

Paying additional margin on derivatives: The missing piece of the puzzle

In July 2016, revised drafts of the subordinate legislation to the Financial Markets Act, 2012 (FMA) were released for comment. However, the second draft of the Margin Requirements for Non-Centrally Cleared OTC derivative contracts (Margin Requirements) was not included. To date we have no indication as to when the Margin Requirements might be published.

By [Bridget King](#) 29 Sep 2016



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To fully understand the impact of the new Margin Requirements on the South African OTC derivatives market, it is essential to first determine which types of derivatives contracts will be subject to the mandatory clearing requirement under the new regime.

Mandatory clearing

This is the critical missing piece of the puzzle. We know that certain contracts will be designated by the regulators as eligible for mandatory clearing through a central counterparty (CCP) and that parties who do not submit their contracts for clearing will be subject to additional margin requirements in respect of those uncleared contracts. However, where a contract has been designated by the regulators as subject to mandatory clearing, there will be no obligation to submit those trades to a CCP for central clearing.

Based on previous drafts of the legislation (circulated in October 2015), some uncertainty arose as to whether the margin requirements would apply to all uncleared derivatives or only to some.

However, in the July draft of the Regulations to the FMA (Regulations), this debate has finally been put to rest by the addition of new provisions to s4 of the Regulations. The Financial Sector Conduct Authority (FSCA) which will be established under the Twin Peaks regime (previously the FSB) must, in consultation with the Prudential Authority (a department to be established within the South African Reserve Bank also under the Twin Peaks regime) will be empowered to designate which OTC derivatives transactions will be subject to mandatory clearing based on certain “eligibility criteria”.

When determining which OTC derivatives transactions will be eligible for clearing, the FSCA and PRA must consider six factors:

- whether the type of OTC derivative transaction is suitable for clearing (for example based on the level of contractual : operational standardisation, volume and liquidity of the relevant OTC derivative transaction);
- the effect of designating a particular transaction as eligible for mandatory clearing on the stability, integrity and efficiency of the South African financial system;
- the inter-connectedness between counterparties to the relevant classes of OTC derivative transactions (and the impact on the levels of counterparty credit risk);
- whether the relevant CCP has the resources available to clear that particular type of OTC derivative transaction;
- whether designating a certain OTC derivative transaction as eligible for clearing, will create a negative or other impact on the competitiveness of the South African markets; and
- any other matters considered relevant.

Additional margin on uncleared swaps

This demonstrates the legislature's intention that only some (and not all) OTC derivatives transactions will be subject to the mandatory clearing requirements. Once these determinations have been made by the FSCA and PRA, market participants will be able to assess which of their own products must be submitted to a CCP for clearing. The second part of the analysis will be to determine whether the OTC derivatives provider (ODP) will submit the transaction for clearing or pay the additional margin associated with not clearing that transaction.

Timing

The period for submitting comments on the draft subordinate regulations to the FMA has now closed. We have not received any indication from the regulators as to when we can expect revised drafts of the subordinate legislation.

There has also been no indication as to when the designation of OTC derivative transactions as eligible for mandatory clearing will be made or when the second draft of the Margin Requirements will be available. In South Africa, parties are looking to the other jurisdictions where mandatory clearing has already commenced (the European Union and the United States) to determine the likely types of OTC derivatives transactions which will be designated for the first phases of mandatory clearing in South Africa.

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