

REDUCING THE RISKS OF OVER-THE-COUNTER DERIVATIVES IN SOUTH AFRICA

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International developments + standards

- Effects of the global financial crisis
 - Certain features of over-the-counter (OTC) derivatives markets have potential to amplify systemic risk in financial markets
- G-20 2009 Pittsburgh statement :
 - “All standardised OTC derivatives should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivatives contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.”*
- IOSCO reiterated calls by the G-20 and the FSB

IOSCO RECOMMENDATIONS

1. **Market entry:** minimum regulatory capital, competent and suitably qualified personnel, technical infrastructure and robust risk management standards.
2. **Investor protection:** Disclosure standards covering risks and features
3. **Investor protection:** suitability tests for unsophisticated OTC investors.
4. **Standardisation:** for systemically critical products taking into account the balance between standardisation, and market efficiency and liquidity.
5. **Standardisation:** carefully decided as to where appropriate
6. **Clearing/CCP clearing:** central clearing more appropriate for large and complex OTC markets
7. **Clearing/CCP clearing** – standards should be carefully defined with required arrangements in place

IOSCO RECOMMENDATIONS CONTINUED

8. **Transparency** – CCPs and TRs must be economically affordable and functionally useful
9. **Transparency:** Regulator should set out general framework and principles for TR
10. **Providing data/reporting:** regular reporting on size of positions with direct access to data source by regulator
11. **Providing data/reporting:** Standards for reporting should be set out
12. **Collateralisation/risk management:** For transactions that are not centrally cleared, the standards for bilateral collateralisation should be set.
13. **Collateralisation/risk management:** For transactions that are not centrally cleared appropriate capital charges should be arranged for the relevant risks.
14. **Valuation:** OTC derivatives should be valued realistically
15. **Valuation:** Market value should be applied as much as possible. Where market value is not available, fair value should be used but explained to investors

South African Regulatory Framework

South African OTC derivatives market partly regulated:

- Securities Services Act (SSA)
 - No provision for proactive regulation, monitoring and surveillance of the South African OTC derivatives market
- Financial Advisory and Intermediary Services Act (FAIS)
 - Does not extend to bilateral counterparties acting in principal capacities
- Banks Act
 - Derivatives not explicitly regulated - banks regulated in terms of general prudential and conduct of business rules
 - But regulatory capital requirements on risk arising from derivative activities
- JSE reporting rules for capital adequacy

Extending the Scope of Regulation

- South Africa committed to implementing the G-20 and FSB recommendations
- 2010 MTBS announcement to extend the scope of regulation to the OTC Derivatives market
- Review of the SA securities legislation
- 2010 OTC Derivatives Regulation Working Group commissioned by the Financial Services Board (FSB-SA)
 - Annexure C: To investigate structure, operation, functionality and risks of SA OTC derivatives market
 - Recommendations broadly accepted by NT/FSB
- 2012 Financial Markets Bill (FMB) tabled in Parliament
 - New legislative framework for reforms

Objectives of SSA review

- Maintaining integrity of the regulatory framework of SA financial markets
- Ensuring regulatory framework continues to meet its objectives:
 - Fair, efficient and transparent fin markets.
 - Promote protection of regulated persons, clients and investors;
 - Reduce systemic risk
- Aligning regulatory framework with relevant local and international developments and standards (G20, IOSCO, FSAP, UNIDROIT)
- Effective mitigation of potential impacts of possible future financial crisis.

The FMB and OTC derivatives market

The Financial Markets Bill:

- Addresses regulatory fragmentation/gaps in OTC derivatives market
- Enabling framework that aligns to international standards
- Extends the scope of regulation to unlisted securities
- Allows for TR: aimed at lack of transparency
- Allows for independent CH: aimed at counterparty risk

CHAPTER IX: SCOPE OF REGULATION

- Extends scope of regulation to unlisted securities
- Regulation to vest with Minister in s.77(1), supported by economic impact assessment.
- The registrar may in accordance with regulations prescribed by the Minister prescribe requirements/impose conditions around:
 - Authorisation of persons;
 - Code of conduct;
 - Reporting requirements;
 - Clearing and settlement
 - Etc.
- S.4(1)(c) no person may provide securities services in respect of unlisted securities in contravention of conditions imposed/prescribed under section 77

CHAPTER V: CLEARING HOUSE (CH)

- **Independent CH** –clears transactions in securities on behalf of any person and authorises and supervises its clearing members in accordance with its clearing house rules
- Chapter VII applies to an independent clearing house as an SRO
- **2 Key Approach:** Must be licensed by the registrar, in consultation with Governor
- Independent CH must inform the registrar of any matter that poses systemic risk to fin. Markets
- **S. 51** – members contribution towards funds of the independent CH
- **In principle**, NT is not opposed to a foreign CH.

