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FINANCE & BANKING **ALERT**

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New Draft Margin Requirements for Non-Centrally Cleared OTC Derivative Transactions

An updated version of the Draft Margin Requirements for Non-Centrally Cleared Over-the-Counter Derivative Transactions (Margin Requirements) was recently published as a Joint Standard by the Financial Sector Conduct Authority (FSCA) and the Prudential Authority (PA). The previous draft of the Margin Requirements was published during August 2018.

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Some of the important changes in the new draft of the Margin Requirements are summarised as follows:

Definition of counterparties

1) The new draft has replaced the closed list of "*covered entities*" with a closed list of "*counterparties.*" Accordingly, in scope entities like authorised users, banks and insurers and others are now referred to as "*counterparties*" instead. Furthermore, a collective investment scheme itself (rather than just the manager of such a scheme) is now also defined as a counterparty and is therefore in scope of the purposes of the Margin Requirements. The regulators have retained the right to designate other persons as in scope counterparties (potentially pension funds) but no further clarity has been provided in this regard.

Foreign counterparty carve out

2) Foreign counterparties have been carved out of the definition of "*counterparties*" and are now defined separately for the purposes of section 2.3 of the Margin Requirements, which deals with the margining of cross border transactions.

Margin Requirements binding on providers

3) Another one of the key changes, is that the Margin Requirements are now binding on "*a provider*" entering into non-centrally cleared OTC derivative transactions with a counterparty. "*A provider*" is an authorised over-the-counter (OTC) derivative provider (ODP). Previously, the Margin Requirements were binding on all "*covered entities*" (now "*counterparties*"). This amendment clarifies who exactly is responsible for ensuring that the Margin Requirements are complied with, by imposing the compliance obligation on the "*provider.*"

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Certain ODPs had requested that the threshold be set at R100 billion, but the regulators' response to this request indicates their stance that the R50 billion threshold is appropriate.

Physically settled FX

4) Previously, physically settled foreign exchange forwards and swaps were subject to variation margin but were excluded from the initial margin requirements. In response to concerns raised by local ODPs, the new Margin Requirements were finally amended, and physically settled foreign exchange forwards and swaps are now excluded from both the variation margin requirements and the initial margin requirements. This change aligns with the approach that is taken in other G20 jurisdictions.

Intra-group transactional exemption threshold increased

5) The intra-group transactional exemption threshold has been increased from R30 billion to R50 billion. Accordingly, the Margin Requirements will only apply to intra-group transactions entered into between a provider and a counterparty once the aggregate outstanding gross notional amount of the non-centrally cleared OTC derivative transactions between the provider and the counterparty in the group exceeds R50 billion at the close of business on the relevant day, subject to further provisos set out in the Margin Requirements. Certain ODPs had requested that the threshold be set at R100 billion, but the regulators' response to this request indicates their stance that the R50 billion threshold is appropriate.

OTC derivative transactions with foreign counterparties

6) Under the previous draft of the Margin Requirements, providers entering into non-centrally cleared OTC derivative transactions with foreign counterparties had to submit information to the FSCA, to obtain prior approval to enter into the OTC derivative transaction, from the FSCA in concurrence with the PA. This onerous approval mechanism has now been removed, and the provider must rather ensure that it has necessary documentary evidence to satisfy itself (ie the provider) that the relevant foreign jurisdiction has implemented margin requirements based on the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions (BCBS-IOSCO) Margin Requirements for Non-Centrally Cleared Derivatives Framework and that the foreign counterparty is subject to those margin requirements and must comply with them. This amendment will reduce bottlenecks for the entering into of transactions with foreign counterparties by removing the requirement of involvement of the FSCA and PA. One criticism however is that participants still need clarity as to what type of documents would be considered "documentary evidence" for purposes of this clause.

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This threshold amount has now been set as 2.5% of the total portfolio of derivatives contracts of the provider and its group.

Non-netting threshold set

7) A provider that enters into an OTC derivative transaction with a foreign counterparty where the relevant local legal framework does not recognise the enforceability of a netting agreement or a collateral opinion upon the insolvency of the counterparty or the default of the counterparty was previously not required to post or collect initial margin or exchange variation margin if the aggregate outstanding gross notional amount of the transactions was below the threshold which was still to be determined. This threshold amount has now been set as 2.5% of the total portfolio of derivatives contracts of the provider and its group. Furthermore, the provider requires a legal opinion confirming that the netting agreement or exchange of collateral is not legally enforceable at all times. This legal opinion must be in written form and must be obtained from external legal counsel but may include jurisdictional opinions obtained on an industry-wide basis by recognised industry associations from external independent legal counsel.

R3 billion daily actual exposure threshold removed

8) The old draft of the Margin Requirements imposed an overarching general requirement that despite any reference to thresholds based on aggregate outstanding gross notional amounts in the Margin Requirements, where the actual outstanding counterparty exposure between two *"covered entities"* at the close of each day exceeded R3 billion, the two covered entities were required to exchange margin. This provision has been deleted in its entirety.

Timing aligned

9) Finally, the phasing-in of the initial margin and variation margin requirements, has been delayed and aligned with the phasing-in dates in the European Union and United States of America. In respect of initial margin, the phasingin process was supposed to begin on 1 January 2019. This has been shifted to 1 September 2019, and the commencement dates of each of the subsequent phases of initial margin implementation have likewise

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The new Margin Requirements are expected to come into effect from 1 September 2019.

been shifted out by 9 months. The "look back" period for calculating the aggregate month-end average gross notional amount of OTC derivatives (AANA) for in scope ODPs and counterparties has also been amended to March, April and May of the year preceding the implementation start date.

The variation margin requirements now also commence on 1 September 2019 and will apply only to new contracts entered into between the provider and counterparty after 1 September 2019. The second phase of variation margin implementation will begin on 1 March 2020. The "look back" period for calculating the AANA for in scope ODPs and counterparties has been amended to March, April and May of the year preceding the implementation start date. The Margin Requirements have no retrospective effect.

The new Margin Requirements are expected to come into effect from 1 September 2019. Given that the Margin Requirements have undergone some fairly substantial changes, interested parties and market participants ought to submit their final comments.

Submissions must be made using the comments template, and must be submitted in writing to PA-Standards@resbank.co.za for the attention of Ms Lyle Horsley and FSCA.JointStandardComments@fsca.co.za for the attention of Ms Elmarie Hamman.

The current deadline for submission of comments is 20 May 2019.

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OUR TEAM

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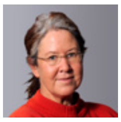

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