acuiti management intelligence

Clearing Management Insight Report

Q3 2024

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Introduction

As one major item fades from senior clearing executives' desks, another arises. The number of significant market changes that face the clearing industry continues to remain elevated.

Clearing firms have had to deal with bouts of volatility, such as that which hit markets in August, while also paying attention to new regulatory challenges such as repo clearing mandates and margin transparency rules.

This quarter's report is brought to you in association with Cassini, the market specialists in margin and collateral analytics. Together, we take a deep-dive into proposals for margin transparency that look set to bring new requirements for FCMs.

Also, we look at the impact of the move to a new CCP at Euronext, how the industry handled the migration and what can be learned from the process.

Hot topics this quarter cover repo clearing, which will be the subject of an Acuiti research paper released in November, and investment priorities for 2025.

This report is based on a survey of the Acuiti Clearing Expert Network, a group of senior executives at the major sell-side clearing providers, taking in bank and non-bank FCMs. Through our anonymised questioning model, we allow members to take the temperature of the industry on how it is approaching the regulatory and operational issues of the day.

Transparency in margin

Centrally cleared derivatives markets provide investors with a means to both speculate and hedge in an environment that significantly reduces counterparty risk. However, extreme outbreaks of volatility experienced over the past five years have exposed potential weaknesses in market structure, with the size and unpredictability of margin calls raising fears of potential risk in the system.

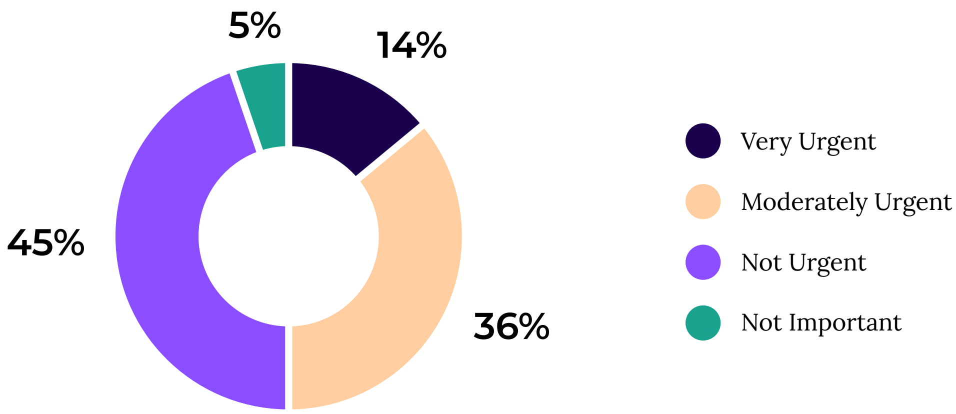
In response, the Basel Committee on Banking Supervision (BCBS), the Bank for International Settlements' Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) as well as other regulatory authorities, including the Financial Stability Board (FSB), have set out proposals that would introduce new processes designed to increase the resilience of the centrally cleared ecosystem in times of market stress.

The proposals emphasise transparency and the responsiveness of initial margin in centrally cleared markets. They explore methods to enhance transparency, such as expanding access to CCP simulation tools, improving measurements of initial margin responsiveness, refining governance frameworks, and allowing margin model overrides. Additionally, they call for clearing members to provide clients with greater visibility into potential margin calls.

This quarter, in partnership with margin and collateral specialist Cassini, Acuiti asked members of the Sell-side Clearing Expert Network about their views on the proposals and how the industry should best go about realising the regulators' ambitions.

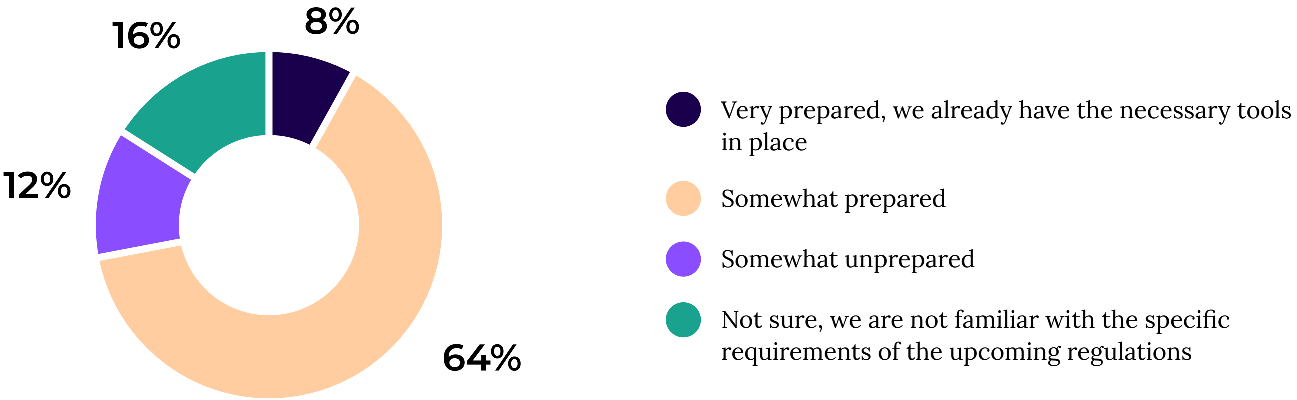
Overall, half of the network thought that the initiatives addressed an industry challenge that was either moderate or very urgent in nature. Considering the relative infancy of the proposals, this is a significant finding and points to a recognition across the industry as to the potential risks of margin procyclicality and opacity.

