

JSE CLEAR

INVESTMENT MANDATE

Initial Margin and JSE Clear Default Fund

July 2022

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1 Version Control

| | |
|----------------------|---|
| Issue date | February 2016 |
| Owner | JSE Clear Chief Risk Officer |
| Document type | Mandate |
| Version | Final v5.0 |
| Approved by | JSE Clear Risk Committee for annual reviews, and JSE Clear Board for approval of initial version |

2 Version History

| Version | Date | Summary of changes | Author |
|---------|---------------|--|----------------------|
| 1.0 | February 2016 | Initial draft | JSE Finance Division |
| 2.0 | July 2017 | Regular review | JSE Finance Division |
| 3.0 | April 2019 | Regular review | JSE Finance Division |
| 4.0 | November 2020 | Regular review | JSE Clear Risk |
| 5.0 | October 2021 | JSE Clear equity credit risk limit increased to 100%; JSE Clear Default Fund MD limit adjusted | JSE Clear Risk |
| 6.0 | July 2022 | Updates relating to the acceptance of securities collateral Risk limits adjusted | JSE Clear Risk |

3 Introduction

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 are the collateralization of trades through margin and the establishment of a default fund to which all clearing members must contribute.

In accordance with the JSE Derivative Rules, JSE Clear separates all client, member and clearing member margins and default fund contributions from its own moneys and manages and invests the margins and default fund contributions posted in cash according to terms and conditions set by JSE Clear. The purpose of this document is to set the parameters within which these client funds must be invested. This investment mandate is consistent with JSE Clear's overall risk-management strategy.

The management of these funds represents a fiduciary duty to the clearing members, members and their respective clients. Consequently, the utmost care must be taken as to where and how these funds are managed. The aim for the management of these funds is:

- primarily to maintain the risk and liquidity profile within the boundaries stipulated in this mandate, and to enable certainty and timeliness of funds when needed at the time of a Clearing Member default; and
- then within this allowed risk and liquidity profile to optimise the investment income earned on the funds invested.

4 Scope

The scope of this document is limited to the investment of market participant initial margin and clearing member default fund contributions, relating to derivative trades cleared through JSE Clear. These funds are placed by each market participant in relation to their obligations within the derivatives markets that JSE Clear operates and are governed by the JSE Derivative Rules and JSE Interest Rate and Currency Rules (“the rules”).

This mandate also stipulates the terms and conditions pertaining to the management and governance of these funds. It sets a clear scope on the risks involved in the investment of funds and defines the limit framework that will guide investment decisions. In addition, this mandate defines the roles and responsibilities of key individuals and committees involved in the investment risk management process.

5 Roles and responsibilities

5.1 Governance

The JSE Clear CRO will be responsible for the annual review and ongoing maintenance of this mandate. Material changes to this mandate are to be recommended by the JSE Clear Risk Committee for approval by the JSE Clear Board. The regular annual review of this mandate will be approved by the JSE Clear Risk Committee.

The JSE Clear CRO must ensure that measurement standards and limits are set to guide investment decisions. The JSE Clear Chief Risk Officer must ensure that these limits are monitored daily and that any breach is addressed timeously and brought back within defined limits.

In accordance with the FMA Regulations, the investment mandate will be disclosed to clearing members and the Prudential Authority.

5.2 Investment and administration of funds

JSE Clear may utilize a service provider for the administration and investment of funds, provided the terms thereof are clearly set out in a service level agreement between JSE Clear and the service provider. JSE Clear is at all times responsible for ensuring adherence to the mandate.

As per the rules, cash margin is held in segregated accounts in trust on the balance sheet of JSE Clear and default fund contributions are held in a separate legal entity.

The performance of the investment activity against this mandate will be reported to the JSE Clear Risk Committee on a quarterly basis.

