Derivatives Clearing 2015

EMIR

MIFID II

BASEL III

Triple whammy

The challenge of change

EMIR, MiFID II and now Basel III. How are the banks coping in ETD and OTC markets? By Niki Beattie

Markets are in continuous evolution. Regulation is only part of the many catalysts for change but it is usually transformational. It can come in the form of measured step changes such as the many EU directives that were spawned by the original European Financial Services Action Plan or a slew of rushed responses such as those that followed the default of Lehman Brothers in 2008. Either way, market participants must constantly adjust their business models or be left behind as new models emerge.

After the financial crisis, regulators, justifiably, are seeking to better understand the firms they regulate while satisfying national governments and the public that something similar could not happen again. In response to increased focus on capital and risk, banks are having to rationalise their business offerings. This is also coupled with the desire to return capital to shareholders. A de-risking of the balance sheet, for example via central clearing or increased collateral, has become a necessity.

The G20 Summit in Pittsburgh of 2009 set in train a number of processes to reduce risk and create transparency in the over-the-counter (OTC) markets. Banks are now having to digest these processes, which were designed to push more business onto recognised markets, increase centralised clearing and capture data within new trade repositories. After a period of extensive consultation, banks are now entrenched in the phased implementation of these regulatory policy responses. The current swathe of regulations and legislation has resulted in a vast amount of implementing measures, which can be considered in two broad dimensions. Firstly the regulators' desire to simplify, or better understand, the balance sheets of financial institutions. And secondly the regulatory desire to de-risk or create adequate provision for risk.

These reforms, which set out a clear desire for more central clearing of OTC derivatives, also mandate that the central clearing of trades should be, in margin terms, more favourable than bilateral exposures (see the Bank for International Settlements and International Organization of Securities Commissions document,

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'Margin requirements for non-centrally cleared derivatives'). As ever, complying with these changes manifests itself as a cost to the business, be it an operational cost and/or a capital charge. This is now the main focus of the banks.

With the implementation of the Markets in Financial Instruments Directive (MiFID) the markets saw the emergence of the multilateral trading facilities (MTFs) and more competition to the domestic bias of national exchanges. Interestingly, the new breed of MTFs did not compete in the price discovery process for the illiquid names of the national market. What had happened was that in the old domestic exchange model there had been a cross subsidy of the trading in illiquid names with the trading of blue chips. The MTFs, with their substantially cheaper pricing, simply did not cater to illiquid names given the notional income that could be received from trading in these names.

Holistic approach

Just as MiFID enabled a light to be shone on the pricing of equity execution, that focus on cost, wherever it resides in the transaction value chain, will only continue. The current suite of regulatory initiatives will simply require firms to examine costs across different segments of their business processes.

Banks are particularly challenged with the complexity of dealing with the current waves of change presented by each regulatory initiative, in all the various jurisdictions where they operate. But these changes cannot be addressed in isolation. Banks have been forced to adopt a more holistic approach in their understanding of their business to implement more cost-effective solutions to address the operational changes required to comply with new regulatory policy. Not easy when some aspects of regulation are still in consultation. Still, what we can be certain of is that the regulatory net will continue to stretch.

How can firms adjust to these demands? Banks and financial institutions are all grappling with how to optimise their balance sheets and capital allocation. The common theme is a pincer movement of growing the balance sheet while at the same time de-risking it. Banks are most likely to be looking at regulatory changes through three different lenses: product, business and client. Looking through each of these tells its own story.

At a product level, there is the challenge of reviewing product characteristics. For example, how many asset classes can be held under the one umbrella with uniform or commoditised processes, eg, equities, derivatives, swaps, foreign exchange? Then the focus is where to execute and report transactions accompanied by the relevant operational and capital charges. Given the capital intensity of each product, what is the optimal collateral management solution?

At a business level, there is a comprehensive review of each business line and the demands it imposes on the organisation. Should particular business lines be exited, or is it a matter of just simplifying existing processes by removing certain aspects of a current business offering? These changes can include redefining, and hence repricing, existing services or merging and consolidating business lines such as bringing together all 'cleared' business, both exchange-traded derivatives and OTC, under the one business line. How firms optimise the collateral they receive will be one aspect of the matrix, while thinking about client and product.

Key accounts, as ever, will be retained on the basis of their profitability and yield. However, these metrics will be more robustly tested on a multi-asset, multi-jurisdiction basis. Certainly a key account will continue to be reviewed on a relationship basis, but there will be a greater focus on the profitability and/or cost of the services provided.

This will extend to co-operation on the allocation and utilisation of capital. All firms pride and distinguish themselves today on the basis of their cost controls. These will continue to be tested as the transition from consultation to implementation of new clearing and capital requirements continues. The

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challenge will be for businesses to redefine what is acceptable under their specific model in a product and regional matrix.

Finally, all this needs to be overlaid at a client level. Which clients do firms want to focus on? No firm wants to lose a relationship with a key account but it does raise the question of where do you draw the line in terms of revenue diversification versus client profitability and the client service offering. Inevitably, a simplification of the balance sheet will result in a rationalisation of the customer base and those customers that don't make the cut in one bank may produce viable business for a different bank.

Ultimately, the question is: what does it mean for the end-investor and the financial institutions that service them? On a product level, bespoke services, for non-key accounts, will be compromised. The pressure that these 'twist and wrinkle' procedures add to the business model through their complexity and balance sheet requirements will preclude them from the service offering. Conversely, in the quest to preserve key accounts, the development and commoditisation of bespoke services may be tailored to cater for this customer segment.

Customers will have to adapt to a change in nuance from their service provider and they will also have more data to analyse about the markets they deal in. Services will be reviewed in conjunction with pricing. It could be that some fragmentation will result.

Some firms, based on size, will find that to meet the new parameters that are set at a business level they will need to review either their service offering (in the case of a broker) or their service provider (in the case of a user). It could be that for bespoke services they will use a different provider compared to the 'vanilla' or less-capital-intensive services.

Adapt and evolve

Finally it will be the client who determines where a product might be cleared. Banks will have to manage increasingly complex relationships across clients and clearing houses. Certainly, there will be continual change. Businesses will adapt and customers will evolve with the changing business models. As banks optimise their models, they will identify new niches. Just as innovation is stifled in one dimension, for the purposes of balance sheet simplification, invention will blossom elsewhere as some firms reposition themselves to cater to bespoke services that clients will always require.

Semper eadem, semper antics. Ever the same, and always forwards. ■