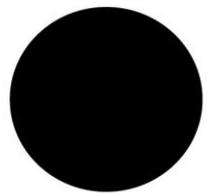


# DISCUSSION DOCUMENT

## STRENGTHENING CAPITAL REQUIREMENTS FOR NON-BANK OVER THE COUNTER DERIVATIVE PROVIDERS



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Financial Sector  
Conduct Authority

**Contents**

- 1. PURPOSE..... 3**
- 2. INTRODUCTION..... 3**
- 3. BACKGROUND..... 5**
- 4. RATIONALE FOR STRENGTHENING CAPITAL REQUIREMENTS  
FOR NON-BANK ODPs IN SOUTH AFRICA..... 7**
- 5. ASSESSMENT OF FOREIGN JURISDICTIONS’ APPROACH TO  
CAPITAL REQUIREMENTS FOR NON-BANK ODPs ..... 9**
- 6. OVERVIEW OF KEY FEATURES OF SOUTH AFRICAN OTC  
DERIVATIVES MARKET ..... 11**
- 7. CONCLUSION AND NEXT STEPS ..... 12**

## **1. PURPOSE**

- 1.1. The Financial Sector Conduct Authority (FSCA) is issuing this discussion document to inform industry participants and stakeholders of its intention to strengthen the capital requirements applicable to licensed Over-the-Counter Derivative Providers (ODPs), with a particular focus on non-bank ODPs that do not form part of a financial group. This initiative seeks to enhance the resilience, solvency, and overall prudential soundness of non-bank derivative providers whose risk profiles warrant more robust financial safeguards. The FSCA invites stakeholders to engage with the proposed reforms and contribute to ensuring that the capital framework remains appropriate, proportionate, and aligned with the evolving risks in the derivatives market.

## **2. INTRODUCTION**

- 2.1. Confidence in the South African financial markets is a cornerstone object of the Financial Markets Act, 2012 (Act No 19 of 2012) (FMA). Well capitalised and resilient financial markets are essential for maintaining financial stability as capital requirements enable financial institutions to withstand unexpected shocks, absorb losses and reduce the risk of failure. A pre-emptive approach to respond to stresses in the financial markets is therefore important for fostering confidence in the financial markets generally.
- 2.2. A regulatory capital regime functions as a protection against financial loss that may impact a number of stakeholders in the financial system. From a macro-prudential perspective, this form of regulation protects creditors, customers and counterparties from a financial institution's instability. At a greater scale, public resources are shielded from having to be used to resolve industry wide instability through bail-outs. At an institutional level, a regulatory capital regime assists in ensuring that institutions remain solvent and can maintain funding liquidity in stressed market conditions and plan for such extreme stress scenarios.
- 2.3. The over-the-counter (OTC) derivatives market fulfils an important role within the South African financial markets sector. OTC derivatives are financial contracts that are not traded on formal exchanges but are instead negotiated directly between parties. These instruments, which include forwards, swaps, and options, have gained popularity, owing to their flexibility and the ability to customize terms according to the specific needs of the counterparties involved. Particularly in emerging markets such as South Africa, non-banking entities such as asset managers, hedge funds, and insurers have increasingly engaged in OTC derivatives transactions, enhancing liquidity, and providing risk management solutions tailored to the unique needs of businesses.
- 2.4. The regulation of OTC derivatives in South Africa has been influenced by growth and uptake of OTC derivatives products in the local and international markets, and the regulatory responses by the international community to the threats and opportunities arising from this industry. From an international perspective, global financial markets have undergone significant transformations in the wake of the 2008 financial crisis, prompting regulators worldwide to reevaluate and, in many instances, overhaul their regulatory frameworks related to derivatives trading.
- 2.5. In terms of local regulation, South Africa has been on a journey to implement an appropriate regulatory framework on derivatives providers generally.

