

# A clear market move

*As the derivatives market moves towards central counterparty clearing, the relationship between banks and their clients looks set to change. Banks have been working to provide clearing services to their clients in the last year and Risk convened a panel in London to discuss the future*



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**Risk:** Who in the market is going to have to clear? The corporates have negotiated some kind of safe harbour, but who else will be dragged into the clearing framework?

**Andrew Ross, Morgan Stanley (AR):** All financial counterparties will have to clear. There might be some exceptions where significant groups – perhaps pension funds – successfully lobby not to clear. There are situations where corporates can be pushed to clear if they are doing a trade of a significant volume, but that's not yet defined in Europe. We're unlikely to see wide-scale exemptions due to the regulators' push for this situation to be more systemically robust than what we've previously seen.

**Risk:** Which products are going to need to be cleared?

**Michelle Neal, Nomura (MN):** It is going to be an increasing spectrum of products as the central parties' capabilities become more advanced. The core asset classes will be interest rate derivatives, credit derivatives and foreign exchange derivatives. It's largely going to depend on the capabilities of a central counterparty (CCP) and the products it can support on its platform that will have to evolve. We'll have to see how prescriptive the regulators become about what products they want to see cleared. It will come down to risk management capabilities and liquidity of the products being cleared.

**Risk:** There will be clients who won't have direct access to CCPs, such as banks that are clearing members or brokers and the CCPs themselves. How will client clearing work?

**Gavin Dixon, BNP Paribas (GD):** Client clearing is quite similar to how it operates today in the bilateral market. The clients will execute with the bank, be it on an electronic platform or on the phone. The trade then needs to be matched or affirmed. Once that is done, the trade can be fed down to the CCP. It is then that

## The Panel

**BNP Paribas** Gavin Dixon, Global Head of Fixed Income Trading Business Management & Market Initiatives

**Morgan Stanley**  
Andrew Ross, European Head of OTC Clearing

**Nomura**  
Michelle Neal, Global Co-head of Electronic Markets and Prime Services

**Royal Bank of Scotland** William Knottenbelt, Prime Services, Global Head of Central Counterparty Clearing



Andrew Ross

it starts to change a bit. The majority of clients today do not post initial margin, but they will have to in the new cleared environment. Most financial counterparties are used to posting variation margin under the bilateral agreements and that will happen again in the CCP world. On top of that, they will post initial margin based on the risk they have in their portfolio.

**Risk:** We've heard the word 'margin' mentioned several times. What's going to count as eligible margin for a client?

**William Knottenbelt, Royal Bank of Scotland (WK):** Predominantly, government bonds and cash instruments will be the main focus in terms of what will be accepted by exchanges. We're also noticing that it's going to be quite prescriptive. In the US, the Commodity Futures Trading Commission (CFTC) put out a paper in which they started to restrict the type of collateral you could use. They are restricting money market funds to 10% of the overall value of client collateral. You've got non-US government bonds, and Fannie Mae and Freddie Mac bonds, which are not going to be acceptable in the US. It'll be interesting to see what happens in Europe. The paper was really quite restrictive compared to what we're allowed to put up at the moment. There will be positioning papers written up by various industry entities trying to get this changed because it is highly restrictive.

**AR:** Until now, counterparties trading under a bilateral agreement could agree to contractual terms to post assets they have available in their funds. If you are a corporate bond fund, you could possibly use corporate bonds as collateral. It is now unlikely that those are going to be acceptable at the clearing house. For variation margin, it is probable the clearing house is not going to accept anything other than cash. That's a challenge for a number of end-users who might not have cash available in their funds, nor financing, such as repo-type activities to enable them to upgrade assets into eligible assets for the security house. From a dealer's perspective, clients who clearly have a demand for cash to meet their margin calls don't want there to be any risk of not being able to meet it. If they don't meet their margin call, they could theoretically be closed out. While the fund may be liquid, it might not have the liquidity in terms of cash to meet the particular margin calls. This creates a new dynamic in this market with existing over-the-counter (OTC) and existing futures.

