

COSTS

What is "To-Clear" Liquidity and how can it reduce your trading costs?

David Holcombe, Head of Product, FX Futures & FX Clearing at 360T explains that, far from being just an expensive post-trade add-on, central clearing actually represents a quantifiable economic opportunity for market participants.



David Holcombe

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With no mandate to clear FX, the majority of FX clearing activity right now is banks clearing their interdealer flows. While this is focused on products where bilateral Initial Margin (IM) needs to be posted – namely NDFs and FX options – the fact that we are seeing an increase in voluntary clearing indicates that the banks are realising benefits from this.

To be specific, the interdealer community is leveraging the margining and operational efficiencies such as clearing house (CCP) multilateral netting, plus regulatory benefits including lower margin amounts and lower capital costs for cleared rather than bilateral positions.

While the adoption of SA-CCR calculations provide further economic incentives for banks to centrally clear, it is clearing’s exemption from CVA Risk RWA that makes it a lifeline for interdealer markets, by removing the risk of key liquidity being removed from the pool because that bank has reached their monthly RWA limit, and it became economically impossible for them to continue to trade freely in bilateral markets until their next calculation period began.

While all of this will drive more pockets of FX activity into central clearing, including deliverable products such as forwards and swaps, the reality is that the

industry’s current approach to clearing severely limits the benefits that can be derived from it. This is particularly true for clients who are not bank clearing members themselves.

LOOKING AT PORTFOLIO LEVEL COSTS

Frankly, it is no surprise that clients have not fully embraced FX Clearing yet. If they are forced to execute bilaterally against OTC liquidity, with the normal costs associated with that, and then as part of a post-trade process select trades based on product and counterparty give them up to clear, then it feels very much as if they are simply adding post-trade costs and processes on top of their normal trading operations.

However, when firms step back from analysing this on a trade-by-trade basis and instead start to consider it at the portfolio level a very different picture can emerge. That is because the additional cost to any one specific trade incurred by clearing can be heavily outweighed by the economic benefits to the overall portfolio. Indeed, we are increasingly seeing buy-side firms moving away from defining best execution as simply the best price available in competition, to instead considering the trade’s overall impact at the portfolio level. And as a result of this some interesting new dynamics are emerging.

CLEARING REMOVES THE HIDDEN COST OF CREDIT

When trading in OTC bilateral markets, the prices that buy-side firms see is not simply the core price of that liquidity provider (LP). It is actually the core price, plus an additional spread which is based on the perceived levels of credit and settlement risk associated with that buy-side firm. Thus, the cost of credit is already baked into the pricing.

Central clearing though can mitigate this credit and settlement risk through the novation of trades to the CCP, which means that both the marker and taker subsequently each face the CCP for the remaining life of the trade. Clearly, this means that the additional spread included in the LPs pricing to account for credit costs can be significantly reduced, with the result that OTC pricing should often be tighter for cleared trades than for bilaterally executed ones.

And we are seeing the natural consequence of this now in the current shift towards “To-Clear” liquidity pools. This is where makers and takers transact knowing ahead of time that the trade will be cleared, resulting in tighter pricing, as opposed to traditional liquidity pools where buy-side firms have to bolt-on clearing as a post-trade add-on.

Incidentally, this cost of credit should be reduced to zero in the case of exchange traded derivatives (ETDs) such as FX Futures, because these products can only execute at the exchange, regardless of whether they are transacted directly in the exchange CLOB or when agreed OTC and given-up to the exchange to print and clear (off-exchange Block / EFP/EFRP transaction).

This trend towards “To-Clear” liquidity also removes another big cost from FX trading activity – the recurring

