JSE CLEAR

DEFAULT FUND POLICY

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1  Context and purpose

As the clearing house for all exchange-traded derivatives in South Africa, JSE Clear plays a key role in mitigating systemic risk in the South African financial market. It does so by ensuring the efficient clearing and settlement of trades, thereby reducing the risk of a single default impacting other counterparties and contaminating the market. In order to effectively perform this function, JSE Clear employs an array of risk mitigation measures. Amongst these is the establishment of a default fund to which all clearing members and JSE Clear make contributions.

The purpose of this policy is to detail the quantification, management and governance of the JSE Clear Default Fund. The policy has been drafted to ensure that JSE Clear meets the standards set out by the Committee for Payments and Market Infrastructures (CPMI) and the International Organisation of Securities Commission (IOSCO) especially with regard to the establishment and maintenance of a default fund.

2  Risk management tools and risk waterfall

JSE Clear’s primary role as a clearing house is to ensure that a market participant default does not affect other market participants. JSE Clear employs an array of risk mitigation measures to achieve this. First, JSE Clear has set entry requirements to becoming a clearing member (spanning financial considerations, capital adequacy requirements and risk management capability). Second, all trades are collateralised through a system of margins. The sufficiency of the quantum of margin is back tested against actual market experience to ensure performance is at the expected confidence interval. Stress testing is done to test and measure the shortfall of margins in extreme market events. Last, there is the JSE Clear Default Fund, to which all clearing members must contribute. The JSE Clear Default Fund can be accessed to cover losses suffered as the result of one clearing member defaulting.

2.1  The JSE Clear risk waterfall

In accordance with the JSE Derivative Rules, in the case of a clearing member default, losses will be funded as follows (this is referred to as the risk waterfall):
1. All initial margin, additional margin and/or other collateral held by JSE Clear in favour of or on behalf of or for the account of the clearing member is used first to settle any obligations the clearing member has to the market.

2. Should these be insufficient to cover all obligations, the defaulting clearing member’s contributions to the JSE Clear Default Fund are used.

3. Thereafter, JSE Clear’s contribution to the JSE Clear Default Fund is used.

4. If any obligations to the market remain thereafter; the non-defaulting clearing members’ contributions to the JSE Clear Default Fund are utilised.

5. Should the defaulting clearing member have any obligations to the market that are not covered by the financial resources listed above, affected market participants will have a claim against the defaulting clearing member.

The obligations of market participants with regards to the replenishment of the JSE Clear Default Fund (following depletion of the fund as a result of a default), is explained in section 4.2.

3 Determining the size of the fund

3.1 The size of the default fund

JSE Clear must have sufficient prefunded financial resources to withstand the failure of their largest clearing member¹ and its affiliates in a severe yet plausible stress event as stated in the risk tolerance statement. These prefunded financial resources consist of the JSE Clear Default Fund and initial margin (including additional margin and/or other collateral held by JSE Clear). The JSE Clear Default Fund is quantified to be large enough to cover stressed losses over and above initial margin, and must be of a value of at least ZAR 500 million.

The minimum size of the fund is determined by considering various quantification methods and theories as well as stress testing results and engagement with the market. The size of the fund is determined by the JSE Clear Board. JSE Clear sets a minimum size of the fund to ensure that the fund

¹ “Cover 1” from Principal 4 of “Principles for Financial Markets Infrastructure (Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions (2012))”
remains relatively stable but also remains sensitive to any increase in the risk profile of the credit portfolio to which it is exposed. This creates the necessity for a buffer to be instated - above the minimum amount specified - in order to reduce the need for pro-cyclical adjustments while at all times ensuring that the fund is adequately capitalised (to withstand sudden market events and exposure volatility).

3.2 Calculation methods – stress testing

Stress testing is performed on a daily basis in accordance with the JSE Clear Stress Testing Policy and Stress Testing Methodology. The stress testing results are compared to the size of the default fund. Where the results of the stress testing program (after the risk waterfall is taken into account) are greater than the default fund, JSE Clear will review the relevant scenarios and may increase the size of the fund to the extent deemed appropriate.

3.3 Quantification procedure

The default fund size, based on stress testing, will be calculated daily and the quarterly maximum will be updated. This will be compared to the size of the fund on a daily basis and will form part of the daily reporting to the Head of Risk (HoR) and monthly to the Responsible Officer (RO). The size of the fund and a summary of the supporting calculation results will be reported quarterly to the JSE Exco and the JSE Clear Board.

The size of the fund will be updated quarterly and members’ contributions calculated as described in section 4.1 below. If the current size of the fund is significantly smaller than the calculated capital amount, JSE Clear will call for an intra-quarter re-balancing of the default fund size and clearing members will be expected to contribute toward the increase in fund size based on the method in section 4.1 below. In this case the RO will inform market participants, the JSE Exco and the JSE Clear Board.

The size of the default fund and the size of JSE Clear’s contribution thereto will be reported to clearing members and their regulator on a quarterly basis, along with the proportion of their respective contributions to the fund calculated as described below. JSE Clear’s contribution to the default fund is specified in this document and will be confirmed to clearing members quarterly.
4 Contributions to the default fund

4.1 Quantifying market participant contributions

The JSE Clear Default Fund is prefunded and made up of contributions by JSE Clear, as the clearing house, and all clearing members of JSE Clear. JSE Clear’s contribution to the fund is determined by considering international CCP practice and regulatory guidance, and is set at ZAR 100 million (currently 20% of the fund size). JSE Clear maintains a fixed commitment for reasons of stability and the need to provide certainty for the market infrastructure and the market it serves. This amount will be reviewed annually by the JSE Clear board or more frequently as JSE Clear’s financial position, market conditions or the nature of the market changes.

