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EquityClear

Equities clearing and CCP resilience

Protecting post-trade from geopolitical turmoil

Headline-making events in 2022 have driven market volatility with sustained increases in trading and clearing volumes. With market participants under pressure, how does central counterparty (CCP) resilience and innovation in equities clearing provide protection from geopolitical shocks and market stress? This LCH EquityClear article discusses CCP resilience and its role in cushioning the falls caused by geopolitical factors

This year has already seen more than its fair share of headline-making events: from Russia's invasion of Ukraine to the UK government's much-discussed mini-budget, as well as the Bank of England's subsequent market-calming intervention. These have driven a surge in market volatility and sustained increases in trading and clearing volumes, with levels remaining elevated even during lulls between major world events, as central banks implement rate hikes to counter inflationary pressures and restore confidence across markets.

But, while a sustained period of elevated volumes can indicate a healthy, liquid market with multiple active participants, could financial market infrastructure (FMI) systems be at risk of failure if the trend continues? We only need to look back to March 2020, to the first Covid-19 pandemic lockdowns, to see how the global clearing ecosystem performed.

At the height of the market volatility, there were no changes to the timing and number of margin calls at LCH, nor to the models and methodology themselves, with a significant percentage of collateral increases at our two central counterparties (CCPs) – LCH Ltd and LCH SA – resulting from new risk positions, rather than from additional collateral being called against existing positions. March 2020 saw huge spikes in volumes at LCH, with several daily records set for volume cleared in a single day.

March 2020 was also when LCH EquityClear's current platform, which clears equity and equity equivalents for UK and multiple pan-European markets, went live.

"We're really proud of our clearing platform," James Stacey, commercial director for LCH Ltd's EquityClear service, says, "and its performance over the past year shows that the investment we made up to its go-live in March 2020, and continue to make in its continuous improvement, is paying dividends."

CCP systems often come under scrutiny from regulators and industry stakeholders, and resilience within those systems is a major selling point for any CCP wanting to compete for clearing flows. "When markets are turbulent, the last thing you want is an issue with the CCP," Stacey continues, "and with the volume increases we've been seeing, it is clear that the market is putting a lot of trust in its CCPs."

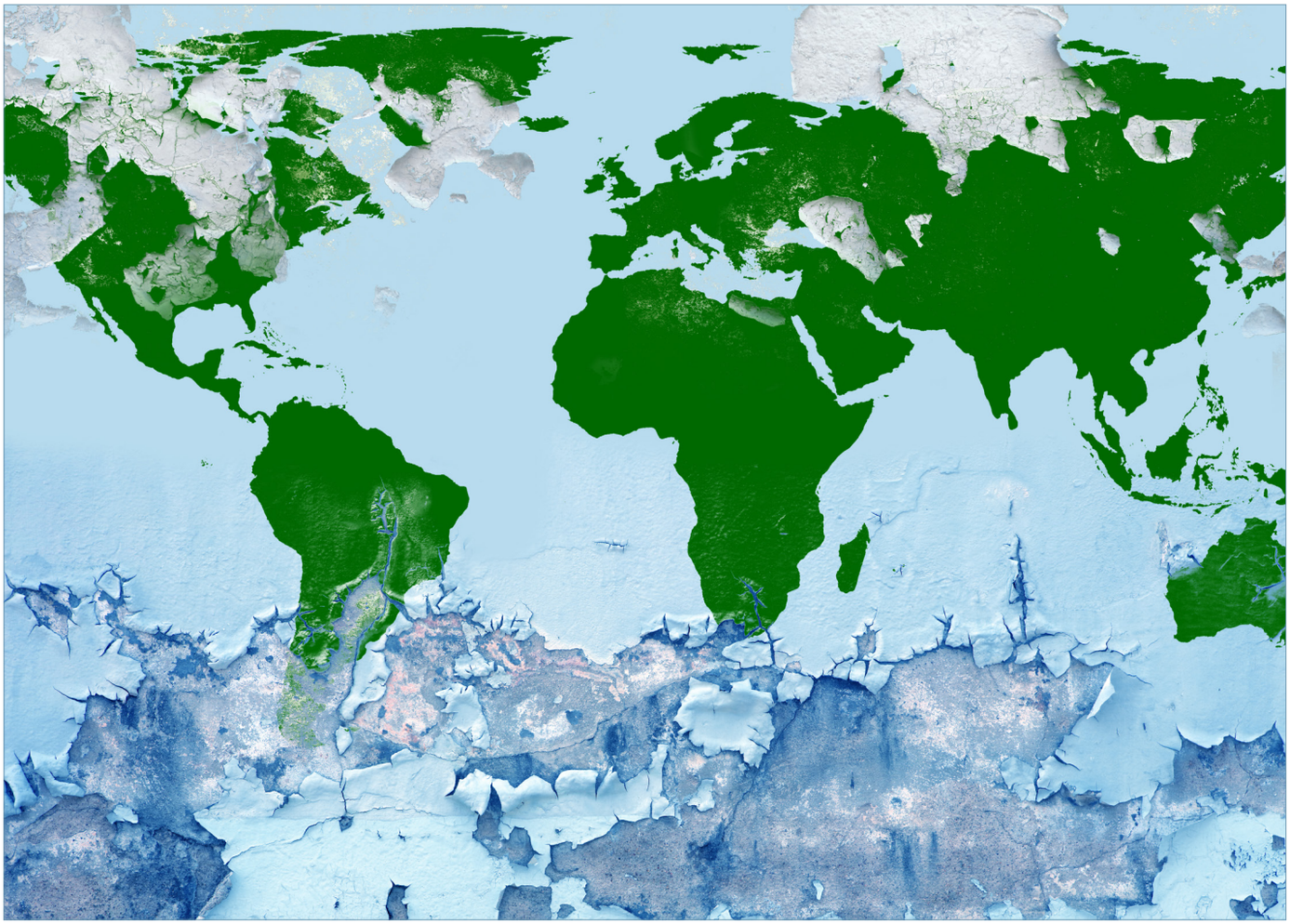
This resilience was further demonstrated on November 14, when LCH Ltd's EquityClear service cleared its two billionth trade side of 2022, breaking 2021's full-year record of 1.94 billion trade sides. Surpassing this record with more than a month to spare speaks to both market volatility and the resilience LCH has built into its clearing services to handle peak volumes in times of market stress.

