The changing times

Tackling exchange trading, mandatory clearing and trade reporting challenges

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Far-reaching changes to the world of over-the-counter (OTC) derivatives will impact not just the infrastructure of individual firms but the shape of the industry itself, as it starts to adopt exchange-traded derivative (ETD) practices. A torrent of regulation including the Dodd-Frank Act, the European Market Infrastructure Regulation (EMIR), the Markets in Financial Instrument Directive (MiFID), Basel III and the rest is forcing the industry to adopt three major changes:

¬ Trading on exchanges rather than over-the-counter

¬ Mandatory clearing

¬ Openness and transparency through trade reporting

Each of these looks sensible at face value, yet each has proven to be fraught with difficulty in practice, not least because the detailed regulations are different in the US and Europe.

Exchange trading and mandatory clearing

In the US, certain categories of interest rate swaps and credit default swaps first became tradable on Swap Execution Facilities (SEFs) in October 2013. It was due to become mandatory in the first quarter of 2014. But it's a different story in Europe, where the equivalent Organised Trading Facility (OTF) concept is still a long way from regulatory clarity, let alone implementation.

Better progress has been made with mandatory clearing, where a central counterparty (CCP) steps in via trade novation to become the seller to the buyer and buyer to the seller. Each OTC party is now exposed not to the original counterpart but to the CCP, which should reduce risk because of the large amounts of collateral collected by the CCP. Again, faster progress has been made in the US, where most swaps are already mandated to be cleared. Europe is catching up, following applications in 2013 by CCPs to be regulated under EMIR. In March 2014 the Swedish FSA approved Nasdaq OMX's application, making it the first clearing house in Europe to be authorised as EMIR compliant. This clears the way for ESMA to develop and consult on its draft Regulatory Technical Standards (RTS). Mandatory clearing will come into force after a phase in period to be defined in the RTS, following endorsement by the European Commission and non-objection by the European Parliament. This will all take time, and may run on until as late as July 2015. But the clock is now officially ticking on European mandatory clearing.

Unfortunately, all this comes at some cost. Because OTC trades have longer maturities than ETD, the collateral required to cover the risk is greater. Estimates of how much extra collateral the industry needs vary widely, but the amount will be measured in trillions of dollars not billions.

Although it is now widely believed that there is enough collateral available within the markets to meet the needs of the regulators, it is not evenly distributed and some firms will find it difficult to mobilise. The buyside in particular is just beginning to grapple with the forthcoming need to stump up much more collateral than before. There is a growing realisation that there won't be enough cash collateral to meet margining needs without liquidating assets, which reduces fund performance. Many expect this to drive a shift towards non-cash collateral, which will require more a sophisticated infrastructure to keep track of collateral pledged, enabling it to be recalled rapidly and securely if it can be put to better use. The investment required over the coming year is not yet clear, but the additional cost of collateralising OTC derivatives is prompting many firms to consider whether ETD may be more affordable than OTC, even if they can't deliver the same precision of market exposure or hedging effectiveness.

While OTC volumes may drop, they will not disappear. This has prompted much innovation amongst the banks that provide clearing services. Many have developed connectivity to multiple CCPs, custodians and triparty agents to help move clients' collateral quickly, cheaply and securely, adding valuable liquidity, credit, collateral transformation and optimisation services. This so called 'collateral plumbing' will be an essential component of the post regulatory landscape, as it will enable firms to tap into otherwise inaccessible pools of collateral in order to meet their regulatory requirements.

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Firms that require access to the collateral plumbing network should have already contacted their preferred solution providers, but there is evidence to suggest that many have not yet done so. We are already seeing early symptoms of a potential on-boarding crunch for buyside clients who are leaving it very late to partner with external service providers. Just as some firms waited too long to implement their trade reporting solutions, some will leave collateral management too late as well. When such firms finally attempt to connect to the industry infrastructure they will discover that they're at the end of a very long queue. In a 'crunch' custodians will inevitably prioritise their platinum clients, so they must encourage other clients to engage early to avoid getting left out.

The challenge for the sellside is how to make a profit from client clearing. Customers expect clearing services to be delivered at little or no cost as part of the broader client relationship, leaving only 'value added' services to provide fee earning opportunities. This has been the established exchange-traded model. The next two years will establish the winners; those banks with the broadest, most flexible services combined with cost leadership. This requires substantial investment in technology and automation that not all can afford, so we anticipate shifts in the industry as some players withdraw from markets they can't make money in, to focus scarce investment on their core franchise.

Yet there is money to be made in the industry. Clearing houses have long recognised that there are substantial revenue streams to be made not just from clearing fees but from the re-investment of collateral held on behalf of members. It is likely that new regulations may affect some realignment in the clearing industry. Historically, whilst many exchanges cleared cash instruments themselves, OTC clearing was often outsourced to established clearing houses. However, in recent times we have seen NYSE LIFFE and LME terminate their outsource arrangements to establish their own clearing facilities. Last year the London Stock Exchange took a majority stake in LCH.Clearnet, further accelerating the emergence of the vertical clearing model in which exchanges and clearing are integrated by asset class. Meanwhile, new European clearing houses such as CME Europe are being established in anticipation of mandatory clearing. Nobody knows whether all CCPs will survive in all the asset classes they are preparing to clear, but we can be sure that the shape of the industry will evolve in coming years. Innovation is also underway in the traditionally slow moving world of custody and securities depositories. Article 47.3 of EMIR prevents clearing houses from placing their assets with custodians, forcing them instead to hold their assets at securities settlement systems, more commonly known as central securities depositories (CSDs). This poses a threat to custodians who do not themselves operate CSDs, as buyside clients will have little choice but to move assets they are using to margin OTC business to venues which are more convenient for CCP collateral allocation.

