Transforming CCP Clearing for Buy-side Firms

CCP Clearing: Looking through Buy-side's Horizon

The financial crisis of 2008 has brought a wide-range of dislocations for the over-the-counter (OTC) derivatives market. Global regulatory stipulations now require centralized clearing of OTC transactions through recognized central counterparty clearing houses (CCP), higher capital provisioning, and more stringent margin stipulations. Further, the shifting market structure and new client clearing models introduce significant changes in post-trade processing, impacting the OTC derivatives market.[1]

Buy-side firms have been affected the most from the mandatory centralized clearing requirements of OTC derivatives transactions. The flux of ongoing and overlapping regulatory requirements, increasing CCP clearing costs and re-aligned market practices present new complexities in designing a forward looking CCP clearing model.

Amidst the evolving CCP clearing landscape, buy-side firms face a few critical business and operational issues which need to be cohesively addressed while devising an approach for clearing service relationship and enabling process capabilities. Figure 1 lists the emerging issues that buy-side firms now face.

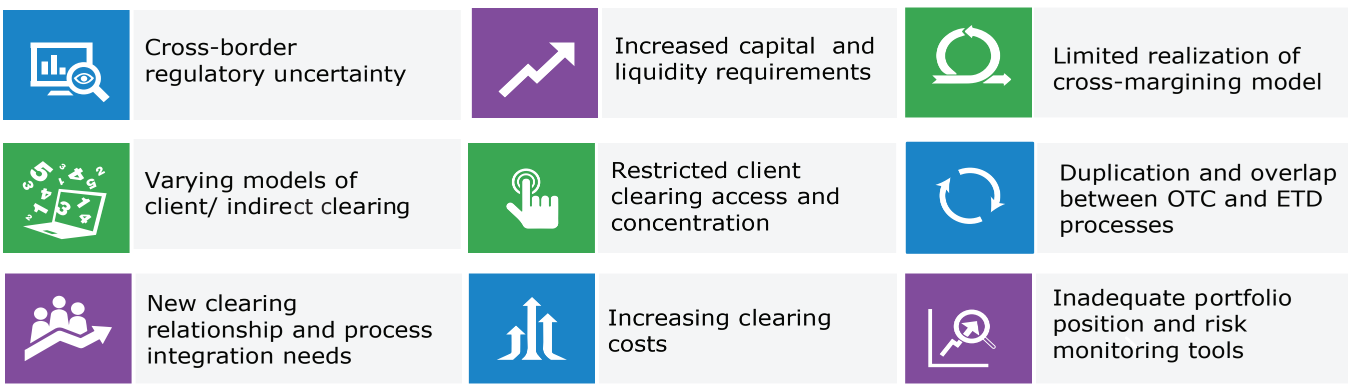

Figure 1: Issues in CCP Clearing

Evolving Themes for Buy-side Firms: Clearing 2020

Facing significant churn under influences from market dynamics and disruptive forces, the CCP clearing landscape remains poised to undergo radical change. As such, a truly harmonized global standard for CCP clearing appears a distant pipedream. Against this backdrop, buy-side firms must identify the dominant themes and ensuing business priorities in the evolving landscape. More importantly, they need to focus efforts towards impending requirements and equipping themselves with the requisite tools and capabilities.

Figure 2 presents a quick summary of evolving themes. Buy-side firms need to take these factors holistically into consideration to make the most of the opportunities coming their way.

Clearing 2020: Evolving Themes in CCP Clearing Landscape

Regulatory Uncertainty	Business Model Innovation	Product and Market Expansion	Process Capabilities Augmentation	Recalibrated IT Infrastructure	Automation and Digital Tools
Deregulatory stance and likely revision of derivatives regulations	Possible adoption of peer-to-peer model in payments, collateral, and SLB	Growing expansion of credit, commodities and currency clearing	ETDfication of OTC/ non-cleared processes	Repurposing and rationalization of IT applications and services infrastructure	Big Data and analytics (predictive, pattern, attribution, simulation) to handle risk, collateral, and capital management
Post Brexit redefined regulatory structure in Europe	Continued experimentation with DLT and smart contracts enabled transaction processing model for non-mainstream products	Increased business focus in emerging markets	Process consolidation to build harmonized multi-market/ multi-product capabilities	Centralized shared services for support functions	RPA and AI based tools to fix manual process constraints and legacy optimization issues
Regulatory equivalence based cross-jurisdiction interoperability and remote CCP membership model		Continued growth of futurization/ swapification based ETD products	Standardization of client clearing/ indirect clearing model across markets/ products	Increased reliance on utility based/ managed services in key functional areas	

