Preparing the ground for the derivatives deadline

Over-the-counter (OTC) clearing is an issue that remains critical and controversial. As the deadline looms for all standardised OTC derivatives to be cleared by the end of this year, market participants are working hard to ensure that large-scale clearing and trading can take place, according to panellists taking part in a forum convened by Risk *in New York*

CME Group MUREX SwapClear LCH.CLEARNET

Risk: **Over-the-counter (OTC) clearing is a complex topic, with services like SwapClear spending a lot of time preparing and educating clients about central clearing for OTC derivatives. Can you tell us what that process actually entails?**
Nathan Ondyak, SwapClear, LCH.Clearnet: Even if a firm has been clearing in the exchange space for some time, clearing OTC products still introduces challenges. We spend considerable time educating clients about what is involved operationally to clear a trade and, from a risk standpoint, how initial margin is calculated or how trades are valued. In addition, even aspects of the futures model that we once thought worked, such as segregation, now generate a lot of interest from clients as they try to understand exactly what happens post-default. So we are having to educate them in the protections they have and the risks they are exposed to.

Risk: **Would CME Group agree with the notion that education is the biggest chunk in terms of getting people prepared for central clearing?**
Sean Tully, CME Group: Education is an incredibly important part of the process. We are working closely with asset managers, regional banks, insurance companies, hedge funds and government-sponsored enterprises. We see a wide spectrum of clients and they each have different needs. We're seeing different customers at different stages of the process. In the US, we have cleared over $560 billion worth of interest rate swaps, credit default swaps (CDSs) and OTC foreign exchange already, most of it since August last year. A lot of that has been driven more by the European credit crisis than by regulation. It has been driven by internal needs to reduce counterparty credit risk. Once a customer decides it wants to start clearing, we have a dedicated team that takes care of all of the customer's needs in order to make sure it is set up and can initiate clearing.

Risk: **What types of clients are ready to start clearing now?**
Sean Tully: They come from different segments but I would describe each of them as a market leader. They are not only doing

The Panel (left to right)
CME Group, Sean Tully, Managing director, interest rate products
Murex, Imane Cherradi, North American clearing product expert
SwapClear, LCH.Clearnet, Nathan Ondyak, US head of product

it because they are concerned about counterparty credit risk, but they are also using clearing as a marketing and sales tool for their own customers.

Risk: **What is required of Murex in terms of preparing firms for central clearing?**
Imane Cherradi, Murex: Murex has been in the clearing space for more than four years now. Our clients are a mix of clearing houses, clearing members doing both house and client clearing as well as buy-side firms. Clearing comes with many challenges – operational, technical and business challenges. As a software provider, we add value by providing our clients with a packaged solution they can use to reduce time to market and to be ready when mandatory OTC clearing takes effect. This includes connectivity, processing, risk and collateral management.

Risk: **In all of those areas, does technology play a large role?**
Imane Cherradi: Technology is a very important aspect. To prepare for clearing, market participants need to think about trade processing and workflow, establish connectivity to swap execution facilities (SEFs), affirmation platforms, central counterparties (CCPs) and revamp their risk methodologies.

Risk management is becoming increasingly important. As clearing houses are expanding the list of eligible collateral and proposing cross-margining, many dealers are looking for a good risk system they can leverage to offer good services to their clients while monitoring their risk. Technology is increasingly becoming a competitive advantage.

Risk: **How does the existence of OTC clearing services fit into a new world in which there is a combination of SEFs and CCPs? Will you have to adjust your model based on what the regulators decide?**
Sean Tully: At CME, we have a model that was purpose-built to fit all the needs of the buy side and dealers. We have connectivity with a number of affirmation platforms. We work closely with the clearing members and customers and, when customers want to start, it's very important for them to pick one of CME's clearing members. The next step is to pick an affirmation platform. Once they have chosen those two, then there is a great deal of documentation between the customer and the clearing member, the customer and CME, and the customer and other execution partners to sort out. We've built a platform that can adjust to any regulations.

