



Bank of Russia

The Central Bank of the Russian Federation



DECEMBER 2017

**FINAL
REPORT**

**ON MANDATORY MARGINING
OF NON-CENTRALLY
CLEARED OTC DERIVATIVES**

MOSCOW

This is an unofficial translation for information purposes only. If there are any discrepancies between the original Russian version and this translated version, the original Russian version shall prevail.

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ABBREVIATIONS

BCBS – Basel Committee on Banking Supervision

G20 – The Group of Twenty

FSB – Financial Stability Board

IOSCO – International Organization of Securities Commissions

ISDA – International Swaps and Derivatives Association

Variation Margin – security intended to cover the current exposure of a position (positions) caused by actual changes in the market value of the underlying asset of a derivative

CC RF – Civil Code of the Russian Federation

Directive 2002/47/EC – Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements

Law on Banks – Federal Law No. 395-1, dated 2 December 1990, ‘On Banks and Banking Activities’

Law on Bankruptcy – Federal Law No. 127-FZ, dated 26 October 2002, ‘On Insolvency (Bankruptcy)’

Law on the Securities Market – Federal Law No. 39-FZ, dated 22 April 1996, ‘On the Securities Market’

Instruction 180-I – Bank of Russia Instruction No. 180-I, dated 28 June 2017, ‘On Banks’ Statutory Ratios’

Haircut – a discount applicable to the price of an asset provided as an Initial or Variation Margin to cover possible change in its value during the period between the last revaluation of the asset and time of its sale

Margining – provision by one party of a derivative to the other party or exchange of assets (margin payments) between such parties to secure their performance under the derivative

Initial Margin – security intended to cover potential change in counterparty’s position in derivatives (potential exposure) during the liquidation period of such position (positions) upon the counterparty’s failure to discharge its obligations

IFRS – International Financial Reporting Standards

NSD – National Settlement Depository

NCC derivatives – derivatives settled outside the organised trading, which are not cleared through a central counterparty (non-centrally cleared derivatives)

Derivative – a contract which is a derivative financial instrument in accordance with the laws of the Russian Federation, unless otherwise specified herein

Repository – a legal entity conducting repository activity in accordance with the laws of the Russian Federation

DB – Derivatives Board

Ordinance 3565-U – Bank of Russia Ordinance No. 3565-U, dated 16 February 2015, ‘On Types of Derivative Financial Instruments’

CCP – central counterparty

INTRODUCTION

In 2011 the G20 leaders decided that it would be expedient to adopt mandatory margining of non-centrally cleared derivatives to enhance the stability of the financial system¹. This decision complemented the program for reforming the OTC derivatives market approved at the G20 summit in Pittsburgh in 2009².

The joint standards document of the BCBS and IOSCO 'Margin Requirements for Non-Centrally Cleared Derivatives' (published in March 2015)³ (hereinafter 'the BCBS-IOSCO Standards') mentions that the purpose of introducing mandatory margining of non-centrally cleared derivatives is to reduce systemic risk. A great deal of derivatives are not standardised and, therefore, cannot be cleared through a CCP. Margining requirements are meant to prevent a series of defaults (cross-defaults) if one of the parties to a derivative fails to discharge its obligations by using the collateral to repay the debt. Margin requirements can also have a broader positive effect by reducing the financial system's vulnerability to destabilizing procyclicality and limiting the build-up of uncollateralised exposures on the financial market.

Furthermore, margin requirements for non-centrally cleared derivatives which reflect the higher risks associated with such derivatives promote the standardisation of OTC derivatives and, as a result, the clearing of standardised OTC derivatives with the participation of CCPs.

The BCBS-IOSCO Standards contain eight main elements which were used as the basis for preparing this Report:

1) Appropriate margining practices should be in place with respect to all derivatives transactions that are not cleared by CCPs (considering the exception set for some deliverable derivatives).

2) All financial organisations and systemically important non-financial entities that engage in OTC derivatives must exchange Initial and Variation Margins corresponding to the counterparty risks posed by such transactions (using the appropriate threshold values).

3) The methodologies for calculating Initial and Variation Margins should: (i) be consistent across entities covered by the requirements for mandatory margining of non-centrally cleared derivatives; (ii) reflect the potential exposure (Initial Margin) and current exposure (Variation Margin) associated with the portfolio of derivatives in question; and (iii) ensure that all counterparty risk exposures are fully covered with a high degree of confidence.

4) Assets collected as margin should be highly liquid and should, after accounting for an appropriate haircut, be able to preserve their value in a time of financial stress. The purpose of this element is to enable prompt liquidation of the collateral in the amount required to cover losses resulting from a counterparty's default on the derivative.

5) Initial Margin should be exchanged by both parties, without netting of amounts collected by each party (i.e., on a gross basis), and held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default; and (ii) the collected margin must be subject to arrangements that fully protect the posting party to the extent possible under applicable law in the event that the collecting party enters bankruptcy.

6) Transactions between a firm and its affiliates should be subject to appropriate regulation by national supervisors in a manner consistent with each jurisdiction's legal and regulatory framework.

¹ Leaders' Statement, The Cannes Summit, Cannes November 4, 2011, <http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html>.

² Leaders' Statement, The Pittsburgh Summit, September 24-25, 2009, <http://www.oecd.org/g20/summits/pittsburgh/G20-Pittsburgh-Leaders-Declaration.pdf>.
http://www.fsb.org/wp-content/uploads/g20_leaders_declaration_pittsburgh_2009.pdf.

³ <http://www.bis.org/bcbs/publ/d317.htm>.

7) Regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements across jurisdictions.

8) Margin requirements should be phased in to reduce the costs incurred by market participants in connection with the change in regulation.

The purpose of publishing the initial draft of the Report (consultation paper) as of April 13, 2017 (hereinafter, the 'Initial Draft Report') was to present the approaches for the fulfilment of obligations assumed by Russia within G20 as regards staged introduction of a requirement for mandatory margining of NCC derivatives for a broad public discussion including participants in financial markets. The approaches presented for public discussion were based on an analysis of the current state of the Russian derivatives market and relevant changes in regulation in Canada, the European Union, Hong Kong, Japan and the USA, with due regard for the best practices elaborated by international professional associations in this area⁴. The current draft of the Report contains the Bank of Russia's position regarding the questions raised in the Initial Draft Report and the approaches ultimately adopted by the Bank of Russia to the implementation of mandatory margining of NCC derivatives based on face-to-face consultations with members of the professional community and based on comments and proposals sent before July 3, 2017, to svc_derivatives@cbr.ru.

The results of the public discussion of the Initial Draft Report were reviewed by the Derivatives Board (DB)

The current draft of the report will form the basis for corresponding draft Bank of Russia regulations.

⁴ Including recommendations and standards developed by ISDA.

KEY PROVISIONS FOR IMPLEMENTING MANDATORY MARGINING OF NCC DERIVATIVES

This Report contains the following positions of the Bank of Russia on approaches to implementing the decisions adopted by the G20 on introducing a requirement for mandatory margining of NCC derivatives:

1. To start phase-in of the requirement for mandatory margining of NCC derivatives starting from 1 September 2019, depending on the category of financial market participants and the threshold values based on the volume of transactions:

a) to establish the following categories of financial market participants:

- Category 1: credit institutions and professional participants in the securities market that are licenced for dealer and/or brokerage activities and/or securities management, as well as organisations that are licenced as management companies for investment funds, unit investment funds, or non-governmental pension funds. This category also includes foreign entities whose states do not set mandatory margining requirements (the Bank of Russia's position on cross-border transactions is stated in greater detail in Chapter 7);
- Category 2: other corporate participants of the OTC derivatives market. This category includes entities making Derivatives on the OTC market which do not belong to Category 1;

b) To start adoption of the requirement for mandatory transfer of Initial and Variation Margins for participants of Category 1 (upon their attainment of the necessary threshold value for the aggregate month-end notional amount of NCC derivatives for the three assessment months calculated on a group basis, in the amount of RUB 100 billion for Variation Margin and in the amount of RUB 600 billion for Initial Margin) from 1 September 2019;

c) To start adoption of the requirement for mandatory transfer of Initial and Variation Margins for participants of Category 2 (upon their attainment of the necessary threshold value for the aggregate month-end notional amount of NCC derivatives for the three assessment months calculated on a group basis, in the amount of RUB 100 billion for Variation Margin and in the amount of 600 billion RUB for Initial Margin) from 1 September 2020.

2. To introduce a minimum transfer amount, not to exceed RUB 100 million, which the party to a Derivative may not claim from its counterparty as a margin payment.

3. To introduce a special threshold value of RUB 100 million for the Initial Margin for all NCC derivatives with one counterparty, the amount of which may be deduced from the amount of the Initial Margin.

4. To set basic requirements to the Initial and Variation Margin in respect of the calculation deadlines and procedure, as well as the deadline for transfer until the business day following the day of calculation.

