

Participants across global capital markets have thrown their weight behind central clearing as the best means of reducing and controlling systemic risk in the OTC derivatives market. But significant obstacles remain, writes [Anuj Gangahar](#)

Clearing: the path

Clearing has never been (this) interesting.

After spending many years as an ill-defined set of activities that occurred after a trade was done, clearing has become a central theme in the debate on reform of global capital markets in a post-crisis world.

The main reason behind the sudden surge in interest in clearing is that it may be one of the best ways to manage counterparty risk that so many are seeking in the over-the-counter (OTC) derivatives markets, and beyond.

Most of the active debate focuses on clearing of interest rate swaps and credit default swaps (CDS) and the

potential reduction of systemic risk that clearing provides.

Walter Lukken, chief executive of New York Portfolio Clearing, a 50-50 joint venture between the Depository Trust & Clearing Corporation (DTCC) and the New York Stock Exchange (NYSE), said that one of the clearest lessons of the financial crisis is that standardised derivatives contracts would undoubtedly benefit from centralised clearing.

“That is what legislation currently does but the trick for those in financial services is to ensure that we can manage the most standardised contracts – for example, interest rate



Source: iStockphoto

swaps – but also cope with the more bespoke derivatives contracts, and this is more difficult,” he says.

But much misunderstanding remains and the levels of readiness for central clearing vary greatly across the range of market participants.

Raymond Kahn, head of OTC derivatives at Barclays Capital, says: “The first step is establishing the necessary connectivity and infrastructure. At the moment, dealer-client-central counterparty (CCP) connectivity needs to be upgraded and that is something that is being worked on. You also have to keep in mind that the counterparty risk that exists in the OTC market effectively becomes clearing and operational risk in a centrally cleared environment.”

Central clearing, it must be remembered, is not a panacea that removes the risks that so disastrously became apparent when Lehman Brothers and a host of other financial institutions failed during the financial crisis.

“One concern is the mistaken belief that clearing gets rid of all systemic risk. It doesn’t. The members supply the capital backing to the CCP and are interconnected and exposed to all other members. This results in a concentration of risk at the central clearer which



Kim Taylor, president, CME Clearing

means it must have robust risk management,” says Tom Benison, managing director in JP Morgan’s credit trading group.

“What worries us is that we don’t want to see a world in which risk is transferred from one venue to another. There is no doubt that central clearing is good, but it is equally true that it does have its problems. There are

concerns within the clearinghouses themselves – that the processes they employ might not be as transparent as they should be,” adds Gary DeWall, group general counsel at Newedge, a global brokerage firm backed by Crédit Agricole and Société Générale, adding that a move to central clearing is to be accompanied by a real effort to make the processes employed by clearers more transparent.

“The fact is that central clearing is a great improvement only if the governance of exchanges and clearinghouses is transparent,” he says.

But those putting forward the various clearing models draw attention to the many benefits of a centrally-cleared market. Kim Taylor, president of CME Clearing, says the CCP model offers a number of risk management, operational and transparency enhancements along with the discipline of daily mark to market, which provide a level of protection that is significantly enhanced from the bi-lateral model.

“Some examples of this include the multi-lateral netting of transactions traded across all counterparties in the marketplace – think of this as an ‘auto tear up’ approach to managing a position – so the open exposure is effectively collapsed to its net level at every point in time,” Taylor says. “Operational efficiencies include the ability to get immediate point of trade confirmations, and the netting of settlement amounts across a broad universe of asset classes.”

Taylor adds that with respect to transparency, the daily mark to market process includes the dissemination to the marketplace of an official valuation price combined with the discipline of paying profits and collecting losses – “so the market moves to a pay as you go model for all market participants.”

The introduction of central clearing is obviously not without significant challenges. Many practical issues are being worked through at great cost in terms of time and resources.

JP Morgan’s Benison says that from an end-user’s perspective the issues

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range from regulatory clarity to the spectrum of cleared products to costs.

"Another challenge in terms of risk management is that most of the products cleared in the past were very different in terms of their risk characteristics, had shorter durations and more liquidity. Now we are beginning to clear longer duration products with less liquidity, which presents risk management challenges. Finally, the general clearing structure has been around since the 1960s and 1970s, but hasn't changed much since then," he says.