How urgent do you feel it is for you as a clearing member to address the challenges posed by potential upcoming margin transparency regulations?



While some of the network was either unfamiliar with the BCBS IOSCO proposals or unprepared, most felt confident that they had some level of preparedness for any regulatory changes.

How prepared do you feel your firm is for any potential upcoming regulatory changes aimed at increasing transparency over margin and stress testing?

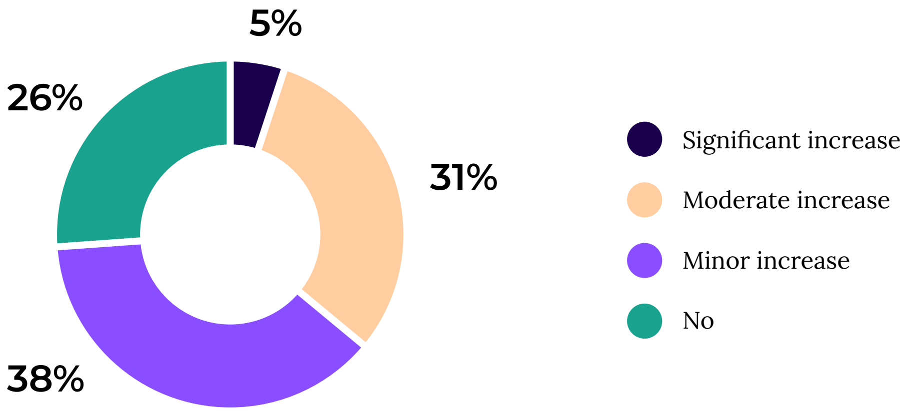


This reflects the investment that FCMs have made in margin transparency over the past decade. From the result of the Brexit referendum to the volatility seen in the early 2020s around the initial outbreak of Covid-19 and the Russian invasion of Ukraine, clearing members have had to manage significant spikes in margin calls during this time.

This has led to both industry calls for amendments to CCP margin methodologies, to reduce their sensitivity to spikes in volatility, and for investment in tools that better predict and manage client margin calls.

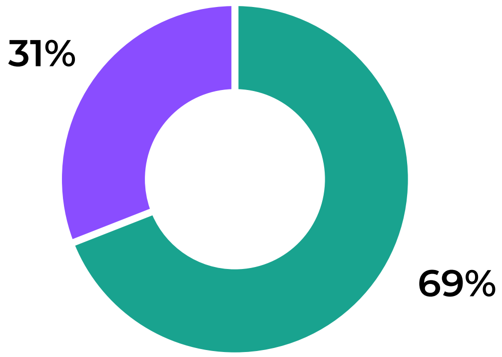
Client demand for greater transparency has also driven investment by FCMs. And that demand shows no signs of slowing. Almost three-quarters of FCMs reported an increase in client requests related to margin transparency and stress testing over the past 12 months.

Have you experienced an increase in client requests to model margins in the last year related to margin transparency and stress testing?



