Why Clearing Matters – Self Clearing as an Alternative

INTRODUCTION

Since the establishment of futures exchanges, market participants that trade listed derivatives and cleared OTC swaps have gained access to the markets through their relationships with Futures Commission Merchants (FCMs). FCMs provide market participants with a range of services including trade execution, market research and clearing.

As access to FCMs providing clearing services continues to decrease and the cost to clear continues to increase, market participants are considering alternative business models that support the clearing of their derivatives contracts.

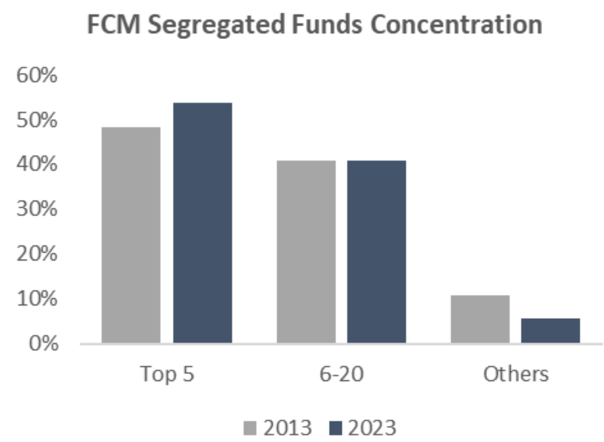
This paper discusses what it means to self-clear. It provides a high-level, but practical, description of the self-clearing alternative and how it can directly affect your business. Asset managers, regional banks, commodity hedgers, and insurance companies that explore self-clearing particularly may find that it brings significant benefits in areas of risk, cost and control.

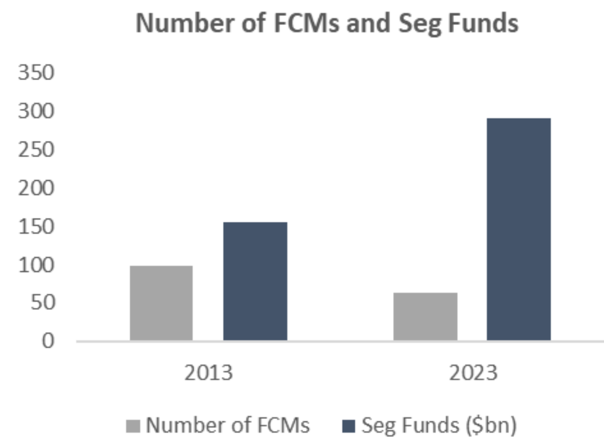
MORE ON CLEARING

Regulatory overhaul in the wake of the 2008 financial crisis, resulted in a number of new regulations mainly impacting large bank owned FCMs. New rules and regulations requiring centralized clearing of most OTC derivatives by brokers, dealers and end user market participants in addition to the introduction of revised bank capital requirements changed the playing field for suppliers and consumers of clearing services.

The mandate to centrally clear OTC swaps and imposition of new bank capital requirements, while making the market more resilient and safer, has resulted in an increase in demand for listed and OTC derivatives clearing services while simultaneously making clearing a less attractive business for bank owned FCMs. FCMs today are extremely selective about the range of products and clients they provide clearing services for, while the cost of clearing services continues to rise.

Just looking at the period from December 2013 through December 2023, the number of FCMs providing clearing services has decreased from 95 to 63. The value of customer segregated funds held by FCMs has increased to $289 billion from $155 billion (cleared swap segregation went from virtually $0 to $167 billion over the same time period).





WHY SELF CLEAR?

Market participants have indicated that clearing costs, control, margin efficiency and FCM risk are the main drivers steering the interest in converting to self-clearing.

Clearing Costs:

Clearing is expensive. Self-clearing may significantly reduce the cost to maintain listed derivatives and cleared swaps portfolios. The classic FCM business model in the simplest sense relies on commissions to cover costs and interest income to generate a profit.

