

LCH ForexClear: UMR and the Growth of Client Clearing

LCH The Markets'
Partner

ForexClear

HISTORY

Following the global financial crisis of 2007-2008, the G20 initiated a regulatory review of global standards governing the OTC derivatives markets and participants. The International Organisation of Securities Commission (IOSCO) and Basel Committee on Banking Supervision (BCBS) were tasked with creating a set of global standards with the aim of reducing systemic risk and promoting **Central Counterparty Clearing**, which reduces counterparty credit risk.

A framework for margin requirements was developed for non-centrally cleared derivatives, with the simple aim of ensuring that derivative transactions are collateralised through Initial Margin (IM) and Variation Margin (VM). The BCBS/IOSCO framework was then implemented by regulators in some jurisdictions forming a set of Uncleared Margin Rules (UMR), which were to be phased in, with the initial phase commencing in 2016.

SCOPE AND TIMELINES

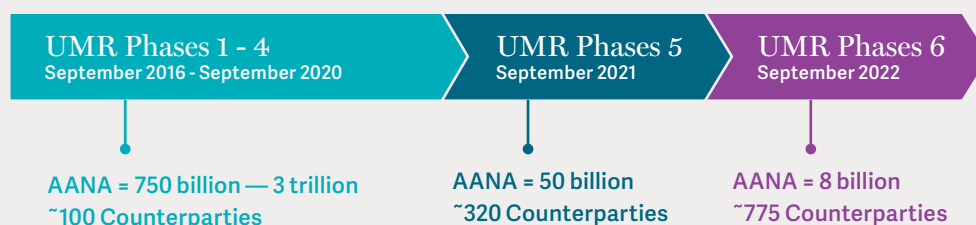
All entities in scope that hold positions in non-centrally cleared derivative transactions must exchange IM and VM to cover future and current counterparty credit risk exposures. Except for physically settled FX forwards and swaps, the initial margin requirements apply to all non-centrally cleared derivatives.¹ (FX spots are not considered to be derivatives.)

To determine scope within UMR, a firm must calculate its **Average Aggregate Notional Amount (AANA)**. ISDA provides the following guidance:² "...calculate the total notional amount of AANA covered products for each relevant business day during the AANA calculation period, sum up the aggregate notional amounts for each relevant business day during the AANA calculation period and divide by the number of relevant business days in the period".

Since the go live of the BCBS/IOSCO framework in September 2016, firms have gradually been phased into UMR depending on their AANA level and the jurisdictions where the framework was implemented. Initial phases saw global banks, which form the core of our ForexClear membership, fall in scope with phases 5 and 6 capturing smaller regional banks and asset managers. From 1st September 2022, all firms with an AANA >=\$8bn (or approximate local currency equivalent) in the applicable jurisdictions will be subject to UMR. The phases and threshold levels are shown in the chart on the next page.



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After the implementation of phase 6, firms should still calculate their AANA, as there is a possibility that institutions not caught initially may breach the AANA threshold in the future.

UMR AND CENTRAL COUNTERPARTY CLEARING

With the implementation of UMR and margin obligations, firms are expected to have to think more carefully about the efficient allocation of capital and collateral. Below we explore the case for clearing FX transactions through a central counterparty (CCP), such as LCH Limited (LCH) via the ForexClear service, by discussing its core benefits through the UMR lens:

- 01. Managing AANA Threshold with FX Clearing:** Cleared transactions are excluded from AANA calculation and its notional cannot be counted against the gross notional for UMR. Firms can use FX clearing to manage their AANA level and ensure they remain below the UMR threshold, while accessing the cleared FX liquidity pool. Additionally, regular trade compression can help reduce gross notional for firms subject to Global Systemically Important Bank (G-SIB) calculations.
- 02. Managing IM Minimum Transfer Amount with FX Clearing:** Once a firm has identified they are in-scope for UMR, there is a second threshold to exceed before triggering the requirement to transfer bilateral IM with counterparties: **Minimum Transfer Amount (MTA)**. The MTA stipulated by regulators is set at \$50m (or approximate local currency equivalent), essentially stating that for each bilateral counterparty, IM does not need to be transferred unless it exceeds the MTA.

Clearing a subset of an FX portfolio is an incredibly powerful lever which can ensure firms stay within their MTA across all bilateral counterparties, as well as reducing the operational burden required to set up margin transfer/receipts with custodians and CSAs etc. The added clearing benefits, such as multilateral netting, ensure clearing can be used to manage IM MTA without incurring prohibitive margin cost at the CCP.
- 03. Multilateral Netting and Reduced Cost of Funding:** Central clearing provides highly effective netting at the portfolio level, with trades netted together under the same counterparty. With cleared IM generally expected to be lower than uncleared IM, firms can settle IM and VM daily with LCH ForexClear, while achieving netting benefits, leading to lower cost of funding. More recently, with both the increased cost of funding, as well as changes to ISDA SIMM®, increasing bilateral margin, clearing presents an increasingly cheaper solution.
- 04. Stabilising Margin Requirements through Central Clearing:** While UMR requires IM to be exchanged bilaterally against each counterparty, trading activity with a counterparty may result in higher margin requirements, even if the net risk of the portfolio has not materially changed. With the use of a CCP as the central counterparty, margin management is simplified and more efficient operationally.



