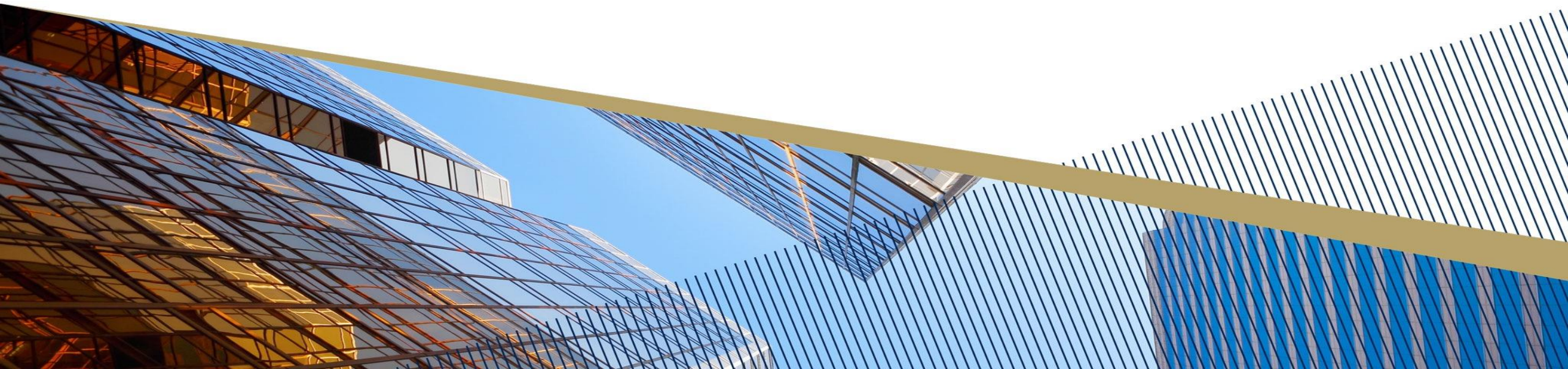


‘The Counterparty Gap’

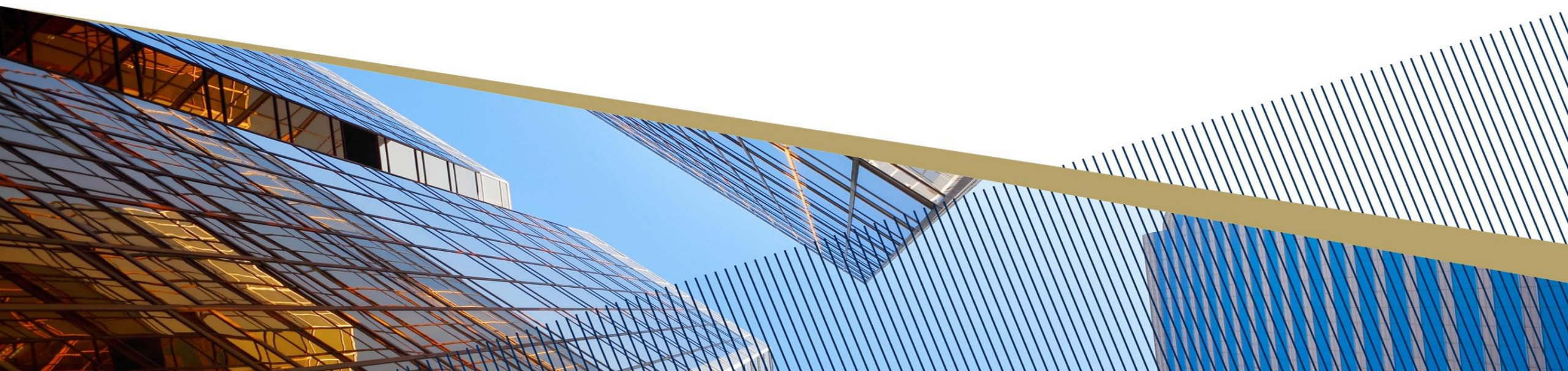
An ICMA ERCC study on the trade registration models used by European central counterparties for repo transactions

27 September 2016



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Introduction

- These slides provide an update on the analysis undertaken by the ICMA European Repo and Collateral Council ('ERCC') during the Spring and Summer on CCPs' trade registration models and focus on a specific area of the trade registration process that creates risk for market participants and needs to be addressed
- The specific area of focus relates to risks borne by market participants arising from different trade registration models and the exact timings when CCPs assume counterparty responsibility for a trade – we refer to this risk as 'The Counterparty Gap'
- These slides contain recommendations from the ICMA ERCC on a number of changes to market best practice that, when adopted, could reduce the risk to market participants arising from these issues
- Further detail on the counterparty gap issue can be found in the ICMA ERCC report on the subject which is published today