5. To initiate the elaboration and distribution of standard documents with the active participation of the DB.

6. To create a special regime for NCC derivatives with foreign participants which would enable the avoidance of duplicate regulatory requirements.

7. To prepare a legal framework for the development of security management services and portfolio compression services for NCC derivatives, and the implementation of modern risk management procedures by the entities covered by the requirement for mandatory margining of NCC derivatives.

CHAPTER 1. CATEGORIES OF DERIVATIVES SUBJECT TO MANDATORY MARGINING

The BCBS-IO스코 Standards contain margin requirements for all NCC derivatives except for Initial Margin posted for physically settled FX forwards and swaps¹. There is also a special regime provided for cross-currency swaps².

In some countries, a mandatory margining requirement does not cover all or certain deliverable commodity derivatives³.

Table 1 shows the status of adoption of a margin requirement for NCC derivatives across jurisdictions.

Table 2 shows the list of derivatives that will be subject to the mandatory margining requirement.

A mandatory margin requirement for NCC derivatives is planned to cover only those derivatives, information about which is to be provided to the repository, where by the derivatives' terms and conditions they mature in a period exceeding 30 days following the derivative conclusion date⁴. Furthermore, NCC derivatives specified in Table 2 shall mean the following contracts.

A physically settled FX option is a physically settled option contract, as defined in Ordinance

¹ That said, the BCBS-IO스코 Standards contain a reference to the supervisory guidance published by BCBS which sets recommendations for banks regarding the exchange of Variation Margin under physically settled FX forwards and swaps with counterparties which are financial institutions or systemically important non-financial institutions. Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions <http://www.bis.org/publ/bcbs241.pdf>.

² For cross-currency swaps with the exchange of principal, the BCBS-IO스코 standards require a special regime, according to which:

- a) Initial Margin is not applied to the principal component of the derivative.
- b) Initial Margin is applied to the interest-rate component of the derivative using a standard or quantitative calculation model.
- c) Variation Margin is applied to both components of the derivative (principal and interest-rate).

³ E.g., in Canada, Hong Kong, and Japan.

⁴ Upon introducing any amendments to the terms and conditions of derivatives that mature after more than 30 days, the margin will have to be transferred no later than on the day following the effective date of such amendments. If as of the date of a contract that constitutes a derivative the maturity date has not been determined, its maturity shall be considered to exceed 30 days.

No. 3565-U, which provides for the obligation of the party, upon receiving a demand of the other party, to buy or sell currency, which constitute the underlying asset, including by entering into a contract of sale of foreign currency between the parties.

A physically settled FX forward is a physically settled forward contract, as defined in Ordinance No. 3565-U, which provides solely for the exchange of two different currencies on a certain date at a fixed exchange rate agreed upon on the effective date of such forward contract.

A physically settled FX swap is a physically settled swap contract, as defined in Ordinance No. 3565-U, which provides solely for the exchange of two different currencies on a certain date at a fixed exchange rate agreed upon on the effective date of such swap contract, and the return exchange of the said currencies on a later date at a fixed rate agreed upon on the effective date of such swap contract.

A cross-currency swap with the exchange of principal is a contract containing the terms of a physically settled FX swap and also providing for the obligation of the party or parties thereto to pay interest periodically and/or on a lump sum basis on the notional amount or amounts established in the contract⁵.

A physically settled commodity derivative is a physically settled option, forward, or swap contract, as defined in Ordinance No. 3565-U, which provides for the obligation of one party to deliver a commodity to the other party within a certain period of time⁶.

⁵ Initial Margin is not posted for the principal component of the derivative, but is posted for the interest-rate component of the derivative.

⁶ The exception does not cover mixed contracts which provide for another underlying asset apart from the commodity to be delivered thereunder, and the contracts with the features of a cash settled derivative.

Table 1

**Status of adoption of a margin requirement
for NCC derivatives across jurisdictions**

	Status of adoption of a margin requirement for NCC derivatives across jurisdictions in accordance with the BCBS-IOSCO Standards
European Union countries	The requirement for the transfer of Variation Margin applies to all covered entities since 1 March 2017. The requirement for the transfer of Initial Margin will be phased in from 4 February 2017 through 1 September 2020.
Hong Kong	The requirement for the transfer of Variation Margin came into force on 1 March 2017. The requirement for the transfer of Initial Margin will be phased in from 1 March 2017 through 1 September 2020.
Canada	Regulation came into force on 1 September 2016 and will be phased in according to the schedule presented in the BCBS-IOSCO Standards.
United States	Regulation came into force on 1 September 2016 and will be phased in according to the schedule presented in the BCBS-IOSCO Standards.
Japan	Regulation came into force on 1 September 2016 and will be phased in according to the schedule presented in the BCBS-IOSCO Standards.

Table 2

**Requirement for mandatory margining depending
on the category of NCC derivatives**

	Physically settled FX options, forwards and swaps; Physically settled commodity derivatives	Cross-currency swaps with the exchange of principal	All other NCC derivatives
	Margin requirement		
Initial Margin	Not applicable	Applicable with due regard to the specific features of the derivative	Applicable
Variation Margin	Not applicable	Applicable	

Comments to Chapter 1, taking into consideration the aforementioned consultations

Most respondents supported the list of instruments for which mandatory margining requirements are to be introduced, including the exclusion of a number of physically settled derivatives from this requirement. Furthermore, compared to the Initial Draft Report, the list of derivatives for which a mandatory margining requirement will be introduced has been supplemented with another exception — physically settled FX option contracts. This exception has been introduced because physically settled FX option contracts, by their economic nature, are similar to physically settled FX forward contracts, and an identical exception will aim to aligning the conditions for using those instruments.

A number of financial market participants suggested that it would be desirable to exclude derivatives concluded for purposes of risk hedging by the entities in Category 2 from the margining requirement. Furthermore, comments received by the Bank of Russia to the Initial Draft Report also

justly note that, firstly, current legislation does not contain a consistent definition of a hedging transaction, and, secondly, the absence of margining for hedging NCC derivatives involving bank clients in Category 2 actually shifts the market risk of the hedging transaction onto the bank, in Category 1, which means the bank will then have to establish sufficient reserves to cover possible losses in connection with that transaction.

The Bank of Russia believes that the exclusion of hedging derivatives in the calculation of threshold values, exceeding which will lead to the application of a mandatory margining requirement for Category 2, will be in line with the international practice, will not increase the system risk significantly, and will make it possible to retain the previous level of costs incurred by non-financial institutions upon the settling of the derivatives. Therefore, the threshold values for Category 2 will be adjusted after the elaboration of precise criteria for classifying the derivatives as hedging derivatives.

Given positive replies received to the question posed in the Initial Draft Report regarding the

desirability of excluding short-term NCC derivatives (which mature within less than 30 days) from the mandatory margining requirement, and taking into account that these derivatives are used largely for

liquidity management, the Bank of Russia believes that the said exclusion for NCC derivatives maturing within less than 30 days may be introduced.

CHAPTER 2. CATEGORIES OF FINANCIAL MARKET PARTICIPANTS (ENTITIES) COVERED BY THE REQUIREMENT FOR MANDATORY MARGINING OF DERIVATIVES

According to Clause 2.4 of the BCBS-IOSCO Standards, mandatory margining requirements shall apply to all financial institutions and systemically important non-financial institutions, with due regard to the achievement of the relevant threshold values by the counterparties to the derivatives. However, the said requirements shall not apply to transactions to which central banks, public entities, multilateral development banks, and/or the Bank for International Settlements are parties.

2.1. General Rules on Covered Entities

Based on the relevant international experience and taking into consideration the potential scope of the participation of Russian participants in transactions with derivatives, the Bank of Russia will distinguish two categories of entities which shall be covered by the requirement for mandatory margining of NCC derivatives.

Category 1: credit institutions and professional participants in the securities market that are licenced for dealer and/or brokerage activities and/or securities management, as well as organisations that are licenced as management companies for investment funds, unit investment funds, or non-governmental pension funds. This category also includes foreign legal entities whose states do not set mandatory margining requirements. The Bank of Russia's position on cross-border transactions is stated in greater detail in Chapter 7.

Category 2: other corporate participants of the OTC derivatives market. This category includes entities trading derivatives on the OTC market which do not belong to Category 1.

2.2. Exceptions to the General Rules on Covered Entities

The Bank of Russia is considering the possibility of establishing the following exceptions to the

general requirement for mandatory margining of NCC derivatives:

- Intra-group derivatives;
- Derivatives with certain entities.

2.2.1. Intra-Group Derivatives

This exception is based on the fact that the risks associated with executing NCC derivatives arise centrally within one group, allowing the parties to the derivative to organise appropriate management of such risks.

The expediency of making transactions between members of the same group an exception to the general requirement for mandatory margining of NCC derivatives is recognized in many legal systems¹.

