LGIM DAT consultation response

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Legal & General
INVESTMENT MANAGEMENT

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Incentives

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

   From our observations in the market and discussions with dealers, we agree with the findings that there are strong incentives for dealers and large clients to centrally clear. In general, for standardised OTC derivatives such as interest rate swaps our firm's preference is to voluntarily centrally clear given reduced t-costs and increased price and valuation transparency which has resulted from dealers being incentivised to move their activity to a cleared venue.

   Anecdotally, we believe some smaller clients can face significant challenges, for example high fixed costs, in accessing central clearing venues which may disincentivise the use of central clearing.

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

   We agree that overall post-crisis reforms have contributed to the incentives to centrally clear. This has been circumstantially shown by the significant increase in our centrally cleared OTC derivatives relative to non-centrally cleared derivatives post-crisis.

   Our clearing incentives have generally been due to non-regulatory factors, such as decreased counterparty risk and t-costs and increased price and valuation transparency. These pull-factors are likely to have largely resulted from regulatory reforms that have incentivised dealers to centrally clear including comparative capital treatment of centrally cleared derivatives relative to those of uncleared ones.

   In general, our clients tend to hold large portfolios of gilts and as a result we do not typically view the initial margin requirements for centrally cleared trades as a disincentive. We are also comfortable with the eligibility criteria for centrally cleared OTC derivatives as we can use the repo market and our cash management framework to source collateral. We agree that there can be high fixed costs associated with participating in clearing, which may act as a significant disincentive for smaller clients to use central clearing.

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

   Many of our clients are currently exempt from mandatory clearing and able to utilise bilateral variation margin only CSAs. As a result margin requirements for uncleared derivatives do not provide an incentive to clear.

   Despite this, our firm's preference is to voluntarily centrally clear standardised OTC derivatives (such as interest rate and inflation swaps) due to the other pull-factors, as highlighted earlier.

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

   In general, our clients currently benefit from clearing exemptions so are not directly affected by "pure" regulatory factors.

We agree that counterparty risk management considerations and the difference in bid-offer spread between cleared and non-cleared derivatives are the top two factors incentivising clients to centrally clear. In our experience, access to a larger set of counterparties (and the knock-on effect to price tension) is also a top three incentivising factor.

We agree that fixed costs are the largest factor disincentivising clearing. The requirement to post IM for cleared trades has not been a large prohibiting factor to our clients using clearing since they typically hold large portfolios of gilts. However, we note that due to the nature of inflation and rates trading (which is typically long) counterparties have developed high initial margins at clearing houses which has affected bank pricing to clear (e.g. LCH inflation basis). This in turn has made it optically look more expensive to clear.

Finally, the termination notice period set by clearing service providers can in some cases act as a disincentive to clear for a handful of clients.

Markets

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

We agree with the report's characterisation of the shift of trading liquidity towards centrally cleared products. Figures D17 and D19 are consistent with our experience that trading cleared interest rate and inflation swaps typically leads to lower transaction costs and higher liquidity compared to trading uncleared.

As a result, the shift of trading towards centrally cleared products has resulted in a decrease in liquidity in uncleared products.

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?**

Our clients' portfolios are typically long interest rate and inflation swap exposure, as a result enhanced portfolio compression is likely to have little direct effect on the incentives to clear.

Our understanding is LCH (which is the main clearer used by us) currently does not offer a direct clearing membership model to non-bank entities. One development that is of interest is segregated account clearing models accessed via a DCM. However, at these early stages it is not obvious that this account structure would be priced more competitively than other account structures.

We note that the repo clear offering has a direct clearing model and our initial analysis suggests that this does not offer any cost saving.

Reforms

7. **Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?**

a. central clearing mandates (both in terms of product scope and entity scope);

We agree that central clearing mandates have been a primary driver behind the increases in central clearing levels.

