Clearing Management Insight Report

Winter 2023

In partnership with:

QUANTILE
An LSEG Business

About this report

The Acuiti Sell-Side Clearing Insight Management Report is based on a survey of the Acuiti Clearing Expert Network, a group of over 100 senior executives from across the global market. Each quarter, members of the network are surveyed on topics suggested by Acuiti, our report partner and other members of the network. This report aggregates the responses which are submitted anonymously by members of the network.

For this issue, we have partnered with Quantile, a leading provider of portfolio optimisation services, to conduct a deep dive on how members of the Expert Network are managing margin and collateral in volatile markets.

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The LDI pension fund crisis

Following what is now near-unanimously termed "Liz Truss' Disastrous Mini-Budget" in September, the pound dropped sharply while UK government borrowing costs spiked by almost 200 basis points as markets took fright over the UK Prime Minister's financial plans.

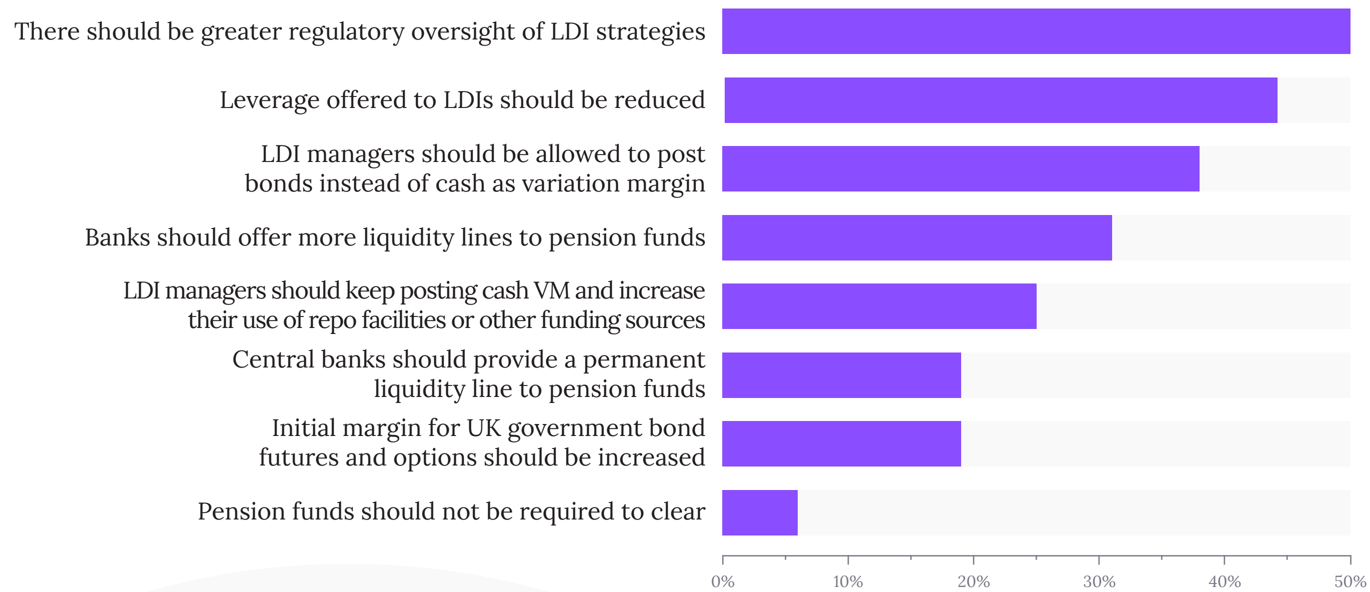
The sheer extent of the price moves was always going to cause market stress and liability-driven investment (LDI) strategies found themselves at the centre of the storm. LDI strategies typically include the use of derivatives, mainly interest rate and inflation swaps, to match the duration profile of their investments with that of their liabilities such as pension obligations.

This allows the investment manager a more flexible approach in their asset allocation, opening up their investment universe to equities and illiquid investments in private markets such as infrastructure projects, while maintaining a matched position in their asset and liability management.

Decoupling the investment decisions from future pension liabilities, however, only works when derivatives, which require little or no initial cash outlay, are traded to bridge the gap, specifically to receive long-dated fixed rate coupon in interest rate swaps to fund future pension payouts.

When UK rates rose rapidly, LDI managers had to meet large variation margin (VM) calls from their dealer counterparties for such swap positions, and often found themselves either short of cash given their illiquid investments or faced with falling bond collateral prices, a scenario sometimes described as "doom loop".

What structural changes do you think should be made to clearing structures in the aftermath of the UK LDI/pension crisis?