In the Russian legal framework, the exception for 'Intra-Group Derivatives' may apply if the following criteria are met simultaneously:

a) The parties to a derivative should belong to the same 'group'. The category of 'control' defined in IFRS 10, Consolidated Financial Statements,² is appropriate for use as a criterion to identify a 'group'. The 'group' may also include foreign organisations;

b) The activities of the parties to the derivative involve the complete consolidation of IFRS financial statements². Furthermore, if a parent organisation that prepares the consolidated financial statements has been founded in the territory of a foreign state, such statements may be drawn up in accordance with the IFRS applicable in the territory of such foreign state.

¹ Regulation in Canada, the European Union, Hong Kong, and Japan may be cited as an example.

² In accordance with Clause 2 of International Financial Reporting Standards (IFRS) 10 'Consolidated Financial Statements' (enacted in the Russian Federation by Order No. 217n of the Ministry of Finance of the Russian Federation, dated 28 December 2015 No. 217n).

2.2.2. Derivatives with Certain Entities

This category will include derivatives with the Bank of Russia, state and municipal bodies, international financial institutions (such as the International Finance Corporation and the European Bank for Reconstruction and Development), and the central banks of foreign states.

2.3. Threshold Values Above Which the Mandatory Margining Requirement Shall Apply

In the light of international experience and the requirements set forth in the BCBS-IOSCO Standards, the Bank of Russia plans to phase in the requirement for mandatory margining of NCC derivatives. Each stage has a corresponding threshold value from Table 3.

In order to determine the need to start margining, the aggregate notional amount of the NCC derivatives entered into by the group of which the entity in question from Category 1 or Category 2 is a member is calculated. Calculation is made as of the end of each of the three assessment months, where:

1) Only categories of derivatives subject to mandatory reporting to a repository will be used for calculation;

2) The category of 'control,' as defined in IFRS 10 'Consolidated Financial Statements', will be used as a criterion to identify the 'group' of which the entity in question from Category 1 or Category 2 is a member.

3) NCC derivatives, entered into between entities within the same group, shall also be used in calculation (each NCC derivative shall only be taken into accountance).

4) March, April, and May will be set as assessment months. If the threshold value is exceeded as of the end of each of those three months, margining shall be mandatory for the respective NCC derivatives executed from September 1 of the same year.

To extend the mandatory margin requirement for NCC derivatives to a particular transaction each counterparty shall exceed the threshold value. Furthermore, if one of the parties to the transaction is a foreign organisation whose state does not set mandatory margining requirements and is not included in the list of the Bank of Russia (special features of regulation of cross-border transactions are described in details in Chapter 7), NCC

Table 3

Stages of introducing a mandatory margin requirement

Threshold Value		The category of participants to which the threshold value applies	Entry into force of the requirement (stage)
Variation Margin			
RUB 100 billion		Category 1	from 1 September 2019
		Category 1 and Category 2	from 1 September 2020
No threshold value		Category 1	from 1 September 2020
For Category 1 no threshold value	For Category 2 RUB 80 billion	Category 1 and Category 2	from 1 September 2021
Initial Margin			
RUB 600 billion		Category 1	from 1 September 2019
		Category 1 and Category 2	from 1 September 2020
RUB 300 billion		Category 1	from 1 September 2020
		Category 1 and Category 2	from 1 September 2021
RUB 150 billion		Category 1	from 1 September 2021
		Category 1 and Category 2	from 1 September 2022
RUB 80 billion		Category 1	from 1 September 2022
		Category 1 and Category 2	from 1 September 2023

derivatives with such foreign organisation shall be subject to margining without any calculation of the threshold values for the group of which such foreign organisation is a member. If one of the parties to the transaction is a foreign organisation whose state sets mandatory margining requirements and is included in the list of the Bank of Russia, the threshold value and other margining rules, as provided for by the law of the corresponding state, shall apply to both parties to the transaction.

The mandatory margin requirement for NCC derivatives shall only apply to new NCC derivatives entered into after the effective date of the respective requirement for mandatory margining of such transactions.

When applying this approach, each party to a transaction must have reliable information on the exceedance/non-exceedance of the threshold value by the counterparty's group in order to make a decision on margining of the NCC derivatives entered into with the counterparty. Counterparties are expected to provide each other the said information on the basis of a standard notification form developed by the DB, which will be exchanged before executing the transaction. An example of such an approach is the Regulatory Margin Self-Disclosure Form developed by ISDA³.

Minimum transfer amount and Initial Margin Threshold

In addition to the threshold values indicated in Table 3, the following two additional threshold values will be introduced: a minimum payment amount to be made as the Initial and/or Variation Margin for NCC derivatives (hereinafter, the 'Minimum Transfer Amount'), and a special threshold value for paying the Initial Margin (hereinafter, the 'Initial Margin Threshold'). The parties to NCC derivatives will be able to indicate in their internal risk management documents and contracts the use of the said additional threshold values, which shall not exceed the amounts established by the Bank of Russia.

The Minimum Transfer Amount is the maximum aggregate amount of the Initial and Variation Margins, which a party to a NCC derivative may elect not demand from its counterparty. The Bank of Russia finds it expedient to allow Category 1

and/or Category 2 participants to stipulate in their contracts that a party is entitled not to pay Initial and/or Variation Margin if the payment amount does not exceed RUB 100 million. Furthermore, the parties may reduce the said Minimum Transfer Amount.

The Initial Margin Threshold shall limit the requirement for the mandatory posting of the Initial Margin in cases where a party is not exposed to significant risks in respect of its counterparty. The Bank of Russia deems it expedient to allow Category 1 and Category 2 participants to stipulate in their contracts that a party is entitled not to demand that its counterparty posts the Initial Margin if the total amount of the Initial Margin to be received by such party under all NCC derivatives with such counterparty does not exceed RUB 100 million. In cases where the total amount of the Initial Margin exceeds RUB 100 million, it may be decreased by a party by the indicated amount. The parties may also opt to decrease the said Initial Margin Threshold.

Therefore, the Initial Margin amount to be posted, considering the Initial Margin Threshold, will be equal to the amount of potential future exposure, less the Initial Margin amount received from the counterparty earlier, and less the amount of the Initial Margin Threshold.

The BCBS-IOSCO Standards indicate the need to apply the Initial Margin Threshold on a consolidated intra-group level to avoid possible abuses associated with an artificial increase in the number of counterparties for purposes of avoiding mandatory margining requirements. Figure 1 shows the application of the Initial Margin Threshold to transactions between companies of two consolidated groups individually. Figure 2 shows the application of the Initial Margin Threshold to transactions between companies of two consolidated groups on a consolidated intra-group level.

Comments to Chapter 2, taking into consideration the aforementioned consultations

The greatest response was evoked by the Bank of Russia's proposals to extend the mandatory margining requirements to Category 2 non-financial institutions, and also by the threshold value amounts specified in Table 3.

³ *Regulatory Margin Self-Disclosure Letter, ISDA, 30 June 2016. <https://www.isda.org/a/VEKDE/wgmr-self-disclosure-letter-template-clean.pdf>.*

Figure 1

**Application of the Initial Margin Threshold to transactions between companies
of two consolidated groups individually**

