Margin Requirements for Non-centrally cleared Over-the-Counter Derivative Transactions

1 Background

In the aftermath of the 2007-2008 financial crisis, the Group of Twenty (G20) initiated regulatory reforms to the financial markets, including reforms to address systemic risk associated with over-the-counter (OTC) derivative instruments. To this end, in September 2009, leaders at the G20 Pittsburgh summit made commitments to implement regulatory reforms in OTC derivative markets and made the following statement:

> "*All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.*"[1]

Subsequently, in 2011 the G20 further agreed that non-centrally cleared OTC derivative transactions must be subject to the exchange of margin and called upon the Basel Committee on Banking Supervision and International Organisation of Securities Commissions (BCBS-IOSCO) to develop consistent standards appropriate for the margin requirements framework. Following the quantitative impact study and consultative processes, in March 2015, the BCBS-IOSCO[2] released the final document on the standards for margin requirements for non-centrally cleared derivative transactions. Due to the high risk factors associated with OTC derivative transactions, exchange of initial and variation margin will serve as additional risk mitigation tools and incentive for central clearing of OTC derivative transactions. Therefore, jurisdictions must align as closely as possible to the proposed standards in order to implement harmonised frameworks to allow for equal playing fields and to reduce chances of regulatory arbitrage among market participants.

The BCBS-IOSCO recommendations proposed the following timelines for the implementation of the margin requirements: 1 September 2016, was the date originally proposed to initiate the phased-in implementation of the margin requirements until September 2020 and the implementation of variation margin was scheduled from 1 September 2016 with the second phase starting on 1 March 2017. According to the latest twelfth progress report on the implementation of the OTC derivatives market reforms issued by the Financial Stability

[1] G20 Pittsburgh Summit Leaders' Declaration, September 2009. Available: http://www.fsb.org/wp-content/uploads/g20_leaders_declaration_pittsburgh_2009.pdf

[2] BCBS-IOSCO Margin requirements for non-centrally cleared derivatives, March 2015. Available at http://www.bis.org/bcbs/publ/d317.pdf

Board[3], at least fourteen (14) jurisdictions have made progress in this reform area. The United States, Japan and Canada implemented the margin requirements within the internationally agreed schedule.

However, certain jurisdictions are experiencing challenges in implementing the margin requirements into the domestic frameworks. To this end, there are concerns relating to the inconsistencies created by significantly different implementation timelines. The local Authorities are cognisant of the issues raised and have prioritised to implement requirements that are aligned as closely as possible to the BCBS-IOSCO framework, in a manner that is appropriate for the domestic market framework.

The Financial Services Board (FSB), National Treasury and the South African Reserve Bank (SARB) have been coordinating through a dedicated steering committee and working groups in order to finalise the Financial Markets Act, (Act No. 19 of 2012) (FMA) regulations and the accompanying board notices. The first and second consultative process was conducted in 2014 and 2015, respectively. In July 2016, the National Treasury and FSB published (i) the third draft of the FMA regulations; (ii) the draft board notice for the criteria for authorisation of OTC derivative providers (ODPs); (iii) the draft Code of Conduct for ODPs; and (iv) the draft notice for the licensing requirements and additional duties for a trade repository. In April 2017, the final draft notice on the trade reporting obligations was published for public comment.

In 2015, the first draft of the margin notice was published by the FSB for public consultation.[4] During November 2016, the Bank Supervision Department (BSD) of the SARB issued a draft directive for margin requirements for non-centrally cleared derivative transactions in terms of the Banks Act (Act No. 94 of 1990). Subsequently, in December 2016, the BSD issued Guidance Note 8/2016[5] informing the banks, branches of foreign institutions, controlling companies, eligible institutions and auditors of banks or controlling companies, of the delayed implementation of margin requirements for non-centrally cleared derivatives to a date later than 1 January 2017. The BSD, FSB and National Treasury have been working closely to develop a revised framework for margin requirements for non-centrally cleared

[3] OTC Derivatives Market Reforms, Twelfth Progress Report on Implementation, 29 June 2017. Available at http://www.fsb.org/wp-content/uploads/P290617-2.pdf

[4] Draft Notice for Margin requirements for Non-centrally cleared derivatives, June 2015. https://www.fsb.co.za/Departments/capitalMarkets/Documents/Draft%20Margin%20requirements%20(05%20June%202015).pdf

[5] G8/2016: Margin requirements for non-centrally cleared derivatives, 20 December 2016. Available at https://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=7609

derivative transactions, which is closely aligned to the BCBS-IOSCO framework, but cognisant of the domestic context.

