BOND ETP

Default management policies and processes

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VERSION CONTROL

Version	Release Date	Comments
V1.0	February 2018	First draft
V2.0	03 May 2018	Addition of default processes and procedures

1. Introduction

In 2012 National Treasury (NT) formed an industry-wide committee called the Bond Market Development Committee (BMDC) whose mandate was to consider developmental issues facing the SA bond market. Representation included the JSE, Strate, the Association of Savings and Investments of South Africa (ASISA), the SA Reserve Bank (SARB) and the Financial Services Board (FSB). As a result of the work undertaken by the BMDC, National Treasury had decided to implement an electronic trading platform (ETP) for the Primary Dealers (PDs) appointed by NT. The JSE is responsible for managing the ETP Project delivery for government bonds that facilitates anonymous trading via a live central order book. The project implementation is overseen by a market-representative project steering committee, with a planned go-live in Q2 2018.

This document forms part of a set of post-trade related documents that include:

- Bond ETP – Settlement Model;
- Bond ETP – Initial Margin Methodology; and
- Bond ETP – Risk Policies and Processes.

The purpose of this document is to clarify the governance, roles, responsibilities and processes for managing the default of a member in the Bond ETP market. The JSE (as the ETP operator) is responsible for facilitating the settlement of Bond ETP securities in terms of the default procedures set out in Section 11 of the Bond ETP rules. A crucial step in these processes is closing out the defaulting member's positions, via an auction process. The objective of the close-out phase is to allow the JSE to dispose of the defaulting member's portfolio to other member(s) and the market in general in a timely manner whilst minimizing losses. This document incudes the details of the close-out process, specifying who is responsible for each step and how the step will be executed.

2. Scope

The scope of this document includes:

- All stages of a Bond ETP member default, including
    - pre-default;
    - event of default;
    - close-out of a defaulter's positions and use of prefunded resources; and
    - post-default activities.
- Readiness and testing, including fire drills.
- Default procedures, and roles and responsibilities

3. Governance

The default management policies and processes for the Bond ETP market are owned by the JSE Head of Risk, Post Trade Services department. The Bond ETP Risk Committee that is chaired by National Treasury (NT), and includes representation from JSE and PDs, will perform an annual review of the policies and processes for the continued appropriateness and compliance with applicable regulation.

4. Objectives

The default management principles and objectives are as follows:

- **Accountability** – to ensure that there is clarity on roles and responsibilities including discretion and when escalation is required;
- **Maintenance of BAU and orderly markets** - operation of a Business as Usual (BAU) trading platform continues in what could potentially be stressed markets. It is likely that staff and technology that are used to execute the default management procedure will need to be ring-fenced and/or relieved of any BAU responsibilities for the duration of the default;
- **Timely and orderly wind-up** – prompt resolution of failed trades due to a member default. It is a requirement that default procedures are executed in a timely manner to ensure that prefunded resources are sufficient in stressed market conditions;
- **Transparency** – the function of default management is subject to intensive external scrutiny, accordingly there is a requirement for transparency and demonstration of all actions and decisions made i.e. an 'auditable' record;
- **Legal capacity –** to ensure all actions are supported by a strong legal framework which includes the rulebook and law of the land.

5. Default policies and controls

5.1. Pre-default

The objective of the pre-default activities is to ensure that, to the extent possible, the JSE is in a state of readiness prior to a default being formally declared; timeliness being a critical factor in any default situation. The principle is that execution of the default management plan should be an extension of business as usual risk management activities.

5.1.1 Pre-default risk mitigation

Settlement obligations vest in the Bond ETP members and are established through the ETP rules. In the absence of a clearing house, the JSE has the responsibility to manage the risks associated with the settlement of transactions in Bond ETP securities.

5.1.2 Prefunded default resources available

Initial margin will be the first and only line of defence against the potential replacement cost losses associated with an ETP member default.