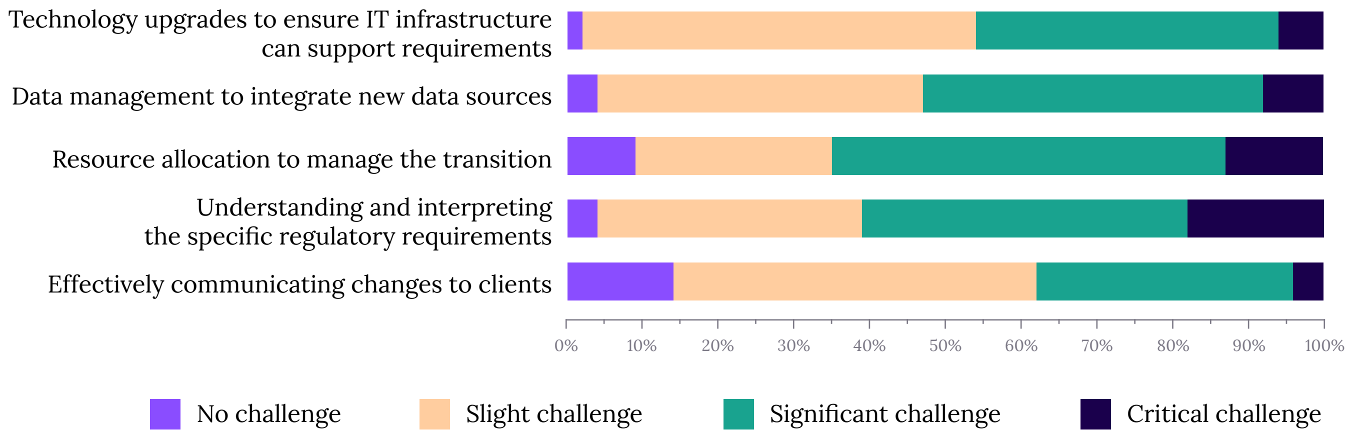
Of those firms that have reported an increase in requests from clients, a majority had implemented new tools to meet the demand.

Have you implemented any new tools to more effectively calculate and communicate margin requirements to clients as a result of the increase in requests?



However, while the industry has made good progress to date, new measures for margin transparency, if implemented in line with the current proposals, will require a significant, industry-wide operational lift. This suggests that levels of preparedness currently reported within the market are perhaps optimistic. Despite firms reporting relatively high levels of preparedness, market participants recognised the challenges ahead. The most critical challenges that network members currently identify are understanding and interpreting any final requirements and determining the right allocation of resources to manage the transition. Data management for integrating new data sources was also identified as a significant challenge.

How challenging do you think the following factors would be to meet any new requirements for margin transparency and "what if" scenario tools?

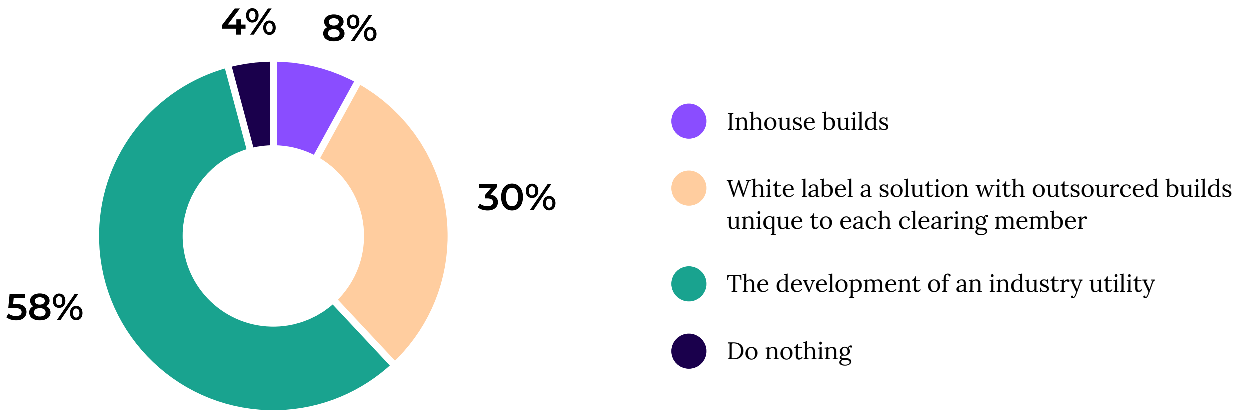


As noted above, the regulatory focus on margin transparency may already be stirring activity around the issue, with most of the network reporting an increase in client requests around margin modelling during the last year, in the wake of spikes in initial margin.