The amount of trades cleared in the South African market is not evenly spread across the clearing members; the bigger clearing members account for a disproportionate amount of trades. To acknowledge this inherent concentration risk it is appropriate to increase the contribution to the default fund by the bigger clearing members. This will be done by establishing 2 separate tiers of Clearing Member contributors, and by placing the bigger clearing members in the Tier 1\(^2\) category and the smaller clearing members into Tier 2\(^3\). This system and the tiers themselves will be reviewed annually. Placing clearing members into tiers is done to account for the concentration of clearing members in the SA market and to account for the disproportionate risk they represent as a result of their trading activity in the market.

Tier 2 clearing members will contribute additional margin (as defined by the JSE Derivatives Rules) in an amount equal to ZAR 10 million. The contributions of Tier 1 clearing members will be the remaining amount needed to make up the default fund. This amount will be divided among the Tier 1 clearing members proportionally - the average initial margin of each Tier 1 clearing member over the previous 3 months will be calculated as a proportion of the total Tier 1 Clearing Members’ average initial margin over the same period.

\(^2\) Tier 1 clearing members will be those clearing members where the 3 month average initial margin per clearing member is greater than one billion rand per day.

\(^3\) Tier 2 clearing members will be those clearing members where the 3 month average initial margin per clearing member is less than or equal to one billion rand per day.
The size of the fund and proportional contributions will be calculated based on the 3 months ending on the 10th day of the last month of the quarter. JSE Clear will disclose the size of the fund and each member’s contribution to them on the 20th of day of the last month of the quarter or next business day.

After any recalculation, clearing members will have 2 days to deposit funds if needed. Thereafter any refunds will be made to correct proportional contributions.

The assets will be invested as per the mandate set out for margin funds (referenced in section 5) and investment proceeds, less applicable service fees will be distributed, each quarter net of contribution movements of that quarter.

In the case of a credit loss event where non-defaulting members’ contributions to the default fund are called upon to fund losses, these losses will be distributed as per the prior contribution proportions as communicated by JSE Clear at the previous quarter-end or later as the case may be.

4.2 The replenishment of the Default Fund

After any loss event where funds from the default fund are called upon, the non-defaulting clearing members will replenish the fund within 3 trading days as per the method described in this section. JSE Clear will contribute an amount equal to the part of its first contribution utilised, and limited to one additional contribution in a 12 month period.

If another loss event occurs within 12 months and the non-defaulting clearing member’s contributions of additional margin are used, the non-defaulting clearing members will replenish the default fund again. The size of each clearing member’s contribution post the default event is limited to 125% of the value of their contribution prior to the default for a period of 6 months after the default.

If another loss event occurs within 12 months and the non-defaulting clearing member’s contributions of additional margin are used, the non-defaulting clearing members will replenish the default fund again but this third contribution of additional margin be limited to 125% of the each clearing member’s contribution prior to the default event and will not be used to fund further mutualised losses.

An example of the replenishment mechanism is shown in Appendix 1.
A clearing members’ contribution of additional margin to the default fund can only be fully used twice to fund mutualised losses over any rolling 12 month period. Should stressed losses exceed the size of the default fund post a default event; the JSE executive committee will review the initial margin parameters to ensure that pre-funded resources are sufficient for cover 1.

Where a clearing member exits the market or ceases to be a clearing member, the terminating member’s contributions will be reimbursed once the process for membership termination has been completed. On the termination date the fund will be recalculated and rebalanced normally as described in this section. The default fund contribution of the terminating member is not at risk for mutualised losses once the termination of membership process has been completed.

If a new clearing member enters the market, that clearing member will simply add to the fund on a weekly basis in the proportion as calculated above as their position increases until the following quarter where a rebalance will take place as per normal. If a default happens during this time, losses will be shared in the proportion to contributions at that time.

5 Governance

This policy is to be maintained by the Head of Risk who will annually review processes and procedures to ensure compliance with this policy.

The Responsible Officer will, after consultation with relevant stakeholders, recommend this policy to the JSE Exco and JSE Clear Risk committee, who in turn will recommend the policy to the JSE Clear Board for final approval (subject to approval by the JSE Board). The JSE Exco is required to approve policy changes in its capacity as executive oversight of the operations and risk management function that is outsourced by JSE Clear to the JSE.

JSE Clear will annually review the policy with which it determines the size of the fund. Periodic backtesting will be performed on the quantum of the fund against stress testing results and breaches will be reported to JSE Clear Board and JSE Exco. The methods of calculation will be validated every two years and assurance of their applicability and accuracy will be provided to the JSE Clear Board and JSE Exco.

The assets of the JSE Clear Default Fund will be invested as per the JSE Clear Investment Mandate. There will be one default fund for JSE Clear and it will apply to all markets for which JSE Clear provides a clearing
service. A default in one market will consequently be funded by clearing members across all markets. This is deemed appropriate due to the size of the different markets and trading profile of clearing members.

The JSE Clear Default Fund exists solely to fund losses as a result of a default event by a clearing member. The JSE Clear Default Fund is separate and exclusive of any un-funded guarantees provided by a clearing member or any other party.
A clearing member’s replenishment obligations are limited in the fashion shown in the example below.

To start, assume Clearing Member AA (CMAA) has previously made contribution to the default fund of R50m. Thereafter, should a default happen on a particular day and the whole default fund is used to fund losses, CMAA will replenish the default fund with not more than R62.500m.

Should a second clearing member default within 364 consecutive days (note – not a calendar year) of that first default (i.e. before day 365) and the whole default fund is used to fund losses, CMAA will replenish the default fund with not more than R78.125m. This amount is now only eligible for being used to fund losses arising from the default of CMAA specifically, as no contribution to the default fund is at risk of being mutualised more than twice in a 12 month period.