Government Securities Clearing Corporation

mbs clearing corporation

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SERVICE BULLETIN

Cross-Margining of Cash and Futures Positions for U.S. Treasury Securities

February 16, 2000

Overview

As announced in a recent Important Notice (GSCC012.00), GSCC will implement a cross-margining relationship with the New York Clearing Corporation (NYCC) on February 25, 2000, which will effectively link the cash and futures markets for U.S. Treasury securities for the first time. This implementation marks the first in a series of cross-margining arrangements GSCC plans to implement with various futures clearing organizations (FCOs)[1] that process fixed-income products, both here in the United States and internationally, over the next several years.

Briefly summarized, the new service will allow for the cross-margining of cash and repo positions held at GSCC against futures positions held at NYCC for all common and/or affiliated members of the two clearing organizations. This could potentially result in a significant reduction in the amount of margin a common member (or affiliate) is required to post at either clearing organization.

The arrangement will be based on an agreement whereby GSCC and the participating FCO (NYCC in this case) will agree to provide each other with access to any proceeds arising from the liquidation of correlated positions and associated collateral in the event of an eligible member's insolvency. Each clearing organization will hold and manage its own collateral; however, the total amount of collateral collected will be reduced to reflect offsets between cash and futures positions.

[1] Discussions to date have included Board of Trade Clearing Corp. (BOTCC), Chicago Mercantile Exchange (CME), and London Clearing House (LCH).

Benefits

Cross-margining programs have long been recognized as enhancing the safety and soundness of clearing systems and reducing clearing system exposure during times of market stress. By minimizing the need for clearing organizations to call for large amounts of additional margin in volatile markets, cross margining reduces the risk of a liquidity crisis of the kind that pressured clearing systems in October 1987. These benefits to the market are accomplished through:

- Providing clearing organizations with more complete data concerning the true risk of inter-market positions;
- Enhanced sharing of collateral resources; and
- Coordination of liquidation processes in the event of a participant's insolvency.

Cross-margining programs also benefit the clearing members that participate in them in a number of ways, including:

- Reduced collateral requirements for common/affiliated members;
- Decreased cost of capital;
- Increased liquidity;
- Improved collateral management; and
- Lower operational costs.

Membership Eligibility Requirements

In order to participate in the cross-margining service, a GSCC member must either

- Be a member of a participating FCO; or
- Have an affiliate that is a member of a participating FCO.

The member must also sign (together with its affiliate, if applicable) a Cross-Margining Participant Agreement allowing GSCC to apply the member's margin collateral to satisfy any obligation of GSCC to a participating FCO in the event of default of the member. (These documents are available on the GSCC Website at www.GSCC.com under "Services," or by contacting Participant Services.)

It should be noted that the use of the cross-margining facility will be virtually transparent to members from an operational standpoint. That is, once a member executes the cross-margining agreement, there will be no further implementation requirements.

Product Eligibility

Upon initial implementation of the cross-margining arrangement between GSCC and NYCC, the following products will be eligible:

- GSCC: 2-Year, 5-Year, 10-Year Note, and 30-Year Bond remaining-maturity class.
- NYCC: 2-Year, 5-Year, and 10-Year Note, and 30-Year Bond futures contracts

Net settlement positions will be eligible for cross-margining regardless of the underlying trade activity (e.g., buy/sell, repo/reverse, auction purchases, futures, etc.).

How the Cross-Margining Service Works

***Internal margining**:* Each day, GSCC and each participating FCO will complete its own internal margining process to determine members' clearing fund requirements. As a result, there may be residual long or short margin positions for members. GSCC and the FCOs will exchange, within agreed upon timeframes, daily position and margin data as to the residual long or short amounts that will be made available for cross-margining offsets on a product or maturity class-by-class basis.

***Cross-margin calculation**: GSCC* and each FCO will agree on the particular products that are eligible for cross-margining treatment. GSCC and each FCO will also agree on a margin formula including:

- Methodology for conversion of futures contracts to Treasury cash equivalents; and
- Disallowance factors, if any, to be applied.

<u>Example:</u> GSCC's long position is less than the aggregate short position available from the FCO (line 1). After the internal calculation of margin (assumed to be at 1%) the FCO would be presented with a reduction for the available offsets (line 2). A minimum margin is applied to offsetting amounts. In this example, the minimum is assumed to be 25%. (line 3). The resulting net margin requirement of the participant is thereby substantially reduced; in this case a reduction of $1,800,000 (line 5). This example demonstrates that the margin savings on matching amounts of offsetting positions could approximate 75%.

Step	GSCC	FCO	GSCC	FCO	Total
	Positions		Margin Requirement		
1. Initial Position	$120,000,000 Long	$140,000,000 Short	$1,200,000	$1,400,000	$2,600,000
2. Cross Margin Allocation	$120,000,000 Short	$120,000,000 Long	($1,200,000)	($1,200,000)	($2,400,000)
3.Minimum Requirement on Offsetting positions (25%)			$300,000	$300,000	$600,000
4. Post Cross-Margining Requirement			$300,000	$500,000	$800,000
5. Cross-Margining Reduction			$900,000	$900,000	$1,800,000

Establishment of Guarantees: The clearing entities will extend guarantees to each other in an amount equal to the cross-margining reduction.

Return of data to FCOs: *The* results of the cross-margining will then be made separately available to the participating FCOs, so that collateral requirements of members may be reduced accordingly.

Independent Collateral Management

Margin collateral will be collected, maintained, valued, and returned separately by each clearing organization pursuant to its own rules and procedures. That means that each clearing corporation will continue to determine the forms of margin that are acceptable collateral, and that both GSCC and the FCOs will independently determine acceptable forms of collateral to provide sufficient liquidity to ensure orderly settlement. The arrangement **does not** involve the pooling of collateral between GSCC and the participating FCOs.

This means:

- The clearing corporation's ability to pledge margin collateral for liquidity purposes is unaffected;
- The clearing corporation's flexibility in managing collateral is unaffected;
- Coordination of margining policies and timeframes is not required; and
- Capped loss sharing arrangement is in place.

Liquidation and Loss Sharing

In the event of the insolvency of a common member, GSCC and the affected FCOs will coordinate their efforts to ensure efficient and orderly liquidation.

Loss sharing between FCOs will be based on applicable formulas and subject to a cap. In the event of the liquidation of a participant, the loss-sharing arrangements between GSCC and each FCO will be proportional to the margin reductions described.

Next Steps

Please complete and return the applicable Cross-Margining Participant Agreement, which is available on the GSCC Web site under "Services" at www.GSCC.com to: GSCC, Attention: Participant Services.

GSCC will continue to explore cross-margining opportunities with other clearing organizations. Important Notices concerning the implementation of additional arrangements will be posted on the GSCC Web site when available.

Contacts

Inquiries regarding the GSCC Cross-Margining Service may be made to:

General:

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