THOUGHT LEADERSHIP ROUNDTABLE

CCPs & SECURITIES LENDING: A perfect partnership?



ROUNDTABLE PARTICIPANTS (from left to right)
Dan Copin, head of securities lending & borrowing Europe, Natixis
Remy Ferraretto, deputy head of global securities financing and Swaps, Candriam
Régis Lavergne, global head of equity finance, Natixis
Sébastien Bietho, president, Alcognis
Richard Déroulède, head of trading equity finance for Europe, Société Générale CIB
Gerard Denham, senior vice president, clients and markets, Eurex Clearing

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THE EXPERT PANEL - Biographical details



Sébastien Bietho, president, Alcognis
Sébastien Bietho is founder and CEO of Alcognis, a consulting firm focusing on the Securities Finance industry. Alcognis covers all areas of the business from the trading desk, business strategy, regulation to systems.Prior to setting up Alcognis, Sébastien was Head of the SBL & Repo desk of ADI Alternative Investments, then joined Fortis Investments to set-up and manage the International Securities Lending & Repo business, and headed the Paris Agency Lending Desk of BNP Paribas Securities Services. Sébastien started his career as an Options & Futures broker with Pinatton Société debourse and was an analyst in the Derivatives Research department of Oddo Securities.



Dan Copin, head of securities lending & borrowing Europe, Natixis
Head of Securities Lending & Borrowing Europe at Natixis. Dan has been a the bank for some eight years, and was instrumental in establishing its securities lending trading desk, having been responsible for operations, expansion of the customer base and defining pricing strategy. In particular, he was responsible for setting up securities lending operations on the bond portfolio and collateral financing operations as well as the implementation of a global product strategy.



Gerard Denham, senior vice president, clients and markets, Eurex Clearing
Gerard Denham is responsible for Clearing Sales and Relations and Business Development for Eurex Clearing's Lending CCP – its Central Counterparty (CCP) service for the Securities Lending market. Denham has 20 years' experience of the Securities Financing and Collateral Management industry gained within the Asset Management, Capital Markets, Global Custody, Investment Banking, and IT sectors located in Chicago, Frankfurt, London and Zurich.



Richard Déroulède, head of trading equity finance for Europe, Société Générale CIB
Richard Déroulède joined SGCIB in 2005 to develop the Structured Equity Finance business; he took over the responsibility of the team in 2006 and further expanded it to structured and flow equity financing solutions. He became head of the Equity Finance Trading team for Europe in 2009 and has since developed the flow and structured business, adding Market Intelligence and Collateral Trading functions to the group. Richard is a graduate from Ecole Normale Superieure and ENSAE.



Remy Ferraretto, deputy head of global securities financing and Swaps, Candriam
Remy Ferraretto graduated from Université de Paris and from the SKEMA Business School, He then joined CANDRIAM (formerly DEXIA Asset Management) in 2003 in the role of OTC derivatives middle office manager. In 2006, Remy worked for the Alternative Investments team and was appointed Deputy Head of securities lending, borrowing and financing in 2014



Régis Lavergne, global head of equity finance, Natixis
Régis Lavergne began his career at Fimat subsidiary of Société Générale as Financial Controller in 1993. From 1995 to 1998 he then joined KPMG (a global network of audit services (Audit), tax (Tax) and consulting (Advisory). as senior banking auditor. In 1998 he became Director of Internal Audit at Fimat and from 2000 to mid-2006, he served as Managing Director of Natexis Arbitrage; after the merger with IXIS he was in charge of the service Equity Solution. Since 2009 Regis has had responsibility as Global Head of Equity Finance at Natixis.

RICHARD DEROULEDE, HEAD OF TRADING, EQUITY FINANCE EUROPE, SOCIETE GENERALE, CIB: The development of our business is driven by three key elements: the automation of standard tasks, the search of innovative solutions to answer client needs and face new regulatory challenges, and the increase of our client database. We consider the topic of CCPs as being highly relevant to our business, as the services they offer could fit within these three axes. They will firstly help automating our flow business by concentrating operations in front of a single counterpart, without reducing the number of end users. Besides, they are offering solutions to the challenges posed by new regulation. And lastly, they could ease the operational on-boarding of new clients.

Also, securities lending through CCPs should not be looked at independently from the other financial products traded on those platforms, namely derivatives products. It will be particularly interesting to see what type of netting effect will be allowed by CCPs and regulators between derivatives, securities lending and repo on the same underlying.