Although our clients have largely been exempt from mandatory clearing, we echo one respondent's comments that "mandatory clearing 'forces' a critical mass of participants to transact in a common liquidity pool enabling the firm to transact with a larger number of counterparties than before". Once established, this common liquidity pool has in turn increased the voluntary trading of cleared products due to their higher liquidity and lower transaction costs.

b. minimum standards for margin requirements for uncleared derivatives;

The majority of our clients are able to utilise (and have historically utilised) bilateral variation margin only CSAs where collateral is exchanged daily. As a result minimum standards for margin requirements for uncleared derivatives have not been a direct incentive to clear.

c. capital requirements for credit valuation adjustment (CVA) risk;

Counterparty capital requirements for CVA risk have not provided a direct incentive to centrally clear, although the effect on counterparty pricing may indirectly incentivised a move to clearing via lower transaction costs.

d. capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));

We are not directly affected by these requirements

e. G-SIB requirements;

We are not directly affected by the G-SIB requirement

f. The leverage ratio.

We are not directly affected by the leverage ratio requirements

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

We are not directly affected by the G-SIB or leverage ratio requirements and their effect on the incentivisation or disincentivisation to provide client clearing services.

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?**

Specifically looking at our client base; the regulatory uncertainty (caused by numerous exemption extensions) around pension fund and Cat 3 entities need to mandatory clear has been confusing for the market and resulted in a more split market between cleared/uncleared products. Regulatory certainty, via a fixed implementation date or permanent exemption would help to clarify the situation.

More generally; harmonising clearing regulations affecting financial and non-financial institutions will lead to a larger and deeper common liquidity pool and avoid the current bifurcation in the market (for example, the LCH inflation basis).

Finally, the incentives to clear could be better by reducing fixed costs for end users. We are a large asset management house who have negotiated good terms (relatively speaking) but in absolute terms the costs could still be lower. For example, changing capital regulations for clearing members so they are able to offer better prices would be helpful.

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 are unable to directly comment on cases of smaller clients individually facing difficulties accessing clearing arrangements. Our smaller clients benefit from pooling and the overall scale from our total book.

Our derivative portfolio is very directional (mainly **receive fixed interest rate swaps)**.

We can only comment on our own experience where we are able to access clearing services. Nonetheless, given some of the challenges we have experienced and what we have heard anecdotally, we do not disagree with the report that other clients can struggle to access clearing in the same way as ourselves.

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

At the overall market level we agree that clearing services are in a relatively small pool of banks (if we compare to the amount of executing brokers or those historically willing to make a price on an uncleared basis).

The number of banks does give modest concerns that banks are not incentivised (or are overly disincentivised) to offer clearing to clients. Equally the current available panel is not so small that it gives us great concern. Importantly at an LGIM level we have been able to sign up backup clearing members which the report suggests is not necessarily common for all.

During a time of stress we are relatively comfortable with the number of clearing members we can access based on the current situation. That said were two major players to leave the market at the same time due to business reasons or a stress event then that would present problems and as the report notes it can take a long period to add clearing members.

12. **Do you agree or disagree with the report's characterisation of the incentive effects created by up-front and ongoing fixed costs of:**

a. using clearing services?

We agree that costs are a big disincentive for clearing based on the feedback we receive. Our analysis suggests that this disincentive is outweighed by restructuring ease, valuation transparency and counterparty risk reduction however there is no doubt that the level of costs are not immaterial.

b. providing client clearing services?

We do not provide client clearing services.

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

We focus on Financial Clients (Cat 2 and Cat 3) clearing interest rate products (including inflation swaps).

Overall we view clearing as offering a more efficient long term approach to rates hedging compared to uncleared. We find that the benefits outweigh the costs (we briefly list these below).

Key benefits: tighter execution spreads, ease of future restructuring, valuation transparency, counterparty risk benefit.

Key costs: clearing costs, creation of a small cash buffer to deal with cash variation margin.

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

It is difficult to state with any certainty what the right process is to move the market to central clearing of OTC derivatives. However, starting with the end state, what we do know now is that there has been a bifurcation in many markets between cleared and uncleared products and that is not beneficial for liquidity and a balanced market. For example, GBP inflation swaps have a different cleared and uncleared price which would not have been an intention as part of clearing.

Given the statements from the G20 back in 2009 we believe there is merit in having a market where standardised products trade cleared and non-standardised products trade uncleared. In order to achieve this end result we believe that it is crucial that smaller and less active players do not bear an unreasonable cost. We note that this is not just a financial firm issue rather this is an issue for all types of firm in order to avoid the split market that we have today along with all the issues that arise with that.