in the consultation process.

The Guideline was effective on November 1, 2014, in order to coincide with the timing of the provincial derivatives data reporting requirements coming into effect. Questions and comments on the Guideline should be sent by email to Joanne Marsden, Senior Analyst, Bank Capital (Joanne.Marsden@osfi-bsif.gc.ca).

Yours truly,

Mark Zelmer

Deputy Superintendent

Annex 1: Summary of Comments Received and OSFI Resolution

Comment	OSFI Response
Definition – P.4	
Suggest deleting the word "market" in the first sentence of this section to appropriately expand the use of derivatives beyond only market risk.	OSFI agrees and the change had been made.
Risk Management – P. 5	
Greater clarity was requested with respect to OSFI's expectations in the context of the phrase "FRFIs should clearly define the nature and types of incidents with respect to its derivatives activities that would constitute issues requiring escalation to senior management and/or the Board."	This was revised for greater consistency with other OSFI guidance as follows "Effective control, monitoring and reporting systems and procedures should be in place to ensure on-going operational compliance with the Risk Appetite Framework."
Market Risk – P.5	
Valuation Adjustments – P. 8	
Any approach to calculate such adjustments should take into account the materiality of such risks. Dealers and active position takers may need more sophisticated models than end-users.	OSFI acknowledges that end-users may generally need less sophisticated models and FRFIs should consider what valuation adjustments are "relevant".
Credit Risk – P.8	
It is unclear what "exceptions to non-standard International Swaps and Derivatives Association (ISDA) terms" would be as all ISDA Master Agreements contain individually negotiated terms. Amend the sixth bullet to specify the approval requirement is for approval of non-standard **credit-related** ISDA terms, as ISDA master agreements often include non-standard non-credit terms that should be approved by the appropriate independent control.	This has been revised to "non-standard **credit-related** ISDA terms". The intention is to ensure that amendments to any of the standard ISDA terms are approved by the independent risk function.

Comment	OSFI Response
Provide clarity on the statement "For end-users, these functions may be embedded into an enterprise-wide credit risk management framework" as a FRFI may be both an end-user and a dealer.	OSFI's expects that the credit risk management function should have analytical capabilities commensurate with the complexity and sophistication of the FRFI's derivatives activities. FRFIs that act as both end-users and dealers would be held to higher standards than those that use derivatives exclusively as end-users.
Measurement of Credit Risk Exposure – P. 9	
Reference to wrong way risk could raise inconsistencies with capital and the internal model method (IMM). Meeting capital requirements guidelines by means of the IMM for EAD should be deemed to satisfy best practice requirements.	Not all FRFIs use the IMM, and the internal credit risk management systems in place should be appropriate for the FRFI commensurate with the nature, size and complexity of its activities.
Netting and Margining – P.10	
The requirement to obtain enforceability opinions, which are usually obtained via membership in ISDA, should not be applicable to end-users as many are not currently ISDA members.	The expectation is that FRFIs used netting agreements "where practicable". The requirement for an enforceability opinion is consistent with the netting requirements for capital purposes.
Greater clarity was requested with respect to netting and margining expectations for limited end-users.	OSFI believes netting and margining are good practices for controlling exposure and risk management purposes, and should be done by FRFIs where practicable. OSFI is planning the application to FRFIs of an international policy framework establishing initial and variation margin requirements for non-centrally cleared derivatives at a future date to be communicated in 2015. The introduction of new OSFI guidance will follow the normal consultation process.
Central Clearing by FRFIs – P. 11	

Comment	OSFI Response
Amend the first sentence to "where practicable **and appropriate** , **new** standardized derivatives **transactions** in which it is transacting where the clearing of such products is offered by **a CCP or** a QCCP" as there may be cases where central clearing may be practicable but not appropriate from a risk management perspective.	The term "where practicable" allows a FRFI to exercise reasonable judgment, but OSFI expects that all central clearing by FRFIs should be done through a QCCP. OSFI has incorporated " **new** standardized derivatives **transactions** " into the sentence.
Amend the sentence re: indirect clearing to "For FRFIs that do not qualify for direct membership, **or choose not to become direct members for business and/or credit reasons** , indirect clearing may be available as an alternative means of accessing central clearing.	OSFI expects that FRFIs centrally clear where practicable but is not prescribing the manner in which this should be accomplished. The sentence has been revised to read "for FRFIs that are not direct clearing members…"
Greater clarity was requested with respect to the use of central clearing entities by limited end-users.	OSFI acknowledges that central clearing may not currently be practicable for all FRFIs in all circumstances. The requirement for central clearing is "where practicable" which allows a FRFI to exercise reasonable judgment with respect to the scope and timing of the move to central clearing of standardized OTC derivatives, consistent with the G-20 commitment. OSFI believe that appropriate incentives are in place to promote central clearing by FRFIs. OSFI is monitoring the development of mandatory central clearing rules by other regulators, and future revisions to OSFI guidance will be considered to ensure there are comparable requirements across jurisdictions in order to provide a level playing field for all counterparties.
Liquidity Risk – P. 12	
Collateral Management – P. 12	
Delete the word "actively" from the requirement to manage its collateral positions.	This term is consistent with other OSFI guidance and is appropriate in this context.
Operational Risk – P. 13	