SEBASTIEN BIETHO, PRESIDENT, ALCOGNIS: I hope to bring a particular perspective to this discussion that reflects the fact that I have worked on both the buy side and the sell side in the international securities lending business. I have run an agency lending desk at a Tier 1 bank and have also set up securities lending and repo desks and businesses for various hedge funds and asset management firms. Now I work both sides as an advisor; looking at the different issues in the restructuring of the securities lending market as a consequence both of regulation and the natural evolution of markets in the post recessionary period.

A number of things are happening, particularly as a result of regulation and changes in market infrastructure. CCPs fall squarely into both developments. Along with the market I am trying to make sense of the direction of change, particularly in terms of the way we are going to trade instruments and securities: will we increasingly use swaps trading as a synthetic loan, for instance? Repo and securities lending are moving closer together every day; and now total return swaps (TRS) are coming into the loop with regard to securities finance.

In common with others I am trying to understand what the new structure of the securities lending market will be. It is changing at a time when the business itself is quite mature and its very nature is shifting significantly. In the past, securities lending was very much a bilateral world. Now it is becoming electronic and an open market. These are substantially different characteristics and we do not yet fully understand the long term repercussions of this change.

REMY FERRARETTO, DEPUTY HEAD OF GLOBAL SECURITIES FINANCING & SWAPS, CANDRIAM INVESTORS GROUP: I have been working for Candriam, formerly Dexia Asset Management, since 2003, when I joined the OTC derivatives middle office, before moving to the equity financing desk in 2006. The desk is based in Paris and runs several operations. For instance, we handle the coverage of our French alternative funds (which are also based in Paris) but also manage the liquidity of these funds.

Clearly, we are in charge of the firm's securities lending (both equities and bonds) out of our Belgium and Luxembourg traditional funds. Recently, the firm increased its assets under management, since when the funds allotted to securities lending have increased accordingly. We are focusing a lot on development and innovation; the business is also becoming increasingly more automated. To be frank, as regards CCPs, we are still at the stage of talking about the implications of the structure within our business. In fact, although we are talking about it a lot, we are still some way from using them.

REGIS LAVERGNE, GLOBAL HEAD OF EQUITY FINANCE, NATIXIS: I run several positions at Natixis. We are not a big prime broker, and have a more discrete offering than global players. Instead, we focus on equity derivatives, and our approach is highly integrated. What does that mean? We have an Equity Finance desk that combines Delta One and stock lending. Indeed, we have developed our business based on this very close interaction between those businesses; being present in both short-term and long-term flow, but also on the structural side.

We have stock lending and repo flow business, where we are very active. Then for our clients in Europe and the US we have been developing specific services solutions, based on our knowledge of repo. So, for example, we have used repo and stock lending to devise a number of solutions for insurance companies, which enable them to comply with incoming regulation and risk coverage. We have leveraged this mix of business rather well. Indeed, we have a small but focused team, and we have found that the two sides of the business are in fact complementary.

CCPs have become an important issue for us to address, as we now face more and more heavy and complex regulation and rules –the LCR ratio and the leverage ratio, for instance – which are forcing us down some very dynamic routes. Every day we are facing new constraints on the overall business – yet we still manage our return on equity, because at the end of the day, it all has to add up to clear profit.

GERARD DENHAM, SENIOR VICE PRESIDENT, EUREX CLEARING: In Europe, three to four years ago, CCPs were not well established for securities lending. Eurex Clearing was in a fortunate position; we had a blank page on which to build our service offering. At this time, a very lengthy consultation process began that lasted a couple of years, which involved bilateral consultations on a working group level. Very early on in the process we were keen to collect the opinion of key market participants about the business model that would emerge. We have a guiding principle on consulting the market, and as a result of this, we have incorporated into our thinking as much of the character and characteristics of the current securities lending market as possible.

It is widely acknowledged that in some ways securities lending remains behind the times compared to other, more mature markets such as exchange-traded derivatives and the cash equity market. In these markets CCPs are well established and they have very standardised transactions. Securities lending is not as advanced and we have had to adapt that fact into our Lending CCP service offering.

