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Trends in global credit markets: the rise of credit default swap clearing in a shifting landscape

As macroeconomic and geopolitical turmoil continues, credit market participants are increasingly looking to clearing for its risk management capabilities and post-trade efficiencies. With a major shift in the clearing landscape under way, Michael Amakye, director, LCH CDSClear sales, explains why choice and innovation are more important than ever

How have recent volatility and macroeconomic developments, such as inflationary pressures and rising interest rates, impacted credit market participants?

Michael Amakye: Geopolitical tensions, soaring energy prices, rising inflation and tougher central bank policies are taking their toll on economies worldwide, with many experiencing stagflation and the prospect of recession. Together with ongoing interest rate hikes, this is driving the heightened credit market volatility and surge in credit default swap (CDS) volumes we've seen throughout 2022, with Europe seeing its busiest start to CDS trading in August in almost a decade.

At LCH's CDSClear service, for example, total notional cleared across indexes, index options and single names in the first three quarters of 2022 was 74% higher when compared with the same period in 2021. This record activity further expands the netting pool, creating more opportunities for market participants to increase trading and efficiencies by clearing CDS products.

How have central counterparty (CCP) margin models performed?

Michael Amakye: It is no surprise that, when market conditions are more volatile, margin procyclicality becomes a major worry among market participants. Not only does this pose serious risks to individual organisations, but it can also intensify the turbulence in financial markets. That is why it's important to have a risk framework in place to mitigate the risk of changes in margin requirements.

A CCP's responsibility is to develop an

Michael Amakye

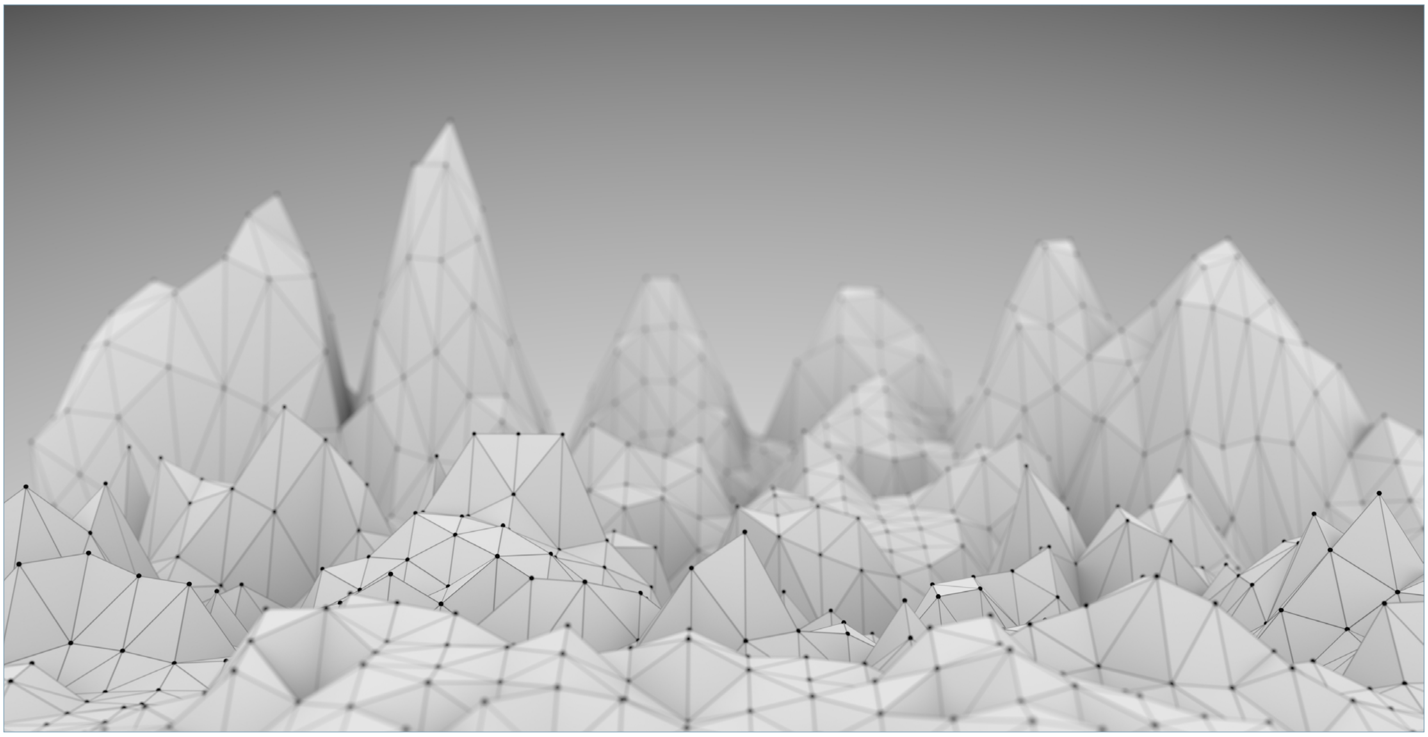
appropriate risk management framework for the markets in which it operates. Margin models must take into account a host of factors, which vary by asset class and reflect the size and nature of the CCP's unique mutualised risk pool.

