The New Execution & Clearing Regime

Documentation: Master Netting Agreements, the Future of the ISDA Master Agreement and Clearing Documentation and Processes

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Introduction

- The Bilateral versus Cleared Trade
- The Matched Principal and FCM models of clearing
- The choice of documentation
- The Capital drivers
- Other challenges to the ISDA
- Timelines

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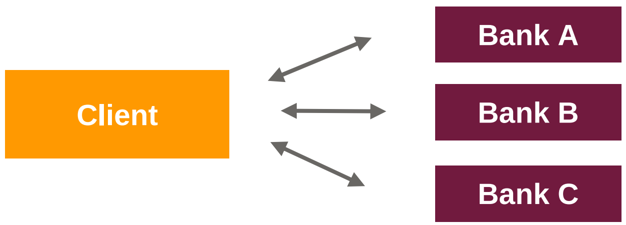
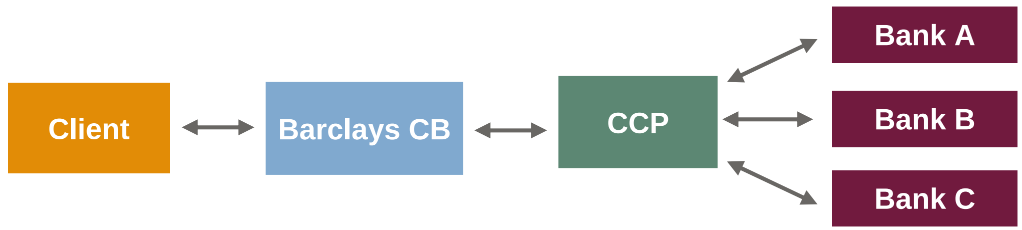
Bilateral vs Cleared Trade

The introduction of OTC Clearing has changed the relationship model

Bilateral Trade	Cleared Trade





Bilateral Trade

- Voice Execution bilaterally agreed upon with Client & Dealer
- Counterparty Exposure is to multiple trading partners
- Must have ISDAs in place with all trading partners
- Margin requirements based on Dealer methodologies
- Initial Margin (IM) held at dealer or third party custodian
- Operational Model is not efficient:
  - Unwinds / Assignments to close out positions
  - Multiple Wires & Collateral calls
  - Inconsistent marks & valuations

Cleared Trade

- Voice Execution bilaterally agreed upon with Client & Dealer
- Counterparty Exposure is limited to one counterparty
  - Margin requirements are based upon CCP margin methodologies
  - Initial Margin (IM) is held in a segregated account at the CCP
  - Variation Margin (VM) passes through to CCP
- Operational Model is efficient
  - Offsetting trades needed to close out positions for Credit trading. Unwinds / Assignments no longer needed.
  - Reduces the number of wires and collateral calls
- In the event of a clearing broker default, the client’s segregated margin at the CCP can be used to port (transfer) the client’s positions to another clearing broker at the same CCP

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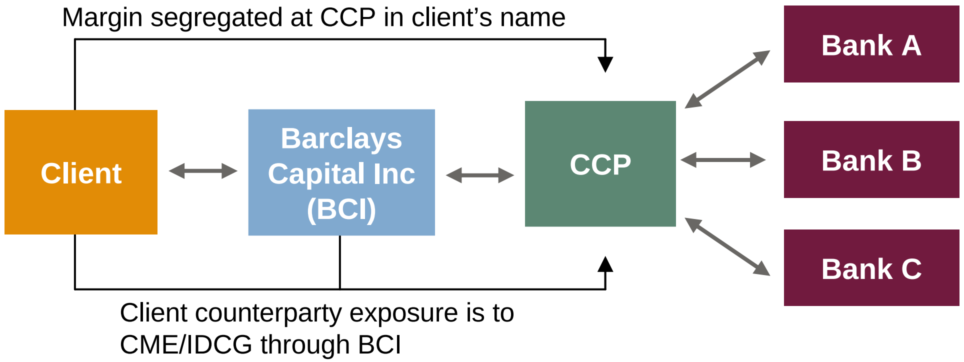
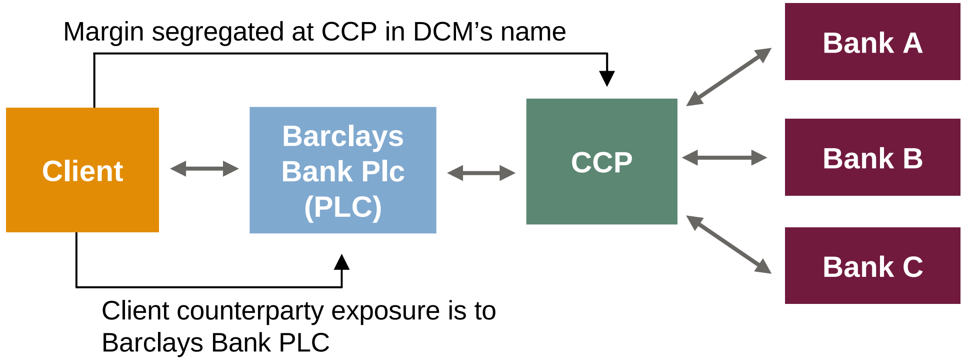
Cleared Trade: Agency and Principal Model

