WHITE PAPER

Client Clearing – The Direction of Travel

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Abstract

A recently proposed Futures Industry Association (FIA) European Trustee Model (EATM) to facilitate client clearing in European jurisdictions indicates the industry's desire to improve clearing brokers' profitability and facilitate access to clearing for derivatives end-users. At the same time, upcoming Basel 3.1 changes (also known as Basel IV) and, in the United States (US), Basel III 'Endgame' proposals, if implemented without amendments, will significantly increase costs of providing access to clearing for both European banks and US-based Globally Systemically Important Banks (G-SIBs) affiliated Futures Commission Merchants (FCMs).

Although the US final rules are yet to be finalised, the emerging picture suggests that clearing access is likely to become more expensive. Mid-tier banks and broker-dealers may benefit from accessing the Central Counterparty Clearing Houses (CCPs) directly and, in some cases, also from becoming FCMs to compete with established G-SIB affiliated FCMs for client business.

Background

The central clearing of standardised Over the Counter (OTC) derivatives is a pillar of the G20 Leaders' commitment to reform OTC markets in response to the global financial crisis. A market participant can access a CCP by becoming either a clearing member or a client of a clearing member. Over the past decade, however, the number of clearing members prepared to offer clearing services to market participants (derivatives end-users) has steadily decreased from 22 firms in 2014, when the Dodd-Frank Act reforms first went into effect, to approximately 12 firms today. All 12 firms are classified as G-SIBs, with seven of these firms comprising 94% of the CCP cleared market volume[1]. The significant decrease in firms willing to offer client clearing services is driven predominantly by how client clearing is contributing to banks' capital requirements. This makes the business less economically viable on a stand-alone basis.

[1] https://www.cftc.gov/MarketReports/financialfcmdata/index.htm

The sections below review current and proposed models utilised in client clearing of derivatives and the Basel III Endgame proposal and their impact on the future availability of this vital service.

Client Clearing Models

There are currently two main models to facilitate client clearing, Principal-to-Principal and FCM models, depending on the jurisdiction of the clearing broker. Recently, the FIA proposed the new EATM designed to address some of the capital-related issues faced by clearing brokers currently using the Principal-to-Principal model, and to maximise clearing brokers' capital efficiency.

Principal-to-Principal Model

The European, Principal-to-Principal model involves a clearing broker entering into a direct relationship with the Client and simultaneously booking a back-to-back trade with a CCP, both on a principal basis. Most non-US-based clearing brokers also use this model.

Agency or FCM Model

In the US, the agency model (also known as the FCM Model) is the predominant structure for OTC derivatives, where the clearing broker acts as an agent for the Client. In this client clearing model, the clearing broker guarantees the performance of a client to the CCP (normally not the other way around) but is not principal to the derivative transaction. Under this model a client's initial margin does not have to be recognised as a risk exposure on an FCM's books and records, provided it is segregated from FCM's own assets.

Proposed FIA European Trustee Model

The client clearing model recently proposed by the FIA was developed in conjunction with the clearing members of European CCPs and largely mirrors the US-style FCM model, The Client enters into the trade with the CCP while the clearing broker acts as an agent and guarantor of the Client. Collateral and payments are transferred directly to the clearing broker under a title transfer collateral arrangement, bypassing client money/client asset rules, while the clients gain a beneficial interest in the transactions entered by the clearing broker as a trustee. There are currently two version of the EATM model, one developed under English law and the other under German law.

Both English and German versions of the EATM would require users to sign a new clearing agreement with their clearing brokers. The structure allows all transactions between a clearing member and the CCP to be deemed as held by the clearing member in trust on behalf of its clients.

The central aim of the EATM model was to address the so-called complexity indicator within G-SIB scoring, which is based on gross OTC notional and includes both house and client clearing activity. In contrast with the European Principal-to-Principal model, where a bank is required to account for the gross notional of transactions facing its clients as well as the CCP, the EATM model allows the clearing member to exclude these notionals because transactions are structured as being done between the Client and the CCP directly. This is broadly similar to the way it is done under the FCM model in the US.

EATM is designed to preserve current closeout and porting arrangements and allow porting between the agent trustee and the principal-to-principal models. This means backup clearing brokers are not required to operate on the same model as a client's primary provider.