This latest draft of the margin notice for non-centrally cleared derivatives has been developed in response to the public consultation processes that have been undertaken to date and applies to prudentially and non-prudentially regulated market participants. The salient aspects of the revised margin notice are as follows:

2 Scope of application

2.1 Covered entities

The BCBS-IOSCO framework recommends that the margin requirements are limited to the covered entities that are systemically important financial entities and systemically important non-financial entities. In particular, there are exclusions for sovereigns, central banks, multilateral development banks and the Bank for International Settlements (BIS).

Considering the BCBS-IOSCO standards and the possibility of the overreaching impact margin requirements would have on market participants, the approach taken in this draft notice limits the application to particular market participants. The FMA regulations introduce OTC derivative providers as regulated persons in order to extend the scope of regulation to previously unregulated activities and participants in OTC derivative markets. This latest margin notice clarifies that the margin requirements are not applicable to a “client”, as it was never the intention to impose such requirements on them and specifies counterparties for the purposes of the margin requirements. The requirements to exchange margin extend to counterparties and authorised ODPs, as defined. The margin requirements are not applicable to any other entity not captured as an authorised ODP or a counterparty.

2.2 Instruments

In the FMA regulations, the definition of OTC derivative excludes foreign exchange spot contracts and physically settled commodity derivatives. In terms of this revised notice, these instruments are excluded from the initial margin requirements, however, the exchange of variation margin is still applicable to such instruments.

2.3 Treatment of intra-group transactions

The margin notice has been amended to carve out OTC derivative transactions between covered entities in the same group, subject to certain requirements as set out in the notice.

2.4 Cross-border transactions

OTC derivative markets are characterised by global transactions. The BCBS-IOSCO recommendations note that because of this factor, the effectiveness of margin requirements could be undermined if margin requirements implemented in various jurisdictions are inconsistent. Implementing consistent requirements would ensure that there are equal playing fields and reduced possibility of regulatory arbitrage. In the South African derivative markets, it is reported that the majority of the derivative transactions facilitated are between domestic counterparties and foreign counterparties. The approach of the Authorities is therefore to implement requirements that are consistent, ensuring that market participants are not subject to unequal or duplicate requirements.

Jurisdictions have implemented different approaches to the treatment of cross-border transactions. In Canada for instance, the approach includes “substituted compliance”, where the covered entity is deemed to have complied with the Canadian requirements – if the covered entity complies with the foreign counterparty’s requirements that are comparable to the BCBS-IOSCO framework and provided documentary evidence is submitted to the Canadian authority.

The Authorities have considered the approaches adopted in other jurisdictions to cross-border OTC derivative transactions. At this stage, the approach is not to adopt an explicit approach that allows for substituted compliance in the domestic framework. The revised margin notice has therefore been amended to allow for cross-border OTC derivative transactions between a local covered entity and a counterparty in a foreign jurisdiction. In terms of this approach, a local covered entity could be deemed to comply with the margin requirements that are applicable to the counterparty in a foreign jurisdiction, provided certain requirements as set out in the margin notice are complied with.

Providers may not necessarily trade with counterparties in jurisdictions that have comparable frameworks or standards aligned to the BCBS-IOSCO framework and where netting agreements are enforceable. In a case where providers transact with counterparties in foreign jurisdictions where netting agreements cannot be enforced upon the insolvency of the counterparty, providers are not required to post initial and variation margin in such transactions, if the aggregate outstanding gross notional amount of transactions between the provider and that foreign counterparty falls below the thresholds determined by the Authority. Where the threshold is breached, the provider must obtain approval from the

Authority in order to continue transacting with that foreign counterparty, and if the conditions specified by the Authority are met.

3 Treatment of Collateral

Considering the increased liquidity demands that may arise from the requirement to exchange margin, cash and non-cash initial margin maybe re-hypothecated only once, subject to certain conditions as set out in this notice. Re-hypothecation is only limited to the initial margin collector, therefore a third party may not re-use or re-hypothecate the collateral.

One of the BCBS-IOSCO recommendations for the treatment of initial margin is the "immediate" availability of the posted collateral to the collecting party in case of counterparty default. It is recognised that the requirement for "immediate realisation" of initial margin would be challenging to comply with, in the context of the domestic insolvency framework in the event of default by a domestic counterparty. Therefore, further engagements are taking place to resolve the issues around the shortcomings in the insolvency framework.