There have been prior attempts in Europe to establish central clearing for securities lending, but these offerings have not been as effective as people would have liked. Eurex Clearing has been able to develop and implement a model that is flexible and sustainable and which will allow models to evolve as different types of assets, participants and new clearing members come into play. We have been mindful to include all of the typical elements of the business as well as ensuring that all of the market participants involved in the stock loan chain (either beneficial owner, agent lender, broker dealer, hedge fund, post-trade service providers, trading platforms or tri-party collateral agents) have the opportunity to adapt and participate to the Lending CCP service. We believe this to be our strong point in delivering the Lending CCP model. We are also aware this service is a new concept for much of this market and our role has been to help educate and cooperate with as many participants as possible. Our consultation has involved an iterative, educational process and we partner with market participants to ensure that their structure and their setup (as it relates to us) is as good as it can be. We work with them over a period of time to get them up and running. That's a good summary of the approach that we take.

On the regulatory side of things, there is no clear directive that states: CCPs are mandated for securities lending transactions. However, there are certain rules within Basel III and Dodd Frank that make it more efficient for counterparties to look at their business models and reassess the best way to employ their capital structure and re-use that structure again and again to make their business more sustainable. This is where Eurex Clearing comes in as the central counterparty.

DAN COPIN, HEAD OF SECURITIES LENDING & BORROWING EUROPE NATIXIS: I work in Regis' team –in charge of flow trading in securities lending. As Regis says, this new market environment requires us to be more flexible and innovative; certainly these elements are becoming more important. We have been in talks for over a year with Eurex, looking at new ways to trade using CCPs. Indeed, we have been involved in extensive testing of the CCP-based model. That said, my particular focus is on the value of stocks and not on the collateral side. However, the changing market environment requires us to understand the synergies between both approaches, and be able to optimise all the points on our trading platform that now also incorporates CCPs, particularly in post trade. It will be interesting to see how this market evolves.

CCPs: NEW WINE SERVED IN OLD BOTTLES? OR THE EMERGENCE OF AN ENTIRELY NEW VINTAGE?

FRANCESCA CARNEVALE, EDITOR, FTSE GLOBAL MARKETS: The market looks to be moving away from (essentially) an OTC bilateral model into one which is much more diversified. A number of you point out that the role of the CCP in stock lending is still in its early stages. Perhaps it is useful to spend a few minutes looking at really what it means for a CCP to be in the securities lending segment, and how it might change the existing or established order.

GERARD DENHAM: From the start, Eurex Clearing's intention was not to radically change the marketplace. Our goal is to provide a service that enhances the current market structure, and to provide the value-added services that a CCP can offer. In Lending CCP, both lenders and the borrowers still transact in exactly the same way that they do right now in the bilateral market. We have simply provided them with an alternative route to market, the option to transmit trades directly via trade capture platforms and flow providers, or by trading electronically and by connecting to exchange-traded platforms and MTFs.

To do this, a number of service partners such as Eurex Repo's SecLend Market and Pirum's Real-Time CCP Gateway have been connected to the service. These platforms not only introduce electronic trading but also allows the bilateral way that participants trade right now. The CCP simplifies the counterparty structure for both the lender and the borrower.

What is the benefit of the structure? Initially, a CCP makes things simpler from a credit perspective; it also allows for a broader distribution. What do I mean by that? It is about the way that banks and lenders interact with each other and it's to do with legal agreements and credit approvals. The reality is that there may not necessarily be significant amounts of credit available within a bank for all of the counterparties that it might want to trade with or have an existing legal relationship with.

It is the same for lenders as well. They might restrict or select a certain number of banking institutions that they want exposure to. When Eurex Clearing takes over the role of counterparty, then immediately there is a wider range of opportunities available. Eurex Clearing carries out its prudent risk management and admission requirements from a membership point of view; it means that any counterparty that's a member and has the facility to transact using our service, can begin to make use of the Lending CCP. In the meantime, it is the trading relationship that remains active on a bilateral basis.

On the one hand, we innovate and provide a more standardised service, and on the other hand we maintain much of the existing market characteristics. In simple terms, the CCP provides credit intermediation, brings standardisation and automation to a very manually intensive business.

SEBASTIEN BIETHO: The securities lending market is clearly mutating. CCPs are pivotal in this change. From the

operational and credit risk perspectives, CCPs are a game changer. With regard to risk, the role of the CCP is clear: on the operation side, the CCP releases the operational burden that securities lending carries and that we have been living with for a number of years.

However, CCPs are not the only outcome in this process of evolution; there are other tools that are developing or entering the market. Electronic trading is on the rise. The tri-party environment is also evolving, and although tri-party collateral management has been developing for a while, the collateral management product offering has been significantly extended to ease collateral access, mobilisation and velocity. On the technology side a lot has happened since the early days of the securities lending market. Pirum, which helps lenders and borrowers matching their trades or billing, has also helped increased operational efficiency. Collateral management systems and securities finance trading systems are now mature and efficient.