There are, however, divergences from the FCM model. For example, collateral payment flows are kept outside the client asset regime in Europe and the UK. As a result, collateral payments and deliveries made in the context of the EATM are completed on a title transfer basis. This contrasts with the FCM model, where all client's assets fall outside the insolvency estate of an FCM.

Initially, the new proposed model is intended to be available only for LCH's SwapClear service, for UK clearing members and only across its most common client types of accounts: individually segregated, omnibus gross and omnibus net segregated accounts. Currently, the model is not intended to be available for indirect clearing.

Basel III Endgame Proposals - US only

The Notice for Proposed Rulemaking for the Fundamental Review of the Trading Book (FRTB) and Basel III Finalisation (collectively Basel III Endgame or 'B3E') was jointly published on 27 July 2023, by the Federal Reserve, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC). In a separate action, the Federal Reserve Board (FRB) proposed amendments to its rule that identify and establish risk-based capital surcharges for G-SIBs. The amendments are intended to improve measurement of the 'systemic indicators' under the G-SIB Surcharge Framework and to enhance the sensitivity of the surcharge to changes in a bank holding company's risk profile.

The B3E focuses on capital held against credit, operational, market, and credit valuation adjustment risks, as well as several parts of the proposals. If finalised without amendments, this will substantially increase capital requirements for providing market access to cleared derivatives (client clearing). The agencies propose to revise how capital add-ons are calculated for the largest US banks classified as G-SIBs. The changes will allocate a higher charge for the provision of client-clearing services[2].

[2] Capital proposal: Endgame for a robust U.S. derivatives market? | ABA Banking Journal

Below are the three main components of B3E proposals that will affect major US-based clearing brokers.

G-SIB Surcharge

The G-SIB surcharge is the main contributor to the increase and will include an additional amount of capital that the largest banks are required to hold based on their systemic importance. The surcharge calculation is based on six indicators. The agencies propose including all client clearing of OTC derivatives into the interconnectedness and complexity indicators and adding OTC derivatives exposures into the cross-jurisdictional activity indicator. The G-SIB surcharge proposals would include FCM model client clearing in the G-SIB complexity and interconnectedness indicators. This would dramatically increase the contribution of client clearing to G-SIB surcharges.

Currently, all client clearing activity conducted under the FCM model is excluded from complexity indicators, and it will remain excluded for non-US G-SIBs, in line with the original Basel Committee on Banking Supervision (BCBS) agreement. Under the B3E proposals in their current form, however, all US-based G-SIBs will no longer benefit from this exemption.

Based on the LCH analysis of SwapClear data[3], which estimated the impact of this amendment to the complexity indicators alone, the G-SIB score of a large FCM will increase by approximately 16 basis points (bps). Given the proposal to tighten Method 2 G-SIB score bands to 20bps, this increase would equate to 80% of a given band. Consequently, it would likely move the bank into a higher Method 2 capital surcharge band for the bank's entire activity (total risk-weighted assets), already significantly higher under the B3E Proposal.

Credit Valuation Adjustment Risk

The authorities propose eliminating the current risk-based approach to calculating Credit Valuation Adjustment (CVA) risk and instead require that banks with over $100 billion of assets use less sophisticated measures. These new measures would also contribute to an increase in capital requirements. Currently, recognising that margin is designed to cover clients' exposure to their clearing members, there is no charge for client-cleared positions. Indeed, European regulators go further, exempting banks' exposures to non-financial counterparties from the charges. The B3E proposals have no such exemption, putting US banks at a disadvantage compared to their European peers.

Standardised Approach for Counterparty Credit Risk

Currently, the largest banks are permitted, with regulatory approval, to use risk-sensitive approaches to counterparty credit risk. Smaller banks (Category III and IV), in the Fed's terminology (roughly $100-250 billion in assets), use a standardised approach developed around 20 years ago. The B3E proposals eliminate both methods, replacing them with a new standardised approach, the Standardised Approach for Counterparty Credit Risk (SA-CCR). Although it is not practical to directly compare SA-CCR with the models used

[3] RIN 3064 AF29 London Stock Exchange Group (fdic.gov)

by CCPs to mitigate risk, it is generally accepted that the latter is significantly more risk-sensitive as the safety of the clearing houses rely on the prudence of their risk models, which are subject to regulatory review and frequent validations. In most cases, the estimation of counterparty risk based on a more generic SA-CCR framework will be more conservative and further contribute to increased costs of client clearing to the US-based FCMs.