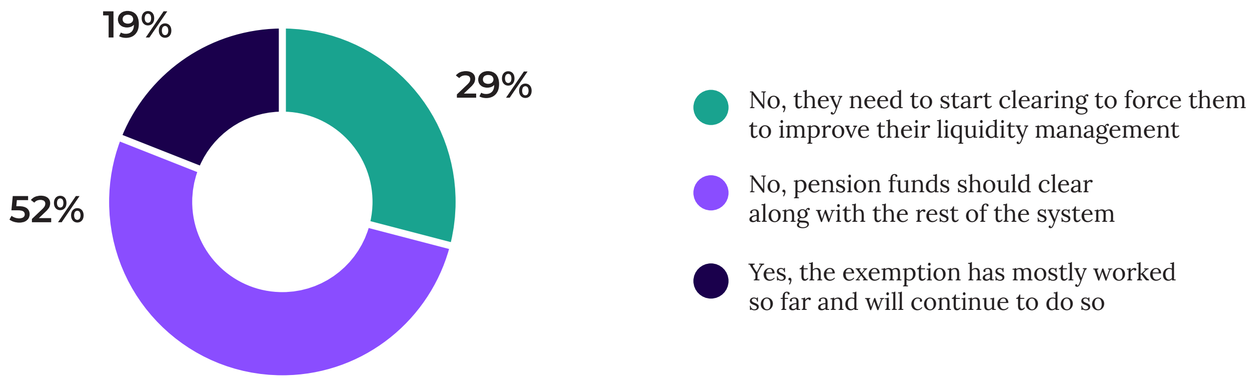


Members of the Clearing Expert Network thought that, following the experience in 2022, there should be greater regulatory oversight of LDI strategies and leverage should be reduced to these funds. However, over a third thought that LDI managers should be allowed to post bonds instead of cash as variation margin (VM).

This is a controversial view with members of the network expressing concern in interviews. Should the market go down the route of accepting non-cash collateral as VM, it would create other problems such as how to transform any bonds received into cash to be posted onwards to other counterparties.

Interviewees expressed concern over negative feedback loops and difficulties in valuing collateral in the event of even gilts being posted as collateral – as the mini-budget showed, these cannot always be considered stable assets.

Should the pension funds be permanently exempt from clearing in the EU and UK?



Another issue that the LDI crisis brought to the fore was the ongoing debate over whether pension funds should be exempted from clearing in the EU and the UK. The current EU exemption for pension funds expires in June 2023.

In December, lobby group PensionsEurope expressed concern about the exemption ending without a specific central bank liquidity scheme in place to support funds looking to raise cash to post as collateral. However, just 19% of respondents thought that pension funds should be permanently exempted from clearing. Just under a third thought that they should clear specifically to improve their liquidity management.

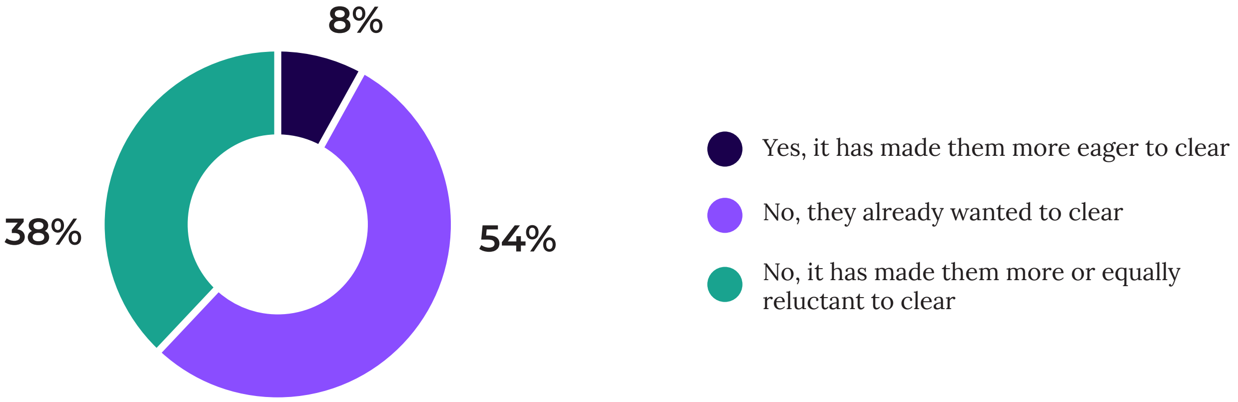
The point raised by PensionsEurope is valid - there is an issue for pension funds, who typically are fully invested, having to raise cash to post as collateral in a cleared world.

However, members of the expert network by 2 to 1 favoured liquidity lines provided by banks rather than central banks and many firms in the network have already started offering clients intra-day liquidity as an add-on service (see page 15).