At LCH, the general approach to mitigating procyclicality is applied consistently across different asset classes offered to clearing by two main CCPs – LCH Ltd and LCH SA – regardless of the specific margin model employed. This includes CDS products, which are cleared at LCH SA in Paris.

Margin models are calibrated to avoid procyclicality, which was demonstrated in March 2020 at the height of the Covid-19-pandemic-driven market volatility. There were no changes to the timing and number of margin calls at LCH, nor to the models and methodologies themselves. More recently, during market volatility resulting from the Russia-Ukraine conflict, the models were able to adapt to market moves by releasing more liquidity when possible, while ensuring sufficient liquidity remained to safely manage the next market event. This underscores the importance of setting initial margin requirements with some buffers during low volatility periods rather than reactively tailoring them to specific market conditions.

How is the CDS clearing landscape evolving? What market infrastructure and clearing developments should credit market participants be aware of?

Michael Amakye: A massive infrastructure change is under way with CDS clearing, as one of the major players exits the market, taking the number of CDS CCPs from three (across two financial markets infrastructure groups) to two, with one based in the US and the other in Europe. This is an important step for supporting further competition in this space, as market participants choose between each CDS clearing house, each jurisdiction with its own regulations, segregation model and bankruptcy regimes. For example, customers of US Futures Commission Merchant (FCM) clearing in the US will need to use a legally segregated operationally commingled (LSOC) account structure under the rules adopted by the US Commodity Futures Trading Commission. Under the LSOC model, each FCM and derivatives clearing organisation (DCO) should



segregate a customer's cleared swaps and collateral from the obligations of the FCM, DCO and any other customer on their respective books and records. While this form of clearing may be well suited to some market participants, for others it might not be optimal from a collateral segregation standpoint, given LSOC's core feature of asset pooling.

LCH is firm in its commitment to delivering a global solution that gives customers the choice of accessing clearing either via European Market Infrastructure Regulation-mandated segregated accounts (individually segregated accounts and omnibus segregated accounts) or via LSOC accounts.

What is driving demand for CDS clearing, including credit index options and client clearing?

Michael Amakye: Clearing enables participants to reduce risk, increase operational efficiency and drive significant funding benefits. This has resulted in LCH CDSClear experiencing increased momentum, which has seen an uptick in firms choosing it as their CCP. Participants want to experience these benefits across many products and diversify risk exposures across their portfolios. This breadth of products, covering corporate, financial and sovereign (subject to regulatory approvals) index and single-name CDS across all geographies (the US, Europe and Asia-Pacific), is a key reason clients choose CDSClear, and LCH will continue to expand it to meet the ever-changing needs of credit derivatives market participants.

Multilateral netting opportunities are also highly sought after to help participants reduce their gross bilateral counterparty exposures down to a single net exposure to the CCP. Therefore, clearing services were expanded to include credit index options, which have enabled the buy side to lower the risk and cost of its credit derivatives portfolio, as well as reduce operational risk by enabling a single exercise instruction per instrument.

"A key factor for us when deciding which CCP to clear through is breadth of coverage. This allows us to diversify our portfolios to create new efficiencies and hedge our positions with an overarching aim of delivering best-in-class execution for our clients. We also look for what's coming through the new product pipeline to help us better navigate the evolving credit landscape, as new rules and regulations come into play," says Christoph Hock, head of multi-asset trading, Union Investment Privatfonds.

While offering clearing across a wide range of CDS products is an important first step, CDSClear's established liquidity for these products is key to enabling market participants to execute and clear their CDS transactions in a cost-efficient manner.

What is the outlook for CDS clearing over the next 12 months? What will be the key areas of focus for market participants?

Michael Amakye: Being able to optimise financial resources is a top priority. Aside from the key requirement of ensuring compliance with regulations, market participants are exploring ways of operating more efficiently under the new regulatory regimes and solutions to unlock and optimise capital, balance sheet and margin consumption. Operational efficiency means seamless, standardised post-trade workflows that support margin, collateral and settlement processing to reduce current inefficiencies. The key to this is innovative technology that automates and streamlines post-trade workflows and drives cost efficiencies.

Driven by our global customer-centric approach, CDSClear will soon be the only Europe-based CCP for CDS and aims to become the only truly global CDS CCP with the potential to offer a single pool of liquidity across credit derivatives products, type and geography of underlying risk, members and clients' jurisdictions and access models. CDSClear will be onboarding its first FCM/broker-dealer in the first quarter of 2023, providing clearing access for the first time to US persons. This will provide a much-needed, credible alternative, opening up access to the broadest range of credit products eligible for clearing. The innovative clearing solutions developed in partnership with the market will also address its specific challenges and deliver real benefits, including reduced risk and lower costs.

We believe that our unique partnership approach and product offering, and the benefits these deliver, will be a tremendous addition to the US market and will increase innovation, choice and efficiency in CDS clearing activity.

LCH CDSClear is here to partner with the market and help clients navigate the shifting landscape. Contact LCH CDSClear's specialist sales team or visit LCH CDSClear for further information.