Figure 2: Evolving Themes in the CCP Clearing Landscape for Buy-side Firms

With an increasing volume of credit, commodities, FX, and other transactions shifting to CCP clearing, a continued growth of clearing services[2] is expected in the coming period. Now more than ever, buy-side firms need a dependable, full-services global CCP clearing partner, who provides the services at an optimal clearing fee structure.

Transformational Opportunities for Buy-side Firms

The regulatory flux and market dynamics also present significant possibilities to buy-side firms for exploiting transformational opportunities. They need to re-evaluate their business model and process infrastructure in the long term, while fulfilling immediate business demands of cost optimization and operational efficiency.

Figure 3 highlights the options available to buy-side firms to re-align their business model and process landscape to realize transformational benefits.

Clearing Model Optimization

- Re-assessing clearing relationship
- Shifting to standard products
- Market coverage

Value-Added Solutions

- Capital and risk management efficiency
- Enhanced market and service access
- Operational enablers

Operational Processes and Platform Augmentation

- Consolidation of ETD/ OTC processes
- Enhanced process integration
- Enterprise shared services
- Leveraging utilities and managed services platform

Digital Transformation Enablers

- Analytics driven insights
- Operational dashboard and heat map
- RPA/ intelligent process automation
- Exploration of innovation ideas/ initiatives

Figure 3: Transformational Opportunities for Buy-side Firms

1. Clearing Model Optimization

Re-assessing the existing clearing model is critical for buy-side firms. To do this, they must re-evaluate their clearing relationships and review the products and markets they deal with.

- **Clearing relationship:** Negotiating relationships with clearing firms who provide global level services might help large buy-side firms to economize margin and collateral requirements, and provide access to enhanced technology infrastructure. Considering volume restrictions and higher fee levels, there are limited options for mid/ small-size buy-side firms. Facing such challenges, it requires a re-evaluation of their continued investment focus in the OTC portfolio in extreme cases.

- **Shifting to standard products:** Firms need to re-evaluate their OTC transaction portfolio to save from costs and complexities, exit non-standard products altogether and opt for identically featured standard products offered on derivatives exchanges.[3]

- **Market coverage:** It would be worthwhile to re-assess the market coverage strategy and exit from those where the right clearing partnership options are restricted or clearing costs do not commensurate with portfolio benefits. In some scenarios, it will affect their multi-currency and multi-market portfolio options.

2. Operational Processes and Platform Augmentation

Buy-side firms could also take the opportunity to comprehensively re-evaluate their operational processes and platforms – its redundancies, overlaps, and its bottlenecks as well as simplification and modernization issues.

- **Consolidation and harmonization of ETD/ OTC processes:** They could take a leaf out of their exchange traded derivatives (ETD) process model, which is a far more mature process, to harmonize how they manage their OTC process. In other words, try to 'ETDfy' the OTC processes. This entails an overhaul of existing processes and requires process automation, application rationalization, and repurposing across product silos to realize platform efficiencies and gain a competitive edge.

- **Enhanced process integration:** To support a near real time view of the portfolio, enabling timely risk management and decision making, it requires an enhanced level of integration with internal and external processes. Adopting a more efficient and well-integrated platform may also allow for timely confirmation of transactions, better settlement management, and quicker reconciliations.

- **Enterprise shared services:** Streamlining some of the key support functions across business silos and development of a centralized shared service – e.g. reference data, exception management, reconciliation and document management, not just provides opportunities to capitalize attractive return in the short term, but also helps to keep foundational block of a modular and flexible business architecture.

- **Leveraging utilities and managed services platform:** At this stage, some buy-side firms might also consider using a managed services or industry utility option in order to take advantage of the cost efficiencies and increased flexibilities in meeting future needs.

