



## Category II Clearing: Expediting Onboarding

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The June 10th date for phase two of the OTC clearing mandate is fast approaching, yet a large portion of buy side firms are still not ready. TABB Group estimates that 500 hundred buy side firms will fall under the Category II mandate and that 75% of them, or 375 institutions, will fail to meet the deadline. When looking at Separately Managed Accounts (SMAs), the universe is much wider, with as many as 3,000 funds still needing to get Know-Your-Customer (KYC) documents in place before an intermediary will set them up for clearing. This failure to meet the deadline will lead to a compression in US swaps trading activity and a liquidity drain of approximately US\$55 trillion in notional terms.

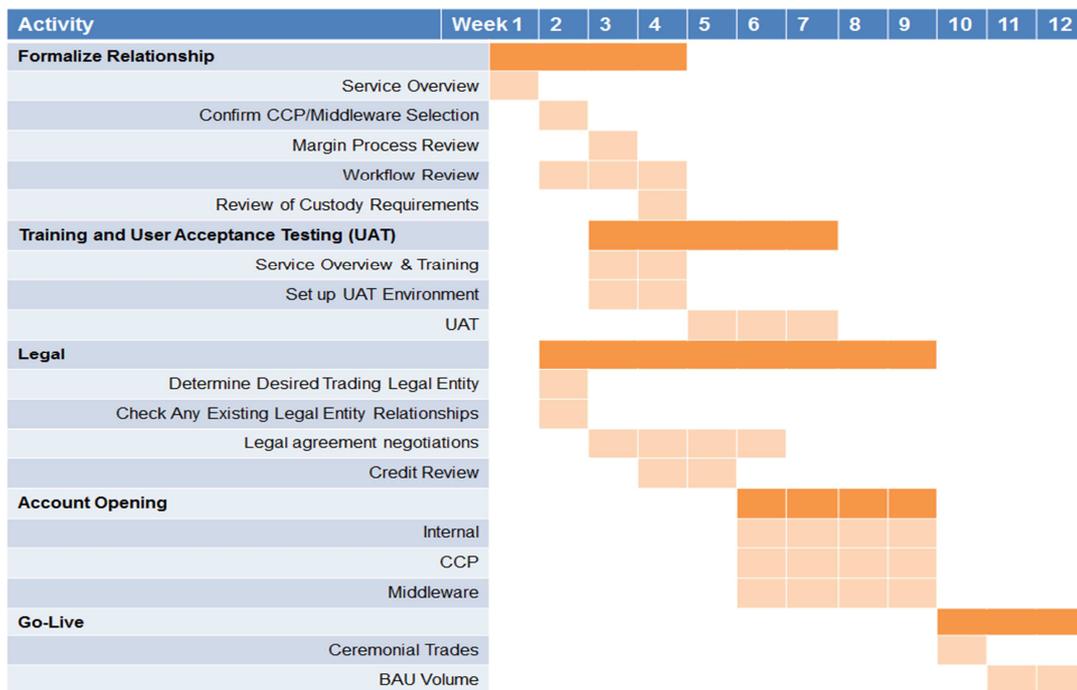
May 14 is the absolute cut-off date for selecting an FCM. This will give a buy side firm a week to complete legal documentation, two weeks for account opening and, if they are lucky, a day or two for testing. Buy side firms have to negotiate legal documents with Futures Commission Merchants (FCMs), middleware providers, Derivatives Clearing Organizations (DCOs), as well as executing brokers. From an operations point of view, they have to establish connectivity to clearing houses, set up Legal Entity Identifiers (LEIs), and upgrade their trade management and portfolio reconciliation systems. For those firms only just now turning their attentions to the clearing challenge, some of the stickier negotiations around collateral haircuts and margin financing will have to be foregone in order to expedite the onboarding process. The period of procrastination is over.

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## Introduction

Buy side firms who have not yet completed test trades for cleared swaps, are now behind. An FCM or clearing broker relationship should be in place and the process of onboarding should have begun. Those commodity pools, hedge funds, and non-swap dealer banks who fall under the Category II definition but are yet to turn their attentions to clearing face a severe risk of being locked out of the swaps market after June 10. The same problem applies to those that should have complied with the Category 1 deadline of March 10 but managed to delay, as well as to those insurance companies who are reconsidering their Category III status. In practical terms, it really takes three months to complete the process - from opening up a clearing relationship to the final testing of trades (Exhibit 1).