- 2.6. Specifically, providers of OTC derivatives in South Africa are currently subject to robust regulation under the FMA, together with ministerial regulations . These laws implement the country’s G20 commitments on transparency, trade reporting, central clearing, and margin requirements for non-centrally cleared derivatives.
- 2.7. The FSCA is, in terms of the FMA, read with the Financial Sector Regulation Act, 2017 (Act No 9 of 2017) (FSR Act), empowered to issue standards prescribing conditions and requirements for the provision of securities services, aimed at ensuring the efficiency and integrity of the financial markets
- 2.8. Regulation 2.1 of the FMA regulations prohibits any person from acting as, advertising or holding themselves out as an ODP unless authorised by the FSCA. Oversight and supervision are carried out mainly by the FSCA, which licenses ODPs and imposes obligations such as client due diligence, capital adequacy, and mandatory reporting of OTC transactions to approved trade repositories. The Prudential Authority (PA) also plays a regulatory role, particularly in margin and prudential requirements for OTC derivatives.
- 2.9. In 2022, the World Bank Group (WBG) and International Monetary Fund (IMF) released the results of its Financial Sector Assessment Program (FSAP)<sup>1</sup> assessment of South Africa<sup>2</sup>. It was recommended in *Technical Note: Collective Investment Schemes and Derivatives Markets Providers Monitoring*<sup>3</sup> that the FSCA enhances the monitoring of ODPs. In this regard, it was recommended that the FSCA strengthens and develops more granular capital requirements for ODPs. The development of the capital framework will take into account the need for appropriate granularity of requirements to ensure that ODPs are appropriately capitalised.
- 2.10. Having established the licensing and supervision frameworks for ODPs, the focus of the FSCA from a regulation perspective is to identify gaps in the framework and to provide an appropriate regulatory response thereto. This Discussion Document communicates the FSCA’s intention to further develop the regulatory framework to strengthen and enhance the capital requirements applicable to ODPs. Although the Prudential Authority (PA) is responsible for prudential regulation, the FSCA issues this Discussion Document in its function as the licensing authority for ODPs. In addition, this is supported by the Memorandum of Understanding agreed between the PA and FSCA in terms of which the FSCA is responsible for all aspects relating to the regulation and supervision of non-bank ODPs.<sup>4</sup>
- 2.11. As will be discussed below, this framework will strengthen the existing capital requirements applicable to licensed ODPs. The intention is to develop a framework that focuses on requiring ODPs to maintain capital on an ongoing basis, that goes beyond only focusing on capital coverage for operating expenses. The framework is intended to be risk

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<sup>1</sup> Further information on the FSAP program can be found at <http://www.worldbank.org/fsap>

<sup>2</sup>The most recent FSAP for South Africa was conducted in 2020–2021, with the resulting assessments published in early 2022.

<sup>3</sup> Available on the website of the WBG at

<https://documents1.worldbank.org/curated/en/09913000222218433/pdf/P1707070e0aa8b01f09e8e0df771ea40902.pdf>

<sup>4</sup> MOU accessible at: <https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-financial/sector-regulation-act/2018/8804>

based and it is not intended to replicate banking regulation solvency requirements but is aimed at ensuring sufficient financial resources to mitigate conduct risk, counterparty and market integrity risks.

- 2.12. An important feature of the local market is that an ODP may be a non-bank or form part of a banking or insurance group or financial conglomerate. Those ODPs forming part of such a group or financial conglomerate would invariably be impacted by the capital regime imposed on the bank or insurer. This is not the case for the non-bank ODP. The capital framework to be developed is aimed at those ODPs that do not form part of a banking or insurance group or financial conglomerate as designated by the PA.
- 2.13. This framework will ensure appropriate alignment of the local requirements with international frameworks applicable to the regulation of OTC derivatives markets. Relevant to this, the International Organization for Securities Commissions (IOSCO) *Objectives and Principles of Securities Regulation* (2017) provides in Principle 30 that there should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
- 2.14. Relatedly, in the report issued by IOSCO on International standards for derivatives market intermediary regulation, it is recommended that market authorities should consider imposing some form of capital or other financial resources requirements for derivatives market intermediaries that are not prudentially regulated and that reflect the risks that these intermediaries undertake.
- 2.15. The approach is aimed at ensuring that the capital framework -
  - (a) levels the playing fields between non-bank ODPs and ODPs forming part of a banking or insurance group or financial conglomerate<sup>5</sup>;
  - (b) is reflective of the risks undertaken by ODPs; and
  - (c) fosters closer alignment to international standards.

