SASLA
south african securities lending association

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Standing Committee on Finance (National Assembly)
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Dear Hon. J Maswanganyi

2022 TLAB: Amendments to Collateral Arrangements

We would like to thank the Standing Committee on Finance for the opportunity to submit comments on to the 2022 Draft Taxation Laws Amendment Bill and on the omission of any amendments to the collateral legislation introduced in the Taxation Laws Amendment Act No. 21 of 2021 that are due to become effective on 1 January 2023.

Prior to the publication and promulgation of the Financial Markets Act (FMA), the only way that securities could be used as collateral was to pledge them via a *cession in securitatem debiti*. This common law process required securities to be pledged, held in a segregated account with no right of use of the securities, until the transaction which was being secured was terminated. No Securities Transfer Tax (STT) or Capital Gains Tax (CGT) accrued to the pledge of securities as collateral, as ownership did not transfer.

During the drafting of the FMA, the market worked with the regulators to ensure that a legally valid way of transferring securities outright in title would be permitted in a way that aligned to international practices. This was important in order to permit securities to be transferred outright in title as collateral, and in so doing allowing the party receiving the collateral to be able to use the collateral assets. This was critical in order to ensure that the liquidity in the market was optimised.

As a result, Section 38 of the FMA was introduced to provide for the out-and-out cession of securities for this purpose. Consequently, the Taxation Laws Amendment Act introduced an exemption from STT and CGT accruing on listed securities and South African and foreign government bonds which are posted as collateral under a 'collateral arrangement' for a period of less than 24 months if all requirements in the definition of

'collateral arrangement' are met. To date this exemption has served the financial markets well in terms of providing a viable way for counterparties to comply with the various regulations which require collateral to be provided for transactions to reduce systemic risk.

The 'collateral arrangement' exemption permits parties to make use of a wide variety of non-cash assets as collateral in a financially viable and tax neutral way (within the confines of the dispensation), and in so doing ensure liquidity in the markets whilst being able to comply with regulations which aim to reduce systemic risk.

SASLA understands that initially the proposed 2022 TLAB was to provide clarity to the market on what the 'collateral arrangement' dispensation required and in particular the limitation on the right of use of collateral. However, on review of the TLAB it appears that the way in which the amendment has been drafted (as an exclusion to the 'collateral arrangement' definition) goes further than that and in fact triggers STT and CGT on any prior compliant 'collateral arrangements' if any subsequent use of collateral falls outside the dispensation.

SASLA understands that National Treasury intends to add a clause to the 'collateral arrangement' definition in the Securities Transfer Tax Act in order to limit the right to re-use collateral to only:

(i) further 'collateral arrangements'
(ii) repo transactions entered into with SARB;
(iii) transactions that ensure compliance with Reg 28; and
(iv) transactions that secure overnight cash placement to comply with Basel III in controlling large exposures.

It is SASLA's understanding that if collateral assets are used for any other purpose, then the STT and CGT exemptions for a 'collateral arrangement' would not apply, and STT and CGT would be triggered not only in respect of the re-used collateral which falls outside the exemption, but also for all prior collateral arrangements.

There are several concerns that SASLA has (from the perspective of the securities lending industry) in respect of this limitation on the right of use of collateral under the 'collateral arrangement' exemption, namely:

1. There is an increased need and demand for collateral generally in the financial markets due to new regulatory requirements that have been implemented under the Financial Markets Act following recommendations from International Organisation of Securities Commission (IOSCO) and Basel Committee on Banking Supervision (BCBS). In 2011 the G20 (to which South Africa is a signatory)

mandated BCBS and IOSCO to develop standards on collateral requirements in order to enhance protection from counterparty credit risk, and in turn reduce systemic risk. South Africa will implement the Joint Standard 2 of 2020, margin requirements for non-centrally cleared over the counter derivatives transactions (the Joint Standard) on 16 February 2023. It is difficult to predict the impact of the Joint Standard on liquidity in the market, let alone in conjunction with the proposed amendment to the 'collateral arrangement' which is due to be implemented on 1 January 2023. Whilst it is urgent that South Africa proceeds to implement the collateral regulations in terms of the Joint Standard (as South Africa is implementing these regulations almost 6 years after the same regulations were implemented in Europe and the US following the IOSCO and BCBS recommendations), it is also important to understand the impact of these regulations from a liquidity perspective in relation to the financial markets as a whole. Due to the collateral requirements being imposed in the OTC derivatives markets as well as collateral requirements in the securities financing markets, there are concerns that there may not be enough eligible collateral to go around and that there could be liquidity issues experienced particularly if a wide range of collateral assets are not available, liquid and free to be used in a viable and tax neutral way (specifically in respect of non-cash assets). It is also a concern that if the use of non-cash collateral will come at a cost from a tax perspective that this will also deter international counterparties from participating in our South African markets.