Interviews suggest a schism in the pension fund market with regards to clearing. Many of the larger pension funds are already clearing trades and have the resources to manage the cash requirements. However, for smaller firms, the need to hold back cash or establish liquidity lines poses a challenge.

Over a third of respondents to the survey that counted pension funds among their client base reported that the LDI crisis had made pension funds equally or more reluctant to clear. However, more than 50% said that they already wanted to clear.

Has the LDI crisis changed pension fund clients' attitudes to clearing among your client base?



In interviews, members of the network expressed the view that exempting pension funds from clearing simply shifted the problem to the bilateral markets rather than mitigating it. While central clearing may make it more expensive for pension funds to trade and there will need to be greater visibility and offerings of liquidity lines to mitigate volatility during periods market stress, central clearing makes the overall system far more secure and creates greater transparency in the market.

Hot topics

Each quarter Acuiti surveys members of the network based on hot topics submitted by the network. This quarter we take a look at exchange ownership of clearing members and interest rate rebates.

Exchange ownership of GCMs

One of the great ironies of the collapse of FTX is that its long-term impact on the industry might be a change of market structure led by CME Group, which staunchly opposed the change when it was initially suggested by FTX.

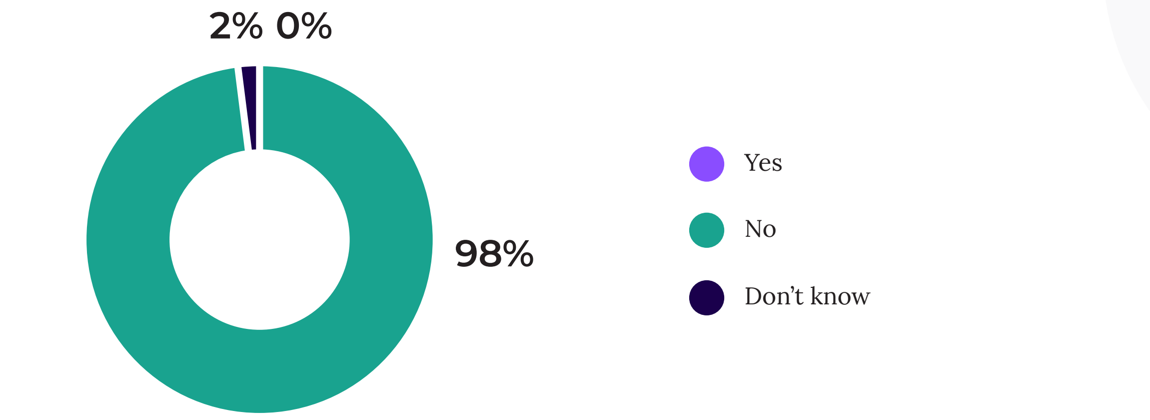
In Q1 2022, FTX submitted a proposal to the CFTC to operate a regulated, onshore market that disintermediated the clearing member by enabling the exchange to fully call and manage risk and margin. There was inevitable pushback from the clearing community who highlighted the paucity of the default fund and inappropriateness of the application of auto-deleveraging to traditional markets. CME led the charge among exchanges in opposing FTX's application.

However, by the end of the year, FTX was bankrupt and the CME was pursuing its own application to own and operate a general clearing member (although not including any other elements of the crypto market structure in its application). CME is not alone. In October Miami Holdings, the parent company of MIAX, and other markets in the US, acquired Dorman Trading, a CFTC-registered clearing member.

Exchanges point to the fact that ownership of a clearing member allows them to bring products to market more efficiently. Currently some clearing members push back on new products without clear evidence of client demand as they often require back-office development work to integrate into systems.

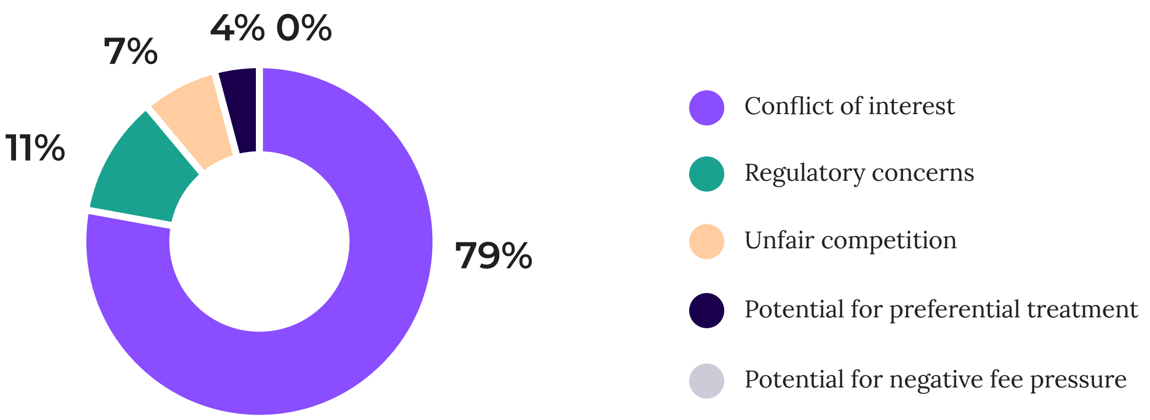
Unsurprisingly, members of the Acuiti Expert Network were unanimous in their rejection of exchange ownership of clearing members. 98% of respondents said exchanges should not be allowed to own or operate clearing members with the remaining 2% saying that they didn't have a view.

