

## **Securities Financing Transaction (SFT) Clearing Initiative Presentation for Treasury Markets Practice Group April 13, 2017**

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<http://www.dtcc.com/legal/rules-and-procedures.aspx>.

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# FICC Introduction

- Fixed Income Clearing Corporation (FICC), a wholly-owned subsidiary of The Depository Trust & Clearing Corporation (DTCC), is a central counterparty (CCP) and the leading provider of trade comparison, netting and settlement for the U.S. Government securities marketplace.
- FICC's Government Securities Division (GSD) was established in 1986 to provide automated comparison and settlement services, risk-management benefits and operational efficiencies to the Government securities industry.
- GSD clients include the nation's major brokers and dealers, as well as a wide range of entities that trade U.S. Government securities.
- FICC is a clearing agency registered with and under the supervision of the Securities and Exchange Commission (SEC). In light of its designation as a Systemically Important Financial Market Utility (SIFMU), FICC is also subject to oversight by the Federal Reserve.

# Benefits of SFT Clearing at FICC

- Reduction of counterparty risk by guaranteeing the completion of settlement in a member default scenario:
  - CCP guarantee may mitigate risk of a large scale exit by institutional investors in a stress scenario.
  - A centralized liquidation of a failed counterparty by FICC would reduce the risk of “fire sales” that drive down asset prices and spread stress across the financial system.
- Members could be eligible for balance sheet and capital relief.
- Centrally clearing these transactions at FICC could alleviate the constraints on borrowers as it may enable them to:
  - Reduce capital usage via netting, potentially enabling the redeployment of scarce capital to other uses
  - Apply lower risk weights in their risk-based capital ratios
- Lending through FICC offers institutional investors potential growth of their on-loan balances and income as borrowers shift their demand to CCP channels.



# SFT Clearing Initiative



## **Centrally Cleared Institutional Tri-Party (CCIT) Service**

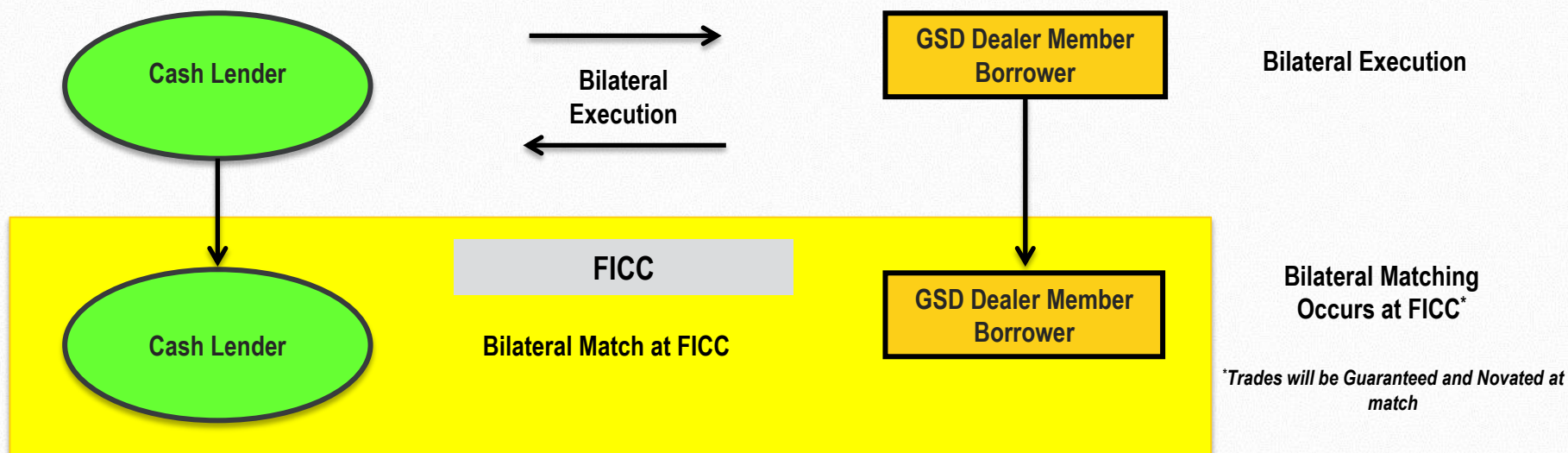
# Centrally Cleared Institutional TriParty (CCIT™) Service (Client-to-Dealer Tri-Party Repo)