### **3. BACKGROUND AND CONTEXT**

- 3.1. In South Africa, the landscape for ODPs has been shaped intricately by a combination of local legislative initiatives and compliance mandates that align with international standards.
- 3.2. In 2012, the National Treasury issued a paper titled "*Reducing the risks of over-the-counter derivatives in South Africa*" (2012 paper), which recounts the issues in the OTC derivatives markets. The paper highlighted that regulation was necessary because the global financial crisis revealed how certain features of OTC markets can amplify systemic risk, threatening overall financial stability. As a member of the Group of Twenty, South Africa committed to implementing international reforms requiring improved transparency, reporting, clearing and risk controls in OTC markets. The South African market had been operating with insufficient regulatory oversight, prompting the need for institutional change to extend regulation to OTC derivatives. OTC derivatives in South Africa displayed structural and operational risks that could contribute to systemic vulnerabilities if left

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<sup>5</sup> To level playing fields in this regard means introducing risk specific capital requirements depending on various factors including the size and nature of the ODPs business.

unregulated. Strengthening regulation was also seen as necessary to ensure robust risk management, adequate governance, and appropriate capital requirements for market participants. The aspects of the FMA that deal with OTC derivative transactions are in response to the regulatory gaps identified in the 2012 paper.

- 3.3. Section 5(1)(b) of the FMA empowers the Minister of Finance (Minister) to prescribe a category of regulated persons, other than those specifically regulated under the FMA, if the securities services provided, and the functions and duties exercised, whether in relation to listed or unlisted securities, by persons in such category, are not already regulated under the FMA, and if, in the opinion of the Minister, it would further the objects of the FMA to regulate persons in such categories.
- 3.4. The Minister subsequently in regulation 1 of the FMA Regulations prescribed ODPs as such category of persons. In terms of section 6(8) of the FMA, the FSCA may prescribe criteria for the authorisation of ODPs as well as conditions and requirements for the provision of securities services by ODPs. This includes being empowered to prescribe conduct standards and to impose reporting requirements on ODPs.
- 3.5. In 2018, the FSCA issued Conduct Standard 1 of 2018: *Criteria for the authorisation of OTC derivative providers* (Conduct Standard 1 of 2018). The Conduct Standard prescribes the process and information required for ODPs to be authorised in terms of Regulation 2 of the FMA Regulations.
- 3.6. The Conduct Standard prescribes the following matters applicable to ODPs, as they relate to capital adequacy requirements:

*“4.1 Operational capital requirements*

- (1) *An applicant and a provider must-*
  - (a) *maintain capital, together with retained earnings and reserves proportional to the risks relating to the business of the provider in the Republic of South Africa;*
  - (b) *hold sufficient capital and liquid net assets funded by equity in the Republic of South Africa to cover potential general business losses to ensure-*
    - (i) *that the applicant and the provider are adequately protected against operational, legal, custody, and investment risks so that it can continue providing services as a going concern; and*
    - (ii) *an orderly wind-up or reorganisation of the applicant and the provider's critical operations and services over an appropriate time period of at least six months under a range of stress scenarios;*
  - (c) *hold equity capital in the Republic of South Africa-*
    - (i) *which reflects a strong cash, cash-equivalent, or securities position to allow the provider to meet its current and projected operating expenses under a range of scenarios; provided that cash equivalents and securities consist of high-quality and sufficiently liquid assets that can easily be converted into cash at little or no loss of value, even in adverse market conditions;*
    - (ii) *which, at a minimum, is equal to six months of operating expenses, provided that the provider considers whether resources are required beyond that amount, taking into account its general business risk profile; and*



- 4.3. In addition, Conduct Standard 1 of 2018 imposes minimum capital requirements that operate as a baseline capital floor. Conduct Standard 1 of 2018 requires a demonstration that the ODP has adequate financial resources and governance arrangements. This is distinguishable from a risk-based approach relating to capital requirements. Risk-based capital requirements emphasise that regulated persons must calculate capital in proportion to specific risk exposures. Essentially, the capital requirements in Conduct Standard 1 of 2018 do not explicitly tie the capital requirements to specific risks which include credit, market and operational risk.
- 4.4. The WBG Technical Note highlights that Conduct Standard 1 of 2018 requires ODPs to hold sufficient capital and liquid assets to meet their potential general business losses. However, there is limited specific guidance on how potential general business losses are to be assessed and how the corresponding amount of necessary capital to be held should be calculated. The Technical Note further recommended that the capital requirements for ODPs also need to be more granular.
- 4.5. Risks affecting ODPs vary widely for a number of reasons including the complexity of products, underlying market risk factors and counterparty exposures, amongst others. These differences necessitate sufficiently granular regulatory capital requirements to appropriately cover these risks.
- 4.6. From a systemic risk perspective, the potential for the realised risks in the derivatives market needs to be managed. Global regulatory reforms promote various ways to ensure the containment of these risks – including through promoting higher capital requirements for non-centrally cleared derivatives and through incentivising central clearing. Although this paper is not aimed at addressing these two reforms, the development of capital requirements of sufficient granularity for non-bank ODPs is expected to ensure that risks to all licensed ODPs are appropriately capitalised.
- 4.7. Essentially, the FSCA is reviewing the existing framework in order to:
  - (a) address the gaps identified following the implementation of the regulatory and supervisory framework relating to ODPs;
  - (b) provide sufficient guidance to ODPs on how potential business losses are to be assessed and capitalised; and
  - (c) ensure that the local regulatory framework is appropriately aligned with international best practice in the area of regulatory capital.
- 4.8. The FSCA is assessing the most appropriate mechanism to ensure that ODPs hold sufficient capital. The considerations are informed by the review of the local ODP market, as discussed in paragraph 6 below. In this regard, the FSCA acknowledges that a minimum capital framework is appropriate where an ODP has a simple, straightforward business model, with limited products and a low inherent risk. In the same way, the FSCA also recognises that the evolution of business models may give rise to more complex institutions which assume more a diverse range of risks including material credit, market and operational risks. The overall development and growth of the market may also bring about greater diversity in size, product mix, risk profile and investment strategies – to which a floor capital framework may not adequately responsive. In addition, these changes both from an idiosyncratic and market-wide perspective may also lead to increased levels of systemic risk.

