FIA PTG
PRINCIPAL TRADERS GROUP

Clearing a Path to a More Resilient Treasury Market

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Table of Contents

The Benefits of Central Clearing

1. Market Resiliency
   - **Alleviates dealer balance sheet constraints** by reducing gross settlement obligations and capital costs through multilateral netting.
   - **Reduces operational risk** as the reduction in gross settlement obligations should significantly reduce the number of settlement fails.
   - **Reduces credit risk** by replacing bilateral counterparty credit exposures with a well-regulated CCP.

2. Market Liquidity
   - **Facilitates new liquidity providers** by eliminating bilateral counterparty credit exposure (and the need for extensive trading documentation between counterparties).
   - **Enables all-to-all trading.**

3. Market Transparency
   - The CCP **provides a robust data source** which leads to increased transparency for both regulators and market participants.

How to Facilitate More Central Clearing

- Currently, uncleared cash Treasury transactions account for more than 75% of the secondary market, and uncleared bilateral repos account for approximately 50% of the U.S. repo market.
- Given the identified benefits, it is important for overall UST market resiliency, liquidity, and transparency to transition more trading activity in cash and repo transactions to central clearing.
- However, achieving more central clearing requires **implementing a client clearing model at FICC that all market participants can access and utilize**.
    - Currently, the vast majority of Treasury clearing at FICC is done by direct members, not through client clearing.

The Importance of Client Clearing

- Irrespective of asset class, most market participants (including buy-side investors and many PTFs) access central clearing through a client clearing model.
- This is due to a variety of reasons, including:
  - Strict eligibility requirements for direct CCP members;
  - The operational capabilities required to directly manage positions, collateral, and settlement at the CCP; and
  - The associated default management responsibilities of direct membership, including participation in auctions in the event of a member default and potential loss mutualization through contributions to the guaranty fund.
- Therefore, it is critical that FICC offer a client clearing model that all market participants can access and utilize.

Limitations of FICC Client Clearing

FICC has three unique indirect clearing models, and all have material limitations.

1. **Sponsored Clearing**
   - Used primarily to clear bilateral repos executed with a specific dealer.
   - Minimal cash transactions are being cleared.
   - Clearing members are permitted by FICC (and, in practice, do) elect to <u>only accept transactions that are executed with them.</u>
     - This means market participants are unable to locate a clearing member to clear their entire portfolio across execution counterparties.
2. **Correspondent Clearing**
   - The client does not have a direct relationship with FICC and does not directly benefit from the CCP's guarantee of settlement.
   - Margin collected on a net basis across all positions held by the clearing member (meaning client positions/margin are not segregated from other clients).
   - Used primarily by custody banks/wealth management divisions to clear cash transactions executed by smaller clients.
     - The major client clearing banks are not members of this service (see "Executing Firm Master List" at https://www.dtcc.com/client-center/ficc-gov-directories).
   - Minimal repo transactions are being cleared.

Limitations of FICC Client Clearing

3. **Prime Broker Clearing**
   - The client does not have a direct relationship with FICC and does not directly benefit from the CCP's guarantee of settlement.
   - Margin collected on a net basis across all positions held by the clearing member (meaning client positions/margin are not segregated from other clients).
   - This model does not appear to be frequently used in practice.
     - In order to avoid incurring additional capital costs, PBs look to maintain a flat book at the CCP. This means that a PB may only be interested in clearing cash transactions where the PB can simultaneously clear both sides of the trade.
     - Minimal repo transactions are being cleared.

In addition, across all three indirect clearing models, FICC rules do not permit clients to benefit from cross-margining arrangements with CME (even though direct members can). This further increases costs for clearing clients.

Relevant Experience in CFTC-regulated Markets

- The FICC Sponsored Clearing offering could provide market participants with a viable client clearing solution if clearing members were not permitted to discriminate based on execution counterparty.
- Importantly, the CFTC has recognized that the identity of the original execution counterparty should not be a relevant consideration for centrally cleared trades (as all parties face the CCP).
    - As a result, the CFTC prohibits any arrangement that discloses the identity of a client's executing counterparty to its clearing member or otherwise limits the number of counterparties with whom a client may trade.
- In addition, in order to further facilitate client access to clearing, the CFTC requires clearing members to comply with detailed conflicts of interest requirements, including operating independently from affiliated trading businesses.
- These steps have successfully expanded client access to clearing in CFTC-regulated products.

Recommendations to Increase Client Clearing at FICC

- We recommend that FICC, in coordination with relevant regulators, implement similar enhancements to its client clearing offering so that it is available to all types of market participants.
- In particular, FICC should:
  - Remove the ability for Sponsoring clearing members to discriminate based on execution counterparty;
  - Require clearing members to operate independently from affiliated trading businesses when deciding whether to offer clearing services to a particular client and the associated commercial terms.
- In addition, FICC should permit both direct clearing members and clients to utilize cross-margining arrangement on fair and non-discriminatory terms.
- Finally, FICC should ensure clients are adequately represented in CCP governance processes (including risk committees) and in working groups involved in determining the rules and design of the client clearing model.

FIA Principal Traders Group

- For more information on FIA PTG, see https://fia.org/ptg.

- Our Paper *Clearing a Path to a More Resilient Treasury Market* can be found here.

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