FCM / Agency Model	DCM / Principal Model

Execution identical for both models (through Barclays Bank Plc)



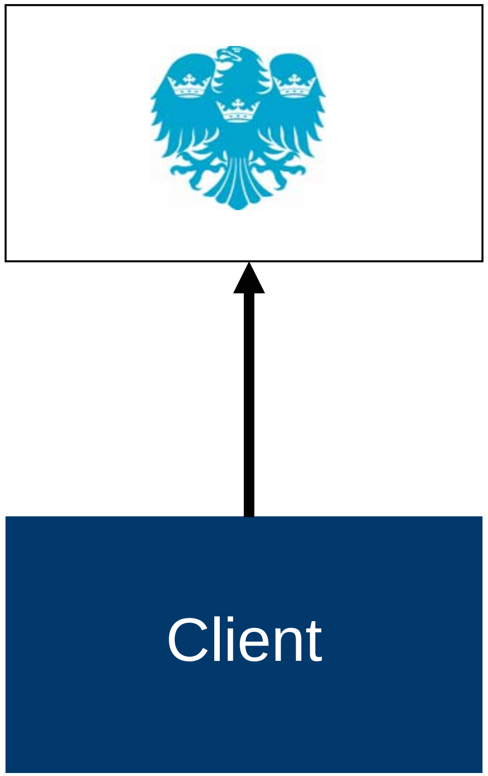
FCM access offers protections including margin collateral being held in the US, portability of client collateral and positions, and arrangements governed under New York State law



While exposure under the DCM model is legally to BBPLC for both trade and collateral, this is protected via the "Deed of Assignment"

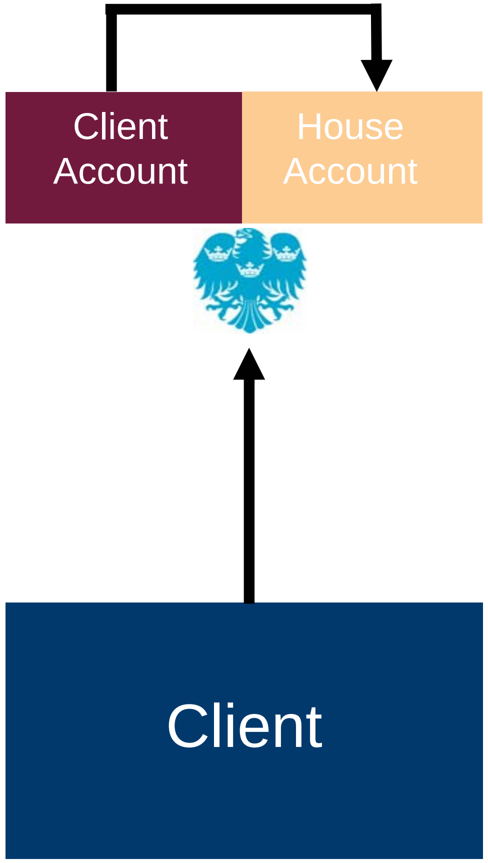
Key Facts	Agency Model	Principal Model
Barclays Execution Entity	Barclays Bank Plc (PLC)	Barclays Bank Plc (PLC)
Barclays Clearing Entity	Barclays Capital Inc (BCI)	Barclays Bank Plc (PLC)
Counterparty Exposure	LCH (US)/CME/IDCG through Barclays Capital Inc	Barclays Bank PLC
Legal Documentation	Futures Based	ISDA Based
Give-up Agreements	Yes	Yes
CCP Offering	LCH (US), CME, ICE Trust	LCH, ICE Clear
Margin Protection	Client Net Omnibus	Individual Seg at LCH, partial seg at ICE Clear

