Clearing House of the Year
A brave new world

Derivatives users had a lot on their plate last year with the rollout of new Dodd-Frank rules on clearing, reporting and trading. Firms have had to adapt to the new reality – and some have been more successful than others. This year’s Risk awards recognise those that have made the most progress. By Lukas Becker, Matt Cameron, Laurie Carver, Clive Davidson, Kris Devasabai, Peter Madigan, Fiona Maxwell, Tom Osborn, Joe Rennison, Cécile Sourbes and Duncan Wood

Many US derivatives users were very much looking forward to the September 2 Labor Day holiday. The previous few months had been a blur of activity as the first US clearing mandates came into force, starting with the largest swap dealers in March and followed by the deadline many were concerned about – clearing for large end-users on June 10. Aside from a few technical glitches, those first mandates went relatively smoothly. Another deadline was looming on September 9 for smaller, less-frequent derivatives users, but many participants were relatively confident and relaxed, and looking forward to the long weekend.

Then came the release of long-awaited rules on uncleared derivatives margining requirements on the Monday holiday, drawn up by a group led by the Basel Committee on Banking Supervision and International Organization of Securities Commissions. For some participants, it meant immediately booting up the laptop or heading into the office to analyse what the rules would mean.

That pretty much summed up the year. With so many lengthy, complex rules being finalised by global and domestic regulatory bodies, and so many new requirements coming into force, participants risked falling hopelessly behind if they spent more than a few days out of the office.

For many banks, last year was all about getting ready for new regulations – and helping their clients through the process too. That doesn’t just mean helping them understand the rules and providing clearing and execution services, though. Many end-users were growing increasingly worried about contingent liquidity risks posed by sudden, large margin calls, leading some banks to focus on developing new, innovative structures that would help alleviate the impact of a cash drain. Others worked to restructure outstanding trades that would be too capital-intensive in the new world, with the aim of optimising their own portfolios and, in theory, reducing costs for their customers. Many of the most successful firms are featured in the following pages.

As always, the winners were incredibly difficult to pick. Risk asked candidates to submit detailed information on their businesses, and the shortlisted firms underwent several in-depth, face-to-face interviews with the editorial team. Demonstrations of key risk and trading systems were given, and calls were made to end-users and other market participants to obtain feedback. The entire process took about three months. Risk would like to thank all those who participated for their time.

In making the final decisions, a number of factors were considered, including (but not limited to) risk management, customer satisfaction, responsiveness to new regulations, engagement with regulators, liquidity provision and creativity.
Often, when people want to explain what a central counterparty (CCP) does, they turn to the world of plumbing – as though margin models, collateral and default funds have something in common with U-bends, washers and waste traps. Michael Davie, chief executive of LCH.Clearnet Ltd, offers a different analogy. “I constantly have this image of air traffic control in my mind. In terms of operating a CCP, we need to act as though we are landing at JFK or Heathrow. You don’t want to worry about who is in the tower today – you just want to be confident you will get to your destination safely and securely every single time,” he says.

That shows in the work the clearing house has been doing for much of the past 12 months. One example is the overhaul of its initial margin model, which until early 2013 was based on historical market moves, measured in relative terms. When those relative moves were applied to near-zero interest rates, it produced margin requirements that were too low – and some SwapClear members became uncomfortable in mid-2012, complaining they were having to call for significant amounts of top-up margin from clients. Risk reported on the behind-the-scenes friction at the end of that year (Risk December 2012, page 8, www.risk.net/2229594).

The CCP claims it was working on the issue before banks brought it to wider attention, but it was a complex project – the aim being to insulate the clearing house not only against a shortfall in margin in a low-rate environment, but also a sudden spike in margin as rates increase. “The model was designed to be stable in all environments,” says Dennis McLaughlin, group chief risk officer at LCH.Clearnet. “In the development stage, we ran thousands of simulations with rates going up to where they were pre-2008 and even up to as high as 12%, and then of course going down into negative territory. It was designed to perform equally well in any scenario.”

So far, so good. Despite an increase in market interest rates during 2013 – which saw yields on 10-year US Treasury debt start the year at 1.86% and reach 2.75% at the end of November, with a bout of intense volatility during June – clearing members say SwapClear’s margin requirements have held steady.

As a result, the clearing house has rolled out improved models across its other over-the-counter derivatives clearing services as well – for credit, foreign exchange and repo. The CCP also kept an even keel as fears of a US debt default peaked in the days leading up to an October 17 deadline. In contrast, the eve of that deadline saw CME Group apply a 12% margin add-on for cleared OTC interest rate swaps, citing potential market disruption.

LCH.Clearnet’s response was different. Margin levels were held steady, but the CCP did try to avoid bonds that were due to mature in the fortnight after October 17 – despite funnelling the vast majority of trades through its Europe-domiciled entity, it still holds a lot of US debt, both as collateral and as part of its investment portfolio. “You don’t want to be waiting for the notional to come in right on the point of market disruption. So if you push that out, then you dramatically improve your risk profile,” says Davie.

