Financial Services Commission
Mauritius

PRACTICE NOTE

ON

SWAPS AND DERIVATIVES

PN/01J2014

(Issued under section 7(1)(a) of the Financial Services Act 2007)

Issued on 01 October 2014

CONTENTS

INTRODUCTION

BACKGROUND

1. This Practice Note:

   (a) explains the concept of swaps and derivatives traded on Over the Counter (OTC) Markets and outlines the scope of regulation and supervision by the Financial Services Commission, Mauritius (FSC Mauritius) as per the present laws of the Republic of Mauritius;

   (b) explicates the manner in which the principles already established under legislation or a guideline will be interpreted and implemented. Practice Notes are issued under Section 7(1) (a) of the Financial Services Act 2007 (FSA 2007);

   (c) needs to be updated following new developments occurring in the financial landscape; and

   (d) has been issued subsequent to discussions with the Mauritius Bankers Association (MBA) to clarify the circumstances to which the law does not require banks to obtain a licence or approval from the FSC Mauritius to engage in derivatives contracts and which are not meant for distribution purposes. It also contains explanations whereby banks will need to take a licence with the FSC Mauritius to trade in 'Swaps and Derivatives'.

2. The FSC Mauritius is deemed to be established under the FSA 2007, as the integrated regulator for the non-bank financial services and global business sectors. The FSC Mauritius is mandated under the FSA 2007 to *inter alia*:

   (a) ensure the orderly administration of the financial services and global business activities;

   (b) ensure the sound conduct of business in the financial services sector and in the global business sector;

   (c) elaborate policies which are directed to ensure fairness, efficiency and transparency of financial and capital markets in Mauritius;

   (d) study new avenues for development in the financial services sector, to respond to new challenges and to take full advantage of new opportunities for achieving economic sustainability and job creation;

   (e) ensure soundness and stability of the financial system in Mauritius; and

   (f) work out objectives, policies and priorities for the development of the financial services sector and global business.

3. Under the FSA 2007, the FSC Mauritius has among its functions to *inter alia*:

(a) license, regulate, monitor and supervise the conduct of business activities in the financial services and global business sectors;

(b) set rules and guidance governing the conduct of business in the financial services and global business sectors;

(c) establish norms and standards in order to preserve and maintain the good repute of Mauritius in the financial services sector; and

(d) prepare, develop and implement a plan for the better integration of the financial services industry.

4. As per Section 2 of the Securities Act 2005 (SA 2005), the definition of securities includes *inter alia* "***options, futures, forwards and other derivatives whether on securities or commodities***". Derivative includes "***futures and option contracts on securities, indices, interest or other rates, currency, futures or commodities***".

In 2009, the FSC Mauritius has amended its Securities (Licensing) Rules 2007 to cater for two new categories of investment dealers namely: investment dealer (commodity derivatives segment) and investment dealer (currency derivatives segment) in line with the setting up of the Bourse Africa Limited which was formerly known as Global Board of Trade Ltd (GBOT). Bourse Africa Limited is the first multi-asset class securities exchange to offer derivatives in Mauritius.

5. The International Organization of Securities Commissions (IOSCO) - the global organisation and standard setter for securities regulation and the Group of Twenty (G20) have called for a review of the scope of financial regulation with respect to financial products. There is a strong will to encourage regulators to foster industry initiatives and take regulatory action to improve confidence in current financial markets and products by promoting fair, efficient and orderly global financial markets. These steps are important to the recovery of a balanced financial system. Further, with the financial crisis and new developments in the financial landscape, it is imperative for Regulators to redefine the perimeters of regulation and scope of intervention in order to diversify the portfolio of investors and ensure their protection.

PART I

EXPLANATORY NOTES: SWAPS AND DERIVATIVES

6. DERIVATIVE

A derivative is a financial contract whose value is "derived from" or depends on, the price of some underlying asset. Equivalently, the value of a derivative changes when there is a change in the price of an underlying related asset.

Derivative contracts can be classified into two broad categories namely contingent claims (for instance *options*) and forward claims (including *forwards* and *swaps*).

7. SWAP

A swap is a contractual agreement between two parties to exchange cash flows. The cash flows that are swapped may be determined on the basis of interest rates, exchange rates, or the prices of indexes or commodities.

Swap is usually customised and its market is considered an OTC.

The salient features of swap are that:

(a) it is a combination of forward contracts and it possesses all the properties of a forward contract;

(b) swap is long term in nature, while forwards are arranged for short period only;

(c) it requires that there is a double coincidence of wants, which is two parties with equal, opposite but matching needs must come into contact with each other; and

(d) there may be a need for a financial intermediary to make the two counterparties meet.

There are different types of swaps, each with its own characteristics and the most common are:

(a) Interest rate/ Plain Vanilla Swap

An interest rate/ plain vanilla swap involve the exchange of a fixed rate loan to a floating rate loan. It has the effect of transforming a fixed rate loan into a floating rate loan or vice versa.

(b) Commodity Swap

A commodity swap is a contract in which the counterparties agree to exchange cash flows that are determined on the basis of commodity prices.

(c) Currency Swap

A currency swap involves exchanging principal and fixed rate interest payments on a loan in one currency for principal and fixed rate interest payments on an equal loan in another currency. The counterparties to gain both interest rate exposure as well as foreign exchange exposure, as all payments are made in the counterparty's currency.

An important distinction between an interest rate swap and a currency swap is that in the latter the principal amounts are typically exchanged on the origination date and at maturity.

