Market participants that trade listed derivatives and cleared OTC swaps gain access to the markets through their relationships with Futures Commission Merchants (FCMs). These FCMs provide a number of services including trade execution, market research and clearing. Now, for the first time, practical alternatives are being considered that would lead to a more direct clearing of derivatives contracts by these market participants. Whether you are an asset manager, pension fund, commodity hedger, or insurance company (end user) this article will provide you a high level perspective of these alternatives and how they can directly affect your business.

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DEMAND AND SUPPLY

Regulatory overhaul in the wake of the global financial crisis of 2008 resulted in a number of new regulations that require the centralized clearing of most OTC derivatives by brokers, dealers and end user market participants. The mandating of central clearing has had the contradictory effect of increasing the demand for listed and OTC derivatives clearing services while at the same time making clearing a less attractive business for FCMs because of higher capital requirements. In this challenging environment, the number of FCMs providing clearing services has diminished and those that remain are being more selective about the types of products and clients they will provide clearing services for and are increasing their fees for clearing services.

THE FCM AND CONCENTRATION RISK

Bank owned FCMs are dually challenged as they must operate profitably and in compliance with new capital and risk based regulations specific to the derivatives customer clearing business. FCMs are redefining the optimal mix of customers, products and services they provide while many banks are considering the strategic value of being in the FCM customer clearing business altogether. This creates concentration risk and leaves end users in an environment where clearing costs will increase while at the same time the number of FCM’s offering clearing services may decrease.

A big concern is clearing capacity, any reduction in the number of firms providing clearing services will create problems for end users. If a bank owned FCM voluntarily (or involuntarily) leaves the clearing business market participants may find it difficult to have their positions transferred to another FCM, otherwise known as porting. This is particularly relevant to market participants such as asset managers, insurers, pension funds and commodity hedgers as they are generally considered to be less attractive FCM clients. This group tends to consist of low frequency traders that maintain sizable directional carry positions which attract significant regulatory capital and balance sheet rent costs while generating lower commissions.

Market participants must also think about FCM clearing relationships in the context of the safety of their margin deposit assets. FCM defaults and fellow customer risk are key concerns that are not entirely mitigated through regulatory segregation requirements.

THERE ARE OPTIONS

An emerging alternative to the standard FCM clearing relationship that could prove interesting to end users involves the establishing of a direct connection to the clearing house by the end user. This may be accomplished either through a sponsored type clearing model or a direct self clearing arrangement.

SPONSORED CLEARING MODEL

New sponsored clearing memberships combine traditional FCM clearing service models with provision of margin and collateral management clearing house connectivity associated with direct clearing memberships. The CME, Eurex and ICE have all recently introduced new sponsored clearing membership models that provide end-user market participants a direct connection to the clearing house. In a sponsored clearing model the clearing house becomes the end users counterparty. The market participant’s margin and collateral assets are kept separate from the sponsoring FCM, the FCM’s other customers and other FCMs assets. Margin and collateral requirements of the end user may be settled directly with the clearing house through a settlement bank bypassing the FCM.

The CME’s newly introduced version of the sponsored clearing model is the Direct Funding Participant (DFP). Under DFP the CME has created a new category of clearing membership. A DFP can clear trades for its own account as long as a clearing member registered as a FCM guarantees the financial and operational obligations of the DFP. A DFP member’s margin and collateral requirements are settled directly with the CME clearinghouse through an approved settlement bank. The DFP’s collateral is

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1 Refco, MF Global and Peregrine Financial are FCMs that have failed dramatically in recent years. The pro-rata loss allocation that may occur if in a FCM bankruptcy the pool of customer assets were unable to cover the losses of a large customer failure.

2 The CME Group (Chicago Mercantile Exchange) operates CME Clearing, Eurex (wholly owned by Deutsche Borse AG.) operates Eurex Clearing and ICE (the Intercontinental Exchange) operates ICE Clear US, ICE Clear Credit and ICE Clear Europe.
maintained in segregation from the guarantor FCM and other clearing members and customers, providing insulation from FCM default and fellow customer risk. The financial guaranty and margin performance obligations of the DFP remain the responsibility of a CME Group clearing member (FCM) guarantor.

