FX CLEARING BENEFITS AND UMR

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Archana Varshney, Head of OTC FX Sales and Business Development at Eurex Clearing (Eurex), analyses both the challenges and benefits associated with central clearing.

After multiple delays, the Uncleared Margin Rules (UMR) are reaching their final phase with many more market participants – particularly on the buy-side – being impacted as a result.

Indeed, a joint report issued by the international Swaps and Derivatives Association (ISDA) and the

Securities Industry and Financial Markets Association (SIFMA) estimated that an additional 1,000 entities could become subject to UMR in the final phases, with the initial margin (IM) requirements within it creating a need for as many as 9,400 new relationships and 18,800 segregated IM accounts which must be set up and tested.

This is why, even in the absence of a mandate to clear FX, we have seen more firms turn towards central clearing for these products in an attempt to mitigate the impact of UMR on their businesses. By centrally clearing parts of their portfolios, firms can keep their Average Aggregate Notional Amount (AANA) calculation below the threshold which determines whether or not they are subject to UMR. Currently the threshold is 50 billion, but this figure drops way down to $8bn in September 2022.

So, for example, Fund A has 2.5bn exposure in NDFs with Bank A, 5bn in uncleared IRS with Bank B and 2bn in uncleared equity derivative swaps (total return swaps). Therefore, Fund A has 9.5bn exposure following its AANA calculation and Fund A is in scope for UMR in Phase 6. By clearing its NDFs, Fund A falls out of scope for UMR as it only has 7bn exposure following the AANA calculation.

In the FX space, Non-Deliverable Forwards (NDFs) and FX options are the key products as they contribute to the overall AANA calculation. While the advantages of not being in scope for UMR are clear, there are some important challenges and benefits that market participants should be aware of when they are considering central clearing and deciding which CCP to use.

Some of the challenges typically associated with central clearing are:

> **Additional costs:** the cost of Initial Margin (IM) and default fund contribution as well as the middleware cost for matching/affirmation of bilateral trades.
> **Operational:** depending on the set-up of the clearinghouse, new processes might need to be established for collateral postings and processing of cleared trades.
> **Either/or** decision for central clearing vs. product optimisation.

Clearinghouses, generally operate with either a horizontal or a vertical approach. In the vertical approach, every asset class is separate with its own margin and default fund contribution. By contrast, a horizontal CCP has one margin call across all asset classes and one default fund.

If a buy-side participant is connected to a horizontal CCP, the participant can largely re-use the existing connectivity, including collateral management and settlement processes. This means that the participant does not need to look into building a new infrastructure to support clearing. If the clearinghouse is directly connected to the trading platform, the need for middleware also goes away, removing the additional cost of matching/affirmation.

Secondly, clearinghouses calculate IM based on daily calibrated data and on a multilateral net basis, whereas the standard initial margin model (SIMM), used in bilateral transactions, is more static and offers no multilateral netting.

Therefore, the switch to central clearing provides participants the benefit of reduced IM.

Lastly, product optimisation and central clearing are not mutually exclusive and can work alongside each other. It is already been proven in other asset classes and can certainly work in FX. By combining central clearing and product optimisation, participants not only manage the AANA exposure but increase the benefits of a credit-neutral CCP, optimised capital requirements and standardised processes.

Eurex is a horizontal CCP and connected directly to 360T, thereby benefiting the participants with:

> **Cost efficiencies:** no additional middleware cost or new default fund. Additionally, CCP participants benefit from capital savings and reduced IM compared to a bilateral SIMM calculation.

> **Operational efficiencies:** by leveraging the existing infrastructure and processes.

> **Margin and collateral efficiencies:** re-use collateral arrangements and benefit from capital savings and reduced IM compared to bilateral SIMM calculations.

> **Eurex also offers ETD FX** including listed FX options as an alternative route to manage derivatives exposure under UMR alongside NDF clearing.

Eurex plans to offer NDF clearing and will capture NDF trades directly from 360T and risk manage the trades by becoming the central counterparty, ensuring settlement of these trades. As NDFs are cash-settled products, a settlement will be within the Eurex payment infrastructure. To support the broader market, Eurex will also connect to MarkitWire and Traiana to capture the NDF trades.

For further information, please contact FX@eurex.com

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