3. Value-Added Solutions

To survive and grow in the new market, buy-side firms might look at tapping value-added solutions, which will enable to fulfill their clients' mandate in the coming period. While selecting a suitable clearing service partner, they need to also seek value-added solutions and enablers, beyond transaction processing support. These would help buy-side firms realize differentiated and forward looking business capabilities.

- **Capital and Risk Management efficiency:** With onerous regulatory demand on capital, an efficient handling of risk management becomes a basic requisite. Buy-side firms need enabling tools and accelerators to take control and optimize capital and collateral requirements.
  - Integrated view of risk across portfolios, real-time pricing, risk and performance attribution, risk scenarios and stress testing
  - Cash management, financing, and liquidity services across markets
  - Collateral pooling and optimization, SLB and tri-party agency services
- **Simplified and enhanced market and service access:** It entails a simplified and fully integrated service delivery paradigm to support single-point transaction processing needs for an expanded product portfolio across markets.
- **Operational Enablers:** Buy-side firms can also benefit from enablers and tools from their clearing service partner, which significantly augments their operational capabilities.
  - Platform based services to support trade matching/ affirmation, reconciliation, and exception handling
  - Capital and Liquidity Management reporting and analytics to fulfil regulatory requirements
  - Reporting-as-a-Service to clients for regulatory reporting across jurisdictions

- Technology enablers for documentation management, client instructions and transaction workflow monitoring

4. Digital Transformation Enablers

While building differentiated service capabilities and competitive advantage, buy-side firms need to keep pace with emerging technological innovations and re-invent their 'digital-enabled services' capabilities. It requires firms to prioritize efforts towards digital-morphing of the enterprise – across product, process, platform, and service delivery infrastructure. Some of the digital initiatives could be:

- Big data and analytics (predictive, pattern, attribution, simulation, etc.) driven insights to enable smarter and faster risk and capital decisions. This could include:
  - Integrated risk view across portfolios, real-time pricing or valuation, P&L and performance attribution.
  - Scenario analysis covering model validation, risk stress testing, and capital and liquidity management.
  - Liquidity forecasting and funding options, collateral optimization, transaction cost analysis, and broker or Clearing Member performance reviews.
- Dashboards and heat maps to support real-time transaction control, exception handling as well as KYC, risk, and regulatory compliance monitoring.
- Robotic or intelligent process automation with self-adaptive and recalibration abilities to streamline transaction processes and simplify breakpoints or manual functions (for example, transaction processing, reference data management, client onboarding, and KYC).
- 'Fintech' ideas on alternate business models and transformative use cases could help remain responsive and innovative. Besides keeping them aware about innovation feasibilities, it will also help prepare for integration and implementation issues at a later stage.

Each of these initiatives is inter-linked, and will ultimately help re-architect the business model entirely so that they can remain strongly positioned in the emerging business environment.

Prepare to Face New Challenges

Buy-side firms will have to radically change their operating models and re-evaluate how they want to conduct business in the new business and regulatory environment. Adopting a 'wait-and-see' approach might not be a good way forward because unpredictable market forces continue to pose new challenges and limit competitive opportunities.

Keeping up with the industry and proactively initiating transformative changes – experimentation and evaluation of disruptive technologies and innovation models, could be one such basic step in this direction.

Even if buy-side firms have a less definitive view of the emerging business landscape, they should start doing the groundwork and laying the foundations for a futuristic business model and process infrastructure to exploit transformational opportunities.

References

1. MiFID 2/R in particular introduces new imperatives regarding Indirect Clearing arrangements for Exchange Traded Derivatives (ETD) in European markets. Additionally, emergence of new designated trading venues – e.g. Regulated Market (RM), Multi-lateral Trading Facilities (MTF), Organized Trading Facilities (OTF) would bring new interfaces and processes integration requirements.

2. BIS, OTC derivatives statistics at end-December 2016, accessed June 2, 2017, http://www.bis.org/publ/otc_hy1705.htm, (According to the Bank of International Settlements, the notional amounts outstanding in the global OTC derivatives market stood at $483 trillion in Dec 2016, of which around 60% was centrally cleared.)

3. More popularly known as 'Futurization' or in some sense 'Swapification': In post-crisis world, leading derivatives exchanges such as CME, ICE and Eurex have been offering standard cleared products on their platforms. These products with standardized features also assimilate some features of an identical OTC products.

About The Author

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