



‘No Creditor Worse Off’: Resolution Mechanisms Update

Also in this issue

- Black Swans Mean Business (Part II)
- OTC Clearing Evaluation (Part II)
- Your Internal Audit: Is it Delivering For You?
- Understanding Model Validation
- Islamic Finance: Unique Risk Management Challenges and the Impact of Basel III

OTC Clearing Evaluation of the EMIR and Dodd-Frank Regulations – The US versus Europe

Michel Dorval is a global market specialist at Misys and leads the thought leadership team. In this second article concerning OTC Clearing he delved deeper into the differences between the EMIR regulation and the Dodd-Frank Act and also possible impact on IT.

As described in the previous issue of Global Risk Update, politicians in the US and Europe took note of the G-20 Pittsburgh Summit by creating the Dodd-Frank Act and the European Market Infrastructure Regulation (EMIR) respectively.

The approach in the US was to pass a complex reform law (now referred to as the Dodd-Frank Act) in Congress. Having approved the Dodd-Frank Act, the two major regulators, the Securities and Exchanges Commission (SEC) and the Commodities and Futures Trading Commission (CFTC) have been busy turning what was a 2,300 page law, into practical rules to be implemented by banks and financial institutions.

Similarly, in Europe the political process has just ended and the final text of EMIR will be published soon. As in the US, this must then be translated into practical rules by the European Securities and Markets Authority (ES MA).

It is worth noting that EMIR and MiFID II together set out the EU's regulatory approach to derivatives contracts. EMIR covers the clearing obligations for OTC derivatives, as well as the reporting of all derivatives contracts to trade repositories, while MiFID II covers the obligation to ensure that only derivatives with an appropriate level of liquidity are traded on trading venues

Asian regulators, meanwhile, have been slower to rule on implementing OTC Clearing, so it is technically possible for financial institutions to avoid stricter regulation in Europe and the US by moving a portion of their business to Asia, given the global nature of OTC derivatives, even though this goes against G-20 guidelines.

This chapter explains the different components of OTC clearing and compares Europe with the US approach.



OTC Clearing Evaluation of the EMIR and Dodd-Frank Regulations – The US versus Europe

Timetable

Given the tight timeframe (in particular in the EU with ES MA’s advice due to be presented only three months before the end of 2012), firms that will be affected need to prepare (if they have not already done so), for the new regulatory regime that will shape the OTC derivative markets for the years to come.

REGULATOR: Time-line	
EMIR	Dodd-Frank Act
The obligation to comply with the rules from ES MA is intended to be in force from January 1st 2013	The obligation to comply with the rules from the CFTC and SEC is intended to be in force by the end of September 2012

Clearing obligation: Scope

In general terms, in both the US and Europe the clearing obligation will apply across the five main derivative asset classes (interest rate, equity, credit, commodity and foreign exchange).

REGULATOR: Scope	
EMIR	Dodd-Frank Act
OTC derivatives: credit, interest rate, foreign exchange, equity from January 1st 2013 and commodities.	OTC derivatives: credit, interest rate, foreign exchange, equity to be in force by the end and commodities.

Clearing: Exemptions

During the clearing process, product and participant exemptions can occur. The differences between US and European regulators are noted below. Unlike the US, the EU (EMIR) does not expressly provide exemption for foreign exchange derivatives or options on equity.

Regarding participants, both Dodd-Frank and EMIR have identified specific instances for exemptions.

REGULATOR: Product exemptions	
EMIR	Dodd-Frank Act
No product exemptions	OTC options on equity, foreign exchange, derivatives like FX swaps and FX forwards.

Trading venue

In the US, there is as yet not much guidance about how the SEF requirement will work. Current CFTC proposals will require transactions to be executed through an order book or ‘request for quote’ system. In Europe, EMIR and MIFID

II are not aligned as regards the trading venue.