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05. Optimising Margin Requirements with FX Clearing: LCH ForexClear offers full portfolio margining across a member's or client's cleared portfolio, allowing offsets between various currencies and products eligible for clearing. The standard model for bilateral margin calculation, ISDA SIMM®, applies rigid correlation parameters between currencies and does not contain the granularity to ensure a high correlation parameter when pairs are highly correlated and vice versa.

LCH can run margin simulations on a firm's full FX portfolio of transactions eligible for clearing at ForexClear to help it identify potential benefits that can be achieved with central clearing and determine estimated UMR obligations.

IM % of Notional

Model	USDBRL		Directional LatAm		Directional USD		Directional LatAm/Asia		B/S LatAm v. Asia		All B/S Asia/LatAm	
	Buy	Sell	50% BRL, 50% other LatAm		Equally Weighted		30% BRL, 30% KRW, rest EM		Equally Weighted		30% BRL, 30% KRW, rest EM	
			Buy	Sell	Buy	Sell	Buy	Sell	Buy LatAm	Sell LatAm	Buy	Sell
ForexClear Client	9.2%	10.5%	7.3%	8.3%	5.4%	5.8%	6.4%	7.5%	3.0%	3.0%	3.8%	3.4%
Uncleared Margin	13.0%		8.0%		7.9%		6.5%		4.0%		5.4%	

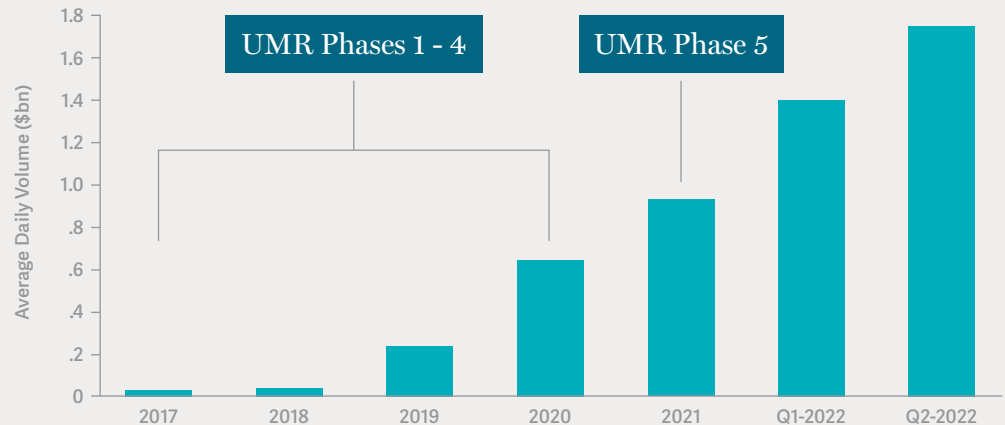
06. Liquidity, Risk Management and Operational Benefits: A key function of a CCP is to provide risk management to its clearing members and clients. Clearing removes exposure to multiple counterparties and replaces it with exposure to the central counterparty. Under the BCBS/IOSCO framework, the use of a CCP that is authorised to operate in jurisdictions that have implemented the international standards for FMI³ lead to the CCP benefitting from a lower credit risk weight and being treated more favourably. In 2009 in Pittsburgh, USA, the G20 set the following objective in response to the 2007-2008 financial crisis: "Non-centrally cleared contracts should be subject to higher capital requirements".

Clearing also provides standardised pricing through the use of standardised collateral and discount curves. Furthermore, LCH ForexClear provides a single pool of liquidity, along with the associated capital and operational benefits. Firms benefit from the cost savings and operational benefits of facing only a central counterparty, as opposed to multiple bilateral relationships.

GROWTH OF CLIENT CLEARING AT LCH FOREXCLEAR

LCH ForexClear is a leading central clearing provider for FX in the industry and has seen tremendous growth in its NDF volumes since UMR went live. You can join LCH ForexClear as a clearing member (FXCCM), or as a client via our US or International (including European) Clearing Broker models. In 2022, ForexClear cleared more NDFs than ever before – leading to record daily, monthly and quarterly records. With close to 800⁴ more counterparties to be phased in post-UMR Phase 6 in September 2022, this growth trend is expected to continue. The firms that are captured by UMR phases 5 and 6 are likely to use a client clearing offering, and the graph below details the strong growth we are seeing in this area of our service.

Cleared NDF Volume - ForexClear Client Clearing



Additionally, increased education on the impact of UMR and the benefits of clearing is leading to an increase in demand for clearing, including, but not limited to, information around how a subset of a portfolio could, in the future, be cleared in an optimal fashion, as opposed to blanket clearing of a whole portfolio, at LCH ForexClear.

Furthermore, client clearing growth is being driven by increased clearing broker choice and lower cost of clearing to the buy-side. In H1 2022, LCH ForexClear had 14 clearing brokers live on the service, offering client clearing solutions across our US and international clearing models. This has increased to 19 and we expect it to grow further in 2023, based on the current onboarding pipeline.

FOR MORE INFORMATION

LCH ForexClear is here to partner with the market on the recent UMR changes. Please reach out to our specialist Sales team for further information or to request portfolio analysis at lchsales@lseg.com, or visit our website: www.lch.com/services/forexclear.

¹Margin requirements for non-centrally cleared derivatives - Second Consultative Document (bis.org)

²AANACalculationUS_4.6.21.pdf (isda.org)

³Principles for Financial Market Infrastructures (PFMI) (bis.org)

⁴Advisory — BIP. Monticello Consulting Group | Case Studies (monticellocg.com)