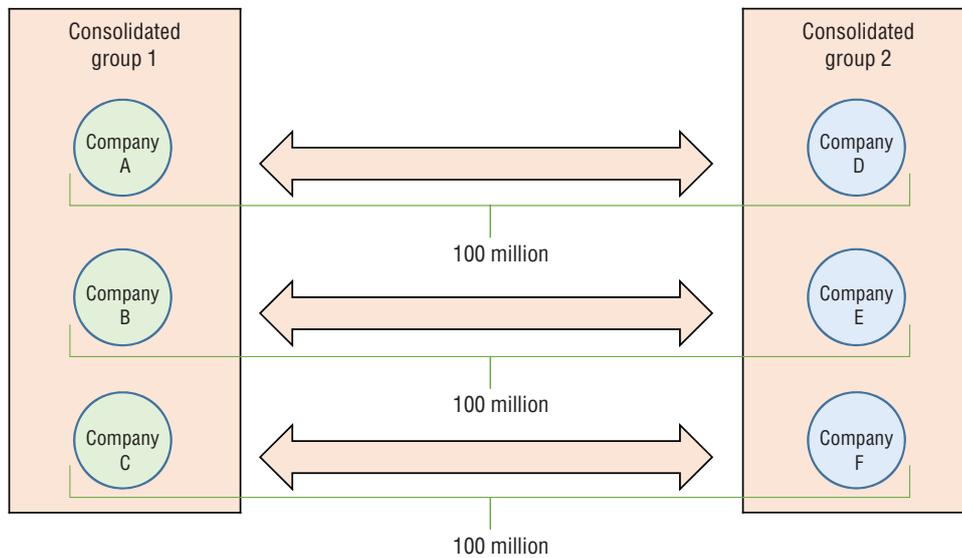
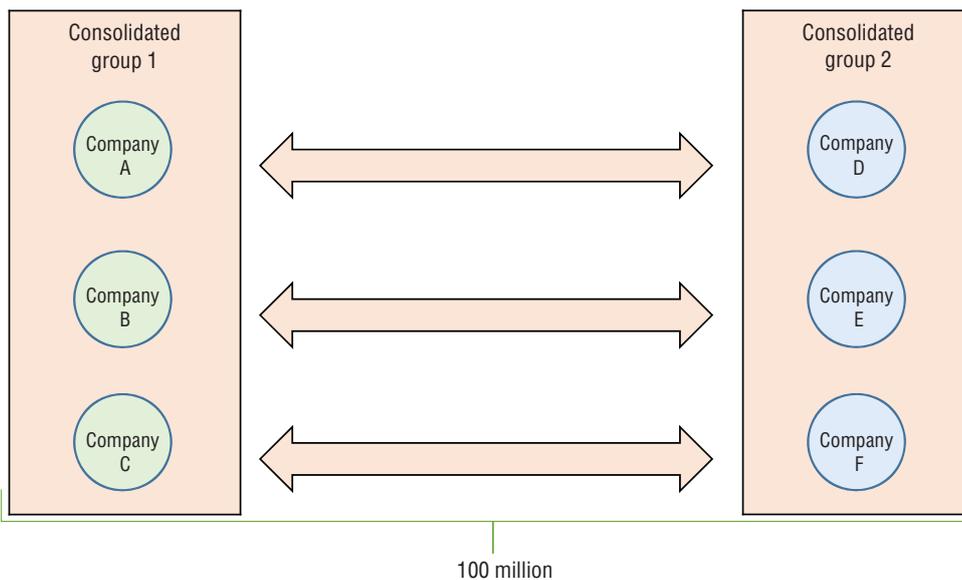


Figure 2

**Application of the Initial Margin Threshold to transactions between companies
of two consolidated groups on a consolidated intra-group level**



Financial market participants and professional associations believe that execution of documents and adjustment of relevant systems, including testing of the Initial Margin calculation models, may take a great deal of time for market participants who have not used margining in their transactions before. Furthermore, it was noted repeatedly that Category 2 non-financial institutions use derivatives mainly for hedging their risks, and that mandatory margining of such derivatives will lead to a significant diversion of such institutions'

resources and increase their hedging costs. It was also noted that foreign legal systems do not take into account the derivatives settled by non-financial institutions for the purposes of hedging their risks in the calculation of threshold values for determining the systemic importance of such institutions. In this regard, the Bank of Russia notes the following.

Firstly, a significant number of physically settled derivatives used, among other things, for purposes of hedging risk, have been excluded from the mandatory margining requirement, something

already indicated in the Initial Draft Report. Specifically, mandatory margining requirements will not apply to physically settled option and forward contracts and to physically settled swaps where the foreign currency or the goods constitute the underlying asset.

Secondly, BCBS-IOSCO Standards set the uniform threshold values for financial and non-financial institutions, which values do not depend on the purpose of the derivative transaction. Furthermore, Clause 2.6 of BCBS-IOSCO Standards indicate that systemically important non-financial institutions are to be established by national law.

Taking into account the foregoing, the planned term for the mandatory margining requirement to come into effect was extended in this Report by one year (from July 1, 2018 to September 1, 2019 for Category 1, and from July 1, 2019 to September 1, 2020 for Category 2). Furthermore, as noted above, the respective threshold values for Category 2 will be adjusted after the elaboration of precise criteria for classifying derivatives as hedging derivatives.

As regards the Minimum Transfer Amount and threshold values in Table 3, as established in the Initial Draft Report, the respondents pointed out that they were far lower than the analogous values established in BCBS-IOSCO Standards. In this regard, the Bank of Russia points out that the amounts suggested in this Report are lower than those in the BCBS-IOSCO Standards and foreign regulations based on these standards, since these amounts correspond to the scale of the Russian NCC derivatives market and to the amounts of transactions settled in the Russian market. The Bank of Russia also takes into account possible consequences associated with the potential adoption by the Russian participants in transactions with foreign counterparties for the purpose of avoiding the requirements of Russian regulation. The threshold values specified in Table

3 and the Minimum Transfer Amount may be further adjusted both downwards and upwards, should such adjustment be necessary. The Bank of Russia plans to comply with the threshold value calculation methodology established by the BCBS-IOSCO Standards.

In connection with certain respondents' comments, the Initial Margin Threshold in the amount of RUB 100 million was added in this Report. The parties will be able to deduct this amount from the total amount of Initial Margin to be transferred.

The exclusion of intra-group derivatives from the general mandatory margining requirement was perceived positively by people who commented on the Initial Draft Report. Proposals were sent to the Bank of Russia to extend the exception to the organisations which do not execute financial statements under IFRS, but which could be combined into one consolidated group using the approaches set forth in IFRS. As regards cross-border transactions with parent companies located abroad, there was a proposal to clarify the rules in accordance with which full consolidated financial statements are to be executed to apply the intra-group exception.

As the requirement for drawing up consolidated financial statements according to Federal Law No. 208-FZ dated July 27, 2010, 'On Consolidated Financial Statements' applies to a relatively broad circle of financial market participants, the Bank of Russia does not find it desirable in this regard to change the approach that has been set forth in the Initial Draft Report. Further, for cross-border transactions with parent organisations founded in the territory of a foreign state, Clause 2.2.1 hereof specifies that, for the purpose of applying the said exception, it would be enough that consolidated financial statements are prepared in accordance with the appropriate IFRS for application in the territory of said foreign state.

CHAPTER 3. REQUIREMENTS FOR THE CALCULATION AND TRANSFER OF INITIAL AND VARIATION MARGINS

Insofar as it concerns the procedure for calculating and transferring Initial and Variation Margin, the Bank of Russia proposes to comply with BCBS-IOSCO Standards.

3.1. Initial Margin

According to Clause 3(d) of the BCBS-IOSCO Standards, Initial Margin protects the parties to the derivative from the potential future exposure that could arise from future changes in the mark-to-market value of the derivative during the time it takes to close out and replace the position in the event that one or more counterparties default. Therefore, the amount of Initial Margin should reflect the size of the potential future exposure.

3.1.1. Transfer Procedure and Calculation Period of Initial Margin

The BCBS-IOSCO Standards provide for bilateral exchange of Initial Margin – upon executing a transaction, each of the parties to the derivative should transfer Initial Margin to the other party. However, in cases when a participant covered by the requirement for mandatory payment of Initial Margin bears zero credit exposure in respect of its counterparty under the NCC derivative, such participant is not obliged to demand that its counterparty provide Initial Margin (unilateral provision). Such situations may occur in transactions where one of the parties fully discharges its obligations under the derivative on the date of the transaction. An example would be a call option on shares, executed on condition of payment of the full value of the option by the purchaser on the execution date. The buyer of the option is not obliged to pay Initial Margin on this instrument, as the seller of the option does not bear the risk of the buyer's default on its obligations thereunder.

As regards the terms of calculation, the Bank of Russia deems it desirable to introduce a requirement for Initial Margin calculation under individual contracts or under a portfolio to be made not later than two business days from any of the following dates:

- a) The date of conclusion of a new NCC derivative or its addition to the portfolio;
- b) The expiry date of the NCC derivative or the date of its removal from the portfolio;
- c) The date of payment or delivery under the NCC derivative, not including payment or receipt of margin;
- d) The date of a change in the derivative maturity date¹ followed by the change in the amount of required margin (if the standard calculation model is used);
- e) No calculation of Initial Margin in the preceding ten business days.

The deadline for Initial Margin payment is no later than the business day following the day of Initial Margin calculation.

3.1.2. Initial Margin Calculation

Element 5 of the BCBS-IOSCO Standards indicates the need to calculate Initial Margin on a gross basis, as the collateral may not suffice to secure each of the parties with a large scope of mutual exposures under the derivatives executed between them, in the event of a default on obligations by one of the parties. This means that Initial Margin shall be calculated not for the net obligation arising as a result of offsetting the mutual obligations of the parties to the derivative, but for the gross obligations of each party to the derivative. Therefore, if, as a result of executing several derivatives between Party A and Party B, Party A is to transfer to Party B an Initial Margin of RUB 10 billion under the portfolio, and Party B is to transfer to Party A an Initial Margin of RUB 8 billion under the portfolio, each of the parties shall transfer the above-mentioned amount to the other party (less the Initial Margin Threshold, if applicable). Transfer of a net amount of RUB 2 billion by Party A to Party B is not allowed.

To determine the Initial Margin amounts, the BCBS-IOSCO Standards prescribe using calculations based on historical data that

¹ Please refer to Table 4.

