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Hon. Mr. Yunus Carrim, MP
Chairperson
Standing Committee on Finance
National Assembly
Parliament of Republic of South Africa

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COMMENTS ON THE PROPOSED CHANGES TO THE INSOLVENCY ACT

The Banking Association South Africa ("BASA") would like to thank the National Assembly Standing Committee on Finance ('the Committee') for the opportunity afforded us to submit comments on the Draft Financial Matters Amendment Bill ("the Bill"), ahead of the Public Hearings taking place on Tuesday, 12 February 2019.

BASA only had sight of the full proposed amendments late last week, however we are open to making an oral submission during the public hearings to highlight the key areas for concerns (as outlined in our response paper).

We would also like to place our response on record as we have previously communicated to National Treasury ("NT") and the Department of Justice and Constitutional Development ("DoJ") that we believe that should the additional changes requested to the Insolvency Act, not materialise, systemic risk will be introduced into our economy.

We have reviewed the Financial Matters Amendment Bill [**B1-2019**] ("2019 Amendment Bill") and welcome the proposed amendments made to the Insolvency Act, subsequent to our ongoing consultation with National Treasury ("NT") and the Department of Justice and Constitutional Development ("DoJ") over the past 3 years. An explanation of the issue is set out in the Executive Summary below and our detailed comments can be read in Appendix 1. For further background, copies of relevant correspondence in relation to our previous engagements with NT & DoJ, are attached hereto as Annexure A & B.

Executive Summary

One of the fundamental legal changes in the ever changing regulatory landscape of OTC Derivatives, is the requirement for regulated parties which come within the scope of the new laws to provide collateral (referred to as initial margin ("IM") to each other in respect of OTC Derivatives transacted between them. The law further requires the IM so provided to be immediately available to the secured party. If a party is

not able to obtain IM on that basis from its counterparty it is precluded by law from trading with that counterparty.

The issue referred to in the Introduction relates to this specific point.

As the proposed amendments are currently drafted, the Insolvency Act will allow the secured creditor immediate access to its IM, but the proposed section 83(10B) then allows any other creditor or the Master to dispute the preference, and after considering submissions from both parties, if the Master is of the opinion that the dispute is well founded the secured creditor is obliged to pay the proceeds of the IM to the trustee. This effectively negates the right of immediate access.

In our view, and in the view of our legal counsel, if such a process exists, it cannot be said that the collateral is immediately available to the secured creditor.

We and our legal counsel are happy that other creditors', the trustee's and the Master's rights to approach a court for an order overturning the preference should not be curtailed, but allowing the Master to opine on the issue would not be acceptable with reference not only to our domestic legislation but also to the laws of the jurisdictions of our major international counterparties.

As set out above, and more fully in our detailed comments in Appendix 1, it is of critical importance that the ability of banks in South Africa to enter into OTC Derivatives with international banks, and with each other, not be curtailed because of a failure of the Insolvency Act to conform to the legal requirements allowing immediate access to collateral.

Failure to have the ability to transfer or mitigate risk, will expose our financial markets to systemic risks and could result in the government and or tax payers having to step in, similar to the international crisis of 2008, but on a domestic scale.

A very simplistic derivative trade explanation is as follows:

- A bank will take over a corporate's risk exposure through a derivative contract
- The bank will then look to offset this risk, either fully or partly (depending on its own risk appetite)
- Most of the trade offset is conducted with international banks (as the local market could have the same directional view)
- To conduct the trade, the local bank will place Initial Margin ("IM") up front and Variation Margin ("VM") during the life of the transaction.
- In the event of a default by the SA bank, the offshore bank is relatively protected by the IM &VM, however, the bank will require the collateral immediately to allow it to offset its exposure.
- If our insolvency law does not allow for immediate access to the collateral, the foreign and or local counterparties will not look to take the risk on board at the onset of the trade.
- Either the SA bank then carries this full risk on its own or declines to take over the corporates risk
- Both scenarios create systemic risk in our economy

We believe that failure to make the recommended changes to the Insolvency Act will also result in South Africa not securing a "clean" ISDA[1] Collateral Legal Opinion. (All banks rely on this opinion for counterparty relationships and trading lines.)

We thank you for the opportunity to comment on the draft 2019 Amendment Bill, and trust that this issue will be resolved in due course and ensure South Africa can continue with its G20 commitments and have the ability to eliminate risk from our economy.

Yours sincerely

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Cas Coovadia

[1] International Swaps and Derivatives Association that fosters safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products.

APPENDIX 1

In the past, the trading of over-the-counter ("OTC") derivatives was a practice that was largely unregulated. Following the global financial crisis in 2008, G20 leaders noted that OTC derivatives were a significant contributor to the global financial crisis and as such the G20 leaders committed to reform the global OTC derivatives market and specifically stated that:

"All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."

BASA and its members fully support this and as South Africa is a member of the G20 and is required to comply with its commitment to the global OTC derivatives reform, South Africa began the process of developing the appropriate legislative framework, with the FMA[2] providing the backbone for the required legislative changes.

