

LCH ForexClear: Addressing SA-CCR Capital Challenges

LCH The Markets'
Partner

ForexClear

THE SA-CCR CHALLENGE IN FX MARKETS

FX is the market that has, arguably, been the most impacted following the adoption of the Standardised Approach to Counterparty Credit Risk (SA-CCR) in the calculation of Risk Weighted Asset (RWA)/Leverage Ratio (LR) requirements.

SA-CCR replaces the Current Exposure Methodology (CEM) as the standardised calculation of capital requirements, marking the transition to a more risk-sensitive approach to estimating counterparty credit risk. Under CEM, the estimated trade exposure/potential future exposure calculation was a function of the trade maturity, favourable to the short-dated nature of FX. Unlike CEM, SA-CCR is based on the true risk of counterparty exposures. This transition from a maturity-based calculation to a risk-based calculation is the driver for sharp increases in banks' capital requirements for FX products.

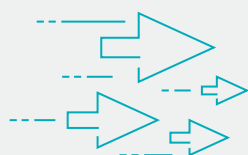
As adoption of SA-CCR has increased globally (European Union since June 2021, United States and United Kingdom since January 2022), the landmark shift to SA-CCR has caused challenges for financial institutions around the world, as noted by Risk.net¹. This has driven unprecedented demand for products to reduce RWA/LR capital requirements.

Following lengthy discussions with our customers, LCH ForexClear is developing an innovative solution to help ease these SA-CCR pains: FX Smart Clearing, which would provide the ability to clear in an optimised way. FX Smart Clearing is currently in the pilot phase and is scheduled to go live later in 2022, subject to regulatory review.

HOW FX CLEARING MAY REDUCE SA-CCR CAPITAL REQUIREMENTS

Along with the array of operational efficiencies achieved through clearing, the risk management expertise provided by a qualified CCP (QCCP)² has led to regulations offering substantial capital benefits for any positions cleared. Entities that clear their FX products can often expect to reduce their capital footprint in multiple ways.

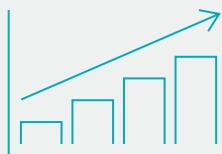
01. Multilateral Netting: Clearing offers netting benefits, that may be maximised via the use of a single central counterparty, reducing the SA-CCR exposure while keeping the net risk neutral. Multilateral netting benefits can be considerable and can provide a direct reduction in SA-CCR exposures. Cleared trades benefit from multilateral netting as previous bilateral positions against multiple counterparties are collapsed to a single counterparty, therefore any offsetting positions are naturally reduced — driving SA-CCR exposure reductions and therefore RWA and LR capital reductions, without any change in risk.



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- 02. **Settled-to-Market Benefits:** Trades that are cleared can then be treated as settled-to-market (STM), which can reduce the SA-CCR exposures by up to **53%** for both RWA and LR capital requirement calculations, based on LCH estimates.
- 03. **Reduced Counterparty Risk Weight:** Cleared positions can receive a **90+%** saving in RWA capital requirements. Bilateral exposures are calculated using a counterparty risk weight that is a minimum of 20%, whereas positions versus a qualified CCP (QCCP)² are treated with a counterparty risk weight of 2%.

FX SMART CLEARING: THE FUTURE



FX forwards and swaps account for a large chunk of the SA-CCR exposures that drive increasing FX capital requirements.

FX forwards and swaps account for a large chunk of the SA-CCR exposures that drive increasing FX capital requirements. Unlike non-deliverable forwards and FX options, FX forwards and swaps do not incur initial margin in the bilateral space (whereas all products cleared incur initial margin at the CCP). Subsequently, these products must be cleared in a “smart” way to maintain the balance between capital benefits and cost of margin.

