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Getting fit for clearing

Pursuing the OTC central clearing market

"Only those who will risk going too far can possibly find out how far one can go."

– T.S. Eliot

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Diamond Advisory Services

Context

Historically, client demand for over-the-counter (OTC) derivatives has spurred the growth of the market, predominantly driving what is now a $580 trillion in notional amount outstanding[1]. Today, regulation is reshaping the future of the OTC market. The Dodd-Frank Act in the US and proposed regulation in the EU is imposing central clearing requirements on broadly defined classes of OTC derivatives. Additionally, Basel III regulatory standards will increase the relative capital requirements for bilateral OTC trading and boost the attractiveness of using a centrally cleared model. Together, these changes will drive fast growth of the OTC central clearing segment, in terms of share of the total market value and the scope of OTC products.

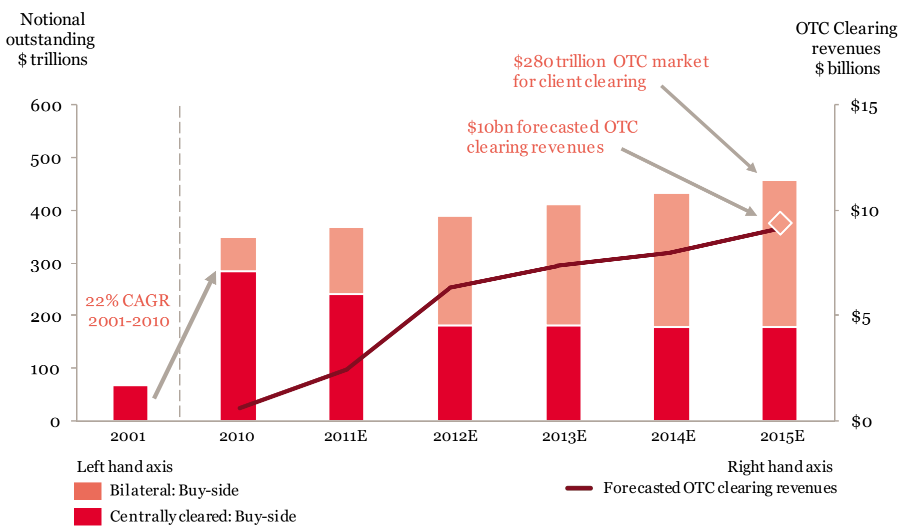
By 2015, the notional value of OTC derivatives being centrally cleared is forecasted to be approximately $470 trillion, with $10 billion in OTC clearing revenues, and will account for the majority of all OTC activity.

Why the buzz?

Less than 20% of the dealer to buy-side OTC market is centrally cleared today[2], with only interest rate swaps and credit default swaps being cleared in significant amounts. The expansion of central clearing provides a market for banks and brokers to provide clearing services to buy-side clients, charging clearing and servicing fees and earning net interest on margin charged to clients. Several large broker-dealers – investment and universal banks – have rolled out OTC client clearing services within the last year, covering major OTC asset classes. By current estimates, around 10 banks globally can now offer OTC clearing services across multiple contract types to their clients[3].

Assuming the current split of dealer-to-dealer and buy-side volumes persists[4]. This fast growth presents new clearing service providers an attractive market to expand existing clearing capabilities to cover OTC products. For existing players, offering clearing services to clients can offset shrinking revenues from OTC market making activity and help cement their OTC execution business.

Estimated growth of the buy-side OTC market



Source: Bank for International Settlements, Deutsche Börse Group; for growth assumptions, see end note†.

[1] Bank for International Settlements
[2] Based on Banque de France estimates, 2009. Remaining 80% are cleared on a bilateral basis.
[3] Risk Magazine, October 2010: Banks gear up for client clearing
[4] U.S Commodity Futures Trading Commission: 60% end-users and 40% dealer-to-dealer

What does it take to succeed as an OTC central clearing new entrant?

