

Chapter 6 – Appendix I

EXPOSURE TO DERIVATIVES

PART 1: CALCULATION OF GLOBAL EXPOSURE TO DERIVATIVES AND EMBEDDED DERIVATIVES

- (1) For the purpose of this Appendix, any reference to ‘high quality’ means the highest long-term credit rating of the issuer.

Commitment approach

- (2) The global exposure of the fund is calculated as the sum of the –
 - (a) absolute value of the exposure of each individual derivative not involved in netting or hedging arrangements;
 - (b) absolute value of the net exposure of each individual derivative after netting or hedging arrangements; and
 - (c) the values of cash collateral received pursuant to–
 - (i) the reduction of exposure to counterparties of OTC derivatives; and
 - (ii) efficient portfolio management techniques relating to securities lending and repurchase transactions.

Netting arrangements

- (3) Netting arrangements may be taken into account to reduce a fund’s exposure to derivatives.
- (4) A fund may net positions between–
 - (a) derivatives on the same underlying constituents, even if the maturity dates are different; or

- (b) derivatives and the same corresponding underlying constituents, if those underlying constituents are transferable securities, money market instruments, or units or shares in CIS.

Hedging arrangements

- (5) Hedging arrangements may be taken into account to reduce a fund's exposure to derivatives.
- (6) The marked-to-market value of transferable securities, money market instruments, or units or shares in CIS involved in hedging arrangements may be taken into account to reduce the exposure of a fund to derivatives.
- (7) The hedging arrangement must–
 - (a) not be aimed at generating a return;
 - (b) result in an overall verifiable reduction of the risk of the fund;
 - (c) offset the general and specific risks linked to the underlying constituent being hedged;
 - (d) relate to the same asset class being hedged; and
 - (e) be able to meet its hedging objective in all market conditions.

PART 2: CALCULATION OF EXPOSURE TO COUNTERPARTY OF OTC DERIVATIVES

- (8) The exposure to a counterparty of an OTC derivative must be measured based on the maximum potential loss that may be incurred by the fund if the counterparty defaults and not on the basis of the notional value of the OTC derivative.

- (9) The total exposure to a single counterparty is calculated by summing the exposure arising from all OTC derivative transactions entered into with the same counterparty.

Collateral

- (10) The exposure to a single counterparty pursuant to paragraph 6.24(b) may be construed as being lowered if the fund receives collateral from such counterparty, provided that the collateral complies with the following:
- (a) It can only consist of cash, debt securities, or money market instruments, that are subject to the investment restrictions and limits, on a portfolio basis, as prescribed under Schedule B of these Guidelines;
 - (b) It is marked-to-market daily by using independent pricing source;
 - (c) It must be sufficiently liquid and tradable in order that it can be sold quickly at a robust price that is close to pre-sale valuation. Collateral should normally trade in a deep and liquid marketplace with transparent pricing;
 - (d) It must be of high quality and should be replaced immediately as soon as the credit quality of the collateral or the issuer of the asset being used as collateral has deteriorated to such a degree that it undermine the effectiveness of the collateral;
 - (e) Its value must not have any significant correlation with the creditworthiness of the counterparty in such a way that would undermine the effectiveness of the collateral;
 - (f) It is not issued by the counterparty or any of its related corporation;

- (g) It must be held by the trustee in a trust account for the fund;
- (h) It must be subject to prudent haircut policy;
- (i) It must be readily accessible or enforceable by the trustee of the fund without further recourse to the issuer of the derivatives;
- (j) It is free from all prior encumbrances; and
- (k) Bonds, sukuk and other forms of securitised debt, and money market instruments, with embedded derivatives are not eligible as collateral.

Re-investment of collateral

- (11) Collateral obtained in the form of cash by the fund may only be reinvested in short-term deposits and high quality money market instruments, and subject to corresponding investment restrictions and limits applicable to such investments, on a portfolio basis, as prescribed under Schedule B of these Guidelines.
- (12) Non-cash collateral received may not be sold, reinvested or pledged.

Management of operational and legal risks

- (13) The management company or the fund manager must have appropriate systems, operational capabilities and legal expertise for proper collateral management.