**Risk:** Is it true that banks may want to charge some kind of top-up or extra margin to insure against the possibility of clients not having the margin when it's required?

**MN:** If you are a significant clearing broker, you could have hundreds of millions to post in client collateral. If you find yourself short of being funded by clients, then that could post a real risk. Looking at what sort of top-up is going to be available to cover the scenarios of when clearing houses are going to be open, when trades can be registered and when payments can be made – it is something that needs to be looked at very carefully by anyone who's offering a clearing service. One other thing to think about would be the client's own risk profile. Not all customers will have the same risk profile and, as a result, what they want in excess or top-up margin paid.

**GD:** Bank risk departments will look at the CCP and its risk management process to determine if the methodology is sound, in addition to the usual credit review of the client. Given the methodology and client, they're going to come up with a



Gavin Dixon

decision on margin requirements. They will want flexibility to charge top-up margin. However, that doesn't mean it will be used. The option is there, but it is not going to be a well-used option. But, banks would still like that safeguard in times of stress.

**Risk:** The whole point of moving to CCPs is that it's going to take away counterparty risk. That margin still belongs to the client. The party that has executed the trade will want some kind of security where, in the event of a default, they will still have some kind of claim on the margin. What is the picture as far as segregation is concerned?

**WK:** There is a push in the OTC world to have individual segregated accounts all the way through to the clearing house. Historically, that hasn't been in place. We have tended to have omnibus accounts.

A CFTC paper outlined four methods – one is total segregation all the way to the clearing house; the second is that the clearer has an omnibus account that reflects the collateral that goes to the exchange clearing house so it can see all the way through; the third is that they change the waterfall they have in place as to when the client account comes into play against clearing members' defaults; and the fourth is to keep existing omnibus accounts that you have on the futures side.

**Risk:** What is the problem with an omnibus account?

**GD:** There is nothing wrong with it per se. It has worked in the past. However, the issue here is that – in the US, in the omnibus structure – the clients in the omnibus account are at risk to the other clients in that account. In the futures world, that has worked because it's easy to liquidate if there's a default. That is less certain in the OTC world – there is much more inherent risk. So, even if clients are paying a bit more initial margin, they would like it legally segregated.

**WK:** An issue is that, with the large asset managers, you have numerous accounts and that gets quite complex. It does become quite costly when you have to individually segregate all the collateral.

**Risk:** Are clients aware of this additional cost? Do they want individual segregation at any cost?

**GD:** The US certainly seems to be more prescriptive in terms of the way it is looking at things. In Europe, it is more open to negotiation between clients and clearing members. There is no regulation around it, so you can see a different service for a different price. The question then becomes 'what do they think they are really getting?' and, in times of stress, 'do they really feel that they've got value for money?' In the end, I would go towards more segregation.

**WK:** It is going to be quite interesting to see what happens because we're already seeing differences between the US and Europe. We will see how those manifest over the coming months.

**Risk:** Are there no guarantees around portability in Europe? Does it come down to negotiations between clients and clearing members?

**WK:** It's quite clear that the client has to negotiate a back-up capability with another service provider in order to get that portability. The number of back-ups they need depends on how large the client is, most would be looking at two.

**MN:** Everybody is going to want to think about the implications of setting up a back-up clearing arrangement and then trying to utilise it if the need ever arises, which could be years away. There are things that back-up clearing brokers are going to require in order to consistently assess if they will be able to take on that business. Maybe they are going to want transparency of customers' risk positions or maybe some sort of weekly report on how much initial margin the client is posting – to get some idea of the funding requirement and the risk positions the client is going to have. Perhaps they will look for some sort of primary business from that customer and some frequency of operational testing to determine that the portability can take place. Also, the CCP has a role to play in how successful portability is going to be in terms of what its technological capabilities are and how smoothly it can facilitate this process.

**Risk:** Can an institution just have one clearing broker and a standby for a rainy day to turn to when things get difficult?

