Non-Deliverable FX Options Clearing from LCH

The launch of non-deliverable FX options clearing builds on LCH ForexClear's existing offering, adding to the clearing of non-deliverable FX forwards, deliverable FX options and deliverable FX forwards. We asked Ankeet Dedhia, Americas Head of Product, ForexClear, at LCH to tell us a little more about it.

Ankeet Dedhia

Why is the launch of this service an important milestone, especially in light of Uncleared Margin Rules?

The demand for cleared deliverable and non-deliverable OTC FX derivatives is rising globally, as market participants seek effective ways to optimise balance sheets by reducing their margin and capital costs across their entire FX portfolio. To meet this growing demand, which has been intensified by the Uncleared Margin Rules (UMR), ForexClear, LCH's FX clearing service, has partnered with the market to deliver clearing for non-deliverable options (NDOs). The addition of NDOs to the ForexClear offering completes the range of vanilla FX products available to clear at LCH. NDOs are in-scope products for UMR's two-way initial margin (IM) exchange mandates, which might make bilateral (i.e., uncleared) NDOs expensive. As seen in other OTC products, market participants that clear a bulk of their UMR-eligible products at LCH likely benefit from lower capital and margin costs in clearing, lower counterparty credit risk, and increased operational and risk efficiency from legal netting against a single counterparty.

What currency pairs are now available with this new clearing service?

Our NDO product launch covers a total of nine currency pairs consisting of four EM pairs: USD/BRL, USD/INR, USD/KRW and USD/TWD; and five G10 pairs: AUD/USD, EUR/USD, GBP/USD, USD/CHF and USD/JPY, with a maximum tenor of two years. Non-deliverable forward (NDF) hedges to NDOs are also available to clear, as many customers net them together.

These nine currency pairs perfectly complement the 17 NDFs available to clear at ForexClear. These comprise 12 EM pairs: USD/CNY, USD/IDR, USD/INR, USD/KRW, USD/MYR, USD/PHP, USD/TWD, USD/RUB, USD/BRL, USD/CLP, USD/COP and USD/PEN; and five G10 pairs: AUD/USD, EUR/USD, GBP/USD, USD/CHF and USD/JPY.

What other opportunities does this service open up for clearing members and their clients to achieve further margin and operational efficiencies?

One of the benefits of clearing is lower margin costs compared to uncleared. This margin benefit is further compounded by CCP multilateral netting, where a firm can achieve netting benefits across all its bilateral counterparties. Clearing members and their clients might realise lower margin costs on their NDO (and wider FX) portfolios when they clear NDOs at LCH. Based on LCH's analysis of member portfolios, clearing may offer savings of up to 85% in margin costs compared to bilateral.

Cleared NDOs also reduce operational complexity compared to uncleared FX options and are cash-settled via LCH's Protected Payment System. This removes the complexities of physical settlement and the exercise/expiry process of FX options, while still offering an identical product for risk management and hedging purposes. Also, it's worth adding that LCH offers standardised rulebooks that are publicly available and applicable to all its clearing members, making cleared operational processes streamlined, transparent and easy to implement for all.

As well as margin and operational benefits, the addition of cleared NDOs provides customers with a holistic view across margin, capital, risk, operational and UMR set-up costs. Over time, this could be reflected in better liquidity or pricing in clearing compared to uncleared positions.

What about capital savings? How will this new service help dealers to optimise their capital and balance sheet usage in clearing?

Aside from margin and operational benefits, regulatory capital savings are another important benefit of clearing. Our cleared NDO offering increases the scope of products available for bank customers to optimise their Basel III capital costs. The favourable Risk Weighted Assets (RWA) and Standardised Approach Counterparty Credit Risk (SA-CCR) treatment for cleared trades under the Basel III capital framework for counterparty credit risk enables bank customers to optimise their capital and balance sheet usage in clearing. The standardised calculation for RWA permits a lower 2% counterparty risk weighting for trades facing a clearing house, compared to a minimum of 20% against a AAA-rated uncleared counterparty. Further, under the SA-CCR framework, trade exposures against a clearing house attract a lower 10-day Margin Period of Risk (MPOR), versus a potential 20-day MPOR for uncleared trades under certain criteria.

How have the market and your own members responded to the launch of NDO clearing so far, and which firms have started to clear the product?

Polling market participants on product requirements, regular consultation on prioritisation and feedback on product design forms a key part of the product development process at LCH. As mentioned earlier, NDOs were built in partnership with FX market participants, who were consulted on the design and mechanics of the product on a regular basis. The response from market participants has been extremely positive so far. At this time, a couple of banks have cleared a small portion of their NDO portfolio at LCH, with the expectation to clear all NDOs against all live members soon. These banks broadly belong in Euromoney's top 10 FX market maker list.

There are many other customers who are conducting portfolio analyses on their FX non-deliverable books, either internally or in consultation with LCH. It's worth highlighting that for many member portfolios, adding NDOs to existing cleared FX books could require no additional margin, since the NDO risk may be completely offset by their respective existing NDF positions at LCH. Also, for some members, adding NDOs to clearing may lead to net reduced margin, driven by a high correlation between NDOs and existing NDF positions in clearing. When you combine these margin benefits with the capital benefits of clearing for banks dealers and prime brokers, the decision to clear NDO books represents a compelling option for market participants.

What might we expect to see from LCH next in terms of building on this new clearing service and further extending the scope of your FX offerings?

We are looking to extend the list of FX products available to clear and offer features to support FX client clearing for the buy-side phase-in of UMR in 2021/2022. In the first half of this year, ForexClear is looking to expand the product set to include more currencies and tenors for FX products, and the launch of NDFs in nine additional G20 currency pairs will bring the total of NDFs available to 26. We also have plans to extend the tenor eligibility of six currency pairs from two years to five years, giving customers a wider set of FX products to optimise their trading books and collateral usage.

According to ISDA, approximately 1,100 buy-side entities globally – 315 in 2021 (Phase 5) and 775 in 2022 (Phase 6) – are going to be impacted by the upcoming phases of UMR. This number further translates to around 9,000 separate counterparty relationships – 3,600 covered under Phase 5 and an additional 5,400 in Phase 6 - for which buy-side firms need to kick off projects with complex implementation rules and strict timelines.

Many such buy-side asset managers, hedge funds, regional banks and non-bank market makers are comparing the overall costs, benefits and timelines of UMR implementation with clearing, and are starting conversations with LCH and their clearing brokers about FX clearing. We hope many of these firms arrive at the same conclusion as UMR Phase 1, 2 and 3 participants, who decided to clear FX once phased into UMR. This demand from buy-side participants is likely to bring a wave of buy-side-specific requests to make client clearing scalable, which might require further product and service enhancements within ForexClear. Additionally, we continue to focus on researching solutions that will enable the buy-side to clear deliverable FX, as interbank direct members currently do.