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COMPRESSSION, COMPACTION AND LINE
ITEM REDUCTION COME OF AGE

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Derivatives Intelligence and Derivatives Week recently made some exciting changes.

We are now part of a new website. In case you hadn’t heard, we just wanted to be clear about what’s new.

**WHAT’S CHANGED?**

- Derivatives Intelligence and Derivatives Week have been incorporated to GlobalCapital.com
- The spirit of Derivatives Intelligence and Derivatives Week remains the same; we’ve just been enhanced
- GlobalCapital.com features responsive design and improved search functions to give you a better user experience
- GlobalCapital magazine now includes a weekly derivatives section

Our new name: GlobalCapital Derivatives
Our new home: GlobalCapital.com/Derivatives
Coverage: Credit, Equity, FX, Interest Rates, Regulation, Clearing & Exchanges. Plus people moves and market updates

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What is SLR and how is it calculated?

Since the 2008 financial crisis, global regulators and politicians have embarked on a vast overhaul of the derivatives markets in a bid to reduce systemic risk. Limits on leverage, through the supplementary leverage ratio (SLR), are the heart of the reforms, and market participants are experiencing its profoundly disruptive effects. Beth Shah reports on what SLR is and why it matters.

THE SUPPLEMENTARY leverage ratio (SLR) was introduced by the Basel Committee in 2010 and finalised in January 2014 at the international level. A major part of Basel III, it is driving banks to examine how they hold their derivatives exposures.

Mariam Rafi, head of OTC clearing for Americas at Citigroup, tells GlobalCapital that SLR is calculated as tier one capital, divided by the sum of a bank’s on-balance sheet assets and specific off-balance sheet assets, including derivatives exposures.

This means it is a capital adequacy measure that ignores the risk intensity of assets, and whether these are included in the bank’s accounting balance sheet. Banks must hold a minimum 3% tier one leverage ratio from 2018, but must report it now.

Bringing in a tough leverage ratio will tend to increase the risk intensity of bank balance sheets.

Oliver Ireland, partner at Morrison & Foerster, notes that if SLR is binding on a bank it discourages firms from holding high quality and low yielding assets because they are taxed by the leverage capital charge just as high risk/high yield assets are taxed.

“So SLR is potentially going to create incentives for banks to adjust their balance sheets in order to deal with it,” says Ireland. “A bank can try to reduce its SLR or increase its yield on the assets which are subject to the SLR. It makes figuring out where to put your money significantly more complicated each time you add in an additional capital calculation that works in a different way, like the supplementary leverage ratio.”

Potential exposure

Measuring exposures is straightforward for cash instruments, but challenging for derivatives. As there is no easy or intuitive way to add up the exposure of a trade which might run for years into the future, derivative exposures in SLR are calculated as the replacement cost of the derivative, plus potential future exposure.

The last part is very difficult, but Basel rules lay out how it should work. Potential future exposure is calculated using the current exposure method (CEM): a grid-based methodology driven by the notional amount, that gives only partial offsets for netting, according to Rafi. “Under Basel III, banks must hold the greater of capital requirements as calculated under risk-based capital and non-risk based capital metrics,” Rafi says. “The current implementation of SLR requirements (using the CEM calculation) in many instances increases the capital requirements for certain business lines significantly.

“SLR requirements are also hard to control, given their non-risk based nature,” says Rafi. “CEM methodology is particularly punitive for large notional portfolios with many line items, as very little credit is given for offsetting long and short positions.”

She adds that certain asset classes, such as credit derivatives and commodities, also face large haircuts.

Banks must apply the SLR calculation to exposures created by trading as a principal, and against the client-facing leg of trades when acting as a client clearer.

Rafi says that large, internationally active banks need to maintain an SLR ratio of at least 5% at the bank holding company level, and 6% at the bank level, because global systemically important banks (G-SIBs) need a 2% buffer over the 3% minimum ratio. If a US G-SIB’s SLR falls below 5%, it will be subject to increasingly stringent restrictions on making capital distributions and discretionary bonuses.

“We have all kinds of capital requirements floating around so the question becomes which are the ratios that are going to be most binding on a bank, i.e. which one is going to be the tightest constraint given a firm’s asset liability mix,” says Ireland. “Therefore, banks may wind up adjusting their balance sheet to deal with that.”

Compression can help

As CEM is based on notional volumes, not net risk positions, compression, which reduces notional exposure, can control SLR. So banks looking to cut their SLR are turning to compression techniques to ratchet down the individual number of swap trades on their books, as well as the overall notional amount that they have outstanding.

“Compression will minimise SLR requirements for sellside, and optimise operational efficiencies for both the buyside and sellside,” Rafi says. “Accordingly, many banks are now asking clients to compress portfolios and reduce line items in order to minimise SLR requirements. Vendors and CCPs have introduced a variety of products and services to aid clients and dealers in compression portfolios, which will lead to increased operational sustainability both at buy and sellside levels.”

When a firm has fewer line items to manage, it needs less capital to meet its leverage ratio needs, but it also helps it to conduct a timely default management exercise. If a client becomes insolvent, and a bank has fewer line items exposed to that client, it is much easier to macro hedge, terminate and eliminate the risk.

“Compression will minimise SLR requirements for sellside, and optimise operational efficiencies for both the buyside and sellside”

Mariam Rafi, Citigroup
Risk Reduction Roundtable

People have been compressing and netting down their portfolios for some time using spreadsheets and voice trading. So where did these new tools which allow for compression, compaction and line item termination originate from?

Supurna VedBrat, BlackRock: In the bilateral world before clearing, we were very good about compressing our trades on a regular basis. And by compression I am talking primarily about compressing similar types of risk, you may have slightly different coupons and slightly different maturities. The idea there was that we wanted to keep our books clean and efficient, as it’s much easier to manage risk with minimum line items, as well as helping minimise operational risk. Compression has been an age-old process for us.