Should exchanges be allowed to own and operate clearing members?



Conflict of interest was by the far the biggest concern with 79% citing this as the main concern. 11% highlighted regulatory concerns and 7% unfair competition. No one, however, raised concerns over the potential for negative fee pressure, probably a reflection of the small percentage of the total cost of trade charged by the clearing member compared to the exchange and CCP fees.

What do you see as the biggest concern regarding exchange ownership of FCMs?



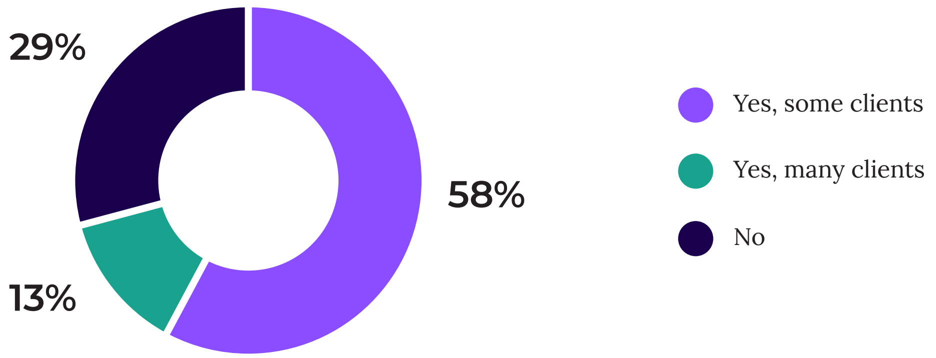
Rebates of interest on margin held

Prior to the financial crisis, clearing members typically made between a third and two thirds of their income from interest on margin held on behalf of clients. For some clearing members, commissions were almost irrelevant compared to the money earned on interest.

When rates went to near zero in the wake of the crisis, this source of revenue dried up. Today with rates rising again, clearing firms are expecting a major boost from revenues on interest held on margin on behalf of clients.

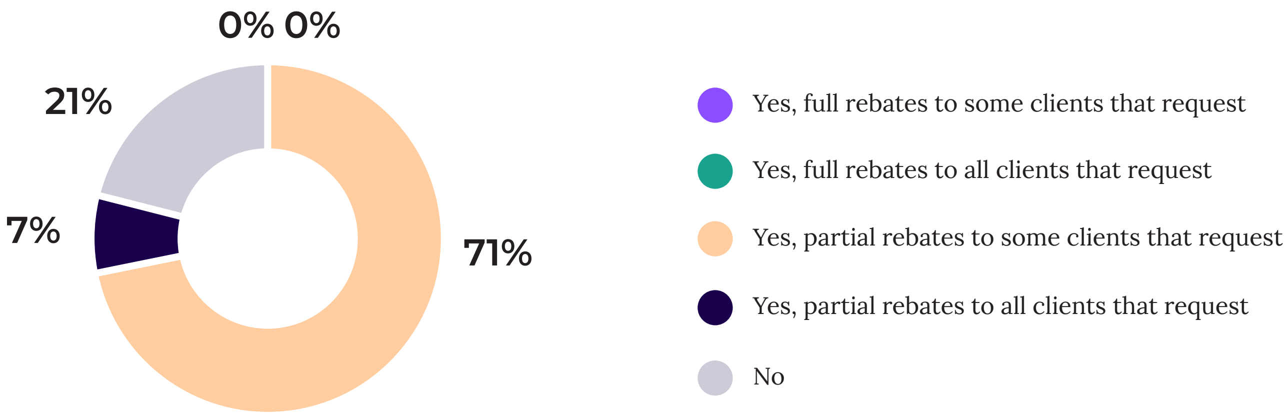
However, members of the Expert Network reported that clients were requesting rebates on that income stream. Over two thirds of the network reported that some or many clients were making such a request with proprietary trading firms and hedge funds the most likely to do so.

With interest rates going up, are you seeing clients request rebates of the income you make from interest on margin held on their account?