Building the models

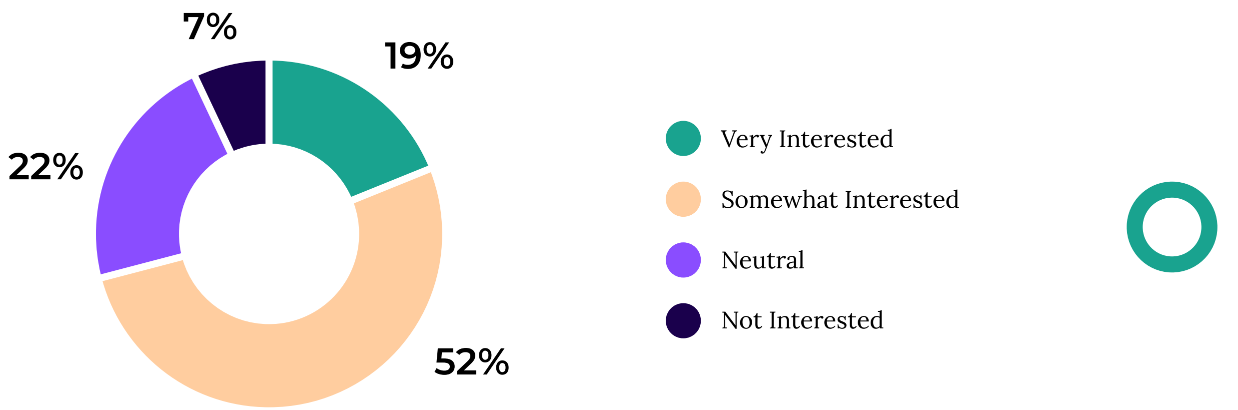
Should the proposals come into effect, clearing providers will have to give clients access to margin models that include CCP rules, as well as inhouse frameworks. Considering the sheer volume of data required, and the need to accurately monitor and reflect ongoing changes to CCP margin methodologies, most network members felt this would require some level of industry coordination, either through an industry utility or white labelling a solution that could be customised according to each clearing providers' needs.

The IOSCO, European Market Infrastructure Regulation (EMIR) 3.0 and FSB proposals suggest that clearing members will have to provide clients with access to margin models which will require inputs from CCPs and house margin policies. How do you think that this should best be achieved?



While bilateral discussion between clearing providers and their clients is clearly already happening as regards transparency, it is also evident that a wider level of industry coordination will be needed to bring margin transparency to the market. Most of the network showed some level of interest in participating in a market-wide forum to explore technical solutions for any new requirements.

Would your firm be interested in engaging with a market-wide forum to explore technical solutions for, and to gain further clarity on, potential upcoming margin and stress testing enhanced requirements for clearing members?



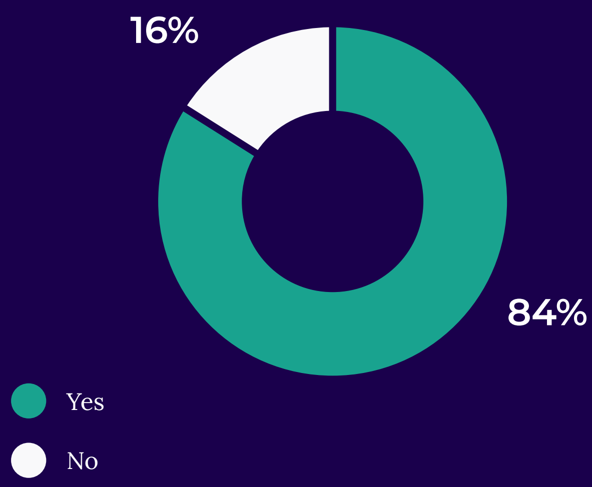
The current state of play

The level of sophistication among clearing members with regards to margin transparency and stress testing is already high.

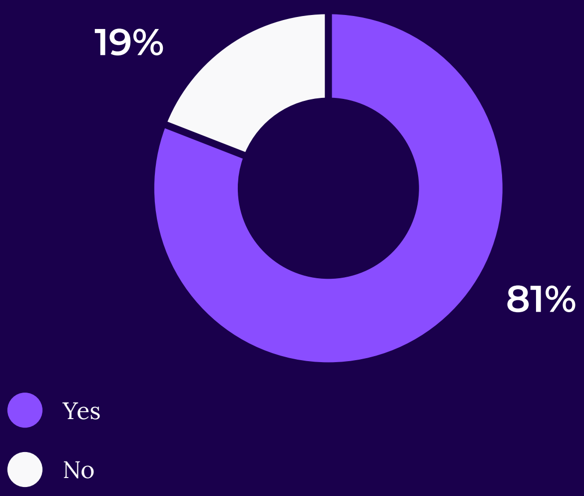
Over 80% of firms in the network said that they already embed higher margin calls into the stress tests they offer for client portfolios. A similar proportion said they directly discussed the implications of stress test results for clients' margin requirements and intra-day margin calls.

Such services were seen as important to provide clients and recognised as increasing the providers' competitive edge by most network members. However, the fact that almost half of respondent do not see margin transparency as a client differentiating service suggests that the benefits of greater margin efficiency are still not universally understood.