2. The proposed 2022 TLAB would result in the 'collateral arrangements' exemption only applying to a very limited list of eligible transactions, and which would exclude:
   a. transactions that would involve the liquidating or selling off collateral assets due to an event of default having been triggered (which would usually attract STT and CGT in any event); and
   b. using collateral in further securities lending transactions (that would typically benefit from an exemption under the 'securities lending arrangement' definition).

3. If the collateral is used for any other purpose other than those listed in (i) - (iv) above, then the STT and CGT exemption will *not* apply and STT and CGT will be levied not only on transactions that relate to the re-use of collateral, but also to any *prior* transactions (that do not fall within the permitted right of use set out in clause (i) – (iv) above). To illustrate the concern please consider the example below:

   Transaction 1: Asset Manager A posts collateral to Bank B (under a valid 'collateral arrangement') and no STT / CGT applies.
   Transaction 2: Bank B places that collateral with Financial Services Provider C as collateral and no STT / CGT applies as it is a 'collateral arrangement'

Transaction 3: Bank B defaults and as a result Financial Services Provider C sells the collateral assets in order to reduce its losses, and in this instance STT and CGT will be applied to this sale. This is not contentious as it is expected that in this Transaction 3 that STT and CGT would accrue.

However, in terms of the 2022 TLAB, upon transaction 3 occurring, transaction 1 and transaction 2 will accrue STT and CGT, due to the fact that the re-use of the collateral in transaction 3 was not a collateral arrangement, and therefore this nullifies the exemption of the 'collateral arrangement' in all prior transactions. This has an unexpected financial cost and impact on Asset Manager A and Bank B. If there is a risk of additional and unforeseen costs related to the use of non-cash collateral, it is likely that the parties would be deterred from placing non-cash collateral via an out-and-out cession and would rather either:

a. place only cash collateral. If this is done, there is a very real risk of there being a liquidity squeeze and strain which could in turn result in increased systemic risk; or
b. defer to pledging non-cash assets by a *cession in securitatem debiti* (where the right of use would not be permitted, and STT and CGT would not accrue, as there is no transfer of ownership) and the market will be faced with the same liquidity concerns as were faced prior to the promulgation of section 38 of the FMA.

4. The recently published FSCA Regulation Plan 1 April 2022 – 31 March 2025 clearly states the intention of the FSCA is to " … ensure that the regulatory framework is robust, *aligned with international standards*, fit for purpose and is sufficiently flexible to position the FSCA to meet its legislated objectives and functions, particularly to ensure that financial customers are protected and treated fairly, and *that financial markets operate efficiently* and with integrity." In addition the FSCA Regulation Plan states that "The FSCA wants to avoid a situation resulting in unnecessary increased cost for industry participants due to legislative changes upon legislative changes. The challenge, therefore, is to find an appropriate balance between mitigating pressing prevailing risks whilst managing the potential impact on industry participants." In line with these statements then, it is SASLA's submission that to encourage international participation in our South African markets, and align to international standards, the use of non-cash collateral should align to similar treatment in international markets. In addition, it is SASLA's submission that an analysis on the impact of regulation on the liquidity in the financial markets is key to ensure a balance is struck between imposing regulation to reduce systemic risk and ensuring that there is sufficient liquidity in the financial markets to ensure a liquidity crisis does not result in systemic risk. Further the cost of legislative changes for industry participants needs to be considered, and in particular, the imposition

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of STT and CGT on all prior non-exempt collateral arrangements should be carefully weighed up to ensure that the cost of complying with this does not outweigh the benefit of reducing systemic risk.

It is SASLA's submission that an amendment to the drafting of the 2022 TLAB to state that the limitation on the right of use of collateral should be a proviso to the definition of 'collateral arrangement' instead of it being an exclusion to the definition. If this is done then STT and CGT should only be applied to the transaction not constituting a collateral arrangement (Transaction 3) and not to prior transactions when a 'non-exempt' transaction is done (as in Transaction 1 and Transaction 2) and this would relieve some of the concerns of the securities lending industry in South Africa.

SASLA would like the opportunity to present oral submissions at the Standing Committee on Finance on Wednesday 14 September 2022. Melissa van der Merwe will present the oral submission and Michael Wright will be in attendance at the oral submission hearing.

Yours Sincerely

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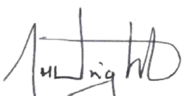

Michael Wright
Chairman: SASLA