**Exhibit 1**  
**A Clearing Relationship Timeline**



Source: Citigroup, TABB Group

Latecomers will now have to take shortcuts and postpone some elements of the legal work if they want to make the deadline. There are several elements to clearing readiness. First, the buy side firm needs to identify the products they need to clear, across the plain vanilla interest rate swaps, Overnight Index Swaps, Basis Swaps, Forward Rate Agreements, Credit Default Swaps and Energy Related Swaps spectrum. They will also need to identify their preferred clearinghouses, as well as the clearing brokers and/or FCMs that will act as intermediaries. Direct connectivity to clearing houses will have to be established as well as a relationship with a middleware provider that can handle bilateral-executed, centrally-cleared trades.

## Legal Hurdles

Finalizing terms with an FCM is a bottleneck. For those that don't already have a Futures Clearing Agreement, they will have to negotiate one – potentially a lengthy process. For those that do, a Cleared Swaps Addendum (CSA) will suffice. Nevertheless, special attention needs to be paid to the differences between the bilateral ISDA documentation, which will no longer cover the swap, and the legal ramifications of the new clearing documents and the Standard Collateral Support Annexes (SCSAs). FCM documents tend to involve heavy negotiation since several important intermediary functions such as margin calculation, collateral financing, haircuts and fees have to be determined. It may also involve collateral transformation services, which will have to take into account the average daily volatility of the security for conversion, the haircut the bank will charge (usually at a premium to the exchange's proposed haircut) and the cost of repo, which could escalate given the new liquidity demands on that market. Clearinghouses only accept cash for variation margin, but for initial margin will also accept highly-rated sovereign, corporate, supranational or agency debt.

**Exhibit 2**  
**Acceptable Clearinghouse Collateral**

	CME	ICE	LCH. Clearnet
Cash	✓	✓	✓
Government Securities	✓	✓	✓
Government Sponsored Enterprise/ Government Agency Securities (ie: FNMA, GNMA, FHLMC)	✓		✓
Corporate Bonds	✓		
Equities	✓		
Performance Bond / Letter of Credit	✓		✓
Money Market Fund Shares		✓	
Precious Metal (Gold Bullion)*	✓	✓	✓

Source: TABB Group

The grim reality for those that have yet to engage with an FCM is that much of the bargaining power over these critical elements has already been lost. With just four weeks left to go until mandatory clearing, time is against the buy side to comply. Many will simply have to accept the terms FCMs present in order to avoid being locked out of the market. Some may be lucky enough to find a clearing broker still anxious to win market share, but will likely find key elements of the CSA negotiation postponed until after the deadline passes. This may solve the problem in the short term but it still puts the buy side firm at a disadvantage when it comes to finally addressing the issue. Others will be satisfied to simply get onboarded at all. Some FCMs have started to turn away business either because of balance sheet constraints or because their legal and compliance departments are choked. Buy side firms should look to ease the strain by pulling their original articles of incorporation or authorization forms for derivatives trading out of the filing cabinet and getting them to their FCMs who will need to fill in KYC forms as part of the new business conduct standard rules that came into effect May 1. Intermediaries are not receptive to searching for the copies they hold in this busy time.

Buy side firms also have to establish Cleared Derivatives Execution Agreements with executing brokers. These documents detail penalty terms for early terminations or if a trade fails to clear. Again, the negotiating power is with brokers here and, since many still harbor a bilateral mindset, they may yet negotiate as if they will be the final counterparty to the

trade. This will come with stiff terms than given that it is actually the central clearinghouse that takes on position risk.