Clearing firms are being accommodating in their response to the requests. While no firms are granting full rebates, 71% are paying partial rebates to some clients that make the request. Non-bank FCMs were most likely to be rebating clients while multinational banks were the least likely to be doing so with just a third granting some requests, compared with 90% of non-bank FCMs.

Are you granting the requests?



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Managing margin and collateral in volatile markets

Prolonged periods of extreme volatility since the initial outbreak of covid in 2020 has put the spotlight on collateral and margin optimisation. While much of the attention in 2020 was on the procyclicality of CCP margin calculations, the focus today is on how clearing members can fully optimise their collateral workflows both in terms of their house business but also with respect to what additional services they can offer clients to smooth margin spikes.

To understand how clearing firms are adapting to the new normal in terms of volatility and its impact on collateral operations, Acuiti partnered with Quantile to conduct a survey of the Acuiti Sell-Side Clearing Expert Network. The survey looked at what steps firms are taking to improve liquidity to clients during market stress, how they are planning to further optimise margin and the business opportunities that are presented by the current climate.

Managing counterparty risk

Quantile's Counterparty Risk Optimisation service reduces risk, initial margin (IM) and capital requirements for OTC derivative market participants globally.

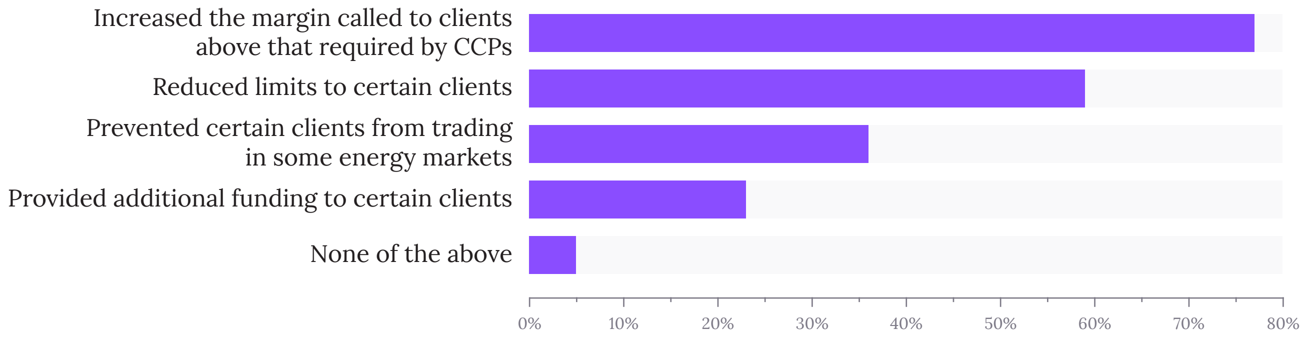
Through advanced algorithms, the service optimises cleared and uncleared IM and risk-based capital under SA-CCR and IMM by analysing the risk of transactions between participants and rebalancing portfolios with new market risk neutral trades that reduce risk and release capital.

By sweeping risk into the clearing house, Quantile enables participants to access greater netting opportunities, reduce capital requirements and hold risk more efficiently.

Energy woes

The experience of energy companies in 2022 is a key example of the challenges parts of the market face during periods of high volatility. As energy prices and inflation surged in the wake of Russia cutting gas supplies to Europe and its invasion of Ukraine, energy utility companies and other market participants faced massive margin calls.

What steps have you taken to mitigate volatility and margin increases in energy markets?



Over three quarters of respondents to the survey said that they had increased margin called to clients trading energy above the levels required by CCPs in response to the energy volatility. Firms are also reducing limits to clients and, in some instances, preventing them from trading in some energy markets.

Calling margin from clients in excess of what is required by the CCP is an increasingly common trend from clearing members. While there remain concerns about the procyclicality of CCP margin methodologies and the tendency for huge initial margin spikes during periods of volatility, there are wider concerns today that overall levels of CCP margin do not adequately reflect the overall market risk.

Some members of the network raised concerns that CCPs were competing on margin methodologies to try to make it more attractive for firms to clear with them.

As clearing members increasingly embed stressed scenarios into their margin and risk calculations (see below), there is likely to be a growing disconnect between CCP and clearing member margin requirements, especially in more volatile markets, such as energy.

The issue of procyclicality of CCP margin models has not gone away either. Members of the network expressed frustration that there remain significant initial margin spikes during periods of volatility that could have been anticipated and moderated.