Background

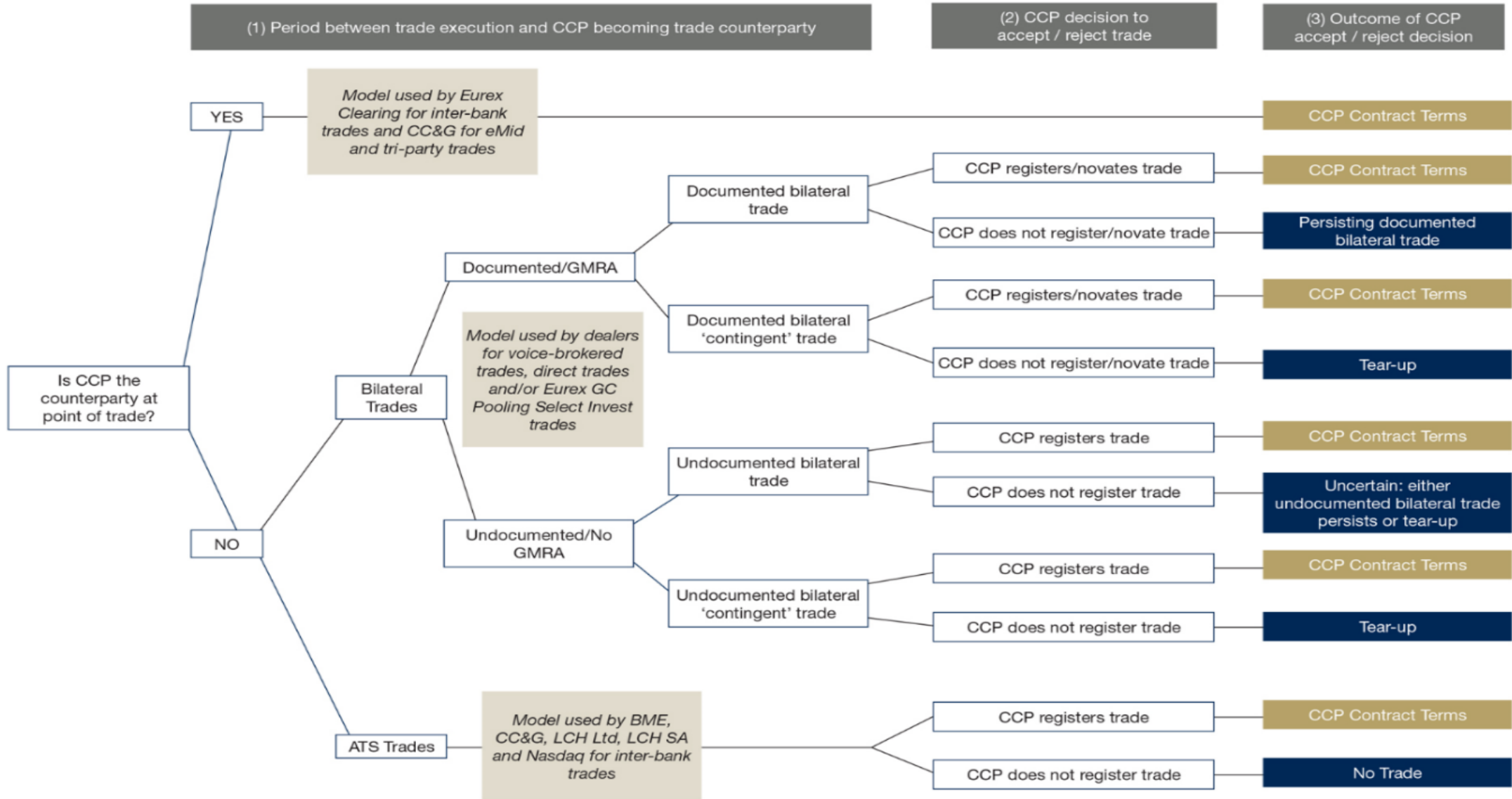
- Analysis undertaken of trade registration process of the six major Fixed Income CCPs in Europe (BME Clearing, CC&G, Eurex Clearing, LCH Ltd, LCH SA and Nasdaq Clearing)
- CCPs each completed a detailed trade registration questionnaire and participated in a telephone conference call with the ICMA project team to discuss, clarify and elaborate responses where required