Combined executing broker/clearing broker model



- Dealer agrees to put on a trade with the Client
- Governed by an amended ISDA Master Agreement
- Parties agree that the trade is to be “cleared”

Combined executing broker/clearing broker model



- Dealer books a mirror trade between its "client" and "house" accounts
- Dealer submits details of mirror trade to CCP to be cleared

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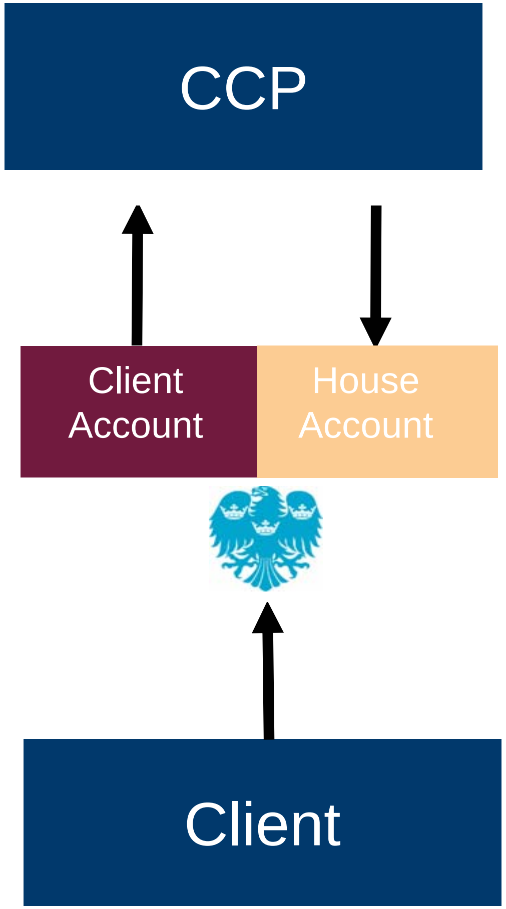
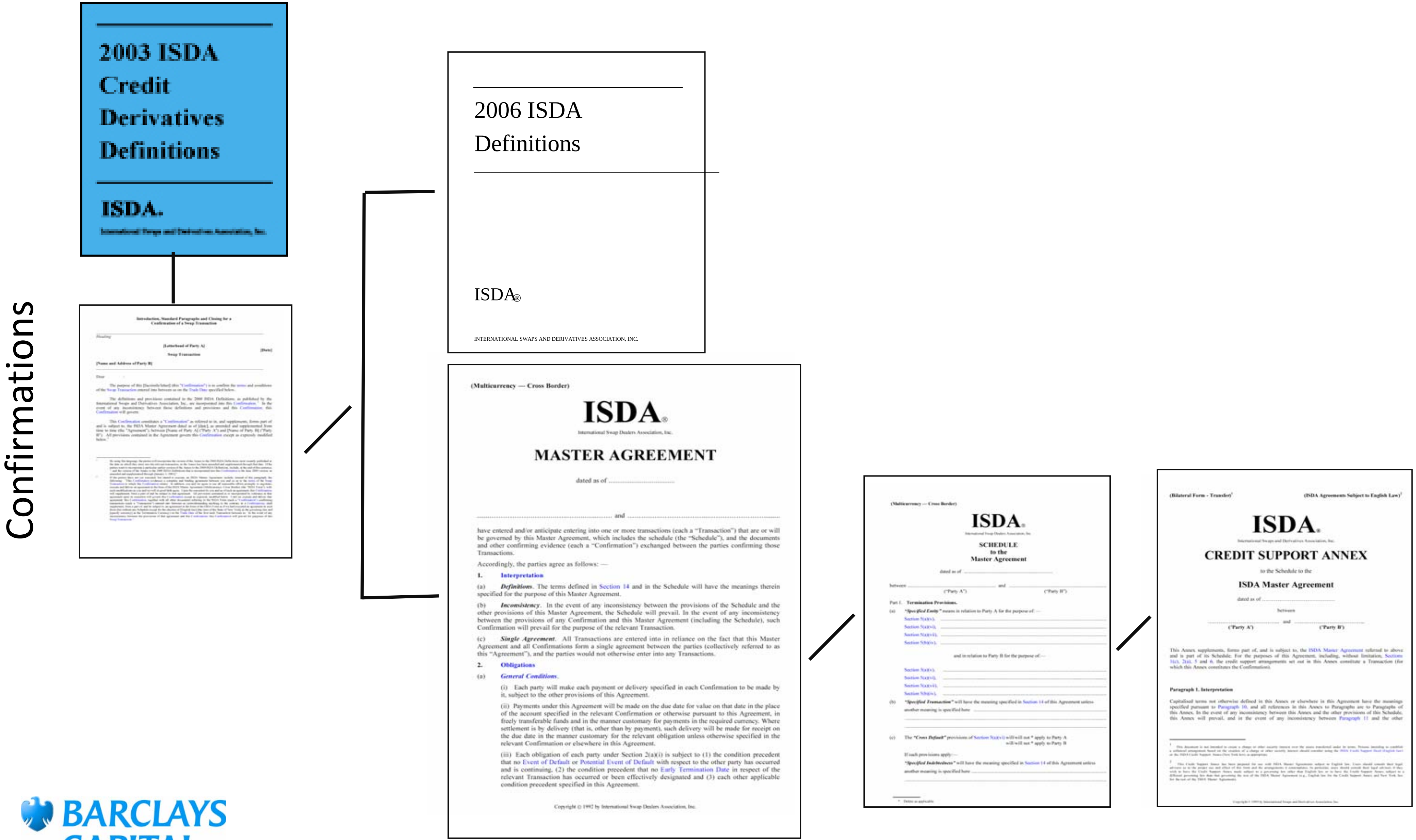
Combined executing broker/clearing broker model



