

The benefits of trading precious metals on exchange and clearing via CCP



SETTING THE GLOBAL STANDARD

The London Metal Exchange (LME) believes that trading precious metals on exchange and clearing via central counterparty (CCP) can bring significant cost savings and operational efficiencies. With the introduction of numerous regulatory measures affecting the over the counter (OTC) market, these benefits will become increasingly compelling for market participants.

Since the financial crisis, the direction of global financial regulation has been to encourage a migration of bilaterally traded products towards centrally cleared and exchange traded venues. The G20 have committed to promote central clearing by providing economic incentives to clear via a CCP, in order to reduce systemic risk in financial markets and in support of promoting fair and transparent markets.

The London bullion market has been slow to adapt, with business continuing to be largely conducted bilaterally. Recent years have seen the closure of numerous prominent precious metals desks in London, impacting traded volumes, bid/ask spreads and liquidity. As new regulations come into force, pressure on the bilateral model and associated costs of capital are increasing. The LME recognises that OTC trading will be uneconomic for many and the justification for committing capital against bilateral credit lines will become harder.

The launch of LMEprecious in mid-2017 is intended to complement and reinforce the existing London precious metals trading market, providing a liquid, transparent precious metals futures trading and clearing venue that settles into existing loco London settlement infrastructure. LMEprecious is traded, cleared and settled in one regulatory jurisdiction, which reduces uncertainty and compliance risk. Our complete solution includes LME Clear, providing real-time clearing, and LMEwire, which enables members as well as their clients to meet their regulatory trade reporting

requirements for trading conducted on the LME. The LME therefore expects to be able to provide significant cost savings in back office processes, risk, credit management and settlement, in addition to focusing liquidity to provide best execution and a more capital efficient solution for trading precious metals.

The LME's observations on the relative effects of the current and emerging regulatory landscape on cleared and non-cleared trading include:

1. Higher capital charges for non-cleared OTC derivatives
2. Increased cost of trading for non-cleared OTC trades
3. Leverage ratio implications
4. Netting benefits from central clearing
5. Operational benefits
6. Reduced market liquidity
7. Increased transparency in the OTC market.

The LME commissioned Deloitte LLP ("Deloitte") to summarise the regulation on cleared and non-cleared trading.

The analysis by Deloitte is elaborated in further detail in the following pages.

Deloitte have summarised the key implications of regulatory requirements with regards to centrally cleared vs. non cleared trading. For the purpose of this analysis, on behalf of the LME, Deloitte have focused on the regulatory arguments for clearing which, depending on certain circumstances, either will or could result in capital, margin, netting and operational benefits. Commercial aspects were not taken into consideration as part of this analysis. There may be additional factors for each firm to consider with regard to application of each regulation to their circumstances.

The OTC market has come under the scope of a number of EU regulatory initiatives – most of which are prompted by the G20 commitments referred to above – aimed at reducing systemic risk and opacity in the market. The sections below present these requirements and their impact on derivatives activity. The following paragraphs focus only on the EU regulatory requirements and do not take into account any relevant aspects of national regulation or third country requirements.

1. Higher capital charges for non-cleared OTC derivatives

Capital Requirements Directive and Capital Requirements Regulation (CRD IV/CRR) favour centrally cleared positions over non-centrally cleared positions. Under CRD IV/CRR, non-cleared OTC trades are subject to higher capital requirements that market participants have to hold for counterparty risk.

Higher risk-weights

OTC trades which are not centrally cleared are subject to a higher risk-weightⁱ compared to those cleared through a qualifying Central Counterparty (CCP).ⁱⁱ Clearing members also incur a capital charge for their contribution to the CCP's default fund.ⁱⁱⁱ

CVA charges for non-cleared trades

Under CRD IV/CRR, certain non-cleared OTC trades will be subject to a capital charge to protect against variations in the credit valuation adjustment (CVA). Specifically, the CVA will account for the risk that the credit quality of the counterparty deteriorates. The CVA capital charge incurred by banks and those investment firms subject to the CRD IV/CRR scope when entering into an OTC trade will have a disproportionate effect on long-dated derivatives, uncollateralised exposures and low credit-rated counterparties.

Calculating the CVA capital requirement can be a complex exercise and it requires financial institutions to identify eligible hedges.