ICE Clear Europe offers market participants direct access to clearing through its Sponsored Principal Account. This program is currently not available to US persons, although ICE Clear US has just indicated that they may be introducing a solution for US persons. In this model the Sponsored Principal is a legal counterparty to trades with the clearing house. The Sponsored principal and the Sponsor are jointly liable to the clearing house. A Sponsored Principal’s margin and collateral requirements may be settled directly with the clearinghouse through an approved settlement banking relationship or though the Sponsor.

Eurex Clearing’s version is called ISA Direct. ISA Direct is available only to participants domiciled in the EU or Switzerland. Market participants establish direct contractual relationships with the clearinghouse. A regular Eurex Clearing member is responsible as the clearing agent for providing the financial guaranty and operational processing support. Margin and collateral movements may be done through the Clearing member or via the ISA Direct participant’s own banking arrangements.

All versions offer end users full segregation of margin collateral. The end user is the primary beneficiary of sponsored clearing. End user assets are protected in the event of an FCM bankruptcy or default. The direct contractual relationship with the clearing house enhances portability as margin assets are completely segregated and insulated from other market participants. Since the sponsored program relieves balance sheet pressure on the FCM, the FCM is more likely to continue providing services.

DIRECT CLEARING

A second alternative to using a FCM as clearing broker is for the end user to become a clearing member of the clearing house and establish a self-clearing operating model. Market participants that meet clearing house membership requirements which include minimum capital maintenance, risk management capability and operational preparedness can qualify to become clearing house members. The self-clearing market participant would become directly responsible for all core clearing functions previously handled by the FCM. Core clearing requirements are broadly grouped into three categories:

- Margin settlement and collateral management
- Transaction processing and reporting
- Guaranty Fund and default management

These core responsibilities can be unbundled and managed internally or in some cases outsourced.

Margin Settlement and Collateral Management: All clearing members including FCMs, sponsored members and direct clearing members are required to establish a banking relationship with a clearing house approved settlement...
bank. Settlement and collateral management functions can be outsourced to a full service settlement bank.

Transaction Processing and Reporting: These functions may be handled in house or outsourced to a 3rd party provider. There is a wide range of service levels available ranging from hiring a full service operation to acquiring discrete processing components. A number of large FCMs have actually migrated this component of their business to 3rd party providers, such as FIS, a leading outsourcing company.3

Guaranty Fund and Default Management: Contributions to the guaranty fund and the obligation to participate in additional assessments are the responsibility of the direct clearing member. New products are under development that look to transfer the guaranty fund and default obligations away from the clearing member to a 3rd party insurance based provider, although to date we are not aware of anybody providing this service.

Sponsored and Direct Clearing – a brief analysis

Sponsored and direct clearing models are intended to bring benefits to the end user in the areas of risk management and cost efficiency.

Generally speaking, adoption of a sponsored or direct clearing relationship mitigates many risk concerns related to the default or failure of an FCM. Risk to margin and collateral deposits are front line concerns, as are the discontinuance of service, transit risk and the inability to port positions and collateral.

A discussion of the comparative financial risk profiles under the different clearing alternatives is warranted. We will start by defining financial risk as the possible loss or diminution of margin collateral, the costs associated with liquidating a portfolio and the obligations associated with guaranty fund contributions and additional default funding assessments.

To begin, let’s briefly describe of the role of the FCM and the clearing house. The clearing house is the counterparty to the two sides of each transaction. The clearing house requires the deposit of margin from the clearing members representing the buy and sell sides. Clearing houses hold margin in segregated accounts offering asset protection.

FCM clearing members are required to post customer margin with the clearing house. FCMs are also required to collect margin from their clients.

