

## Box D

# Trade Compression

Trade (or portfolio) compression is the practice of eliminating or reducing the size of over-the-counter (OTC) derivative positions by terminating offsetting trades or replacing them with a smaller set of netted trades. The process, which can be applied to both bilateral and centrally cleared trades, leaves each counterparty's market risk exposure unchanged (or within a pre-defined range). There are two broad types of trade compression:<sup>1</sup>

- *Bilateral compression* involves only two counterparties that compare their portfolios to identify offsetting trades for termination or replacement.
- *Multilateral compression* usually involves more than two counterparties and is facilitated by a central counterparty (CCP) or a specialist service provider that compares relevant trades and, subject to the market risk tolerances of each participant, identifies a set of trades to be terminated or replaced. It typically provides more opportunities to terminate offsetting trades because it involves more counterparties. While initially limited to non-centrally cleared trades, this service is now also widely offered for centrally cleared OTC derivative trades.

Global use of trade compression has increased rapidly in recent years. The total notional value of interest rate derivatives (IRDs) that have been compressed is estimated to have more than tripled between late 2011 and June 2015 (the latest available date). A number of factors have contributed to this trend. Market participants have a direct incentive to engage in trade compression

because it reduces the number of individual trades to be managed; this in turn lowers both costs and operational risk. Recent technological developments and process changes such as the 'unlinking' of trades (that is, recording each side separately) have also enabled more compression.

Another significant driver of the recent increase in compression activity has been the anticipated introduction of the leverage ratio requirement from January 2018. Under current plans, OTC derivative exposures can be only partially netted, while eliminating such trades through compression can reduce a bank's calculated leverage without significantly affecting its net exposure. Reforms to counterparty credit risk capital requirements provide another incentive for banks to compress non-centrally cleared trades, by introducing higher capital requirements for such contracts.

To address some of the risks associated with non-standardised OTC derivatives, in early 2015 the International Organization of Securities Commissions (IOSCO) released risk mitigation standards for non-centrally cleared OTC derivatives that encouraged trade compression. Specifically, these standards require entities to implement policies and procedures to engage in portfolio compression when appropriate. The requirements are already in force in Europe and the United States, with some Australian entities affected through their dealings with international counterparties. Similar standards are currently being proposed for the Australian market.<sup>2</sup>

<sup>1</sup> For further information on the different types of trade compression see RBA (2015), 'Box A: Compression,' 2014/15 Assessment of LCH.Clearnet Limited's SwapClear Service, pp 11–12, December.

<sup>2</sup> See the Australian Prudential Regulation Authority's draft Prudential Standard CPS 226 for further information.

In contrast to the global trend, participation in Australian dollar-denominated compression, by both Australian and foreign banks, has to date remained relatively low. Survey data suggest that no more than 10 per cent of notional principal outstanding was terminated via compression in the year to May 2015. This was partly because, until recently, pricing conventions for swaps made it difficult to identify offsetting trades. In addition, Australian banks have not needed to use compression to meet anticipated requirements for the Basel III leverage ratio.

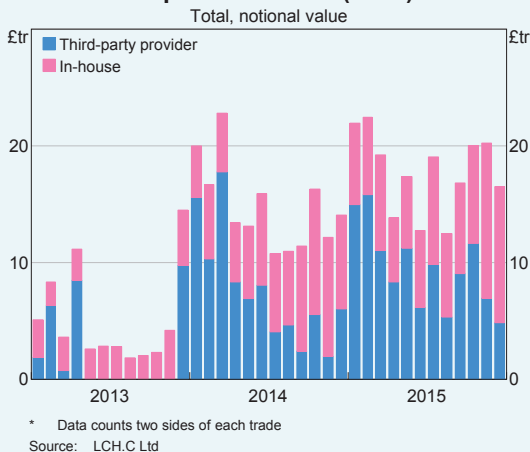
Nevertheless, the use of compression in Australia has increased in recent years. The latest survey data available, covering the year to May 2015, indicate that a number of large Australian and foreign banks had participated in a few multilateral portfolio compression cycles in Australian dollars and a higher number of bilateral compressions.<sup>3</sup>

Use of compression in the Australian market can be expected to increase further as a result of the greater use of CCPs. CCPs generally offer services to facilitate compression, as well as periodic access to third-party multilateral compression. In addition, the process of back-loading existing trades onto CCPs is likely to be encouraging bilateral compression, as the Australian ADIs seek to minimise the amount of trades to be back-loaded.

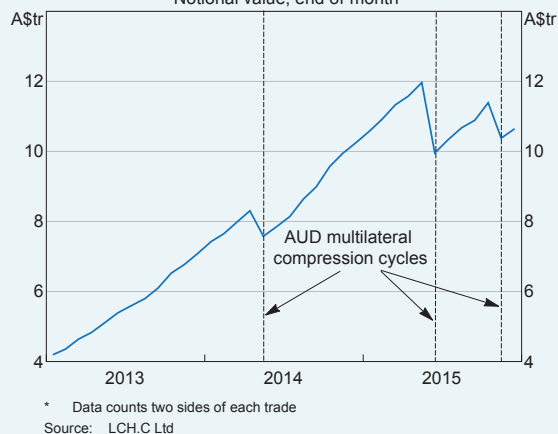
Compression in LCH.C Ltd's global SwapClear service has increased markedly since late 2013, including for Australian dollar-denominated trades (Graph D1). The June 2015 multilateral compression cycle run in LCH.C Ltd's SwapClear service was the largest to date for Australian dollar-denominated IRD trades, involving a notional value of \$2.2 trillion (Graph D2).<sup>4</sup> This cycle was the first since resolution

of the pricing convention mentioned above, which, along with the unlinking of trades, contributed to the increased volume of trades that were compressed. ✕

**Graph D1**  
**Compression in LCH.C Ltd's SwapClear Service (Flow)\***  
Total, notional value



**Graph D2**  
**AUD Value Outstanding in LCH.C Ltd's SwapClear Service (Stock)\***  
Notional value, end of month



3 For further information, see Section 6.2.2 of APRA, ASIC and RBA (2015), Report on the Australian OTC Derivatives Market, November.

4 Third-party multilateral compression runs for the SwapClear service are facilitated by TriOptima, a privately held company that provides post-trade infrastructure and risk management services for the OTC derivatives market.