The evolution of clearing and FX market structure

Following on from our roundtable feature earlier this year, which focussed on some of the complexities and current models of FX clearing, we asked Kah Yang Chong, Head of ForexClear Product, Europe, the Middle East and Africa, at LCH to give us his views on how the clearing landscape is likely to evolve further.

Kah Yang Chong

Electronic FX trading is becoming more prevalent. In what ways does this pave the way for changes in market structure that will support greater use of clearing?

Since the introduction of Uncleared Margin Rules (UMR) in 2016, the cost of trading for many participants has increased, or is increasing, due to the requirements of two-way initial margin (IM) postings on derivatives exposure.

The latest ISDA margin survey indicated that, as of year-end 2019, $105.2 billion of regulatory IM was collected by the largest 20 market participants. Against this backdrop, many dealers have moved to clearing their non deliverable forwards (NDFs) and FX options (FXOs) – the FX products in scope for UMR. Clearing provides margin benefits versus bilateral exposures, which is in line with the G20 regulatory impetus. Consequently, dealers executing trades with participants that do not clear are increasingly reviewing the margin cost of trading and considering incorporating these costs into their bilateral execution.

Electronic FX trading provides a low-touch, low-latency solution to execution. This streamlines operational workflows and logistics pre- and post-execution, resulting in greater efficiency than is possible with voice execution.

The electronification of the FX market is one driver for wider adoption of clearing, providing an avenue for dealers and electronic venues to incorporate margin costs into execution on a systematic basis. For example, liquidity could easily be tailored at a counterparty level, or a separate liquidity pool could emerge on central limit order books or electronic communication networks (ECNs). The straight-through-processing (STP) nature of electronic FX trading also allows the seamless registration of a trade at the clearing house, providing rapid certainty of trade to participants.

In the future, an increasing share of FX market liquidity will come from non-bank and other financial institutions that may have a more regional focus. What impact could that have on the clearing landscape?

Market participants can access clearing services either by becoming a direct member of the clearing house or through the client clearing model via an FCM or clearing broker. This provides a broad range of global participants – including banks, funds, other financial institutions, sovereigns and corporates – with an access model to clear their derivatives with LCH, which has a presence at a global level, covering all major regions.

Further, the regulatory change sweeping the industry in the past decade has been coordinated across the G20 leaders and their respective countries. This has resulted in a knock-on effect in other countries that were not initially part of the G20 reforms. This has essentially led to a global convergence on post-crisis financial reforms. That's why at LCH we believe the benefits of clearing and the incentives to clear apply to the majority of financial institutions, including both regionally focussed and global players.

PEEK AHEAD

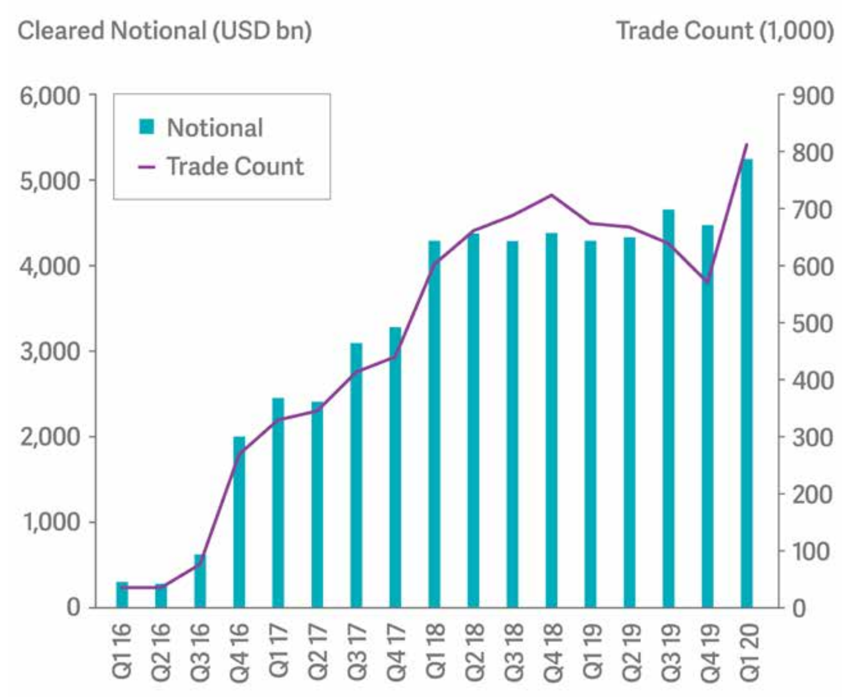
In what ways do you think the benefits of clearing will drive changes in FX market structure that could lead to more efficient ways of trading?

We consider that the benefits of clearing are evident in three key areas: margin savings, capital savings and streamlining of operational processes. With respect to margin savings, LCH ForexClear recently undertook a cost comparison that analysed a number of portfolios across a diverse set of participants, including dealers, hedge funds and asset managers. ForexClear's findings suggest clearing may result in up to 70% IM savings versus bilateral trading in some cases. This is primarily driven by the cleared IM methodology and the consolidation of counterparty positions through a central counterparty (CCP).

As far as capital savings are concerned, Basel III's risk-weighted assets (RWA) attribute a lower counterparty risk weighting for dealers facing a CCP versus a bilateral counterparty. The RWA and leverage ratio framework also benefit from the increased netting effect of consolidating positions against a single counterparty, which may reduce overall capital requirements.