Under the phased-in-approach of global legislative changes[3], financial market participants have to place Initial Margin ("IM") and Variation Margin ("VM[4]") with counterparties (local and or international) to limit excessive and opaque risk-taking through OTC derivatives and to mitigate the systemic risk posed by OTC derivatives transactions, markets, and practices.

In short, IM and VM aims to protect a covered entity from loss in the event that its counterparty defaults.

It should be noted that most local market participants are already exchanging VM and certain international markets have already commenced the phasing in of IM in 2016. Covered entities "come-into-scope" for IM depending on their aggregate month-end average gross notional amount of OTC derivative outstanding in a certain period.

Systemic market risk

As South African banks come into scope with other major trading counterparties regulations for IM & VM as illustrated below;

Country	Phase 1 (IM/VM) Sept 16	Phase 2 (VM) March 17	Phase 2 (IM) Sept 17	Phase 3 (IM) Sept 18	Phase 4 (IM) Sept 19	Phase 5 (IM) Sept 20
US	$3 t	$8 b	$2.25 t	$1.5 t	$0.75 t	$ 8 b
EU	€3 t	€8 b	€2.25 t	€1.5 t	€0.75 t	€ 8 b

These systemically important financial institutions will be required to post IM and VM under foreign legislation[5] in respect of their OTC derivatives trading with foreign counterparties.

In order for these systemically important local institutions to continue to trade with foreign counterparties, they must be able to post IM such that it is *immediately* or *promptly* available to the secured foreign counterparty in the event of the South African institution's default.

A critical flaw in the revised draft of the 2019 Amendment Bill, is that, as currently drafted, it empowers the Master (in his sole discretion, i.e. in his "opinion") to require a secured creditor (including a foreign secured creditor) to repay to the trustee the proceeds of any property that the secured creditor had been holding as security for claims arising out of a "Master Agreement" and which had been realised and retained under the new section 83(10A)(a) of the Insolvency Act, 1936 ("Insolvency Act").

If the retained proceeds of realisation can be clawed back at the instance of the Master, this could defeat the purpose which the new section 83(10A)(a) of the Insolvency Act seeks to achieve.

[2] Financial Markets Act, 2012
[3] Margin requirements for non-centrally cleared derivatives
[4] Daily mark-2-market movements (M2M)
[5] South African legislation on margin requirements is only expected to come into effect in Q3/19

In particular, where the Master forms the "opinion" that another creditor has a "well founded" dispute of the secured creditor's preference, the secured creditor will have to repay the retained realisation proceeds (and interest) to the trustee and then dispute the repayment on application to court.

The ability of the Master to subjectively require repayment in this manner cuts across the very purpose of the new section 83(10A)(a) of the Insolvency Act, removing market certainty and creating timing delays which the new legislation seeks to avoid. This could have severe consequences for the South African banking system, as neither local nor foreign counterparties may be able to comply with the margin requirements of their local or foreign legislation and foreign counterparties in particular are likely to be unwilling or unable to trade with South African banks once they are in scope.

The same systemic market risks arise between South African counterparties trading with one another. It is impossible for South African parties subject to the draft Joint Standard on Margin Requirements for non-centrally cleared OTC derivative transactions ("Joint Standard") to comply with section 4.3(2)(a) of the Joint Standard unless section 83(10) of the Insolvency Act (particularly section 83(10B)(e)) is amended so that the security held by a secured creditor under a master agreement can be "*immediately available*" to the secured party in the same away as described above, the subjective discretion of the Master, may undermine the purpose of section 83(10A)(a) of the Insolvency Act.

Critical flaw persists under section 83(10B)(e) of the Insolvency Act, 1936

Section 83(10B)(e) : Adjudication of objections by the Master

Under the 2019 Amendment Bill, Section 83(10B)(a) of the Insolvency Act now confirms that a creditor should only be permitted to dispute a secured creditor's preference by submitting the "*reasons therefor*".

We submit that the creditor so disputing the secured creditor's preference must do so on certain limited grounds by furnishing a full explanation of the reasons and grounds upon which the preference is disputed, and not merely by providing "*reasons therefor*".

However, it is concerning that Section 83(10B)(e) of the Insolvency Act has not been amended in line with our previous consultations and therefore potentially defeats the purpose which the new section 83(10A)(a) of the Insolvency Act seeks to achieve.

In terms of the new clauses, as currently drafted, if the Master is of the opinion that a dispute as to preference is well-founded, the secured creditor must immediately pay the net proceeds of realisation (including accrued interest) to the trustee. Thereafter the secured creditor may apply to court to be repaid such proceeds and the court may make any order as it deems just. If the proceeds of realisation can be clawed back in this manner at the instance of the Master, this would defeat the purpose which the new section 83(10A)(a) of the Insolvency Act seeks to achieve.

The Master should never be empowered to adjudicate on matters of substantive law.

The manner in which the new section 83(10B) of the Insolvency Act is currently drafted means that, the Master will have to consider the validity and enforceability of the secured creditor's preference (i.e. security interest) over the property (in terms of South African law but also under the laws of the foreign jurisdiction in which the property was located and the security interest was established).

