Margin leaves its mark

As the derivatives market's new margining regime expands, banks are starting to fret about the funding and operational costs.

Or so say the results of this year's survey of respondents to the *Risk.net* broker rankings.

The margin rules for non-cleared derivatives are rolling out in annual phases, with the largest 20-or-so dealers caught in September 2016. Since then, six were added in phase two, and it's understood this month's third phase caught a further 10 firms, including at least one buy-sider, Brevan Howard. However, banks are most worried about phase five's "big bang" in 2020, which is expected to bring hundreds – or even thousands – of counterparties into the regime.

Non-cleared trades are intended to be more costly to fund and operationally complex to manage – features of the regime that ought to encourage dealers to clear more trades, and potentially create a price advantage for cleared trades.

Almost two-thirds of respondents now say they price cleared and non-cleared trades differently, compared with just 53.3% last year. In 2017's survey, 22% of respondents said they expected to see differential pricing emerge within the coming 12 months, so this year's increase bears out those expectations.

Just over 40% of respondents say so-called clean CSAs – those that are cash-only, and require margin to be posted in the same currency as the trade – should be used as standard between dealers in order to support the non-cleared market – a sharp increase compared with just 29.9% last year. Clean CSAs reduce some of the complexity associated with non-cleared derivatives.

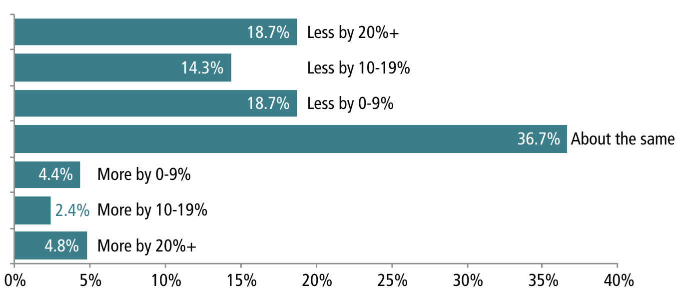
Clients should be offered a price incentive to switch to clean CSAs, according to 16.1% of this year's respondents – a doubling from just 7.9% last year. The number of banks favouring more widespread use of compression and netting – another way to manage margin funding requirements – also jumped from 18.3% to 31%.

Meanwhile, trends in the broker market remained largely stable over the past year. A majority of banks say they are spending less on annual broker fees as the trends of consolidation and diversification in the broker market persisted. Just over half of respondents say spending on broker fees is lower than it was three years ago – a drop from 60% last year.

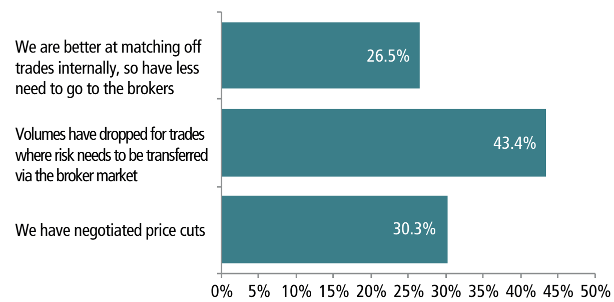
The principal reason for the drop in spending, according to 43.4% of this year's respondents, is because activity is lower in products where risk needs to be transferred via the broker market. Just over a quarter of respondents attribute lower broker fees to an improvement in their ability to match off trades internally, meaning they do not need to use a broker – this is up from 20.6% last year.

Three-quarters of respondents to the survey – down slightly from 78.1% last year – believe volumes of non-cleared OTC interest rate derivatives will decline in the future. ■

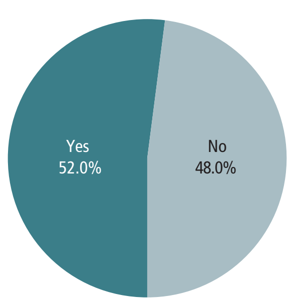
Q1 Is your bank spending more or less on annual broker fees than it was three years ago?



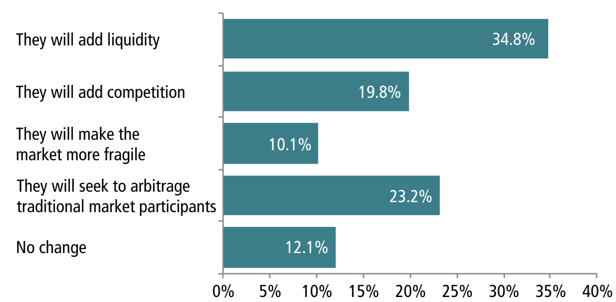
Q2 If your broker costs have dropped, what is the principal cause of the decline?