6 Risks

In order to manage the funds within the stated mandate, the JSE Clear CRO must evaluate and consider the primary risks relating to the placement of these funds. The primary risks relate to credit and liquidity risk. Credit risk is defined as the risk of default by the recipient institution and liquidity risk as the risk that the funds invested cannot be timeously accessed; both of these risks must continuously be considered and monitored when funds are placed.

6.1 Credit risk

In line with this mandate, due consideration is to be given to the credit risk of each recipient institution. Limits are thus in place to ensure funds will only be placed with reputable, regulated¹ banks.

Institutions will be assessed based on the most recently published licensed rating agency ratings. Funds will only be placed with institutions with a national short-term rating equal to, or better than, an A-1 (Standard and Poor’s) equivalent rating. The A-1 and A-1+ ratings indicate the strongest capacity for timely payment of financial commitments, relative to other issuers or obligations in the same country. Under the agency's national rating scale, this rating is assigned to the lowest default risk relative to others in the same country.

Should any of the existing counterparties be placed on a “ratings watch-list” or be downgraded, their eligibility will immediately be reviewed and placements will be adjusted accordingly. Placements will be distributed as per the credit diversification limits listed below.

Consideration must also be given to the size of the JSE Clear investment relative to the investment institution’s total equity and any guarantee provided on that institution’s performance. JSE Clear’s investment with any institution will be less than the maximum of 100% of the investment institution’s total equity, updated using the latest information per the bank returns published on the SARB website; and the total guarantee of that institution’s performance provided by a party acceptable to JSE Clear.

6.1.1 Initial margin credit limits

In order to limit concentration risk, placements may not exceed below limits:

| | |
|--------------------------|---|
| Locally regulated banks: | Per A-1 rated and above: Up to a maximum of 20% of fund size. |
|--------------------------|---|

Exception: JSE Clear’s settlement bank: Up to a maximum of 25% of fund size.

¹ For the purposes of this mandate locally regulated will be defined as prudentially regulated by the South African Prudential Authority

Note: the additional limit for JSE Clear's settlement bank will assist with managing intraday liquidity when the fund size declines materially i.e. margin is returned to participants (outflows).

6.1.2 Default fund credit limits

In order to limit concentration risk, placements may not exceed below limits:

Locally regulated banks: Per A-1 rated and above: Up to a maximum of 20% of fund size.

If an individual bank is part of a group of banks then the limits applied are for the banking group as a whole.

6.2 Liquidity risk

JSE Clear must ensure that there are sufficient liquid assets to meet payments as they become due as part of the daily margin process, or in the case of a clearing member default. In order to do so JSE Clear has identified the main factors that affect the ability to repay funds when needed and will monitor these factors through the application of liquidity limits.

Liquidity limits will be monitored on a daily basis.

A log of penalties that may apply in the event of early release from term placements will be maintained.

6.2.1 Margin liquidity limits

Initial margin is deposited by a market participant when a trade is booked, and returned to the market participant when the trade is settled, or used by JSE Clear to cover losses in the case of a market participant default. As such, initial margin investments experience a lot of movement on a daily basis. JSE Clear needs to ensure that sufficient funds are available on a daily basis to return margin on trades settled and/or cover losses in the case of a default, by adhering to the following placement limits:

- At least 30% of the total fund size must be invested on call at all times.

- Not more than 30% of the amount on call may be invested with one institution, with the exception of JSE Clear’s settlement bank, where up to 35% of the amount on call may be invested.
- The maximum tenor for investment of funds is 270 days.
- The weighted average maturity of the fund may not exceed 75 days².

Note: The increase in tenor from the previous 180 days maximum and 75 days weighted average maturity offers a higher return profile for the investment in liquid money market assets and the ability to invest across the horizon. Banks will still offer the same breakage costs and conditions in the event the assets need to be liquidated (term broken), however this will be done on a “shortest duration liquidation first” basis.

6.2.2 Default fund liquidity limits

The JSE Clear Default Fund is made up of contributions by clearing members and JSE Clear. The fund is quantified and rebalanced regularly in accordance with the JSE Clear Default Fund Policy, and contributions returned to, or called from, all clearing members. This fund may only be used by JSE Clear to cover losses in the case of a clearing member default.

