EurexOTC Clear – Creating efficiencies and safety for the Buy Side in OTC Clearing

'All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest'.

G-20 Leaders' Statement, Pittsburgh, September 2009.

Introduction

The introduction of legislation for the mandatory clearing of OTC derivatives by way of the Dodd Frank Act in the US and the imminent regulatory legislation in Europe by European Market Infrastructure Regulation (EMIR) has created significant challenges for the buy side. To meet those challenges, Eurex Clearing is introducing a series of interlinked initiatives that will comprise its OTC clearing service, EurexOTC Clear:

- Multi asset OTC product scope
- Individual client asset segregation
- Portfolio margining of listed and OTC derivatives
- Eligible collateral for margin

Multi asset product scope

Building upon the position as Europe's leading clearing house with over two billion transactions in fixed income and equity listed derivatives, cash equities, repo, bonds and energy in 2010 and already a leading CCP in the clearing of bilaterally agreed derivative transactions by way of its EurexOTC Trade Entry service[1].

[1] See http://eurexchange.com/trading/eurexotc_en.html for an outline of EurexOTC Trade Entry service. In 2011 over 880 million contracts were traded via the facility.

Diagram 1: EurexOTC Clear multi asset product scope

Interest rate	Initial release	Future phases
Currency	EUR, GBP, CHF and USD	Additional European - SEK, NOK, DKK, PLN and other currencies - JPY, CAD, AUD, SGD
Maturity	Up to 50 years (CHF to 30 years)	
Effective dates	Spot, forward starts and stub periods	
Types	Plain vanilla	Compounding
	Fixed versus Floating, Basis: Floating versus Floating, Overnight Index Swaps to 3 years, FRAs to 2 years	Zero Coupon, Caps, Floors, Swaptions and Inflation Swaps

Equity Derivatives	Initial release	Future phases
Types	Vanilla options (exchange look-alike)	Total Return Swaps, Variance Swaps and other option structures
Underlyings	STOXX, DAX and individual European equities	Other major indices and equities

Access for the buy side to EurexOTC Clear will initially[2] be via the bilateral workflow model of MarkitWire[3] enabling the buy side complete anonymity from the Executing Broker of the clearing member and the final fund allocation identity. Buy side customers can allocate a block trade across multiple Eurex clearing members for each single transaction. EurexOTC Clear will provide the buy side with two options to connect to the service – as a Registered Customer ('RC') which can be established by way of a signed tripartite agreement with Eurex Clearing and the Clearing Member – or as an Agent of the Clearing Member. To give the buy side invaluable operational workflow experience of EurexOTC Clear through MarkitWire, from November 29, Eurex Clearing is offering a simulation program which

[2] Phase 1, with connections to Bloomberg VCON, TradeWeb and RfQHub to follow.
[3] See link: http://www.eurexclearing.com/download/market/EurexOTC_Clear_Services.pdf which outlines the operational workflow of EurexOTC Clear via MarkitWire.

includes trade registration and novation through the MarkitWire UAT system and post clearing services through the new OTC Clearing GUI[4].

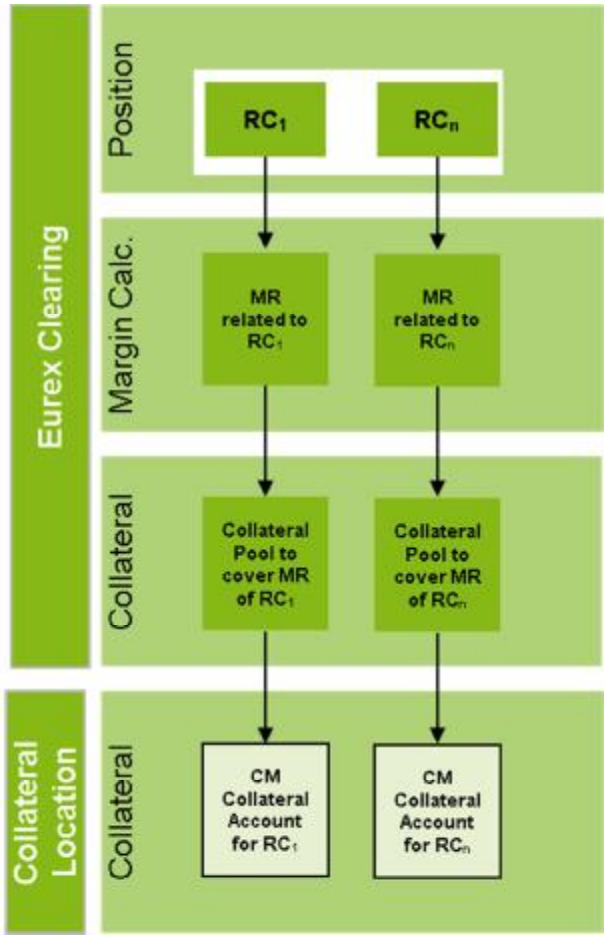
Individual client asset segregation

The collapse of Lehman in 2008, and more recently, the MF Global default, has underlined the need to give the asset management industry complete protection of funds' assets in the event of a clearing member default. Eurex Clearing has responded to that challenge by introducing[5] an innovative individual client asset segregation offering that gives the buy side the highest level of protection of funds' assets in the event of a clearing member default. Individual segregation will be offered to Registered Customers ('RC') of EurexOTC Clear. Collateral is segregated from the proprietary collateral of the clearing member and held in a separate segregated RC collateral account at Eurex Clearing by way of a double title transfer from the client via the clearing member to the clearing house. Positions of the RC will also be held in segregated RC position accounts. In the case of a default an individually segregated RC can also become an Interim Participant for a limited period, making margin payments direct to Eurex Clearing, whilst they organize to transfer to a new clearing member.