- As an expansion of the GCF Repo Service, the CCIT Service will extend FICC's CCP services and guaranty of completion of settlement to tri-party repo transactions between GSD Dealer Members and eligible tri-party cash lenders (referred to as CCIT Transactions).
  - Pending regulatory approval (anticipated in Q2 2017), a new limited GSD membership type will be created for tri-party cash lenders (referred to as CCIT Membership) other than Registered Investment Companies (RICs). *{Note: RIC participation in CCIT is pending approval by SEC Division of Investment Management and will require a separate regulatory filing by FICC.}*
  - CCP guarantee will attach upon comparison for CCIT Transactions.
  - Collateral eligibility for CCIT Transactions will follow the GCF Repo Generic CUSIP schedule.
  - Consistent with GCF Repo collateralization, obligations for CCIT Transactions will be collateralized at 100%.
  - Timeline for trade matching and netting will follow the GCF Repo Service timeline.
  - Existing processes with the clearing banks for tri-party repo settlement will be leveraged.
  - Settlement will occur at the clearing bank of the GSD Dealer Member repo counterparty.



# CCIT Service: Trade Flow

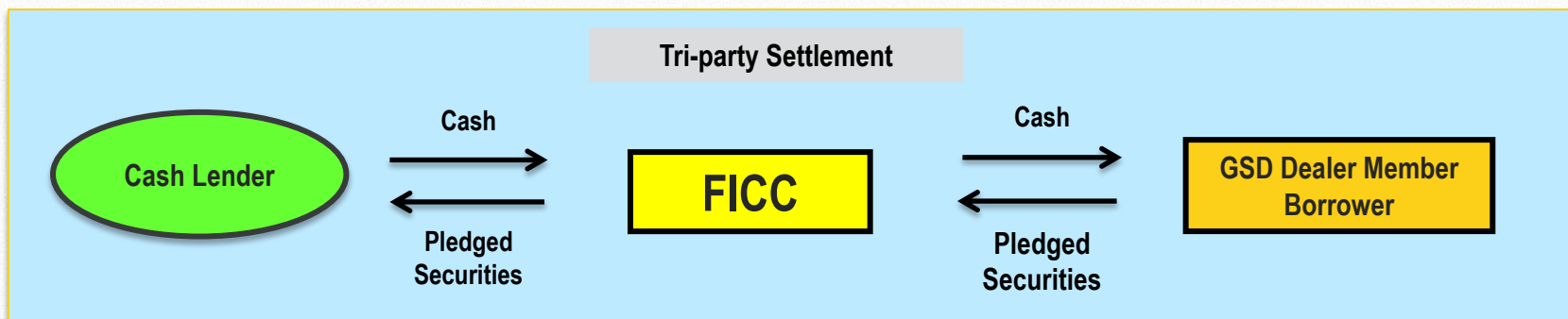
## Day 1: Execution and Match



Both sides execute tri-party repo trade on a bilateral basis.  
Both sides submit trade information to FICC for matching.

# CCIT Service: Trade Flow

## Day 1: Settlement



Based on details of matched trades, FICC will transmit Start leg settlement obligations to designated Clearing Bank.

### Settlement Occurs:

Step 1: GSD Dealer Member Borrower pledges collateral to FICC.

Step 2: Clearing Bank validates collateral and value.

Step 3: FICC onward pledges collateral to Cash Lender.

Step 4: Clearing Bank debits Cash Lender and credits cash to GSD Dealer Member Borrower via FICC's account.