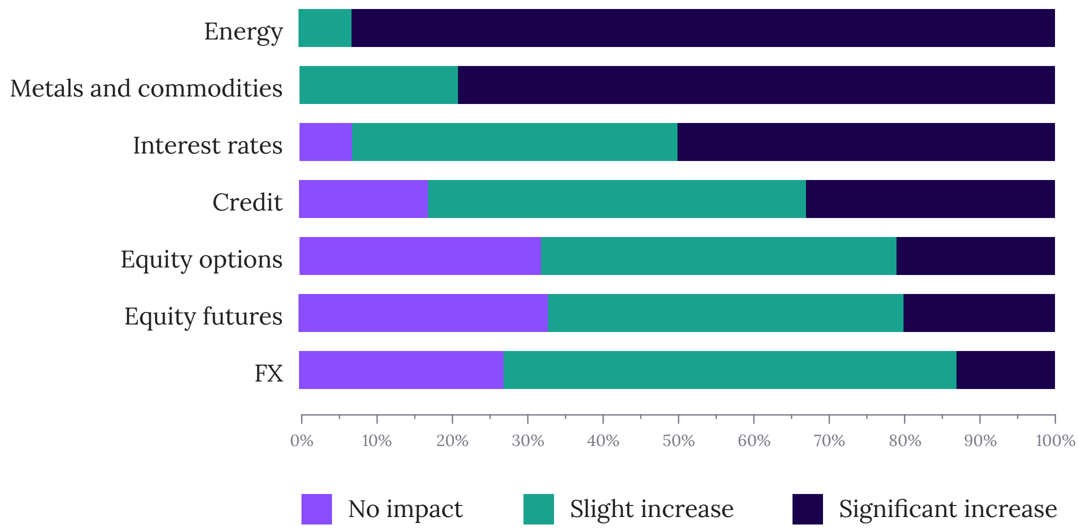
One example is in interest rate markets. The near zero interest rate environment has reversed sharply during 2022 in the wake of rising inflation. However, as, prior to 2022, interest rate volatility has been very low, initial margin was correspondingly low.

The frustration of the industry is that the sharp rise in rates seen this year was a predictable and inevitable reversal to the norm but not one that is captured in all CCP margin methodologies. Clearing firms are again left calling CCPs for more stable initial margins, even if that means higher margins during periods of low volatility.

Margin increases

Margin increases have been most notable in energy, metals and commodities and interest rates markets this year. 93% of the network reported a significant increase in margins for energy trading this year, while 79% pointed to a similar increase in metals and commodities. As noted above, interest rates have also been subject to sharp increases in margin, in particular with regards to variation margin. Respondents reported smaller increases in equity futures and options margins. This is likely due to the fact that margins were already elevated above historical norms owing to the volatility around covid in 2020 and subsequent equity market volatility throughout the period since.

What impact has there been on the total cost of margin across the following asset classes this year?

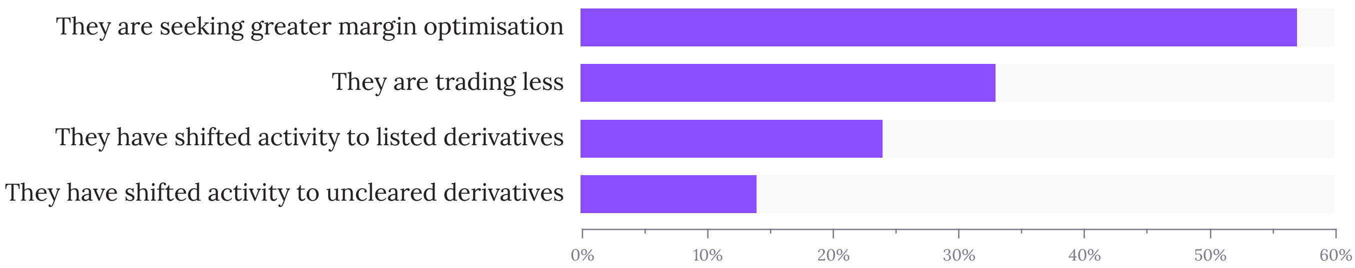


Margin reduction

Quantile is seeing increased demand for its Counterparty Risk Optimisation service as participants look to mitigate rising margin costs. In 2022, the service delivered record-breaking margin reduction for FX, interest rates and equities – often in excess of 50%.

