



JOINT DISCUSSION DOCUMENT

EXPANSION OF ELIGIBLE COLLATERAL TYPES AND RISK MITIGATION PROTOCOLS

**Determinations to be issued in terms of Joint Standard 2 of 2020:
Margin Requirements for non-centrally cleared over-the-counter
derivative transactions¹ made under
the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017)**

May 2024

¹ As amended by Joint Standard Amendment 1 of 2023: Amendments to Margin Requirements for non-centrally cleared OTC derivative transactions, 2023.

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1. Purpose

- 1.1 The purpose of this Joint Discussion Document is to communicate proposals by the Financial Sector Conduct Authority (FSCA) and the Prudential Authority (PA) (hereafter, jointly referred to as the Authorities) in relation to matters contained in Joint Standard 2 of 2020: Margin requirements for non-centrally cleared over-the-counter (OTC) derivative transactions (Joint Standard).² The proposals consider:
- (a) The further expansion of eligible collateral types as referred to in paragraph 6(2) of the Joint Standard; and
 - (b) proposed risk management measures to be implemented by providers³ wanting to make use of non-cash collateral in line with paragraph 6(1) of the Joint Standard.

2. Background

- 2.1 In 2015, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) jointly published a policy framework on the margin requirements for non-centrally cleared OTC derivatives transactions (policy framework).⁴ The BCBS and IOSCO policy framework considers the types of collateral that may be deemed eligible in satisfying margin requirements. The policy framework required national supervisors to develop their own list of eligible collateral types based on prescribed key principles and stipulated considerations, as well as the conditions and market dynamics prevalent in their respective jurisdictions. The BCBS-IOSCO policy framework considered an approach for the use of high-quality liquid assets as eligible collateral to ensure that the value of such collateral could be fully realised when held as margin during periods of financial stress.
- 2.2 On 2 June 2020, the Authorities published the Joint Standard, which came into effect on 16 August 2021.⁵ The Joint Standard was amended on 9 June 2023 through Joint Standard

² <https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-public-awareness/Communication/2023/Joint-Communication-1-of-2023-Amendments-to-Joint-Standard-2-of-2020>

³ An authorised OTC derivative provider as defined in the FMA Regulations.

⁴ <https://www.bis.org/bcbs/publ/d475.htm>

⁵ <https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-financial-market-infrastructure/market-infrastructure-joint-standards/2021/Joint-Communication-2-of-2021---Det-effective-date-of-JS-Margin-Requirements>

Amendment 1 of 2023: Amendments to Margin Requirements for non-centrally cleared OTC derivative transactions, 2023.⁶

- 2.3 Paragraph 6(2) of the Joint Standard explicitly specifies cash and gold as the permissible eligible collateral types. However, paragraph 6(2) of the Joint Standard is also enabling in its construct, by providing for the Authorities to specify, in writing, other assets or instruments that may constitute eligible collateral for the purposes of satisfying initial and variation margin requirements.
- 2.4 On 13 December 2022, the Authorities specified under Joint Communication 3 of 2022 and Joint Notice 2 of 2022 that South African central government bonds with a credit rating issued by a licensed credit rating agency, as defined in section 1 of the Credit Rating Services Act, 2012 (Act No. 24 of 2012) (CRSA), constitute eligible collateral.⁷
- 2.5 Subsequently and informed by the outcomes of the public consultation underpinning Joint Notice 2 of 2022, the Authorities are proposing expanding the current eligible collateral set to include other types of assets or instruments, as empowered by the Joint Standard. This proposal is set out in paragraph 3.1 below.
- 2.6 Alongside the proposed additional collateral set, the Authorities are empowered to determine and impose conditions on risk management, internal controls and assurance requirements related to the use of non-cash collateral as per paragraph 6(2A) of the amended Joint Standard.⁸ These proposed conditions are set out in paragraph 3.2 below.
- 2.7 Once the consultation associated with the above proposals are finalised, the expanded collateral set and associated risk mitigation conditions will be published in a determination by notice on the respective websites of the Authorities, as required in paragraph 6(2A)(b) of the Joint Standard.
- 2.8 It should be noted that the Authorities may review the eligible non-cash collateral determinations periodically, or at any such time deemed necessary. Such a review may be prompted, for example, by a significant change to relevant financial sector laws or changes to international standards. Such a review can also be driven by exogenous and distinctive risks relating to the use of such collateral in line with the objectives of the FSCA and PA respectively (including safety and soundness of financial markets, market integrity, consumer protection, competition implications or assisting in maintaining financial stability).
- 2.9 The Authorities hold the capability to withdraw existing determinations that could be detrimental to market integrity, consumer protection or financial stability at any given time, and will do so with suitable engagement and consultation with the industry and affected parties. In such instances, the Authorities will allow for a sufficient transitional period to enable covered entities to remove such collateral from all relevant transactions, agreements and arrangements.

⁶ Documents available at : <https://www.fsca.co.za/Notices/Joint%20Standard%20Amendment%201%20of%202023-Amendments%20to%20Joint%20Standard%202%20of%202020.zip>

⁷ Documents available at : <https://www.fsca.co.za/Notices/Joint%20Notice%202%20of%202022%20and%20Joint%20Communication%203%20of%202022.zip>

⁸ See <https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-public-awareness/Communication/2023/Joint-Communication-1-of-2023-Amendments-to-Joint-Standard-2-of-2020>

3. Proposals

3.1 Proposal to expand eligible collateral to include other instruments and assets types

3.1.1 The Authorities propose that the following asset types be recognised as eligible collateral in satisfying either initial or variation margin requirements. The proposed asset types mentioned below will be subject to the credit rating issued by a registered credit rating agency⁹ as defined in section 1 of the CRSA:

- (a) United States of America government bonds;
- (b) European Central Bank government bonds;
- (c) United Kingdom government bonds

3.1.2 The proposed asset types mentioned above, will be subject to the imposition of certain risk management conditions, as set out in paragraph 3.2 below.