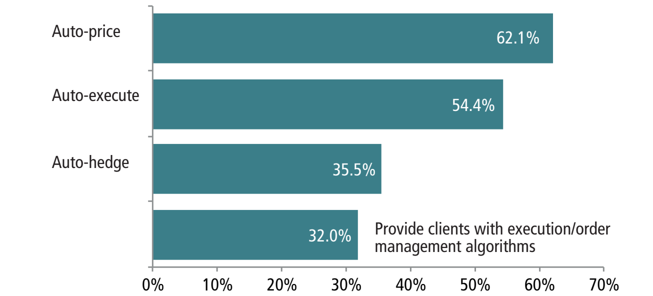
Q3 Do you expect non-banks to become significant providers of liquidity on interdealer platforms?



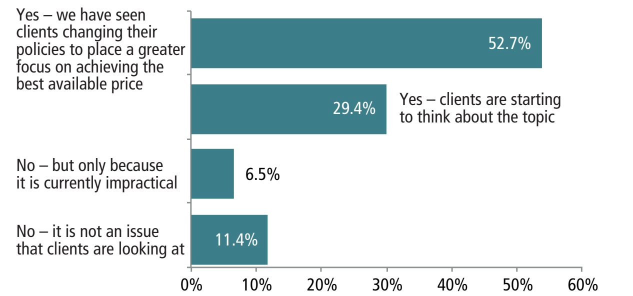
Q4 What will be the most notable effect on OTC markets if proprietary traders (eg DRW, KCG, Virtu) gain access?



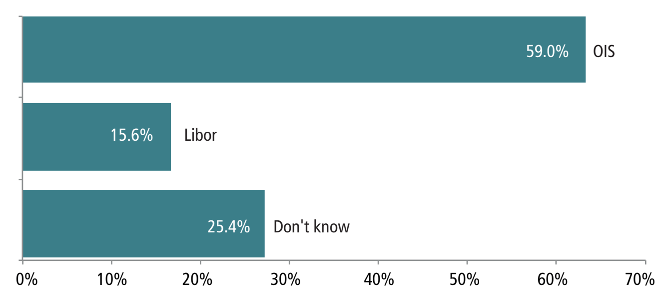
Q5 For electronically traded products, what can you currently do? (select all that apply)



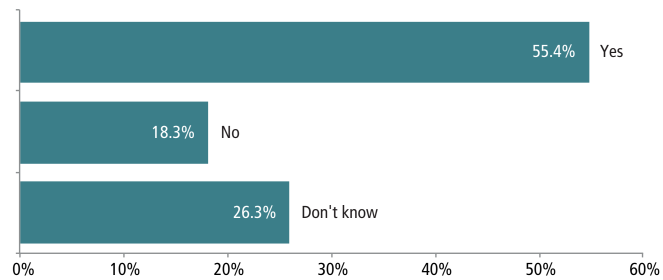
Q6 Are clients taking more interest in best execution for OTC trades?



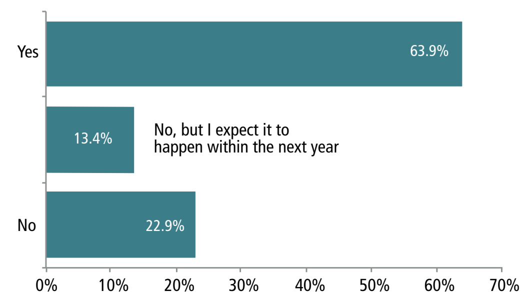
Q7 What rate do you use to discount cash-collateralised trades?



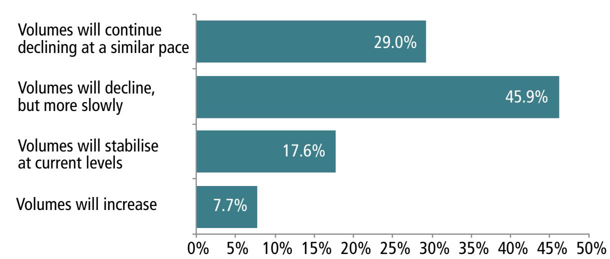
Q8 Does your firm take collateral posting optionality into account when valuing trades?



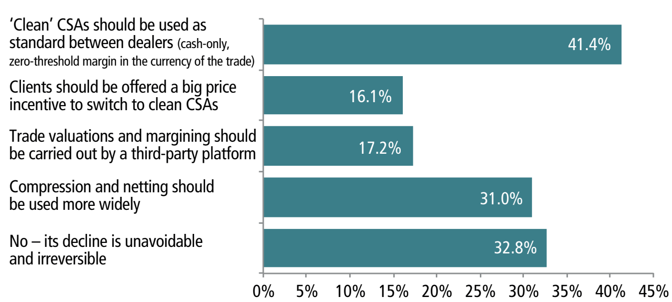
Q9 Do you currently price cleared and non-cleared trades differently?



Q10 Volumes of non-cleared OTC interest rate derivatives outstanding have more than halved in the past two years. What will happen over the next two years?



Q11 Can the industry do anything to support the non-cleared market? (select all that apply)



Q12 If the interest payable on variation margin posting in your CSAs is negative, are you paying interest on top of your out-of-the-money margin postings?