

Rising initial margin costs tilts the balance in favour of clearing

As international standard-setters have extended the implementation period of the lowest threshold for the uncleared margin rules (UMR) to 2021, Kahyang Chong, head of ForexClear product, Europe, the Middle East and Africa at **LCH**, explores the options available to market participants likely to be caught in the upcoming UMR phases and the benefits that can be derived from clearing.



What options are available to market participants likely to be caught by uncleared margin rules (UMR) in the next two phases?

Kahyang Chong: With the advent of UMR, there are increasingly strong incentives for firms to consider clearing across all asset classes. FX products, non-deliverable forwards (NDFs) and FX options (FXO) are all in-scope for UMR – at LCH, NDFs are available to all ForexClear participants for clearing (i.e. clearing members and clients); FXO may be cleared by clearing members of ForexClear.

Clearing brings two major benefits to UMR. First, cleared trades can likely result in lower margin requirements under the cleared initial margin (IM) methodology and through the netting effect of consolidating counterparty positions. Second, cleared trades do not contribute to the aggregate average notional amount (AANA) calculations, which each firm undertakes to determine their in-scope UMR date.

The major banks that came under UMR in previous phases predominantly adopted centralised clearing as an effective solution. As the majority of the buy-side community comes into scope for UMR in 2020 and 2021, this may also be an attractive choice for optimising total margin requirements.

What benefits does clearing present to market participants, and how does the cost compare to that of posting margin for uncleared FX derivatives?

Kahyang Chong: Under UMR, participants maintaining bilateral trading relationships face a new and daunting challenge of counterparty selection for IM optimisation. Deciding which counterparty to trade with has funding implications, and adoption of margin valuation adjustment to pricing may be required to reflect the cost of trading bilaterally under UMR. However, participants can negate these additional costs through clearing, where positions are consolidated and IM is optimised.

For firms subject to Basel III requirements, clearing trades also leads to capital benefits. Basel III's risk-weighted assets (RWA) attribute lower counter-



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party risk weighting to facing a central counterparty (CCP) versus a bilateral counterparty. The RWA and leverage ratio framework also benefit from the increased netting effect of consolidating positions against a single counterparty, which may reduce overall capital requirements.

ForexClear recently undertook a cost comparison examining a number of portfolios across a diverse set of participants, including dealers, hedge funds and asset managers. ForexClear's analysis suggests clearing may result in large IM savings versus bilateral trading – up to 70% in some cases.

Once you combine the potential higher capital costs of bilateral trades with additional IM – which firms subject to UMR have to pay to their bilateral counterparties – it tilts the balance in favour of clearing as many products as possible, including NDFs.

How should market participants re-evaluate their exposure to particular FX derivatives and counterparties to minimise capital costs in light of the next UMR phases?

Kahyang Chong: Market participants preparing for UMR face a demanding and complex process with numerous steps, as the International Swaps and Derivatives Association highlighted in its fact sheet, *Getting ready for IM regulatory requirements – What steps do I need to take?*¹

Major work is required for all participants to comply with the new rules. This involves

calculating and monitoring AANA; determining when they are in scope in each jurisdiction and for which entities; for each trading counterparty, agreeing to new credit support annexes (CSAs) and custody relationships; reconciling margin numbers on a daily basis; and managing the daily postings required under the CSAs, potentially with third-party assistance.


For the buy side, this work may lead to substantial legal and operational overheads. Buy-side firms may need to evaluate their trading relationships and choose to reduce the number of trading counterparties to lower these overheads.

Clearing can be a viable solution to help reduce this burden. All cleared trades are governed under CCP rules and margin terms, and only light-touch documentation is required to set up new trading counterparties. This may lead to wider counterparty selection and a shorter time to market, ensuring participants continue to access a wide range of dealers for best execution.

Which market participants would benefit most from clearing, and what procedures would they need to undertake to do so?

Kahyang Chong: The past three years have seen growth in the clearing of NDFs among firms in scope in the early phases of UMR. As asset managers and hedge funds fall under the regulation in 2020 and 2021, LCH expects to see the same behaviour from most of these entities.

Increasingly, many FX prime brokers (FXPB) are part of business units that include clearing brokers. We anticipate that some of these FXPBs will embrace clearing of FX products, as there may be significant cost savings for FXPBs, clients and dealers.

Given the timeframe to UMR 2020, market participants should start preparing as soon as possible. Starting conversations now with prospective clearing brokers will ensure sufficient time to undertake due diligence to assess the pros and cons of the options available to them. 

1. *Isda (2018), Getting ready for IM regulatory requirements – What steps do I need to take?*, <https://bit.ly/2CsewU>