Table 4

Initial Margin rates

Category of derivatives* (depending on the underlying asset)	Initial Margin Requirement (% of notional exposure)
Credit derivatives (0–2 year residual maturity)	2
Credit derivatives (2–5 year residual maturity)	5
Credit derivatives (over 5 year residual maturity)	10
Commodity derivatives	15
Equity derivatives	15
FX derivatives	6
Interest rate derivatives (0–2 year residual maturity)	1
Interest rate derivatives (2–5 year residual maturity)	2
Interest rate derivatives (over 5 year residual maturity)	4
Other derivatives	15

* For the derivatives that have more than one underlying asset and, therefore, may be related to two and more categories, such derivatives shall be generally assigned to the category that assigns the highest rate of interest.

incorporates periods of stress scenarios, with a 99 per cent² confidence interval over a 10-day horizon³. In the Bank of Russia's opinion, a 10-day horizon will be optimal for NCC derivatives on the condition that Variation Margin is exchanged between the parties on a daily basis (Clause 3.2.1. hereof).

The Initial Margin level according to BCBS-IOSCO Standards may be calculated based on either the Standardised Margin Model or the Quantitative Portfolio Margin Model.

Standardised Margin Model

Table 4 shows the Initial Margin rates determined subject to the underlying asset of the derivative. If there is a legally enforceable netting agreement that covers derivatives⁴ for which Initial Margin is to be paid, the gross amount of Initial Margin calculated under the Standardised Margin Model

may be additionally adjusted by the net-to-gross ratio calculated using the following formula⁵:

$$\text{Net-to-gross ratio} = \frac{\text{(net replacement cost for the derivatives subject to netting agreement)}}{\text{(gross replacement cost for the abovementioned derivatives)}}$$

Quantitative Portfolio Margin Model

According to the quantitative portfolio margin model, Initial Margin is calculated on a portfolio basis. This model may apply only to a portfolio of derivatives, that are subject to the same legally enforceable netting agreement. According to the BCBS-IOSCO Standards, Initial Margin shall first be calculated for a group of derivatives with the same type of underlying asset (with a commensurable scope of risks), and then the Initial Margin amounts for each separate group of derivatives with the same type of underlying asset are summed up, thus forming a total Initial Margin amount for the portfolio (Figure 3).

According to Clause 3.3 of the BCBS-IOSCO Standards, the following rules apply to the quantitative portfolio margin model:

- A quantitative portfolio margin model shall be approved by the regulator;

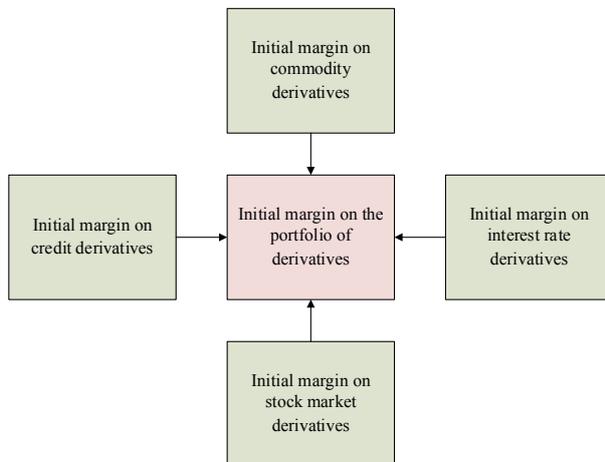
² A per cent probability (confidence interval) is used to calculate the expected maximum adverse deviation in the price of the collateralised obligation specified in the derivative from its market value within a time horizon.

³ The time horizon is the period of time from the date of the last collateral exchange under a portfolio of non-centrally cleared derivatives settled with a defaulting counterparty to the date of closing out the positions on the said portfolio and hedging the market exposure.

⁴ Netting agreement should comply with the requirements of Article 4.1 of the Law on Bankruptcy.

⁵ Detailed information on this ratio and on the Initial Margin calculation formula based on that ratio is given in Clause 3.6 of the BCBS-IOSCO Standards and in Clause 5 of Annex 3 to Instruction 180-I.

Figure 3
Initial Margin calculation for the portfolio



- A quantitative portfolio margin model may be either internally developed or sourced from counterparties or third-party organizations;
- A quantitative portfolio margin model is subject to internal control and assessment by the institution using it.

In the opinion of the Bank of Russia, self-regulatory organisations operating in the financial markets field, and also foreign institutions from the list specified in Clause 5 of Article 51.5 of the Law on the Securities Market, shall have the right to send the relevant quantitative models to the Bank of Russia for approval. In global practice, ISDA has become the developer of one of the corresponding models, called the Standard Initial Margin Model, or SIMM⁶.

3.1.3. Initial Margin Disposal and Segregation

With respect to Initial Margin, the BCBS-IOSCO Standards establish a limited list of cases when the collecting party is entitled to dispose of property posted as Initial Margin. The said limitations come from the underlying rules for Initial Margin, as set forth in the BCBS-IOSCO Standards:

a) Initial Margin collected should be immediately available to the collecting party in the event of the counterparty's default.

b) Initial Margin collected must be subject to protection to the maximum extent possible under

applicable law in the event that the collecting party enters bankruptcy.

For example, at the present time the European Union and the USA adopt a conservative approach and prohibit the disposition of Initial Margin received, except when Initial Margin received in cash is reinvested by a third-party custodian of the collateral asset in a different form of collateral. This approach is based on the possibility of additional risk occurring if third-party claims to the collateral property arise. Furthermore, legal and operational difficulties may delay or prevent the return of the collateral in the event of a default of the collateral taker or a third party.

Until recently, Russian law did not allow a pledge holder to dispose of the object of pledge, except when the object of pledge includes the rights of claim to money in a bank account, and the pledge holder is the bank where such collateral account is opened (Articles 358.9–358.14 of the CC RF)⁷. With the appearance of Clause 5, Article 51.6 of the Law on the Securities Market⁸, the situation with regard to pledges has changed. According to that clause, a person in whose favour an encumbrance is imposed cannot be given the right to dispose of the securities on which such encumbrance is imposed, including the right to demand from the issuer or entity obliged under the securities to repurchase, acquire, or redeem these securities, except as otherwise established by federal law or contract. Thus, in their pledge contract the parties may establish the right of the pledgee to dispose of securities. The application of Clause 5, Article 51.6 of the Law on the Securities Market in margining of NCC derivatives might cause disputes in practice. For example, Russian laws do not establish a criterion for equivalent replacement of pledged securities by the pledgee in the event of their alienation by the latter before the grounds for their enforced seizure occur and the pledgee's obligation to return the same or equivalent securities before the secured obligation matures. It should be noted that these issues were fixed in the European

⁶ <https://www.isda.org/2017/09/07/isda-launches-latest-version-of-isda-simm-non-cleared-derivatives-margin-model/>
<https://www.isda.org/a/7FiDE/isda-simm-governance-framework-19-september-2017-public.pdf>.

⁷ According to Clause 2, Article 845 of the CC RF, a bank may use money available on an account but must guarantee the client's right to freely dispose of these funds.

⁸ Article 51.6 was introduced by Federal Law No. 210-FZ dated 29 June 2015, 'On Amending Certain Legislative Acts of the Russian Federation and Invalidating Certain Provisions of the Legislative Acts of the Russian Federation'.

Union by Articles 2 and 5 of Directive 2002/47/EC, respectively.

In general, the appearance in Russian law of the pledgee's right to dispose of pledged securities is consistent with the global practice regarding financial collateral. In the event that the title transfer collateral is used, where the ownership of the asset is transferred to a person the obligations to whom are secured, such person shall be free in disposing of such asset, unless otherwise established in the contract.

In the opinion of the Bank of Russia, the Initial Margin taker and a third-party custodian of the collateral shall have a limited possibility under the contractual documents to dispose of the Initial Margin received. Furthermore, a third-party custodian of the collateral shall be able to reinvest the Initial Margin in the assets that may be transferred as the Initial Margin, according to the list provided in Chapter 4.

According to BCBS-IOSCO Standards, assets comprising the Initial Margin should be duly segregated in order to mitigate the risks of the party transferring the Initial Margin.

According to the European and the US rules, Initial Margin must be segregated from other property of the collecting party and of the third-party custodian, if any, both at the level of contractual documentation and at the level of the relevant internal books of the collecting party and the third-party custodian. Moreover, in some cases foreign regulators require that Initial Margin be held only with a third-party custodian that is not affiliated with any of the parties to the derivative⁹.

Furthermore, according to the BCBS-IOSCO Standards, the party collecting Initial Margin and the third-party custodian must provide the party posting Initial Margin the possibility of holding Initial Margin separately from other customers and counterparties (individual segregation).

3.2. Variation Margin

According to Clause 3(c) of the BCBS-IOSCO Standards, Variation Margin protects the parties from the current exposure that has already been incurred by one of the parties to the derivative from changes in the mark-to-market value of the derivative after the transaction has been executed.