Summary of CCP responses relating to the counterparty gap issue

	BME Clearing	CC&G	Eurex Clearing	LCH Ltd	LCH SA	Nasdaq Clearing
Timing that CCP becomes counterparty to trade	Receipt and Acceptance <i>Moment of receipt and registration of trade by CCP</i>	Receipt and Acceptance <i>Moment of receipt and registration of trade by CCP</i>	Execution <i>Moment of execution on trade platform</i>	Receipt and Acceptance <i>Moment of receipt and registration of trade by CCP</i>	Receipt and Acceptance <i>Moment of receipt and registration of trade by CCP</i>	Receipt and Acceptance <i>Moment of receipt and registration of trade by CCP</i>
<i>exceptions</i>		1) eMid trades at time of execution 2) Tri-Party trades at time of execution	<i>GC Pooling Select Invest: Binding declaration of intent to execute a trade whose legal conclusion is contingent on CCP novation. Novation is subject to cash pre-funding for the opening leg.</i>			
Can CCP clear bilaterally executed trades?	Yes	Yes	Yes	Yes	Yes	Yes
Can CCP clear anonymous ATS executed trades?	No	Yes	Yes	Yes	Yes	No
Does CCP prescribe form of contract before becoming counterparty?	No <i>CCP silent</i>	No <i>CCP silent</i> <i>Not applicable for eMid and Tri-party trades</i>	<i>Open offer transactions : not applicable.</i> <i>GC Pooling Select Invest transactions: No. The binding declaration of intent is set out in the Eurex Repo rules & regulations.</i>	No <i>CCP silent</i>	No <i>CCP silent</i>	No <i>CCP silent</i>
What happens if CCP rejects trade?	CCP silent	CCP silent	<i>If CCP doesn't novate the trade due to missing cash pre-funding, the Select Invest Bank may request to stop further novation attempts after two unsuccessful novation attempts. The binding declaration of intent would dissolve.</i>	CCP silent	CCP silent	CCP silent

- A number of changes have been made to the CCPs' trade registration processes and the exact timing when they become counterparty to the trades routed to them for clearing
- The CCPs' motivation for these changes has principally been to manage their operational risk. The CCPs do not seek to explain nor take responsibility for the motivation or intention of the dealers or the trading platforms/intermediaries
- To understand the entire risk picture of the trade registration process, important to understand the inter-play between the dealer, the ATSS/intermediaries and the CCPs
- Any trade sent to a CCP that uses the Receipt and Acceptance trade registration model poses a question as to the legal status of the trade during the period between execution and the point where the CCP assumes counterparty responsibility
- An equivalent counterparty gap risk exists if a trade is rejected by a CCP for any reason
- In both circumstances, the original trade counterparties are left with two critical risk questions:
 - does my trade exist?
 - if so, who is my counterparty?

Contract outcome scenarios



(1) Period between trade execution and CCP becoming trade counterparty

(2) CCP decision to accept / reject trade

(3) Outcome of CCP accept / reject decision

Model used by Eurex Clearing for inter-bank trades and CC&G for eMid and tri-party trades

Model used by dealers for voice-brokered trades, direct trades and/or Eurex GC Pooling Select Invest trades

Model used by BME, CC&G, LCH Ltd, LCH SA and Nasdaq for inter-bank trades

CCP Contract Terms

CCP Contract Terms

Persisting documented bilateral trade

CCP Contract Terms

Tear-up

CCP Contract Terms

Uncertain: either undocumented bilateral trade persists or tear-up

CCP Contract Terms

Tear-up

CCP Contract Terms

No Trade

- A complex picture. Multiple different trade registration models being used by CCPs
- The changes by CCPs to become counterparty at the point of Receipt and Acceptance of the trade addresses operational risk for the CCP but has had the effect of transferring an amount of risk from CCPs onto market participants
- Industry-wide, the majority of European CCP cleared repo trades are executed on ATSs (estimated at >95%) and in the majority of cases with the CCP becoming counterparty when the trade is received and accepted by the CCP
- Industry-wide, bilateral trades account for a small proportion of European CCP cleared repo trades (estimated at <5%)... *but 100% for BME and Nasdaq*
- Irrespective of whether a trade was executed anonymously on an ATS or transacted directly between two counterparties, any trade sent to a CCP that uses the Receipt and Acceptance trade registration model poses a question as to the legal status between execution and the point the CCP assumes counterparty responsibility
- If a trade is rejected by a CCP and the treatment for a trade rejection has not been clarified in the ATS rules or agreed between the original bilateral trade counterparties at the outset, the legal status of the trade can be ambiguous