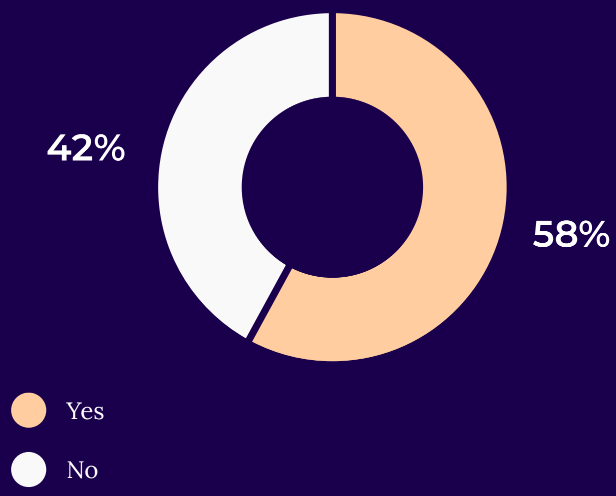
Do you discuss with clients directly how various stress scenarios could impact their margin requirements and the potential for intra-day margin calls?



Do you embed the impact of higher margin calls into your proprietary standard stress tests across your client portfolios?



Do you think providing clients with standard stress test results that fully embed margin implications is a client differentiating service?



Conclusion

The proposals set out by BCBS-IOSCO and others regarding increased margin transparency go a long way to addressing a known risk in the market. Severe volatility spikes have become a perennial feature of derivatives markets over the past eight years and with that have come massive increases in margin requirements.

FCMs have long recognised the challenges that these margin spikes pose both their firms and their clients. In response, many have invested in tools that enable them to more accurately predict margin requirements.

However, the measures set out in the proposals represent a major increase in transparency requirements — well above what exists today.

These measures will ultimately boost the resilience of derivatives markets. However, the operational lift required to realise them is significant and, this report finds, potentially under-appreciated in the market.

Recent initiatives to improve data harmonisation across the market have reaped significant rewards and efficiency gains. The proposals to increase transparency in margin will require a similar cross-industry approach.

The creation of a centralised database of margin calculations upon which FCMs can overlay their inhouse adjustments and processes will save the industry significant time and resources on the road to greater margin transparency. Indeed, resource allocation was the most pressing challenge reported by FCMs in realising the goals of the regulatory proposals.

Business performance in 2024

The year to date has generally been positive for FCMs.

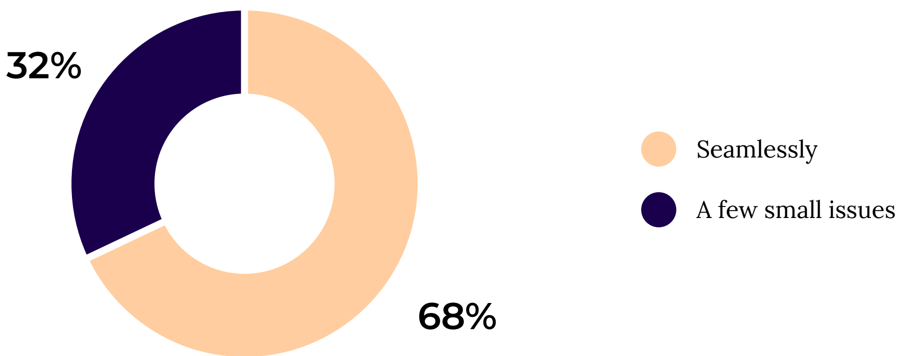
Trading volumes of exchange-traded-derivatives have also been high this year so far, with increases in activity across Asia-Pacific, Europe, North America and South America when compared to the January to July period last year, according to FIA data.

At the same time, interest rates remain elevated compared with the past decade, boosting net interest income for FCMs.

In August, clearing providers had to deal with a sudden sell-off, particularly in Asian stocks, that caused brief but widespread panic across global markets.

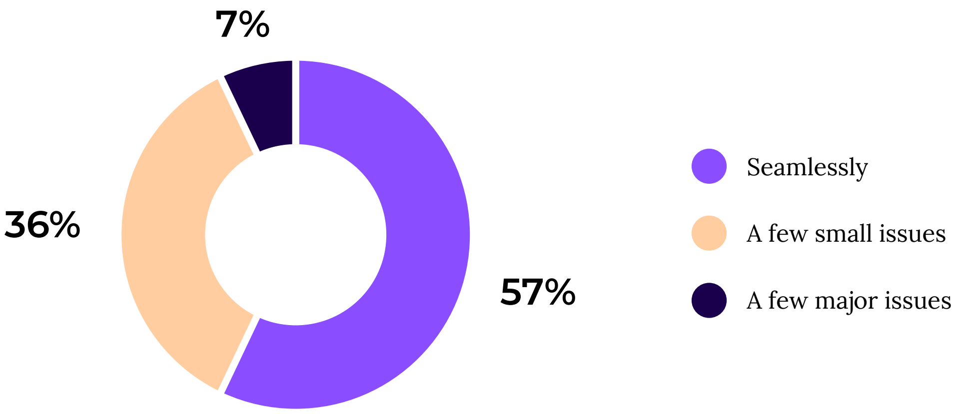
The clearing industry was largely able to take this event in its stride, with most of the network reporting seamless functioning of their internal clearing and trade processing systems.