Imane Cherradi: The challenge with connectivity comes from the multitude of connections that are needed. If we look at SEFs, for example, clients usually haven't yet decided which one they would like to go with as they do not know where the liquidity will go. They are trying to be open and build connectivity to multiple SEFs, which brings complexity.

Sean Tully: A lot of the transformation that we're seeing isn't just driven by the regulation, it's driven by the concern over counterparty credit risk. CME, for example, has been clearing OTC energy products since 2002, so we have about 10 years' experience in this marketplace already. That was really an adoption that has occurred since the Enron crisis. We're seeing now that this move towards clearing volumes that we're already seeing is really being driven less by the regulation than by the need to address counterparty credit risk.

Risk: **A lot of market participants are rather unprepared for central clearing. Are some CCPs concerned there could be a huge rush towards central clearing once the rules are finalised, and do you think you can cope with that?**
Nathan Ondyak: The SwapClear platform already handles large volumes, so we're ready for a so-called 'rush' today. To date, we have cleared more than $1 trillion in interest rate swaps for clients. That does not include the $300 trillion outstanding we already have from our dealer business, which is something we have been doing for over 10 years. It's not new to us and we're ready to go.

Sean Tully: We have started seeing this massive ramp-up in volume since August. We've already got more than 1,800 accounts clearing with us and another 2,500 that are testing. The market leaders are already clearing and a second group of participants are actively testing. There are still folks who are not yet testing and the sooner they get involved, the better.

Risk: **To get OTC clearing working, there are a number of other considerations, such as risk management and collateral. Do you agree the move towards central clearing is necessitating other improvements in some of these areas that perhaps ought to have been done a while ago?**
Imane Cherradi: I agree. When the Dodd-Frank Act was passed into law, most firms were concerned about connectivity and processing. After that, they quickly became more concerned about risk management. This includes real-time risk and position monitoring, default management and margin requirements.

Also, in order to attract more clients and be more competitive, dealers need to be able to offer more services around collateral like optimisation and transformation. This has been a big subject in the past few months.

Nathan Ondyak

Risk: **Margin segregation has been a hot topic in the debate over what form the central clearing model in the US should take. The Commodity Futures Trading Commission (CFTC) has opted to pursue the approach to margin known as the legally segregated, operationally commingled (LSOC) approach. What are the advantages and disadvantages of the LSOC approach?**
Sean Tully: The CFTC will request that LSOC be the minimum requirement, so we will be ready by November 8 to provide that. The question is providing customer choice. Are there customer choices we can provide on top of the LSOC requirement? In the bilateral swap world, there are some customers that have tri-party trusts set up that allow them more inter-customer protection than the LSOC model. There are significant issues to resolve before we know if that will be feasible.

Nathan Ondyak: We were very public in our support of LSOC as a segregation model when many of our peers were not. It's important to understand what you get with LSOC and what you don't. LSOC restricts clearing houses from using your money to satisfy the loss of another customer. That's the primary benefit you get over the current futures model. In Europe, we have been running an LSOC-like model for many years for client clearing. Before Dodd-Frank and mandatory clearing, it was something that customers demanded. When we talk about some of the things we can do beyond LSOC, that's something we as an industry need to come together and look at. Nobody wants something like MF Global to happen. Nobody wants the client to lose any money as a result of an action not related to the position they have.


Sean Tully

Risk: **A lot of clients prefer to have a fuller segregation model and some of them talk about the risks posed by firms such as MF Global in the futures market. Do you think clients ought to have the option of a fuller segregation model?**
Nathan Ondyak: We're definitely in favour of client choice. In our European model, we offer multiple segregation models. Each model has different advantages and disadvantages for each customer and we don't see any reason why clients should be forced to go into one model if they are willing to pay for additional protection. That said, it's ultimately a far more complex issue than just saying you are for client choice. The US bankruptcy code currently restricts our ability to offer clients additional choice.

Sean Tully: The futures model has obviously worked very well for a long time. We will be ready for LSOC and be prepared to offer it to our customers, but LSOC actually would not have prevented MF Global.