REGULATOR: Trading venue	
EMIR	Dodd-Frank Act
Trading venue can be regulated markets (e.g. the London Stock Exchange); multilateral trading facilities (MTFs), such as BATS/Chi-X; and organized trading facilities (OTFs) – a new kind of trading venue introduced in MiFID II)	Trading on a swap or security-based swap execution facility (SEF)

Margin requirements

Neither the US nor the EU provides transparency as to how margin requirements are calculated. With regards to EMIR, it is possible that only cash and government bonds will be eligible as collateral for such purposes; not corporate bonds or equity.

REGULATOR: Cleared OTC derivatives	
EMIR	Dodd-Frank Act
Initial margin as well as daily variation margin requirements. This will be done by CCP.	Initial margin as well as daily variation margin requirements. This will be done by CCP.

REGULATOR: Un-cleared OTC derivatives	
EMIR	Dodd-Frank Act
Daily margin calculation and segregated exchange of collateral mark-to-market (or where this is not possible, mark-to-model)	Calculation of initial and variation margin, although no regulatory proposal to hold collateral from the swap dealer.

Reporting to trade repositories

To address concerns that regulators do not have a full picture of the exposure of the firms they regulate, and about the possible systemic implications that these may pose, a number of trade repositories have already been established, with others in the process of doing so.

These essentially form a central database, where information on positions is collected. Both US and EU proposals require reporting of full trade data within one day of execution. This could result in compressed time periods for negotiating trade confirmations.

OTC Clearing Evaluation of the EMIR and Dodd-Frank Regulations – The US versus Europe

REGULATOR: Reporting to trade repositories

EMIR	Dodd-Frank Act
All derivatives need to be reported. This includes OTC and exchange-traded instruments.	All swaps need to be reported. This includes OTC and exchange-traded instruments.
All transactions, modifications and terminations to all EU counterparties fall within scope.	All transactions, modifications and terminations to a US -controlling parent entity, or entity in the US are in scope.
The details of these transactions must be reported no later than the working day after the conclusion, modification or termination of the contract.	The time gap for transactions that need to be reported varies between 15 minutes and one day.

A Checklist for Compliance with OTC Clearing

In this chapter we will analyze in more detail the requirements for banks to integrate their existing front-to-back solution to other platforms. In the OTC Clearing framework, this involves connecting with new intermediaries, such as banks, clearing members/brokers and CCPs.

Connectivity to key players

An affirmation platform in the OTC clearing model provides post-trade execution functionality such as trade matching, affirmation, confirmation and trade reconciliation. These platforms also send trades to CMs and CCPs, as well as to TRs, where necessary. It is therefore crucial that each bank builds an interface between their capital markets solution and an affirmation platform.

This interaction is dynamic in the sense that the interface needs to follow up possible post-release processes, such as amendments and cancellations, in the capital markets solution. The data mapping required includes static mapping for trade economic data that doesn't change, and dynamic mapping to handle data that does change (such as third parties, floating rates and so on), error handling (technical and business errors, recovery...) and reconciliation.

Connectivity also means the ability to connect to different sources for position and trade information in order to capture all the data points that have a bearing on how the instrument is traded. This part of data management definitely has an impact on the ability to accurately calculate risk exposure, profit and loss and to carry out reporting.

For clearing members in particular, connectivity also means the requirement to connect to CCPs. This is crucial for the exchange of various flows, such as a request for collateral or for valuation details.

Flexible and advanced calculation engine

Clearing members and CCPs are required to calculate initial margin (IM). In the case of banks, it is very difficult to re-compute the IM requirement.

The following process must therefore be followed:

- The IM requirement is calculated and sent by the clearing member/clearing broker to its clients
- The client receives a report (FP ML, XML, FI X...) and is asked to settle the collateral required to cover the IM
- The client can cover the IM in cash or securities. It is technically very difficult (if not impossible) for the banks to re-compute the IM requirements; but the client can simulate the initial margin by using the tools provided by the clearing houses.

Clearing members and CCPs need a system to calculate IM on an intra-day basis, based on a VaR methodology where all cleared transactions are included in the IM calculation, and a separate collateral service to assess the collateral available. The difference is calculated to derive a margin call instruction or novation.



