

# Non-deliverable options clearing from LCH

As LCH's ForexClear is about to start clearing non-deliverable foreign exchange options (NDOs), we asked Kah Yang Chong, Head of ForexClear Product, Europe, the Middle East and Africa, to tell us more about this initiative.



Kah Yang Chong

### Why are NDOs a natural progression and such a good fit with your existing clearing offerings?

The addition of non-deliverable options (NDOs) to the ForexClear line-up completes the range of vanilla FX products that are available for clearing at LCH's FX clearing service. The portfolio benefits of this are particularly interesting; we have analysed portfolios where NDO risks are completely offset by existing cleared Non-Deliverable Forward (NDF) positions. In these cases, NDOs cost either no additional margin to clear, or could potentially provide margin savings on existing cleared NDFs.

This highlights how NDOs complement our existing product suite.

It is therefore no surprise that the appeal of FX clearing has grown rapidly since the introduction of uncleared margin rules (UMR), with ForexClear clearing an average of USD 70bn to USD 80bn of FX transactions between members and clients daily, and hitting all-time record volumes in H1 2020.

While a key driver for this growth is the opportunity to realise net funding savings by optimising margin requirements, it is not the only reason. By expanding the scope of cleared products, market participants can also maximise the efficiencies gained from risk, operational and legal netting against a single counterparty (the CCP).

### How significant is the market demand for NDO clearing, and where is it coming from?

Our analysis of volume data from publicly available sources (such as the 2019 BIS Triennial Survey, and SDR data) validates the strong demand coming from our existing membership, which includes both global and regional banks that are seeking to further optimise their margin requirements across the board. Buy-side clients, such as asset managers and insurance funds, have also shown interest in both emerging market (EM) and G10 NDO currency pairs, with the

arrival of UMR Phases 5 and 6 acting as the main driver.

### What are the benefits of NDO clearing for both clients and market makers?

As well as providing margin savings and netting benefits, the addition of cleared NDOs enables a holistic view across margin, capital, risk, operational and UMR set-up costs. Over time, this could be reflected in better liquidity or pricing in clearing compared to uncleared positions. Just as importantly, it also opens up new categories of users, with clients, such as buy-side firms and corporates, now able to access the CCP to clear their FX options. This access was previously limited to direct members.

Those clients that are able to clear most of their FX products in scope for UMR, including NDOs, may be able to better navigate the rules, which will capture many hundreds of firms in Phases 5 and 6. By choosing to clear all their in-scope FX products, clients may be able to avoid the burdensome UMR set-up process, which includes ISDA negotiations, collateral schedule negotiations, custodian set-up, and reconciliation of daily initial and variation margin, typically at fund level.

According to ISDA, dealers are expecting to set up UMR relationships with up to 9,400 existing relationships, in aggregate, ahead of the final two phases. We therefore believe dealers would also welcome any savings in UMR set-up costs through FX clearing.

Another important benefit to dealers is capital savings. The favourable Risk Weighted Assets (RWA) and Standardised Approach Counterparty Credit Risk (SA-CCR) treatment for cleared trades under the Basel III framework for counterparty credit risk enables dealers to optimise their capital and balance sheet usage in



Buy-side clients, such as asset managers and insurance funds, have also shown interest in both emerging market and G10 NDO currency pairs

clearing. The standardised calculation for RWA permits a lower 2% counterparty risk weighing against a CCP, compared to a minimum of 20% against a AAA-rated entity. Further, under the SA-CCR framework, trade exposure against a CCP attracts a lower 10-day Margin Period of Risk (MPOR), versus a potential 20-day MPOR for uncleared trades under certain criteria.

### How have you gone about testing the clearing of NDOs, and how have you responded to the feedback this generated?

We partner closely with our customers to ensure all relevant functionality and workflows are tested prior to going live. Active testing is currently underway with our customers in a beta environment, and any feedback we receive is continuously looped back to our product team and developers to enhance or fix, as needed. Our teams work using agile principles, so we are constantly learning and building on our features, which is especially important during testing cycles. This will ensure our customers are ready to reap the benefits as soon as the service launches, seamlessly and efficiently.

### What products will the new cleared service initially focus on, and what currencies are involved?

Our NDO product will launch in four EM currency pairs (USD/BRL, USD/INR, USD/KRW and USD/TWD) and five G10 currency pairs (AUD/USD, EUR/USD, GBP/USD, USD/CHF and USD/JPY), with a maximum tenor of two years. NDF hedges to NDOs will also be accepted as part of LCH's non-deliverable FX service, and the portfolio of NDFs and NDOs will be settled and margined together.

### Who will be able to access the new service?

Both direct members and buy-side and corporate clients are able to access the non-deliverable FX service, which will consist of cleared NDFs and NDOs, through a clearing broker or FCM.

### How would you envisage expanding the service in the future, and what factors could influence this?

We will continue to work with our customers to engage and listen to their requirements for future product enhancements.

Our current road map includes plans to add new currency pairs to the service and extend the maximum tenor for certain currency pairs from two to five years. These enhancements have been prioritised based on the demand we have received from our customers.

ForexClear is seeing surging volumes of NDF trades cleared

Region	Currency Pair	Volume		Open Interest	
		Weekly (in USD)	YTD (in USD)	Trade Count	Notional (in USD)
APAC	USD/CNY	25,485,715,622	709,636,977,100	5,522	103,417,901,807
	USD/IDR	38,118,945,984	1,067,971,803,783	29,494	158,620,450,129
	USD/INR	75,804,526,481	2,828,558,969,427	65,927	457,278,719,877
	USD/KRW	72,518,421,823	2,400,412,433,701	63,518	348,480,670,484
	USD/MYR	1,651,682,788	64,848,506,892	1,748	7,320,657,957
	USD/PHP	16,129,331,326	571,209,814,968	14,564	83,647,294,354
EMEA	USD/TWD	90,052,806,141	2,776,415,459,315	53,292	536,259,952,102
	USD/RUB	7,853,283,962	106,862,353,162	1,142	15,134,143,263
	AUD/USD	2,790,821,290	131,792,060,318	907	22,847,716,094
	EUR/CHF	0	3,014,397,141	18	465,720,066
G10	EUR/GBP	1,345,217,450	18,791,079,386	170	4,167,268,911
	EUR/USD	7,398,242,984	436,451,118,421	2,458	112,769,883,965
	GBP/USD	4,023,047,950	80,758,838,361	574	25,133,434,196
	USD/CHF	729,000,000	49,492,180,600	192	8,663,360,000
	USD/JPY	904,000,000	40,169,955,594	44	3,418,842,859
LATAM	USD/BRL	29,588,555,530	1,394,216,420,563	6,323	174,977,585,327
	USD/CLP	13,855,424,143	393,203,139,530	7,078	75,919,876,088
	USD/COP	7,585,312,153	243,400,273,676	5,220	38,542,726,730
	USD/PEN	2,508,309,188	104,093,135,430	1,296	9,196,140,609
<b>Total</b>		<b>398,342,644,816</b>	<b>13,421,298,917,368</b>	<b>259,487</b>	<b>2,186,262,344,819</b>

Figures as of COB 11/09/2020. Weekly figures as of COB 04/09/2020 to COB 11/09/2020.