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CDS clearing – The looming mandate

The future of the credit derivatives market is inextricably linked to that of clearing. A regulatory mandate and a reflective clearing solution should help constrain costs for banks as well as capital, make the market more efficient for end-users and provide more in terms of liquidity for the product. Without these, however, credit default swaps trading will continue to struggle. Malavika Solanki, head of business development at LCH Clearnet CDSClear, responds to some of the more pressing questions on the subject

Risk: Could you provide the timeframes for credit default swaps (CDS) clearing, and explain the difference between this and the interest rates swap market?
Malavika Solanki: The interest rates regulatory technical standards (RTS) were published at the end of September. The European Commission now has about three months to endorse those rules, after which the European Council and Parliament have another month or two to either provide a non-objection or seek to alter those rules. This is why the term 'draft final' still hovers.

The expectation is that the mandatory rates clearing timeline will be in four stages, starting from Q3 2015 and running through to Q1 2018. The draft final RTS for credit derivatives was due at the end of November 2014.[1] There really is not as much of a difference as people initially thought.

A lot of asset managers have been encouraged by execution counterparties to start looking at clearing earlier than the mandatory date to benefit from the pricing differential (between cleared and uncleared products). So the possibility exists of accelerated timelines on a voluntary basis, albeit for a subset of the markets.

The participant profile in credit derivatives varies quite significantly – especially for Category 1 (Cat. 1) – from that for rates. Interest rates have been broken down into four categories. The first two are current clearing members and larger financial counterparties. Then rest of the financial counterparties fall into the new Cat. 3, and, finally, non-financials.

The rates mandate raises an interesting question. Do the Cat. 1 counterparties for interest rates automatically become Cat. 1 for credit derivatives? Or is that Cat. 1 mandate going to be set on an asset class-specific basis? A lot of the banks that aren't necessarily members of credit derivative clearing services today are going to be looking at that question in the coming weeks to determine whether they have to be ready 12 or 18 months from now.

Risk: Looking at some of the other categories: what are the implications for end-users in CDS clearing and who exactly is going to be affected here?
Malavika Solanki: I was at a primarily buy-side event last week and almost every institution was looking at its peers in the room and asking, 'is it you? Is it me?' The segmentation is between large counterparties and other financial counterparties. Large is set at €8 billion in notional, calculated on a monthly basis in the three months preceding the interest rates RTS coming into play.


Malavika Solanki, Head of business development, CDSClear

There is a fair amount of lobbying around what happens and when that calculation period should start in order to give the market some time to adjust, but that becomes a definition of Cat. 2 versus Cat. 3. The expectation is that, by Q4 of next year, Cat. 1 CDS institutions would have to start to clear. Come Q2 2016, Cat. 2 would have to start; Q4 2016 I believe Cat. 3 would, and then Q2 2018 would be Cat. 4. Now, if Cat. 4 is non-financial counterparties for credit, that's a much more restricted set than perhaps some other asset classes.

If you look at the differences between the way the rates players are affected and those in the credit markets are affected, there is a question about where the banks that are clearing one asset class, but not clearing credit today as members, fit in. There is a question about defining asset managers and residual funds that aren't already clearing under the US regime.

There isn't really a lot of conversation about Cat. 4. There are players out there, but there aren't enough to 'make noise' thus far.

Risk: Talking about Q4 2015 and into 2016, what are the benefits of moving to central clearing today, rather than just waiting for a year?
Malavika Solanki: A hot topic is frontloading. Participants are discussing: calculation processes; whether they are subject to it; and whether Cats 3 and 4 will be subject to it.

Setting aside the complexities around calculations, if an institution is subject to frontloading, it would need to start tracing its trades over the next 12 to 18 months. That comes with its operational complexities.

What hasn't been discussed much is the scenario in which two participants trade a CDS and are both subject to frontloading. Do they each continue their clearing broker selection processes and have 12, maybe 18, months to start clearing? This is, effectively, delaying a very important question.