Clearinghouses require onboarding forms with firm specific information, such as a Legal Entity Identifiers (LEIs) as assigned by the DTCC, as well as their list of dealers, clearing brokers and any authorized third parties such as fund administrators or custodians for end-of-day reports. While the CME requires funds to fill out a simple registration form, both ICE and LCH.Clearnet require End-User License Agreements (EULAs). In the instance of ICE, for example, this can include a participation agreement, a Know Your Customer/Anti-money Laundering (KYC/AML) form, and a Clearing Addendum (or an ICE Link Approved Third Parties Form for those who are not members of their in-house connectivity and middleware platform, ICE-Link). After the buy side firm has filled out the necessary documents it is important to ensure that their FCM also sends through an approval form, otherwise production accounts will not be enabled. Given the expected bottlenecks in the run up to the June 10 deadline, clearinghouses have started to issue deadlines for documentation submission and they are asking that onboarding firms standardize their email subject headers to ensure faster processing. The CME schedule is as follows:

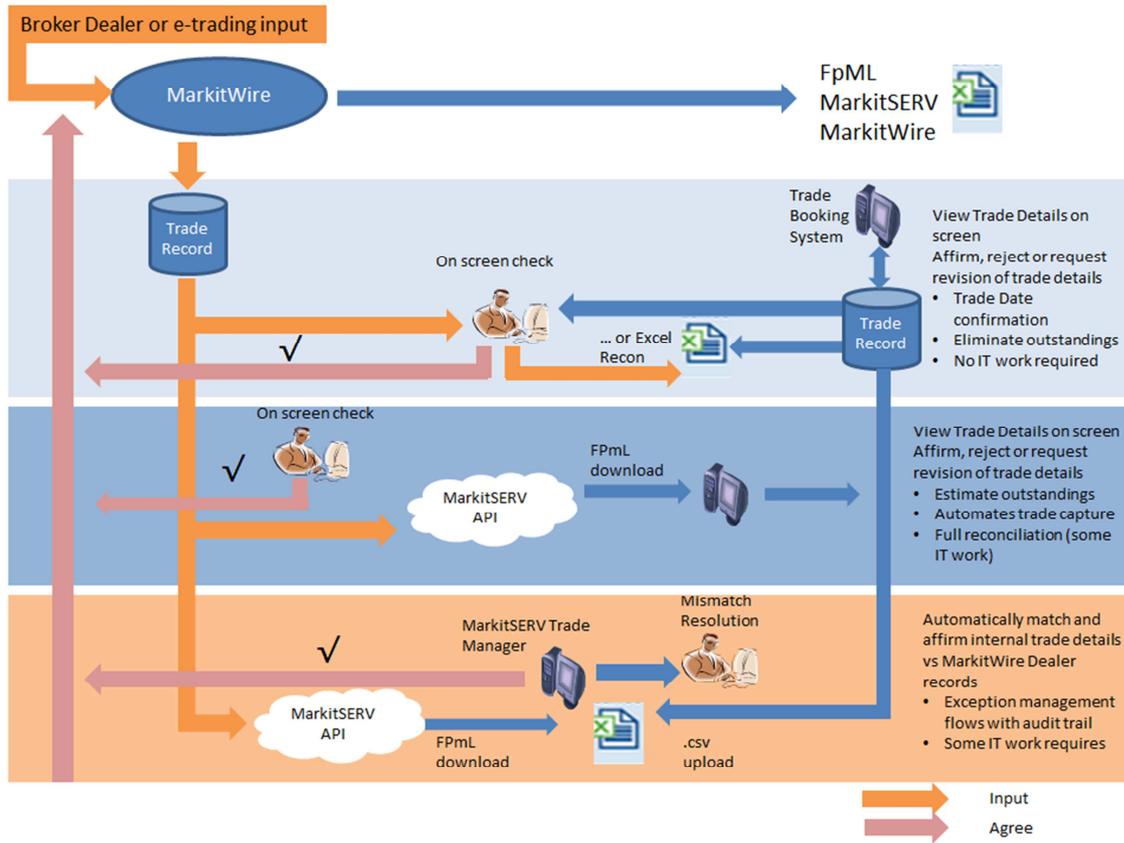
- May 24: Clearinghouse registration and LEI submission
- May 28: FCM provides Consolidated Account Setup Spreadsheet for information about the client account
- May 31: Registered accounts linked to the affirmation platform that the client will use for submitting trades

## Operational Readiness

Until the swap execution facility (SEF) rules are determined, cleared transactions will continue to be executed bilaterally. The coming bifurcation of trading and clearing will require changes to processes and procedures. Buy side firms will have to adapt to an operational workflow than can incorporate allocations, confirmations, novations, clearing, reconciliations, disputes and accounting. Both clearinghouses and third party middleware providers such as MarkitSERV offer toolkits for clearinghouse connectivity, as well as electronic trade affirmation and reconciliations. These allow users to view trade details on screen for affirmation, or to reject or revise the trade prior to it being sent to the DCO (Exhibit 3).