The Master must then make a quasi-judicial finding on the merits of the disputing party's case, and ultimately decide whether the secured creditor was <u>entitled to retain the proceeds</u> from the realisation of the property which the secured creditor was holding as security.

A secured party who is directed to repay the realization proceeds retained under section 83(10A)(a) of the Insolvency Act may take the Master's decision on review in terms of section 151 of the Insolvency Act, thereby adding further delays to a time-critical process.

In addition, these are far reaching powers to confer on the Master and deviate from the typical functions performed by the Master. The Insolvency Act empowers the Master to make certain determinations of an administrative or procedural nature. Exercising judgement as to the merits of disputes (potentially involving significant sums of money) is at role typically reserved for the courts. In addition, the practical impact of

managing and opining on the disputes would require suitably qualified persons and would place an additional burden on the existing resources of the Master's office.

Requiring the repayment of the proceeds of collateral which had already been realised and applied to settle a debt owing under a Master Agreement should be referred to a court to decide. Unravelling the payments after they had been effected could cause undue hardship on the secured creditors, especially if the courts find that the Master's finding was incorrect.

During the discussions at our consultation, we had been advised that it was not the intention of the legislature that the Master adjudicate on the validity and enforceability of the creditor's claims and security interests. We had been advised that the powers which would be conferred upon the Master would be limited to:

- assessing the documents submitted by the secured creditor;
- determining whether a "master agreement" and security document had in fact been provided; and
- providing a *prima facie* determination on whether the creditor is a secured creditor or not.

We are concerned that these amendments are not reflected in the 2019 Amendment Bill.

We had been advised in previous meetings, that the proceeds of realisation would remain with the secured creditor (with no repayment to the trustee) if the three factors in the paragraph above had been met. We were also advised that a secured creditor would only be required to repay the proceeds of realisation at the instance of the Master if the secured creditor had failed to submit an affidavit, or failed to submit the correct documents substantiating the secured claim etc. This is a critical requirement to comply with the local regulation, Joint Standard.

Notwithstanding the practical and legal issues described above, the proposed process for creditors to dispute a secured creditor's preference to the Master and for the Master to make a determination as to whether the dispute relates to preference is well founded and whether the proceeds of the realised property must be paid back to the trustee, would be more palatable if, no repayment of the proceeds of realisation had to be made until resolution of the dispute. However, this should be clearly set out in a revised draft of section 83(10) to avoid any ambiguity.

[Alternatively, we would propose that the party disputing the preference and the secured creditor be given a limited number of days to resolve the dispute by arbitration.]

In circumstances where the legislature intends that the Master be empowered to adjudicate matters of substantive law, then an appeals procedure should be provided for. Although section 151 of the Insolvency Act allows for a decision of the Master to be taken on review, we submit that the parties must be able to lodge an appeal against the decision of the Master. The appeal of an administrative decision is based on the merits of a case, not merely on whether the process followed was procedurally fair.

Administrative appeals allow for the reconsideration of decisions by a higher authority to challenge the merits of a particular decision. Appealing an administrative decision is appropriate in circumstances where an interested party is of the view that the decision maker (in this case the Master) came to the incorrect conclusion based on the facts presented or the law. The person or body to whom the appeal is made would step into the shoes of the original decision maker and decide the matter anew. Therefore, in appealing a decision taken, the second decision maker (i.e. the courts) will be entitled to declare the first decision right or wrong.

Therefore, the parties must be able to appeal against the Master's decision, and not to merely take it on review in terms of section 151 of the Insolvency Act.

We request that section 83(10B) of the Insolvency Act be reconsidered (and re-drafted) in light of the above.

Clarification in relation to the use of the word “authenticated” in Section 10A(a)(i)

The amendments to Section 10A(a)(i) contain a new requirement that the documents must be authenticated.

The challenge we see is that a lot of the international counterparties have moved to signing online and do not use wet ink originals anymore. Does authenticated for such purposes mean parties can merely print that

document and have it certified internally or would authentication mean parties would require a notarised document with seals?

Our understanding of "authentication" when applied to a document, is that for any document executed in any place outside South Africa (which is the case with most of the cross border master agreements), such document shall be deemed to be sufficiently authenticated for the purpose of use in South Africa if it be duly authenticated at such foreign place by the signature and seal of office:

- of the head of a South African diplomatic or consular mission or a person in the administrative or professional division of the public service serving at a South African diplomatic, consular or trade office abroad; or
- of a consul-general, consul, vice-consul or consular agent of the United Kingdom or any person acting in any of the aforementioned capacities or a pro-consul of the United Kingdom; or
- of any Government authority of such foreign place charged with the authentication of documents under the law of that foreign country; or
- of any person in such foreign place who shall be shown by a certificate of any person referred to in paragraph (a), (b) or (c) or of any diplomatic or consular officer of such foreign country in the Republic to be duly authorised to authenticate such document under the law of that foreign country; or
- of a notary public in the United Kingdom of Great Britain and Northern Ireland or in Zimbabwe, Lesotho, Botswana or Swaziland; or
- of a commissioned officer of the South African Defence Force as defined in section one of the Defence Act, 1957 (Act No. 44 of 1957), in the case of a document executed by any person on active service.