What happens if, 12 to 18 months from now, participants have chosen different central counterparties (CCP)? Most aren't thinking that way, because they don't have to agree on the CCP up front today. They are still thinking about how to choose their broker, and what they put into clearing. These are bigger strategic questions. What happens if on December 1 next year, both are Cat. 1 with different CCPs for clearing? We don't know. Participants should start thinking about the strategic decision about which CCP they want to be clearing at up front, and finding some way of agreeing that.

Risk: How do market participants prioritise execution, clearing, bilateral integration? What should they be doing here, and what should they be – or what are they – prioritising?
Malavika Solanki: Firms should be looking at what benefits clearing delivers, and how to best take advantage of those. Also, how it fits their business models on a holistic level to capture classes beyond what is required. Including things that are available for clearing, but not part of the mandate, might open opportunities to offset risk. Firms will have to find clearing brokers who can service their business appropriately – even in disrupted market conditions.

Even before participants determine where – or what – they want to clear, they should be thinking about which relationships are the best fits. What is important to you? Is it your prime broker business or other parts of your business? What is your service model, what is your desired service state and how much are you prepared to pay for that service state? Because that's part of the conversation here.

Once firms have a comprehensive view of your business strategy and needs, they should begin talking to clearing brokers and CCPs in parallel. I was at an event recently where about 50% of the audience said they were still working through the strategic pieces, let alone the 'how do you start setting up clearing brokers?'

As for their view of bilateral business and execution, I think that is determined by what firms want to clear. Look beyond what you have to clear to what you want to actively clear, because the cleared versus uncleared prices are going to be different. This is why it is definitely worth looking at what firms 'can do' rather than what they 'have to'. The execution aspects are linked into venues, pricing and all of those pieces. Once you know what they want to clear, they can then consider what was not clearable and what they don't want to clear. And then address those pieces bilaterally.

Risk: You're obviously out there yourselves at CDSClear, but how are you helping your members and your clients prepare for the mandate?
Malavika Solanki: When we're talking to members, especially on the house side of their business, the conversations with big members are more focused on

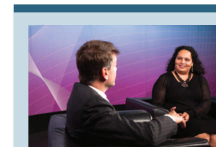
efficiencies. When we talk to people who aren't yet clearing but are looking for clearing, the conversation tends to be on topics like frontloading, and the best way to do it.

We start the conversation by asking 'what are your needs? What is the problem you really want to solve? Is it just the mandatory piece on day one? Is it more holistic?' Most institutions have a clear view about the immediate problem they're trying to solve. We work with them to understand what they're trying to get done, and look at areas such as product coverage, margin simulation and compression services. Because of the capital conversations, both our members and clients are especially interested in top quality compression services.

Risk: Is that something you're planning on doing?
Malavika Solanki: We've had flexible compression for a while. Whether you're a member or a client, the terms are effectively the same. The only difference is how accounts are setup to maximize compression efficiency and frequency for users.

Our product coverage is quite broad, which is key to our customers and prospects. We work with them and their brokers on margin simulation services to understand the operational implications and then move into implementation. A lot of our bigger clients want to put a couple of trades in to see what happens to their profit and loss and then slowly start to use it. Ironically, the conversation frequently comes back to not just what we're offering on a sales basis, but specifically: will the benefits of clearing earlier than the mandate help their business?

Risk: In terms of any new tools you're planning on launching with CDSClear, can you tell us any plans for the future?
Malavika Solanki: One of the things we're looking at is extending compression and our corporate instruments into new products. We're also looking to enhance our collateral and trade management services. I can't be overly specific about this at the moment, but we are constantly developing our product suite and operational efficiencies around trade submissions, receipts, messaging and collateral management.



>> View the full proceedings of the LCH.Clearnet CDSClear sponsored Q&A, *CDS clearing –The looming mandate*, at *www.risk.net/2384578*

[1] *The European Securities and Markets Authority is delaying draft rules on CDS clearing until the European Commission has adopted its draft RTS on interest rate derivatives.*