How did your internal clearing and trade processing systems perform during the volatility of early August?



When it came to external systems, however, more network members reported issues, with 7% saying that they had seen some major issues with the external systems they dealt with. Issues ranged from exchange outages and trade cancellations, delays in trade volume and overnight processing and issues with processing time limits.

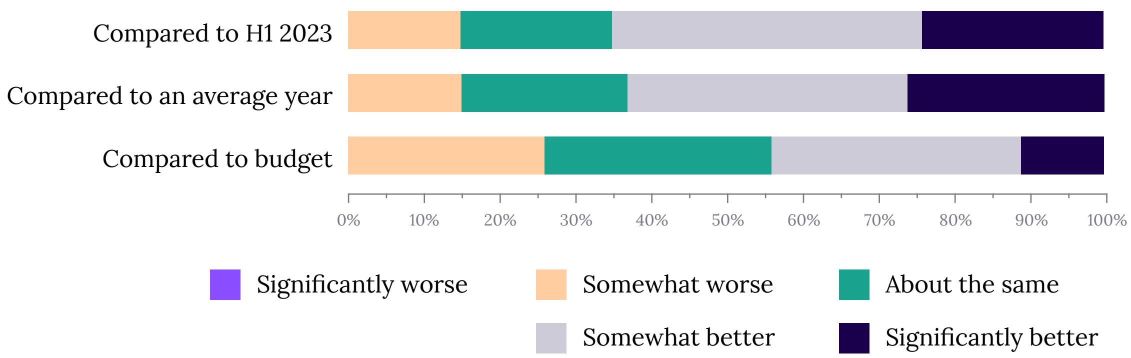
How did external systems cope (i.e. client systems, other sell-side systems and exchanges and CCPs)?



This demonstration of overall resilience added to a positive picture in terms of revenues for the first half of 2024. Looking back on the first six months of the year, most of the network said that H1 2024 had been better than H1 2023 and better than the first half of an average year.

However, a significantly lower proportion had outperformed budget, suggesting that expectations for the year have not been entirely met and investment and expansion plans may be subdued in the second half of the year as a result.

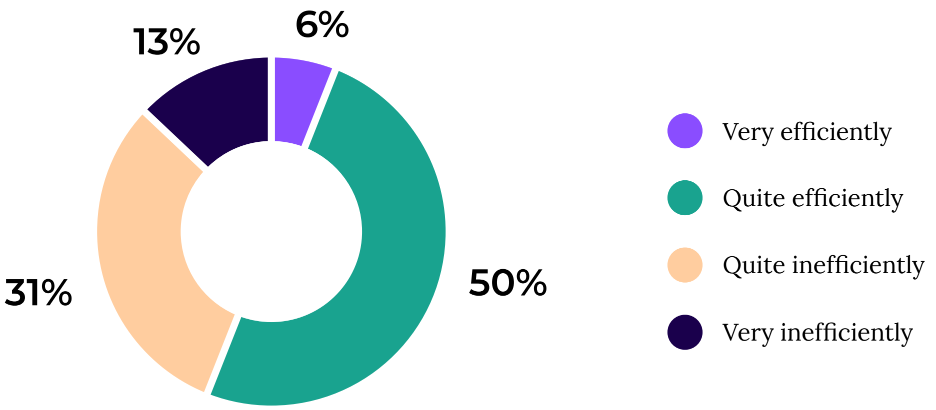
How did your business perform in the first half of 2024 relative to last year, an average year and what you expected/budgeted for?



Learning the lessons from the Euronext clearing migration

Euronext recently completed the transition of its exchange traded derivatives into its Milan-based CCP. The transition to a new clearinghouse is among the most challenging migrations in the market and inevitably there are lessons to be learned. Most network members that cleared at Euronext said that the transition to the Euronext CCP had been going efficiently. However, at the stronger ends of the range of opinion there were more members saying it was very inefficient as opposed to 6% saying it had been very efficient.