The major beneficiaries of this regulation are likely to be firms who are both custodian and securities settlement system, such as the iCSDs Euroclear and Clearstream. However, other custodians are making strategic moves to position themselves for this new environment and further delays in the implementation of regulations could enable them to erode the competitive advantage of the established providers. For example, BNY Mellon has decided to launch its own CSD in Belgium, whilst JP Morgan is partnering the London Stock Exchange, itself setting up a new CSD in Luxembourg based on its Monte Titoli infrastructure. We will of course see further huge changes in European CSD infrastructure as participants gear up in 2014 for the advent of T2S in 2015, which promises radical restructuring and cost reduction for cross-border securities settlement.

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A shift to mandatory trade reporting

Another area where the OTC world is moving towards the exchange-traded model is via mandatory trade reporting. Once again the US has led the way, benefiting from its simpler, centralised infrastructure. Europe has now caught up, as mandatory trade reporting came into force on 12th February 2014. However, the European regulations go much further than the US, in that: ETD as well as OTC trades must be reported, both sides to the trade are accountable for reporting, and far more information is required, including (later in 2014), collateralisation of trades and portfolios.

Many firms were under-prepared for EMIR trade reporting, perhaps because they thought the deadline might slip again. This manifested itself in a last minute rush to obtain Legal Entity Identifiers (LEIs) and to select and onboard with one of the authorised trade repositories (TRs). Further, many firms were confused about how to generate Universal Trade Identifiers (UTIs) and failed to design an efficient process and communications infrastructure. These factors meant that many firms were unable to submit reports, and that many of those submitted were either incomplete or unmatchable. Furthermore, some TRs underestimated the last minute demand for onboarding services, which led to an onboarding bottleneck, epitomised by the high profile backlog at DTCC in the early weeks of the reporting mandate.

Most firms have now resolved their connectivity issues and are able to submit trade reports of some description. However, it remains to be seen exactly how regulators will use the submitted data, particularly in light of the fact that much of it is unpaired with the counterparty side (and therefore unconfirmed), or incomplete.

The year(s) to come

Regulators worldwide are seeking to make the perceived ‘risky’ OTC world behave more like the (presumed to be) ‘safer’ ETD industry, through the introduction of exchanges, mandatory clearing, and trade reporting. This is causing upheaval for all parts of the industry, as firms redesign their operating models, processes and technology to meet new regulations.
All market participants have been forced to invest in new infrastructure and connectivity solutions, but the level and type of investment has varied from firm to firm. Those with the clearest strategic vision will continue to invest most wisely. Those with the largest volumes will spread their costs more thinly, achieving a lower cost-per-trade. Yet many banks have inherited infrastructure designed for a pre-crisis world they no longer inhabit, and which they can no longer afford. Revenues of the biggest firms are currently about a quarter below the peak in 2009. According to McKinsey, average return-on-equity for the largest firms fell to 8% last year, and without deep cost cutting this will fall further, to 4% by 2019. As the regulatory compliance deadlines fall into place during 2014 and beyond, the winners will be those that embrace radical simplification. As banks prepare next year’s investment budgets, plans that tinker at the edges to generate 5-10% per annum marginal cost savings will not be enough. Cost reduction programmes will need to be more radical. We anticipate a polarisation of the industry as volumes gravitate towards ‘flow monsters’ with zero-touch operations and very low cost-per-trade, leaving others to retreat to a core franchise. Some will abandon their global aspiration for geographical focus, outsourcing securities processing to others that operate more cheaply. We will see the strengthening of service utilities that can process huge volumes, cross-border and asset class. Achieving regulatory compliance will continue to be the primary focus of firms throughout 2014, but the wisest participants are already positioning for radical industry change in 2015 and beyond.

Featured specialists

Tony Sodhi

Managing Principal

Tony joined GFT in 2014 with seventeen years of investment banking experience gained in line, change and programme management roles running operational and IT teams. Tony previously worked for a niche consultancy, where he spent five years as Head of Post Trade Operations and was responsible for business development, target market identification, leading bid teams/assignments and building the internal post trade operations team expertise. Prior to that role, Tony spent four years at KPMG/Atos as a Principal Consultant. Tony has also held positions as the Head of Reconciliations, Head of Loans and Director of FX IT, as well as working in teams within Equity Derivatives, Fixed Income and Treasury functions. Tony has run a wide range of complex assignments ranging from business process modelling to implementing complex derivatives trading systems in multi asset trading environments.

Ian Weavers

Specialist in operational strategy

Ian is an expert in business and technology architecture. His architecture and roadmapping methods have been successfully deployed more than 50 times at 20 Financial Institutions. Ian has also trained more than 30 consultants in current industry architectures, spanning: Derivatives, Risk, Commodities, Payments & Cash Management, Securities Lending and Corporate Banking. Prior to GFT, Ian led many change management, IT and consultancy programmes across the global financial services marketplace. He has held senior positions at Standard Chartered, UBS and Prudential, has a degree in computer science and is a Chartered IT professional.

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