Buy Side Clearing: What must be done to make it work?
A DTCC/CSFI Post-Trade Fellowship round-table discussion with Juan Landazabal (Fidelity), Paul Swann (ICE Clear Europe), Tom Springbett (FSA) and Brian Oliver (JP Morgan)

Held on Thursday, May 3rd 2012, from 12:30 to 2:15pm.
At Innholders’ Hall, 30 College St, London, EC4R 2RH

Part of the DTCC/CSFI Post-Trade Fellowship Programme

The idea of CCP clearing for the buy-side emerged in the height of the 2008 financial crisis and subsequently came to be included in the September 2009 G20 agenda for reform of the global financial system. But having enthusiastically supported central clearing of its OTC derivatives trades immediately after Lehman’s collapse, the buy-side increasingly appears to have become disenchanted with the idea.

The meeting was held to examine how buy-side clearing was progressing, where the difficulties lay, and whether it would give users added security or just add to costs. Important factors affecting the discussion were the impact of new legislation on clearing that is emerging in the EU and around the world as well as the default in 2011 of broker-dealer MF Global.

As usual, the Chatham House rule was applied, under which views expressed during the meeting could be reported but without attributing them to any of the participants.

Perceived downsides of buy-side clearing dominated the debate in the early part of the meeting. It was claimed that regulators were pursuing a flawed agenda in promoting buy side clearing because the buy-side did not pose systemic risks. If a fund or its counterparty defaulted, the resulting problems were not systemic. Therefore, buy-side clearing wasn’t worth the effort involved.

It was further argued that the buy side already had procedures to distinguish between counterparties with good credit quality and those that were less good. It would lose out by having to post margin when clearing its trades. Another fear was that clearing would give comfort to weaker banks among the counterparties of CCPs. Transparency, one of the objectives of the G20 agenda, could be obtained through trade repositories. Who, it was asked, stood to benefit by forcing buy side companies to clear?

Moreover, it was alleged that clearing houses could themselves create risks. Meanwhile, clearing member banks could create leverage, mismatches and new risks when carrying out the process of collateral transformation.

The treatment of collateral was a recurring concern. Buy side firms would be handing over assets and putting them outside their control. There were question marks over the proper segregation of
collateral in CCPs and the portability of positions. In the meantime, unrealistic deadlines were adding to uncertainty, volatility and confusion about how to trade, adding to fears of reduced liquidity in derivatives markets and rising costs. All these factors would reduce the yields due to savers.

Causing concern at a more micro level was the cost for the buy side of implementing and understanding the changes underway while the sequencing of clearing eligibility by the authorities could see the buy-side lose out to other market participants. It was claimed that initial margin didn't take account of the true credit quality of counterparties. Buy side firms used derivatives trades selectively to smooth out rates and to help cash flows and did not have a multitude of offsetting trades. They would therefore lose out in a clearing environment to intensive users of derivatives.

A further worry was extraterritoriality, where many uncertainties remained. Concluding a litany of complaints about plans for buy-side clearing, one speaker suggested that buy side involvement in clearing should be postponed two years to give regulators time to work out clear rules and for dealers to satisfy themselves that there were no inconsistencies in the way clearing worked.

From a CCP perspective, the main question was how to extend the exchange traded clearing environment – which has operated successfully for many years - to OTC products that were less liquid and yet which could evolve eventually into cleared products.

It was acknowledged that there would be a continuing role for OTC instruments with bilateral clearing because there was demand for it from investors and also end users. Also OTC derivatives acted as a "sand box" for developing the next generation of exchange traded products.

The rationale for bringing the buy side into clearing was the same as that for the existence of CCPs. It was to keep the superhighway of financial markets open at times of stress. Central clearing could keep markets functioning and keep open opportunities to hedge in a crisis. This was difficult in a bilateral environment. That said, the market should drive the trend to clearing, not regulation.

As far as systemic risk reduction was concerned, it was accepted that many cleared products were not systemically important. But there had been pressure from the buy side for clearing solutions after Lehman’s collapse.

CCPs shared the concern about a degree of prescription in the emerging rules in the US and EU. Solutions were needed which did not undermine unnecessarily bank intermediaries in the marketplace.