Comment	OSFI Response
Risk related to derivatives should be considered in a FRFI's "significant business units".	The sentence has been revised to read "If derivatives products, activities, processes or systems are material to the FRFI, the inherent operational risk should be identified, assessed and understood…" The concept of materiality should provide sufficient flexibility, and the proposed exemption may be inconsistent with other OSFI guidance.
Legal Risk – P. 13	
Requiring all material terms to be agreed in writing prior to executing a non-centrally cleared derivative would in some cases be a significant change from current practices and would place FRFIs at a competitive disadvantage relative to non-FRFIs and foreign market participants.	OSFI believes that FRFIs should seek to agree in writing to all material terms prior to or at the time of execution of a non-centrally cleared derivative, as this is a good practice which promotes legal certainty. OSFI understands that a similar requirement for other market participants (non-FRFIs) may be considered in the future as part of an international policy framework.
Stress Testing – P.14	
The effects of price changes on the close-out value of the portfolio as well as changes in assumptions about the adjustments to the close-out price may not be an applicable or appropriate consideration for FRFIs using derivatives to hedge complex structured liabilities.	OSFI acknowledges that stress testing scenarios should be appropriate for the FRFI based on the nature, size and complexity of its involvement in derivatives, and has incorporated "if appropriate" in this sentence.
Please provide greater clarity on existing and/or future guidelines addressing the following requirements: explicit stress testing of wrong way risk; potential enhancements in capturing liquidity constraints ("prolonged inactivity"); evaluation of the effect of price changes on the close-out cost of the derivatives portfolio; and, evaluation of the breakdown in historically stable correlation relationships.	A reference to OSFI Guideline E-18 Stress Testing has been added. Future updates to OSFI guidance will be made as required.
System Infrastructure Considerations – P. 15	
Portfolio Compression – P. 15	

Comment	OSFI Response
It may not be feasible for end-users to engage in portfolio compression.	OSFI acknowledges that portfolio compression may not always be feasible for end-users with low volumes or primarily directional trades, and has reflected this in the wording. The requirement is to **periodically assess** the potential for portfolio compression and, **where appropriate** , engage in portfolio compression.
Portfolio Reconciliation – P. 15	
This section should acknowledge that a FRFI cannot compel counterparties to reconcile, and should clarify that this requirement only applies to un-cleared derivatives.	OSFI acknowledges this, and would note that the requirement is for FRFIs to " **seek to** periodically engage in portfolio reconciliation of **uncleared** derivatives".
Reporting Obligation – P.16	
The words "or cause to be reported" suggest that an end-user is responsible for ensuring dealer counterparties report trades.	The provincial data reporting requirements that OSFI directs FRFIs to follow address the reporting hierarchy. In order to avoid duplication or inconsistency, OSFI has removed "or cause to be reported".
FRFIs should report derivatives transactions following the derivatives data reporting requirements that have been adopted in the province in which **the head office and/or** the principal place of business of the FRFI is located.	The suggested wording has been incorporated into the guideline.
Please clarify that FRFIs are not to breach any foreign privacy and data protection laws in order to comply with this section.	OSFI understands that certain FRFIs have obtained relief from provincial and foreign derivatives data reporting requirements related to foreign privacy and data protection laws, and therefore does not believe that changes to the section are required.
Greater clarity was requested with respect to the annual compliance report requirement.	A reference to OSFI Guideline E-13, which addresses reporting by the chief compliance officer (CCO), was added. OSFI expects that this will include an assessment of compliance with the local reporting requirements. The wording has been revised and this requirement has been limited to dealers.
Greater clarity was requested with respect to expectations for reporting to TRs by limited end-users.	The provincial data reporting requirements apply to all FRFIs pursuant to Guideline B-7. The timing and content of the reporting obligation for different market participants are specified in the local reporting requirements.