The FIA has estimated[4] that the current B3E proposal along with the Fed's proposed changes to the capital surcharge that applies to US G-SIBs, would collectively increase the capital required to engage in client clearing activities by more than 80%. This is a very significant increase in cost of capital that is unlikely to be fully absorbed by FCMs and expected be passed, at least in part, to clients.

BCBS Basel IV

Following the financial crisis, the Basel Committee for Banking Supervision (BCBS) has updated Basel framework to enhance its robustness further. In December 2017, it published its post-crisis regulatory reform, often referred by the industry as Basel IV, that introduces a package of changes to the use of standardised and internal models' approach to credit risk, operational risk, leverage ratio, capital floors and CVA. These reforms apply to all banks globally; however, some details and implementation timelines will vary by jurisdiction. It is also worth noting that B3E is the specific US version of Basel IV reforms.

Table 1 below aims to broadly compare global and US versions of implementation of BCBS reforms. Although the package of reform is very comprehensive, the main issue that is likely to impact major non-US clearers is the 72.5% output floor based on SA-CCR calculation method. Currently many major European clearers are relying on their internal models to calculate counterparty exposures. However, the benefits of this method will decrease by 2027 to a maximum of 27.5% compared to SA-CCR numbers that are mandated in the US by the Collins floor (2010 amendment to Dodd-Frank Act that requires banks to apply higher of SA-CCR and internal model to capital calculations). This will still provide a significant competitive advantage for non-US clearers, such as the gap between internal models and SA-CCR, as the Bank of America[5] reported at the end of 2021, which stood at over USD200bn (highest reported divergence).

[4] FIA - 2023 Basel Endgame Comment Letter.pdf
[5] The Collins flaw: backstop turned binding constraint - Risk.net

Table 1 – Global and US implementation of BCBS reforms

	Basel IV	US Basel III Endgame
Scope	Global regulatory framework by BCBS	US-specific adjustments to global regulatory framework by BCBS
Risk-Weighted Assets	Significant changes to Risk Weighted Assets (RWAs) calculations, stricter rules for internal models	Revisions to the calculation will result in higher RWAs
Output Floor	Introduces an output floor of 72.5% of SA-CCR	SA-CCR
Operational Risk	Eliminates advanced approaches, moves to standardised approach	Eliminates advanced approaches, moves to standardised approach
Capital Requirements	Higher due to the output floor and revisions to standardised approach	Proposes higher CET1 capital levels, 16% increase for G-SIBs
CVA	Replaces current CVA risk requirements with revised approaches	Replaces current CVA risk requirements with revised approaches
Leverage Ratio	Additional requirements for G-SIBs	Includes supplementary leverage ratio for large banks
Implementation Timeline	Varies by jurisdiction	Transition starts 1 July 2025, full compliance by 1 July 2028

Summary

There are a significant number of factors that affect the cost of client clearing. Client clearing models are certainly one of the major factors and proposed introduction of EATM will improve the profitability of European clearers and probably encourage more banks to enter the client clearing business. A similar trend can also be observed in the US, where some non-G-SIBs are applying to become an FCM. At the same time, profitability of both global banks offering client clearing and US based G-SIB-affiliated FCMs will suffer due to upcoming Basel IV and B3E.

At the time of writing, there is a major lobbying effort underway[6] to soften B3E proposals, the outcome of this effort remains to be seen. Suppose the final B3E rules remain as proposed. In that case, it is inevitable that banks, particularly US based G-SIBs, will have little choice but to increase fees for providing market access, reduce the amount of risk that they allow clients to transfer, and probably limit provision of access to the least profitable clients. Global banks outside of the US that currently benefit from RWAs calculations based on internal models will also see costs of capital increase once the output floor of 72.5% is implemented.

[6] Sunday night football and the Basel III endgame - Risk.net

The overall picture that emerges from numerous proposed changes and regulations points out, on one hand, the industry's efforts to improve availability and profitability of providing access to client clearing services and, on the other hand, the tightening of regulatory capital rules. This will make providing such access scarcer and more expensive as new regulatory frameworks are implemented.

Smaller mid-tier banks and broker-dealers that heavily rely on access to client clearing services will need to review their specific business cases with an understanding that access to clearing is not going to become any cheaper or easier in the foreseeable future. They may consider direct membership of CCPs to reduce costs and enhance certainty of their access to clearing.

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