By extending the maturity of the debt, LCH.Clearnet removed the risk that a failure to pay would eat into the principal it was owed. “Our margins were good and the model played a large part in that. Underneath, though, we took steps to insulate ourselves against the possibility of a US default. We repositioned our liquidity portfolio, repositioned our investment portfolio and took measures to change the collateral members were posting to us. There was no need to panic. We didn’t want to send signals to the market and exacerbate the problem. We thoughtfully diagnosed our position and then took action,” says McLaughlin.

Elsewhere, SwapClear made significant changes to the way it registers
trades for clearing. It previously used a batch process to accept or reject trades, which meant trades were taking up to 15 minutes to be confirmed for clearing as recently as January 2013. The approach involved assessing the margin for a batch of trades, rather than assessing each transaction individually, so if two offsetting trades were sent for clearing in quick succession, no margin call would be necessary.

But despite efforts to persuade the Commodity Futures Trading Commission otherwise, a rule requiring trades to be accepted or rejected by a CCP in less than 60 seconds came into effect in March, forcing SwapClear to change its ways. As the March 10 mandate for clearing loomed, it became evident the clearing house would not be ready in time. It was the only CCP to need an extension, eventually completing the changes in May – six weeks late.

“It’s a little cheeky to say, but we are clearing more than $2 trillion a day. It’s not uncommon to do 10,000 trades a day. I am sure other CCPs are busy, but when we switched over in May, we couldn’t just hope it would be OK. We had to be extremely confident that for all 90 members and more than 600 clients, in all currencies, everything would continue to work as it had the previous day. We breathed an enormous sigh of relief when that was the case. It took longer than we would have liked, but the most important thing was that this would be a safe and secure transition,” says Davie.

The CCP’s fear about real-time trade registration was that it would end up accepting trades for which it had not yet received margin. The solution has been to establish cover amounts for each clearing member based on its trailing one-month activity, creating an excess against which new transactions can be accepted. If excess collateral is not available, then tolerance limits exist for each clearing member against which a decision to accept or reject a trade is made. To compensate for the creation of these tolerance limits, SwapClear made increases to its default fund. If a trade exceeds the tolerance limit and no excess collateral is available, then the transaction is rejected.

The suspension of the batch model also forced a postponement of regular trade compression exercises in April – a service that cuts the number and notional amount of a clearing member’s trades at the CCP, reducing operational burdens and clearing fees and also helping banks comply with the leverage ratio. But compression exercises involve tearing up packages of trades and, in some cases, putting new ones in place – which would not work in a real-time registration model because the trades would all be fed through individually and may end up being rejected if there is insufficient margin cover.

A revamped version of the service restarted in December, but Davie says that even with the hiatus, there was more compression over the course of 2013 than throughout the whole of 2012 (www.risk.net/2309337).

Some of these adjustments – the cover amounts and tolerance limits, the increased default fund size and suspended compressions – have not gone down well with all members. But Davie says most firms recognise and respect the motives.

“Commercially, these changes have been challenging, but as people look at the concentration of OTC risk into a small number of CCPs, on the one hand they want us to be bulletproof, and on the other they want us to be cheap. We are not meant to be lending money or resources for long periods or size, so people respect that we have a high-grade credit model as much as it might be painful in terms of price. The testament to that is our market share, not just the monthly buy-side share, but also the sell side, where in both cases volumes continue to grow,” he says.

So, how are volumes doing – and did LCH.Clearnet come out of the start of mandatory clearing in the US with an advantage over CME Group? According to data for August and September collected by software firm Clarus Financial Technology, CME Group’s total volumes were around 67% of the client clearing volumes of LCH.Clearnet for US dollar interest rate swaps. That equates to a roughly 60% market share for LCH. Clearnet – down from a similar analysis conducted in June, at which point CME had less than 50% of the client volume recorded at its UK rival.

“Asked three years ago if I would be happy, by any measure – you know, people use different measures to assess market share – to have a minimum share of the buy side of around two-thirds, I would have said that’s a pretty good place to be,” says Davie. “There is no way we were ever going to be a monopoly provider, as much as we might like to be.”

That might look like LCH.Clearnet has the edge, but the danger is that where clients go, interdealer volumes could follow. It was this logic that led LCH.Clearnet to buy short-lived US swap futures clearing International Derivatives Clearing Group in 2012, using it to set up its own US-dominated CCP. The idea was to allay any concerns US clients might have about clearing to a CCP based in Europe, says Davie.

This could be seen as backtracking from LCH.Clearnet’s aim to be the industry’s only global CCP. Davie says that is not the case, and can point to other developments in 2013 as evidence. Despite initial concerns among regulators in Australia, Canada and South Africa, banks in all three jurisdictions have been given the go-ahead to use an overseas CCP – effectively meaning SwapClear.

“There are some people who have a different view and say the global model introduces different risks – and it’s true that if the CCP went under, then it would be addressed under a particular regime. Clearly, the vast majority of activity suggests that isn’t a concern or constraint, but we wanted to provide the US CCP as an addition. We are certainly still committed to the global model we started with,” says Davie.
Risk magazine has named LCH.Clearnet Clearing House of the Year 2014, marking the third time we have won this prestigious award for best practice and innovation in derivatives clearing.

www.lchclearnet.com

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