IIACACCVM

FIXED INCOME MARKET REGULATORY UPDATE

February 2018

Key regulatory and policy developments shaping industry supervisory, operational and business practices.

Canada

OSFI Delays Implementation of the Net Stable Funding Ratio (NSFR)

On February 6, 2018, the Office of the Superintendent of Financial Institutions (OSFI) announced its intention to extend its implementation timeline of the Net Stable Funding Ratio (NSFR) to January 2020. While NSFR is a key Basel Committee reform to promote a more resilient banking sector, an area of considerable attention by IIAC Members has been the potential effects of the NSFR on collateral management and liquidity in our capital markets. The delay provides OSFI the opportunity to undertake additional stakeholder consultations to ensure domestic implementation is appropriately calibrated for the nuances of the Canadian market. The delay will also help market participants digest the NSFR requirements and incorporate necessary changes to their business and operational practices. OSFI's announcement better aligns Canada's NSFR implementation with progress at the international level, given that few jurisdictions appear ready, or determined, to implement their NSFR frameworks before 2020.

2018 Federal Budget Measures

The Federal Budget released on February 27, 2018, proposes changes to existing anti-avoidance rules meant to prevent Canadian banks and other financial institutions, from gaining a tax advantage through sophisticated financial instruments such as Synthetic Equity Arrangements (SEA), Securities Lending Arrangements (SLA) and Structured Share Repurchase (SSR) transactions. These measures build on those first introduced in Budget 2015 targeting SEA and dividend rental arrangement rules.

Budget 2018 also proposes to introduce legislative amendments that would implement a resolution framework for Canada's systemically important Financial Market Infrastructures (FMIs) such as the Canadian Depository for Securities (CDS) and Canadian Derivatives Clearing Corporation (CDCC). The objectives of the FMI resolution regime are to maintain the critical services of the FMI, promote financial stability, and reduce potential public exposure to loss.

Europe

ESMA's Stress Test of CCPs

On February 2, 2018, the European Securities and Markets Authority (ESMA) published the results of its second EU-wide stress test of Central Counterparties (CCPs) established in the European Union (EU). The stress test builds on the first CCP stress test conducted in 2016, which focused only on counterparty credit risk, with the second exercise focusing on whether CCPs would adequately meet their liquidity needs under different stress scenarios. The tests aim to assess the resilience and safety of the EU CCP industry and helps identify possible vulnerabilities.

Sixteen European CCPs, with approximately 900 clearing members EU-wide, were captured in the second test. The aggregate amount of collateral held by CCPs in the form of margin requirements and default fund contributions on the test date was approximately €270bn. ESMA indicates that the results of the second stress test show that overall the system of EU CCPs is resilient to multiple clearing member defaults and extreme market shocks. In addition, the report also highlights individual CCP-specific results.

ESMA Monitoring Priorities for Credit Rating Agencies, Trade Repositories and Clearinghouses

The European Securities and Markets Authority (ESMA) published its annual report and work programme to highlight its direct supervisory activities in 2017 regarding Credit Rating Agencies (CRAs), Trade Repositories (TRs) and non-European central counterparties (TC-CCPs), and outline its main priorities in these areas for 2018. Some of the stated supervisory priorities include:

- IT and internal controls with a focus on information and cyber security;
- TRs' governance structures and management quality;
- Quality of the credit rating process, including CRAs' validation practices;
- Monitor the potential risks TC-CCPs might introduce in the EU; and
- Monitoring the impacts of Brexit on the third-country CCP regime.

International

IOSCO Consultation to Protect Investors of OTC Leveraged Products

On February 13, 2018, the International Organization of Securities Commissions (IOSCO) issued a consultation report proposing policy measures for its members to consider when addressing the risks from the offer and sale of OTC leveraged products to retail clients.

The Report on Retail OTC Leveraged Products identifies various regulatory approaches to enhance the protection of retail investors who are offered OTC leveraged products, often on a cross-border basis. The report covers the offer and sale by intermediaries of rolling-spot forex contracts, contracts for differences (CFDs), and binary options.

Transition Roadmap for Interbank Offered Rates

On February 1, 2018, a consortium of industry trade groups published a benchmark transition roadmap (the 'Roadmap') that highlights key challenges involved in transitioning financial market contracts and practices from interbank offered rates, or 'IBORs', to alternative risk-free rates (RFRs). The Roadmap focuses on key IBORs in five currencies: euro, sterling, Swiss franc, U.S. dollar and yen. The Roadmap sets out many potential challenges that need to be addressed when transitioning to RFRs, including market adoption of the new RFRs, valuation and risk management complexities, documentation issues, infrastructure requirements, and regulatory, tax and accounting implications. It also outlines the steps taken by the various public- and private-sector RFR working groups to resolve these challenges. Based on publicly available data, the Roadmap estimates total outstanding notional exposure to the IBORs at more than $370 trillion, with derivatives, syndicated loans, securitizations, business and retail loans, floating-rate notes (FRNs) and deposits, all significantly exposed to LIBOR and other IBORs. The Roadmap is aimed at raising awareness of the work conducted to date by industry and public authorities, and creating a central resource for interest rate benchmark transitions across market sectors.

Research Corner

Libor's Costly Transition

In its report titled 'Changing the World's Most Important Number' Oliver Wyman outlines the considerable costs and risks for financial firms in transitioning away from Libor. The report notes that since the proposed alternative rates are calculated differently, payments under contracts referencing the new rates will differ from those referencing LIBOR. The transition will change firms' market risk profiles, requiring changes to risk models, valuation tools, product design and hedging strategies. The report also references early industry estimates that the cost of transition could be greater than $200 million for some banks – a similar order of magnitude to recent regulatory change programs such as MiFID II. The report provides insights on what firms can do to manage the transition.