

TO: Clearing Member Firms

FROM: CME Clearing

DATE: January 23, 2017

ADVISORY #: 17-039

SUBJECT: **Initial Payment Calculation Change for CDS Transfers in FECPlus**

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Please be advised that the **Production date** for the Initial Payment Calculation Change for prior day Credit Default Swap (CDS) Transfers in FECPlus is **Monday February 13, 2017**. The final version of the code for this change will be in the New Release (NR) test environment starting the afternoon of Wednesday, January 25, 2017. In the meantime, the regular Initial Payment calculation will be automatically applied to prior day CDS Transfers, or users can specify their own Initial Payment value.

#### **Initial Payment Calculation Change**

Previously, for CDS transfers, FEC would calculate an Initial Payment on the Transfer based upon the Trade Price and Original Trade Date specified by the User. Users could also specify an Initial Payment to move with the transfer. This might have led to money movements that parties did not intend to make with one another. Additionally, CDS clients wanted better alignment between the CDS & IRS transfer process in terms of allowing clients to move transfers with Variation Margin. Doing so would prevent clients from having to double-fund Variation Margin at their FCMs. The FEC process for supporting this was manual and relied upon the FCMs to calculate and input the proper calculation results. We're hoping to make this process more straightforward in FECPlus.

For any prior day CDS transfer, on which an Initial Payment is not specified, FECPlus will use the new calculation for Initial Payment which will represent the trade's Variation Margin, Price Alignment Interest (PAI) and Coupon (when applicable). Whether a transfer is a prior day transfer or not is determined by the trade date. If the Trade Date specified is before the current Trade Date, the new calculation will be used, otherwise FECPlus will use the standard (legacy) Initial Payment calculation. Additionally, if a user supplies a specific value for Initial Payment, FECPlus will use that value and will not include additional VM or PAI in the IPMT amount. Below is a table that outlines potential scenarios:

	Current Day specified as Trade Date	Prior Day specified as Trade Date
<b>IPMT not Specified by User</b>	Standard Calculation	New Calculation
<b>IPMT Specified by User</b>	Use specified amount	Use specified amount
<b>IPMT of 0.00 Specified by User</b>	Use 0.00	Use 0.00

Below is an example that helps explain this functionality:

- Client A has a trade cleared at Clearing Member Firm 1 and wishes to transfer the trade to Clearing Member Firm 2.
- Prior to transfer, client A has paid or received daily variation margin and PAI on this trade. Let's say that as of the current date, the client has paid variation margin equaling +\$1,000.00.

In this scenario, if client A transfers the trade from Clearing Member Firm 1 to Clearing Member Firm 2, the client will be required to pay Clearing Member Firm 1 +\$1,000.00 only to receive that money plus any additional variation margin back from Clearing Member Firm 2. Additionally, the client would exchange a PAI cash flow with Clearing Member Firm 1.

In order to prevent clients from facing potential double-funding scenarios like the above, FECPlus will now automatically calculate the proper cash flow required in order to offset the variation margin and PAI payment to Clearing Firm 1.

In the above example, FECPlus would calculate a +\$1,000 credit plus PAI on the offsetting trade to offset the client's variation margin & PAI payment to Clearing Firm 1. FECPlus would also perform the same on the onsetting trade, however the cash flows would be in the opposite direction. The end result is that client A will be able to easily continue making daily variation margin and PAI cash flow exchanges with its new clearing firm without any cash flow hassle.

The formula that will be used in the calculation is as follows:

$$\text{Initial Payment} = - (\text{Variation Margin} + \text{PAI Amount} + \text{Coupon Amount (1)})$$

(1) Coupon Amount to be considered only if the CDS Transfer occurs the day before Coupon Payment

The executing side of the Transfer will have the ability to amend the Initial Payment on the CDS Transfer after the transfer has been submitted, but only until the transfer has been accepted, after which no change to the Initial Payment can be made.

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