- The critical point in the process is the CCP acceptance or rejection of the trade
 - *Equivalent to counterparty finality*
- In the majority of cases, the CCP's confirmation of acceptance (*or in exceptional circumstance, rejection*) should be the trigger for a dealer to know whether the trade actually exists and who their counterparty is
- The term 'novation' is often used erroneously by market participants
 - Technically, it means one legal contract being replaced by another contract
 - However, it is often used as if it is the time that a CCP contract arises
 - This may confuse because it pre-supposes that a contract of some kind would exist prior to a CCP contract being created... whereas in the majority of cases there is no prior contract
 - We use the term 'Receipt and Acceptance' to describe the moment of counterparty confirmation following receipt, interrogation and registration of trade by CCP
- Clarification of the counterparty gap issues will provide market participants with certainty on a trade's status at all points in its lifecycle
 - Helpful in a market-wide operational or default event
- By working together now to clarify the position regarding the counterparty gap issues, market participants and infrastructure providers will achieve an enhanced operating and risk management environment for CCP cleared business and ensure that any future increase in CCP activity e.g. Dealer to Client trades, can be managed more comfortably

ICMA ERCC promotes as best practice that all repo trades should be documented:

- for ATS/CCP trades this includes their respective rules/documentation
- for bilaterally organised trades this is achieved through agreed GMRA's and should include appropriate trade confirmations

All trades intended for central clearing should, as a matter of best practice, be contingent upon the CCP's acceptance and will otherwise be cancelled:

- for ATS trades, the ATS should make this clear within its rules/documentation; and
- for bilateral trades this should be agreed between the parties and reflected in writing
- Where the applicable CCP involvement is not on an "open offer" basis, ATSs should explain clearly within their rules / documentation the status of a trade that has been executed in anticipation of CCP clearing, but not yet registered by the CCP – this should include the ATS explaining clearly that any trade rejected by the CCP is automatically cancelled and that appropriate procedures are in place for such exceptional events
- For bilateral trades executed in anticipation of CCP clearing but not yet registered by the CCP, it should be clearly stated that the trade is contingent upon CCP registration – this should be reflected in writing, by the trader and in any associated confirmation (unless included in the applicable GMRA's as a mutually agreed negotiated clause)

Clarifying via a market convention that all CCP destined trades are CCP Contingent Trades highlights that it is important that everything is done to ensure that, to the extent reasonably possible, the time gap between a trade being executed and it being accepted by the CCP is minimised:

- Dealers should have transparency on the length of time it takes for all trades to progress from point of electronic match to the point of CCP's Receipt and Acceptance, meaning: (1) length of time for trade from ATS (execution) or the trade matching service to receipt at CCP gateway; and (2) time from receipt at CCP gateway to CCP acceptance as counterparty to the trade
- Asking for transparency in this way should serve to: (1) provide essential operational risk management information to dealers; and (2) provide incentives to ATSS and CCPs to optimise the speed of their trade acceptance process
- Dealers will need to consider any implications for the point at which they represent within internal systems that these trades exist – the assumption is that these trades are captured within internal risk and control systems from the point of execution, despite the fact that some of them might fail to be accepted by the applicable CCP and hence be cancelled
- CCPs should be encouraged to provide trade acceptance, or rejection, confirmation messages to dealers in the fastest economically rational time possible – this may require investment by the CCPs in reporting systems and STP messaging, but can be justified because the trend by CCPs towards becoming counterparty from the point of trade registration, instead of trade execution, has shifted significant operational risk onto the dealer community; and timely CCP reporting of trade registration is important to allow dealers to manage this risk

Cash Bond Trades

It is important that consideration is given to the applicability of an equivalent CCP Contingent Trade market convention for cash bonds

The cash bond community will need to understand the implications of the current CCP registration model for their market and what the CCP Contingent Trade convention is seeking to achieve for repo

It would increase complexity and create additional operational risks if the cash bond community elect to pursue a different approach to the repo market

A dialogue is being initiated with relevant cash bond market stakeholders to discuss the situation and advise them of the steps that ICMA ERCC plan to take for market best practice in the repo market

Any other business and next meetings