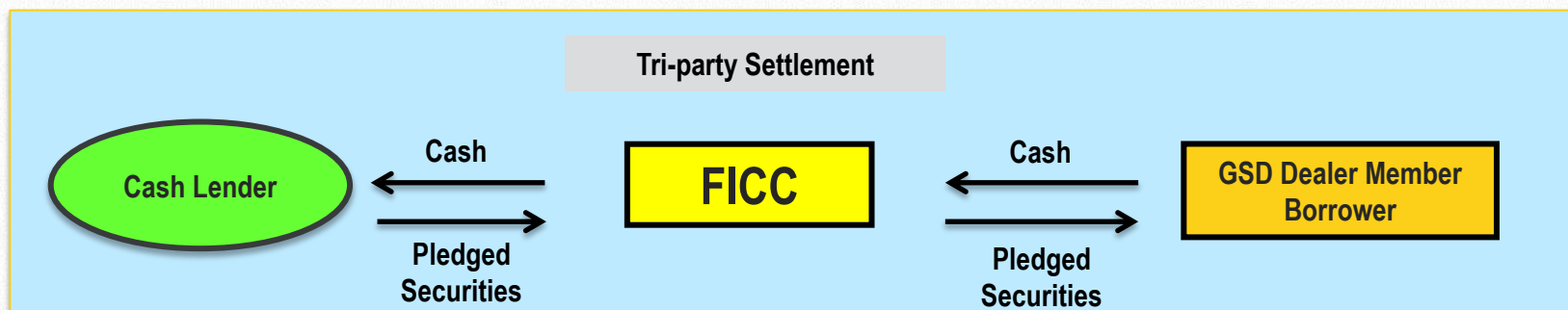


# CCIT Service: Trade Flow

## During Life of Trade

Dealers can substitute pledged collateral during the day.

## End of Trade



Assuming no other new trade was added, off leg of tri-party trade unwinds:

**Step 1:** Clearing Bank moves pledged collateral out of Cash Lender's account to FICC's account in exchange for cash - original value (interest paid via Funds Only Settlement).

**Step 2:** Clearing Bank moves pledged collateral out of FICC's account into GSD Dealer Member Borrower's account in exchange for cash - original value (interest paid via Funds Only Settlement).

# CCIT Service: Account Structure

- As principal counterparties to the CCP, individual cash lenders must become CCIT Members at the legal entity level. All individual funds must go through the GSD membership process.
- For trade matching purposes, GSD accounts for cash lenders may be opened at the legal entity level of the fund or at the joint account level. Investment advisers, agent lenders or other authorized agents may submit trades to FICC on behalf of their cash lender clients.
- Each cash lender or joint account (as applicable) will also be required to enter into a specific custody agreement at BNYM for the CCIT Service.



# CCIT Service: Risk Management

- CCIT Members: In lieu of collecting Clearing Fund (like FICC does with its Netting Members), CCIT Members will instead by rule grant FICC a lien in the collateral posted to them in tri-party, which would be exercisable by FICC only if a CCIT Member were to default, to protect the CCP from a market risk perspective, i.e., if a CCIT Member were to default to FICC, FICC would be permitted by rule to instruct the Clearing Bank to deliver to FICC the securities that the CCIT Member is obligated to return to FICC against payment by FICC of the repurchase price of the CCIT trade. Related legal comfort for FICC will be required.
- Netting Members: Netting Members' CCIT trade activity will be risk managed by FICC in the same manner as their GCF Repo Trade activity through the collection of Clearing Fund.

# CCIT Service: Dealer Default Loss Waterfall

- In light of the fact that cash lenders will only engage in reverse repos in the CCIT Service, and the fact that the lien structure (described above) mitigates market risk if the cash lender defaults, a cash lender will only be subject to potential loss allocation obligations with respect to CCIT Transactions it had open with a defaulted Dealer Member at the time of its default, and not the potential loss mutualization obligations to which Netting Members are subject.
- Funds available to absorb Dealer Member default losses before any loss allocation to GSD Membership (including CCIT Membership)
  - Defaulted Dealer Member's Clearing Fund deposit
  - Amounts from Cross Margining / Cross Guaranty Arrangements
  - Up to 25% of FICC retained earnings, or such higher amount as the DTCC Board determines
- Loss Allocation Steps:
  1. All assets traded with the defaulted Dealer Member in clearing at GSD are liquidated.
  2. The net losses (if any) after application of the funds available to absorb Dealer Member default losses (described above) are then proportionally distributed across (i) Netting Members who are subject to default loss mutualization (referred to in GSD Rules as "Tier 1 Members") and (ii) CCIT Members who are subject only to default loss allocation if they had open CCIT Transactions with the defaulted Dealer Member at the time of its default (referred to in GSD Rules as "Tier 2 Members").



# CCIT Service: Dealer Default Loss Waterfall

- Loss Allocation Steps (continued):
  3. All losses are summed up and the proportional distribution of those losses between Tier 1 Members and Tier 2 Members is calculated. Separately, all Tier 2 Member losses are summed up and the proportional distribution of those losses amongst Tier 2 Members is calculated.
  4. Proportional Tier 1 Member losses are mutualized across all Tier 1 Members in two steps:
    - Up to \$50,000 assessed equally to all Tier 1 Members' Clearing Funds
    - Assuming \$50,000 assessment of all Tier 1 Members is not sufficient, remaining losses are allocated to Tier 1 Members pro rata based on daily average level of Members' clearing fund in last 12 months
  5. The total Tier 2 Member losses are pro rata distributed across the Tier 2 Members that incurred losses during the liquidation process. Loss Allocations are distributed based on the loss incurred at the Generic CUSIP level.

