

# A regulatory bottleneck

With the recent announcement of an extended preparation period for posting IM for smaller entities, the new timetable could cause a bottleneck for firms busy repapering derivatives contracts linked to the discredited Libor benchmark at the tail end of 2021. As the threshold for compliance reduces and more buy-side firms are caught, a panel of experts examines the key preparatory steps required, including documentation, custody account setup, margin calculation and the backtesting of IM models to smooth the process and ensure compliance



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## How will the extension of the implementation phase affect firms' preparations?

**Paddy Boyle, LCH:** Splitting the original phase five across two years extends the time available for market participants to prepare for and implement their compliance plans for uncleared margin rules (UMR). While this provides all parties enough time, market participants subject to the final phase in 2021 should not slow down their internal UMR preparations, which require a great deal of work – including managing straight-through processing (STP) and workflows upstream, as well as engaging all relevant counterparties. Despite the extra time, it is essential to stick closely to an implementation plan, given the challenges of including legal, structural – order management systems (OMSs), for example – and back-office implementation modules. An extension also gives participants time to consider and implement strategic alternatives, such as voluntary clearing of in-scope products, which reduces the scope of eligible sub-accounts.

## What are the key challenges for firms in approaching the non-cleared margin rules?

**Paddy Boyle:** Market participants preparing for UMR face a demanding and highly complex process with numerous steps – as the International Swaps and Derivatives Association (Isda) has highlighted<sup>1</sup> – and must tackle two distinct sets of work. The first involves setting and running compliance with the new rules. Uncleared derivatives users must calculate their aggregate average notional amount (AANA); determine when they are in scope in each jurisdiction, and for which entities; agree new credit service agreements (CSAs) and custody relationships; and then run those CSAs, potentially with third-party assistance. Second, changes to behaviour can minimise the burden of operating within the new framework. Compressing more portfolios, clearing new trades and back-loading old ones into clearing can significantly reduce the number of entities in scope. Clearing more flows will also reduce the amount of margin that needs to be paid.

## What impact will the rules have on firms' trading strategies?

**Paddy Boyle:** Prior to UMR, firms took a relatively simple approach to execution, with the view that the best price delivered the best execution. However, participants trading bilaterally under UMR face the daunting challenge of who to trade with to optimise IM, as not all equal prices have equivalent collateral implications. Post-trade, there is the secondary economic impact of needing to pay for optimisation vendors, third-party custodians and other consultants – costs not captured in 'price' but linked to execution decisions.

Where it is more efficient to do so, prepared firms will now switch from an uncleared to a cleared strategy, which removes the need to think about who to trade with. But LCH does not anticipate that firms will change what they trade, except in very limited circumstances.

## How will the need to post IM affect firms' choice of products?

**Paddy Boyle:** For firms taking longer-dated or large positions in in-scope products, LCH expects a significant move to clearing, which is even more efficient once bilateral trades are also subject to uncleared bilateral IM. This efficiency accrues not only to the end-client, but their bank trading counterparties will also derive benefits, both in the form of reduced IM via clearing and from the superior balance-sheet treatment of cleared versus bilateral risk exposures; risk-weighted assets (RWAs) and leverage ratio calculations attribute lower capital obligations for cleared trades, making dealers even more inclined to see clients clear trades.

## What tactics are firms using to reduce IM exposure?

**Paddy Boyle:** There are two approaches for firms looking to reduce margin exposure. First, they can reduce their uncleared over-the-counter (OTC) derivatives notional below the \$50 billion or \$8 billion threshold, as applicable. Where this can be achieved through more compression of bilaterally held portfolios and more voluntary clearing, entities can be kept out of scope entirely. Alternatively, for in-scope entities, more voluntary clearing will significantly increase the margin efficiency of most portfolios.

## How will the rules affect relationships with bilateral counterparties and prime brokers?

**Paddy Boyle:** For bilateral counterparties, maintaining some positions may become very expensive. We expect these to move to clearing and, if foreign exchange follows the pattern of other asset classes, we'll see a significant increase in accompanying market volume too.

Over the past three years, LCH has seen huge growth in the voluntary clearing of in-scope products – mostly non-deliverable forwards (NDFs) – among the groups caught in the early waves of UMR. We expect to see the same behaviour from most entities coming into scope next year and are working with many of them on clearing projects. Most – but far from all – forex prime brokers (FXPBs) are part of business units that include clearing brokers. Some of these FXPBs expect and intend to move a large amount of their client business from FXPB to cleared forex, as there are significant cost savings for FXPBs, clients and also executing brokers.

Furthermore, given that clearing presents a new phase in the evolution of the forex market, this creates a new chance for early adopters on both the dealer and clearing side to become market leaders and thought leaders in the space. In short, the transition to clearing will likely open an opportunity for new leadership and a revamped league table, which will in turn change the dynamics among counterparties, dealers and their clearing brokers. ■

<sup>1</sup> Isda (2018). Getting ready for IM regulatory requirements – What steps do I need to take? <https://bit.ly/2JrPiPr>