NEX Group Response to the FSB DAT report

Incentives to centrally clear over-the-counter (OTC) derivatives
A post-implementation evaluation of the effects of the G20 financial regulatory reforms
(the Report)

Background to NEX Group and our response

The following introduction to NEX Group highlights the multiple ways that the company interacts with the clearing environment, despite not having a clearing house within the Group. Focussing on the Optimisation side, NEX is a connector and enabler for clearing, as well as a reducer of risk via numerous post trade risk reduction services (compression, being only one of these). These entities form a key role in the transaction lifecycle and can assist with promoting incentives to central clearing. However, inhibitors to these types of activities, performed by many companies globally, also disincentivise clearing. Our answers therefore do not all fit naturally within questions asked, and so have been collected together under questions 6, 9 and 10.

NEX

Ranging from pre-execution credit checking to multilateral portfolio compression, our purpose is to simplify our clients' workflow and help them optimise their resources. NEX Optimisation is an integrated team of financial markets and pioneering financial technology specialists who operate in all asset classes, geographies and business sectors across the financial markets. NEX Optimisation is dedicated to mitigating risk, increasing efficiency, reducing costs and streamlining increasingly complex processes for our clients.

TriOptima

TriOptima offers post-trade risk reduction (PTRR) services in the OTC derivatives markets. The company's client base is made up of major broker/dealer banks and other financial institutions globally.

TriOptima offers PTRR services for the OTC markets such as:

- triReduce: a service for early termination of OTC derivatives - so called portfolio compression;
- triBalance: a service for the mitigation of portfolio risk imbalances across bilateral and cleared OTC derivative exposures/netting sets.

Traiana

Traiana enables global market participants to automate cross-asset risk management and pre/post-trade processing, for both listed and over the counter transactions. We solve the complex problems facing both the markets and individual organisations in a creative way, so firms can implement the most cost-effective solution.

Reset

Reset provides sophisticated and bespoke risk mitigation solutions for banks and dealers to efficiently offset and manage various types of basis risk to their trading portfolios. We focus on the second order risks that result from the structure of the instruments traded or the build-up of imbalanced exposures over time. Reset provides its post trade risk reduction service on a cyclical basis in multiple underlying asset classes. Reset establish mid-market consensus price curves to be used by all participants and users submit portfolio risk exposures they wish to reduce together with individual matching criteria. From the collected pooled liquidity and criteria the Reset engine identifies large scale multilateral packages of transactions for each user which will reduce or remove their underlying risk positions. Reset services clients globally but is headquartered in Singapore.

Questions for public consultation

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?

Compression is complementary to clearing. As a post trade service, compression does not influence the costs of clearing a trade. The ability to regularly reduce the gross notional and line items of a cleared portfolio in a CCP serves to encourage clearing.

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?

Post-trade risk reduction services, such as triReduce and Reset reduce secondary risks in existing OTC derivatives portfolios, without changing the market risk of the portfolios. They are always designed: (a) to be market risk neutral for each participant within its tolerances (b) to reduce secondary risks emerging from existing derivatives transactions, such as counterparty credit risk, operational risk and/or basis risk; and (c) as cycle-based, with two or more participants and must be accepted in full by all participants or its component transactions will not be executed at all. Currently however this risk reduction is limited due to misclassification of administrative non-trading transactions as trading.

In the EU, under EMIR Refit it has been proposed that administrative transactions arising from PTRR services such as portfolio compression should not be subject to the clearing obligation. US regulators are also reviewing, most recently under the auspices of the SEF rule re-write, whether to recognise PTRRs as an overall category and possibly exempt them horizontally from certain requirements, such as the clearing obligation, in a similar way to the EU approach.

Without the exemption PTRR services have developed ways to reduce risks using products outside of the clearing obligations. However, these are complex and may disincentivise some firms from reducing their risks. It would be preferable for firms to be able to manage their portfolios and reduce their risks using vanilla products that are or may become mandated to be cleared.

It should be made very clear that carving PTRRS out of the clearing and execution rules is not exempting a transaction from clearing which today is cleared. All price forming transactions arising from trading activity which are today subject to the clearing obligation would remain subject to the clearing obligation in future.

The PTRRS waiver would only apply to 'new administrative transactions' arising from post trade risk reduction activities to reduce secondary order risks (e.g. operational and counterparty risks). In addition to being market risk neutral and non-price forming, a condition of undertaking the activity is that it reduces systemic risk in existing derivatives portfolios, which of course would be subject to regulatory approval.

It is also important to recall that CCPs have counterparty risks themselves. CCPs can measure these counterparty risk exposures and achieve the best possible risk mitigation (through margining policies), but they cannot eliminate the counterparty risks. PTRRS can help the CCPs to reduce this net overall counterparty risk exposure to their clearing members.

In March 2013, the CFTC No-Action Relief from Required Clearing for Swaps Resulting from Multilateral Portfolio Compression Exercises was issued to promote the benefits of compression for uncleared swaps. Such relief has proved extremely important in the industry's ability to continue to use compression to meet the risk reducing objectives set forth in Pittsburgh in 2009.

https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/13-01.pdf

Access

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?

We agree that there are difficulties for clients accessing clearing, however the reasons can be characterised as structural rather than being driven by the client clearing service provider's imposing constraints on their clients:

Risks: As documented in the report, client clearing service providers may be incentivised to reducing their exposure to smaller clients, or certain asset classes in order to improve institutional resilience.

Technical: Organic evolution of the end-to-end clearing infrastructure has led to a fragmented and somewhat costly environment which underpins the clearing workflow, this implies a higher cost per ticket for the service providers and all participants in the chain.

Operational: The proliferation of CCPs, ever expanding number of execution liquidity pool and additional clearable products has implied constant change and evolution for client clearing service providers which has led to a focus on targeted high-end clients. Those firms outside this elite group have not benefited from clearing.

The clearing industry will over the next 3 to 5 years transition towards a long-term target operating model that will enable cost efficiencies and enhanced services for all client segments. We believe that companies such as Traiana are able to assist many firms in achieving these goals and therefore provides an incentive to clearing for all participants.

In order to support the growth in cross-asset OTC clearing due to the impact of both direct clearing mandates and the indirect impact of wider regulatory and industry reform including the DFA, MiFIR, UMR and the FX global code of conduct, Traiana have launched and manage two core services.

Our cross-asset pre-Trade/Post-Trade risk management service has been designed to meet the limit management requirements of regulated trading venues for both CFTC 1.73/1.74 and MiFIR RTS 26 technical standards. The service, Traiana LimitHub, has been adopted by all SEFs and MTFs that are offering instruments mandated for trading and clearing and provides connectivity to all FCMs/CMs providing client clearing services to CCPs. The service is also being adopted for instruments cleared on a voluntary basis, where there is no clearing mandate, in order for banks to manage their global client risk centrally using the same operational procedures e.g. FX globally and venue executed IRS/CDS outside of the US and Europe. Traiana worked closely with regulators in both the US and Europe during their respective legislative processes.

The limit monitoring service works in conjunction with Traiana's CCP connectivity service, Traiana Clearing Hub, for the management of messaging and workflows between OTC CCPs and clearing participants including SEFs/MTFs, dealers, clients and client clearing members. The CCP connectivity service simplifies the effort required to establish and maintain connectivity across multiple CCPs and supports all messaging associated with pre-novation, novation and post-novation clearing events including the initial back-loading of trades for new clearing members and the messaging associated with a CCPs default management processes.