When the clearing mandate came to life, the regulation actually stated you are required to compress trades if you executed a certain number of swap transactions and you are a swap dealer or major market participant. What was missing — and it’s not necessarily that there has to be regulation behind it — was a regulatory push for the providers of such services to actually make it available on an optional basis to the broader community, which would include the buyside. As a result, there was no focus on providing such a service to the buyside until PTC (portfolio terminations and compactions) came along, and some of the other compression offerings started to emerge.

The buyside did not have an optimal way to compress trades, especially if you are a multifund asset manager. Our compression trades have to be an all-or-nothing compression, as you cannot have some of your line items compressed and others not.

Compression is something we need. I think now there are solutions. It is just a question of being able to connect from a technology perspective and optimisation required from the service providers.

James Wallin, AllianceBernstein: I would echo most of what Supurna said. For us, it has been something that has always been part of our rubric in the context of keeping things tidy. Historically, we would not
even necessarily call it compression, but we would call it netting because whenever we are taking exposure and then taking it off, we don’t want to leave those two trades on. And because we don’t want to burden our own systems — because that in turn burdens our clients with multiple line items — we would always go to a lot of trouble to make sure that, as we are taking off exposure, we are netting that exposure as we don’t want the financial impact of having two trades on.

And again, to the extent that the netting is available in a cleared environment, we will take advantage of it. When we manage real money mandates for clients, there are sometimes multiple sleeves, and even though for a number of a reasons those multiple sleeves will be reflected by an legal entity, we don’t want to net or compress those trades because we need orderable performance for each sleeve.

So that again is an area where the financial and the operational advantages of compression may be there, but we can’t deliver the product to our client in terms of an auditable track record if we are worried about how we would vis-à-vis the Street.

**Michael O’Brien, Eaton Vance:** The new tools for trade compression allow us to have more flexibility to manage our execution process. The use of spreadsheets and voice trading was too cumbersome and error prone to be an effective tool. The flexibility to execute smaller trades multiple times — inevitably with different coupons and maturities — and then compress those trades, without worrying about the number of portfolio line items, makes swaps trading more attractive. This feature allows us to execute smaller and more frequent trades such that they will net or compress against positions at the clearing house. It is an electronification of a process that was previously happening manually, in which buyside participants requested prices from market-making participants on lists or packages of offsetting swaps, which would then be submitted to the clearing house to net.

**VedBrat, BlackRock:** To add to that, there may be certain types of clients where you may not want to compress trades due to accounting rules etc.

**Wallin, Alliance Bernstein:** That is a very good point. For example, there are legal reasons in that insurance companies have hedge rules and every hedge has to be specifically tied to an investment. So you can’t do that if you compress away its characteristics.

**Global Capital:** How do these various compression and compaction offerings work? What do you, as providers, offer and which market participants use and benefit from your services?

**Elisabeth Kirby, Tradeweb:** Tradeweb launched our compression service in November 2013. Our platform allows buyside participants to execute lists offsetting trades such that they will net or compress against positions at the clearing house. It is an electronification of a process that was previously happening manually, in which buyside participants requested prices from market-making participants on lists or packages of offsetting swaps, which would then be submitted to the clearing house to net. Tradeweb’s offering introduces all of the benefits of electronic trading to these netting and compression exercises. These include straight through processing, submission to clearing, regulatory reporting and the ability to put multiple market-makers in competition. Shifting compression on to an electronic platform adds significant efficiency and streamlines the front-to-back workflow.

**Sunil Hirani, trueEX:** Our core product is PTC and it has kind of taken on a life of its own. It allows users to terminate what holdings they have with the [central counterparties], but you can also use it for new risk. I think prior to all the mandates, people were thinking about automation from a single line item, two line items or three line items.

What both trueEX and Tradeweb have done is to really change that paradigm because the buxside does not think in terms of one, two or three, they think in terms of end line items. So the big innovation that has occurred in 2014 is that now the buyside has access to ‘n’ line items in a portfolio that you can either terminate, offset and replace with new risk, or to do a true riskless blended compression. Now all of those offerings are available for the buyside.

There are additional things like giving access to the buyside to get on an API (application programming interface), and being able to access their positions directly at the CCP. But it all comes down to the fact that the buyside now has the ability to directly manage their positions that they have at the CCP, along with the ability to manage their uncleared positions.

**Sunil Hirani, trueEX:** So what is the difference between riskless blended compression and the other types that are available to market participants?

**Hirani, trueEX:** As Supurna mentioned earlier, normally the coupons, the dates, or anything else has to match. You can say ‘here is the set of positions I have,’ and then shop it to multiple dealers. The riskless blended compression, however, allows the buyside to say ‘here are 50 line items that I have and there are multiple pays and receives,’ and it allows them to re-coupon these positions into two line items. So if someone is doing a MAC-like swap and they are just paying and receiving, this is a way to clean up their books more efficiently.
Kirby, Tradeweb: To add to that, we currently have over 80 buyside customers using the platform and we’ve found that participation is not unique to just one segment of the customer base. We see participants from across the buyside spectrum — including asset managers, hedge funds, insurance companies, and back desks — using the compression platform in different ways. Some participants use the platform as a bespoke list trading tool to put on new risk. Some are using it to compress some positions and add new positions, and some are using it for true risk-free netting. That theme of flexibility is something Tradeweb looks to offer across our markets and that manifests itself in the way that different participants choose to use these tools.

Vikash Rughani, TriOptima: Our triReduce service offers what we call post-trade multilateral risk constrained compression. That differs in a couple of ways to what we’ve just talked about.

Firstly, it is purely a post-trade service, so there is no trade execution as part of the compression exercise. So what we do is take existing portfolios of cleared trades (of course, we can do this for non-cleared trades as well) and we identify packages of trades that fit within certain risk-based parameters. So again that means that the maturity dates and coupons don’t have to line up, but the package must still be within the market risk-based constraints that the participants of the compression exercise choose to set. It is something that we are actively rolling out for the buyside.

