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A clear case for change

The move to central clearing for OTC derivatives is causing consternation, especially amongst fund managers, and many foresee changes in investor behaviour to avoid charges when the new regulations come into force, says **John Gubert**.

"It was not a wolf pack of hedge funds that shorted Lehman but banks covering their exposures through OTC credit derivatives," declares Stephen Fulford, head of derivatives at Fidelity. "The whole central clearing initiative is driven by the need to concertina down the open position between banks." Views such as these make many fund managers feel they are being unfairly treated by the drive to central clearing for over-the-counter instruments. With pension funds likely to be given exemptions from some of the planned OTC derivatives regulations, there is a strong belief that this should be extended to fund managers. "Hedging risk for investor protection should be exempted. Only positions taken for

investment should be subject to the new rules," states Laura Weatherup, head of derivative oversight at Threadneedle Asset Management.

Dr Anthony Kirby, director, regulation and risk at Ernst & Young Financial Services, is more optimistic than most that help will be given to the fund manager community, exempting them from central clearing requirements – at least in Europe. "In Europe, a proportionality test will be applied to determine when activity is speculative. As it is unlikely that pension funds are managing funds in a speculative sense, it is expected that such entities might be exempted once the final measures are announced." The move to central clearing is

likely to force change in investor behaviour, with managers opting for instruments exempted from the new regime. Forward exchange contracts may be used as a substitute for swaps, although that could drive regulators to put that market within the scope of central clearing. Christopher Coleman, Derivatives360, North America business manager at BNY Mellon, says, "Managers may act differently but they will not abandon their hedging strategies. We may see managers utilising a pure speculative trading strategy start to reduce their derivative activity." Kirby notes that buy-side entities such as pension funds in the UK and Netherlands are already concerned that extra may be fed back to them and have made



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public submissions to that effect. Regulators are promoting the move of OTC instruments to central clearing to reduce risk. Jonathan Bowler, Derivatives360 EMEA and APAC business manager, BNY Mellon, says interest rate swaps are 70% of total OTC volumes and that they will be the immediate focus of attention. Yet the fact that some instruments will be centrally cleared and others still subject to bilateral clearing is cause for concern.

Markus Reutimann, head of operations, Schroders, comments: "A perfect example is the liability driven investment area in that LCH will clear interest rate swaps but has yet to confirm that they will clear inflation-linked swaps. The capital cost of clearing could be much greater if we clear interest rate swaps through central clearing and use bilateral processes for inflation-linked swaps given the inability to net the positions for margin purposes." Reutimann sees extra costs coming from multiple sources, including initial margin payments (most OTC agreements currently require variation margin to be paid), different rules depending on investor profiles and the requirement for trade repositories. From a risk perspective, he would also like margin payments to be treated as client money.

Both Reutimann and Weatherup express concerns at the growing complexity of the market. Reutimann notes the challenge of updating documentation,



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whilst Weatherup, given that Threadneedle is a low user of derivatives with approximately 200 positions across 20 to 30 funds, expresses real concern at the cost of automating low-volume processes to meet likely mandatory market standards.

Liability benchmarks

Fulford of Fidelity is more relaxed on the cost front, for mutual funds. "Our retail funds will be less affected by the higher margin requirements because we expect them to be holding more than adequate amounts of eligible collateral." He recognises the problem for others, however. "Some of our peer group who manage portfolios against liability benchmarks are estimating that costs, in selected instances, will be high enough to challenge the economics of the proposition."

Some fund managers are concerned that standard contracts will be less efficient than OTC ones. Rory Cunningham, director of public affairs at LCH.Clearnet, claims it will be a choice between

"standardised and therefore clearable instruments that may be less perfect hedges" and the better hedge but possible poorer credit quality on an OTC instrument. All recognise the need for CCPs to have robust risk management policies. Fulford believes their risk is manageable. "Clearinghouses are the lesser of two evils. I think their level of exposure in complex instruments will not be that great and they will be protected by conservative margining, high capital requirements and an aversion to complex risk."

Diana Chan, CEO of EuroCCP, stresses the need for prudent management of clearinghouses and especially availability of current prices for the assets they clear. "They need this data to market the obligations from clearing participants." She insists that a liquid market is needed so that when a clearing participant defaults, the CCP can close out the open obligations of that member. "Without a liquid market, the CCP may end up as principal for the duration of the contract," she explains. "To avoid this, a CCP could, through its rules,



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require surviving members to bid for the defaulter's portfolio." Such a risk avoidance policy by the CCPs mitigates in favour of mooted plans for material increases in minimum capital requirements for CCP participants.

Marco Strimer, CEO of SIX x-clear, has no plans to extend its business model into the OTC area. However, SIX x-clear has launched a CCP-eligible stock borrowing and lending product. Some fund managers are concerned, given the volumes involved in stock lending and borrowing and the lack of full transparency over such activity, that regulators will be attracted to this model to further extend the usage of CCPs. Strimer notes that "under Basel III, users have lower capital requirements" when clearing borrowing and lending transactions through a CCP.

CCPs appear to be masters of their own destiny, although some fear they are becoming "too big to fail" and also may be subject to political pressures to take on instruments that may not live up to their current risk appetite. Strimer believes there is a need for close co-operation between regulators and the CCP community moving into the OTC markets. "The different US and European regulators all believe that it is good to put transactions through a CCP, but they need to help and support the CCPs," he says.

Buyers must be relieved that service providers are focusing on



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eliminating some of the pain of the new world, but even those providers are concerned at the growing market complexity. Bowler notes that SwapClear has indicated it may make up to 13 intraday margin calls a day. "We do not find this sustainable if physical assets have to be moved." Segregation will also add complexity, albeit reduce risk. Fulford of Fidelity expects "regulation to require clearers to margin fund by fund at the CCP and not across their client net position – a change that will eliminate what Bowler calls "the slush fund of surplus collateral".

Prime collateral

Intermediaries are focusing on collateral management. Bowler believes clients want it to provide consolidated collateral services and are also looking for margin liquidity services such as pledging, repo, reverse repo, cash liquidity products and security substitution. He recognises that prime collateral will be in short supply but believes the problem is manageable. "We have a USD 12 trillion custody book and have clients who are long on fixed

income but do not trade derivatives and we will be offering a securities substitution service to those clients who need such collateral." Intermediaries know they must simplify the process. "We are also working hard with CCPs and clearing brokers to be able to offer our clients collateral services that do not involve movement of the underlying securities but meet the market margin requirements," adds Bowler.

Many funds are further irritated by the realisation that they could carry part of the heavy capital costs associated with bilaterally-settled OTC transactions. "I am hearing, anecdotally, a modest 2% risk-weighted asset will be applied to trades which will be centrally cleared," says Kirby of Ernst & Young. "The risk weights for OTC trades which remain bilateral may be three-to-five-fold."

Greater operational complexity, higher operating costs, changed risk management, the potential for a wider range of activity to be captured through CCPs and mandatory investment in new operating procedures for an industry that was not the cause of the OTC problem seems pretty rough justice. //