



DAUDS ADVISORY

Finance Briefs

“The South African OTC Derivatives Market: Has A Case Been Made For Its Formal Regulation?”

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Introduction

1. Being a member of the many clubs South Africa has joined as a country since 1994 comes at a price. The most recent club is BRICS (which started out as BRIC until SA joined and the “S” was added). SA’s membership has, among some sceptics at least, sparked the debate whether, having regard to the size of the country’s population and economy¹ it was worthy of admission — especially when other potential candidate

¹ For 2014, SA’s gross domestic product (GDP) amounted to \$349.82 billion with a population of 53 million. This compares as follows to the GDP and population of the other BRICS members: Brazil – GDP for 2014, \$2.35 trillion, population 202 million; Russia – GDP for 2014, \$1.86 trillion, population 146 million; India – GDP for 2014, \$2.06 trillion, population 1.28 billion; China – GDP for 2014, 10.36 trillion, population 1.39 billion.

countries have a much larger GDP and population than South Africa. Having regard to the statistics in the footnote below, SA strikes one as a very junior member of the BRICS club. And, in these very tough economic times when the country can least afford, it is required to make a club membership contribution of billions of rands, even if it is by way of some guarantee that these funds will be available. But stay in this club SA believes it must because it believes there are many benefits to be derived from its membership.

2. However, the club that is actually of relevance here is another one, the Group of Twenty, (G20) made up of a group of the finance ministers and central bank governors of twenty countries² which include the USA, the UK, France, Germany, South Africa³. Starting in 2009, the G20 resolved that derivative contracts traded over-the-counter (OTC) should be regulated in the same manner as derivatives traded on formal exchanges. This resolution was sparked by the global financial crisis of 2007 which emerged from the US housing market. At the time, banks recklessly lent large amounts of money to low-income borrowers to buy homes. The regular mortgage payments streams were then securitised and sold as securities to mostly institutional investors.

² These countries represent two-thirds of the world's population, 85% of global GDP and 75% of global trade.

³ The other members of the G20 include Canada, Australia, Japan, South Korea, Brazil, Russia, India, China, Argentina, Mexico, Italy, Turkey, Saudi Arabia, Indonesia and the European Union (EU).

⁴ There are those who argue, though, that South Africa was indirectly affected by the crisis.

3. Credit derivatives were used to manage credit risk. For the securitisation to work, borrowers had to keep making payments on their mortgages. However, a situation was soon reached where the household debt levels of borrowers exceeded their income – as a result, the borrowers defaulted on their mortgages and gave up their homes. This is what was referred to as the subprime lending crisis. The knock-on effect was such that it led to the bankruptcy of large American institutions such as the investment bank Lehman Brothers, AIG, some big US government financial institutions. Other private financial institutions that were also affected included ABN-Amro, Royal Bank of Scotland (RBS), several Icelandic banks, Fortis, Wachovia and a few more.

4. The global financial crisis of 2007 was triggered by the reckless lending practices of American banks. The crisis itself did not have a direct impact on South Africa⁴. The G20, rather than resolving to tighten the lending practices of banks that were responsible for the crisis, resolved that the OTC derivatives market should be formally regulated in all 20 member countries. South Africa had no part in the subprime lending crisis. Nevertheless, in conformance to the G20 resolution, SA's National Treasury issued two Draft Policy documents together with Ministerial Regulations and Board Notices under the Financial Markets Act No. 19 of 2012 to commence the process of the formal regulation of the SA OTC derivatives market. The question remains, though, has a case been made for the formal regulation of the SA OTC derivatives market?