4 Thresholds and Phase-in requirements

In the explanatory memorandum published on 5 June 2015[6], and 21 July 2016[7], it was proposed to implement the margin framework in line with the BCBS-IOSCO recommendations. The BCBS-IOSCO framework proposed implementation timelines for initial margin to start from 1 September 2016 and phased-in over a 4-year period. The initial margin requirement will apply if aggregate month-end average gross notional outstanding amounts for non-centrally derivative positions that are in excess of €3 trillion, and this amount will be subsequently, reduced by €0.75 trillion per year until 1 September 2020, when a permanent threshold of €8 billion will apply. From 1 September 2016 and the second phase from 1 March 2017 was the proposed implementation dates for covered entities to comply with the variation margin requirements.

The domestic framework is largely dependent on other parallel processes that include; the finalisation of the FMA regulations that are required for the authorisation of ODPs; and the commencement of the consequential amendments to the FMA that will enhance the OTC derivative market regulatory framework. The consequential amendments to the FMA are subject to the promulgation of the Financial Sector Regulation Bill (FSRB). Therefore, the proposed implementation timelines for the margin requirements differ from the BCBS-IOSCO

[6] Explanatory Memorandum on Regulating Over-the-counter derivative Markets in South Africa. 5 June 2015. Available at http://www.treasury.gov.za/OTC/

[7] Explanatory memorandum, 21 July 2016. available at http://www.treasury.gov.za/OTC/Explanatory%20Memo%20%20Regulating%20OTC%20Markets_July2016.pdf

internationally agreed timeframe due, in part, to the financial sector regulatory reform processes as provided for in the FSRB.

4.1 Initial and Variation Margin thresholds

The thresholds proposed in the margin notice are determined based on their appropriateness for the domestic market and framework, and are objectively high not to subvert the domestic markets through increased liquidity requirement on market participants. In addition, due to the lack of central clearing infrastructures and pending decision to mandate central clearing, the intention is not to follow a capture-all approach under this framework, to avoid unintended consequences that may arise from increased compliance requirements.

The initial and variation margin thresholds align to the BCBS-IOSCO thresholds, but not a one-to-one conversion of the BCBS-IOSCO thresholds. The concern is that such application would result in no margin exchange between the domestic covered entities and therefore not address any risks arising from non-centrally cleared derivatives that the margin requirements are intended for. The margin thresholds proposed are as follows:

- Covered entities must exchange initial margin on a bilateral basis, subject to an initial margin threshold not exceeding R500 million;
- Full variation margin amount must be exchanged on a regular basis;
- The transfer of margin is also subject to a de-minimis minimum transfer amount not exceeding R5 million.

4.2 Phase-in Initial Margin

The phase-in date differs from the BCBS-IOSCO proposed date; however, the initial margin phased-in is over a 4-year period. Covered entities whose aggregate gross notional outstanding amount for the months of July, August and September 2017 exceeds **R30 trillion** will from 1 January 2018 to December 2018 exchange initial margin on the derivative transactions, and the thresholds will be reduced per year until January 2022 (see table 1 below for details on the thresholds and envisaged timelines).

Table 1- Initial Margin Phase-in

Initial Margin Phase-in	Aggregate Month-end notional amount	Threshold
1 January 2018 to 31 December 2018	July, August, September 2017	R30 trillion
1 January 2019 to 31 December 2019	July, August, September 2018	R23 trillion
1 January 2020 to 31 December 2020	July, August, September 2019	R15 trillion
1 January 2021 to 31 December 2021	July, August, September 2020	R8 trillion

Initial Margin Phase-in	Aggregate Month-end notional amount	Threshold
1 January 2022 onwards	July, August, September of the preceding year	R100 billion

4.3 Phase-in Variation Margin

A provider and a covered entity must on a daily and bilateral basis exchange the appropriate amount of variation margin from 1 January 2018, if the aggregate month-end average gross notional amount of the OTC derivatives for the period July, August and September 2017 exceed the threshold amount of R30 trillion. From 1 July 2018, exchange of variation margin will be applicable on all non-centrally cleared derivative transactions entered into after 1 January 2018.

5 Effective date

The board notice only comes into effect on the date determined by the Registrar of Securities Services.

The latest draft notice on the margin requirements for non-centrally cleared derivatives and the accompanying comments and response matrix is available at https://www.fsb.co.za/Departments/capitalMarkets/Pages/Documents-for-Consultation.aspx

Market participants are therefore encouraged to review the proposed draft notice and provide comment on the above to elmarie.hamman@fsb.co.za by **8 September 2017**.

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