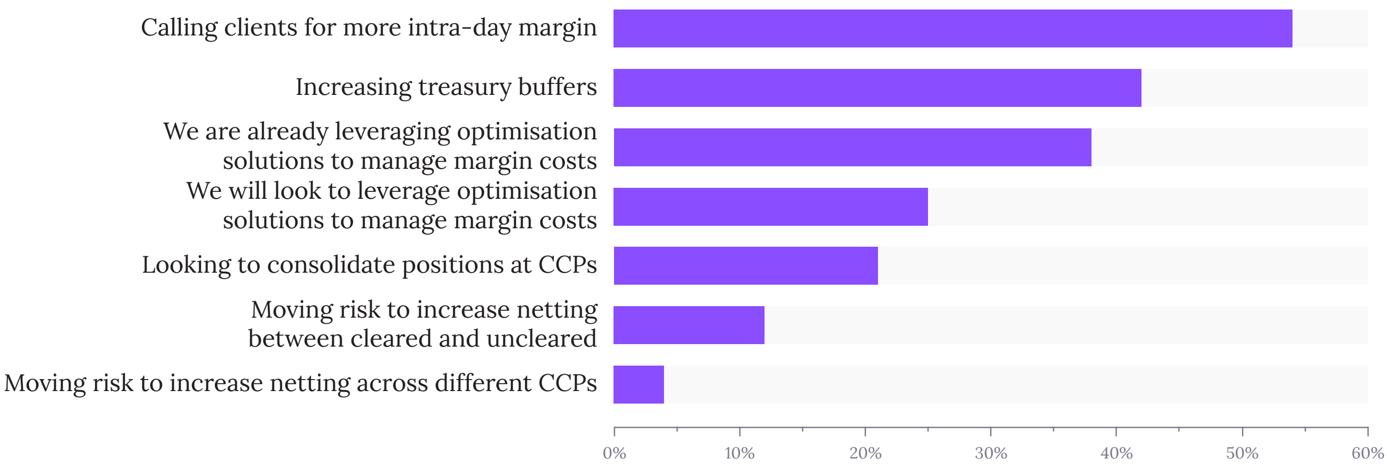
The higher margins are having a major impact on clients. Not only are clients having to hold more cash back to fund margin calls, they are also changing how they approach markets. Members of the network reported that the most common response from clients was to seek greater margin optimisation. However, a third were reporting to be trading less – this has the effect of reducing liquidity and potentially increasing unhedged risk.

How have your clients predominantly reacted to volatility and margin spikes?



The survey found that clearing firms have responded also to volatility and margin spikes in several different ways. Optimisation solutions are set to be the most common means of mitigating rising margin costs with 38% of the Clearing Expert Network reporting that they already use optimisation solutions and a further 25% looking to do so. Regional clearing banks were the most likely to be looking to use greater optimisation with 60% of respondents from these firms saying that was how they would tackle rising margin costs going forward.

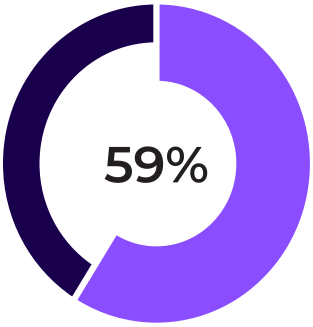
How are you tackling rising margin costs?



Another dominant response has been to call clients for more intra-day margins. Clearing firms are also increasing treasury buffers to mitigate rising margin levels. Less commonly firms are increasing efficiency through the consolidation of positions at CCPs and increasing netting. This is a strategy that is likely to increase in prominence as more sophisticated tools are brought the market.

Managing collateral resources

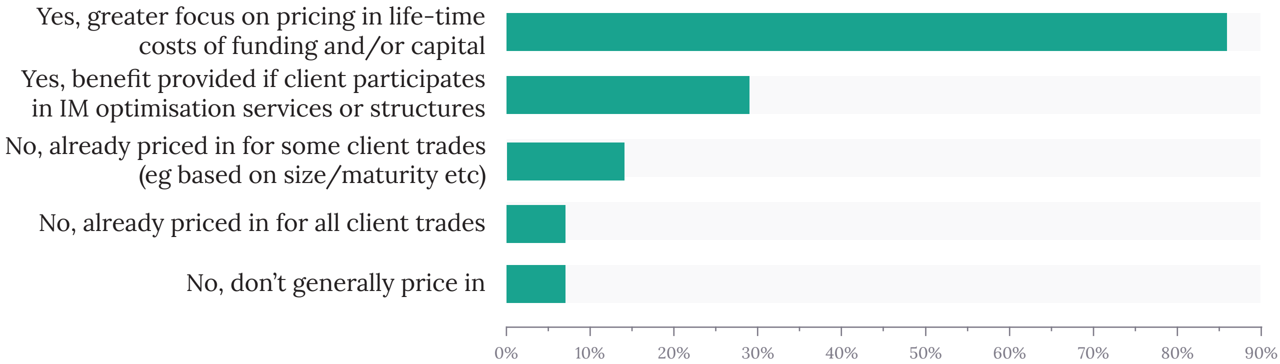
The volatility and spikes in margin calls is leading to a rapid evolution in how firms are managing collateral resources. Overall 59% of respondents were managing collateral resources using stress metrics while half were holding more cash back to manage extreme market events. Over a fifth were giving more importance to margin in/margin out metrics.



of respondents are already actively managing resources using stress metrics

Clearing providers are also looking to change their approach to the pricing of uncleared initial margin charged to clients. Almost nine in ten were putting a greater focus on the lifetime costs of funding. Elsewhere, around a third were looking to offer a cost benefit to their clients if they participate in IM optimisation services.

