SwapClear

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LSOC with Excess Explained

Highlights:

- Ability to hold excess collateral at the CCP
- Decreases prospect of swap portfolio liquidation
- Increases likelihood of porting
- Potential for rapid asset value recovery
- *Expected at SwapClear, September 2013*

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LSOC WITH EXCESS EXPLAINED

Introduction

The introduction of mandatory buy-side clearing has caused a seismic shift in the derivatives market structure. While the sell-side had been clearing swaps and other derivatives for many years, the process was new for most buy-side customers. While comfortable with the principles behind clearing, many customers were wary of the existing "omnibus" model for collateral segregation due to "fellow customer risk" concerns. In response, the U.S. Commodity Futures Trading Commission (CFTC) introduced the LSOC (Legally Segregated, Operationally Commingled) model for segregation of cleared swaps customer collateral, which prohibits derivatives clearing organizations (DCOs) from using the value of collateral from one customer of a futures commission merchant (FCM) to cover another customer's losses.

Under LSOC, each FCM and DCO must segregate the cleared swaps and collateral of a customer from the obligations of the FCM, DCO and any other customer on their respective books and records. Due in large part to the complex operational changes it required, LSOC was introduced in two phases: LSOC without Excess, followed by LSOC with Excess.

Comparing the Two Models

	Removes Fellow Customer Risk	Excess permitted at DCO
LSOC without Excess	✓	
LSOC with Excess	✓	✓

LSOC without Excess is the current industry standard for swaps. It requires a DCO to accept, and segregate on its books and records, only the minimum collateral required to meet initial margin requirements of customer cleared swaps. The FCM holds any excess collateral. There are no FCM reporting requirements to the DCO under this model, which was implemented by LCH.Clearnet Limited in November 2012.

LSOC with Excess allows customers to take advantage of the ability to pledge excess collateral to the DCO. In the view of LCH.Clearnet, benefits for the customer in the event of an FCM default include a lower likelihood of liquidation and therefore a higher probability of portability—the ability for a customer to move its portfolio and collateral to another FCM—and the potential for speedier asset recovery.

LSOC with Excess is intended to be offered by LCH.Clearnet Limited in September 2013.

LSOC WITH EXCESS EXPLAINED

Lower Chance of Liquidation

With LSOC with Excess, customers have a better chance of preventing their portfolio from being liquidated by the DCO in an FCM default event. This is because swap portfolio liquidation has a higher chance of taking place if the DCO is uncomfortable with its level of exposure compared to the value of available collateral that it holds for a given customer. Customers with excess collateral are less likely to be liquidated, as their swap portfolio is unlikely to give rise to such concern at the DCO. This allows the customer additional time to avoid the market losses and opportunity costs associated with liquidation and to maintain the ability to port to another FCM.

Liquidation Risk

	Position	Initial Margin Requirement	Collateral	Risk of Liquidation
Client 1 [No excess collateral at the DCO]	5-year IRS	$1,000	$1,000	Higher
Client 2 [Excess collateral at the DCO]	5-year IRS	$1,000	$5,000	Lower

Becoming a More Desirable Porting Candidate

Customers that have excess collateral posted at the DCO prior to the default of their FCM are more likely to have a positive collateral account balance at the time of a bulk port ordered by a U.S. bankruptcy court, and therefore may be much more attractive to potential transferee FCMs. This is because FCMs must cover any shortfall in initial margin as part of receiving a new customer in a port, and there is potentially a lower risk and cost to the FCM associated with receiving a customer with excess collateral.

Portability

	Collateral	Day 1 – Day 3 Variation Margin	Balance	Deficit	Portable Candidate Desirability
Client 1 [No excess collateral at the DCO]	$1,000	-100	900	100	Lower
Client 2 [Excess collateral at the DCO]	$5,000	-100	4,900	0	Higher

Speed of Asset Recovery

Liquidated Customers

In the event that LCH.Clearnet determines it is necessary to liquidate a customer's swap portfolio, that customer's portfolio will be moved by LCH.Clearnet to a default management account for hedging and eventual liquidation. Final liquidation will not occur until after all customers' swaps are either ported or moved into the default management account and LCH.Clearnet is able to auction the hedged swap portfolios. As such, the court will be unable to determine the value of collateral that can be distributed to such customer, as LCH.Clearnet will not know the "cost" of hedging and auctioning the customer's swap portfolio until after the completion of the auction process. In the view of LCH.Clearnet, it is therefore highly unlikely that collateral will be returned to customers whose swaps are to be liquidated with the same speed at which some collateral may be returned to customers who are able to port.

Porting Customers

LCH.Clearnet believes that under LSOC with Excess, the trustee and the court will likely determine the amount that should transfer with each customer based on the value of collateral segregated and allocated to each customer at the DCO. Customers with excess collateral value allocated to them at the DCO are therefore more likely to have the court direct the DCO to transfer their cleared swaps with some or all of their associated excess collateral value. Of course, it is also possible for the court to direct the DCO to transfer excess collateral value with customers even if at the time of default their excess collateral was held at the defaulted FCM. In either case, it is worth noting that because the distribution of property to customers is ratable, and the trustee and court will likely be concerned with overpayment in any initial distribution, customers included in the initial distribution may not necessarily receive the full value of collateral allocated to them at the DCO or defaulted FCM. They should at least however have the benefit of a speedier recovery of some, if not a majority, of their asset value. Determinations relating to the timing of distribution of collateral, and the value of collateral to be distributed, are not an exact science. Further details relating to the legal process surrounding such determinations are set out in the following section.

LSOC WITH EXCESS EXPLAINED

The Legal Process

The legal process associated with an FCM default is typically lengthy. Once an FCM files for bankruptcy protection, all of the estate assets, including customer collateral, are frozen by the bankruptcy court. Only a court-ordered distribution can result in the collateral being transferred to a transferee FCM or returned to a customer. In an FCM default, the court will instruct the DCO to distribute collateral as part of a bulk transfer of customers to one or more transferee FCMs. Typically, only customers whose positions can be ported are included in this first distribution of collateral—normally in the first few days following the bankruptcy. The amount the court will allow the DCO to transfer may be somewhat conservative to ensure that collateral is not overly distributed to any single group of customers, and that a rapid determination can be made to expedite the bulk port. For amounts that are not distributed as part of a bulk distribution, customers will need to file a claim with the trustee and court for the amount still owed by the estate of the defaulted FCM.

Under the CFTC's Part 190 rules and Section 766(h) of the Bankruptcy Code, at the end of the bankruptcy process, all swaps customers will be returned the amount owed by the estate of the bankrupt FCM (or an equal share of their claim in the event of a shortfall as a result of fraud, etc.). But the length of time it takes to recover the funds can vary. The final distribution generally occurs much later, once the trustee and court are able to determine the exact amount that should be distributed to each customer. As such, customers can increase the probability of the speedy return of the largest amount of their collateral possible by ensuring that they are not liquidated, and to some extent that their excess is allocated to them at the DCO.

Summary

LSOC with Excess is the latest development in collateral segregation and is expected to be popular with many customers, as it is likely to decrease the prospect of portfolio liquidation and increase the likelihood of porting (which may have an impact on the speed of recovery by customers of a significant portion of their collateral value).

Important: In either LSOC without Excess or LSOC with Excess, customers are encouraged to establish multiple FCM relationships. In general, it is not practical for an FCM to set up hundreds or thousands of new accounts "on the fly" and customers are advised to err on the side of caution. The more FCM relationships that a customer has, the higher the probability of portability.

For a fuller explanation of LSOC with Excess see:
http://www.swapclear.com/knowledge/lsoc-viewer/