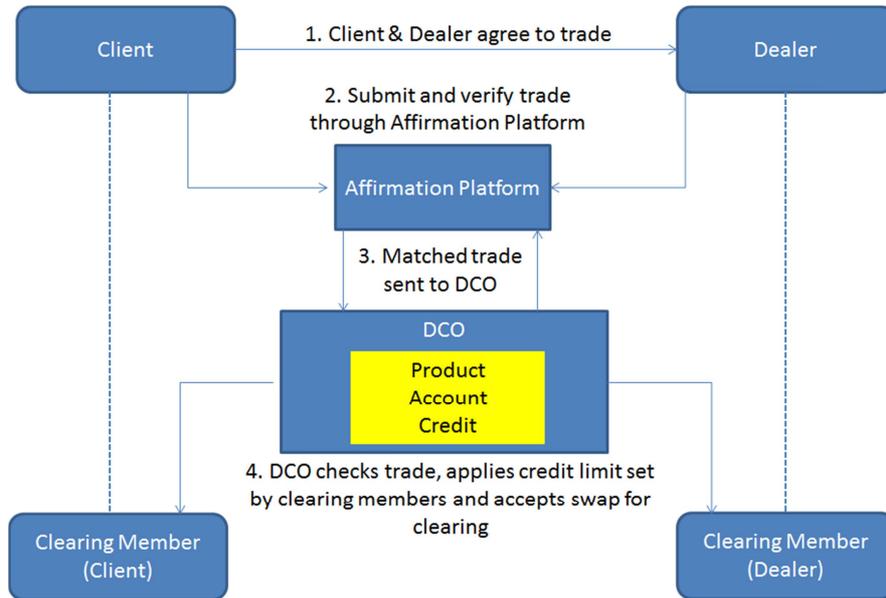
It is important for buy side firms to have systems than can communicate with clearinghouses. If not, it may find that swaps that have been designed to net out are not recognized by the clearinghouse system and this could lead to more, not less, collateral being required. In order to realize portfolio margining efficiencies, therefore, buy-side firms will need to reconcile their positions with the DCO prior to executing a new trade. While there has been a lot of energy spent on connectivity to clearinghouses, they buy side will also need new systems that can communicate with DCOs to ensure that offsets are realized.

**Exhibit 3**  
**Bilaterally-traded/Centrally-cleared Operational Workflow**



Source: MarkitSERV, TABB Group

Buy side firms will also need independent systems to identify differences in position economics such as valuations and collateral requirements. Since the credit crisis, more emphasis has been placed on proactive position reconciliation, investigation of mark-to-market differences and formalized dispute processes. Systems that can handle the reconciliation process will have to do so in a real-time setting since the Commodities Futures Trading Commission (CFTC) has deemed that swaps clearing must occur “as soon as technologically practicable following execution.” DCOs, FCMs and clearing brokers must be able to accept trades for clearing within just one minute of submission. If the buy side firm has an issue with the terms of the trade, they too must be able to operate within a real time environment (Exhibit 4).

