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Upfront on clearing

The first clearing mandates have come into force in the US, with a further deadline due in September, while Europe and parts of Asia will follow in 2014. In this roundtable discussion, convened by Risk *and sponsored by* **Nomura***, a group of clearing experts discuss the challenges facing the industry*

Risk: **A recent survey conducted by *Risk* found most buy-side respondents are currently using two or fewer clearing members, but expect to sign up an additional four, or more, in the future. Does that tally with your experience?**
Ricky Maloney, Ignis Asset Management: Absolutely. Ideally, we would like to use as many clearing brokers as we can for risk diversification. But, unless you're a very large asset manager with sufficient flow, the business is not going to want to engage with you in that context. In addition, there are the documentation challenges. We are currently engaged with three clearing brokers, but that means three lots of documentation with each clearer. A lot of the documentation is done at entity level so, when you consider the 20 entities we have within our organisation, you're looking at 60 different sets of documentation just with our clearing brokers. This is without the documentation needed to sign with the central counterparties (CCPs), and there's also the documentation that we, as an asset manager, sign with our own clients, which sets out our responsibilities. So the biggest challenge is probably the documentation.

Risk: **What is the ideal number of clearing members?**
Bill Hodgson, The OTC Space: I'm not sure there is an ideal number. I think diversification is something you think about. Where are these clearing members based? What is their business model? What do they offer? What's their capital base? What is their stability in the market? In a crisis, you ideally want enough lifeboats to have the option. As long as you have some, you stand a chance of being able to port. There isn't really an ideal number, but you have to think carefully about your selection criteria.

Risk: **From the perspective of a clearing member, what are clients looking for?**
Lee McCormack, Nomura: People are asking about diversity of the clearing members. While there is an operational process to go through and an educational process, you have to understand what your requirements are as a client and work with people who are going to partner with you and will help you to understand what

The Panel (left to right)
Ricky Maloney, Co-head of service delivery, Ignis Asset Management
Lee McCormack, Client clearing business development manager, Nomura
Steven French, Director, product strategy, Traiana
Bill Hodgson, Owner, The OTC Space

those requirements are. Then, once you're live with one or two, you can look to diversify and expand and have the ability to use risk limits that your clearing members will provide.

Risk: **The *Risk* survey suggests credit strength is most important, with cost relatively unimportant. Do you agree that credit strength should be a key consideration?**
Lee McCormack: I think it's important. You don't want your clearing member going bust every day, but the clearing houses are building out their processes, so they now have this concept of business-as-usual portability. If a client wants to move some business away from its existing clearing member, the clearing member doesn't have the ability to block it if it is a risk-reducing portfolio and doesn't increase risk to the remaining clearing member. So, once people understand the process of business-as-usual portability, post-default portability and the protection of their assets at the clearing house – this concept of individual segregated accounts – it means the credit rating of the clearing broker is actually becoming less of an issue. That's not to say it is not an issue at all, but I think it was more of a concern for clients at the initial stages, when the market was still relatively formative.

Ricky Maloney: There are several elements to credit. There's the view from our credit office in terms of the banks themselves, but the biggest issue is which firms the big banks wish to do business with, and so what is their target market in terms of client clearing? If you're a bank that is happy to on-board riskier clients, then I probably wouldn't want to be in that same space. At some point in time, if there was an issue caused by one of these riskier animals, then we would have work to do to resolve what, quite frankly, we could have avoided by being more selective in our credit appetite process.

Risk: **How important is it to leverage an existing relationship with a clearing member?**
Steven French, Traiana: If a client has an existing relationship with a clearer, they want to get that one up and running. What they're interested in is the support by that clearer for the up-and-coming regulations – so connecting with additional clearing houses and understanding the segregation types a certain clearer can support. Under the European Market Infrastructure Regulation (Emir), there is the clearing member's capability around reporting, and some of the other regulatory issues coming in. Connectivity has been established for a long time, but we're seeing so much change, especially on segregated accounts. This was defined quite neatly in the end by the Commodity Futures Trading Commission, but in the case of Emir we're up against all sorts of different segregation models. So, the main thing is getting connected and then leveraging the existing connectivity.

