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FX Clearing: Exploring the Benefits and Roadblocks for Buy Side Adoption



Introduction

The first instalment of The Finance Hive's UMR Digital Boardroom series focused on FX Clearing, and why this should be considered an option for the buy side looking to address the UMR rules. The bespoke group of senior buy side keen to discuss the evolution of clearing in FX were joined by Hive recommended partner Eurex, who were on hand to share their expertise and experiences in a rapidly developing market.

In addition to having benefits in light of the regulation, it was also discussed how clearing can help in other areas such as the reduction of counterparty risk, simplified operations, reduced funding costs and access to deeper liquidity. Although education around the practical application and integration of clearing into buy side workflow is increasing, there are still many areas that require clarification. Here are some of the findings from the session:

Discussion moderated by:



Time is of the essence when it comes to UMR - buy side need to start preparing now!

- Upcoming deadlines for UMR are in Sep 2021 (Phase 5) and Sep 2022 (Phase 6)
- Buy side firms need to calculate their total outstanding uncleared derivative notional with counterparties to identify whether they are in scope
- It is critical for every asset manager to assess whether their Fund(s) will be impacted by UMR
- There is an element of client engagement that is required to establish outstanding notional across all institutional clients mandates to other asset management firms

UMR Boardroom 1: FX Clearing: Exploring the Benefits and Roadblocks for Buy Side Adoption



AANA Calculations are time consuming and a constant ongoing process that need to be revisited every year

- UMR is not a moment in time, but rather an ongoing process of oversight and monitoring
- Even if a firm is not captured by Phase 6 of the regulation, it is important to conceive a UMR strategy in case they fall into scope at a later date
- Deadlines are in place to calculate and declare outstanding notional in spring 2021 and 2022
- Calculations do not just involve FX, they include all non-cleared derivatives across asset classes
- While physically settled FX forwards, FX swaps and currency swaps are exempted from two-way IM exchange, importantly they still count towards a firm's aggregate average notional amount (AANA)
- Firms need to have processes in place to calculate AANA on an annual and ongoing basis. This means firms not impacted in 2022 may still be impacted in subsequent years.



Brexit leads to further regulatory uncertainty

- Brexit is causing further uncertainty for EU participants, as temporary third country equivalence is only in place until mid 2022
- This could potentially lead to products cleared with third country CCPs and exchanges being included in future AANA calculations for European market participants
- ESMA recently published a consultation on this topic, **which can be found here**.

FX Clearing is lagging behind other products due to the current regulatory environment, but it's a case of "when" not "if"

- Due to regulatory mandates, clearing has existed in other OTC markets and has come to be accepted normal market practice.
- So far FX has been slow to adopt central clearing, but regulators are starting to take note and UMR is highly unlikely to be further delayed
- It is likely that NDFs will just be the first step and expected that FX Futures will continue to grow in popularity. We are also likely to see more clearing of deliverable FX products in the future.
- The operational and technical workflow for FX clearing is simple and identical to other asset-classes but continues to be perceived as more complex
- Clearing houses are well equipped to deal with the significant volume of trades, notional and margin that will be posted through the clearing of FX products

In addition to reducing counterparty risk, clearing provides a host of other benefits

- Clearing is there to ensure the smooth functioning of markets in times of market stress and counterparty default. This sometimes get lost when talking about UMR
- Clearing can go one step further in terms of reducing counterparty default risk than a Prime Broker, so worth considering even for firms that have a PB set up
- Clearing provides a simple and elegant solution, ensuring operational efficiency and simplicity against a single counterpart, as well as reduced funding and margin costs
- Disputes are removed through clearing as all participants adhere to the same single rulebook, fixing rate source and margin methodology

FX Futures are a potential solution as by definition they are a cleared product

- Buy side participants could use FX Futures as a pro-active tool to lower their IM thresholds as well as adding a new liquidity source. Client clearing for FX futures is well established, therefore quick, and easy to deploy
- One perceived barrier right now is a lack of liquidity, but banks are continuing to look at adding FX futures to their capabilities. Exchanges are also continuing to make the products more flexible outside the main trading dates.
- Buy side can use Exchange for Physical Trades (EFPs) to overcome liquidity concerns associated with futures. This enables clients to trade Spot (or similar) and then roll the product into a FX futures position. This workflow is not fully developed with liquidity providers, but technology vendors and LPs continue to work to enable more electronification of this trading mechanism.

Next steps

The main takeaway from the group was to act fast, and to ensure their UMR project is fully up and running. From an integration and workflow perspective, clearing is simple and will have an overall positive impact on the FX market.

The Finance Hive will continue to support buy side and partners by facilitating further conversations for these areas to be addressed in discussions on Zoom, and on our private buy side only membership platform, which offers instant and direct connection to peers who can soundboard ideas and share their own opinions and perspectives. If you would like to find out more, please get in touch with Georgia Frett, General Manager of The FX Hive - Georgia@thehive-network.com

Eurex stands for the leading European derivatives exchange and - with Eurex Clearing - one of the leading central counterparties globally. We are the architect of market liquidity, efficiency and integrity by providing our customers with innovative solutions to seamlessly manage risk. www.eurex.com

Firms that contributed:

