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Clearing house of the year

LCH The Markets' Partner

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In October 2018, the world's largest swaps clearing house was on the brink of serving cancellation notices to one-third of its members. A no-deal Brexit had become the base scenario and LCH faced an existential crisis as its ability to serve European Union clients hung in the balance. In just a decade, clearing had gone from sleepy backwater, to critical financial infrastructure to unlikely political bargaining chip.

Fast forward to 2019, and the central counterparty (CCP) not only retained its vast market share, but grew activity by 20%, and even won grudging approval from large buy-side clients for margin model changes that hiked collateral requirements.

This change in fortune came thanks to assurances from the European Commission that cross-border clearing would continue, whatever form Brexit took – assurances that were hard-won by LCH top brass. Equally pivotal was the CCP's extensive market engagement on a range of transformational issues, from transition to risk-free rates (RFRs), to consolidation of European repo clearing activities and expansion of forex clearing services – an asset class reliant on a voluntary shift away from bilateral markets.

Clients singled out LCH for its 'cerebral', 'deliberate' and 'academic' approach to rulemaking and product development, and welcomed its consultative efforts – even when the result might not fall in their favour.

"Ultimately, you're not looking for a CCP to drive a fast car, but to be strong, stable and consistent – and I think LCH are just that," says an executive at a large asset manager who isn't a fan of LCH's summer margin increase, but acknowledges the CCP's strength and resilience.

The margin changes, implemented in July, proved their mettle in August, when the clearing house weathered a storm of rates volatility not seen since the financial crisis. For LCH, alarm bells began to ring in late 2018, when margins for client positions seemed low compared with historical levels.

Like other value-at-risk margin models, LCH's methodology is split between a dynamic component, which depends on a 10-year rolling lookback of data, and a static component made up of fixed scenarios. This second component acts as a floor for the dynamic part, and lower volatility saw client margins drop. This was partially due to the turbulent Lehman Brothers default period rolling out of the dynamic calculation.

The CCP's fix was to increase the margin period of risk (MPOR) for the static part of the model for client clearing from five to seven days. Changes that hike margin requirements aren't always an easy sell, but users were well versed in the need for resilience, and appreciated the frank communication.

"LCH has a solid margin methodology and proactive risk management approach, which allows them to effectively enhance their model, accounting for market changes as well as liquidity and concentration concerns," says a risk expert at a large futures commission merchant. "They strive to be transparent in how they do this."

Left to right: Bruce Kellaway, Susi de Verdelon and Paddy Boyle

Photo: Geraint Roberts

According to Susi de Verdelon, head of SwapClear and listed rates at LCH in London, users understood the need to restore coverage levels in order to protect the client clearing service. The move was vindicated when margins remained stable through August's volatility.

"The model held up to August rates volatility really well," she says. "We didn't see an impact on overall levels of margin because we had the new model implemented at the time. We managed to buffer the unprecedented levels of volatility with the static part of the model, which had higher margin levels after the model update."

Another epic task saw the clearing group consolidate its euro repo offering at Paris-based LCH SA. The group's euro government bond repo activity was previously skewed towards London-based LCH Ltd. Market participants had expressed interest in moving these instruments to the eurozone to take advantage of the Target 2 Securities settlement system, where financial institutions link up to central banks to shore up settlement procedures.

Understandably, no-one wanted to make the first move.

"If one member moved alone, they would have had no-one to trade with," says Bruce Kellaway, the global head of rates, securities and collateral at LCH. "We spent lots of time bilaterally with members to talk about the benefits of consolidating their euro-denominated repo and government debt clearing in Paris, and then facilitating wider discussion in working groups."

On the agreed date of February 19, 2019, business shifted from London to Paris – most of it in just three days, he says.

"At first glance, it seems like an easy thing to do. All members seemingly had to do was change counterparty. But, operationally, it was challenging, as all the bonds would in all likelihood settle in different places. We worked closely with Euroclear and Clearstream to make sure everyone was aligned in time for the move," adds Kellaway.

Activity flourished following the consolidation. RepoClear volumes for the combined euro pool totalled €141 trillion ($156.3 trillion) in the first 10 months of the year, a 23% year-on-year increase. Gross notional outstanding peaked at €3.2 trillion in September.

Preparing for RFRs

Clients and members welcomed the CCP's consultative approach in shepherding the rates market away from discredited Libor and towards alternative RFRs. Libor's anticipated post-2021 demise is a critical issue for LCH, which houses around $270 trillion notional of swaps linked to soon-to-be-defunct benchmarks.

"Libor transition underpins a huge amount of our book, and we are a very big counterparty to trades in the industry, so the market looks to us for thought leadership and guidance," says de Verdelon.

The CCP cleared its first swaps linked to the euro short-term rate, or €STR, on October 21 – less than three weeks after the rate was first published by the European Central Bank.

Swaps linked to the secured overnight financing rate (SOFR), US dollar Libor's successor, expanded since the July 2018 launch, with more than $1 trillion notional cleared at the CCP in 2019. In line with dollar Libor swaps clearing, LCH uses the effective fed funds rate to discount future cashflows on SOFR swaps and for price alignment interest – the interest paid on cash collateral. The well-understood discounting regime allowed participants to dip their toes into SOFR swaps, but regulators are urging all dollar swaps to be discounted with SOFR, whether they reference US dollar Libor, Fed funds, inflation benchmarks or the RFR itself. It's a gargantuan task for LCH, which worked closely with clients to map out a strategy for switching $131 trillion of dollar swaps to the new discount regime and develop a mechanism to square winners and losers.

In a November 2018 consultation with market participants, the CCP offered a choice between a transition phase in which SOFR and Fed Funds discounting could coexist, or a 'big bang', which would see all dollar-denominated swaps – new and old – switch to the new discount regime together.

Participants overwhelmingly preferred the big bang. The CCP settled on an October 2020 date, giving participants time to opine on the minutiae of the process, which includes a scheme for winners to compensate losers through cash payments and basis swaps. Clients can accept a cash alternative to the compensating swaps, to be priced via an auction. One rates expert at a large bank says the CCP has been "instrumental in giving the market comfort" during the RFR transition.

"We are consulting on our plans for compensating swaps, client opt-outs and what the auction rules might be," adds de Verdelon.

Betting on forex

While regulators have pushed three-quarters of interest rate swaps into clearing – first via mandate, and more recently through regulatory initial margin on bilaterally held instruments – in foreign exchange markets, there are few drivers. Forex derivatives have no clearing mandate, and physically settled swaps and forwards have been carved out of initial margin rules, which are being implemented in six annual waves out to 2021.

With only 2% of the forex market currently cleared, according to US Commodity Futures Trading Commission swaps data, LCH is taking a strategic bet as many firms seek capital and operational efficiencies. It seems to be paying off, with the non-deliverable forward clearing breaking notional records in September, hitting $1.66 trillion.

"For the first time, the non-cleared outstanding notional in the forex market is greater than the non-cleared outstanding notional of the rates market," says Paddy Boyle, the global head of ForexClear. "Forex is rapidly becoming the prime area of focus for financial institutions, so we have launched products to help users better manage their capital costs."

The CCP is beginning to make its mark in deliverable forex. In July 2018, LCH connected with settlement utility CLS to launch forex options clearing. The CCP cleared over $48 billion notional in deliverable forex during the first quarter of 2019 – 47% more than the total for the second half of 2018. ForexClear added standalone deliverable forwards in October 2019.

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"We are not expecting a rapid move to clearing in deliverable forex, as happened in NDFs. It is a little more complicated than clearing non-deliverable products like rates swaps or NDFs," adds Boyle. "It will take a little bit longer, but the potential benefits are commensurably far larger than clearing only non-deliverable products."

Boyle's team plans to add cash-settled options clearing in the first half of 2020, subject to regulatory approval. The move pits LCH directly against CME Group.