Traditionally, we set it up so that it is something that the dealers can tap into at the CCP, and their benefits have been more direct because of the default management process and certain efficiencies that can be gained from having a smaller portfolio. That was the motivating force in 2008 and 2009 to get this process up and running at the various CCPs. The next step really is to make sure that we offer this service to more participants, because ultimately, we have a pool of liquidity where all market participants can benefit from performing efficient compression.

VedBrat, BlackRock: There was a mention by Sunil and Elisabeth that there is an execution component to some of these offerings. We, in the bilateral, or pre-clearing, world, always considered any type of compression to be a post-trade or a maintenance-type function. So one of the components of the proposed solutions that we dislike is there is an execution component to something, where, essentially, you are not putting on new risk: you are either compressing risk or there may be a sliver of old risk that remains after the compression.

We are hoping that over the next year, as the providers keep refining this service, it will move into a post-trade type environment, because there is no reason why we should have to pay execution twice for the same risk, which is what we are doing now.

Rughani, TriOptima: I think to that point, the regulators have recognised compression as a separate category of its own. When parties report their transactions they are required to specify: ‘is it a compression trade?’

Wallin, AllianceBernstein: The challenge for some of the banks now is, because of their capital rules, it’s going to be hard for them to price these services as non-execution. That is the only complicating factor. I agree with you that a lot of it should be viewed as post-trade processing, but unfortunately I think that there may be some complications, because the dealers are the ones that are regulated in a way that might tie their hands.

VedBrat, BlackRock: Yes, but the whole reason there has been traction coming up with this solution for compression isn’t because the buyside has been asking for it for two years: it’s because the dealers and [futures commission merchants] are feeling the pressure of capital, and they need to be able to reduce or optimise risk exposure, initial margin, or gross notional with clients.

GlobalCapital: Reducing line items is important for the sellside in order to reduce gross notional, but why are these tools so important for the buyside?

VedBrat, BlackRock: Current compression offerings direct with the CCPs are very restricted, because trades have to be exactly offsetting. For example, for offsetting trades your coupon or maturity has to match and that doesn’t necessarily fit into our normal trading. I think that when MAC contracts or similar MAC-like contracts start to trade, then you will see a natural progression to using the CCP solution. Other than that, you send a portfolio and it is either voice transacted or [request-for-quote], so it’s a bit of a clunky process, but we still do it because the net benefit of keeping the line items down and being able to run clean books efficiently is very important to us from an overall risk management perspective.

Also now that clearing is over one year there may be certain fee structures that are introduced into swaps that were executed more than one year ago, so you have to keep all that in mind.

Plus the optimisation is only going to come if people are using it, even if it’s not in the most optimal way.

O’Brien, Eaton Vance: Reducing line items is important, not only for more efficient portfolio and risk management, as previously mentioned, but also...
VedBrat, BlackRock: The reason it’s so important is because of same-way or offsetting exposures is slower, more prone to error, and can result in increased execution costs; as measured by market movements between the time a decision is made on the exposure to the time the trade is executed.

The execution costs of portfolio compression today, which will hopefully reduce over time, in many cases are outweighed by the benefits of reduced transactions costs in portfolios with minimal line items.

Wallin, AllianceBernstein: Our experience is that we are focused on netting. That is really where the bulk of our activity is focused. Due to some of the clunkiness and accessibility problems, we’ve not really been focused on compressing same-way exposure.

GlobalCapital: What are the effects of compression-like tools on capital requirements and the supplementary leverage ratio (SLR)? How does it relate to Basel III and other regulation pertaining to capital requirements, such as the European Market Infrastructure Directive?

Wallin, AllianceBernstein: We are not directly concerned about it. What we are concerned about is whether those factors are being used by our counterparties as leverage to get higher fees and to resist, among other things, moving compression from a front-office expense to a back-office expense.

Hirani, trueEX: The reason it’s so important is because the banks provide liquidity to the buyside. And as they are putting on positions their gross notional increases and that has an impact on the amount of capital that they have to hold. If the banks cannot be competitive then you will see the bid/offer widen and people charging more for doing transactions.

Capital charges could hamper liquidity to be taken away from the market and these compression tools will help maintain liquidity, so that is primarily why it’s important for the market to have compression tools.

VedBrat, BlackRock: Overall, if you compress your book, your collateral requirements are also optimised.

We do receive portfolio level margin requirements, but I think if you compress there is more optimisation on collateral. And the dealers or the clearing members do have capital charges that are formulaically linked to the amount of initial margin and variation margin that they are holding on behalf of clients. So anything that the system does to optimise it without introducing additional risk — which these tools don’t introduce — helps overall.

I also think that having compressed trades is beneficial from the standpoint if ever swap transactions need to be analysed to look for any type of behavioral pattern, whether it’s market driven or not, the lower number of line items allow for a much more systematic study, as the noise is already taken out by everybody being diligent about compression.

GlobalCapital: How do these tools help with clearing fees, in addition to other costs of clearing such as margin costs?

VedBrat, BlackRock: Your fee is supposed to be reflective of a clearing member’s cost, which includes their capital charge, which is linked to the amount of margin that you have put down along with some level of profitability.

So by reducing the cost of capital, because there is a lower amount of collateral necessary, it would help us to, not necessarily reduce our fees from our current levels, but prevent them from going up. Especially as more and more clearing and some of the Basel requirements come into effect. So there is definitely a direct correlation there.

Another focus for us is if the amount of margin you have outstanding is also linked to your counterparty risk exposure. So just from a counterparty risk perspective we want to be able to optimise how much we’ve posted, whether it is to a CCP or to a clearing member. So all these things add to the benefits that you get from compression. Additionally, the SLR is linked not to risk, but to gross notional.