- 4.9. Bearing in mind that the FSCA is in the very beginning stages of the revision of the capital framework applicable to non-bank ODPs, the maturation of the regulatory framework relating to the OTC markets both locally and from an international perspective, has prompted the FSCA to assess the appropriate mechanisms to ensure that capital requirements better reflect the risk profiles of licensed ODPs.

## **5. ASSESSMENT OF FOREIGN JURISDICTIONS' APPROACH TO CAPITAL REQUIREMENTS FOR NON-BANK ODPs**

- 5.1. The paragraphs below draw some observations on the approach to capital requirements for non-bank ODPs in comparable foreign jurisdictions. The observations are based on comparisons between these jurisdictions, and across various themes.
- 5.2. In Australia, Australian Securities and Investments Commission (ASIC) has developed capital requirements which take the following into account the type of Market Participation: In this case, a minimum core capital amount is set depending on whether the provider is a securities market participant or a futures market participant.
- 5.3. A distinction is also drawn between liquid capital and a total risk requirement. The total risk requirement is calculated based on exposure to market, credit, and operational risks. ASIC requires that liquid capital must always exceed the participant's total risk requirement. Participants must also comply with risk-based capital rules, which consider position risk (market exposure), counterparty risk, and operational risk.
- 5.4. In Canada, a minimum working capital requirement for non-bank ODPs is imposed by the Ontario Securities Commission (OSC). An amount is imposed for a registered adviser that is not also a registered dealer or a registered investment fund manager, and a higher amount is imposed for a registered dealer that is not also a registered investment fund manager.
- 5.5. The OSC also provides that the frequency of working capital calculations depends on many factors, including the size of the institution, the nature of its business and the stability of the components of its working capital. If, at any time, the excess working capital of a registered institution is less than zero, the registered institution must notify the regulator as soon as possible. Furthermore, the excess working capital of a registered institution must not be less than zero for 2 consecutive days.
- 5.6. In the European Union (EU), non-bank OTC derivatives intermediaries are treated as Markets in Financial Instrument Directive (MiFID) investment institutions and fall under the dedicated prudential framework made up of the Investment Firms Regulation (IFR) and Investment Firms Directive (IFD). These institutions must hold capital equal to the highest of: their permanent minimum capital requirement (PMR), their fixed overheads requirement (FOR), or (for Class 2 institutions) their so-called K-factor requirement. The value of the PMR depends on the institution's authorised activities in terms of the MiFID. The FOR equals 25% of the previous year's fixed overheads, ensuring institutions hold resources to wind down safely if needed. The regulation furthermore imposes a 'K-factor' for institutions deemed class 2 intermediaries. Class 2 intermediaries in terms of MiFID are those entities that are small and non-interconnected but are also not large enough to be classified as systemically important credit institutions. The "K-factor" capital

**DISCUSSION DOCUMENT: STRENGTHENING CAPITAL REQUIREMENTS FOR NON-BANK OVER THE COUNTER  
DERIVATIVE PROVIDERS**

requirements are a set of risk-based indicators—named K-factors—that quantify the risks investment institutions pose to:

- (d) their clients (Risk-to-Customer),
- (e) the market (Risk-to-Market), and
- (f) themselves (Risk-to-Institution).