**Exhibit 4: The One Minute Clearing Cycle**

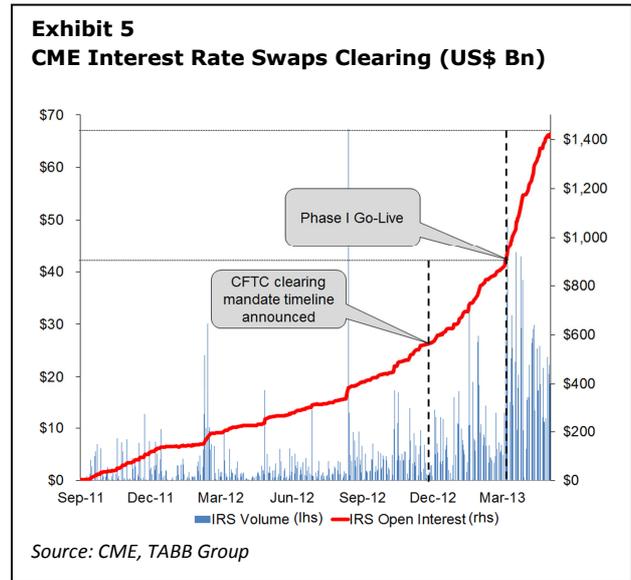
Source: CME, TABB Group

**Testing, Testing, 1, 2, 3**

After the account registration and operational setup process is completed it is recommended that buy side firms clear at least a few trades in each relevant asset class prior to the start of the mandate, to ensure that connectivity and mappings are properly deployed to support a clean trade flow. The industry already experienced ID mapping issues during phase I in March. The risks of failures in phase II, which will likely represent ten times more clearing volume, is high. Given the number of new constituents and platforms that buy side firms now need to integrate with, it is important to ensure that all connectivity and setup criteria are correct. Testing cannot begin unless all the necessary legal documents are in place. Most FCMs and DCOs have test environments. These allow buy side firms to test trades as they pass from the point of execution with the broker, through to trade affirmation and matching, onto the clearinghouse, and then to the FCM, who will send final details back to the buy side's portfolio management system, which will monitor cash flows and margining requirements from thereon.

While this may sound like a heavy lift but, in reality, many the third party providers, as well the clearinghouse connectivity/workflow solutions, can take the weight. A buy side portfolio management system will likely simply need to be upgraded to handle cleared trades. The only unknown is how the overall system will handle the sudden escalation of clearing volume as the June 10 deadline hits. There is no way of knowing where stresses and breakages may occur since no precedent for this degree of clearing onboarding exists. For this reason, FCMs and DCOs are urging the buy side to start turning up the dial on clearing sooner rather than later and, if possible, not to wait until the first week of June, to minimize the risk of disruptions.

Some are responding to the call. Since the clearing deadline was first announced, clearing at the CME has increased 150%, to reach US\$1.4 trillion in outstanding interest as of May 2. Average weekly client-side clearing flows at the CME for the eight weeks prior to November 28 were \$4.9 billion. In April, average weekly clearing flows increased nearly six fold, to \$26.2 billion, and are still climbing, with some weekly flows topping \$50 billion (Exhibit 5). Meanwhile, at LCH SwapClear, client-side notional values outstanding have increased more than 158% since the timeline announcement, to \$6.1 trillion. While still small relative to the total notional values outstanding on the client side, it is interesting to note that the pace of adoption has accelerated quite dramatically at the CME. TABB Group expects a significant pickup in the pace of adoption as we move through June.



## Contingency Plans

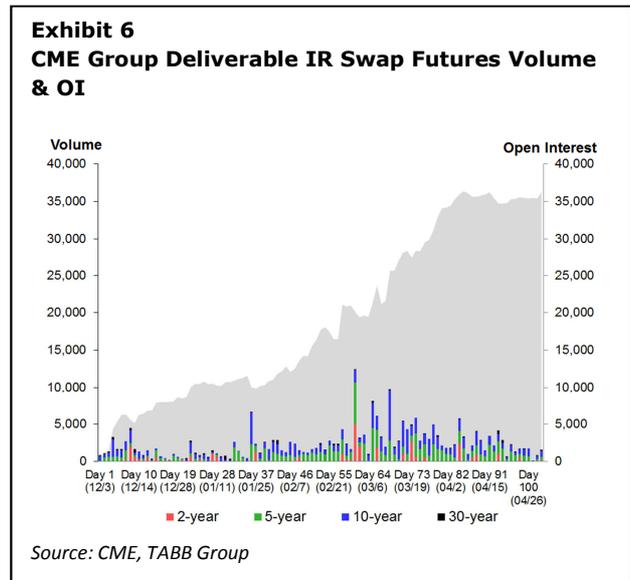
So what if you are one of the buy side firms that won't be ready in time? Your only real option is to proxy hedge with other instruments such as cash treasuries, futures or swap futures, until a clearing arrangement is in place. It is widely expected that the CFTC will have little tolerance for firms that miss a deadline that has been widely anticipated, and intermediaries have little incentive to flout the new rulebook. While there will be concerns over the efficacy of proxy hedges, there are certain benefits that some of the newer products, such as swap futures, bring to the market, principally in terms of margin treatment and the ability to realize cross product margining offsets.

