Transitioning to a Central Counterparty

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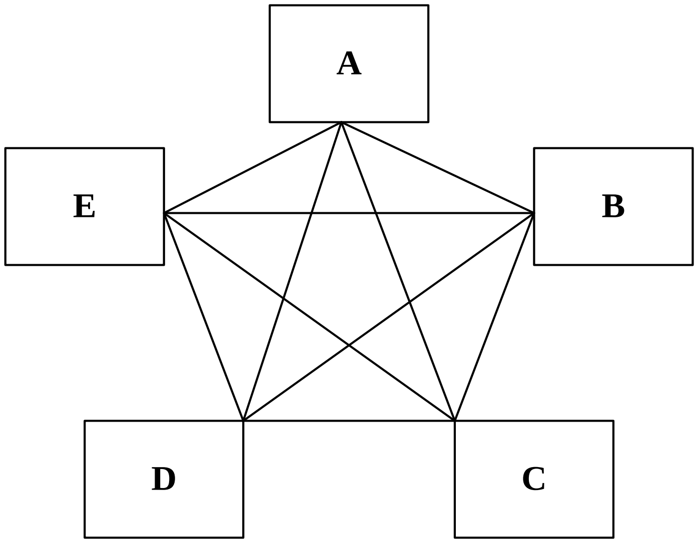
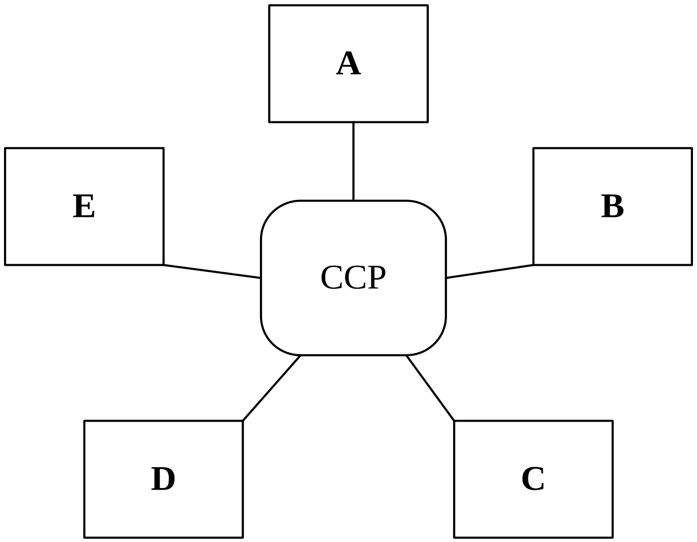
What is a central counterparty?

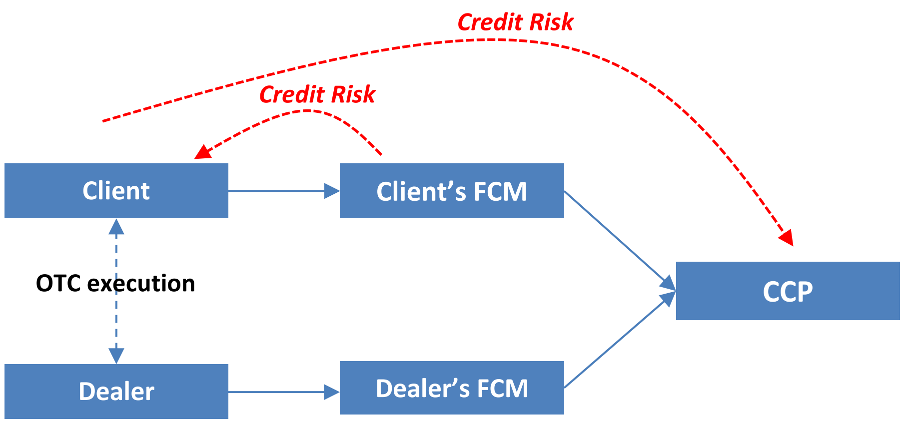
- Central Counterparties
  - Act as market-neutral counterparty for all transactions
  - Centrally manage and mitigate counterparty risk for its participants
  - Reduce total number of positions through netting
  - Manage defaults of participants





Who bears the risk?

- A FCM doesn't guarantee the performance of the CCP to its clients
  - As a result, a client bears CCP counterparty risk
- A FCM guarantees the performance of its clients to the CCP
  - As a result, the FCM bears client counterparty risk



<u>Note</u>: the diagram above is meant to be illustrative and doesn't address agency (US) vs. principal to principal (EU) booking flows, which are generally identical from a risk allocation perspective

Why is central clearing important?

- The financial crisis demonstrated some significant weaknesses in the OTC derivatives market
- With respect to counterparty credit risk management, the bilateral nature of counterparty exposures, coupled with the number of counterparty relationships that existed in the market, created a complex web of interconnections. This counterparty credit risk was not appropriately managed.
- Consequently, in September 2009, G-20 Leaders committed to improving the OTC derivatives market through the following commitments:
    - **Standardized OTC derivatives contracts to be centrally cleared**, as well as traded on electronic trading platforms where appropriate;
    - Trade information to be reported to trade repositories;
    - Uncleared trades to be subject to higher capital requirements;
    - International standards on margining for non-centrally cleared should be developed.

➢ Overall objectives to mitigate systemic risk, increase transparency, and protect against market abuse