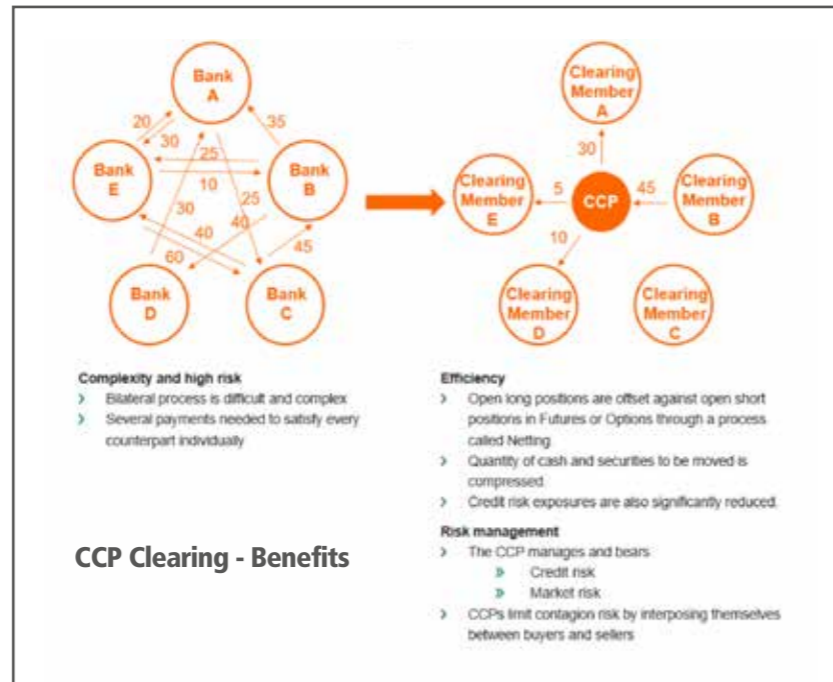


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costs of having to establish and then maintain a credit relationship, such as ISDAs, with every one of their trading counterparts.

EXECUTION MODELS REMAIN UNCHANGED

It is important to emphasise that To-Clear liquidity is compatible with any execution model, it makes no difference whether a trade is being done via RFQ, streaming, ECN, central limit order book (CLOB), etc. Equally, there is no change in terms of the value of relationship trading. All that happens is that "how much and who's asking?" just becomes "how much and who's asking and will it be cleared?".



The differentiation of To-Clear liquidity is simply that the maker and taker both have access to clearing and interact in the knowledge that their resulting trade will be cleared.

While there is price discovery value in seeing To-Clear and bilateral liquidity in the same stack, for example to produce an aggregated view of the market to inform and pinpoint opportunity areas pre-trade, we will see To-Clear liquidity work its way into single and multi-dealer platforms, using existing OTC execution models, as makers and takers pursue distinct trading opportunities that are not available bilaterally OTC, or where a cleared trade delivers a specific portfolio benefit that they seek.

WHAT COMES NEXT?

We have already seen that the impact of SA-CCR on the interdealer market will be for banks to use clearing as a tool to optimize their capital allocation and to avoid bilateral limit and liquidity issues. Beyond this initial use of To-Clear liquidity, where each trade is done in the knowledge it will be cleared, the larger benefit to banks and their clients will be seen once the concept of To-Clear reaches all on the client side too ... something likely to

be labelled the 'cFX' revolution. To-Clear does not need to replace existing bilateral relationships, but rather offers a complementary liquidity pool for a regulatory-favoured product set.

Price makers and takers alike can reach clients without the need to establish and maintain bilateral credit and settlement relationships, and they can trade in the knowledge that they can operate the right number of netting sets in terms of clearing members to optimise their benefits and mitigate their costs of this cleared activity.

For the wave of Clients considering when to include clearing in their

operating model, To-Clear liquidity is the remaining piece of the puzzle that can help them move from the perception that clearing is a post-trade add-on, to understanding the opportunity it offers in terms of stripping out the credit costs currently embedded in their FX pricing.

It also enables them to seize further price improvement from LPs sharing their cleared portfolio benefits, gives favourable regulatory treatment of their cleared positions, plus opens the door to further relationship-based agreement on fee capture for the use of their bank's holistic clearing services.

BENEFIT TODAY

To-Clear liquidity is not a forward-looking projection of where the market will go. At 360T, in addition to already supporting OTC FX Clearing for spot, forwards and swaps, we also offer 'OTC' bilateral futures trading built into our disclosed LP-to-Client execution models. This means firms don't have to trade FX Futures in an anonymous CLOB, they can instead continue to use OTC FX trading models, such as price enquiry and streaming, to agree futures trades bilaterally with To-Clear trading counterparts, and then have the trade automatically given up to the exchange to clear. We also have a range of tools for our clients wanting to bridge the OTC/Listed markets, ready for them to start exploiting their cleared eFX opportunities.