The Changing Shape of Derivatives Markets

Take a Walk on the Buy Side
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One of the consequences of the global financial crisis (GFC) of 2008 has been heightened demand for centrally cleared derivatives.

Specifically, for end clients, the market now demands individual segregation of centrally cleared over-the-counter (OTC) interest rate swap (IRS) transactions to guarantee efficient porting of positions and any margin collateral posted, should a clearing broker ever default. As levels of trust have diminished across the financial sector, and the collapse of Lehman Brothers demonstrated that no party is “too big to fail,” market participants on both sides have looked for a different tact.

Today, a decade after the GFC, the greater capital requirements on banks have somewhat alleviated the fears around counterparty risk, as around 90% of end clients’ OTC IRS are estimated to be cleared through an individually segregated model, according to Frank Odendall, Head of Buy-Side Repo Solutions at Eurex.

As clearing eventually became mandatory under European Market Infrastructure Regulation (EMIR) in 2016—having been postponed multiple times—it also saw costs travel upwards. As sell-side costs increased, these were ultimately passed on to the buy side, with annual clearing fees of €500,000 not uncommon. Simultaneously, many banks exited the space due to high regulatory capital requirements associated with the provision of clearing services, leading to the concentration of IRS clearing among just a handful of brokers.

In this environment of high costs and clearing broker concentration, it became clear that the buy side needed to look at other options. Eurex launched ISA Direct three years ago, and it has taken until now for momentum to really start to build. In allowing buy-side clients direct membership to central counterparty (CCP) clearing, they become principal to the transaction, while a bank acting as the clearing agent takes over the legal responsibility on their behalf, enabling them to contribute to the mutualized default fund and participate in the default management. While the ISA Direct service was initially adopted by some smaller regional banks, traction on OTC interest rate swaps is finally picking up.

In June, Eurex announced that Swiss Life Asset Management, a large-scale buy-side member, was the first to use its CCP ISA Direct service for OTC interest rate derivatives. The model is designed to reduce the client’s financial and operational burden of clearing while offering a more robust model that improves resilience and security across the marketplace.

With Swiss Life Asset Management signed up for OTC IRS and pension fund provider PGGM for repo, are others likely to follow suit, or are the hurdles still too high for most?

“The benefit [of the cleared repo market] could be a better risk diversification within the cleared portfolio and a lower initial margin requirement.”

— JAN GRUNOW
HEAD OF INVESTMENT OPERATIONS, SWISS LIFE ASSET MANAGEMENT
Jan Grunow, Head of Investment Operations at Swiss Life Asset Management, believes the ISA Direct model is only really appropriate for established buy-side clients of a certain size.

"By becoming a direct client of Eurex Clearing, Swiss Life exposed itself directly to the processes that are normally taken care of by the clearing members, leading to more direct exposure to the CCP, but at the same time, a lack of safety net provided by the clearing broker. Only large and midsize buy-side members will currently be able to cope with the requirements to become an ISA Direct member of Eurex Clearing," he says.

Size restriction may be one factor holding back more widespread adoption, and general aversion to veering from the status quo may be another, while many industry commentators have expressed concerns following the NASDAQ Clearing member default (fig. 1) last September, almost 10 years to the day after Lehman Brothers collapsed.

While there is a perception in the market that only large-scale players might be willing to take on their own collateral management, the rise of consolidation across the asset management space suggests that this might be a reality sooner rather than later.

For smaller players and smaller funds, the additional outlay required may not be worthwhile, and it may be more efficient for them to continue with their existing framework. But Odendall believes the operational difference is insignificant; only the legal implications are fundamentally different, which he foresees as the major investment required, once all internal stakeholders are convinced.

Swiss Life AM decided to clear its OTC IRS directly at the clearing house rather than using an intermediary, to bring its exposure in-house rather than have it sitting with a third party. With less dependence on clearing brokers, there is a lower risk of porting open trades should a clearing broker default. Grunow explains that the initial margin for Eurex Clearing remains in a pledged account at the triparty collateral manager SIX SIS, owned by the SIX Swiss Exchange. This substantially reduces counterparty and collateral transfer risk, as the initial margin (IM) stays in a Switzerland-based securities account pledged to Eurex Clearing, allowing Swiss Life AM to continue to consolidate the securities to the pool of covered assets, in line with Swiss regulation.