FCM Cost Model:
(Clearing costs + Allocated Overhead) - (Interest Income - Commissions) = Net Profit
Self-clearing Cost Model
Clearing cost – Interest Income = Net cost

FCMs, especially large bank owned FCMs have large overhead costs allocated to the business segment. If it is true that FCMs generate a significant profit from the spread applied to credit and debit interest, and if agreed that an FCMs overhead is greater than a self-clearer's then it is logical to believe that the FCM's profit accrues to the benefit of the self-clearing firm. Of course, the actual accounting is more complex, but most FCM versus self-clearing analyses do indicate substantial cost reduction.

Control:

Addressing the challenges of operating profitably while being in compliant with new capital and risk based regulations specific to client clearing, bank owned FCMs have redefined the optimal mix of client accounts and products and services they provide. Any category of trader or client that carries a low frequency and sizable directional carry position will attract significant regulatory capital and balance sheet rent costs but generate lower commissions and net interest, hence are less favored as a FCM customer.

FCMs have adopted methods to control client behavior:

- Applying initial margin requirement multiples.
- Applying position and portfolio limits.
- Limiting or curtailing business with certain clients.

Firms that are self-clearing have greater control over their costs, risks and their destiny.

Margin Efficiency:

Firms that self-clear may be able to take advantage of cross margin offsets. These risk offsets can produce significant reductions in initial margin required to support portfolio operations. For example, in 2023 the CME and DTCC announced an enhanced cross-margining arrangement that permits clearing members of both the CME and DTCC to reduce margin requirements and enhance capital usage.

Further to Consider (FCM Risk):

Increased clearing demand and decreased clearing supply is a formula for increased concentration risk. Concentration risk (defined as a smaller number of FCMs hold a greater share of the total cleared business) left unchecked leads to greater systemic risk, but also has practical implications for clients and their portfolios.

Concentration risk leads to concerns about clearing capacity. One possible consequence of concentration risk is porting. If a bank owned FCM voluntarily (or involuntarily) leaves the clearing business, market participants may run into difficulties transferring their portfolios to other FCMs.

Porting can impact all categories of clients, but is especially relevant to certain client types. Among those are; insurers, regional banks and commodity hedgers. Based on risk and profitability profiles they are generally considered to be less attractive FCM clients.

FCM clients must also think about the clearing relationship in the context of the safety of their margin deposit assets. FCM defaults and fellow customer risk, even though they may be fat-tail events, remain key concerns. Newly introduced FCM regulatory requirements and rules do not entirely eliminate the risk of loss or liquidity in a default situation.

THE SELF-CLEARING OPTION

The self-clearing model is predicated on the end user establishing a proprietary clearing member relationship with the clearing house. The end user establishes a wholly owned legal entity and assumes core clearing operational requirements (discussed later in this paper). Applicants that meet clearing house membership requirements, which include but are not limited to, minimum capital maintenance, risk management capability and operational preparedness can qualify to become clearing members.

Core clearing requirements can be broadly grouped into three categories:

- Margin settlement and collateral management
- Transaction processing and reporting
- Guaranty Fund and default management

Margin Settlement and Collateral Management:

Clearing members post initial margin and pay/receive variation margin directly with the clearing house. Clearing members are required to establish a banking relationship with a clearing house approved settlement bank.

The settlement bank is the conduit through which initial margin postings and variation margin payments are made between the clearing member and the clearing house. Settlement banks meet the strict timelines for margin call settlement, including meeting intra-day calls within one hour from the issuance of the call.

Clearing members benefit from control of their collateral. Cash margin receives full (non-haircut) interest, and securities are not subject to additional custody charges.

Transaction Processing and Reporting:

Maintaining books and records and reconciling trades, positions and monies, filing regulatory and financial reports are the responsibility of the clearing member. To do so effectively and efficiently specialized software and knowledgeable staff are required.