Risk: **Is there enough capacity within the dealer community to absorb this demand? After all, even the biggest clearing members say they expect to take on hundreds, rather than thousands, of clearing clients?**
Bill Hodgson: By the time the September deadline comes, the futures commission merchants (FCMs) will have had a chance to trial and test their on-boarding procedures, their technology and their documentation. You would hope it gets easier and their capacity expands. But I suppose a mitigating factor in Europe is that the mandating of clearing is some way off. The European Securities and Markets Authority (Esma) has just begun the process of consulting on what should be cleared. Given how long things take in Europe, I imagine it will be quite a while before it actually comes out with a recommendation and then mandates it. Late next year is the predicted deadline. So, while some firms have a finite capacity to take on client clearing business, maybe it'll work out in the wash and either existing providers will step up or we'll see new entrants look to soak up the capacity. They may just say this is an operational challenge – you just need some technology, some automation and some volume thrown at it to make it work. So it's one of these icebergs – we can see the tip of it, but is there much beneath it? I'm not sure. It may turn out to be a non-event.

Lee McCormack

Lee McCormack: We've seen that from our side as well. In late 2009, there were maybe five or six of the larger banks with existing prime brokerage platforms or fixed-income intermediation platforms. They were out there, and they had a lot of the technology and the processes up and running. So they were out there marketing and educating early, well in advance of the mandates. Some of the clients wanted to understand how it worked then, so there was almost a perception that there were only five or six providers of clearing. In reality, there's a large group of providers in a second-mover category that have built their products as client demand started to increase and as the deadlines got a little closer. So there are certainly more providers out there than potentially what is perceived. The technology is becoming more commoditised and standardised, and the clients have got over the hump of building connectivity to clearing members and clearing houses and understanding how it all works.

Bill Hodgson: Some firms don't necessarily have the resources to offer clearing but would do it for relationship reasons. So they have a small group of top clients, and they want to keep them on board. I've been involved in discussions about whether firms would launch clearing, and they're looking at the Esma timetable and asking, 'when exactly is it going to happen?'. So when you go to get the budget, unless it's really staring you in the face and your clients are saying, 'we're going somewhere else', then you're not going to get the money, because it's quite a big effort to build what is, in effect, a small business to offer a service that you didn't offer previously. I think for some firms, culturally, it's a stretch to create an external-facing business that isn't trading – it's actually an operational service. With the deadlines coming along and, with them, more pressure, you may then see the justification for people to say, 'give me the budget to build the service', even if it's on a small scale.

Lee McCormack: There are barriers to entry in terms of clearing-house memberships and investment in the technology in the first place. But, once you're above that barrier, then you're able to build a scalable business. It depends on how you see it as a revenue model. Some people want to create a business purely out of over-the-counter (OTC) clearing, whereas others, including Nomura, have it aligned with their futures and prime brokerage business. If you can look at your clients holistically across three or four bundled services, then the ability exists to see a client across all of those services rather than to just ask whether they are going to be a good client from a pure OTC derivatives clearing point of view. So there are ways of being able to get comfortable that a client is going to be a good to work with.

Risk: **To what extent are clients choosing the firms with which they have a pre-existing futures clearing relationship? How much of an advantage is this?**


Steven French

Steven French: I think it depends on the FCM. Some FCMs have decided to collapse their OTC business into their futures business and others have kept it separate. The key thing is the client relationship side of things. There's this term we hear – 'OBO' (on behalf of), which is basically code for 'please take the problem away from me'. So, if a client can speak to an FCM and say, 'I don't really understand this, give me a package that takes it away', and there's an acceptable price point there, I think that's one option. We've seen some FCMs that are quite bullish about selling the new regime and actually going on the front foot across the different regions, whether that's Europe or Asia. So we're seeing a mix. But I think most clients are going to stick with what they know best in the first instance and then look for diversification with new FCMs across a number of different regimes.

