FSB consultation on incentives to centrally clear

7 September 2018

Questions for public consultation

M&G Prudential welcomes opportunity to respond to the consultation. Key points for us are:

- we think that central clearing service providers should be given more incentives to offer the service so that these incentives can be passed on to clients (especially smaller clients who may encounter restricted access and a high cost of obtaining the clearing service);

- we are constrained by counterparties and types of collateral they accept under uncleared margin framework;

- we find that eligible collateral set in a cleared pool is narrow (cash VM) and certain types of clients may struggle to maintain an appropriate collateral pool to be able to centrally clear;

- we support OTC derivatives market heading towards ETD model (cheaper, more liquid, standardised);

- we are concerned about concentration of risk at clearing providers and CCPs as well as pro-cyclicality of margin requirements.

1. Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?

Yes, we agree with these statements. Liquidity ratios and capital charges have driven large dealers into clearing their OTC derivatives activity. This resulted in market liquidity moving into cleared pool. Large clients followed the move to clearing. Smaller clients encounter challenges with accessing client clearing service and face high clearing costs. Some clients may have difficulties with maintaining and posting appropriate collateral with CCPs in a cleared pool.

2. Do you agree or disagree with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear? Is the consultative report's characterisation of distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?

Yes, we agree. Overall incentives to clear are strong. However, for smaller clients the upfront and ongoing back office costs as well as potential minimum fees relating to accessing central clearing service create a disincentive to clear.

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3. Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In such cases, are there specific aspects of the requirements that diminish incentives to clear?

Yes, but margin requirements for uncleared derivatives are not the only incentive (others are better pricing, better liquidity, standardisation etc.).

The question around interaction of margin requirements with mandatory clearing is unclear – there is no choice for market participants here.

M&G Prudential supports central clearing because it is designed to increase liquidity and reduce counterparty exposure. However, the benefits and considerations relating to central clearing vary depending on the client type. Some of our fund managers would prefer all instruments to be clearable (either voluntarily or as part of a mandate) including futures, swaps, CDS, and one day even FX.

However other fund manager expressed a view that the expansion of the instrument scope for central clearing must be thought through very carefully. Many clients, such as pension schemes, are not in a position to post collateral for instruments such as FX. Where they centrally clear there is a cost associated with it (account costs and cash collateral drag). Where they do not clear there is a cost due to the loss of potential performance. The benefit to markets (and the knock-on effect to the real economy) of maintaining 'frictionless' hedging should not be underestimated. The ability to benefit from international investment relies on the ability to hedge out risk at minimal cost (transaction and collateral).

M&G Prudential observed recently that, in addition to instruments subject to the FSB analysis, inflation swaps market was characterised by a significant pricing differential between bilateral and cleared pools.

A requirement for small corporates to post margin in a cleared environment acts as a disincentive to clear.

4. The consultative report seeks to identify the most important regulatory and non-regulatory factors which affect incentives to centrally clear OTC derivatives for dealers, other financial intermediaries, large clients and small clients. Please identify any significant missing factors and comment on the relative strength of regulatory and non-regulatory factors discussed in the consultative report.

Factors affecting incentives to centrally clear are: price differential (better pricing in cleared liquidity pool), liquidity (more depth in the cleared pool), standardisation (higher for cleared trades), operational ease (higher for cleared trades), more transparency (for cleared pool), predictability of lifecycle (for cleared trades). Factors reducing incentives to clear are: one sided documentation for cleared trades which in practice cannot be negotiated by buy-side, narrow eligible collateral set permitted to be posted with CCPs in respect of margin requirements on cleared portfolios[1],

[1] The need to maintain a pool of eligible collateral in portfolios that are not designed to hold such instruments (high yield funds, or private/illiquid asset funds) can be a significant drag on performance and impose constraints on investments. Indeed, many of UK pension schemes, which are heavy users of derivatives to manage their liabilities, do not want to hold cash collateral as this imposes a significant drag on returns.

constraints on client clearing providers to offer client clearing which are passed on to clients. If the clearing providers are offered incentives to offer the service or extend their offering to a larger group of clients, and these incentives are passed on to clients this would create a very strong incentive to clear (clients who clear already would clear more and clients who don't currently clear may decide to start clearing). In addition, although clearing reduces counterparty risk, pro-cyclicality of the collateral mechanism is a concern and a factor reducing incentives to clear. When volatility rises so does the requirement to post collateral – which may be hard to find in the 'more volatile' environment or exacerbate the volatile environment.