A key issue was the procedure of CCPs after the insolvency of a clearing member. Not all buy-side institutions could take on the duties expected of clearing members of CCPs in default situations. It was therefore suggested that an elective element could be brought into CCP membership with different levels of protection depending on the size and responsibilities of the buy side participants in the clearing house. CCPs depended on a limited number of participants who could help to manage the default of a clearing member. Buy-side participants that were unable to do this should perhaps be reconciled to having their positions in omnibus accounts.

Whatever the reservations expressed in the meeting, participants were reminded that buy side clearing was coming and they had better get used to the idea. The buy side had to prepare for the inevitable. But the big and small clients of clearing member banks would be affected in different ways. Many smaller buy side firms would no longer be able to trade OTC derivatives bilaterally. Their options would be different and most likely less optimal and more costly than before. This prompted an observation from the floor about a lack of joined up thinking on the part of the authorities.
In riposte, it was pointed out that in the days following Lehman’s collapse people no longer had confidence that the OTC markets would function.

That said, while regulators saw a strong case for mandated clearing among major dealers, the arguments in favour of buy-side clearing had been more finely balanced.

On the one hand, regulators accepted that OTC derivatives could play a useful role in allowing companies in the real economy to hedge their risks. But it was questionable whether the vast size of the OTC derivatives market was commensurate with what the world’s economies needed. The resulting package was a step in the right direction.

It was pointed out that EMIR, the regulation most affecting buy-side clearing in Europe, would not become truly effective until around mid-2013 at the earliest.

Buy side membership of a CCP would suit only the very largest traders. Small and medium-sized firms would have to find another solution. This was client clearing to be provided by clearing member banks. In preparation, these would at least have to segregate client positions from “House” positions as well as offer the option of full segregation. If a clearing member went bust, the CCP should return assets to the client and not to the estate of the clearing member.

Two models of client clearing were outlined: the principal to principal model where the client conducts a trade with the clearing bank, which then puts a corresponding transaction through the clearing house, and the US type agency model, where the client has a direct relationship with the CCP and the futures commission merchant (US clearing member) guarantees the performance of the client.

It was acknowledged that client clearing was one of the most challenging elements of EMIR. Uncertainty surrounded the availability of collateral, standards of documentation and the availability of suitable clearing brokers as well as transparency of fees and whether or not services would be bundled. It could take a long time - maybe two to six months - for the on-boarding process to complete.

A lively debate followed. It was pointed out from the floor that risk would be hugely increased in the next three to four years because of the pressure to adapt operations to all the new regulations.

One buy side representative complained there would be less freedom to transfer risks than in a bilateral environment. Companies which had never had to clear trades would be forced to have counterparties with which they had never done business before. If pushed into using CCPs, they would no longer be able to know in detail how much risk they were taking on. Central clearing could incentivise banks that were less well rated to use CCPs.

There were complaints that OTC buy side investors would leave behind a world of bilateral clarity for one without clear direction. The risks were said to be huge, including increased credit and liquidity risks. Warnings flew thick and fast. One speaker warned that CCPs were exposed to big risks in their settlement banks. Another predicted that ultimately the taxpayer would have to pick up the tab. In addition, buy side investors were warned that they could lose their collateral in the event of CCP failures.

On the other hand, it was pointed out that CCPs existed to cope with defaults among their members. They had very robust risk management standards. Increasingly they put their own capital at risk in the “Waterfall” of protections against default and that should reassure the buy side. CCPs took a very
conservative view of margin offsets. There was very clearly no wish among CCPs to extend interoperability in clearing beyond cash equities to derivatives. The provisions of EMIR would ensure a CCP could withstand the collapse of its two biggest clearing members.

But some questions remained unanswered. It was acknowledged that collateral posed enormous challenges for clearing houses. They would have to be more flexible in their approach to asset classes to counter the declining credit quality of hitherto risk-free investments. Variations in bankruptcy law were another problem that affected the portability of client accounts and it was noted that the UK bankruptcy law would have to be changed to bring it into line with EMIR in this regard.

One speaker concluded that the buy-side would engage in fewer derivatives trades in a cleared environment.

If the Fellowship round table was any guide, buy side clearing has few friends among those it is supposed to benefit. Neither CCPs nor regulators appeared particularly enthused at the prospect. However, there was no doubt that it will become a feature of European post-trade landscape once the necessary regulations are in place.