Building resilience through market partnership

Maintaining and strengthening CCP resilience is a continuous process, and LCH Ltd has several key projects in the pipeline that are expected to further add to clearing volumes. In partnership with LSEG's Turquoise multilateral trading facility (MTF), LCH now offers clearing in US equities for settlement by The Depository Trust Company. Additionally, LCH is looking to begin clearing crypto-based exchange-traded products next year (subject to regulatory approval), with volume growth set to continue as new connections to over-the-counter matching platforms and MTFs across cash equities and exchange-traded funds are added.

Aside from concerns around the resilience of tech systems in the face of increased volumes, increased market volatility usually means increased margin calls. "We constantly evolve our margin models to ensure the right level of protection is provided in the most efficient way," says Dhruve Bhavsar, head of frontline risk at LCH Ltd. "For insurance, nobody wants to pay a higher premium for the same level of cover, and this same concept carries over into our thinking on margin."

LCH is working on products to make capital and margin usage among its members more efficient. The LCH initial margin model is in a process of simplification to allow for greater portfolio netting and will better account for settlement and decorrelation risk. The model also benefits from built-in anti-procyclicality measures. These changes are expected to be implemented for members in 2023.



On the product side, LCH Ltd and Turquoise NYLON are partnering to launch clearing for equity swaps, a key initiative focusing on capital and margin efficiency, also expected in 2023. Demand for clearing of equity swaps has increased in the wake of uncleared margin rules, the new standardised approach to counterparty credit risk (SA-CCR) capital framework and the impact of the Archegos failure. LCH will focus on clearing swaps referencing UK, European and Swiss single stocks in the first phase, and in the near-term will extend to US-listed underliers (subject to internal risk and regulatory approval).

"The key benefits of cleared equity swaps include reduction of net trade exposure and counterparty risk, increased margin and capital efficiency and streamlining of operational processes," says Tom Archer, head of product for EquityClear. Overall, net margin requirements can potentially be reduced via multilateral netting of exposures in a well-constructed portfolio, such as netting exposures for clients across dealer counterparties and for dealers across client counterparties.

Capital efficiencies for cleared swaps trades are seen in multiple ways. First, cleared trades have a lower counterparty credit risk because of the lower risk weight attributed to CCPs, which reduces the dealer's risk-weighted assets. Second, the SA-CCR can reduce capital costs for banks by introducing more meaningful recognition of netting benefits via offsets of long and short exposures with the same counterparty.

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Finally, users can characterise their cleared contracts as 'settled-to-market' rather than 'collateralised-to-market'. This last point means that daily variation margin is treated as actively settling changes in the mark-to-market value rather than simply collateralising those changes, resulting in further efficiencies for risk-based and leverage ratio capital.

"LCH's continued innovation and resilience during recent market volatility goes to highlight the importance of CCPs as core FMIs," Ivan Gilmore, head of the cash equities business for LCH Ltd and LCH SA, says. "EquityClear's ongoing investment in our technology platform and refinement of margin models," he continues, "coupled with our new product pipeline, strengthens our position as Europe's foremost equity clearing service."

[1] *Helen Bartholomew (September 2022), LSEG to launch clearing for equity swaps,* Risk.net, *www.risk.net/ 7954688*

LCH EquityClear partners with the market to provide protection from geopolitical shocks and market stress. Contact LCH EquityClear's specialist sales team or visit LCH EquityClear for further information.