# CCIT Service: Dealer Default Loss Allocation

## Waterfall Example

RESULT OF REPO SECURITIES LIQUIDATION		
1	TIER 1 MEMBER A	\$5,000,000
	TIER 1 MEMBER B	-\$5,000,000
	TIER 1 MEMBER C	-\$15,000,000
	TIER 2 MEMBER A	-\$20,000,000
	TIER 2 MEMBER B	-\$10,000,000
	TIER 2 MEMBER C	\$15,000,000
	TOTAL LOSS	-\$30,000,000

-\$20,000,000
-\$30,000,000

### PROPORTIONAL DISTRIBUTION OF ALL LOSSES

TIER 1	40%
TIER 2	60%

### PROPORTIONAL DISTRIBUTION OF TIER 2 MEMBER LOSSES

TIER 2 MEMBER A	67%
TIER 2 MEMBER B	33%

FUNDS AVAILABLE TO ABSORB LOSSES:		
2	1. DEFAULTED MEMBER'S CLEARING FUND	
	2. CROSS MARGINING / CROSS GUARANTY	\$20,000,000
	3. 25% OF FICC RETAINED EARNINGS	

NET LOSS		
3	FUNDS AVAILABLE TO ABSORB LOSSES - TOTAL LOSS	-\$10,000,000

PRO RATED DISTRIBUTION ACROSS OF NET LOSS MEMBER TYPES		
4	TIER 1 MEMBER LOSSES = 40% OF -\$10,000,000	-\$4,000,000
	TIER 2 MEMBERS LOSSES = 60% OF -\$10,000,000	-\$6,000,000

PRO RATED ALLOCATION OF TIER 2 MEMBER LOSSES		
5	TIER 2 MEMBER A LOSSES = 67% * -\$6,000,000	-\$4,000,000
	TIER 2 MEMBER B LOSSES = 33% * -\$6,000,000	-\$2,000,000

MUTUALIZATION OF TIER 1 MEMBER LOSSES		
6	UP TO \$50,000 ASSESSED EQUALLY TO ALL TIER 1 MEMBERS' CLEARING FUNDS	---
	REMAINING LOSS AMOUNT AFTER \$50,000 ASSESSMENT IS ALLOCATED TO TIER 1 MEMBERS PRO RATA BASED ON AVERAGE DAILY LEVEL OF MEMBER'S CLEARING FUND IN LAST 12 MONTHS	---



# CCIT Service: Liquidity Facilities

- In order to ensure that FICC maintains sufficient liquidity in a Netting Member default situation, each CCIT Member will be required (by rule) to provide temporary liquidity to FICC (in the form of a tri-party MRA repo with FICC collateralized at 102%) to the extent such liquidity is required by FICC in the event that a Netting Member with whom the CCIT Member transacted in clearing defaults to FICC.
  - Liquidity repo commitment is limited to the amount of a CCIT Member's outstanding cleared activity with the defaulted Netting Member.
  - Liquidity repo commitment is terminable on demand by FICC, subject to a maximum draw period of 30 days for U.S. Treasuries and Agencies and 60 days for Agency MBS.
- Uncommitted Liquidity Repo: Cash lenders will also (by rule) enter into a uncommitted MRA repo with FICC, whereby a cash lender could choose (but would not be required) to provide liquidity to FICC on demand by FICC in a GSD Dealer Member default situation.