Hirani, trueEX: The other thing I’ve been hearing from the buyside, even though they don’t have the direct capital implications, is that some of them have to report their gross notional or margin to their investors, so they don’t want those numbers to be gigantic.

Rughani, TriOptima: To a certain extent, the fact that SLR is linked to gross notional is by design, because the regulators found that through the last crisis capital requirements were not large enough because they had become more risk-based over the 10 years prior to that, resulting in lower capital reserves. So I don’t think that is changing anytime soon.

GlobalCapital: How do CCP switch trades tie in with all this? Such as LCH-CME swaps and similar CCP position switch services?
Kirby, Tradeweb: In the last few months, we’ve started hearing a lot of talk about people looking to access the CCP switch trade type, and we rolled out functionality within our compression platform to support these trades in October 2014. The market has now begun to see a manifestation of the pricing differential between LCH and CME, and I think we will start to see this type of trade pick up even more in the coming months as that differential continues to make itself more distinct.

Hirani, trueEX: We’ve also had a lot of people talk about it. We’ve something called CCP Porter which is different to what happens in the interdealer market, where you can just pay in one CCP and receive in another CCP. As it’s currently constructed in the interdealer market, you have one position and you are paying fixed at LCH and you want to do a basis swap to recreate it at CME. So you are currently paying fixed at LCH, but then you would receive fixed at LCH and pay fixed at CME, but what would happen is you would go from one line item to having three line items because that received fix is not exactly going to be an offset. This causes you to have to look at it from a risk perspective.

Our product allows you to load up your exact portfolio and look at your positions that you want to move from one CCP to another. For that service you need an intermediary, a market-maker, or a dealer to take over the positions at the originating CCP and do the opposite set of positions with you at the other CCP. In turn, it gets rid of all the exact line items at the original CCP, which is the differentiator from other services that I’ve heard of elsewhere in the market. The same concept can be applied to profitability between FCMS.

Kirby, Tradeweb: I think that is a very valid point, and it remains to be seen whether the fact that a market-maker needs to be there to price those switches will be a significant constraining factor, and what the impact on execution cost will be for participants to have access to that type of trade.

GlobalCapital: What is the effect of these tools on collateral? How do these services open up credit lines for firms in managing counterparty credit exposure?

Wallin, AllianceBernstein: It goes back to gross notional. Anything that reduces gross notional is going to be beneficial from an operational standpoint.

VedBrat, BlackRock: From my perspective, an FCM-to-FCM swap would be a sophisticated way in which we can manage portability. So if the offering is post-trade, and I could seamlessly move my positions from one FCM to another, that would be a very useful post-trade tool to have.

Rughani, TriOptima: There is a post-trade way to what we call “risk rebalance your net positions”, and it can be at different FCMS or different CCPs as well.

Something that regulators are now starting to talk more about is CCP recovery and what happens again in that default scenario. Most CCPs have a default management process that requires them to bring traders from the dealer community in house to hedge out large exposures on these defaulted portfolios, in order to get them to a relatively risk-neutral state, where the CCP feels it can afford to run that portfolio for a couple of days before entering into the auction process.

Now, if you have these unbalanced positions at different CCPs or FCMS that risk needs to be hedged in that default management situation. We now have so many CCPs across the world, if they all have a similar default management process it’s really untenable.

So one of the things we are discussing is having a mechanism on a proactive, periodic and ongoing basis to manage down any extreme net exposures where you might be long in one CCP and short in another, or long with one FCM and short with another.

VedBrat, BlackRock: We would be concerned if an FCM had an imbalance in risk from one CCP to another and we were told you have to move your positions from one CCP to another.

We look at multiple factors when we choose to execute a particular swap, including which CCP it will clear at. At the time of execution we ask for a price execution and the number of trades that you’d execute to unwind and re-establish risk is probably going to outweigh any type of benefit that the switch may provide.
for a particular CCP swap, so it’s an educated decision at the time of trade which CCP you are taking on as counterparty risk.

**Rughani, TriOptima:** This sort of mechanism would allow you to post-trade move risk between different CCPs at a single FCM. But potentially if you can support it, then it should be possible to support risk being moved across different FCMs as well, providing that the FCM can check for credit limits.

**Hirani, trueEX:** Moving across FCMs at the same CCP can happen post-trade. However, moving across different CCPs then becomes execution. I think the headline is that these tools are available, but I think there is still a lot of talk particularly about the CCP and FCM porting and feasibility, but it will be important for the marketplace to have these tools.

**Wallin, AllianceBernstein:** If you go back to what we were facing vis-à-vis our clients’ concerns back in 2008, when certain dealers were rumored to be having troubles after certain other dealers did have trouble, having that ability to manage risk prospectively could even forestall a crisis, in terms of allowing people to move positions away from weaker dealers ahead of any big market crash.

**GlobalCapital:** How do clients accessing your compression, compaction and termination tools and platforms? How do you offer connectivity, and which is most suitable for different market participants, whether they are sellside or buyside?

**Kirby, Tradeweb:** The Tradeweb compression tool can be utilised by any direct or indirect members of the swap execution facility, as we offer direct SEF participation as well as agency access.

Accessing and populating the compression tool itself can be done in a number of ways. A participant can paste lists of swaps directly into the Tradeweb screens from an Excel spreadsheet. Or historical swap details can be imported directly from the Tradeweb blotter into the compression ticket.

Bespoke swaps may be built into our compression ticket, which is something that participants have found especially attractive for flexible list trading, as opposed to the pure compression element.

We also offer API connectivity, so participants using proprietary or third-party order management systems (OMS) can feed orders directly into our compression ticket via FIX, and we are also working with third parties, CCPs and middleware providers to link up for the purpose of extracting trade information from those third parties.

We have endeavoured to offer buyside participants any means that they prefer to put those risk positions into our ticket for the purpose of executing a list of offsets or a new custom list.