5.1.3 Preparation

Should a default appear possible then all appropriate management information should be easily extractable, prepared and internal resources mobilized. In performing this role the JSE will obtain information from the CSD and will work with the CSD to resolve any settlement issues.

5.1.4 Stakeholder management

The JSE will convene appropriate decision makers to recommend a course of actions in accordance with the default management policy. Regular checkpoints will be in place as the event is managed.

5.1.5 External liaison

The JSE will be responsible for initiating communication with the regulator and the broader market.

5.2. Event of default

This section defines the circumstances under which default proceedings are likely to be initiated and specify the steps that will be executed. The JSE (as ETP operator) and the SARB (as banking regulator) is jointly responsible for determining whether a Bond ETP member has defaulted, and communicating this to the market (to be confirmed by end February 2018).

As per the Bond ETP Rules, a member shall default if:

- it is unable to meet its obligations to another member or its margin obligations in terms of the rules, arising out of a transaction in Bond ETP securities;
- its failure to meet its obligations is due to an insolvency proceeding or is otherwise caused by a position of financial distress; and
- the JSE, in consultation with the SARB, considers that it has defaulted.

If an ETP member is declared to be in default, the following will happen:

- all outstanding trades with said member would be cancelled; and
- an auction would be initiated by the JSE in an attempt to place all non-defaulting members in the same economic position that they were in prior to the default being declared.

5.3. Close-out strategy

The objective of the close-out phase is to allow the JSE to dispose of the defaulting member's portfolio to other member(s) and the market in general in a timely manner whilst minimizing losses.

Once a default is called, the following steps will be initiated by the JSE:

- The defaulting member will be suspended from trading
- The JSE will obtain an extract of the gross trades that the defaulting member has in an unsettled status from the CSD
- The JSE will inform the non-defaulting members affected by these trades
- Settlement of the defaulting member's gross trades will be cancelled (by allowing the trades to fail)
- Non-defaulting members may enter into a repo/loan with NT/SARB if required to facilitate liquidity in bonds or cash that they will not receive due to the default
- An auction would be called by the JSE on the same day to auction the net positions
    - The auction trades would be booked as new trades at the auction price and will result in successful bidder/s taking over the positions of the defaulter against the counterparties to the original (cancelled) trades
- The JSE will then do a calculation of the gross profit & loss of the resulting transactions across the ISIN's to determine, at the end of that settlement run, what the resulting net positions would be for all of the non-defaulting parties
    - All non-defaulting members who were counterparty to failed transactions with the defaulting member, that realised a net profit from the auction process, to pay the money to the relevant account (to be specified in the Default Management Procedures)
    - All non-defaulting members who were counterparty to failed transactions with the defaulting member, that realised a net a loss from the auction process, would have to claim from the defaulters' initial margin posted
    - Loss claims will only be paid once money is received from parties who profited

5.4. Post-default

5.4.1 Financial reconciliation and loss allocation

Following the conclusion of the default the JSE will conduct a formal financial reconciliation of available defaulting member's initial margin against any attributable costs. This reconciliation may be required to support any return of margin to the defaulting member's estate and other regulatory scrutiny.

If the losses from the default exceed the financial resources (initial margin) available from the defaulting member, the JSE will apportion the shortfall to each non-defaulting member pro-rata to the value of each of their respective loss claims, as calculated by the JSE.

5.4.2 Post-default review

The JSE will convene a review meeting(s) to walk through the process of the default and review areas that worked well and issues that need to be resolved i.e. lessons learned. The objective of the meeting is to enable the default management process and associated infrastructure to be refined and improved as appropriate.

Together with lessons learned, all major incidents of a default should be documented and policies updated accordingly. This policy, in particular, will be subject to review.