Key factors for entry: Market relationships

While the revenue potential in OTC central clearing is attractive, new entrants will need to deliver on some key factors in pursuing the market:

Building relationships with OTC clients: New entrants need to establish their own relationships with OTC clients, even where clients continue to have a first point of contact with a large dealer. Broker-dealers provide liquidity in the capacity of OTC transactions and clearing brokers will need to source execution from dealers. New entrants can still build an attractive relationship proposition for clients – for example, by allowing multi-asset clients to consolidate their clearing relationships. Furthermore, there may be an advantage for new entrants without proprietary trading desks whose clients may prefer clearing relationships that do not pose a threat to their related proprietary trading activities.

Establishing clearinghouse memberships – dealer requirements: Some existing OTC clearinghouses also require that members have dealer operations. The broker-dealers' role as a dealer supports price discovery and the potential wind-down of failed members positions, functions which brokers without proprietary trading desks are unable to assume. However, recently, a number of new central clearinghouses have sprouted, some of which cater to the old guard of broker-dealers and others, such as IDCG, which are more focused to the buy-side. New entrants therefore have some option in clearinghouses where dealer operations are not a requirement and need to determine whether building dealer operations for expanded access to clearinghouse memberships is required to support their OTC clearing offering.

Establishing clearinghouse memberships – capital requirements: In the past, the large broker-dealers have advocated stringent capital and size requirements for access to clearinghouses. The banks cite that such high capital requirements (net worth of $500 million at the CME Group's CDS clearinghouse and $5 billion at ICE Trust[5]) are necessary to ensure clearinghouse viability and help unwind a failed member's positions. To qualify as members of the largest clearinghouses, new entrants must build scale. The growing number and variety of clearinghouses also provides smaller brokers access to clearinghouses where capital requirements are less onerous.

Key factors for entry: Operations and technology

Clearing members pursuing the OTC central clearing market will have to make investments in both technology and operations in order to develop the required capabilities to compete in the OTC central clearing space. The size of the investment will vary according to the current capabilities in related markets, such as bilateral OTC and listed derivatives processing.

Establishing clearing access: A number of central counterparties (CCPs) exist for similar products, each with unique business processes. For example, CME, Eurex, and SGX have all recently announced or rolled out OTC clearinghouses for a variety of contracts. Without a clear winner among the clearinghouses, entrants into the OTC clearing space will need to invest in infrastructure to support multiple central counterparties.

Investing in OTC clearing platforms: Centrally cleared OTC products will still be characterised by OTC attributes, such as periodic coupon payments. Existing futures systems will likely struggle with the record keeping of such transactions, and solutions currently in the market are not well adapted for centrally cleared OTC processing[6]. Internal systems development will be required of both incumbents and new contenders.

Developing OTC expertise and trade flow processes: Even firms with well-established OTC and listed derivatives clearing capabilities will find that re-engineering of the preclearing process is required, including trade capture, affirmation and risk management[6]. Even where existing processes can be leveraged, such as reconciliation and regulatory reporting, the variety in OTC products and CCPs will entail further process development. In addition, bringing together OTC and clearing expertise, which do not typically reside in the same teams, will be important, especially in terms of developing and ensuring that the right skills exist.

Supporting non-standardised and manual processing: The current intense competition between CCPs will likely mean that harmonisation of CCP business processes and data flows, as has happened with listed derivatives, will not happen for centrally cleared OTCs for some time. This will leave Operations departments supporting a mixture of differing clearing processes across OTC CCPs. OTC trade attributes will also challenge existing clearing and downstream functions, as trade information will often need to be enriched, at least initially manually, for the purposes of margining, risk assessment and accounting. Particularly, the complexity of reference data (for example, broker codes) required for processing OTC instruments will be a challenge and require strong controls to prevent operational errors.