2. Increased cost of trading for non-cleared OTC trades

Higher margin requirements for non-cleared OTC trades

European Markets Infrastructure Regulation (EMIR) mandates the exchange of initial and variation margin for OTC derivative transactions not cleared through a CCP provided that certain conditions are met.^{vii} The Bank for International Settlements (BIS) has estimated that the implementation of these reforms – combined with the increased capital charges for OTC trades discussed in the previous section – has reinforced incentives to clear centrally as central clearing is cheaper than bilateral trading.^{viii} The increased cost of capital associated with non-cleared trades may incentivise market participants to clear voluntarily trades which are not subject to the clearing obligation.^{ix}

It should be noted that market participants also have to post initial and variation margin to CCPs for their cleared trades. The amount of initial margin, however, that firms subject to these requirements have to post for their non-cleared trades is expected to be higher.^x The rules provide that initial margin for non-cleared transactions can be calculated based either on a standard schedule or a bespoke initial margin model subject to specific parameters. The International Swaps and Derivatives Association (ISDA) has developed its Standard Initial Margin Model (SIMM) which most firms are intending to use to carry out their calculations and which is expected to result in higher margin requirements than the CCPs' internal models.^{xi}

There are also operational considerations associated with the implementation of the rules. In particular, firms will need to revisit their documentation ('repapering') for the exchange of initial and variation margin, increasing the complexity of documentation management.

Reduced close out period for exchange traded products

In order to safeguard against the case where collateral cannot be liquidated immediately after the default of a counterparty, it is necessary, when calculating initial margin, to take into account the expected time between the most recent exchange of collateral covering a netting set of contracts with a defaulting counterparty and when the contracts are closed out and the resulting market risk is re-hedged. This time period, which is known as the 'margin period of risk', is shorter for centrally cleared trades compared to non-cleared ones, resulting in lower margin requirements for these trades. Exchange traded derivatives transactions have an even more preferential treatment as the timeframe for the liquidation period can be reduced to one day provided that margin is recalculated on an hourly basis amongst other conditions.^{xiv}

3. Leverage ratio implications

Lower derivatives exposure for cleared trading based on shorter MPOR

The 5 versus 10 day margin period of risk (MPOR) for cleared and non-cleared derivatives respectively would result in a lower exposure at default number with regards to cleared trades as part of the denominator of leverage ratio (LR) calculation. All other elements of the denominator being equal, this will have a positive impact on the target leverage ratio.^{xv}

Client clearing exempted from leverage ratio

CRD IV/CRR currently do not confer a preferential treatment on client clearing for the leverage ratio calculation. This is, however, expected to change under the recent legislative proposal for revised regulation – CRD V/CRR II. In particular, the European Commission has proposed exempting the initial margin held for client clearing from the leverage ratio calculation for banks which act as clearing brokers. The suggested amendment – which comes as a response to banks’ reduced appetite to provide client clearing services because of the negative impact it currently has on the leverage ratio – will incentivise further central clearing as it will ease access to CCPs for smaller financial and non-financial counterparties.

4. Netting benefits from central clearing

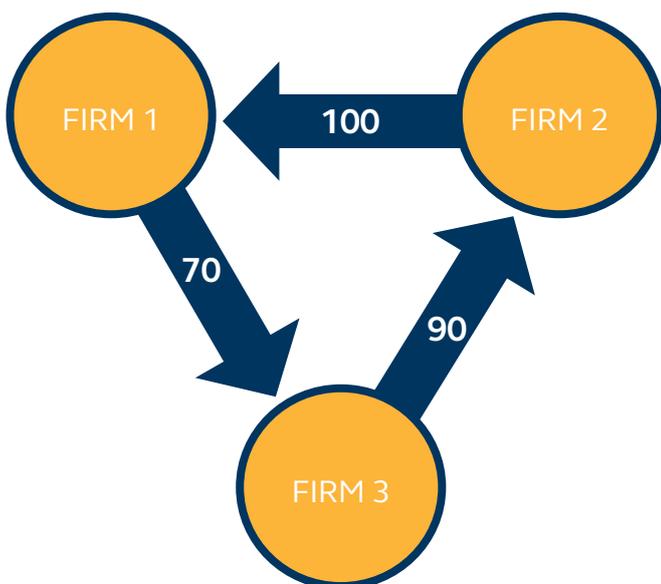
Clearing through a CCP can offer substantial multilateral netting benefits, compared to bilateral trading, as it allows market participants to offset their assets and liabilities with different counterparties against one another. This can result in reduced exposures and associated lower capital charges.

Reduced trade exposures also might result in reduced collateral that market participants have to provide to the CCP in the form of initial margin compared to the amount of initial margin they may have to post bilaterally when they face multiple counterparties. This in turn can have a funding implication, if firms have to source less collateral for their trades.