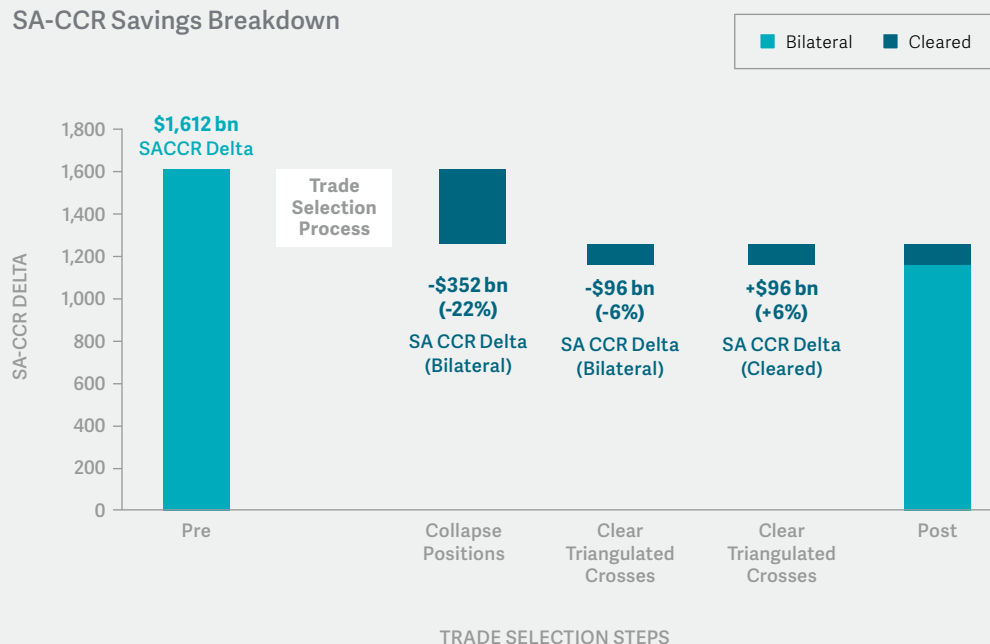
To ensure the margin costs of a cleared portfolio can be minimised whilst maximising the capital reduction benefits, LCH ForexClear is launching a novel programme that gives market participants a new way to clear — in an optimised fashion.

Following a successful proof of concept with seventeen large banking groups in H2 2021 and a successful trade-booking trial run in Q1 2022, ForexClear has begun a period of collaboration with its membership and third-party optimisation providers to prepare for the launch of FX Smart Clearing later this year. By offering direct connectivity for ATSPs (Approved Trade Selection Providers) and an enhanced trade-booking model, ForexClear clearing members can benefit from the expertise of third-party optimisation providers, as well as the capital and multitude of operational efficiencies gained from clearing FX.

LCH PROOF OF CONCEPT

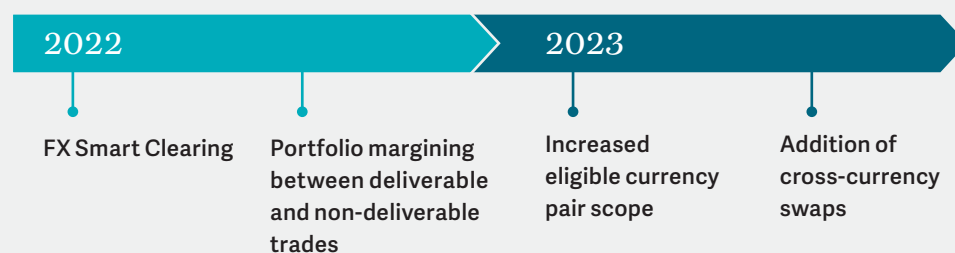
ForexClear performed a proof of concept in 2021 to demonstrate the potential advantages of selectively clearing FX forwards and swaps. Seventeen banking groups participated in this proof of concept, in which \$1.6 trillion of SA-CCR delta in eight currency pairs was submitted, resulting in a reduction of \$449 billion (or 28%) and providing cost savings of \$42 million across all participants.

SA-CCR Savings Breakdown



Enhancements to ForexClear's product offering, as well as the introduction of the expertise of ATSPs, will further increase the potential for capital savings (in relation to both RWA and LR capital requirements) via FX Smart Clearing, without materially increasing initial margin.

Examples of ForexClear's planned initiatives include, subject to regulatory review or approval:



FOR MORE INFORMATION

To find out more about the benefits of FX Smart Clearing at LCH ForexClear, please contact lchsales@lseg.com. Full service information can be found at www.lch.com/services/forexclear.

All clearing services are provided in accordance with the terms of the LCH rulebook. The contents of this article are for illustrative purposes only. All results will depend on individual ForexClear users individual circumstances. ForexClear users should seek their own advice regarding the use of LCH Limited's clearing services.

¹SA-CCR hits Citi's FX forwards pricing – [Risk.net](#)

²In accordance with the BCBS standards, for the purposes of calculating banks' capital requirements for exposures to CCPs, a QCCP is an entity licensed to operate as a CCP and prudentially supervised in a jurisdiction where the relevant regulator/overseer has implemented domestic regulations that implement the CPMI-IOSCO Principles for Financial Market Infrastructures. As a result, financial institutions using QCCPs benefit from lower capital requirements for exposures to CCPs.

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