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BEING CLEAR ON CLEARING

Debate continues to rage about the merits of clearing, with some market observers arguing that the benefits of using central counterparties are outweighed by the precipitous costs involved. But such criticisms fail to take the full burden of over-the-counter business into account, argues Steffen Köhler

The current discussion surrounding the cost of clearing is not a new one. In the years following the 2008 financial crisis, many market commentators and academics have focused on the strengths and weaknesses of cleared versus non-cleared derivatives. Some studies have pointed to the very high potential cost of clearing over-the-counter derivatives, with authors citing figures in the billions or even trillions of dollars at a system-wide level.

So, what can I add to this debate? To clear or not to clear is not necessarily the question here; rather, it's about making an informed decision on whether or not clearing will work for your business. Obviously, we all need to calculate and consider the relative costs of each option, but do we really know the extent of the costs involved in cleared versus non-cleared business?

Usually, the first costs we think of are direct costs – for instance, the actual clearing fees, as well as the cost of the collateral that must be pledged with the central counterparty (CCP). However, there are a number of indirect 'hidden' costs that may not spring to mind immediately, but are still relevant when making an informed decision.

For example, before your firm engages in OTC trading, you have to establish and maintain your own rule book by negotiating European Federation of Energy Traders (Efet) master agreements with all your counterparties. Individual counterparty limits will also have to be established with each firm, requiring a sound know-your-counterparty and risk analysis process. On top of this, individual and portfolio counterparty risk metrics need to be monitored on a frequent basis.

Furthermore, instances of fraud or improper behaviour require counterparty confirmations and market conformity checks. As a result, you'll need lawyers on board, as well as risk and compliance officers, not to mention a significant number of back-office staff. Unsurprisingly, this costs money – and we haven't even discussed the extra costs involved if you experience a real default, or simply wish to hedge your exposures via credit derivatives.

> *To clear or not to clear is not necessarily the question here, [but] whether or not clearing will work for your business*

Next, you have to consider the question of liquidity requirements that could stem from clearing. This is most often quoted as a reason not to clear. However, think of the proprietary trader that manages to lock in a profit on their trading activity: this profit will be immediately available to them in a cleared environment. The risk of loss will always be present, but if they do not have the liquidity to cover those potential losses, they should probably not take on a position of that size in the first place.

Quite different to this situation is the role of an operator of a power plant, which may be trading only to hedge the price risks incurred while selling power. Their trading will be more one-sided. At times, they may occupy a net risk-neutral position – with losses on their derivatives position offset by increases in the value of their power plant – but still face demands for margin from the CCP.

In part, CCPs can address this by offering significant margin offsets with other transactions that are also cleared, such as the plant's forward purchases of coal or natural gas. But even if overall liquidity costs are higher, the anonymity provided by clearing and the opportunity to participate in an organised market on equal terms might also be attractive.

It is important to remember that cost is not the only consideration – time is also a very real and important factor. It takes a long time to get set up for OTC business. In fact, one London-based trading firm told me that it took almost 14 months to get all their Efet contracts in place. That may sound crazy, but when you consider that it had to negotiate between 80 and 100 Efet contracts, 14 months suddenly seems quite reasonable. While the firm in question was experienced and knew the market well, it was surprised by the amount of time and effort this process took.

The issue of clearing is not as simple as many people think; it's not just about 'ticking a box' and handing over a fee, but much more hands-on. Even the consideration of counterparty risk is not easy. You need to ask yourself: "How many counterparties do I have?" The more counterparties you have, the more value a CCP might offer – something that might seem counterintuitive, because a higher number of counterparties

means greater diversification. Why is this? Because the CCP helps you to reduce multiple risk exposures and cashflows down to one net position facing a trusted counterparty with a healthy credit rating.

To summarise, I don't believe clearing is the best option in every case. There will always be transactions that are better suited to the OTC market, particularly if they involve special contracts that are not currently offered by a CCP. However, I strongly believe that if you do a fair calculation – and by fair, I mean a thorough consideration of all the costs, time and effort involved – then I am convinced clearing has its place. ■

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