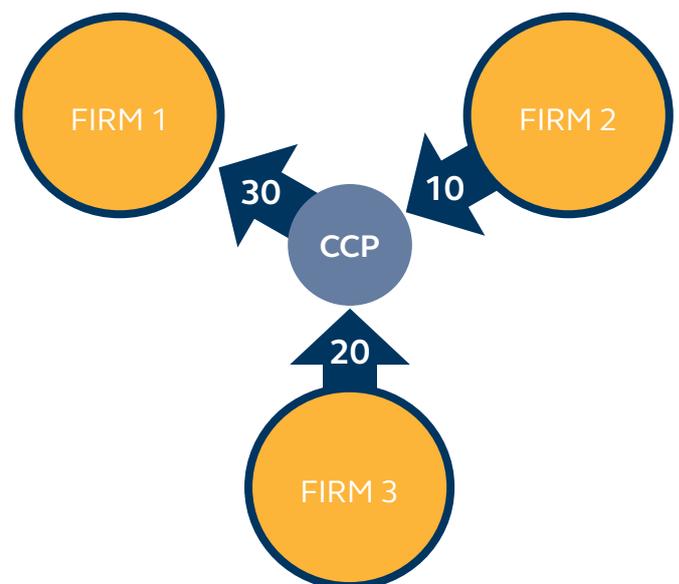
Multilateral netting benefits can be maximised where CCPs can determine participants’ margins across products (portfolio margining), allowing them to offset risk by holding positions on correlated products.

From an operational perspective, facing a CCP eases the operational burden of settling variation margin each day against a number of OTC bilateral counterparties. It also reduces the risk of margin settlement delays between bilateral trades which could be a drain on intraday cash flow.

Bilateral trading – Exposure for firm 2: 190



Clearing through a CCP – Exposure for firm 2: 10



5. Reduced market liquidity

Decline in market making

Following the introduction of higher capital requirements and liquidity requirements under CRD IV/CRR, market makers are focusing on activities requiring less capital and balance sheet capacity.^{xvi} In line with this development, banks might be incentivised to allocate less capital to their market-making activities and reduce the size of their inventories by cutting back on their holdings of less liquid (non-eligible) assets and assets with high risk-weights.^{xvii} Some observers expect this trend to have an adverse effect on market liquidity which could be offset by the increase in liquidity provided by other participants and venues.^{xviii}

Most importantly, the reforms in the OTC derivatives market are expected to shift banks' market-making activity from non- to centrally cleared derivatives as well as from OTC to exchange traded derivatives.^{xix}

6. Operational benefits

Reduced regulatory reporting burden

Under the EMIR, the details of both OTC and exchange traded derivatives have to be reported to a trade repository. EMIR, however, allows the counterparties to delegate the reporting of their contracts.^{xx} In the case of exchange traded derivatives, the operator of the exchange can report on behalf of the counterparties, reducing the operational burden for its members.

Increased compliance with best execution requirements^{xxi}

Under the Markets in Financial Instruments Directive (MiFID), market participants have to demonstrate compliance with best execution requirements, which will be strengthened under MiFID II. In relation to exchange traded transactions, it may be easier for market participants to demonstrate compliance with best execution requirements because of the available information on the prices. The scarcity of data in the OTC market, however, may pose difficulties for firms in demonstrating that they have achieved best execution.^{xxiii}

7. Increased transparency in the OTC market

MiFID II will expand the scope of the transparency regime and bring more bilateral trading on venue.

Increased pre- and post-trade transparency requirements will apply to a broader set of financial instruments, including derivatives.

Investment firms that engage in OTC trading on frequent and systematic basis will be required to register as Systematic Internalisers (SIs) once their OTC trading activities exceed pre-defined thresholds. SIs will be subject to pre- and post-trade transparency requirements, including having to make specific firm quotes available to other clients.^{xxiv}

The trading obligation will require some types of derivatives trades to be executed on trading venues aiming at reducing opacity in the market. Due to the introduction of the trading obligation, a reduction in OTC trading is expected with more trading taking place on venues. As part of a recent Deloitte survey, a number of asset management firms have reported that all-to-all trading venues can provide firms with additional source of liquidity.^{xxvii}

Regulatory timeline

Key:

Full implementation
Phase in

		2017			
		Q1	Q2	Q3	Q4
Leverage Ratio – LR	GLOBAL	From 2013 until January 2017: Testing ('parallel run') phase			
	EU				
	UK	From 2016: Binding requirement is in force for the largest UK financial institutions and additional LR buffer applies to G-SIBs			
MiFID II	EU/UK				
EMIR/IM requirements	EU/UK	February 2017: Initial margin requirements apply to phase 1 firms		September 2017: Initial margin requirements apply to phase 2 firms	
		February 2017: Variation margin requirements apply to phase 1 firms		March 2017: Variation margin requirements apply to all firms	

2018				2019				2020			
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
From 2018: Binding requirement											
				From Q1 2019: Expected to become binding requirement under the legislative proposal for CRD V/CRR II subject to political negotiations and final rules							
From January 2018: LR to apply to all PRA-regulated firms											
From Jan 2018: Entry into force											
				September 2018: Initial margin requirements apply to phase 3 firms				September 2019: Initial margin requirements apply to phase 4 firms			
September 2020: Initial margin requirements apply to all firms											