CHAPTER VI: TRADE REPOSITORIES

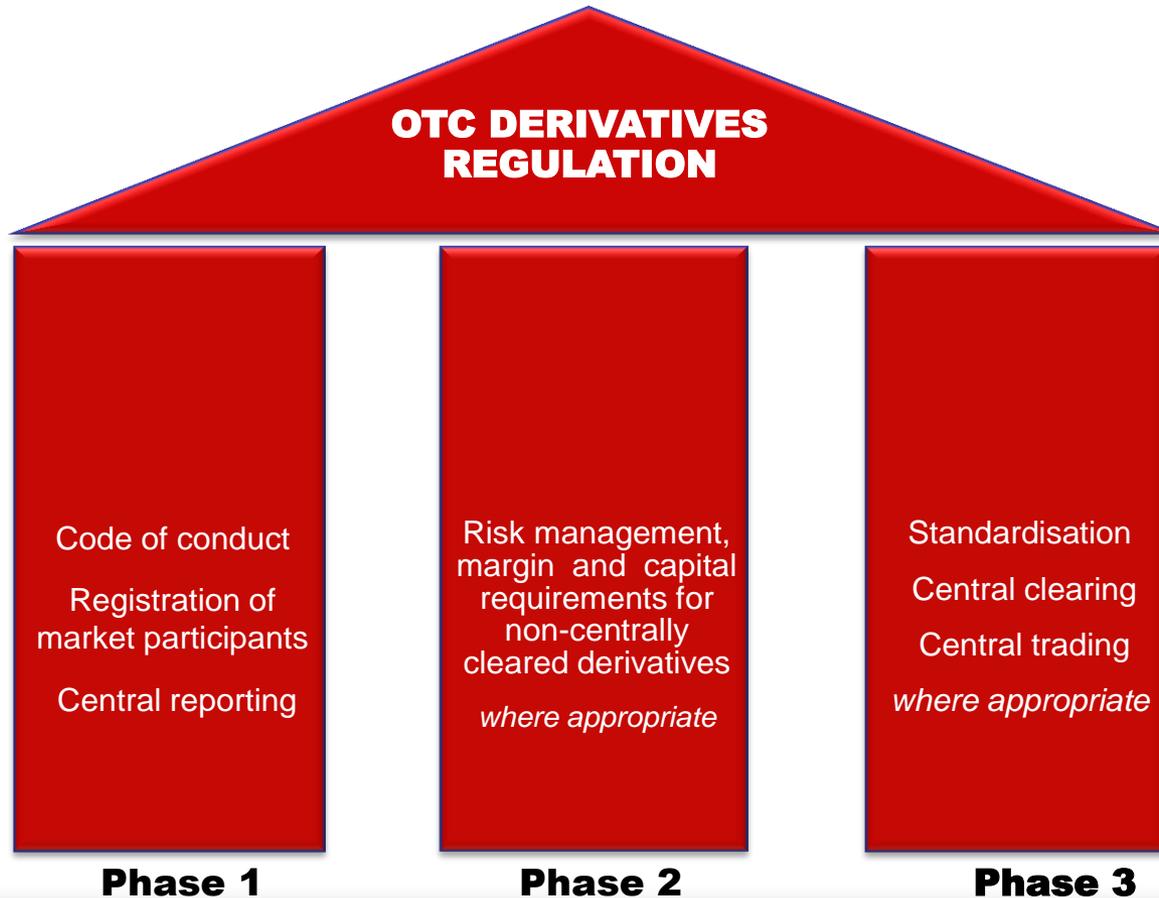
- **Trade Repository** – means a person that maintains a centralised electronic database of records of transactions data
- A trade repository is not an SRO
- **2 Key Approach:** Must be licensed by the registrar, in consultation with Governor
- A TR must provide the Governor with any information requested to monitor and mitigate systemic risk.
- **In principle,** NT is not opposed to a foreign TR.