Most clearing members (FCMs and proprietary firms), rely on 3rd party technology providers for processing needs. Software can be made available in different configurations, a) maintained by the clearing member on their hardware or b) hosted and delivered by the 3rd party provider.

Clearers have options in meeting operations and accounting staffing needs. These human based functions may be 1) handled in-house by adequately trained and knowledgeable individuals 2) outsourced to a 3rd party provider or 3) via a hybrid model where some functions are retained in house and the balance to the 3rd party provider.

Clearing houses require that the clearing member have a designated person that represents the clearing member in all matters related to the clearing membership and requirements to the clearing house.

Guaranty Fund and Default Management:

All clearing members contribute to the clearing house’s guaranty fund. The guaranty fund is part of a clearing house’s default waterfall and is sized to cover obligations resulting from the two largest clearing members (largest risk) failing. The waterfall is a construct that protects the mutual interest of the clearing membership in the instance of default by one or more clearing members.

Contributions to the guaranty fund and the obligation to participate in additional assessments are the responsibility of the clearing member. Though they vary by clearing house and clearing member, guaranty fund requirements are roughly equal to around 2.5%[1] of a clearing member's initial margin requirement.

In the event of a default, assets making up the financial safeguards waterfall are utilized in a prescribed sequence. The contributions of the defaulting member are first, followed by contributions of the clearing house. If that is not sufficient then guaranty fund contributions of non-defaulting members are applied. Finally, to support coverage in an extreme tail risk event the clearing house may use its power of assessment to collect additional guaranty fund contributions of up to 2.75 times[1] the original contribution.

During an actual default clearing members may be asked to participate in an auction of the defaulting members portfolio.

SELF-CLEARING VERSUS NOT SELF-CLEARING

The decision to move to self-clearing is not a simple one, with many issues specific to the firm to be considered. Every firm considering self-clearing needs to; evaluate if the benefits of clearing membership are attainable for their particular business model, have a view into risk profile deltas and be aware of changes in the operating model.

Risk Profile Comparison	FCM	Self Clearing
Fellow customer risk	yes	no
Clearing-house risk mutualization	no	yes
Clearing cost	high	lower
Cost control	no	yes
Full collateral segregation	no	yes
Operational risk	no	yes
Continuance of service	at risk	no risk
Transit risk	yes	no
Portability	at risk	no risk
Liquidation risk	yes	no risk

Self Clearing Requirements	FCM	Self Clearing
Exchange trading rules	yes	yes
Clearing house rules	no	yes
Position limits	yes	yes
Default management obligations	no	yes
Financial reporting	no	yes
Guaranty fund maintenance	no	yes
Clearing house audits	no	yes

Given that cost and risk is an inherent part of the FCM eco-system, it is important that end users take a look and evaluate the potential benefits and impact of self-clearing. The practice of adopting a self-clearing model is a practical alternative to the standard FCM model that is being actively considered and implemented today. The derivatives markets have a history of constantly adapting to challenges and one should expect to see continued development addressing the challenges and opportunities in the market.

[1] Per CME rules.

ABOUT BLUE FLANNEL CO.

Blue Flannel Co. was established in early 2020 with the objective of providing strategic consulting and advisory services to cleared derivatives market participants. We focus on matters related to clearing and collateral management. Lately our work has been concentrated in clearing alternatives, guiding firms through the analysis, execution, and implementation of self-clearing operational models.

ABOUT FRANK PERRONE

The founder of Blue Flannel Co. author of this paper, has over 40 years of experience in financial services. His experience includes: operations management, IT management, settlement bank management, trading and market making, and product and business development. His business philosophy is built around applying the highest level of integrity in attaining positive results, applying extensive experience with curiosity, adaptability, and partnering with colleagues and clients.

CONTACT

For more information on research and consulting services, please contact:

Frank Perrone
+1-631-343-9993
fperrone@blueflannelco.com

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