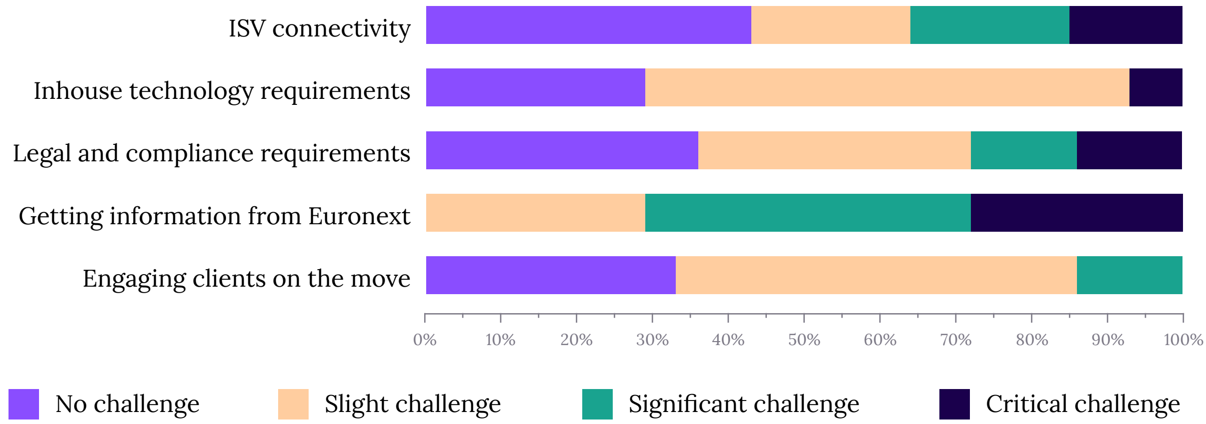
Overall, how well is the transition to the new Euronext clearinghouse going for your clearing business?



By far the main challenge with the move that network members identified was getting information from Euronext, which almost a third cited as a critical challenge.

Other commonly cited critical challenges were legal and compliance requirements and ISV connectivity, which is understood to have resulted in one major vendor not being ready for the transition.

What challenges, if any, have you faced during the move to a new CCP at Euronext?



The Euronext transition represented a significant operational lift for the industry and, as with any such process, lessons can be learned to improve on.

In this instance, the importance of advanced communications with independent software vendors was a key suggestion from several in the network. One member questioned Euronext's decision to go live without making the code for liquidity and concentration add-on calculations available to the ISVs that had a vital role in the transition.

Another also said that Euronext had understated the requirement to get third-party vendors over the line in time, which had knock-on effects for a number of clearing brokers. Some also voiced frustration with the transition timeline, which they said did not factor in the French elections.

Other members called for greater transparency and communication from exchanges that roll-out major infrastructure development projects.

Preparation, documentation and taking FCM feedback onboard earlier in the process, rather than waiting until the last minute (a behaviour that delays go-lives) were also cited as areas for improvement from exchanges.

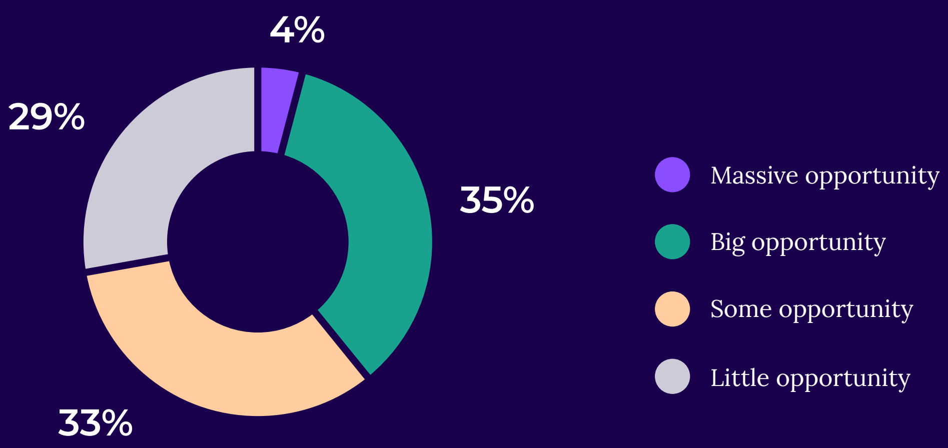
Hot topics

Repo Clearing

The SEC mandate to clear US Treasury spot and repo transactions, set to be introduced over the next two years, represents one of the most significant shifts in market structure since the financial crisis.

While meeting the mandate will require investment, over two-thirds of the network believe that it will be an opportunity to grow their business.