LESSONS FROM ABROAD: IMPLEMENTATION

- **THE DEVIL IS IN THE DETAIL!**
- Lessons from abroad:
 - There is NO advantage to being a first-mover
 - Consultation is crucial for effective implementation
 - Costs and benefits must be adequately weighed

Phased Implementation

National Treasury envisages a phased implementation for OTC derivatives regulation in South Africa:



PROCESS FOR THE IMMEDIATE FUTURE

- Collect responses to survey – deadline 25 May
- Convene an OTC Derivatives Advisory Group – fair representation
 - Aligned with other existing policy Committees where possible
 - Responsible for development of policy/implementation for reform of OTC derivatives market.
 - Same group/representation expected from Phase 1 to end of process
- Consultation papers released at start of each Phase

Phase 1:

Code of conduct
Registration of market participants
Central reporting

Registration of Market Participants

OBJECTIVES:

- Ensure that professional participants possess sufficient resources and governance structures; provides necessary safeguards for consumer protection

RECOMMENDATIONS:

- Registration requirements include capital, infrastructure, fit and proper requirements, risk management, corporate governance
 - Licensing of “*professional participants*”? Who qualifies?
 - Should other participants be subject to registration requirements? Foreign?
 - If yes, should this be less onerous than on professional participants?

Code of Conduct

OBJECTIVES

- Protection of participants particularly non-professional retail counterparties in relation to *professional* participants (except where activity under FAIS)

RECOMMENDATIONS

- Code of conduct for participants
 - but which participants? Foreign, professional?
- Suitability tests for unsophisticated OTC investors
- Full disclosure of material risks/ health warnings
 - Should Code of Conduct extend to valuation methodologies, collateralisation procedures, KYC, early termination, dispute resolution?

Central Reporting

- G-20 recommends central reporting of all OTC derivative transactions to trade repositories
 - Public, transparent and aggregated information builds greater confidence in and understanding of the markets
- Policy objectives :
 - Assessment of systemic risk and financial stability
 - To monitor the build-up and distribution of exposures especially for trades that are NOT centrally cleared
 - Market surveillance and enforcement
 - Market supervision
- **NT/FSB support establishing a TR but this requires regulatory oversight**

Central Reporting continued...

Recommendations relate to:

- **Trade repository and policy objectives**

- proposed mandatory reporting of all OTC derivatives transactions to a TR to enable the prudential regulators to assess and monitor systemic risk
- What level of detail should be reported to assist with market surveillance and enforcement
- Supervision; aligning OTC requirements with stringent requirements in listed derivatives market

Central Reporting continued...

Recommendations relate to:

- **Regulatory framework**
 - The FMB provides for a trade repository to be established/licenced
- **Trade repository's role and responsibilities**
 - Safety, access, security, reliability, and confidentiality of reported data
- **Structure and financing of the trade repository**
 - The FMB is not prescriptive about a repository's structure and ownership

Central Reporting continued...

Recommendations relate to:

- **Reporting requirements**

- *Nature and type of information to be reported* – FSB SA proposes that all OTC derivatives transactions data reported should include reporting on both **transactional data**, i.e. type, underlying, notional maturity etc. as well as **position, valuation** and aggregated data
- *Reporting party* – proposed separate **reporting by both counterparties** to a transaction; where a transaction is between a **local and a foreign counterparty**, either party may report to the TR provided their reporting is made to a locally licensed TR and such foreign counterparty is able to meet the reporting timeline
- *Timing of reporting* – proposed **real-time reporting** of OTC derivatives transactions to the TR – avoid regulatory arbitrage between listed and OTC derivatives
- *Legal Entity Identifier (LEI)* - financial regulators and industry to establish a universal entity identifier system for uniquely identifying parties to financial transactions. LEI to be a foundational step in building data standards.

QUESTIONS OR COMMENTS

- Questions on FMB to Retha/Kathy/Norman
- Comments on Implementation Natalie/Roy
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