# SFT Clearing Initiative



## **Sponsoring Member/Sponsored Member Program**

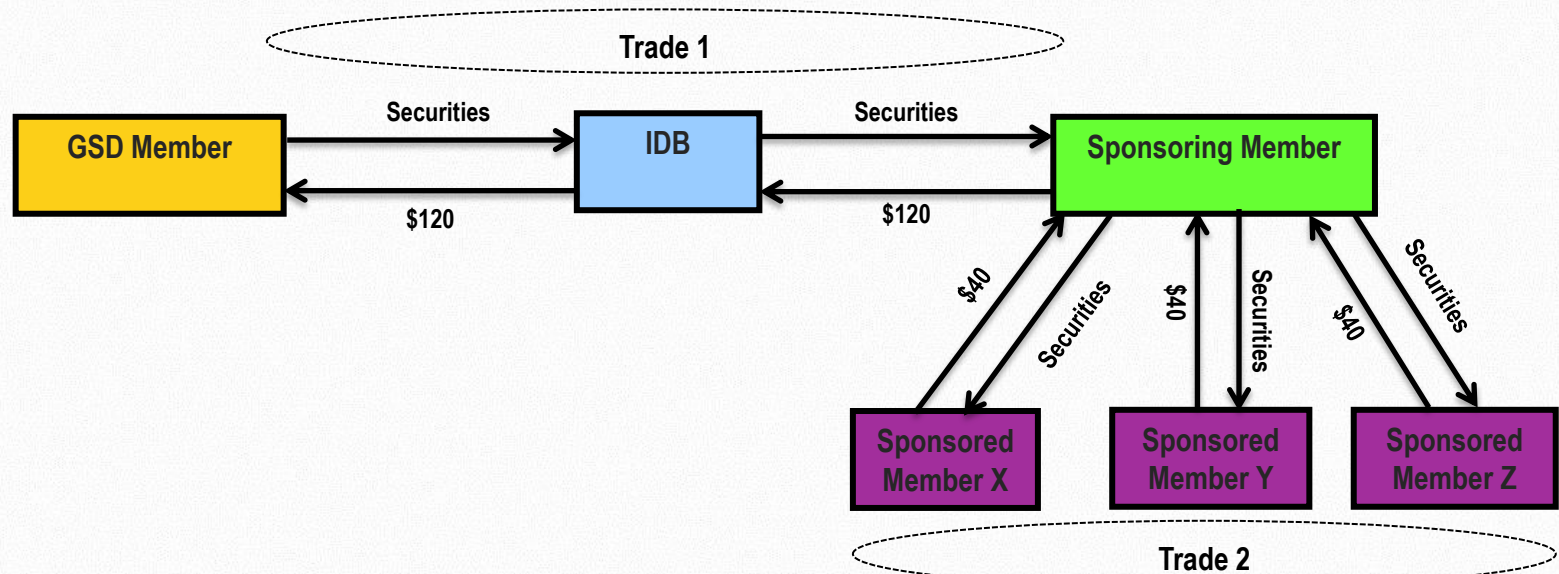


# Sponsoring/Sponsored Member Program – Current Service Offering

- Since 2005, FICC/GSD has offered a program under Rule 3A that allows GSD Bank Netting Members that are (i) “well-capitalized” (as defined by applicable regulations) and (ii) have at least \$5 billion in equity capital to act as “Sponsoring Members” for purposes of sponsoring certain buy-side entities (“Sponsored Members”) into GSD membership.
- For operational and administrative purposes, a Sponsoring Member acts as processing agent on behalf of its Sponsored Members and establishes an omnibus account for all of its Sponsored Members’ activity, which is separate from the Sponsoring Member’s regular FICC/GSD netting account.
- Sponsored Members are only permitted to trade with their Sponsoring Member(s) in clearing.
- Currently, eligibility to become a Sponsored Member is limited to entities that (i) are Registered Investment Companies (RICs); (ii) are also Qualified Institutional Buyers (QIBs) under Rule 144A of the Securities Act of 1933; and (iii) have at least one Sponsoring Member custody bank willing to sponsor them into FICC/GSD membership.
  - In light of eligibility in the existing service being limited to RIC custody clients of Sponsoring Members, trading activity in the program has historically been limited to overnight DVP repo (with the RIC Sponsored Members acting as cash lenders in the repo transactions).

# Sponsoring/Sponsored Member Program – Sample DVP Trade Flow

## Trade Bookings – Same Day Start Repo



### Trade Steps:

**Step 1:** Sponsoring Member executes a \$120 overnight Reverse Repo versus GSD Member through IDB.

**Step 2:** IDB sends FICC 2-sided submission for Trade 1. Trade 1 Data = Sponsoring Member's Reverse Repo with GSD Member booked to Sponsoring Member's Netting Account. GSD Member's Repo with Sponsoring Member booked to GSD Member's Netting Account. Upon FICC match, the off leg of Trade 1 is guaranteed and novated to FICC.