Accordingly, the amount of Variation Margin should reflect the size of this current exposure and can therefore change over time.

3.2.1. Transfer Procedure and Calculation Period of Variation Margin

Variation Margin shall be paid unilaterally to the party to a derivative indicated by the results of market revaluation of the positions under an individual contract or under a portfolio. Thus, Variation Margin shall be paid only by the party to a derivative which is a net debtor under the individual contract or under the portfolio at the time of payment of the Variation Margin.

The Variation Margin shall be calculated once a day, and is meant to be paid no later than on the next business day following the day of Variation Margin calculation.

3.2.2. Calculation of Variation Margin

Variation Margin shall be calculated by the parties to a derivative in accordance with the contracts executed between them. Furthermore, the Variation Margin amount shall fully collateralise the mark-to-market exposure. Since some NCC derivatives are not liquid enough, and there is no transparent pricing of such instruments, the parties should elaborate a detailed procedure for the settlement of disputes that may arise in respect of Variation Margin calculation before executing a transaction. In the opinion of the Bank of Russia, the DB may become the main developer of the corresponding rules, which would allow the market participants to effectively settle their disagreements regarding calculation and timely transfer of Variation Margin. At the international level, such standard documents are developed by ISDA¹⁰.

Comments to Chapter 3, taking into consideration the aforementioned consultations

The comments with regard to the circle of persons entitled to elaborate and apply their own quantitative models of Initial Margin calculation

⁹ E.g., the European Union and United States.

¹⁰ As an example of a standardised procedure for settling disagreements on the calculation of Variation Margin, consider paragraph 4 in the ISDA 2016 Credit Support Annex for Variation Margin (VM) (Title Transfer – English Law).

were varied. Some respondents were in favour of introducing restrictions, while others believed that the regulation should not limit the users of derivatives, since for the purposes of efficiency, cost reduction, and unification with international practice, the market participants will adhere in a greater degree to one or to a limited list of quantitative models of Initial Margin calculation. Taking into account that each quantitative model of Initial Margin calculation will have to be approved by the Bank of Russia, we believe that such models may be elaborated and submitted to the Bank of Russia for approval either by self-regulatory organisations in the field of financial markets or by foreign institutions from the list provided in Clause 5, Article 51.5 of the Law on the Securities Market.

In contrast, there is a certain unity of opinions as regards the subjects who shall be entitled to retain the Initial Margin. Specifically, many respondents advocated the option to have the Initial Margin for the derivative kept by other party (the margin recipient), subject to the condition that the necessary level of segregation at the legislative level be provided for, or by a third party, provided it is sufficient reliable and independent with respect to the parties to the derivative. Furthermore, in the

opinion of the Bank of Russia, there are contractual structures that already exist under Russian law, which make it possible to protect the Initial Margin from the risk of bankruptcy of the transferring and receiving parties. Among such legal devices are pledge (security interest) and, from June 1, 2018, an escrow agreement, described in greater detail in Chapter 5.

Taking into account the practical difficulties of cash funds segregation, the need to account for the credit risks of the third party (collateral custodian), and also on the basis of relevant international experience, the Bank of Russia also deems it desirable to introduce a rule mandating that the Initial Margin in cash form be kept only by a third party which either has the status of a bank with a universal licence and which is not affiliated with the parties to the derivative, or, alternatively, is a central depository. An Initial Margin in the form of securities may be kept either by a third party or by either of the parties to the derivative, provided such Initial Margin be sufficiently protected with respect to a bankruptcy of the transferring party and provided such third party or party to the derivative holds a depository's licence.

CHAPTER 4. REQUIREMENTS FOR ASSETS TRANSFERRED AS INITIAL AND VARIATION MARGINS

In global practice, requirements for assets that constitute collateral are among the most important requirements applicable to NCC derivatives.

Based on the BCBS-IOSCO Standards, the Bank of Russia suggests proceeding from the following parameters for choosing assets for margining:

- High liquidity;
- Capacity to retain value during financial stress, subject to the application of appropriate haircuts;
- Resistance of the asset to excessive credit, market, and currency risks;
- Proper diversification of assets, including minimization of concentration on a particular issuer or class of issuers or class of assets;
- Inadmissibility of securities issued by the counterparty or its affiliates as collateral¹.

The Bank of Russia deems it desirable to establish the following kinds of assets as a permissible margin collateral:

- Rubles and the following foreign currencies: euros, US dollars, pounds sterling, Japanese yens and Swiss francs;
- gold on banks' accounts;
- securities issued by states, national central banks, and organisations which have been authorised under the law of the respective countries to make borrowings on behalf of the state; international financial institutions and international development banks specified in 2.3.1 of Clause 2.3 of Instruction 180-I (hereinafter, 'Public Securities');
- debt securities of other issuers (with a credit rating of debt securities issue (issuer)) no less than the level established by the Bank of Russia Board of Directors: for Russian objects of rating – assigned according to the national rating scale for the Russian Federation by credit rating agencies included by the Bank of Russia in the list of credit rating agencies; for foreign objects of rating – assigned according to the international rating scale by foreign

credit rating agencies (hereinafter, 'Private Securities');

- equity securities included in the lists for calculating the MICEX Index and/or the RTS Index, as well as the following stock indices (hereinafter referred collectively as 'Equity Securities'):
 1. ASX 100 (Australia);
 2. S&P/Toronto Stock Exchange 60 Index (Canada);
 3. Shenzhen Stock Exchange Component Stock Index (China);
 4. CAC 40 (France);
 5. DAX 30 (Germany);
 6. NIKKEI 225 (Japan);
 7. KOSPI 100 (South Korea);
 8. FTSE 100 (Great Britain);
 9. Dow Jones Industrial Average (USA).

Evaluation of an asset included in the Initial or Variation Margin provided by a counterparty is important for the future stability of the organisation, as the quality of such evaluation affects the level of the counterparty's credit risk. Therefore, assets chosen as margin collateral shall be subject to appropriate haircuts reflecting the reliability of a particular asset.

The BCBS-IOSCO Standards establish that assets accepted as margin collateral which meet all applicable requirements should not be exposed to excessive credit, market, and FX risk (including through differences between the currency of the collateral asset and the currency of settlement). Therefore, calculation of the haircut rate should take into account the impact of the respective risk on the asset.

A haircut may be calculated using either a standardised model based on the standardised haircuts indicated in Table 5 or a quantitative model.

Standardised model

The Bank of Russia will also set a requirement for an additional haircut of 8% which would apply should FX risk arise if the currency of the cash or non-cash asset provided as margin and

¹ This principle does not apply to the Bank of Russia's bonds.

Table 5

Calculation of a haircut under a standardised model

Type of asset	Credit quality step (CQS)*	Term to maturity (early redemption)	Haircut (%)**	
			Public securities	Private securities
Debt securities	1	up to 1 year	0.5	1.0
	1	1 year to 5 years	2.0	4.0
	1	over 5 years	4.0	8.0
	2–3	up to 1 year	1.0	2.0
	2–3	1 year to 5 years	3.0	6.0
	2–3	over 5 years	6.0	12.0
	4	any	15.0	inadmissible asset
Equity Securities			25.0	
Gold on banks' accounts			15.0	
Cash funds in the currency of settlements			0	

* The likelihood of default: CQS 1 – 0.00–2.39%; CQS 2 – 2.40–10.99%; CQS 3 – 11.00–26.49%; CQS 4 – 26.50–100.00%.

** The said haircut value is a minimum and may be increased by agreement of the parties for a given asset.

the currency of settlements established in an agreement between the parties to the derivative are different. Furthermore, for the Variation Margin, the said haircut shall apply only to securities in a currency other than the currency of settlements as established in an agreement between the parties to the derivative.

Quantitative model

The quantitative model shall be based on the following principles:

The haircut should be calculated subject to the market exposure level of the asset provided for margining;

Haircut calculation should be calibrated to a lengthy historical period of time, including at least one stress period, to calculate the coverage of a potential decline in the value of the asset provided for margining.

In the opinion of the Bank of Russia, self-regulatory organisations in the field of financial markets, and also foreign institutions from the list specified in Clause 5 of Article 51.5 of the Law on

the Securities Market, shall have a right to send the corresponding haircut calculation models to the Bank of Russia for approval.

Comments to Chapter 4, taking into consideration the aforementioned consultations

The consultations led the Bank of Russia to update the list of assets for marginal collateral. Specifically, in connection with questions that have arisen concerning the storage, accounting, and transfer of gold bars, this asset has been removed from the list of permitted assets. However, gold held on bank accounts remains an eligible asset.

Taking into account respondents' comments on the high level of haircut (50%) for Equity Securities suggested in the Initial Draft Report, which exceeds the haircut applicable to Equity Securities in foreign states, the Bank of Russia revised its approach to the said haircut and has set it at 25% in the current Report, bringing it closer to the approach set forth in Basel II² (Clause 151).