- Upon registration at CCP, the position booked between dealer’s house and client accounts is cancelled
- Replaced by two back-to-back cleared trades
  – between dealer’s client account and CCP
  – between CCP and dealer’s house account

Documentation Platform for OTC



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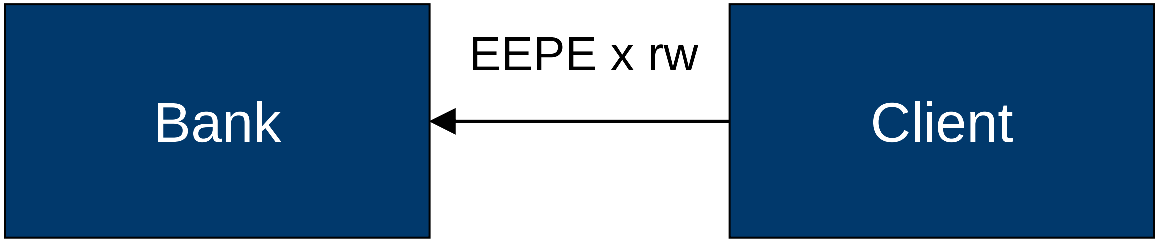
Cleared Trading Documentation

- Can be based upon the ISDA model
- Significant amendments required to reflect the rules of the CCP
- An alternative is to use "futures" style documentation
- Either approach needs to capture core requirements relating to the treatment of collateral and porting, in conjunction with the CCP rules
- Trading through CCPs also introduces additional sources of laws which define the relationship between the parties, such as idiosyncratic insolvency laws (e.g., those introduced under the Companies Act 1989 in the UK)
- Various drivers will influence the future model of participation in CCPs and the client facing documentation
- One of those factors is likely to be capital……why?

OTC business Basel 2

Current treatment



The bank is exposed to the client's non-performance. This is calculated (for example) under an EEPE waiver.

The charge considers the MtM, a Monte-Carlo simulation of exposure based on the underlying market risk factors and the frequency and level of re-margining. This is risk weighted.

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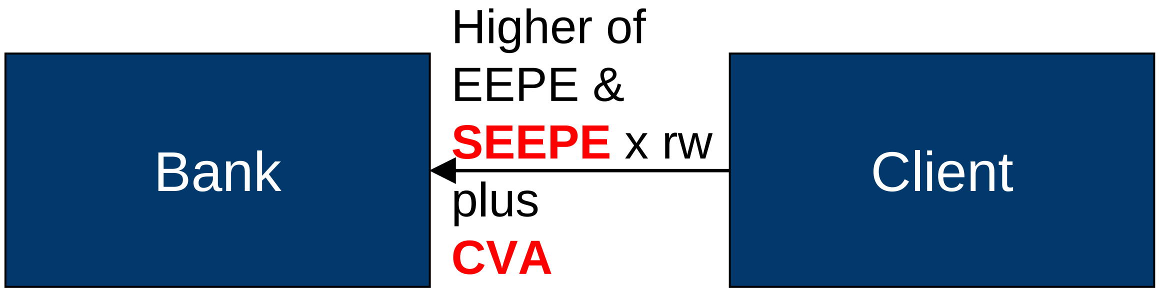
OTC business Basel 3

Future treatment



Basel 3 introduces Stress EEPE based charges and a charge for the client's credit quality volatility (CVA) to recognise the risk of raising market based credit provisions.