**VedBrat, BlackRock:** An important element for us is that there is true STP via an API etc, because when you are dealing with compression you are dealing with real executed trades and you don’t want to introduce any type of unintended operational risk. So it’s essential that the existing swap information is exactly what our books and records reflect. Otherwise with manual intervention or spreadsheet solutions you can end up with data integrity problems.

**Hirani, trueEX:** The buyside can connect to trueEX via an API that they have or an OMS that can be hooked up to their current systems. Most people want to directly connect from the OMS, so they can also query their database directly at the CCPs. There are some idiosyncratic issues at the CCPs, so for those reasons we provide buyside direct access. But the significant majority of the buyside wants to originate the trades from their OMS, whether via an API or a spreadsheet.

**Rughani, TriOptima:** With multilateral compression the biggest difference is that it requires more than one single client. It requires a multilateral network of participants, so for that reason we’ve set up scheduled compression events market-wide. and what we’ve been doing in recent months is working closely with clearing brokers and FCMs to enable them to provide those facilities to their clients in the short term.
In the medium term we’re engaging with buy-side participants to offer them the risk-constrained compression mechanism directly.

VedBrat, BlackRock: The way we are structured to manage counterparty risk and credit limits, each fund may have multiple clearing. So one of the components that we’ve spoken to trueEX and Tradeweb about is to look across FCMs for each CCP. Looking at only one FCM is only a piece of our portfolio. Solutions that actually allow us to either look at our own books and records or positions at a CCP are much more optimal. I believe most asset managers are structured in a similar style, and given the constraints in general with credit limits there’s a chance we’ll see a trend where clients have more than one FCM for an account.

GlobalCapital: How do you expect these tools to evolve as the trading landscape changes?

VedBrat, BlackRock: I think there is enough regulation in the system where the need for these tools is felt by the market, so I don’t think you need a specific regulation stating that you have to compress all your trades. If build-up of line items are not managed there is an actual force in the market to make these tools work due to the capital requirements in addition to any type of increase in fee structure.

Right now it’s more a question of having the resources to be able to develop on the provider side, and then link to the various market participants. If we could schedule the time of day where compression takes place on a post-trade basis, requiring no additional collateral, and it was an efficient and automated process, that would be an ideal solution. But there has been a lot progress made. A year ago, I don’t think we could have had this meeting.

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Rughani, TriOptima: Our goal in 2015 is to get as many appropriate buyside institutions on our platform as possible. There are differences between compression offerings. There are certain buyside institutions for whom it’s not relevant because of the way they trade, but any buysider that’s typically trading a five year or a 10 year on any given day will see value in this sort of compression where they don’t have to put on like-for-like cashflow matching swaps.

Our other aim is the risk rebalancing service and the huge systemic benefits it will bring the industry and the global financial system.

Kirby, Tradeweb: I think we will see a continued ramping up of the activity that we’ve seen in the past 12 months. We have transacted over $650bn through our compression tool and we’ve more than 80 buyside customers using it, and I expect that trend to continue.

I think that using these types of platforms as flexible list trading tools is something that is undeniably attractive to the buyside, and as customers get increasingly comfortable with list trading, they’ll continue to use it even more. Some of the other things that are happening in the industry around the topic of compression — e.g. the processes that the CCPs are introducing around blended rate compression — may become increasingly important, if we assume that some proportion of the market is going to start moving towards central limit order book-style execution.

A big open question in the marketplace continues to be average pricing for CLOB execution, and currently it seems as though downstream solutions, such as those being pursued by the CCPs, will be most readily available to participants in the near term.

Hirani, trueEX: I think it’s about scaling and getting it out into a broader universe of buyside clients. I think it’s also about getting people to use the functionality that has been built over the last couple of quarters. That is one portion of it. Some of the post-trade services have come out of PTC as well, for example bunched order allocations. And so the next big thing is going to be taking the approach that we took for bunched order allocations — which, in essence, is just debiting and crediting accounts — taking that approach and applying that to average pricing.

I think that it already exists, but more work needs to be done to really get it out into the marketplace and hook it up with other systems. TrueEX processes over $4tr over the PTC and post-trade services platform, so we already know that it exists and that it works very well.
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Netting tools tipped to spike as EU plays regulatory catch-up

The US has raced ahead of Europe and the rest of the world in implementing derivatives regulation since the global financial crisis in 2008. So it will come as no surprise that US buy and sellers are also ahead in implementing compression and similar tools to tidy up their balance sheets. However, Europe is not far behind, as Hazel Sheffield reports.

ELISABETH KIRBY, director of rates strategy at Tradeweb, says that while her firm offers the same service with the same rules in the US and Europe, the delayed regulatory framework in Europe means she still sees market participants using spreadsheets or voice trading for compression.

Meanwhile, in the US, customers have dedicated resources to technological development. Many of them have a seamless workflow from execution to the clearing house that allows them to take advantage of electronic compression.

“European clients are beginning to compress more trades electronically, but the US has seen quicker, more robust adoption due to the relative maturity of the centrally cleared swap market,” she says. “We’re already seeing an increase in appetite from European customers, resulting from the European regulatory timeline and increasing numbers of European customers getting ready for and adopting clearing.”

After mandatory clearing took effect in the US in September 2013, counterparties started to wake up to the benefits of other services offered to them at the clearing house, such as compression and tools that allow them to net down their portfolios.

Clearing itself has helped market participants reduce operational risk by reducing the number of counterparties a broker dealer faces, so that they just face the clearing house, but counterparties still have the same number of line items to reconcile. Hanging on to trades at the clearing house after they are completed can incur maintenance fees, especially for trades with longer dated maturities, stretching out 30 or 40 years.