Regarding operational efficiencies, positions at the CCP are governed under the CCP's Rulebook, which is required to be clear and transparent. This reduces valuation/margin disputes and provides clear guidance on failure management during periods of market stress. Having a single point to reconcile, along with standardised processes, reduces operational overheads for clearing participants. We believe that as more firms realise these benefits, the clearing ecosystem will increase in robustness and strength.

NON DELIVERABLE FX VOLUME



What impact on clearing do you expect to see once buy-side firms come into scope for UMR in 2021 and 2022?

The past four years have seen growth in cleared volumes of NDFs among firms that were in scope for the early phases of UMR, i.e. dealers and large buy-side institutions. The chart above illustrates the growth in NDF clearing since the first phase of UMR in September 2016. LCH's FX clearing volumes have continued to grow since 2016, as more participants fall into scope for UMR in each successive phase.

As the threshold for Average Aggregate Notional Amount (AANA) drops from $750 bn to $50 bn and $8 bn in 2021 and 2022, respectively, many asset managers and hedge funds are expected to come into scope for UMR. The buy-side community will face similar considerations as the dealers who first came into scope in 2016. They will have to review their operating models and assess their counterparty exposures to optimise their IM requirements.

Further, many FX prime brokers (FXPBs) are now part of business units that include clearing brokers. We anticipate that an increasing number of FXPBs will embrace clearing of FX products, as there may be significant cost savings for FXPBs, clients and dealers.

We would encourage market participants to begin preparations as soon as practicable. Starting conversations now with prospective clearing brokers and their dealers will ensure sufficient time to perform due diligence and assess the pros and cons of the options available.

A regulatory tsunami is challenging traditional buy-side operating models and requiring these firms to develop new skills and competencies. Can anything be done to help them by reducing the complexity of clearing? For example, by introducing more light-touch documentation.

As highlighted in ISDA's 2018 IM factsheet, market participants preparing for UMR face a demanding and complex process with numerous steps. The preparation includes calculating and monitoring AANA; determining when they are in scope in each jurisdiction and for which entities; for each trading counterparty, agreeing to new credit support annexes (CSAs) and custody relationships; reconciling margin numbers on a daily basis; and managing the daily postings required under the CSAs, potentially with third-party assistance.

STEP 1: IDENTIFY IN-SCOPE ENTITIES EARLY
STEP 2: MAKE EARLY DISCLOSURES TO COUNTERPARTIES
STEP 3: EXCHANGE INFORMATION ON COMPLIANCE
STEP 4: IDENTIFY SPECIAL CASES
STEP 5: ESTABLISH CUSTODIAL RELATIONSHIPS
STEP 6: PREPARE FOR COMPLIANCE
STEP 7: NEGOTIATE/EXECUTE DOCUMENTATION
STEP 8: FINALIZE PREPARATIONS

ISDA has published a fact sheet that sets out the steps firms should take when preparing to comply with regulatory initial margin requirements.

For the buy-side, the work required may lead to substantial legal and operational overheads. Firms may need to evaluate their trading relationships and choose to reduce the number of trading counterparties to lower these costs. Clearing can be a viable solution to help reduce this burden. All cleared trades are subject to CCP rules and margin terms, and documentation is standardised for setting up new trading counterparties. This may lead to wider counterparty selection and a shorter time to market, ensuring participants continue to access a wide range of dealers for best execution.

If euro-denominated derivatives clearing leaves London, either due to supervisory pressure or voluntarily by market forces, could this also lead to a relocation wave for FX instruments as well?

LCH is committed to ensuring continuity of service for its customers, and the overwhelming consistent feedback we receive from members and clients is that there is no support for fragmentation of global liquidity. Customers want to be able to continue to access LCH services post-Brexit and to obtain the numerous benefits of the extensive suite of products cleared by us in a single CCP, as well as the benefits of the global liquidity pool. LCH remains an EMIR Article 14 authorised CCP throughout the transition period, and we are seeking smooth transition to permanent recognition.

In what ways has LCH been working to further develop straight-to-clearing workflows and expand the current clearing ecosystem?

There has been an increase in demand from the buy-side for building out STP clearing workflows directly between the CCP and FX electronic venues (including EMS and OMS platforms). This allows buy-side firms to continue using their venue of choice for execution, while providing a streamlined operating model to access clearing.

This has been our focus at LCH in recent months. LCH operates an open access model, which means we offer connectivity to multiple trading venues, offering our members a choice of where to execute their trades. In September 2019, LCH announced its successful integration with FX Connect TradeNeXus, a buy-side execution venue, thereby facilitating direct connectivity to clearing for the buy-side. We are also continuing discussions with several other FX electronic trading venues.

What new clearing solutions can we expect to see LCH launching over the coming months? For example, with respect to NDOs and NDFs.

The two key areas of focus for ForexClear over the coming months are the launch of cleared non deliverable options (NDOs) and the extension of eligibility to our existing NDF offering.

NDOs are subject to UMR, which has increased demand for a cleared offering. Market participants will receive portfolio margining between cleared NDOs and cleared NDFs, which will provide netting benefits and margin efficiencies for both dealers and buy-side participants.

On the extension of existing NDF eligibility, LCH is planning to increase the maximum tenor of trades in certain currency pairs from two to five years and to introduce several new NDF currency pairs by the end of the year, subject to regulatory approval.

Taking a longer view, we are constantly looking to innovate and partner with key stakeholders to develop our cleared FX offering, and we will continue to communicate our initiatives to our members and the wider market.