**AR:** We started this because we wanted to reduce systemic risk. Let's say Lehman Brothers defaults in a world where clearing has been ongoing. All those trades port to a counterparty. We, as clearing members, suddenly have to find additional capital associated with that. This is additional capital held against those trades and the guarantee fund to which we contribute. In the current incarnation of the LCH.Clearnet Swap Clear model, this is a low-risk process because the amount of guarantee fund contribution is relatively small compared to the current model to the initial margin. For other clearing houses with credit, for example, IntercontinentalExchange or Chicago Mercantile Exchange Group, you could have up to 40% of initial margin being funded by the guarantee fund. The day after Lehman has gone bust, you are guaranteed to back up a whole series of counterparty risk – you have to put a whole load of cash into the clearing house the day after one of your correlated counterparties has gone bust in an environment where funding is particularly scarce. Secondly, you could see a situation where, for instance, a British bank was clearing for another large British bank that has gone bust. You are taking portfolios of trade from a very correlated entity to the one that has just gone bust. In the credit world, where you have big fat tails around binary outcomes and jump-to-default risk, it is a very interesting position to be in.

**Risk:** Talking now about the costs that users of client clearing would face, both in terms of the margin costs and the fees associated with clearing itself as a service – how are you thinking about pricing this as a service?

**WK:** It very much depends on the client you have and your relationship with them. If it is a new client – someone with whom you don't have a particularly strong relationship – then that will be



Michelle Neal

borne in mind in the costing. We will have other relationships on the prime brokerage side or the futures side with clients, and this will act as part of the overall offering. This way, depending on the size of the client and what they are doing with us, we will determine what we charge. There are costs to be assumed from both the clearing side and from the client side.

**GD:** If you look at today's non-cleared world, the dealers make money by executing deals with clients. That's not going to change in the future, so you are going to see a different pricing if a trade is executed and cleared with you versus a trade just cleared. However, it will depend on the client relationship that you have across the entire organisation.

**Risk:** Could accepting a client for a client clearing service be dependent on them providing execution business? Would you accept someone who just wanted to clear with you?

**MN:** We have to look at that in terms of what sort of risks you are taking on for what type of reward. You're going to look for some upside in this relationship or some economics that make sense for the risk that you are taking on. One thing is for sure – the CCP is already charging fees and one would expect these fees to be passed on to customers at some level. On the flip side, people are obviously looking at clearing as a way of defending, maintaining and growing their execution businesses. You need to look at the overall relationship. If you don't really have any type of relationship with a customer and they just want to use you to clear, you need to look at its individual merits. Similarly, from a customer's perspective, they are going to look for excellence in execution when selecting a clearing broker. Clearing brokers won't just be selected on the basis of operational excellence, they will also be selected on the basis of execution because you would expect to give perhaps a disproportionate amount of execution to your clearing broker. If you want the dynamics of this relationship to work, you would be thinking about channelling your business and thinking about it from both perspectives.

**Risk:** Is cross-product margining deliverable?

**GD:** There is potentially cross-product margining at the CCP itself, for example, where it has products that offset futures against swaps. There, you can get additional benefit at the initial margin level that the CCP is charging. Equally, within the clearing broker side of things, you could look to offset cleared businesses with uncleared businesses across assets. The question then is: if the level of margin that you calculate in a value-at-risk model across all cleared and uncleared business that the client does with you, is less than the sum of all the minimum amounts that the CCP wants to charge – do you offer financing and how does that get treated for capital? There are a number of things that need to be worked through, but cross-product margining is definitely something that will take place.

**Risk:** Is cross-product margining across cleared and uncleared products something you have talked to clients about?



**WK:** We have had discussions, I wouldn't say they have been in depth. There are three circles that overlap – intermediation, futures and CCP. These cross over, so it is very important how you integrate them to provide a service to a client. But, we are still waiting for more regulation concerning the detail of what we're allowed to cross-margin.