“Generally, we now clear substantially more of our market volume than we did in the past, which has led to large number of trades in the clearing house, many offsetting each other,” says Bill Stenning, managing director of clearing, regulatory and strategic affairs at Société Générale in London. “From an operational standpoint, rather than having these trades that don’t add any value, it’s good to remove them.”

Kirby adds that as traders in Europe start to clear swaps and realise the cost of holding line items within the clearing house, minimising line item exposure will become a priority.

In Europe, clearing for interest rate swaps does not become mandatory until this summer, but market participants expect that the take-up of compression services, line item reduction tools and netting cannot be far behind its implementation.

Compression is mentioned under the European Market Infrastructure Regulation (EMIR). The text excludes compression portfolios from any actual requirement to be completed on an organised trading facility (or, as they are known in the US, a swap execution facility). According to the text, compression can be provided by clearing houses, trade repositories, investment firms or market operators, even when those facilities are not subject to clearing and reporting rules under EMIR. EMIR clearly states that while it is appropriate to make specific provisions for portfolio compression, the regulation is not intended to prevent the use of other post-trade risk reduction services.

Despite the fact clearing is not yet mandated in Europe, many market participants in Europe are already clearing, or at least prepared to clear, because of relationships with US counterparties or in a bid to get ahead of the pack in implementing the mandate. Once the regulation is in place, many market participants will have renewed impetus to build relationships with clearing houses that can offer them compression.

“European counterparties will soon have little choice but to allocate the resources to electronic trading to clear, and as clearing becomes an accepted part of trading it will drive standardisation of the over-the-counter swaps market, which will make it easier for trades to be netted, compressed, or netted down and compressed.

The word spreads

Cameron Goh, head of clearing solutions at LCH.Clearnet in London, tells GlobalCapital that they have been talking to buy-siders in Europe about the benefits of clearing for three or four years now. However, recently he has noticed a trend for regional banks joining the clearing house specifically to take advantage of the benefits of compression. He gives the example of a recent conversation he had with a trader at a regional bank in Germany who said he needed to compress through clearing, because the cost of doing it bilaterally was not sustainable.

This feeds into trading itself, as Goh notes that we could soon be living in a world where counterparties will trade fewer products that cannot be cleared and compressed.

“From discussion with most of the major dealers, every single one of them is excited about compression,” Goh says. “They had previ-
The derivatives portfolio clean-up

Europe January 2015

The clients who (delink sides of a trade) the most are generally the ones who put through the largest number of trades on a daily basis

Jack Callahan, CME Group

As the regulatory impetus for implementing compression differs between the buy and sellside, so too does the timeline European market participants are following for getting on board.

On the sellside, the Basel III leverage ratio, calculated as capital measure divided by exposure measure, means that global financial entities have had to report that their leverage is no more than 3% of their balance sheet since the beginning of 2013.

In the US, global systemically important banks (G-SIBS) are required to hold a higher supplementary leverage ratio (SLR) of 5%, and all banks are now required to disclose their SLRs. Meanwhile, the Bank of England expects big UK banks to hold capital equal to 4.05% of their assets from 2019 — up from the 3% expected under Basel III, but 0.9% shy of 5%, so that this buffer can be added to squash excessive lending in times of stress.

Under the leverage ratio rules, banks have renewed impetus to lower their gross notional exposure. “We’ve been using compression for several years,” Stenning says. “The regulatory changes have driven the uptake faster, particularly with leverage ratio calculations being sensitive to gross notional exposure, but they were being taken up before that.”

“With proposed leverage ratios, taking trades off the books becomes very important,” says Gavin Dixon, global co-head of fixed income clearing at BNP Paribas in London. “Banks have been doing compression for some years driven by balance sheet management and risk-weighted assets. Over the last 12 months or so, with draft rules on the leverage ratio, banks are doing as much as possible.”

Goh adds that the FCA has asked to start seeing reports stating that banks are meeting their leverage ratio requirements, with a view to making them public documents visible in financial statements. “The US banks are pushing compression because they have an SLR requirement,” he says. “But most of the banks in the eurozone are also under similar pressures.”

“We’re certainly seeing a bigger push from US and UK-based banks given the proposed leverage ratio number is higher,” adds Dixon at BNP Paribas. “However it’s equally a problem for European banks.”

These economic benefits differ between buy and sellside, however. Kirby at Tradeweb adds that she expects the sellside and buyside would continue to use compression in different ways in Europe. “We expect to continue seeing the sellside and the buyside compress risk in separate spheres, as there is a different manner in which the compression exercises occur,” she says.

Last September, LCH worked out an algorithm to delink two sides of a swap so that the two sides of a trade could be compressed separately.

“The clients who have used this the most are generally the ones who put through the largest number of trades on a daily basis, and those who have migrated to trading swaps with standardised dates but different coupons rather than a standardised coupon, as those two trading styles generate a large number of trades eligible for blending,” says Jack Callahan, OTC product specialist at CME Group.

Goh says LCH has 100 sellside members and that the number of buysiders choosing to clear is increasing all the time. Some of the bigger European hedge funds have decided to clear before EMIR, even though they weren’t mandated to. Pension funds and liability driven institutions are holding off so far because they operate under a clearing waiver. “They are quite big users of swaps and we are hoping they will get on board before the mandate because there are real economic benefits,” he says.

The timelines might be different, but the end result is the same: compression and line item reduction tools are here to stay in Europe as a changing regulatory environment brings the habits of European market participants more in line with their US counterparts. ▲
Standardisation is the solution to post-trade efficiency

The process of minimising line items in a portfolio has been a driving force behind trade compression and termination tools, but whether or not it is the ideal solution has been questioned by some market participants. Gabriel Suprise investigates.