5.5. Testing

As defaults are a relatively rare occurrence it is necessary to have regular tests of the processes, referred to as ‘fire drills’. The objectives of the fire drills are as follows:

- To provide realistic scenarios of the default event;
- To demonstrate default management capabilities to members and regulators;
- To comply with best international practice i.e. PFMIs;
- To include ‘stressed’ scenarios e.g. the default of a large and complex member portfolio;
- To familiarise all parties that have to handle actual defaults with the procedures and processes;
- To simulate processes and system infrastructure that will require utilization in a default;
- To include if appropriate external parties including members, the CSD and National Treasury;
- To identify potential enhancements to the Default Management Procedures.

As such, the fire drills should be an approximate representation of an actual member portfolio and should be conducted using actual market conditions e.g. in real-time with live prices. The tests should be varied to include all relevant aspects of the default process including auctioning of unsettled trades. The full tests should occur at least annually, but certain aspects (e.g. testing of infrastructure) should be more frequent. Additionally, the JSE and those risk and operational staff responsible for supporting the default management process should be an integral part of such tests.

As with the post-default review, lessons learned should be documented, recommended enhancements prioritized and communicated to the JSE Executive Committee as a means of ensuring the default management process remains robust and relevant.

6. Default procedures

6.1. Role-players and systems

The following role-players are essential to the ETP default management process, and should familiarise themselves with the detailed steps and their responsibility:

- JSE oversight*:* Director (Post Trade Services (PTS)), Director (Market Regulation), Director (Capital Markets), Head of IRC (Capital Markets)
- JSE default process execution*:* Head of Risk (PTS), Head of Operations (PTS), Head of Trading (ITD)
- Strate
- National Treasury
- SARB
- Bond ETP Members

The following systems will be used in executing the Bond ETP default management steps, and should be tested as part of the regular default testing (as described in 'Testing' section):

- MTS
- Bloomberg – the SARB's auction platform
- Nutron
- Strate CMFE
- SWIFT INFO
- Risk calculators (Excel/Omega)

6.2. Default management steps

Once a default is called, the following steps will be initiated by the JSE.

- **Step 1 – The defaulting member is suspended from trading**
  - The JSE PTS Head of Risk will instruct the suspension of the defaulting member from further trading in the Bond ETP market. This will be executed through MTS.

- **Step 2 – The CSD and CSDPs are informed that no settlement must take place for any of the defaulting member's trades (giving consideration to the time that commits become irrevocable), for all trades across the settlement cycle**
  - The JSE PTS Head of Operations will inform Strate and the CSDPs via SWIFT INFO Broadcast or email notification.

- **Step 3 – The JSE obtains an extract of the gross trades that the defaulting member has in an unsettled status from the CSD**
  - The JSE PTS Head of Operations will request this information from Strate and confirms info via the CMFE system.

- **Step 4 – JSE calculates net unsettled exposure and the associated P&L per ISIN to each non-defaulting member**
  - The JSE PTS Head of Risk will use the information from step 3 to calculate this, using a tool, custom built for this purpose by the JSE.

- **Step 5 – The JSE informs each non-defaulting member affected by these trades of their resulting net unsettled positions (only per counterparty, not overall market positions)**
  - The JSE PTS Head of Operations will communicate this via email.

- **Step 6 – To effectively cancel the defaulting member's trades, the JSE informs Strate and CSDPs to ignore / fail these trades for settlement**
  - The JSE PTS Head of Operations will contact Strate and the CSDPs to let the defaulting member's trades fail, by the CSDPs not committing to the trades / lifting their commits.

- **Step 7 – Non-defaulting members may enter into a repo/loan with NT/SARB if required to facilitate liquidity in respect of bonds or cash that they will not receive due to the default**
  - Should non-defaulting ETP members face potential liquidity pressure due to the defaulting member's trades not settling, these members should approach NT and SARB regarding a repo / loan agreement. This process should be agreed between the ETP members and NT/SARB. The JSE PTS Head of Risk will send the NT/SARB a list of gross unsettled exposures per non-defaulting ETP member to assist the process.

  - The rate at which these repo/loan agreements will be conducted, will be negotiated between the respective ETP member and SARB/NT.