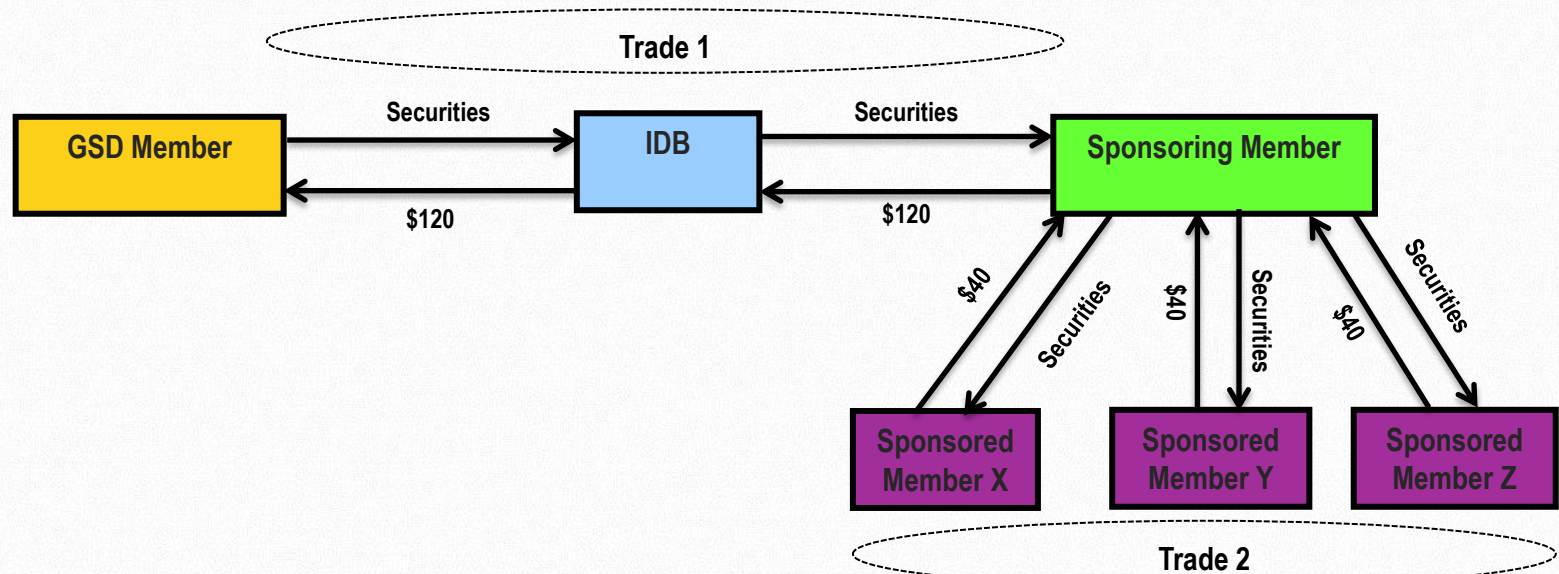
**Step 3:** Sponsoring Member executes three overnight Repos versus Sponsored Members X, Y and Z (\$40 each).

**Step 4:** Sponsoring Member sends FICC 2-sided submission for Trade 2. Trade 2 Data = Sponsoring Member's Repos with each of Sponsored Members X, Y and Z booked to Sponsoring Member's Netting Account and each of Sponsored Member X, Y and Z's Reverse Repos with Sponsoring Member booked to the Sponsoring Member Omnibus Account. Upon FICC match, the off leg of Trade 2 is guaranteed and novated to FICC.