While the use of compression has spiked among derivatives participants in a bid to reduce line items, the viability of compressing positions seems to fall short of achieving intended goals for some participants, according to Isaac Chang, global head of fixed income at KCG Holdings. "The idea that I trade a 10 year swap today and it’s different than a 10 year swap tomorrow, and it’s different than a 10 year swap the day after is part of the problem compression is trying to solve," he explains. “The current structure makes no sense because you have a vanilla swap where every trade in the 10 year is a different rate and then you wind up with many different line items and different instruments. Compression tries to simplify that process, which is admirable and a good goal, but rather than do that, what you should actually do is change the instrument that you trade.”

Changing instruments
In lieu of trading vanilla swaps with different rates or maturities, simplifying the process through using a standardised product may be a more practical alternative to compression. "You’re taking a weird instrument which is the current benchmark vanilla 10 year swap rate, and then you’re trying to simplify the post-trade process, when in fact I’d argue that you should just trade a different product, something along the lines of a standardised MAC swap, which very naturally lends itself to a net single position at the end of every day," Chang says. He adds that this would work well given income derivatives at the Vanguard Group, also notes that MAC swaps make moving in and out of positions within a given timeframe much easier, as well as mitigating the number of line items from which swaps positions can be ascertained. MAC swaps have pre-determined, standardised terms which begin on the International Monetary Market dates. The standardised nature of such swaps allows for greater initial margin and line item efficiencies for market participants. "Our portfolios are not collateral-constrained and we use a sophisticated and robust portfolio management system," he says. "Hence we don’t have the same problem with having multiple line items. That being said, we use MAC swaps as an alternative to swaps compression. I believe that standardisation is the way out of having multiple line items. The day after you trade benchmark swaps, they are no longer available to trade on swap execution facility (SEFs). The ability to trade in and out of a swap over one whole quarter is the one of the main attraction of MAC swaps.”

Portfolio management is key
The viability of a firm’s portfolio management processing and reconciliation is also a key component in determining the utility of a compression or compaction service. "Using compression services or compaction services will involve working with a SEF that offers such services potentially in conjunction with the clearing houses," Priyadarshi adds. "People don’t need a SEF compaction service if they have a good portfolio management system, as then they can do it themselves.”

Trading on swaps execution facilities has become a litmus test of sorts regarding the per-trade compression feasibility for firms, so if a firm operates with a large volume of trades and a cost-effective service, then it make sense to operate with compression services, Chang says. “To the extent that compression is a central utility and is priced as a service so that SEFs can gain volume then that’s great, but to the extent that people are going to use it and try and drive revenue, that will be a significant friction,” he adds. “My guess is that people are going to want to build compression capability for free; right now it does seem like the cost of compression is low relative to other parts of the trading process.”

However, Chang is optimistic that standardisation will become the norm: “There is a lot of resistance to change because of inertia: people are used to doing things the way they’re used to doing them, but over time it will be a capital and transparency issue. “If you have an instrument that is very easy to put in an order book that increases price transparency and efficiency of trading, my belief is that over time, that will win out,” Chang says, “especially once you factor in the capital reduction and operational simplification from having only one position, rather than many line items that need to be compressed.” ▲
Portfolio Compression Takes the Spotlight

By Susan Hinko, head of industry relations and Vikash Rughani, business manager at TriOptima

Innovation, creativity and adaptability have characterised the over-the-counter derivatives industry since the first interest rate swap was executed between IBM and the World Bank in 1981. As the market for OTC derivatives grew, the need for better post-trade management also emerged, and TriOptima’s multilateral early termination service, triReduce was an early leader in addressing that need.

Compression is in the news these days, fuelled by the impending Basel III leverage ratios and by steep capital charges and margin requirements for OTC derivative transactions. Since the enactment of Dodd-Frank legislation in the US and the European Market Infrastructure Regulation in Europe, the regulatory authorities have emphasized the importance of compression in reducing notional principal exposure for individual institutions and for the clearinghouses. And they have required periodic assessments of compression opportunities, putting the industry on notice that compression is a critical risk management activity.

Understanding the Compression Landscape
Compression is now shorthand for many new initiatives that seek to reduce notional exposure with execution or after execution, in the clearinghouse. The tendency to identify all these recent activities as compression has created confusion in the market, in the regulatory community and in the press. While many of these new approaches are effective, multilateral risk-free compression is the most comprehensive compression solution with the most flexibility and the broadest reach. The characteristics of each approach are discussed below.

• Execution driven, cleared (compaction),
• Post-trade bilaterally uncleared,
• Post-trade in a clearinghouse (netting, coupon blending, multilateral risk-constrained compression), or
• Post-trade uncleared multilateral risk-constrained compression.

• Compaction: Execution Driven Cleared
Clearing eliminated the popular buyside custom of novating/assigning away trades to sellside institutions in order to reduce their portfolios. In place of novation, compaction developed. Compaction is offered on execution platforms enabling the buyside to enter into new swaps that mirror existing cleared trades. The process facilitates the execution of trades that are equal and offsetting for netting recognition by the CCP. The new mirrored trade is tagged to the existing one, which the CCP nets at the end of the day.
Compaction is often used by firms with swaps spread across many small unbalanced funds that do not always lend themselves easily to other forms of compression.

• Bilateral Negotiated Compression: Post-trade Uncleared
Counterparties have always been able to negotiate early termination of transactions bilaterally. Two institutions identify a trade that they both want to exit and then negotiate and agree a close-out valuation of that trade. One counterparty pays the other based on the agreed valuation and the trade is terminated. While this allows for ad hoc scheduling and some flexibility, it can be time-consuming and it can be difficult to achieve consensus on valuations and risk neutrality.

• Risk Free Netting/Coupon Blending: Post-trade Cleared
CCPs offer a simple netting process available to all members/
clients. This netting process enables individual members to offset perfectly matched trades in their own portfolios – trades with the same coupon and payment dates. Each institution can cull its cleared trades in the CCP by selecting their cleared trades for CCP netting. This type of netting only applies to one member’s portfolio and does not involve any other firm.