Risk: **Coming back to the documentation challenges, there has been some progress in developing a European standard contract for clearing, led by the International Swaps and Derivatives Association (Isda) and Futures and Options Association (FOA). Has that made it any easier?**

Ricky Maloney: We waited some time for the Isda/FOA addendum to be published, and we've now reviewed that joyful piece of work. My expectation – and it may have been misguided – was that, on receipt, the banks would say, 'that's the bit we like, that's in, that's out'. But, of the three banks we're heavily engaged with, not one of them has been able to say, 'OK, these are the terms that we can agree to'. So, for a document that was supposed to be a short cut in terms of the time it takes to shape that documentation, I really don't think it has achieved what it set out to do. That's really disappointing from my perspective, because we've waited a long time for this market standard and I can't see much benefit to it. I think there are 235 pairs of brackets you need to complete. You need to insert the relevant information into those brackets. To my mind, that's not a standardised document that is going to assist you in any way.

Getting back to the diversification issue, we could probably appoint three, four or five clearing brokers if we wanted to. But, in 12 months, one or two of those banks might say, 'hang on, you've not given me enough business, and therefore I'm going to hit you with a minimum charge'. And why shouldn't they? Why should they hive off some of their balance sheet for me and I'm not going to use it? So what we perceive to be the model we would like could be completely different in 12, 18 or 24 months. If it then gets to the position where you're down to two clearing brokers, why wouldn't they say, 'we're going to hit you with a cost because we can? We know you've got two clearing brokers, so we're going to charge you'. That's why it's very important to pick a clearer you have a tremendously strong existing relationship with, which is pretty much what we've done.

Risk: **How might these potential charges develop?**

Lee McCormack: It comes down to how your clearing member views that relationship. Is it across the futures and the OTC clearing space together? Is it alongside prime brokerage? Is it alongside a repo facility or a credit line it is extending to the client elsewhere? OTC clearing is very much a bundled service in our eyes. If you don't see it as a stand-alone business and you see it as a bundled service, in the same way you get your broadband, phone, TV and email accounts all provided by the same provider, then you can work with your clients across a range of businesses and make it work as a commercial relationship together.

Risk: **Nonetheless, it's early days for clearing. It's inevitable that additional fees will creep in if someone isn't getting enough business from the clients they've signed up.**

Lee McCormack: Yes, I think we'd try and be very transparent with the clients about it, and obviously they understand that it is a business that has got to pay for itself – it's not something you're giving away for free. We're seeing a little bit more harmonisation with regard to fees and costs across all clearing members and providers. It's something that will play out to a natural level over the course of the next few years.

Ricky Maloney: We're seeing the banks are trying to put fairly short notice periods in terms of additional costs. So, with 30 days' notice, for example, they could raise the price of their services. The buy side doesn't like to spend money, so your initial thought would be, 'I really don't like that'. But, if you think about it, you've appointed a clearing broker and you need it to remain in business. If it goes out of business, then you're in a hell of a lot of trouble. So you don't want to be in bed with a clearing broker that is running a business model that's making a loss. They need to be there in two, three, four or five years' time. So it does need to be costed appropriately. And I fully understand there are so many unknowns within those costings.

Risk: **The *Risk* survey also shows a wide variation in the pricing for clearing services. What is driving the differences in pricing, and do you expect the market to converge?**


Ricky Maloney

Ricky Maloney: There was a slight variation in the initial proposals we saw, but the beauty of having multiple service providers is you take the best rate. You say, 'come on guys, this is the level we're looking at. I know it's not unreasonable, because bank A has promised me this is the level at which we can do business. How close to that can you get?'. I don't want to drive people into a loss-making business, so it has to be a number that works for us both. So, variations in price? Not really, if I'm completely honest.

Lee McCormack: I think it happened at the start. You had firms that were negotiating with 14 different firms, and through the price discovery mechanism and the feedback they get from their clients, eventually the pricing starts to standardise quite rapidly.