[4] See http://www.eurexchange.com/download/documents/circulars/cc0842011e.pdf for details and contact to participate in the simulation programme.

[5] The individual client asset protection offering is available for customers in England and Wales and Germany and is currently being updated to reflect the addition of France, Belgium, Netherlands, Switzerland and UCITS countries of Ireland and Luxemburg.

Diagram 2: EurexOTC Clear individual client asset segregation offering



Portfolio margining of listed and OTC derivatives

Starting November 2012 Eurex Clearing plans to set new standards by replacing the existing margin methodology (Risk Based Margining) with anew portfolio based margin approach. Eurex Clearing Prisma will give the buy side significant margin and collateral efficiencies in the clearing of their OTC derivative instruments by allowing the cross margining between listed and OTC derivatives by way of asset class. Default management at Eurex Clearing will be aligned with the introduction of portfolio margining whereby in the default of a clearing member, positions will be liquidated in terms of asset class or ‘liquidation group’. Each liquidation group will be handled separately in the case of a default.

Eligible collateral for margin

Probably the biggest consequence for the buy side with the mandatory clearing of OTC derivatives will be the need for the posting of collateral for initial margin on a daily on-going basis at central counterparties. The problem[6] for the buy side will be having the sufficient and required collateral to centrally clear their OTC derivative transactions – terms such as 'collateral transformation' and 'collateral swaps' have recently become synonymous with OTC Clearing. To meet the needs of the buy side in terms of collateral management for OTC Clearing, Eurex Clearing offers a wide range of collateral – over 25,000 ISINs – to meet margin requirements[7]. Eurex Clearing accepts[8] a broad range of bonds (government, corporate, state agencies, mortgage), equities (DAX®, EURO STOXX 50®, SMI), cash (Euro, Swiss Franc, US Dollar, Sterling) and Xetra® gold certificates[9].

Conclusion

The new regulatory regime of centrally cleared OTC derivative transactions has created immense challenges for the asset management industry. By recognizing and responding to those challenges with a number of interlinked initiatives, the EurexOTC Clear offering gives the buy side significant efficiencies and safety in OTC clearing.

[6] A number of papers on this topic have been written - M. Singh, 'Velocity of Pledged Collateral: Analysis and Implications', IMF Working Paper, TABB Report, 'Initial Margin for OTC Derivatives: The Burden of Opportunity Costs' and Morgan Stanley & Oliver Wyman, 'The Future of Capital Markets Infrastructure'. The authors estimate that between $1.4 trillion and $2.5 trillion in collateral will be needed for OTC Clearing.

[7] See http://www.eurexchange.com/risk/parameters_en.html for the full list of eligible collateral for margin.

[8] Securities are deposited to pledged securities accounts at Clearstream Banking Frankfurt AG (CBF) or SegalInter Zurich (SIS).

[9] Stringent criteria apply to all collateral pledged at Eurex Clearing - be rated ECB eligible liquidity classes I – IV (V and ABS are not accepted). To maintain integrity of the Clearing House in terms of its eligible collateral there is a limit of 25% of each bond issue accepted as collateral and, no bond with less than 15 days to maturity will be accepted.

Global EurexOTC Clearing Contacts

Europe

Paris
Paul Beck
T +33-(0)155 2 76- 7 72
paul.beck@eurexchange.com

Florence Besnier
T +33-(0)155 2 76-7 70
florence.besnier@deutsche-boerse.com

London
Alison King
T +44-20 78 62-72 66
alison.king@eurexclearing.com

Renaud Huck
T +44-20 78 62-72 32
renaud.huck@eurexchange.com

Frankfurt
France Schuster
T +49-(0)69-21 1-1 52 38
france.schuster@eurexchange.com

Lothar Kloster
T +49-(0)69-21 1-1 72 89
lothar.kloster@eurexchange.com

Zurich
Markus-Alexander Flesch
T +41-(0)43-43 0-71 21
markus-alexander.flesch@eurexchange.com

Juan Martini
T +41-(0)43-4 30-71 25 25
juan.martini@eurexchange.com

USA

Byron Baldwin
T +1-21 2-8 97-02 49
byron.baldwin@eurexchange.com

Christopher Malling
T +1-21 2-8 97-02 39
christoper.malling@eurexchange.com

Asia

Roland Schwinn
T +49-(0)69-21 1-1 85 98
roland.schwinn@eurexchange.com