Coupon blending is a recent extension of the netting process. Offered by the CCPs it enables individual clearing members to combine trades with the same end date but different coupons and reduce notional by putting on a replacement trade with a smaller notional that captures any residual cashflow or mark-to-market differences of the original trades. While more effective than simple netting, coupon blending opportunities remain limited by the need for full cash flow neutrality.

- **Multilateral Risk-Constrained Compression: Post-trade Cleared and Uncleared**
  Multilateral risk-constrained compression differs from the other offerings in several respects.

  First, it includes the participation of multiple institutions submitting as many trades as possible in compression cycles. This increases the pool of trades available for termination.

  Second, by including the ability to set risk-based constraints that limit changes in risk profile, trades can be compressed that have similar but not identical payment dates. When executed within a CCP, the results leave the CCP fully cashflow neutral. Without the constraint of perfectly matched cashflows and payment dates for each participating entity, a multilateral risk constrained exercise results in significantly increased compression efficiency.

  Reflecting this increased efficiency, participants automatically compress both:
  - trades with different coupons but ending on the same maturity date **AND**
  - trades across different maturity dates within a predefined time bucket constrained by a market risk tolerance.

  Third, each participant can terminate its trades at its own mid-market valuation rather than having to agree the valuation of each compressed trade with the counterparty.

  Multilateral compression cycles run according to a schedule. Currently TriOptima offers at least two cycles in various products and locations a week and modifies or adds to the schedule as requested by its clients.

  As summarised in the chart below, the total notional eliminated by TriOptima through November 2014 reached $524 trillion. TriOptima’s **triReduce compression cycles** cover all OTC derivative trades including credit, interest rate, cross currency, and commodity products both cleared and uncleared.

  While the notionals compressed in the cleared environment are substantial, eliminating notional in uncleared interest rate swap currencies also contributes to achieving Basel III leverage ratios and reduces capital charges, credit risk and country risk. The same is true for commodity transactions and for uncleared credit default single name and index swaps.

**Getting the Most Bang for Your Compression Buck**

The increase in opportunities to reduce notional by any of the methods now offered to both sellside and buyside market participants is a positive development. However, as illustrated below in the table of TriOptima’s offerings, multilateral risk-constrained compression can also reduce notional in some of the more exotic currencies or products that typically carry higher capital charges, credit risk or country risk.

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*Planned for 2015

Always working closely with clients to introduce new services that meet their evolving needs, in 2014 TriOptima inaugurated compression in precious metals and cross currency swaps, as well as an on-demand bespoke compression service with a new focus on compressing buyside cleared trades. In 2015, inflation swaps and FX forwards compression as well as additional CCP relationships are planned in a bid to continue to reduce notional and line items; and enhance best practice risk management.

**TriOptima is an ICAP Group company.**
BASIS SWAPS

LCH-CME basis swaps take off side-by-side with PTC

LCH-CME basis swaps have been growing in frequency as dealers seek to balance exposure between one or more central counterparties, reports Beth Shah.

OVER THE PAST few months, demand for LCH-CME basis swaps — in which one counterparty pays a fixed rate on a swap cleared on LCH, Clearnet’s SwapClear versus receiving a fixed rate on a swap cleared by CME Clearing, and vice versa — has sharply increased and is beginning to represent a new market norm as dealers look to exchange central counterparty (CCP) positions in a bid to net down their margin exposure.

In June 2014, Trad-X’s CCP switch service went live for dollar interest rate swaps between CME and LCH, enabling dealers to flatten their cleared portfolios. The firm will be adding euro IRS to its suite of products this month, due to customer demand.

“We have seen an increase to do these trades not only in our auction but also within Tradition SEF utilising our hybrid [central limit order book] services,” says Dan Marcus, chief executive of Trad-X. “We have operative on Trad-X both a CME CLOB and an LCH CLOB and in January we will offer live CLOB basis trading between the two.

“When we have an open market in the SEF it will be more than just banks executing these trades,” says Marcus. “In the absence of product fungibility across CCPs we are providing an effective risk management tool, as the CCPs themselves can only offer intra-CCP margin-efficient products. So, in effect, we are assisting the compression process and therefore this is very much a complementary product to those offered within CCPs.”

Picking up
In the US, the clearing mandate requires the majority of market participants to clear their trades, as well as their customers. Such customers will be trading with banks, therefore, large positions can be built up in multiple clearing houses. From a buyside perspective, when a client executes a trade, they have the ability to tell the bank which clearing house they want to use and the bank will price accordingly; therefore, the bank has limited control over where the flow clears.

trueEX offers a CCP Porter service allowing market participants to port actual line items from one CCP to another. Sunil Hirani, chief executive of trueEX explains that a market participant can stage a portfolio into the firm’s portfolio terminations and compactions (PTC) service and then port it through an intermediary.

“trueEX’s PTC service allows market participants to optimise their margin management programme at the various CCPs,” Hirani explains. “This service could also be utilised to manage CCP and [futures commission merchant] risk in times of uncertainty.”

Hirani adds that trueEX’s PTC service differs from Trad-X in that it allows exact line item portability between CCPs and FCMs — not just the risk. “This is a more efficient way to manage gross notional and line items,” he says.

Marcus explains that Trad-X runs the auction once a week and if two parties have corresponding interests — i.e. someone wishes to sell CME and buy LCH, and another wishes to sell LCH and buy CME in the same tenor — that will cross and match up their corresponding positions. “We start off with a basis and depending on the interest each side we work up the basis,” he says. “So if we run a first auction for example at 0.25 bid on the CME side and we find that there is more interest on one side than the other our algorithm alters the basis for the next auction period.”

Sunil Hirani, TrueEX

“trueEX’s PTC service allows market participants to optimise their margin management programme at the various CCPs”

Dan Marcus, Trad-X

“We have operative on Trad-X both a CME CLOB and an LCH CLOB and in January we will offer live CLOB basis trading between the two”
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