(d) Equity Swap

An equity swap is an agreement in which counterparties pay and receive cash flows based on rates of return of a stock, basket of stocks or stock market index.

Swaps may be used to:

(a) lower borrowing cost;

(b) access New Financial Markets;

(c) hedge risks;

(d) correct asset-liability mismatch; or

(e) earn additional income.

PART II

SWAPS & DERIVATIVES

REGULATORY FUNCTIONS IN RESPECT OF BANKS

8. Banks and their subsidiaries are currently licensed by the FSC Mauritius to conduct non-banking activities in accordance with requirements under the FSA 2007 and the relevant Acts.

9. The International Swaps and Derivatives Association (ISDA), in a paper published in March 2011 and entitled: '***Swaps execution facilities – Can they improve the structure of OTC Derivatives Markets',*** mentioned the following:

Swaps are generally traded on a bilateral basis, i.e., between two counterparties. Most derivatives are executed between a bank dealer and its clients or between two dealers who seek to hedge risks they have taken or as a means of taking on new risk. …An exception to the bank dealer market is the commodity derivatives market where non-bank dealers are quite common. Dealers in the OTC derivatives markets act as principals, i.e., assume the market and credit risks associated with the trade until its maturity. In the futures markets, futures commission merchants (FCMs) act as agents for their clients.

FOR THE PURPOSE OF THIS PRACTICE NOTE, THIS PART DEMARCATES THE CIRCUMSTANCES WHEREBY BANKS:

(i) ARE NOT REQUIRED TO SEEK A LICENCE WITH FSC MAURITIUS; AND

(ii) ARE REQUIRED TO SEEK A LICENCE WITH FSC MAURITIUS.

10. Banks are licensed by the Bank of Mauritius. However, a bank, engaged in derivatives contracts, is not required to apply for a licence with the FSC Mauritius in the following circumstances:

(a) bilateral contracts are entered;

(b) trades are executed as per mutual agreements and settled directly as per the terms and conditions specified;

(c) the standard contracts in swaps and derivatives are entered with clients and this occurs in the normal course of business activities; or

(d) when a bank is trading or holding itself out to trade in securities as principal for its own account or in proprietary trading.

11. When a bank is acting as an intermediary in derivatives and swaps transactions on a trading system over the counter or on a Securities Exchange trading platform, it needs to take a licence from the FSC Mauritius under Section 29 of the SA 2005.

PART III

CONCLUSION

12. The financial crisis exposed weaknesses in OTC markets that contributed to the build-up of systemic risk. These weaknesses included:

    (a) the build-up of large counterparty exposures between particular market participants which were not appropriately risk-managed;

    (b) contagion risk arising from the interconnectedness of OTC derivatives market participants; and

    (c) the limited transparency of overall counterparty credit risk exposures that precipitated a loss of confidence and market liquidity in time of stress.

    To address these weaknesses, in September 2009, G20 Leaders in Pittsburgh called for reforms in OTC derivatives markets. It was agreed 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. The Financial Stability Board (FSB) and its relevant members were also asked to regularly assess implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.

13. National authorities and international bodies, with the FSB as a central locus of coordination, have advanced financial reform OTC Derivatives programs. The FSB, in April 2010, had established the OTC Derivatives Coordination Group led by representatives of the Committee on Payment and Settlement Systems (CPSS), the IOSCO and the European Commission to form and to make recommendations on the implementation of the G20 objectives.

14. The FSB and the standard setters have since been publishing reports on progress which are being made in setting international standards for the advancement of national legislation and regulation and for the practical implementation of reforms to market infrastructures and activities.

15. Standard setting bodies such as the CPSS and the IOSCO have made significant progress in developing international policies that facilitate the advancement of OTC derivatives reforms across jurisdictions. Policy makers and Regulators worldwide are in the midst of bringing significant changes to regulate financial derivatives by setting up new rules to bring increased visibility and tighter security measures. They are implementing organisational standards for clearing houses and data repositories and establishing exhaustive reporting, cross-checking and netting standards. It has become equally vital that market participants remain well informed as to the implications of changes and regulations.

16. In February 2012, IOSCO released the report on '**Requirements for Mandatory Clearing**' in response to the G20 commitment to ensure that all standardised OTC derivatives contracts were cleared through central counterparties by end 2012. In Mauritius, standardised OTC derivatives are traded in limited extent. Banks are under the regulatory purview of the Bank of Mauritius and as mentioned the transactions in swaps and OTC derivatives form part of their normal banking transactions.

17. The FSC Mauritius follows on the international developments to keep pace and to act accordingly.

Financial Services Commission
01 October 2014

REFERENCES

1. Financial Services Act 2007

2. Securities Act 2005

3. Securities (Licensing) Rules 2007

4. International Swaps and Derivatives Association ('ISDA') website: *www.isda.org*

5. FSB website: *http://www.financialstabilityboard.org* -Extracts from October 2010 – FSB Report on Implementation OTC Derivatives Market Reform & FSB Third Implementation program report on OTC Derivatives Report _June 2012

6. IOSCO website: *www.iosco.org*

7. IOSCO, report on 'Requirements for Mandatory Clearing', *http://www.iosco.org/news/pdf/IOSCONEWS226.pdf*

8. D.Dubofsky and T. Miller Jr, 2002, Derivatives, Valuation and Risk Management, Oxford University Press

Financial Services Commission
Mauritius

FSC House, 54 Cybercity, Ebene, Republic of Mauritius
Tel: (230) 403 7000   Fax: (230) 467 7172
E-mail: fscmauritius@intnet.mu, Website: www.fscmauritius.org