Nathan Ondyak: Agreed, LSOC would not have prevented the MF Global situation, but it does provide the customer with more proection than they currently have in the futures world. The next step is to figure out how we can give customers the option to opt into segregation models that protect them specifically from MF Global.

Imane Cherradi: One of the solutions proposed by the CFTC is a third-party custodian; it is supposed to provide something very close to full segregation. We have been hearing from the market though, this is not going to solve the problem completely because accounts will still be under the futures commission merchant (FCM) name, and the FCM can still withdraw or liquidate assets without the client's approval.

Nathan Ondyak: That is the key issue. Certain clients have been pushing for full physical segregation as a way of addressing the MF Global issue. However, in this model, assets are still part of the OTC account class so, even though they are physically segregated, if there is a shortfall, that shortfall loss is attributed on a pro-rata basis.

Risk: **This tri-party model you referred to earlier – is that something we should try to achieve?**
Sean Tully: Talking about tri-party earlier, I was referring to the existing bilateral model. With bilateral swap relationships, some people take the collateral and post it at a third-party trustee to create a similar protection. The question is whether we can create something in our market, in a cleared space, that follows the regulations that would give customers a choice.

Imane Cherradi: There is a question as to whether the trustee will be under the FCM or under the clearing house. Each solution has advantages and disadvantages. Having it under the FCM means the FCM can liquidate assets or withdraw assets without the client's approval. Having it under the CCP presents a lot of operational challenges for the CCP, as well as removing some incentive from the FCM to clear for the client.

Risk: **On the issue of segregation, do you foresee any risk management challenges to having different segregation regimes in different jurisdictions?**
Imane Cherradi: From a technology perspective, there is no problem, it's feasible. But having different regimes and having many different local CCPs will reduce the offset capacity, increase the amount of money that market participants need to post and contribute to a collateral shortage.

Risk: **On collateral, a lot of liquid, safe assets will be needed to satisfy requirements to clear OTC derivatives globally. A recent survey by Morgan Stanley and Oliver Wyman predicted that there is a global increase in collateral demand of $500 billion–$800 billion. How is that squeeze going to affect the market?**
Sean Tully: That is a massive new requirement and it's a new cost. It is replacing another cost that has always been there, which is the credit value adjustment (CVA) risk. People are taking their CVA risk and transferring it into initial margin risk via this collateral transformation. We are focused on creating margin and capital efficiencies for our customers and making it as painless as possible. In March, we started accepting corporate bonds as collateral for swaps clearing. As of May 7, we started offering cross-margin offsets for house accounts between our interest rate swap cleared product and our entire interest rate futures complex.

If you are a swaps dealer, you really want to have all of your risks in one bucket, just like you would in a single netting set with a customer. How valuable is this? We've seen as much as 85% margin offsets. If you do it intelligently and if you get all of your risks into a single bucket – your futures plus your interest rate swaps – you can dramatically reduce the costs.

Risk: **Safety is a key concern of regulators as well as many clients. A lot of people are concerned about the risks of throwing margins for two different products together or accepting corporate bonds, for example. How can firms reassure people that their tools are safe?**
Nathan Ondyak: The industry benefits from margin efficiency – that is, reducing margin requirements through natural offsets that are safe from a risk management perspective, as well as broadening the eligibility of collateral. From LCH.Clearnet's standpoint, we are doing both. We recently announced our collaboration with New York Portfolio Clearing (NYPC), the Depository Trust & Clearing Corporation (DTCC) and NYSE Euronext to explore cross-margining LCH.Clearnet's SwapClear's interest rate swaps with DTCC's cash, US treasury, agency and repo businesses, and NYPC-cleared NYSE Liffe euro/dollar and treasury futures businesses. The cross-margin aspect of that is very important and we think it will give us a leg-up in that space as far as the assets that provide the largest amount of offset for our customers.