# Sponsoring/Sponsored Member Program – Sample DVP Trade Flow

## Start Leg Settlement



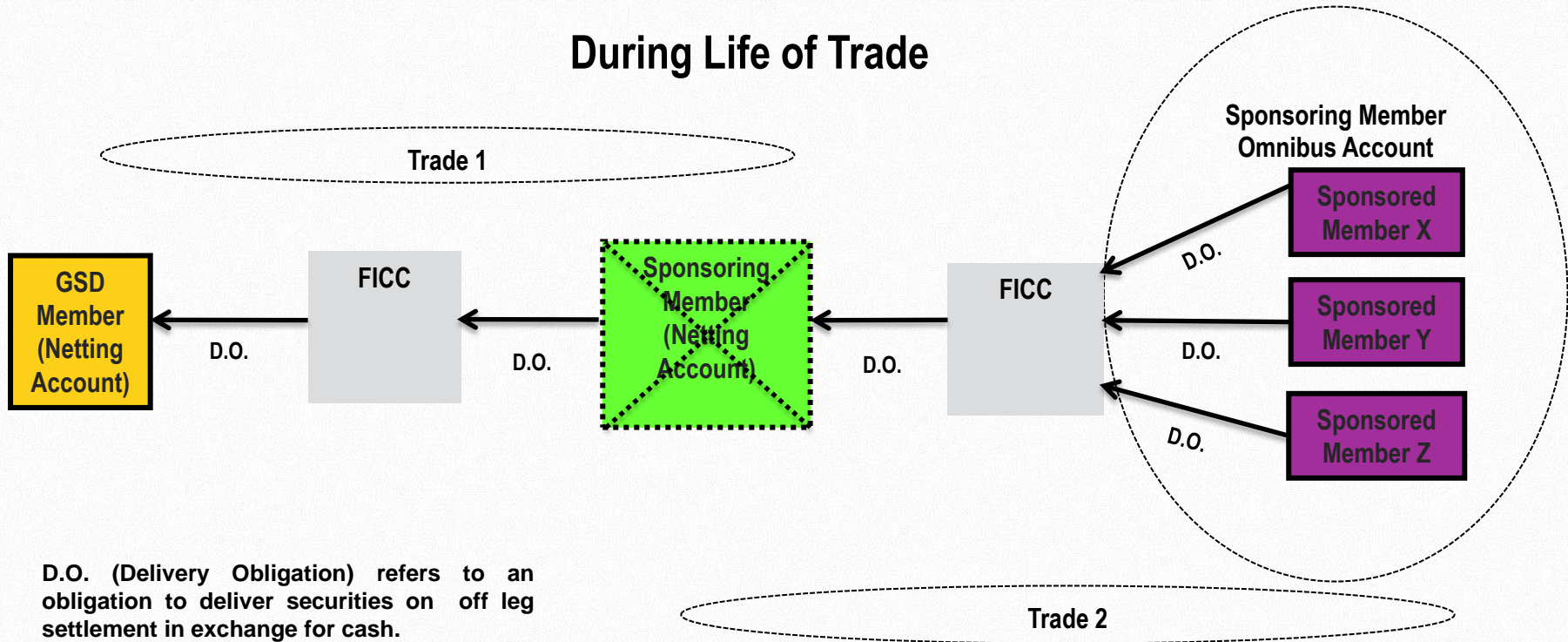
### Start Leg Settlement Steps:

**Step 1:** IDB delivers securities versus cash to the Sponsoring Member.

**Step 2:** Sponsoring Member has the securities in its box and subsequently books three Repo trades (\$40 each) versus each of Sponsored Members X, Y and Z and holds the securities on their behalf.

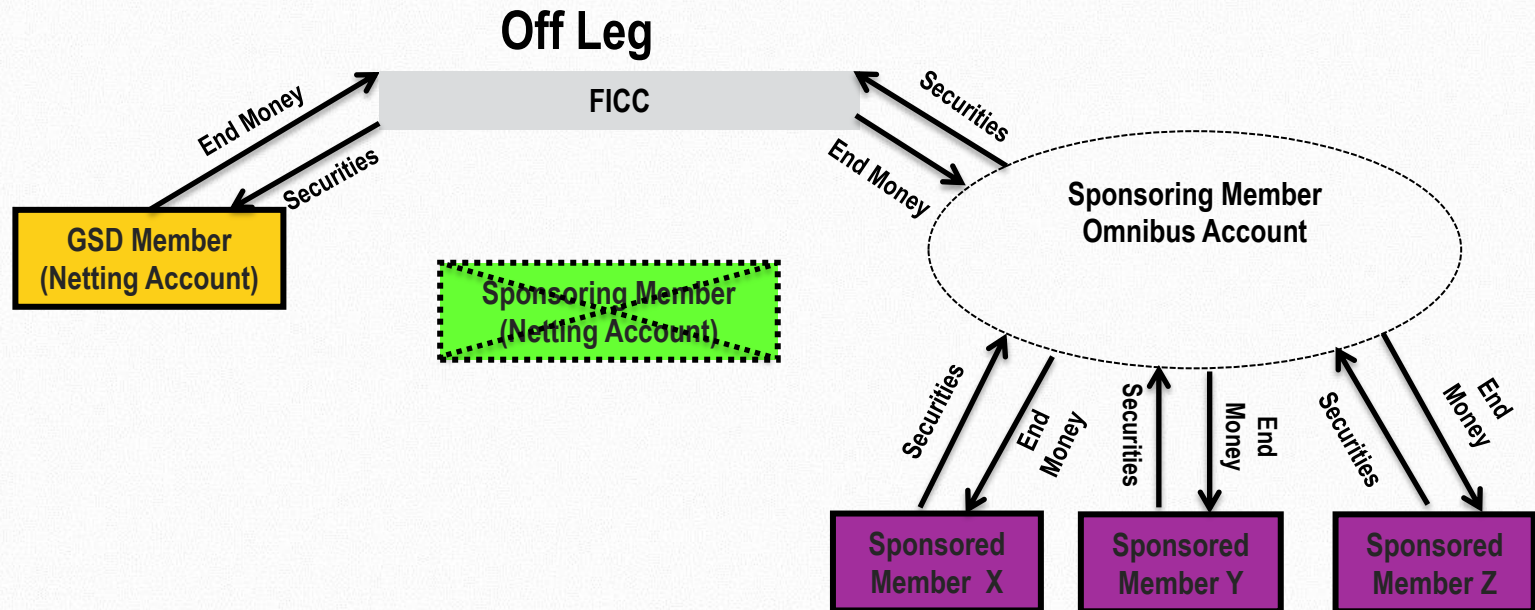
# Sponsoring/Sponsored Member Program – Sample DVP Trade Flow