Basel 3 counterparty risk charges are anticipated to be approx 3 times higher than the Basel 2 equivalent.

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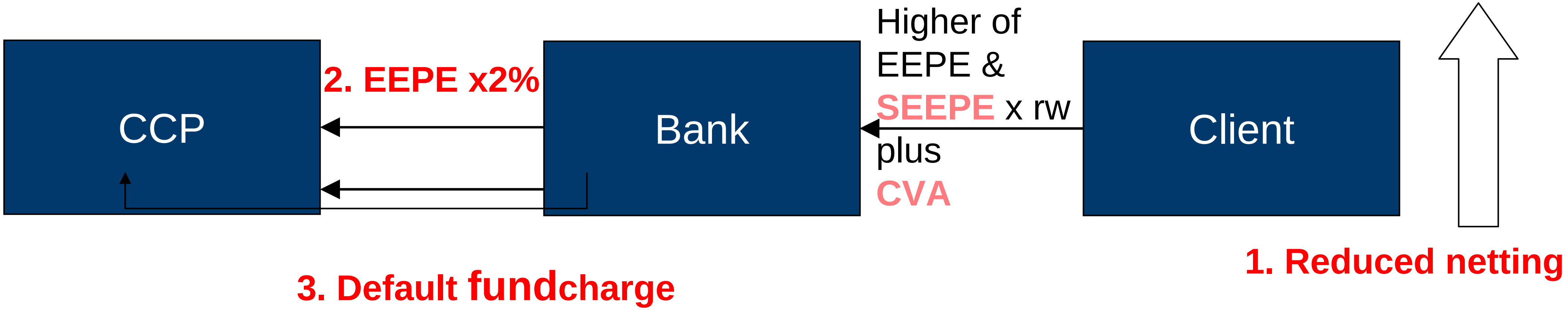
Cleared OTC business Basel 3

Proposed treatment introduces 3 sources of increased capital requirement



The proposals leave the client facing trade as OTC, still subject to SEEPE and CVA. In fact due to reduced netting arising from trades being taken out of ISDA documents and being included in exchange documents, this relationship is likely to have higher EEPE, SEEPE and CVA.

The charges against the CCP will be based on the client and house trades (i.e. for 1 bilateral swap between clearing bank and client, there will be 2 swaps with the CCP, 1 house and 1 client). This is calculated as EEPE x 2%, whilst the rw is low the EEPE is additive to the pre-existing OTC position.

The CCP is likely to have a higher CEM based default fund charge. This is charged as 100% capital (1250% risk weight). This is additive to the pre-existing Basel 3 OTC charges

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Master Netting Agreements

- The Banking Consolidation Directive
- The risk of fragmentation and disaggregation of trading risk
- Increased direction in trading books
- Other changes on the horizon?

Market Landscape

Timeline to OTC Clearing

Jul ’10	Sep ’10	Dec ’10	Mid 2011	Late 2011	End 2011	2012
Dodd-Frank Financial Reform Bill signed in the US	European Markets Infrastructure Regulation published	ECOFIN Agreement expected	EU Parliament vote expected	US mandatory clearing effective*	European Secondary legislation	European mandatory clearing effective

US

- US Financial reform bill (Dodd-Frank) was signed into law in the US on 21st July 2010
  - Swap dealers and major swap participants required to clear swaps through a clearing house
  - Transactions to be executed on a central exchange
  - Requires reporting of swap transactions to regulators in a timely manner

* US mandatory clearing will be required the latter of 360-days from the date of signing Dodd-Frank, or 60-days after the SEC/CFTC have completed the rule writing

Europe

- European Markets Infrastructure Regulation was published on 15th September 2010
  - Mandates most investors to clear OTC derivatives through a clearinghouse
  - Cleared and non-cleared OTC derivatives to be reported to a trade repository
  - Notable for its similarities with Dodd-Frank in the US

NB: European Legislation is currently only a proposal – it is subject to change as it goes through the political process

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