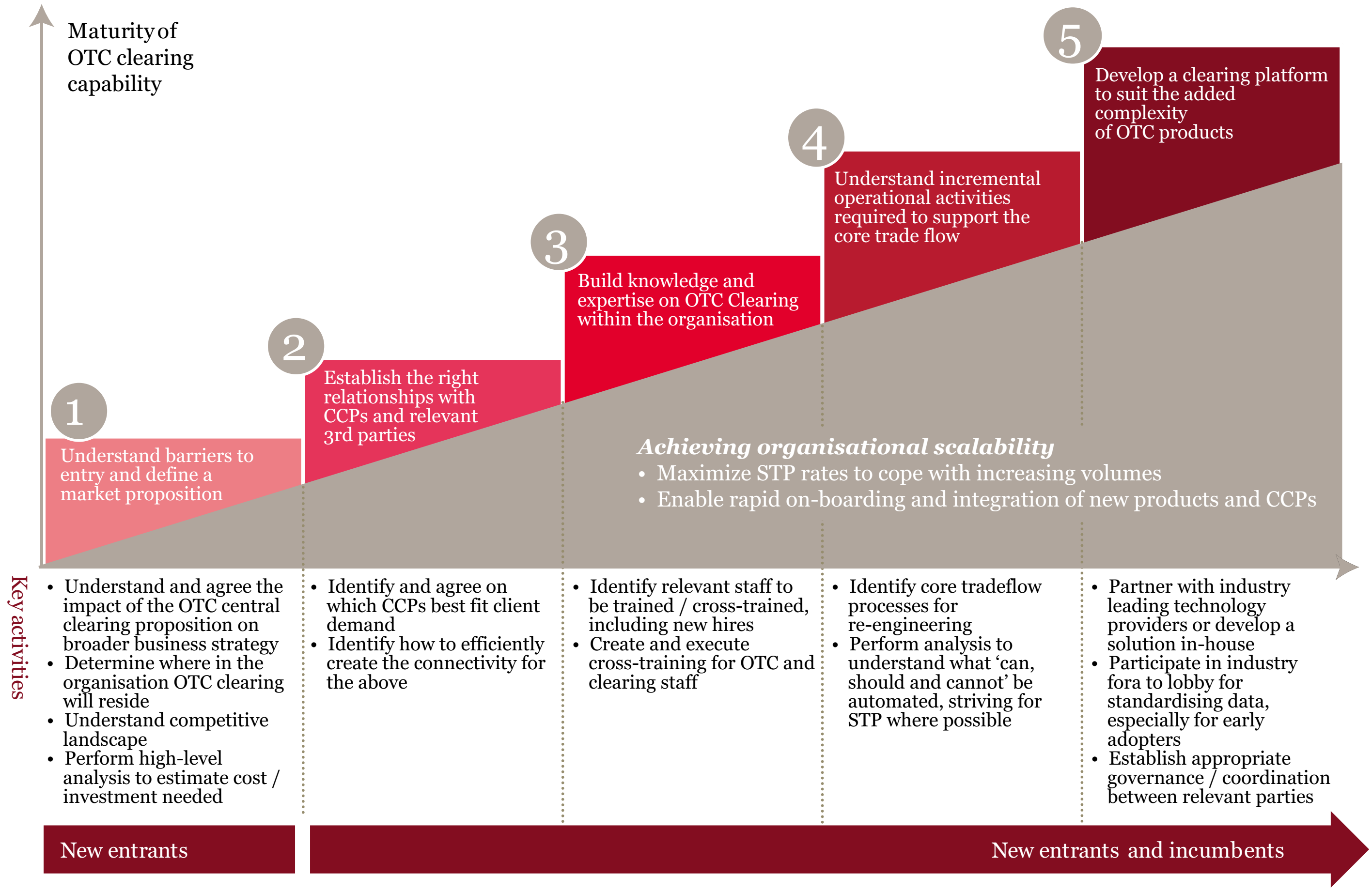
The above operations and technology investments are not currently as great as they are likely to be in the future, as even the larger OTC centrally cleared markets involve only a relatively small number of trades each day (for instance, circa 3,000 per day for Swapclear[7]). By selecting promising markets and supporting them manually for an interim phase, players can potentially defer significant investment until a market has been proven.