Are you planning to change your approach to the pricing of uncleared initial margin charged to clients?

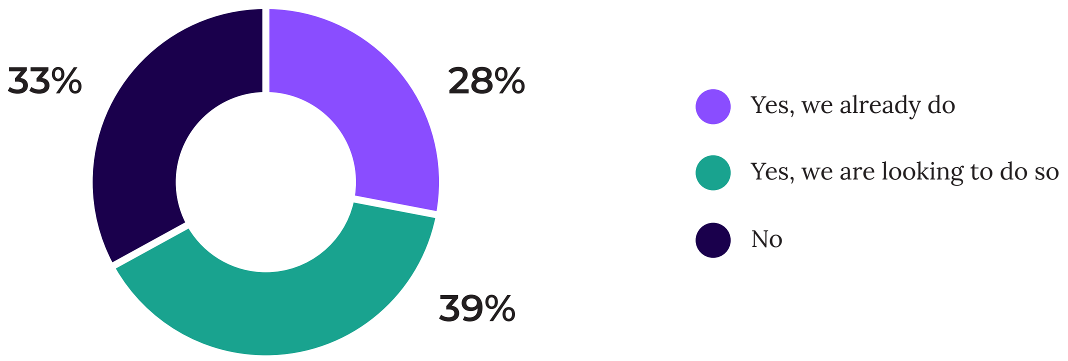


Lifetime optimisation

At the heart of derivative valuation adjustments – the so-called "XVAs" – lies the focus on pricing costs or benefits over the lifetime of a derivative trade which had not been captured in earlier valuation approaches. This has a direct impact on the optimisation of bank resources such as capital and funding – and Quantile are focused on reducing both short-term and lifetime costs. The requirements for lifetime optimisation are far more demanding, as the derivative portfolio has to be simulated over time.

Firms are also increasingly charging for intra-day liquidity - only a third of respondents were now either charging for intra-day liquidity or looking to do so. This represents an interesting opportunity for clearing firms to generate additional revenues.

Are you charging or looking to charge clients for intra-day liquidity?



However, other members of the network called for different solutions than providing intra-day margin. While calling firms intra-day for additional margin is an increasing trend across the industry, it is still seen as an extreme measure during periods of intense market stress. Decreasing settlement cycles is a key element to normalising intra-day margin calls.

Currently the end of day batch processing at most major clearing providers means that they do not always have a clear view of a clients' mark-to-market position during the day. This reduces efficiency and requires firms to hold or call additional buffers to mitigate the uncertainty over total exposures.

Having a near real-time intra-day view of risk would enable clearing members to call clients with certainty of their exposures. While there is the potential to charge clients for intra-day funding, it would undoubtedly be better for the industry as a whole were clearing firms to more readily call clients for intra-day margin.

This would also require investment from clients, however, who would have to further optimise their margin and collateral processes in order to measure and meet expected margin calls. However, ultimately, a more efficient intra-day margining environment would reduce risk and inefficiency in the system.

Network growth

Quantile already has an extensive optimisation network, including the largest dealer banks, regional banks, buy-side firms and other institutional market participants. The company is rapidly onboarding more participants so it can materially reduce margin requirements and counterparty risk at a time where reducing costs is critical.

Innovation in clearing

Margin optimisation is just one area of innovation in the clearing industry today. Acuiti asked respondents where they see the most potential for innovation.

Development of DLT/blockchain processes was the most commonly cited area of innovation followed by repo and FX clearing.

1. Development of DLT/ blockchain processes
2. Repo clearing
3. FX clearing
4. Market structure changes led by digital assets markets
5. Direct client clearing models

Markets have tackled cleared and uncleared separately. Quantile enables participants to optimise both cleared and uncleared exposures in one single process.

There are tremendous opportunities in markets where clearing is not mandated by rule but beneficial from a risk and resource perspective, such as in foreign exchange and repo markets.

It is no longer an "either/or" decision between clearing or bilateral trading, but an "and" – a lot of risk in the fragmented derivative markets can be optimally cleared without incurring outsized impacts from the participation in the CCP, such as initial margins or default fund contributions.

New technologies in data processing such as digital ledgers can lay the foundation for such risk optimisations by providing a robust and timely basis to trade positions and risks. The broad spread of opinions about innovations in clearing shown above is testament to the fact that clearing models are still evolving and spreading into new technological arenas and asset classes, such as FX.

To learn more about Quantile and its margin and capital optimisation solutions, visit quantile.com.

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