5. Is the consultative report's characterisation of the shift of activity and trading liquidity towards centrally cleared products, and the consequent impact on uncleared products, consistent or inconsistent with your experience?

Yes, it is consistent.

6. There are various industry efforts underway to reduce the cost of clearing, including portfolio compression and direct clearing membership models. Based on your experience are these proposals, or other forthcoming changes to clearing infrastructure and models, likely to affect incentives to provide or use clearing services?

Yes, these changes are likely to positively affect incentives to provide or use clearing services. If it was easier for clearing service providers to offer the service, more clients would centrally clear their OTC derivative activity and they would clear larger proportions of their portfolios. Direct access would also provide another avenue to access clearing for firms which can accept this level of risk and have sufficient expertise and capacity to manage it.

7. Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear? a. central clearing mandates (both in terms of product scope and entity scope); b. minimum standards for margin requirements for uncleared derivatives; c. capital requirements for credit valuation adjustment (CVA) risk; d. capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM)); e. G-SIB requirements; and f. The leverage ratio.

a. incentive. b. incentive however clients are constrained by dealers' restrictions with respect to collateral (agreements with dealers are stricter than minimum regulatory standards, dealers have ability to dictate terms to clients). c. incentive. d. incentive. e. disincentive. F. disincentive.

8. Do you agree or disagree with the consultative report's characterisation of the impact of these reforms on the incentives to provide client clearing services?

Yes, we agree.

9. Are there any areas where potential policy adjustments should be considered which would enhance the incentives for or access to central clearing of OTC derivatives, or the incentives to provide client clearing services?

No, it would be helpful if there were minimal policy changes or adjustments so that the reforms can be bedded in and market participants have time to adjust to them.

10. Do you agree or disagree with the report's characterisation of the difficulties some clients, especially clients with smaller or more directional derivatives activity, face in: a. accessing clearing arrangements; and b. conducting trading and/or hedging activity given the restrictions imposed by their client clearing service providers?

Yes, we agree. When portfolios are directional clients do not benefit anyway as there is no margin offset.

11. Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks? Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?

Yes, we agree. At a time of market stress if one large clearing service provider defaults it is highly unlikely that the remaining clearing providers would be able to accept ported positions from all clients of a defaulted clearing provider. Having a back-up clearing service provider may not guarantee ability to port at times of market stress. In addition, CCPs are points of concentration of systemic risk. We are concerned about CCP's ability to haircut client margin under the CCP recovery and resolution framework and pro-cyclicality of the margin requirements.

12. Do you agree or disagree with the report's characterisation of the incentive effects created by up-front and ongoing fixed costs of: a. using clearing services? b. providing client clearing services?

Yes, we agree.

13. In light of the finding in this report that economic factors generally incentivise central clearing for certain market participants but perhaps not for others, please describe your views regarding the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.

Please see a response to question 3.

14. Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing? Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please elaborate.

In our view OTC derivatives market should be heading towards becoming as similar as possible to the ETD market. The benefits are: better pricing and liquidity, standardised product, ease of access, clear and transparent margin requirements, no extra constraints, transparency of cost, standardisation of the lifecycle, reduction in counterparty credit risk. A universal clearing mandate for all market participants might not be the best solution but we strongly support incentives to centrally clear.

We also support that OTC derivatives market universally collateralises its exposure at the end of the day.