- **Step 8 – An auction is called by the JSE on the same day to auction the net positions**
  The JSE PTS Head of Risk will request the SARB to facilitate an auction, using the SARB's existing platform. The following practical rules will apply:
  I. The SARB will extend the auction invitation to all ETP members only (other participants to bid through ETP members);
  II. ETP members will not be obliged to bid in the auction;
  III. ETP members will be able to submit their bids from the time the invitation is sent, to the scheduled closing time for the auction. It is anticipated that the auction will remain open for a period of at least one to two hours – will be assessed and confirmed upon event;
  IV. The auction will be a Dutch style auction, where the entire amount on auction in a particular bond will clear at a single clearing level;
  V. Once the auction has closed, the SARB will inform the JSE of the resulting allocations per bond, together with the relevant clearing levels;
  VI. In instances where too few bids were received to clear the entire amount on offer in a specific bond, the JSE will not allocate anything to the winning bidders. Instead, the JSE will inform the SARB to issue another auction invitation. The auction invitation will restate the original amount on offer in each bond. The steps above will then be repeated.

- **Step 9 – The auction trades are booked as new trades at the auction price and will result in successful bidder/s taking over the positions of the defaulter against the counterparties to the original (cancelled) trades**
  - The JSE PTS Head of Risk will calculate new trades that have to be booked per counterparty, trades will be allocated on a pro rata basis to each winning bidder in each bond. The JSE PTS Head of Operations will inform ETP members to book the trades through Neutron. However, the new trades will still be governed by the ETP rulebook, even though they were executed bilaterally.

  - A mark-to-market (MtM) process similar to that employed for the JSE's normal end-of-day calculations will be used to determine the price at which bilateral trades between non-defaulting ETP members should be booked, in instances where the defaulting ETP member had a flat scrip position in a particular bond (i.e. there would not have been an auction in the particular bond).

- **Step 10 – The JSE calculates the gross profit & loss of the resulting transactions across the ISIN's per non-defaulting member**
  - The JSE PTS Head of Risk will do this calculation, based on information from MTS (original trade data) and the auction (rebooked trade data).

- **Step 11 – The defaulting member's initial margin is maintained in its CPD account, and managed according to the rules governing the default procedures (which enjoys protection under the insolvency act)**
    - The JSE will be able to load beneficiaries (the non-defaulting ETP members) to the defaulting ETP member's CPD account, and instruct the CPD to make payments to non-defaulting ETP members from this account.
    - Non-defaulting ETP members will also be able to make payments to this account.
    - The defaulting ETP member will not be able to make withdrawals from this account.

- **Step 12 – All non-defaulting members who were counterparties to failed transactions with the defaulting member, who realised a net profit from the auction process, pays the money into the defaulter's CPD account**
    - Non- defaulting ETP members must deposit profits into their CPD account after which the SARB will transfer those funds into the defaulter's CPD account

- **Step 13 – All non-defaulting members who were counterparty to failed transactions with the defaulting member, that realised a net a loss from the auction process, will be paid from the defaulters CPD account**
    - The JSE PTS Head of Risk will calculate gains/losses, the available funds will be allocated according to the ETP members who made a net loss in the proportion of their loss to the total amount of losses across all bonds. The JSE PTS Head of Operations will instruct the CPD for payment to loss-bearing members.

- **Step 14 – Loss claims will only be paid once money is received from parties who profited**
    - The JSE PTS Head of Operations gives instruction to CPD to make payment.

- **Step 15 – If the losses from the default exceed the financial resources (initial margin) available from the defaulting member, the JSE will apportion the shortfall to each non-defaulting member pro-rata to the value of each of their respective validated loss claims**
    - The JSE PTS Head of Risk is responsible for calculating the apportioned shortfalls.

- **Step 16 – If the losses from the default are less than the financial resources (initial margin) available from the defaulting member, the JSE will return the surplus initial margin to the defaulting ETP MEMBERs estate, once all losses have been paid.**
    - The JSE PTS Head of Risk is responsible for calculating the surplus margin.