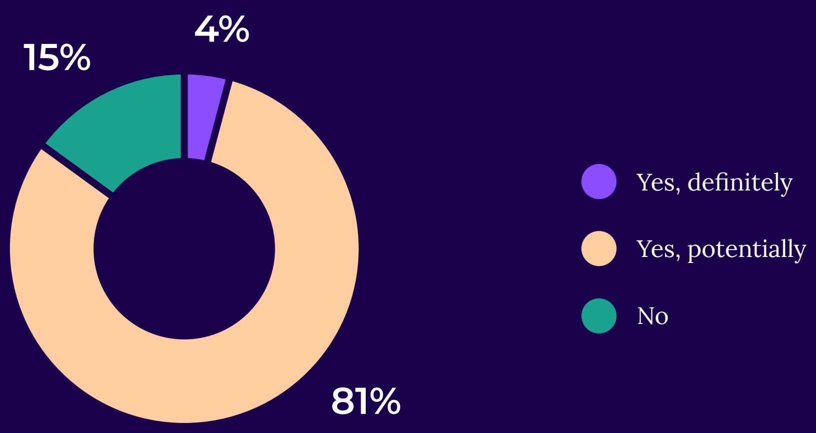
How big an opportunity to grow your business do you think that repo clearing in the US poses?



Europe still doesn't have a mandate for clearing repo, but many market participants in the region are pushing the netting and consistency benefits that it provides (in the case of the latter, liquidity is much more likely to be available in cleared repo markets during times of market stress than from bilateral channels).

The majority of network members were supportive of a clearing mandate in Europe, but this was not a high conviction position.

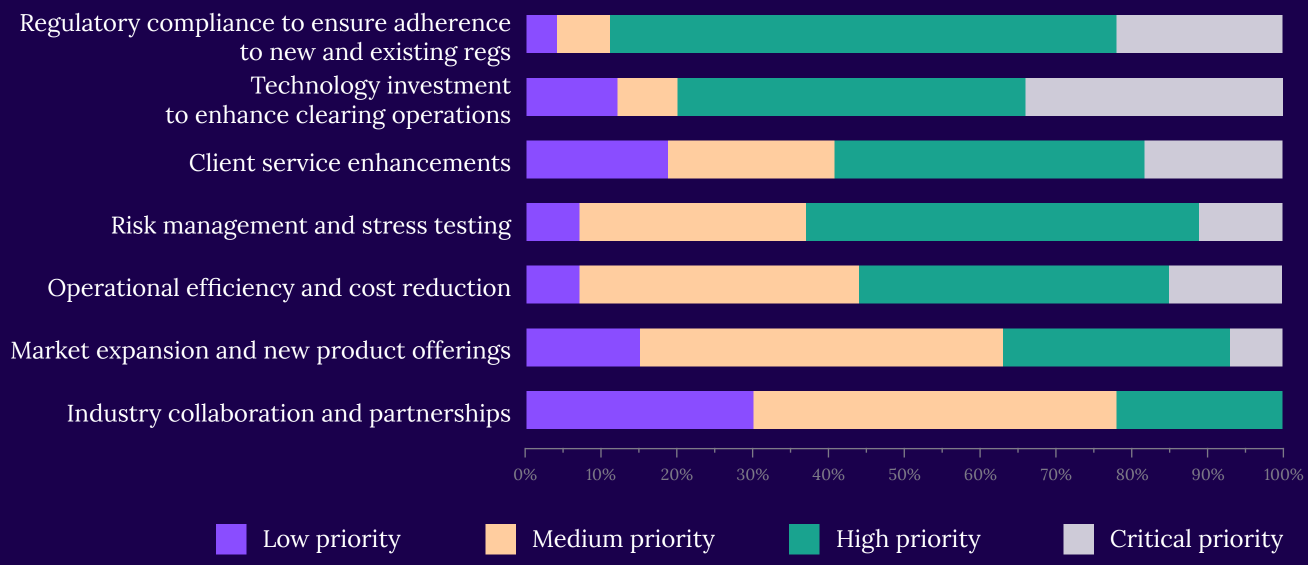
Do you think repo clearing should be mandated in Europe?



Investment priorities

Looking ahead to next year, the most critical priority that firms were budgeting for was technology investment for enhancing clearing operations. This has been a priority for many firms — boosted by the recent rise in net interest income — which had held back investment plans during the period of ultra-low interest rates that preceded rate hikes. With rising rates boosting revenues, many are now in a position to improve their competitiveness through technology investment. This was also reflected in the precedence given to client service enhancements by members. Regulatory compliance expenditure was also ranked highly, reflecting the ongoing burden this places on the clearing industry.

What are the primary areas your firm is budgeting for next year as it pertains to clearing?



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