The nature of financial derivatives

5. Derivatives are hugely both effective and efficient risk management tools. The primary function of these financial instruments is to efficiently facilitate the redistribution of risk between economic agents. This is done by transferring risk from those who are risk-averse to those who are better able, or willing, to bear such risk. This risk may emanate from fluctuations in interest rates, currency exchange rates, commodity prices or equity prices. The use of a derivative contract is not the only way to transfer risk though — it is just more efficient. Risk may also be transferred by entering into a standard transaction in the market in which an asset is traded — the underlying cash market. However, such a transaction typically involves transaction costs greater than those incurred by entering into a derivative contract. A transaction in the cash market also typically requires the investment of principal by way of actually purchasing the asset while a derivative contract does not. The greater transaction costs and investment of principal make the cash market a less efficient means of transferring risk. A far more efficient way of doing this is made possible by the ability of derivatives to unbundle the risks inherent in an asset or a transaction, thus making the various risk components more manageable. This allows a market player to choose the particular type of risk he or she wishes to be exposed to and the types of risk the person prefers to avoid or offload. Derivative instruments have always fulfilled a very valuable function in financial markets by:

- allowing corporates to hedge their risk.
- reducing funding costs or locking in future borrowing costs.

- contributing to the expansion of investment products by way of the creation of structured products.
 - ensuring greater price discovery.
 - overcoming regulatory barriers that restrict access to certain investment instruments or funding sources.
6. Derivative contracts come in two forms — standardised contracts and non-standardised contracts. Standardised contracts, examples of which include futures contracts and some option contracts, are usually traded on exchanges (e.g. the JSE) and are accordingly formally regulated. Non-standardised contracts, which make up the bulk of all derivative contracts traded⁴, are not traded on formal exchanges, but rather over-the-counter and are thus referred to as OTC derivatives. These contracts are not formally regulated.

Justification for the formal regulation of OTC derivatives

7. The G20 has argued that the formal regulation of the OTC derivatives market will offer counterparty risk protection and reduce systemic risk. This argument assumes such protection does not already exist in the OTC market. While this market may not be formally regulated, it is self-regulated. For instance, standard documentation (the Master Agreement with its relevant Annexures) issued by an industry body, the International Swaps and Derivatives Association (ISDA), is typically used to enter into

⁴ OTC derivative contracts constitute up to 85% of all derivative contracts traded in the global market, including the SA market.

contracts in the OTC derivatives market. These documents are commonly used to record the terms and conditions, as well as the close-out netting of OTC derivative transactions. Dealers use this standard agreement to conclude contracts with other dealers and with end-users. One great benefit of the Master Agreement is its potential to mitigate default risk on outstanding transactions by way of the close-out netting provisions. These provisions allow a non-defaulting party to accelerate and terminate all outstanding transactions and net the current market values of the transactions so that a single amount is owed by, or owed to, the non-defaulting party. Counterparty risk protection thus does exist in the OTC derivatives market.

8. Another justification for the formal regulation of the OTC derivatives market is that, while derivatives traded on formal exchanges offer counterparty risk protection by way of the margining requirement, this form of protection does not exist for OTC derivatives. The margining requirement comes in two forms — the initial, or original, margin and the variation margin. The initial margin may take the form of a cash deposit, collateral or guarantee (a third-party commitment) and serves to protect a party against losses which may be suffered as a result of the default by a counterparty. Futures contracts traded on formal exchanges are typically marked-to-market on a daily basis which means that losses and gains arising from daily market movements must be settled on a daily basis. This is done by posting what is referred to as the variation margin. Players in the OTC derivatives market have increasingly demanded the posting of collateral to provide protection for any losses to be suffered in the event of a default by a counterparty. Where collateral is not demanded it is often

because of the creditworthiness of the counterparties which enjoy a high credit rating (e.g. one bank dealing with another bank). The creditworthiness of the counterparties in these cases tends to provide them with such comfort that they do not consider it necessary to demand collateral.

Conclusion

9. Having addressed the issue of risk, what remains to be said is that while the formal exchanges offer standardised and inflexible contracts, the OTC derivatives market offers the kind of contracts which cater to the unique objectives of parties — contracts which require customisation, flexibility. It may accordingly not be appropriate for the OTC derivatives market to be tarred with the exchange-traded derivatives market brush by expecting the OTC market to be as formally regulated. Besides, the SA financial market is already well-regulated — so are the banks which are the major dealers in OTC derivative contracts. SA has also not quite seen any of the major derivatives-related disasters experienced in other jurisdictions. Simply because some of the G20 members believe that OTC derivatives should be formally regulated because these instruments have on occasion wreaked havoc on their financial markets does not mean SA, although a member of the G20 club, should tag along when the case for such regulation in this country does not appear to have been made.