



## CENTRALLY CLEARED SWAPS FREQUENTLY ASKED QUESTIONS

*The information in this document is intended to provide an overview of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the services Northern Trust provides to facilitate centrally cleared swap activity.*

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### Overview

#### What is the Dodd-Frank Wall Street Reform and Consumer Protection Act?

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) - signed into law on July 21, 2010 - established a new regulatory framework for Over-The-Counter (OTC) Derivatives. The objective is to create a more transparent derivative market, better manage systemic risk posed by OTC derivatives and reduce the likelihood of another global financial crisis.

#### How has Dodd-Frank changed the OTC derivative market?

Clearinghouses have been established to act as central counterparties (CCP) on eligible OTC transactions. The impact of these centrally cleared trades will be evident through numerous changes pertaining to how OTC transactions are currently processed. For example, initial margin will be required and set by the clearing houses and passed down to clients by the clearing members. The list of acceptable collateral will vary from one exchange to another, and will generally be restricted to cash and highly liquid, stable instruments such as government bonds. In addition, variation margin will be required for centrally cleared transactions and must be paid in cash. The financial crisis also highlighted the insufficient data available to regulators on OTC derivatives. The new regulation calls for the creation of swap data repositories as a solution to address the lack of information necessary to manage systemic risk. These repositories will require real-time reporting of all OTC and centrally cleared derivatives.

#### Who will these changes impact?

The impact of U.S. regulations on the mandatory clearing of swaps will largely depend on two key factors:

1. Whether an entity is classified as a dealer, a major swap participant, or an end user; and
2. OTC derivatives traded, i.e., interest rate swap vs. credit default swap, etc.

In the United States, many corporations and pension funds may receive end-user exemptions from having to clear swaps. For firms that do not receive exemptions, any trade that is accepted by a clearing exchange will be subject to mandatory clearing and will most likely be executed through a swap execution facility.



## What is the difference between bilateral and cleared transactions?

A bilateral swap is booked directly between two counterparties. Each party takes on the risk—known as counterparty credit risk—that the other party may default at some time during the life of the contract. Collateral for these agreements is exchanged but subject to negotiations between the counterparties.

With centralized clearing, the original buyer and seller of a contract are no longer counterparties to each other. The central clearinghouse becomes the buyer to every seller and the seller to every buyer. These trades are limited to standardized contracts and require daily settlements of margin to act as collateral to mitigate counterparty credit risk.

1. The managing of counterparty risk, since the clearinghouse makes sure enough collateral is on hand and "guarantees" that the transaction will be completed;
2. Netting of transactions at the end of the day, thereby reducing the amount of capital needed to back trading;
3. Increased transparency, with the reporting of prices, quantities and other details of transactions

## What types of assets are traded on central counterparties?

THERE ARE FIVE CATEGORIES FOR SWAPS ELIGIBLE FOR CENTRAL CLEARING:

1. Interest Rate Swaps
2. Credit Default Swaps
3. Foreign Exchange
4. Equities
5. Commodity Swaps (includes all others)

## How many exchanges are there?

THE MAJOR CENTRAL COUNTERPARTIES AS OF NOW ARE AS FOLLOWS:

1. Chicago Mercantile Exchange (CME )
2. ICE Trust (US)
3. ICE Clear (EU)
4. LCH.Clearnet
5. Eurex



## Northern Trust's Roles and Responsibilities

### What is Northern Trust doing to prepare for centrally cleared trades?

The Dodd-Frank Act will have major impacts on financial institutions. Northern Trust has organized a regulatory team to focus on the impacts of the Dodd-Frank Act and has been actively monitoring industry developments and the financial regulatory landscape. We have participated in several industry forums and working groups to better understand the trends and the impact to our asset servicing clients. Depending on their needs and our role, we have taken a consultative approach with our clients in some cases, and in other instances we have taken a collaborative approach.

With respect to the central clearing of OTC derivatives, we have developed standard client service definitions; detailed all aspects of post-trade processing of cleared swaps ranging from trade capture to client reporting; and defined the roles and responsibilities of all parties—Northern Trust, our clients, investment managers, clearing brokers, exchanges, and other third parties. We are currently evaluating the services that Northern Trust needs to develop in order to best assist our clients, as well as our technology requirements. Central clearing, in particular, has many dependencies that will require the development to be flexible contingent on changing regulations, adoption of rules, standardization of processes, and acceptable accounting treatment. In anticipation of these requirements, we have licensed a system solution to address how we will connect to central clearing to support Custody, Investment Operations Outsourcing and Fund Accounting, and are in the implementation planning phase.

We are currently in the midst of evaluating what will be significant corporate platform enhancements to further automate these anticipated changes, as well as other regulatory requirements. Our intention is to be at the forefront of regulations that impact our business while helping our clients to do the same.

### Is Northern Trust ready to receive centrally cleared trades?

Yes, Northern Trust has already begun processing cleared trades. Cleared swaps are currently being processed very similarly to OTC derivatives. Central counterparty trade reporting is almost identical to OTC derivatives reporting. The only difference is the counterparty describing the clearing firm and exchange. In Management Reporting, the Swap Holding Detail template will identify the clearing exchange in the counterparty field.

### Will Northern Trust be able to independently value these cleared swaps?

Yes, Northern Trust has leveraged our current valuation vendors, as well as the automated systems in place to allow for the daily independent valuation of cleared swaps. We are also exploring other valuation sources, i.e. exchanges and clearing firms as potential data providers so that we can meet current client reporting standards.



## Will Performance, Risk or Compliance services be impacted?

No, currently all services should remain unchanged as we have adopted an interim processing plan for cleared swaps. In the future, the inclusion of cleared swaps onto these services will undergo system enhancements but will largely resemble the current service.

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