**AR:** We have tried to set ourselves up for that eventuality – that we book everything through internal systems, rather than an off-the-shelf vendor package – because it gives us the energy to pump it all into firm risk systems and make the best of the technology that we have in prime brokerage, and so forth. This allows us to offer those types of solutions if and when the regulations allow it. That is a kind of strategic architecture decision that we'd made to support that, but it's a long way from anyone being able to do that with a degree of confidence. It is not clear yet what the demand is from clients. It is also not clear what the regulation in the US and Europe will allow.

**Risk:** If there was a situation where a bank calculated that the net margin made across cleared and uncleared positions would be less than the amount required by the CCP, implying that one could hold zero margins across bilateral positions, do you think regulators would be happy with that?

**MN:** You would have to think there would be capital charges associated with that scenario. I'm not sure if that particular outcome has been specifically contemplated and what the restrictions would be with respect to cross-margining and margin finance. You could think about all kinds of parameters that you could implement in a firm to manage that sort of outcome – from your sales process, with respect to the kind of business people are encouraged to put on, to the collateral management process where CCP margin will need to be posted on a gross basis for the most part. I don't know the firm answer to the question, but I think, in general, around this is an area in which banks will seek to differentiate themselves.

**Risk:** The Group of 20 (G-20) nations has already called for all standardised derivatives to be cleared through a CCP by the end of 2012. Do you think it's possible to meet that deadline?

**GD:** Not as we stand today. There is still a lot of ambiguity in terms of the rule-making process. There is a lack of CCPs in most countries in the G-20 structure. While Europe and the US might have a number of CCPs, Japan and various other G-20 countries have nothing live, so there's little chance they are going to get all their financial derivatives cleared by the end of 2012. I think the realistic target is to have the process started by then.

**Risk:** How long is it taking from initial contact with a client – dealing with first principles – through to talking about backloading, portfolios and signing legal agreements?

**WK:** It's an iterative process. This is something that will develop over time. There is no quick solution. With the regulations still not completely refined, we're having conversations with clients and trying to help them as much as we can. Certainly in the next



William Knottenbelt

six months we are going to get more definition and we'll be able to work further with the client.

**AR:** In the US, the timeline is even tighter than that. It looks like the Securities and Exchange Commission and the CFTC have 360 days to write and publish their rules. There had been significant comments from the chairman that this would occur and it looks like July is when the rules could come out, with anything as short as a 60-day implementation period. You could be having to cope with this by the end of 2011 in the US. It's not clear if we have all of the CCPs set up yet to cope with all of that.

**Risk:** Do you think the move away from bilateral counterparty risk to one based on hubs, spokes and smaller hubs is the right way to go?

**WK:** On the whole, yes. Centralised clearing and the clearing houses have proved, historically – through the futures market – that they've managed risk very well. So, my initial indication would be that it does work. Again, we come back to the detail that surrounds it and how much the regulators allow you to do.

**GD:** Clearing is not the cure for all the problems in the financial markets. When Lehman defaulted, LCH was the only working OTC clearing house and the process worked well. But, as you get more clearing houses and more competition between them, the regulation of the clearing house becomes central to the issue. You end up putting more risk in the clearing house. It has moved from the banks being the problem to the clearing house being the potential problem. A lot is going to depend on the right regulation and the financial backing and capital that the clearing house has, as well as its risk methodologies.

**MN:** It does represent a different model. It will be more expensive to carry risks, whether it's net or not. If you look at all of the pressures around reduction eligibility criteria, and so on, you might have non-specialist providers entering the market. You could have outcomes that we don't know how would play out in that sort of eventuality. This is one of the interesting things about Europe – it seems committed to not compromising the integrity of risk management and the process – whereas in the US there is a lot of pressure around eligibility criteria and open access.

**AR:** If you could fast forward five years, clearing would be somewhat boring and everyone would be comfortable with it. Everyone would be wondering why we spent so much time fussing over it and be happy that there will be consistency in processing and in the legal side. It will be a much more streamlined process; there will be liquidity and a better ability to get pricing clarity as a result of clearing. It's the bumpy road between now and five years' time that is the challenge for us.

To view and listen to the full proceedings of the *Risk* client clearing forum, visit [www.risk.net/media-centre](http://www.risk.net/media-centre)