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## Introduction of the Safcom Default Fund

The JSE is pleased to announce the introduction of a new default fund and risk waterfall for Safcom, the licensed clearing house for the JSE's derivatives and cash bond markets. The fund was initiated in January 2013, supported by a commercial agreement and has recently received legislative approval for the supporting JSE rules that enable this fund. This approval strengthens Safcom's risk management capabilities, and provides investor protection to participants during a default caused by a participant failing to honour its trade settlement obligations on the JSE derivatives market.

The default fund will enhance Safcom's default waterfall by featuring a structure that offers limited liability for its clearing member firms. The implementation of the default fund is aimed at adding certainty to the lines of defence against losses being incurred in the event of a default of a market participant, and is driven primarily by the desire to enhance investor protection and reduce systemic risk. This also forms part of the improvements introduced in 2012, focused on improving Safcom's overall risk management standards and also to support its CPSS-IOSCO compliance. Safcom's IOSCO compliance is necessary for banks to receive capital relief for exchange traded derivatives under Basel 3 regulations (which came into effect in South Africa in January 2013).

Safcom now offers a full risk waterfall with initial margin and a pre-funded default fund with contributions from the clearing members and Safcom. Where initial margin is quantified to capture losses under 'normal' market movements, the default fund is quantified to protect against losses in *extreme market conditions*.

Under the old model, each of Safcom's non-defaulting clearing members were morally obliged to make up for losses incurred in the default of another clearing member. The new risk waterfall and default fund allow Safcom to cap the liability of clearing member default exposure, while also having its own "skin in the game" (creating a more equitable line of defense should our market ever experience a significant default event).

The Safcom Default Fund is structured as follows: the nine clearing members (together with the JSE on behalf of Safcom) will pay collateral into the default fund, which will be held by the Fund and invested per the agreed Safcom investment mandate. The default fund contributions of the clearing members will be held in a legally separate and bankruptcy remote legal entity. The JSE and/or Safcom will have no claim on the fund should either entity be liquidated or go insolvent - except for their capital contributed to the fund. All the clearers have been notified of their initial obligations and have contributed accordingly. The size of



**JSE Limited Registration Number: 2005/022939/06**  
One Exchange Square, Gwen Lane, Sandown, South Africa.  
Private Bag X991174, Sandton, 2146, South Africa. Telephone:  
+27 11 520 7000, Facsimile: +27 11 520 8584, www.jse.co.za

**Executive Directors:** NF Newton-King (CEO),  
F Evans (CFO) **Non-Executive Directors:** HJ Borkum  
(Chairman), AD Botha, MR Johnston, DM Lawrence, A Mazwai,  
NS Nematswerani, N Nyembezi-Heita, N Payne **Alternate  
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the fund and proportional contributions will be recalculated by Safcom quarterly, and Safcom will disclose the size of the fund to the market (while informing each member of their respective contribution individually).

The journey to an established default fund started over two years ago, with the concept and quantification of the fund being discussed at Safcom Risk and Advisory committees and management boards. During the last quarter of 2012, the quantification of the fund was finalised and accepted by market participants and regulators.

The structure of the fund was agreed, and a two-stage approach adopted to operationalise the fund: the first stage would be an interim period where the existing JSE default rules continued to apply and would be enforced by the JSE in the case of a default. Under the terms of an *Interim Agreement* signed by all parties, the JSE would apply the new risk waterfall approach and utilise the collateral contributions (paid by all the parties into a ring-fenced trust account) in the event of a clearing member default during the interim period. The second stage is focused on the formal set-up of the new fund structure, supported by revised rules that enabled the incorporation of the fund into the default waterfall.

The recent promulgation of the rule amendments means that Safcom is now able to proceed with the final steps in the process to operationalise the fund. Clearing members will shortly sign-off a detailed Collateral Agreement, to allow the collateral held in trust by the JSE to be transferred to the new fund, resulting in it becoming a fully operational default fund in its own right.

**Sincerely,**

**Leila Fourie**

Designation: Director  
Division: JSE Post-Trade Services  
Tel: +27 11 520 7005  
E-mail address: [leilaf@jse.co.za](mailto:leilaf@jse.co.za)