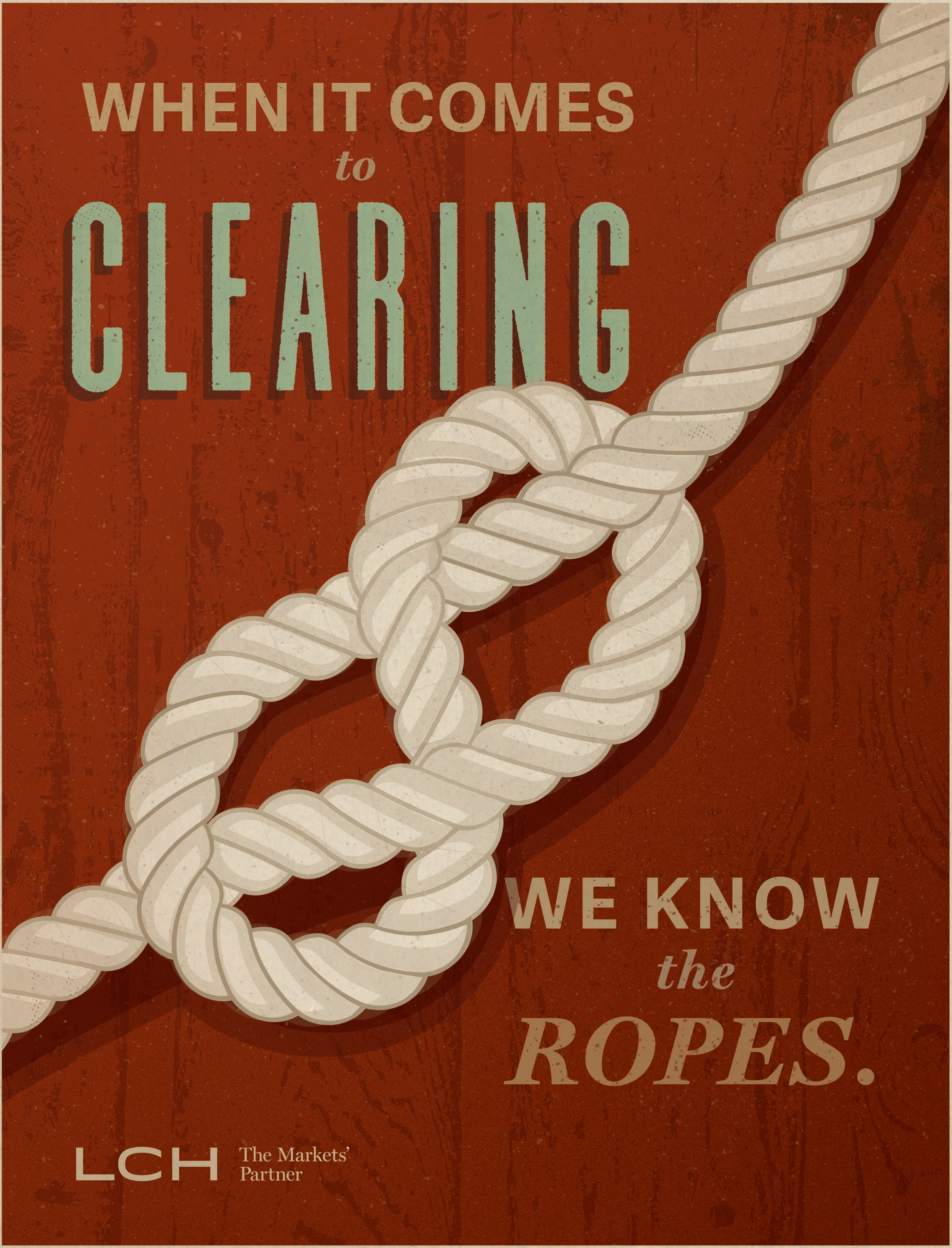
LCH also linked up with State Street's forex platform FX Connect TradeNeXus in September, allowing the buy side to more easily tap into clearing. While client clearing notional is still low compared with dealers, activity increased fivefold in the 10 months to October 2019.

Break in the Brexit clouds

LCH's roster of 2019 accomplishments is impressive for a business so severely threatened by Brexit. With the UK parliament failing to vote through a deal that would trigger a two-year transition period, the CCP faced the prospect of a disorderly exit in which it could no longer service EU clients. Adding to the pressure, Frankfurt-based rival Eurex redoubled efforts to take the euro swaps market share.

LCH led its defence from the very top of the house, dispatching chief executive Daniel Maguire to Brussels to discuss the issue with senior politicians. Enlisting the help of its members, clients and trade associations, the CCP successfully steered the debate from a political issue to a matter of sound risk management. In March, the CCP won a much-needed reprieve when the EC granted temporary third-country equivalence, ensuring EU clients would not be forced to flee the CCP.

It's not quite 'job done'. The exemption runs out in March 2020, just two months after the UK's next scheduled departure date on January 31. LCH has rallied the support of 14 trade bodies, which wrote to the EC in November, seeking an extension of the equivalence arrangements. ■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