On the collateral side, you don't want to go too far down the credit curve of the collateral that you accept because you're increasing your risk portfolio. But, when you're talking about $500 billion–$800 billion in additional collateral, it behoves the CCPs to have a broader dispersion of collateral types than they have historically accepted. It is important to make sure you thoroughly evaluate any new collateral type and ensure that it has the right size haircuts and eligibility framework. We have extended our collateral throughout this year and are working on additional extensions for the future.


Imane Cherradi

Risk: **Looking at the issue of collateral and how a lot more of it will be required as margin in the future – presumably, firms will have to manage their existing stock of liquid, safe assets as scrupulously as they can. How can that be achieved?**
Imane Cherradi: We see an appetite in the market to go with models that provides more protection. Customers are willing to go with the LSOC model or are even asking for the full segregation model; this would definitely put a lot of pressure on high-quality collateral. Market participants are trying to propose different solutions. FCMs, for example, offer collateral optimisation and transformation. This could work in a normal market but, in a stressed market, it is going to be very hard to support this service because of lack of liquidity.

Clearing houses have been doing a great job of proposing new solutions like cross-margining. Calculating a margin across products sharing the same risk factors seems natural and will increase liquidity and improve collateral management. Another solution is expanding product eligibility; it is a very good solution if we know how to play with the haircuts to make it less risky.

Risk: **We talked about eligibility criteria and initiative with the corporate bonds at CME, for example. We've also talked about cross-margining, but you mentioned collateral transformation and optimisation. What do those terms actually mean?**
Imane Cherradi: Collateral transformation is the process of upgrading collateral. Buy-side firms, for example, would like to pledge assets they have that are not eligible for the CCP. So the FCM will take this asset, repo it and get the cash that will be posted to the CCP. Optimisation is a way of improving profitability by optimising the allocation of collateral.

Risk: **How do you feel collateral transformation is going to operate in the cleared environment. Do you see a big demand for services like that?**
Nathan Ondyak: There is certainly demand for it. Whether there is enough balance sheet available to offer it on the scope that many participants want is a different question. CCPs can help by broadening the collateral eligibility base, but we're talking $500 billion–$800 billion in collateral and we have heard estimates a lot higher as well. Ultimately, it's going to be one large piece in the puzzle.

Risk: **Another potential solution to the collateral shortfall that has been proposed is interoperability. Do you feel that interoperability is really a feasible solution?**
Sean Tully: What the market is most concerned about is credit safety. If we forced interoperability between CCPs, then a CCP would be forced to take the credit risk, the margining policies and the collateral acceptances of another clearing house without it having the right to manage its own credit risk.

If you forced the connectivity of the CCPs, it could have the potential to increase systemic risk. Forcing credit risks on people who don't want to take them is the exact opposite of what we have been talking about. To be very clear, that is very different from co-ordinating with and, in some cases, working very closely with other CCPs on different initiatives. We are very interested in working closely with other CCPs where it makes sense for the market and where it's safe – and we have done so with a variety of CCPs for more than 20 years. Forcing interoperability that creates credit risks doesn't make any sense.

Nathan Ondyak: We are currently looking to enter into an agreement to participate with a couple of other CCPs in a joint cross-product margining arrangement. There are opportunities for CCPs to enter into these things and let the market ultimately decide. Forcing interoperability is not a good idea.

Risk: **Do you have any views on the technological and operational hurdles that would be involved in that, even if you could actually get the CCPs to sign up?**
Imane Cherradi: It's going to be complex but, technology-wise. it is something achievable. Interoperability looks like a sweet dream but it is very difficult to implement in reality. Every CCP has its own risk methodology and its own way of calculating initial margin. Being forced to accept another clearing house's model will be hard. Also, if a customer chooses to be exposed to a specific clearing house, it is because he trusts their model, whereas interoperability will expose him to another clearing house, which is a risk that he is maybe not keen to have. It may become possible one day, but there are a lot of considerations that need to be taken into account.

To view and listen to the full proceedings of the *Risk* OTC derivatives clearing webinar, visit *www.risk.net/2181339*