Risk: **What lessons have been learned from the first two clearing mandates in the US?**

Steven French: We've seen two categories coming into play so far in the US. The first thing we have to do is take a step back, and there has been a lot of discussion on what the issues were. So there has been FCM readiness or ability to on-board their clients. There has been client understanding and then documentation – the time it can take to get the documentation in place. Then there's the technology. We hear stories about spreadsheets being sent around to get trades cleared after the mandate. So the key lesson for me is you can't spend enough time reiterating what needs to be done in order to get ready. We've seen this in a lot of our conversations with regard to reporting. We started talking about that particular subject a year ago, and you say it and you say it, and then you say it again, but unless a client or an FCM is ready to hear it and is tuned in at that particular time, it just gets lost. The industry groups do a very good job, and the independent vendors do a very good job. So I think the lesson is concentrate, listen, and make sure you're on your FCM's radar, and make sure you're fully aware of what the up-and-coming regulations are.

Lee McCormack: The lesson from the US is that some people did get a little bit caught short, and they also got caught a little bit late, so negotiating documentation should be something that's not rushed. What we've seen is actually a huge pick-up in business after the deadline, because people did something to get live with their first clearing member, and then the second, third, fourth and fifth clearing members were receiving an increasing number of reverse enquiries from clients about access to clearing. In Asia, it's different, because, while there is no mandate for a lot of the countries in Asia, we think that, once the European timelines kick in, then that's the US and Europe both online. Providers of liquidity – sell-side providers – won't be able to shift their trading books from the US or Europe into Asia, because there's an anti-avoidance clause in both Emir and Dodd-Frank. Clients that trade global OTC derivatives with these liquidity providers will be encouraged to put their trades into clearing because of the pricing as a result of Basel III and the bilateral margin rules. Liquidity and pricing are going to push the Asian market, but I don't think that will necessarily really catch light until Europe comes in.

Risk: **To what extent will the different models being developed for margin segregation in Europe hamper the ability of derivatives users to trade across different CCPs? Can clearing members facilitate all the segregation models being developed by CCPs?**

Steven French: We have three types of model under Emir – two that are mandated and we also have the omnibus account. I think there are something like 14 or 15 variants, so the first thing is, what suits the client? Then, what does the clearing member support and what does the CCP support? Technology aside, there are already three participants that have to be aligned in order to provide a service. Then, when you plug the technology in on top of that, how long is it going to take to get compliant with the various systems? What about testing? If a CCP introduces a new model, how do you back-test that? So there's a massive impact. I think lessons could be learnt from what happened under Dodd-Frank, where we had the single model. I don't see how that's going to happen under Emir right now. I think it looks like we're going to end up with these 14 or 15 different models.


Bill Hodgson

Bill Hodgson: But then the question is, would anybody choose a clearing house solely because of one of the models? I did analysis once comparing all the different selection criteria, and product coverage and counterparty coverage are the two main reasons you choose a CCP. If they don't clear the product you want to clear, then there is no point in going there. If they do clear the product but your counterparty's not there, don't bother. Without the counterparty and without the product, you haven't got a business. So I suspect that, while it's a topic for us to debate in public, I think we'll find there are other criteria. The models will even out a bit, like the cost and everything else. I think conceptual discovery and disclosure under Emir will mean the clients will drive the models towards where they want them to be and the rough edges or wrinkles will go away.

Risk: **Have the regulators put the right incentives in place to encourage the central clearing of OTC derivatives? How will the forthcoming uncleared margin rules from the Basel Committee on Banking Supervision and International Organization of Securities Commissions impact that?**

Bill Hodgson: When the margin requirements on uncleared trades come out, you'll be absolutely desperate to go into clearing because, if you've got to be charged value-at-risk margin per asset class with no offsets between them, uncleared business will become very expensive. I think at the moment we're all waiting to see what the future landscape looks like, and then I think the economics will drive people to stop doing uncleared business and should just develop products in clearing. I think that's the way the world is going to go.

Lee McCormack: I think those holding off from going into clearing are doing so because they're comparing today's bilateral world with no exchange of initial margin versus the cleared world and saying, 'actually, that's a bit more expensive so I don't want to do it'. But what is going to push people into it is when the bilateral margin rules come in.

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