[5] CME and ICE Trust
[6] Futures Industry, November 2010: Operational challenges of Moving OTC products into Clearing
[7] LCH.Clearnet Group

‘Stepping up’ to OTC central clearing

Contenders for the OTC central clearing market should adopt a structured approach to evaluating and pursuing the market. We believe that there are five key steps to position a firm at the forefront of the OTC central clearing market:

5 key steps to ‘getting fit to clear’



1. **Define a market proposition:** Understand client demands and define the key OTC products and CCPs you will support and the services you will provide to match these demands. The scope of products and CCPs to support should be balanced with the challenges of managing a more complex trade flow and should consider whether clearing services, such as margining, can be effective across multiple products and CCPs. Additionally, understand and gain buy-in upfront around where in the organisation the OTC central clearing business will reside.

2. **Establish the right relationships with CCPs and relevant 3rd parties:** Understand which CCPs have the most support from the relevant dealers and clients and decide on the key trade capture and reporting platforms to integrate.

3. **Build knowledge and expertise in OTC clearing within the organisation:** Integrate OTC and clearing knowledge into the same team to guide the effective design and development of the end-to-end trade flow.

4. **Understand the incremental operational activities required to support the core trade flow:** In the short term, existing futures clearing processes can likely be adapted to support limited volumes of centrally cleared OTC activity. However, in the longer term a combination of wholesale re-engineering of some processes and the adaptation of others will have to be accomplished. To guide these efforts, design clear target trade flow processes for OTC products.

5. **Develop a clearing platform to suit the added complexity of OTC products:** Heavy manual intervention can be supported initially, but developing a platform that supports the specific attributes of OTC instruments is critical for increasing volumes in a cost-effective manner. Efforts to build an OTC platform should aspire to establish a standardised approach to processing OTCs, ultimately aiming to eliminate differences in processes between types of contracts, execution venues and counterparties.

Conclusion

The size of the OTC market related to providing client clearing services is forecasted to grow on average 30% per annum. Existing players and new entrants have already started investing in OTC client clearing capabilities. However, the challenges of an emerging market still in flux are shared across all contenders, and virtually none have yet been able to achieve notable scale across their clearing offering.

Firms that move quickly and approach building their capabilities in central clearing effectively will be in a good position to carve out a share of the market.

End notes

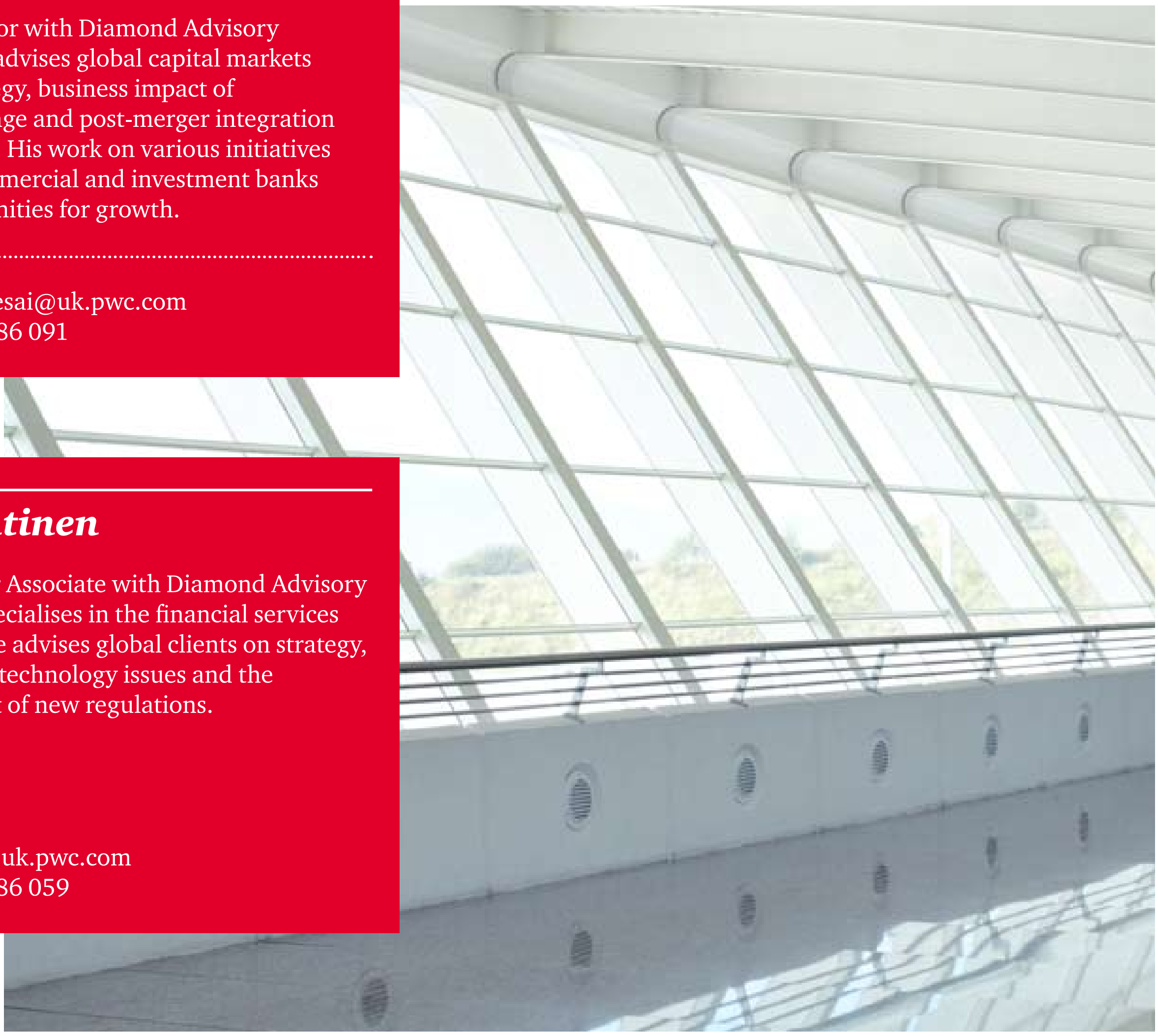
† This forecast is primarily based on the following assumptions about the evolution of the OTC and centrally cleared OTC markets:

(a) Over the last 10 years the OTC market has grown at a compounded annual growth rate of circa 22%. We conservatively forecast that, over the next five years, the market for OTC derivatives, and therefore the OTC buy-side market will grow at an average yearly rate of approximately 5%. We are discounting the historical growth rate by c. 75% due to the expected increased use of compression and the margin requirements for OTC contracts, as well as the increasing capital costs for non-centrally cleared OTC derivatives, which, taken together will have a restricting effect on the growth of notional value outstanding in the OTC market. Per contract type, forecasted growth rates are: Foreign Exchange at 3.4%; Interest Rate at 5.9%; Equity-linked contract at 3.6%; Commodity contracts at 4.8 %; CDS at 6.1%; and Unallocated contract types at 3.2%.

(b) IMF and ECB, 2010: The majority of OTC derivatives that are 'fit for clearing' will migrate to central clearing over the next 5 years. We estimate this to account for 2/3 of all Interest Rate and CDS contracts, which will reach this level by 2012. For all Foreign Exchange, Equity-linked, Commodity and Unallocated contracts, we forecast that 1/3 will migrate to central clearing, beginning in 2012 and reaching the target level by 2015.

(c) The ratio of clearing revenues derived from the size of the market has been estimated on the basis of clearing revenues in the listed derivatives market. In 2006, the last year that comparable data was available for, £74 trillion in notional value drove listed derivatives clearing revenues of £1.5 billion (i.e. a 0.002% ratio). This has been assumed to maintain constant through the next 5 years.

About the authors



Amit Desai

Amit is a Director with Diamond Advisory Services*, and advises global capital markets clients on strategy, business impact of regulatory change and post-merger integration transformation. His work on various initiatives has helped commercial and investment banks realise opportunities for growth.

amitkumar.b.desai@uk.pwc.com
+44(0) 7715 486 091

Jussi Tahtinen

Jussi is a Senior Associate with Diamond Advisory Services. He specialises in the financial services sector, where he advises global clients on strategy, operations and technology issues and the business impact of new regulations.

jussi.tahtinen@uk.pwc.com
+44 (0)7715 486 059