² International Convergence of Capital Measurement and Capital Standards, revised framework, June 2006, <https://www.bis.org/publ/bcbs128.htm>.

CHAPTER 5. LEGAL FRAMEWORK OF MARGINING

There are two main legal devices in international practice which are used for margining of NCC derivatives: collateral with the transfer of the full scope of rights to the collateral asset to the collateral taker (hereinafter, the 'Title Transfer Collateral') and collateral where a security interest in the collateral asset is obtained by the collateral taker, while full ownership of the collateral asset remains with the collateral provider (hereinafter, the 'Pledge'). Division of financial collateral into Title Transfer Collateral and Pledge can be seen, inter alia, in Directive 2002/47/EC. The contractual practice for derivatives based on standard forms of contracts developed by ISDA has also adopted both legal frameworks mentioned above. ISDA, whose form for a master agreement for transactions with derivatives is used in one version or another in over 90% of international transactions with OTC derivatives¹, has developed packages of standard documents (hereinafter, 'ISDA Credit Support Documentation') used for margining of OTC derivatives by using the benefits of Title Transfer Collateral and Pledge².

Statistical data on the use of credit support documentation

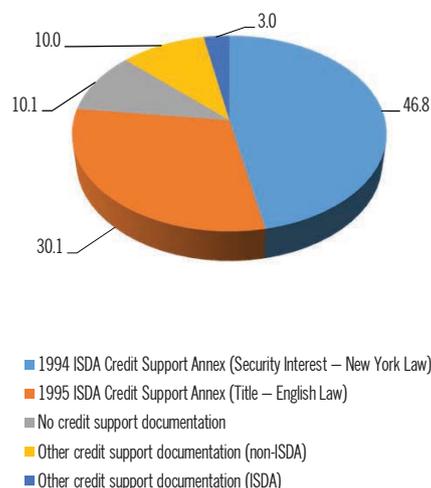
ISDA credit support documentation under English Law and New York Law, regardless of the legal framework used, usually has the following common attributes:

- ISDA agreements are bilateral, which means that each of the parties may act as a collateral taker and as a collateral provider.

- The collateral is provided by way of transferring the property (title) from one party to the other party; however, the services of a third-party custodian, who holds custody of the collateral, may be used.
- The collateral is revalued periodically based on the market value of the assets provided as collateral (therefore, the legal device should allow for the prompt substitution and/or supplementation of the provided collateral).

For the purpose of margining of NCC derivatives under Russian law, the following legal devices may be currently used, in the opinion of the Bank of Russia: Pledge³, Standard terms of the agreement on the procedure for paying floating margin amounts⁴, and security payment⁵.

Figure 4
Statistical data on the use of ISDA* credit support documentation for non-centrally cleared derivatives as of 31 December 2014



* ISDA Margin Survey 2015 <http://www2.isda.org/attachment/Nzc4MQ==/Margin%20survey%202015%20FINAL.pdf>.

¹ This argument was used in the legal proceedings in England during the insolvency of the financial group Lehman Brothers: <https://www2.isda.org/attachment/NDMxMA==/ISDA%20Firth%20Rixson%20Appeal%20First%20Submission.pdf>.

² See, for example, ISDA 2014 Standard Credit Support Annex (Transfer - English Law), ISDA 2016 Credit Support Annex for Variation Margin (VM) (Title Transfer – English Law) (based on the device of Title Transfer Collateral); 2016 Phase One IM Credit Support Deed (Security Interest – English Law), ISDA 2016 Phase One Credit Support Annex for Initial Margin (IM) (Security Interest – New York Law) (based on the device of Pledge).

³ Paragraph 3, Chapter 23 of the CC RF.

⁴ Standard terms of the agreement on the procedure for paying floating margin amounts constitute a composite part of standard documents for derivative transactions in the financial markets developed with the participation of three associations – the Association of Russian Banks, the National Financial Association, and the National Association of Stock Market Participants. http://www.spfi.info/files/Standart_docs.pdf.

⁵ Paragraph 8, Chapter 23 of the CC RF.

5.1. Pledge (Security Interest)

Pledge is typical of the Russian legal system and well-regulated. The general rules on Pledge are set forth in the CC RF, and special rules related to the pledge of non-certificated securities and immobilized certificated securities are set forth in Article 51.6 of the Law on the Securities Market.

At the same time, Pledge has certain deficiencies for use with respect to derivatives.

Enforced seizure of pledged property under Russian law is a rather lengthy process with the following barriers:

- Clause 8, Article 349 of the CC RF provides for a minimum 10-day period before the extrajudicial liquidation of the object of pledge may be started.
- Extrajudicial liquidation of the pledged property may be delayed or blocked intentionally by the pledger, with reference to Clause 3, Article 350.1 of the CC RF.
- The obligation of collateral creditors to wait for bankruptcy proceedings to satisfy their claims in the order of priority (according to the collateral procedure) in the course of bankruptcy proceedings, including because in the supervision stage of bankruptcy proceedings set-off of claims against the debtor is forbidden, as a general rule⁶. Furthermore, in the event of the bankruptcy of a credit institution which is a pledger, the pledgees will bear the risk that the pledged property will be used in full to satisfy the claims of the primary and secondary creditors⁷.

Unlike Title Transfer Collateral, Pledge does not create a contractual right of claim against the pledgee for the return of the pledged asset or its equivalent value, which could be included in the calculation of a close-out amount. Therefore, the object of pledge is not involved in the close-out netting process, but may be used to pay the close-out amount arising from the close-out netting by selling the object of pledge. In the absence to date

⁶ With regard to credit institutions, according to Subclause 4, Clause 4, Part 9 of Article 20 of the Law on Banks, after a credit institution's banking licence is revoked, unless otherwise stipulated in federal law, and until the effective date of the arbitration court's resolution on recognition of the credit institution as insolvent (bankrupt) or on its liquidation, it is prohibited, among other things, to terminate liabilities to the credit institution by way of offsetting mutual similar claims.

⁷ Clause 4, Article 189.92 of the Law on Bankruptcy.

in the Russian OTC derivatives market of standard credit support documentation prepared under the pledge-based structure, the issue of the possibility and expediency of concluding a pledge agreement on the terms of a master agreement (single contract), as per Clause 1, Article 51.5 of the Law on the Securities Market, remains open.

It should be mentioned, however, that the possibility of using close-out netting in the Russian Federation for NCC derivatives has been confirmed, inter alia, by the international law firm Clifford Chance in its memorandum of law, prepared for ISDA in 2015⁸.

5.2. Title Transfer Collateral (Floating Margin Amounts Model)

According to Clause 1, Article 329 of the CC RF, the fulfilment of obligations may be secured, apart from the methods established by law, in the manner prescribed by the contract. Besides, in accordance with Clause 1, Article 51.5 of the Law on the Securities Market, counterparties may conclude on the terms and conditions set forth in the master agreement (single contract) a contract that provides for the obligation of one of the counterparties thereto to transfer to the other party securities and/or money, including foreign currency, to secure the fulfilment of obligations arising out of contracts concluded on the terms and conditions of such master agreement (single contract).

Standard terms of the agreement on the procedure for paying floating margin amounts allow the parties thereto to exchange margin in the form of cash funds, on the terms and conditions set forth in a master agreement (single contract). Unlike Pledge, close-out netting is applicable to such floating margin amounts. However, Standard terms of the agreement on the procedure for paying floating margin amounts do not allow the parties to exchange other types of assets except money, and do not apply to the derivatives executed outside the framework of the master agreement (single contract). Besides, the tax laws do not currently establish a special taxation procedure for floating margin amounts.

⁸ Clifford Chance. Memorandum of Law for the International Swaps and Derivatives Association, Inc. on the Enforceability under Russian Law of the Close-out Netting Provisions under ISDA Master Agreements, 6 February 2015. This memorandum of law was updated on 12 January 2017.

5.3. Title Transfer Collateral (Security Payment Model)

Following the adoption of Federal Law No. 42-FZ dated 8 March 2015, 'On Amending Part One of the Civil Code of the Russian Federation', a new type of collateral appeared in Russian civil law—that is, a security payment. According to Clause 1, Article 381.1 of the CC RF, a monetary obligation, including the obligation to compensate losses or to pay a penalty upon the violation of a contract, or an obligation arising on the grounds set forth in Clause 2, Article 1062 of the CC RF may be secured by agreement of the parties by transferring a certain amount of money by one party in favour of the other party (a security payment). Upon occurrence of the circumstances stipulated in the contract, the security payment amount is applied towards the fulfilment of the respective obligation. At the same time, a security payment in the form established in the CC RF has limited functionality. In particular, according to Article 381.2 of the CC RF, a security payment in the form of the transfer of securities cannot secure the fulfilment of any obligations other than the obligation to transfer those same securities.