- i The risk-weight reflects the probability of default and loss given default of the counterparty. The risk-weight ranges between 20% and 150%, Article 127 CRR.
- Article 306 CRR for clearing members and Article 305 CRR for clients' exposures.
- For a clearing member, the risk weight will be:
- 0% for client trades where there is no obligation to indemnify them against losses in the event the CCP defaults (i.e. clearing member does not 'guarantee performance')
 - 2% for all other trade exposures
- A client may 'look-through' to the CCP provided that client business is segregated from the members house account at the CCP. In this case, it will apply a risk weight of either:
- 2% where the client's funds are individually segregated with its own account at the CCP;
 - 4% where they are segregated from the default of the clearing member, but pooled with other client accounts (omnibus segregation)
- ii Qualifying CCPs will need to meet the requirements laid down in EMIR or be subject to equivalent rules, in the case of a third-country CCP.
- iii Capital charges for contributions to the CCP default fund will be calculated either using the risk-sensitive 'hypothetical capital requirement' approach (Articles 307 and 308 CRR) or apply the alternative method under Article 310 CRR.
- iv It should be noted that products not traded on exchanges can be classified either as derivatives or Securities Financing Transactions (SFTs).
- v Capital Requirements Regulation, Articles 381 – 386. CRR exempts from CVA charges transactions with non-financial counterparties below the EMIR clearing thresholds and most intragroup transactions, Article 382 CRR.
- vi CRR exempts from CVA charges transactions with non-financial counterparties below the EMIR clearing thresholds and most intragroup transactions, Article 382 CRR.
- vii Commission Delegated Regulation (EU) 2016/2251. The margin requirements for non-cleared transactions apply to all financial counterparties and those non-financial counterparties that exceed the clearing thresholds provided that their aggregate three month-end average notional amount of non-centrally cleared derivatives exceeds €8 bn. The implementation of the requirements will be phased in according to the timeline provided at the end of the paper.
- BIS's paper "Regulatory reform of over-the-counter derivatives: an assessment of incentives to clear centrally" (October 2014)
- ix Commodities are not subject to the clearing obligation under EMIR and there is currently no work undertaken by ESMA for the inclusion of this asset class in the scope of the clearing obligation. This, however, might change in future.
- x The internal initial margin models should be based on a margin period of risk (MPOR) of at least 10 days, whereas the CCPs' internal margin models are based on a shorter MPOR as explained in footnote 15 below. Article 15 Commission Delegated Regulation (EU) 2016/2251.
- xi The ISDA SIMM uses a 10 day MPOR compared to CCPs' internal models which use shorter periods for cleared products as described in the section below. ISDA, Standard Initial Margin Model for Non-Cleared Derivatives, December 2013.
- xii Under the EU rule, the liquidation period for exchange traded products is either 1 day or 2 days, for cleared OTC derivatives is 5 days and for non-cleared derivatives is 10 days. Article 15 Commission Delegated Regulation (EU) 2016/2251 and ESMA Final Report on Review of Article 26 of RTS No 153/2013 with respect to MPOR for client accounts.
- xiii This is only the case for non-cleared transactions subject to the exchange of initial margin which is mandated for certain transactions under Commission Delegated Regulation (EU) 2016/2251. These requirements will be implemented on a staggered basis starting from February 2017.
- xiv Under the European Supervisory Markets Authority (ESMA) draft Regulatory Technical Standards (RTS), the one day MPOR will apply to both individual segregated accounts and gross omnibus accounts. For the conditions see ESMA Final Report on Review of Article 26 of RTS No 153/2013 with respect to MPOR for client accounts.
- xv Article CRR 285 2(a) for cleared derivatives and 2(b) for non-cleared derivatives.
- xvi Committee on the Global Financial System, Market-making and proprietary trading: industry trends, drivers and policy implications, November 2014 and Bank for International Settlement (BIS), Shifting tides – market liquidity and market-making in fixed income instruments, March 2015.
- xvii Ibid.
- xviii Bank of England, Dealing with change: Liquidity in evolving market structures - speech by Minouche Shafik, October 2015.
- xix Ibid.
- xx Regulation (EU) No 648/2012, Article 9.
- xxi It has to be noted that MiFID II/MiFIR does not apply to spot commodity contracts as defined under Commission Delegated Regulation (EU) of 25.4.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.
- xxii MiFID II enters into force in January 2018.
- xxiii It has to be noted the price is one of the elements in demonstrating best execution. In certain cases, a comparison between exchange traded and OTC products may be not be relevant as OTC products may be more appropriate for the clients' needs (i.e. to hedge their risks).
- xxiv Articles 18 and 21 MiFIR.
- xxv MiFIR Art. 28 defines the criteria for the derivatives trade obligations.
- xxvi Deloitte, Navigating MiFID II – Strategic decisions for asset managers.
- xxvii Ibid.

Contact us

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