The most immediate benefit, he says, is cost reduction; the group’s clearing costs are significantly lower as no clearing broker has to provide balance sheet capacity for its swaps.

Another consideration is finding a clearing agent that supports ISA Direct. In the case of Swiss Life AM, their partner is ABN AMRO, which can develop this revenue line with lower-risk exposure than full clearing membership.

Multiple challenges are at stake, with various product areas demonstrating their own idiosyncrasies, but Eurex’s decisions regarding order of product rollout were driven by market demand.

Sources: BIS, FT, NASDAQ
The larger margin requirements of the OTC IRS market presented a pressure point; the strong directional trades commonly made by pension funds and big insurance companies building large positions over time meant that the margin requirement became very expensive in the traditional clearing model.

Comparable pressures exist in repo. The final implementation of uncleared margin rules (UMR) will require additional collateral management expertise and more reliable access to the repo markets for buy-side entities, as the differences between collateral requirements for uncleared and cleared derivatives all but disappear. Repo liquidity is best under the centrally cleared model.

While different drivers motivate the IRS and repo markets, opportunities exist across both, with the ISA Direct model allowing clients to access cleared OTC IRS and repo in an integrated fashion, therefore managing cash requirements from cleared derivatives in the most efficient manner. For example, one could remove cash transfer risk by using a single cash account for the settlement of repos and cash variation margin (VM) for cleared derivatives.

Europe’s repo clearing market is surprisingly immature, with a much better market established in the U.S., with currently 1,700 buy-side entities clearing repo, according to Odendall.

Reports suggest repo clearing has been around for about 14 years in the U.S., yet only began raising its profile in the past couple of years, and it has only just started in Europe, according to Eurex.

The next stage of rollout might be in ETCs or in the FX market, which Grunow says would be of particular interest, as Swiss Life AM has already begun exploring the cleared repo market.

“The benefit could be a better risk diversification within the cleared portfolio and a lower initial margin requirement than under the bilateral clearing regime,” he says.

**PHASED MARGIN RULES**

All financial firms and systemically important non-financial entities with more than €8 billion ($8.8 billion) in derivatives notional exposure must exchange variation margin (VM) and initial margin (IM) on their trades.

IM requirements phased in, according to levels of notional exposure, as follows:

- **Phase 5 September 2020, €8 billion**
- **Phase 4 September 2019, €75 billion**
- **Phase 3 September 2018, €1.5 trillion**
- **Phase 2 September 2017, €2.25 trillion**
- **Phase 1 February 2017, €3 trillion**

Source: International Swaps and Derivatives Association
The role of collateral has evolved in recent years to become a crucial part of improving liquidity across financial markets.

Further, the new margin rules for OTC derivatives—intended to reduce counterparty risk by insisting market participants exchange collateral through initial margin (IM) and variation margin (VM) for uncleared OTC derivative transactions—give collateral a new function of mitigating systemic risk, arguably behaving almost like an asset class. With the traditional clearing model, buy-side clients are limited in terms of what they can use as collateral for margin requirements, compared with a direct model, according to Eurex.

Philip Simons, Eurex’s Global Head of Fixed Income Derivatives Sales, says that in addition to higher capital requirements for the banks, concentration risks across the market and challenges on the porting side—where clients move between clearers—one of the biggest challenges facing the buy side lies in collateral management across multiple parties. By adopting a direct model, some of that exposure is alleviated.

Direct clearing may introduce one less transfer risk and one less operational effort, but is that sufficient incentive to better engage the buy side? Previously, buy-side clients would have been on a credit support annex (CSA) and had no uncleared margin requirements, and borrowing was cheap.

“I do not think the market has yet provided an efficient solution for the buy side in terms of collateral, especially when it comes to enabling the efficient use of collateral across multiple requirements—multiple clearing brokers, multiple CCPs, and so on,” says Simons. “If we can make that all simpler, more efficient, more automated, I foresee more of the buy side, even the pension funds, coming in voluntarily.”