With all the risk mitigants that JSE Clear has in place in addition to the Default Fund, the likelihood of having to access the fund is relatively low. Should a clearing member default occur however, it is likely that a large portion of the fund will have to be used to cover losses. Due to the low probability / high impact trade-off, the liquidity limits are kept in line with those set for margin placements:

- At least 30% of the total fund size must be invested on call at all times.
- Not more than 30% of the amount placed on call may be invested with one recipient institution.
- The maximum tenor for investment of funds is 365 days.

² Annexure A contains an example of this calculation.

- The weighted average maturity of the fund may not exceed 100 days³.

7 Eligible investment instruments

Cash collateral may be invested in the following eligible instruments, within the credit and liquidity limits specified in the previous section:

- Overnight call deposits;
- Fixed deposits (only with interest payable on a monthly basis)
- Where fixed deposit contracts include break clauses detailing that term deposits may be extracted early, and that the costs thereof may be negotiated by the managing agents.

8 Escalation

All breaches of the terms of this mandate are to be reported to the JSE Clear CEO and to the JSE Clear Risk Committee. In the event of a breach of the limits stated above, the following escalation procedures will be followed.

8.1 Breach of concentration limit due to a rating down-grade

If an institution with which funds have been placed is downgraded and the amount placed with that institution is now above the concentration limits set in this mandate, a plan to bring the risk profile within the required limits will be formulated by the JSE Clear CRO, supported by the appointed service provider for the administration and investment of funds, and communicated to the JSE Clear CEO.

8.2 Breach of liquidity limits due to an unforeseen reduction in initial margin balance

If the amount of cash on call decreases below the minimum percentage of total funds or the duration increases above the maximum allowed (due to an unanticipated sudden substantial decrease in the balance of initial margin), a plan to bring the risk profile within the required limits will be formulated by the JSE Clear CRO and communicated to the JSE Clear CEO.

³ Annexure A contains an example of this calculation.

8.3 Any other breach of the limits set in this mandate

All other breaches of the limits set in this mandate will be escalated to the JSE Clear CEO immediately and an action plan to bring the exposures within the limits of this mandate is to be presented by the JSE Clear CRO within 3 days of the breach.

8.4 Further escalation

Should any breach be considered significant or not be rectified with the agreed time, the JSE Clear CEO will notify the JSE Clear Risk Committee.

Annexure A

Example: Calculation of weighted average maturity

(Example assumes funds must have a maximum of 60 days weighted average maturity)

| | | |
|-----------------------------|---|---------------------|
| Total fund size | | R500 million |
| Amount invested on call | 20% | R100 million |
| Amount invested for 45 days | 20% | R100 million |
| Amount invested for 90 days | 60% | R300 million |
| Weighted Average Duration | = $((100*1) + (100*45) + (300*90))/500$ = 63.2 days → NOT COMPLIANT | |

| | | |
|-----------------------------|---|---------------------|
| Total fund size | | R500 million |
| Amount invested on call | 30% | R150 million |
| Amount invested for 30 days | 30% | R150 million |
| Amount invested for 90 days | 40% | R200 million |
| Weighted Average Duration | = $((150*1) + (150*30) + (200*90))/500$ = 45.3 days → COMPLIANT | |

Annexure B – Governance Committee Actions

| No. | Ref | Action Item | Frequency | Applicable Governance Forum |
|-----|-----|--|---------------|---|
| 1. | 5.1 | Material changes to this mandate are to be recommended by the JSE Clear Risk Committee for approval by the JSE Clear Board | Not specified | <ul style="list-style-type: none"> • JSE Clear Risk Committee • JSE Clear Board |
| 2. | 5.1 | The regular annual review of this mandate will be approved by the JSE Clear Risk Committee. | Annual | <ul style="list-style-type: none"> • JSE Clear Risk Committee |