OTC Clearing Evaluation of the EMIR and Dodd-Frank Regulations – The US versus Europe

In the case of the End of Day (EOD) process, the workflow is just the same. Clearing members and CCPs are required to calculate EOD, although this is not mandatory for banks who are allowed to simply import the EOD:

- The EOD report is calculated and sent by the clearing member/clearing broker to their clients;
- The client receives a report (FP ML, XML, FI X...) and is requested to settle the EOD netting flow.

A ‘trade offset’ is the process being developed by the CCP to reduce the overall number of trades being transacted with the same counterparty. This process should identify trades that can be compressed. All participants verify the proposed trades. Once the ‘unwind’ proposal is accepted by all parties involved, the CCP calculates the margin impact and, where necessary, asks for additional margin cover. Once satisfied, the CCP declares the trades terminated and processes any deletions.

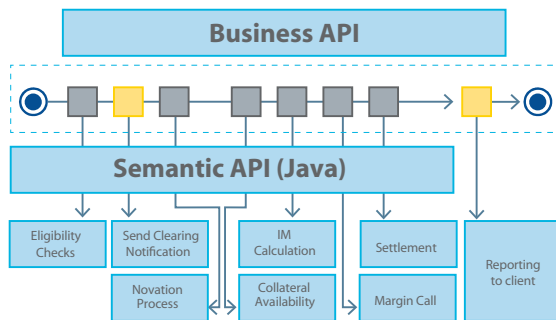
Configurable, rules-based workflow

To ensure a smooth integration between internal and external services, a configurable rules-based workflow is required. A graphical representation of the workflow-based rules will make it easier to maintain this configuration (figure 6).

Monitoring dashboards and blotters can help to identify exceptions when they occur. These should also be flexible enough to perform controls such as eligibility checks. Flexibility is required because deal data comes from every CCP and evolves over time. For clearing members it is quite a challenge to incorporate this level of flexibility into the control definition.

- If all controls are passed, the trade is accepted for clearing and the CCP proceeds with the novation
- If one of the controls fails, the trade is not accepted for clearing or follows a different workflow (a clearing consent request to the CMs, in some cases)

Figure 6: Configurable, rules-based workflow



An open relational database schema is required to allow for flexible reporting requirements that will potentially change over time. It should be possible to run all reports in real-time to reflect the most up to date view of positions and trades within the system; so these can be linked to margin and cost of carry reports.

Conclusion

The credit crunch certainly exposed the weak points in the OTC derivative markets: lack of transparency, counterparty credit risk and operational risk.

The initial reaction of the politicians, followed by the regulators, was to push standard OTC derivative contracts to an exchange or electronic trading platform, to be cleared through central counterparties (CCPs).

The effect of this will be that bilateral clearing will gradually disappear, to be replaced by a CCP that will intervene between the two counterparties in a transaction designed to manage the counterparty risk.

Different players have a role in the CCP workflow to finalize the derivative transaction: the affirmation platform that provides post-trade execution functionality; the trade repository that makes it possible to see a firm’s underlying position and exposure from a central vantage point; and the clearing members that act as a liaison point between buyers and the CCP for all post-trade functions, including daily margin management.

With the implementation of OTC Clearing reforms at different stages in different regions, this paper focused specifically on Europe (EMIR) and the US (Dodd-Frank), to show the overlaps and highlight some differences in approach, for example in exceptions, time-line and reporting requirements.

The challenge facing the different players now is how to integrate these requirements into their business systems, where topics like connectivity, calculation engines, configurable rule-based workflow and specific reporting requirements are top of the agenda for organizations needing to comply with the OTC clearing framework.

Above all, it is a question of time. This transformation of the capital markets is happening at speed. With a deadline set by the G-20 of 31 December 2012, the players involved need to have their preparations well under way to be part of the new regime.

The author can be reached via Ms Joanna Kraska
JK@riskrewardlimited.com

For further information please contact:

Dennis Cox – CEO
telephone: +44 (0)20 7638 5558
email: DWC@riskrewardlimited.com

Lisette Mermod – New York
telephone: 1-917-310-1334
email: LM@riskrewardlimited.com

Joanna Kraska – Public Relations
telephone: +44 (0)20 7638 5558
email: JK@riskrewardlimited.com