When clearing through an FCM the end user is exposed to a possible, albeit unlikely, loss of up to 100% of the margin assets and other funds deposited with the FCM. Although margin funds are required to ultimately be placed at the clearing house a major FCM customer default, or a fraud may work through to affect the customer margin pool. Additionally, if the FCM is unable to provide clearing the end users portfolio would need to be transferred to another FCM. If this is not possible the customer’s portfolio would be liquidated. Portfolio liquidation costs can be significant, estimated by industry experts to be around 10% of the margin requirement, and are applied to the margin collateral.

Sponsored type clearing arrangements are designed to provide a direct path for end users to post and maintain margin collateral directly with the clearing house providing full segregation and insulation from FCM and other customer defaults. Sponsored models are not without financial risk. If the sponsoring FCM clearing member withdraws its services, either voluntarily or involuntarily, and the portfolio can not be ported to another sponsor or FCM the account is exposed to the same liquidation risks as in the FCM clearing model, ie an estimated 10% of the margin on deposit.

Looking at the direct clearing model the end user’s collateral is safe and there are no liquidation risks, assuming the end user remains a clearing member in good standing, but there are financial exposures associated with the clearing houses’ secondary level of market protection. Each clearing member is required to contribute to a “guaranty fund” that is used in the event of a major default to mitigate losses to non-defaulting members. The size of the guaranty fund is based on calculations that quantify the risk the member brings to the clearing house. Generally it is equal to approximately 10% of the members margin requirement. Clearing houses require clearing members to be obligated to satisfy calls to replenish the guaranty fund by up to 150% or an additional 15% of the margin requirement.

3 FIS is a global provider of financial services technology and outsourcing.
Sponsored and direct models address a number of the financial risks associated with margin collateral deposited with an FCM. Adopting a sponsored or direct model may create other benefits for the end user addressing concerns about increased clearing charges, portability, continuation of service, and transit risk (collateral movement failure between intermediaries). Even FCMs may benefit as their capital requirements may be reduced in a sponsored model. Both models may have a systemic benefit by serving to distribute settlements between more participants reducing concentration risk.

The costs to clear are better managed under these alternatives. In a sponsored model the key functions of margin and collateral management, transaction processing and guaranty fund obligations may be unbundled resulting in cost transparency and service options. When acting as a direct member the end user assumes responsibility for the key clearing functions and related expenses. Direct members may benefit from reduced clearing costs by avoiding FCM specific costs including those for, balance sheet rental, regulatory capital, compliance, regulatory reporting and ROI.

Taking the costs and benefits into consideration becoming a sponsored or direct member may be a viable alternative for some end users.

### CLEARING MODEL

<table>
<thead>
<tr>
<th>Clearing Model Attributes</th>
<th>FCM Intermediary</th>
<th>Sponsored</th>
<th>Direct Member</th>
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<tbody>
<tr>
<td>Fellow customer risk</td>
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<tr>
<td>Full collateral segregation</td>
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<tr>
<td>Liquidation risk</td>
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### FINANCIAL RISKS

- Original Margin Collateral: 100% At Risk
- Guaranty Fund and additional Default Obligations: 10-15% of Original Margin
- Liquidation Cost: 10% of Original Margin

### PARTING THOUGHTS

The decision to continue using the services of an established clearing broker relationship versus the option of a sponsored clearing model or a direct self clearing arrangement is not a simple one and there are a number of issues to consider, but given the unsettled state of the industry and the continuing evolution towards a more direct clearing model it is important for end users to be aware at the least and proactive as appropriate for their organizations. For asset managers, a further complication is that they are not beneficial owners of the assets they manage and their AUM are generally spread over hundreds if not thousands of accounts. This dispersion of accounts creates obvious complications when considering the use of sponsored or direct clearing models.

The concept of adopting sponsored and direct models as practical alternatives to connect to clearing are new and evolving solutions. The derivatives markets have a history of constantly adapting to challenges and one should expect to see continued development addressing the complexities introduced by the new models.