"All of these issues and more are being worked on by the industry right now and, as a whole, the industry is going flat out to get this done. The dealers are devoting huge resources from a business, legal and operational perspective," he adds.

Despite the challenges, most agree that central clearing, if used properly, could provide a means of keeping tabs on the OTC derivatives markets that governments and regulators so desperately want, while going at least some way to mitigating the counterparty credit exposures that cost so many so dear during the course of the crisis.

There is much discussion also about whether regulators need to force changes through, or instead let the industry take its time to ensure the necessary infrastructure is established for central clearing across products and asset classes.

Newedge's DeWall says: "There shouldn't be a regulatory mandate to fix this so we do like the fact that different clearinghouses have different models. One of the key issues is capital. For us, wherever we are located, we are subject to very strict rules on our capital. But clearinghouses don't have fixed capital requirements."

The clearing competition

The clearers that are likely to battle it out for supremacy with respect to central clearing across a range of OTC derivatives include LCH.Clearnet, CME Group, ICE Trust, Eurex, NYSE and Nasdaq.

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Each has a slightly different model. London-based LCH.Clearnet is by far the most established – volumes for its interest rate swaps service, SwapClear, cleared more than 40 per cent of the \$342,000bn global market for interest rate swaps, measured by notional outstanding as at February 2010, across 14 currencies.

LCH.Clearnet is also expanding its US operations and global operating hours to accommodate rising interest since the collapse of Lehman Brothers. The company is enlarging its New York office, established in March 2009, and expanding its global hours of operation, to catch more of the US trading day.

In the US, the Intercontinental-Exchange (ICE) and the CME Group are seen by most dealers as the most likely to succeed, although the battle lines are still blurred due in part to the uncertainty of future regulation of OTC derivatives.

CME Group is targeting a third-quarter launch for new services to handle swap transactions tied to interest rates and currencies.

The Chicago-based exchange giant, which is working with dealers and swap buyers as it shapes the initiative, is broadening its clearinghouse services

to handle a range of off-exchange derivatives contracts.

Meanwhile, ICE says that its ICE Trust US clearinghouse has now cleared \$5,100bn of US CDS since its inception last year. This figure is up from \$4,200bn at the beginning of March. ICE Clear Europe, which launched in December 2009, has cleared \$2,800bn, up from \$2,100bn at the start of March.

ICE, the CME and Eurex spent large portions of last year locked in a race to build the first credit default swap (CDS) clearing facility, with ICE winning in the end.

The CME is also trying to get a London-based CDS service up and running in order to compete with ICE's London-based CDS offering. Meanwhile, the Paris-based arm of LCH.Clearnet Group recently gained some ground on the CME by launching a new CDS clearing service out of France.

As regulators push for more clearing of OTC derivatives, the competition between these clearers for business will only intensify over time.

Nasdaq OMX Group has taken a typically aggressive stance and said recently it will take on LCH.Clearnet and CME Group and others in the market for clearing interest rate swaps.

Robert Greifeld, chief executive, said the company's majority-owned clearinghouse, International Derivatives Clearing Group (IDCG), is in the final stages of customer testing and expects to add new members – including “a large clearing firm” – in the next few weeks.

“We expect to be a vibrant competitor in this space in the months to come,” Greifeld said on a conference call accompanying the exchange group's quarterly results.

“There is a very small number of customers in the industry who are not testing with us at this point, or who are not engaged with us in a productive way. Certainly the IDCG office is very busy,” he says. And the NYSE, not to be left out, also recently formed its joint venture with New York Portfolio Clearing. Lukken, its chief executive, says: “Our goal is to establish ourselves as a long-term competitive solution and alternative to the CME. I think what we could be moving towards is almost a mixture of the vertical model where the exchange owns the clearinghouse and the horizontal model. What we are really proposing is a bridge, call it open access clearing, that is an amalgamation of vertical and horizontal models.”

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Despite all the activity, regulators have belied signs of nervousness. The European Commission has said that the increasing use of CCPs “will inevitably increase their systemic importance”. That is why Brussels and US authorities insist that there be robust regulatory requirements for CCPs to avoid a race to the bottom on risk management standards.

Part of the problem in the eyes of many is that central clearers were never really supposed to be for-profit institutions. Like the exchanges that operate most of them, they started life as market utilities. What many are afraid of now is that a competition to attract the most business will turn quickly into a “race to the bottom”, with the clearer that demands the lowest capital faring best.

The question is, will regulators have to intervene in order to make sure that this doesn't become a reality?

DeWall at Newedge says: “Over time, people will become more sensitive to the differences between the various clearinghouses. The competition will be healthy, but regulators must set parameters so that the competition is not just about which one has the lowest capital requirements.” He adds that the situation could be likened to the hedge fund world



Conrad Voldstad, chief executive, ISDA

where many funds use multiple prime brokers and shift their balances between them. “Now you need multiple clearers and so you need to hold balances with more than one. The key thing is that clearers must be transparent.”

The model of the future

The International Monetary Fund (IMF) noted in its Global Financial Stability Report, published in April, that in order to achieve the multilateral netting benefits of a CCP, a critical mass of OTC derivatives needed to move to central clearing. It also said that close cross-border co-ordination of regulatory and supervisory frameworks is required and that, ideally, CCPs would develop linkages that allow for more netting and lower collateral needs. So far, however, the IMF said legal and other obstacles has made this difficult.

The report pointed out however that this process would be costly for some active derivative dealers. “CCPs require that collateral (called initial margin) be posted for every contract cleared through them, whereas in the OTC context dealers and some other types of participants tend not to currently adhere to this practice. As a result, active OTC derivative dealers, those likely to be members of CCPs, will incur

costs in the form of the increase in posted collateral and, if enacted, potentially higher regulatory capital charges against remaining derivatives contracts on their books.”

But demonstrating the differences of opinion that are being expressed about the move to central clearing almost every day, Conrad Voldstad, chief executive of ISDA, responded to the IMF report in a letter dated April 26, saying that there was evidence the industry would, and indeed already was, moving to central clearing despite the costs.

“The fact is, the industry has already cleared over \$200,000bn of interest rate swaps despite the ‘costs.’ Should firms be able to clear forward rate agreements, caps, floors and swap options, very sizeable volumes would be cleared very quickly. Similarly, single-name default swaps can only be cleared for the most liquid names,” says Voldstad.

He pointed out, however, that there were some barriers beyond cost that needed to be addressed and that the clearinghouses have to develop the means of clearing these products safely before the dealers can use them.

Similarly, the clearinghouses typically have very stringent standards about membership because of the potential capital calls if a member defaults and the need for members to bid for the positions of a defaulting member. Members must be able to assist in hedging the clearinghouse as well as bid on positions. Presumably, over time, a clearinghouse will not require comprehensive risk management strength for all its members and enable more dealers to become members.

The IMF report added that without an explicit mandate to do so there is some uncertainty as to whether dealers will voluntarily move their contracts and whether enough multilateral netting can be achieved.

That being said, it does seem that the dealer community has at least decided that central clearing is the model of the future, if not quite having made up its mind as to how exactly the model will look.

“It is fairly clear that we are moving towards clearing across the board. It will be interesting to see if the entry of official institutions such as Freddie Mac and Fannie Mae, which may start using central clearing by the end of the year, will help speed up the process.”

Harry Harrison, head of rates trading at Barclays Capital, says: “CCPs, the buy-side and the sell-side are working very hard to come up with an industry-wide solution. Various CCPs are being considered and that adds more complexity to the planning and due diligence process.”

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As we look ahead, the jockeying for position by clearers is unlikely to continue indefinitely as volumes become key and one of them (or maybe more than one) establishes itself as the market leader. JP Morgan’s Benison said: “In terms of the central clearers available now, all have the ability to succeed, but I don’t think all of them will in the long term.”

Despite today’s unanswered questions about clearing and the operational challenges it presents, the industry feels the benefits of clearing sufficiently address many of the concerns about counterparty and operational risk. A recent report from research firm Celent concludes that OTC trading of derivatives exists today and predicts that alternative systems, like exchanges, will have a difficult time gaining traction, mostly because market participants have confidence in the work under way to improve clearing and post-trade processing of OTC derivative trades. ■



Harry Harrison, head of rates trading, Barclays Capital