Small, non-interconnected institutions must comply with a lighter-touch regime and need only meet the higher of PMR or FOR, without K-factors.

- 5.7. In Hong Kong, providers are required to hold minimum paid-up capital that captures operational and residual risks. This capital represents permanent loss-absorbing buffer supporting systems, governance and operational resilience and a structural backstop for trading, model, complexity and tail risks not fully captured by daily risk calculations.
- 5.8. In respect of liquid capital required, Hong Kong imposes a high liquidity floor ensuring a minimum buffer regardless of modelled risk. Heavier haircuts and exclusions are applied that reflect volatility, complexity and liquidity risk. The requirement driven by balance-sheet size amplified by leverage, margining and trading exposures.
- 5.9. In addition, providers must factor in market risk, in terms of which market risk arising from trading activities of investment institutions must be taken into account, determined by net position risk. Margin requirements are also used as risk mitigants, but this approach does not eliminate the need to charge market risk on margined transactions. In Hong Kong it is assumed that margin may be insufficient in fast markets, where close-out costs may dominate in stress and liquidation causing liquidity to be insufficient when needed most.
- 5.10. In respect of concentration risk, providers must capture concentration risk arising from large exposures to specific counterparties and for counterparty credit risk, providers must measure their exposure to default by trading counterparties, using a various counterparty credit risk frameworks.
- 5.11. In Singapore, the required capital applied is affected by membership to an approved clearing house, exchange or neither. In this regard, a member of an approved clearing house attracts the highest charge, whereas a member of an approved exchange or where the provider is neither a member of a clearing house nor an exchange attracts a lower charge. The customer base also impacts capital requirements where a higher capital requirement applies to a provider that deals with retail clients than that applied to a provider that deals only with accredited, expert or institutional investors. The capital requirement is also influenced by whether the provider handles customer positions and assets. A higher capital requirement is applied where the provider carries customer positions, margins, or accounts in its own books. Additionally, the nature of products dealt with by the provider are considered, taking into account whether these include specified commodity futures contracts only, or spot FX leveraged trading.
- 5.12. The United Kingdom (UK) OTC derivatives intermediaries fall under the Investment Firms Prudential Regime (IFPR) administered through the Prudential Sourcebook for MiFID Investment Firms (MIFIDPRU), which applies to investment institutions not subject to consolidated supervision. Similarly to the EU, UK institutions must meet the highest of: Permanent Minimum Capital, Fixed Overheads Requirement, or the applicable K-factor requirement. Under this regulation, the intermediary must maintain robust own funds to

absorb losses and protect counterparties.

- 5.13. Across all jurisdictions, common threads include proportionality, risk-sensitivity, and higher capital where leverage, client vulnerability, or handling of customer assets increases risk.
- 5.14. For purposes of the exploratory work underway, the FSCA will consider these areas of commonality and also specifically take the following into account, amongst other matters:
- (a) Types and complexity of instruments traded by ODPs;
  - (b) types of clients, whether retail or institutional;
  - (c) trading strategies;
  - (d) leverage ratios;
  - (e) whether ODP holds client positions; and
  - (f) margin.

## **6. OVERVIEW OF KEY FEATURES OF SOUTH AFRICAN OTC DERIVATIVES MARKET**

- 6.1. As a starting point, an assessment of the key features of the domestic OTC derivatives market is relevant when considering what would be considered an appropriate capital framework within the South African context. A sound description of the structure, behaviour and risks of the domestic OTC markets is important for ensuring that the capital requirements are risk-sensitive, proportionate and effective at addressing systemic risk.
- 6.2. As such, the FSCA will consider various factors for the design of a comprehensive capital framework for non-bank ODPs. With the strong technical support from the PA, the FSCA has created an outline profile of the OTC derivatives market in South Africa including both non-bank ODPs as well as ODPs forming part of a banking group. The following core factors were considered: types of products and clients in the market, active liquidity providers, trading systems, leverage ratios and contracts for difference (CFD) trading strategies.
- 6.3. The table below illustrates a high-level view of the findings from the market profile:

<p><b>Product types</b> <i>Different OTC contracts carry different risk profiles</i></p>	<p>Majority of financial institutions offer contracts for difference (CFD) across various asset classes such as currency pairs, indices, commodities, shares, metals; some also offer cryptocurrencies. Few institutions also provide equity swaps or focus on commodity trading for professional clients.</p>
<p><b>Client types</b> <i>Different client profiles bring different default risks, liquidity and leverage use</i></p>	<p>Retail clients are the most common group served by ODPs. Clients also include corporates, counterparties, institutional clients, professional clients in agricultural sector, asset managers and high net worth clients.</p>
<p><b>Access to Liquidity</b> <i>Liquidity differs in respect of product or client segments and capital requirements must take into account these</i></p>	<p>Many ODPs rely on external liquidity providers, whereas some use internal liquidity or proprietary systems or hedging broker relationships</p>

<i>differences</i>	
<b>Trading systems</b> <i>Trading systems may impact operational risk</i>	Most use MetaTrader 4/5 (MT4/MT5). Some use in-house built trading systems or trading systems of third-party vendors.
<b>Leverage ratios</b> <i>Capital frameworks must reflect leverage-induced vulnerabilities.</i>	Varies significantly across institutions. Some use tiered leverage based on asset volatility. Others use dynamic or adjustable leverage based on factors such as market conditions.
<b>CFD Trading Strategies</b> <i>Most non-bank ODPs offer CFDs</i>	A-Book strategy, where client trades are passed directly to the market, is prevalent across the market. B-Book strategy, where client trades are kept within the internal book and managed by the ODP, is used by several institutions. A few institutions combine both strategies (A-Book and B-Book), adapting based on the client's profile, the liquidity of the market or rand value of the transaction.

6.4. These findings provide a practical scope of the domestic OTC derivatives market. These factors are seen as relevant for capital requirements because they provide insights into the overall financial risk profile of an ODP. It is from these factors that the FSCA will be in a position to determine whether stricter/higher or lower capital requirements need to be imposed in order to give effect to the objectives of this project. However, as stated, this information will be supplemented by empirical data at the disposal of the FSCA.

## 7. CONCLUSION AND NEXT STEPS

- 7.1. Introducing a new and strengthened capital framework is expected to have impacts on the overall derivatives markets. It is anticipated that from a competition perspective, additional requirements will increase start-up funding, particularly for new entrants. In addition, regulatory costs will increase, which may also impact ODPs differently based on the nature and scale of their operations. It is also expected that the capital framework will also support a well-regulated and stable market that aligns with global best practice.
- 7.2. The development of the capital framework will be informed by the gaps identified in the regulation and supervision of non-bank ODPs. The FSCA will be guided by a need to ensure that the capital requirements are proportional to the activities and features of the domestic OTC derivatives market.
- 7.3. The FSCA will request information from licensed ODPs to map out the risks in the industry, which will inform the level of granularity to be implemented. This will involve both formal and informal consultation with impacted stakeholders. To this effect the FSCA has engaged licensed ODPs to obtain information required to inform the framework. Active input and participation from stakeholders will be required to ensure a structured, methodical and coherent approach to introducing risk-based requirements that are relevant and appropriate in the South African context. It is expected that informal and targeted consultation with industry stakeholders will continue throughout 2026 and into 2027.
- 7.4. Once the FSCA has clearly defined a capital framework, it will issue an appropriate regulatory instrument to give legislative effect to the requirements in the framework. At that stage, the draft regulatory instrument (i.e. standard) will be issued for public consultation for a period of six weeks, as prescribed in the FSR Act.

**DISCUSSION DOCUMENT: STRENGTHENING CAPITAL REQUIREMENTS FOR NON-BANK OVER THE COUNTER  
DERIVATIVE PROVIDERS**

- 7.5. The FSCA highlights that as the capital framework is developed and consulted upon, more detailed and specific information will be communicated to the industry, including matters relating to phasing-in of requirements and transitional timelines and arrangements.
- 7.6. The South African financial markets depend on strong confidence and robust capitalisation, making pre-emptive, risk-sensitive regulation essential for maintaining stability and protecting stakeholders. The existing operational capital requirements for ODPs have provided a foundation, but supervisory experience since 2018 shows that more granular and updated capital standards are necessary. Because non-bank ODPs differ fundamentally from ODPs in a group or financial conglomerate in size, business model, liquidity profile, and systemic footprint, a tailored and proportionate capital framework is required to match their unique risk exposures. International and foreign approaches consistently reinforce the need for risk-based, proportional, and ongoing capital requirements for derivatives intermediaries, particularly where client assets, leverage, or retail activity increase potential harm. Drawing from these insights and grounded in extensive data collection and consultation, the FSCA will develop a strengthened capital framework that reflects global best practice while addressing the specific characteristics of the South African OTC derivatives market.