3.2 Proposed minimum risk management requirements to be implemented by providers wanting to make use of non-cash collateral

3.2.1 Paragraph 3 of the Joint Standard refers to the need to promote effective and sound risk management in respect of non-centrally cleared OTC derivative transactions. Paragraph 3(1)(b) further requires that a provider must put in place robust processes, procedures and board-approved policies to ensure that the provider complies with the requirements specified in paragraph 6 which is related to eligible collateral.

3.2.2 Paragraph 6(1) of the Joint Standard requires that a provider must ensure that assets or instruments collected or posted as collateral for purposes of initial or variation margin can be liquidated in time to generate proceeds that sufficiently protect the provider, its clients or counterparties. It further sets out that the provider must have sufficiently robust processes, procedures, and board-approved policies in place to address the risks associated with collateral and the valuation of the underlying assets collected as collateral.

3.2.3 In order to mitigate the increased risk associated with the use of non-cash collateral, it is necessary that the Authorities impose the relevant risk management requirements on providers wanting to make use of such non-cash collateral.

3.2.4 A provider will only be allowed to make use of non-cash collateral subject to the provider having in place the following minimum risk management requirements that will include:

- (a) collateral risk management policies, procedures, and processes;
- (b) collateral management systems;
- (c) valuation of collateral; and
- (d) limit frameworks.

Collateral risk management policies, procedures, and processes

⁹ In terms of section 1 of the Credit Rating Services Act, 2012 (Act No. 24 of 2012) (CRSA), a “registered credit rating agency” means a credit rating agency or an external credit rating agency registered in terms of section 5. This would include an external credit rating agency determined by the FSCA to be from an equivalent jurisdiction to that of South Africa.

- 3.2.5 A provider will be required to have approved collateral risk management policies, procedures, and processes in place, which must be subject to regular review in order to ensure that they remain appropriate and effective.
- 3.2.6 These policies, procedures, and processes will be required to include:
- (a) the terms of collateral agreements, types of collateral and enforcement of collateral terms (for example, waivers of posting deadlines);
 - (b) the management of legal risks;
 - (c) the administration of legal agreements;
 - (d) the prompt resolution of disputes, such as valuation of collateral or positions, acceptability of collateral, fulfilment of legal obligations and the interpretation of contract terms;
 - (e) a robust risk management process relating to collateral management;
 - (f) a duly articulated strategy for the use of collateral, which must form an intrinsic part of a provider's general risk management and overall liquidity strategies;
 - (g) the computation of collateral mark-to-market values and revaluation at regular intervals, i.e., at least daily.
 - (h) periodic stress testing of the collateral portfolio to assess its resilience under adverse market conditions and the allowance for the adjustment of risk management practices based on the outcomes of the stress testing.

Collateral management systems

- 3.2.7 A provider will be required to establish and implement a collateral management system that -
- (a) is well-designed, operationally efficient, and flexible;
 - (b) accommodates changes in the ongoing monitoring and management of collateral;
 - (c) allows for the timely calculation and execution of margin calls, the management of margin call disputes,
 - (d) allows for accurate internal and regulatory reporting of levels of initial and variation margin;
 - (e) tracks the extent of re-use of securities held as collateral;
 - (f) has functionality to accommodate the timely deposit, withdrawal, substitution, and liquidation of collateral;
 - (g) has properly integrated systems to facilitate timely and accurate collateral valuation, monitoring of composition and reporting.

Valuation of collateral

- 3.2.8 A provider will be required to establish and implement policies, procedures, and processes to -
- (a) mark-to-market its collateral at least on a daily basis;
 - (b) monitor the credit quality, market liquidity and price volatility of each asset accepted as collateral, as frequently as is necessary; and
 - (c) apply haircuts to account for market fluctuations and credit risk.
- 3.2.9 A provider will be required to review the adequacy of its valuation policies, procedures, and processes on a regular basis and whenever a material change occurs that affects the provider's risk exposure.

Limit frameworks

- 3.2.10 A provider will be required to establish and implement policies, procedures, and processes to ensure that the collateral remains sufficiently diversified to allow liquidation within a defined holding period without a significant market impact. These policies, procedures, and processes must determine the risk mitigation measures to be applied when the concentration limits are exceeded.
- 3.2.11 In this regard, a provider will be required, as a minimum, to determine concentration limits based on thorough due diligence and consideration of creditworthiness and overall market stability at the level of:
- (a) individual issuers;
 - (b) type of issuer;
 - (c) type of asset; and
 - (d) jurisdiction.
- 3.2.12 A provider will be required to:
- (a) monitor the adequacy of its concentration limit policies, procedures, and processes on a regular basis;
 - (b) review its concentration limit policy and procedures regularly, and whenever a material change occurs that affects the risk exposure of the provider;
 - (c) implement policies and procedures to rectify any breach of concentration limits set by the provider.
- 3.2.13 A provider will be required to set limits on the rehypothecation of non-cash collateral to manage counterparty risk and comply with regulations or other relevant requirements specified in writing regarding the reuse of collateral provided by counterparties.

4. Invitation for comment

- 4.1 All interested persons are hereby invited to submit comments on the abovementioned proposals as set out in paragraphs 3.1 and 3.2 above by using the comment templates attached as Annexure A.
- 4.2 Comments must be submitted to the Authorities via email at queries.otc@fsca.co.za and marginrequirements@resbank.co.za by no later than **8 July 2024**.
- 4.3 For further information related to this discussion document and the proposals contained herein, please contact the Authorities via the above-mentioned emails.