## During Life of Trade





# Sponsoring/Sponsored Member Program – Sample DVP Trade Flow



## Off Leg Settlement Steps:

**Step 1:** The night before the off leg is due to settle, FICC runs a net. The Sponsoring Member's Netting Account is flat. FICC instructs (1) the Sponsoring Member's Omnibus Account to deliver \$120M securities to FICC on the next business day versus the end money and (2) the GSD Member to receive \$120M securities from FICC on the next business day versus the end money.

**Step 2:** The next business day, (1) the Sponsoring Member delivers \$120M securities to FICC on behalf of the Sponsoring Member's Omnibus Account versus the end money as instructed and (1) the GSD Member receives the \$120M securities versus the end money as instructed.

# Sponsoring/Sponsored Member Program – Risk Management

- FICC's risk management of the arrangement occurs primarily at the Sponsoring Member level.
- All applications for Sponsoring Membership are decided on by FICC Management and the FICC Board of Directors.
- The Sponsoring Member is responsible to FICC for posting all of the Clearing Fund associated with the activity of the Sponsoring Member Omnibus Account, which is calculated twice daily on a gross basis (i.e., for Clearing Fund calculation purposes, each Sponsored Member's trading activity is VaR margined separately and the sum of those total VaR charges is collected and held by FICC separate from the Clearing Fund posted by the Sponsoring Member for its proprietary activity).
- While the Sponsored Members are principally liable to FICC for their securities and funds-only settlement obligations, the Sponsoring Member is required to provide a guaranty to FICC with respect to all obligations of its Sponsored Members, so that if a Sponsored Member does not satisfy any of its obligations to FICC, FICC can invoke the Sponsoring Member's guaranty.
- Liquidity needs created by activity in the Sponsoring Member Omnibus Account will be considered when calculating the Sponsoring Member's Capped Contingent Liquidity Facility (CCLF) requirement (subject to regulatory approval).



# Planned Expansion of FICC Sponsoring/Sponsored Member Program

- Subject to regulatory approval (anticipated in Q2 2017),
  - Any legal entity that satisfies the QIB standard and has at least one Sponsoring Member willing to sponsor it into FICC/GSD membership will be eligible to participate in the program as a Sponsored Member;
  - Eligible transactions will include two-directional (i.e., cash borrowing and cash lending) overnight and term DVP repo in U.S. Treasury and Agency securities; and outright purchases and sales of such securities; and
  - No custodial relationship will be required by FICC for purposes of a client being sponsored into FICC membership by a Sponsoring Member.

# SFT Clearing Initiative



## Next Steps for FICC



# Potential Future SFT Service Offerings

- Start Leg Repo Settlement
- Enhancements to GCF Repo
  - Non-Broker functionality
  - Sponsored functionality
- Equity/Corporate Financing (Securities Lending & Repo)
- Limited CCP membership for firms with matched-book, two-directional activity