The requirement to post initial margin for swaps immediately swings the pendulum in favor of futures products. For a swap, initial margin is calculated by looking at the maximum loss (using VaR) over 5 days; for a future, the IM can be calculated using just one day of Value at Risk (VaR). Investors will need to incorporate the opportunity costs associated with posting margin into the economic benefits of a trade. While portfolio margining for cleared swaps will help alleviate some of the burdens of IM, the futures contracts will require less offsetting positions because of the lower VaR calculation. They will also bring the added appeal of being able to net against cleared swaps trades at the clearing house, reducing the new collateral burden that the clearing mandate brings.

Collateral management is becoming a dominant theme. This is in part because of BCBS-IOSCO delays in finalizing margin requirements for uncleared trades, as well as by concerns of a collateral shortfall in the system. The proposed approach to encourage transactions to move to clearing - 10 day VaR for bi-lateral vs. 5 day VaR for cleared vs. 2 day VaR for a swap future - is being debated. But what we do know is; with collateral mandated for both

bilateral and cleared trades, the cost of swaps is about to increase dramatically. Balance sheet impact to providers and the opportunity cost to investors now required to post collateral will likely have a compression effect on the market. This, combined, with the high degree of ill-preparedness among buy-side firms is raising concerns of a liquidity drain in the swaps market around June.

And even if contracts such as the CME’s Deliverable Swap Futures (DSF) contract or ICE’s proposed futures contract on index CDS provide some level of relief, TABB Group does not believe the market will move overnight. It took about 20 months for the CME’s Ultrabond futures contract to gain significant market share. It should also be noted that the proposed ICE futures contract will not be for the existing series, but for the next one. Those firms looking to trade IG Series 19, then, will not turn to the futures alternative since it will be referencing the IG Series 20 index. Assuming that activity in swap futures begins in earnest with the June 10 deadline, TABB Group believes that contracts such as the CME’s DSF should account for at least 3% of the notional outstanding of the swaps and swaps futures market by mid-year 2014 and that growth will be incremental (Exhibit 6).



## Conclusion

What will happen when a buy side portfolio manager requests a trade for a security that has moved to central clearing but their traders lack the legal documentation and infrastructure to comply with the new requirements? Will there be a legal bottleneck as players rush to comply with regulation at the last minute? How will a clearing broker’s time and resources for onboarding be allocated? Will some market participants be temporarily locked out of the swaps market come June 10? Will they have to find alternative ways to meet their investment objectives? Will firms that have prepared for clearing face liquidity challenges as latecomers create drag in the system? What will that mean in terms of their ability to manage risk effectively? Will the new infrastructure be able to handle the sudden escalation in clearing volumes? How will buy side firms handle portfolio risk in the event of a major market disruption? These are the questions keeping the industry awake at night, as it prepares to pass through a ring of fire fast approaching.

## About

### TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of first-person knowledge, TABB Group analyzes and quantifies the investing value chain, from the fiduciary and investment manager to the broker, exchange, and custodian. Our goal is to help senior business leaders gain a truer understanding of financial markets issues and trends so they can better grow their businesses. TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, visit [www.tabbgroup.com](http://www.tabbgroup.com).

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Will Rhode is a principal at TABB Group. He is the director of fixed income research, as well as a respected thought leader in market structure reform and financial technology. Rhode has authored several research reports, including: "Corporate Bond Market Transformation: Dealers, Platforms, Investors"; "US Buy side Swaps Trading 2012 – I Can See Clearing Now"; "Corporate Bond Trading: Building Networks, Realizing Liquidity"; "European Credit & Rates Dealers 2011: Capital, Clearing & Central Limit Order Books"; "Breaking Down the UK Equity Market: Executable Liquidity, Dark Trading, High Frequency and Swaps"; "European Derivatives 2010: The Buy side Perspective on Equity Options, Futures and Swaps"; and "The Alternative Emerging Market: Equity Swaps and Synthetic Prime."



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