Just as with floating margin amounts, the efficiency of extending the security payment on the derivatives executed outside the framework of the master agreement (single contract) is dubious. As mentioned above, set-off during the period of supervision in bankruptcy proceedings is limited from the Russian law perspective. In particular, according to Paragraph 7, Clause 1 of Article 63 of the Law on Bankruptcy, it is not allowed to terminate the debtor's monetary obligations by offsetting a counter-claim of the same kind, if such termination violates the order of satisfaction of creditors' claims, as established in Clause 4, Article 134 of the Law on Bankruptcy. Therefore, upon occurrence of the circumstances stipulated in the contract, set-off of the security payment amount towards the fulfilment of the secured obligation in accordance with Clause 1, Article 381.1 of the CC RF may appear to be impossible.

However, Paragraph 7, Clause 1 of Article 63 of the Law on Bankruptcy makes an exception for financial contracts (one of which may be a contract of security payment) executed on the terms and conditions of a master agreement (single contract) in

which case the amount of obligations is determined as per Article 4.1 of the Law on Bankruptcy⁹.

Comments to Chapter 5, taking into consideration the aforementioned consultations

Many respondents pointed out that, at the moment, the Russian laws contain barriers to the use of the legal constructs listed in Clauses 5.1–5.3 hereof for paying the Initial Margin while complying with the following principles established in BCBS-IOSCO Standards:

a) Initial Margin collected should be immediately available to the collecting party in the event of the counterparty's default.

b) Initial Margin collected must be subject to arrangements that fully protect the posting party to the extent possible under applicable law in the event the collecting party enters bankruptcy.

In the opinion of the Bank of Russia, the existing barriers generally do not hinder the option to use collateral under Russian law to exchange the Initial Margin, and they will be removed, step by step, along with the improvement of legislation concerning financial collateral. Moreover, Federal Law No. 212-FZ dated July 26, 2017 'On Amending Parts 1 and 2 of the Civil Code of the Russian Federation and Certain Legislative Acts of the Russian Federation' provides, from June 1, 2018 adds some new rules with regard to escrow agreements, which include rules as to the segregation (separation) of deposited assets. Thus escrow agreements under Russian law may potentially be considered for use in the margining of NCC derivatives. Furthermore, the Bank of Russia does not plan to establish a closed list of legal devices which may be used for purposes of margining NCC derivatives. This is due, among other things, to the fact that foreign law may be used in cross-border transactions, and such foreign law may provide for financial collateral arrangements that differ from those available under Russian law. Applicable foreign law may also be either more or less effective from the point of view of compliance with the principles of Initial Margin protection established in BCBS-IOSCO Standards.

⁹ A similar exception is contained in Clause 7, Article 20 of the Law on Banks, insofar as it concerns revocation of a credit institution's banking licence.

CHAPTER 6. SERVICES FOR THE CALCULATION, SELECTION, AND REVALUATION OF COLLATERAL AND STANDARDISATION OF DOCUMENTS

The calculation of Initial and Variation Margins to be posted and the selection of appropriate assets for margining may be assigned by one party to NCC derivatives to the other party or to a third party. Both parties to NCC derivatives may appoint a third party which will perform the said actions for both parties.

Because mandatory margining requirements for NCC derivatives are planned to cover not only professional securities market participants, but also financial market participants who do not have the necessary experience and expertise, the Bank of Russia points out the need to develop a segment of specialised services for the calculation, selection, and revaluation of collateral for NCC derivatives. In the international financial market, such services are usually provided by large infrastructural organisations¹.

The services of collateral management in the Russian financial market are currently provided, for example, by the NSD².

We also think that for the purpose of margining, it would be reasonable to develop the following standard documents under the aegis of the DB:

- Standard forms, time frames, and procedures for disclosure by counterparties to NCC

derivatives of information on attainment of relevant threshold values, for the purpose of applying the mandatory margining requirement.

- Standard credit support documentation under Russian law for the exchange of Initial and Variation Margins.
- Rules for resolving disputes on the calculation and timely transfer of Variation Margin.
- Models of calculation of Initial Margin.
- Haircut calculation models with respect to assets accepted as margin.

Based on Recommendation 11 of the FSB Report 'Implementing OTC Derivatives Market Reforms', the Bank of Russia also suggests preparing a legal framework for the development of compression services for portfolios of NCC derivatives and the implementation of modern risk management procedures by the entities, which are subject to the requirement for mandatory margining of NCC derivatives, in order to enhance the effectiveness of margining, reduce operational risk, and release the liquidity and capital of credit institutions.

¹ Such as Clearstream (<http://www.clearstream.com>), Euroclear (<http://www.euroclear.com>), Trioptima (<http://www.trioptima.com/>).

² Currently such services are provided in respect of repo transactions only.

CHAPTER 7. CROSS-BORDER TRANSACTIONS

The absence of sufficient uniformity in the international derivatives market, in terms of time frames and approaches to regulation of mandatory margining of NCC derivatives, gives rise to prerequisites for regulatory arbitrage and the risk of discrimination of financial market participants of one country against financial market participants of another country.

When resolving these issues, in the Bank of Russia's opinion, attention should be paid to the following areas:

- Synchronisation of entry into force of the new regulation at the international level.
- Improvement of the definition of derivatives and their types and bringing them in line with global practices.
- Possible acknowledgement of the equivalence of foreign regulatory regimes.

The Bank of Russia plans to extend the rules of mandatory margining of NCC derivatives, as set forth herein, to NCC derivatives executed with foreign entities. As Russian regulation is not of extraterritorial applicability, the mandatory margining requirements will apply only to Russian legal entities. Therefore, a Russian legal entity of Category 1 or Category 2 will have to ensure receipt of margin payments, but will not be obliged to provide margin payments to a foreign counterparty, unless otherwise established by a contract between these parties or by the requirements of applicable foreign law.

Mandatory margining requirements will not apply to contracts for obligations which are cleared through a foreign CCP.

If, in accordance with *lex societatis* of a foreign organisation or, if it acts through its branch, in accordance with the law of the location of such branch, it is covered by a mandatory margining requirement, NCC derivatives with such foreign organisation shall be subject to mandatory margining on the basis of the rules established by *lex societatis* (the law of the location of the branch), provided that the respective state to which the *lex*

societatis (the law of the location of the branch) pertains is included in the list established by the Bank of Russia (hereinafter, the 'List')¹. In this case, the Russian party will not be covered by the requirements stipulated by the Russian regulations, but will be covered by the requirements stipulated by the regulations of the relevant foreign state.

If, in accordance with the procedure established by the law of a state from the List, the foreign party and the Russian party to the NCC derivative are not obliged to exchange margin payments (e.g., upon failure to achieve the threshold value by one of the counterparties), the Russian party, in accordance with Russian law, will not be obliged to demand margin payments from the foreign party.

If, in accordance with the procedure established by the law of a state from the List, the foreign counterparty is not obliged to make margin payments to the Russian counterparty, but is obliged to receive margin payments from the Russian counterparty, the Russian party under Russian law will not be obliged to demand margin payments from the foreign counterparty (unilateral margining will be allowed).

¹ Upon the formation of the List, the extent to which a mandatory margining requirement is applied in specific foreign states will be taken into account. Specifically, the List will not include states which do not have mandatory margining requirements (where transactions with counterparties from such states are concerned, the Russian party will not be obliged to transfer the margin, but will be obliged to receive margin payments in accordance with the Russian rules).

Table 6

Applicable margining rules for foreign counterparties

Contracting party 1	Contracting party 2	Applicable margining rules (including, but not limited to, the list of instruments and entities covered by the rules; amount and calculation procedure of threshold value)
A foreign entity, the lex societatis of which is the law of a state that is on the list of the Bank of Russia.	A Russian entity	Foreign
A foreign entity, the lex societatis of which is the law of a state not on the list of the Bank of Russia (if a foreign organisation acts through a branch, the law of the location of such branch may be determinative).	A Russian entity	Russian

Table 6 specifies the applicable rules, depending on the lex societatis of a foreign counterparty.

Comments to Chapter 7, taking into consideration the aforementioned consultations

This Report details the Bank of Russia's approaches to the planned regulation of cross-border transactions, as compared to the approaches found in the Initial Draft Report, which have been generally supported by the consultation participants. In the future, these approaches may be revised for the purpose of harmonisation with the foreign regimes based on BCBS-IOSCO Standards.

Some respondents suggested including the List in the Report. In spite of the fact that many countries have already introduced mandatory margining requirements in accordance with BCBS-IOSCO Standards, the Bank of Russia deems it appropriate to submit the List later. According to Table 3, margining of NCC derivatives will become mandatory in Russia from September 1, 2019 for Category 1. In the opinion of the Bank of Russia, the number of states where margining of NCC derivatives is mandatory will grow by 2019, making it possible to make the List more complete and more representative.