On the business side, there are clearly two elements to the market. It involves both the broker-dealer and the lender sides. However, while communication between them is extensive, the reality is that they do not trade in the same way. It is relatively straightforward, for the broker-dealer to incorporate CCPs into the work flow. Lenders appreciate the structure too, but tend to look at it in a very different way. There are new processes that will emerge as the lender side comes to terms with CCPs and most likely, regulation will put meat on the bones of that emerging relationship.

The market is in a process of evolution and all three elements: the new players, lenders and brokers will all put their mark on it; though regulation is probably the most important driver of market structure over the near term. In summary then, the securities lending market is multi-faceted, bilateral and trilateral, and most likely we will also witness the emergence of a multi-lateral facility. The market then will be a mix of the three.

FRANCESCA CARNEVALE: Richard, as a traditional broker-dealer, listening to those comments, and the influences on market evolution: is the CCP structure in synergy with the agent lender side, or might it evolve into competition with it?

RICHARD DEROULEDE: Agent lenders haven't been spared from regulatory changes threatening their business model. In particular, they now have to put up capital for the indemnification provided to customers, in the case of loss through a default by the borrowing counterparty. This forces agent lenders to reduce the credit exposure in order to maintain their profitability. As CCPs receive a better capital treatment credit wise, they could represent a beneficial solution for them.

FRANCESCA CARNEVALE: Regis, do you see the emergence of CCPs as creating a level playing field between institutions that are active in the market? CCPs look to have a role in diminishing the credit risk of some of the counterparties in securities lending trades, particularly smaller players which will be able to work on the same basis as larger players. Is that ultimately beneficial for everybody?

REGIS LAVERGNE: It's a good question, and of course, if you introduce CCPs, and theoretically open the market to a large number of participants, then this could affect pricing in the expected margin. At the end of the day, if you want to trade, even if you trade through a CCP, you will be asked for initial margin. If you are a clearing member, then there are very strong constraints about what you can or cannot do. If you do not want to be a clearing member, you will have to work through a clearer, and open a credit line. If you are a small player, meanwhile, you will have to provide enough credit to trade on the market. Even so, although the CCP becomes the counterparty to both sides of the trade, if you are a small player you still have to work with the same capital constraints as a larger player with your clearing member service provider.

Irrespective of size then, everyone has to work with the same margin and collateral requirements. The introduction of CCPs will facilitate and open the market. Yet where large nominal remains traded (and especially for stock lending) you still have to post the initial margin, and, I venture, it will be very hard for a small player to act on this market if they do not have access to a huge balance sheet.

GERARD DENHAM: Francesca, you hinted that agent lenders might see a more competitive landscape in future, with some of that competition coming from CCPs. We all need to be realistic, and everybody is around this table, that we know that CCPs will take a while to be fully embraced by all market participants. The reason for that is in Europe, along with the coverage we have for fixed income securities, Eurex Clearing covers five equity markets at the moment, there's a number of other CCPs around the world that cover individual equity markets; the US and Brazil are two examples of that. Securities lending is active in all of the major markets and it will take some time to roll out to new markets for Eurex Clearing. We have a number of equity markets on the horizon over the next year or so, and beyond that, there's over 30 other markets globally where securities lending is active. Moreover, I expect there will also be consolidation in the market as to which counterparties will maintain their position, or stay in the market, particularly on the lender side, as the indemnification issue comes to the fore. For some lenders it might be too problematic and no longer cost-effective.

FRANCESCA CARNEVALE: Would you mind explaining that? Why is it problematic?

GERARD DENHAM: For a long while agent lenders have provided a guarantee to their underlying beneficial owners; that in the event of a borrower going into default, their position is protected and the agent lender would make whole any loss. In addition, regulators have voiced their concerns about some of the cash re-investment programmes that were in operation in relation to securities lending transactions, there has been more focus on that side particularly from the regulators in the US, and globally by the Financial Stability Board (FSB). The regulators are trying to devise ways to ensure that all lenders engaging in securities lending are aware of the risks involved and are adequately supervised.

As a result, with the new Basel III and Dodd Frank directives taking effect agent lenders now have to account fully for the indemnification they provide to their beneficial owners. It is no longer a free guarantee any more. Agent lenders have to put up capital against the indemnification now, and that's an added cost for them. Agent lenders also need to look at their underlying beneficial owners and ask themselves: can I really maintain this level of service with them, at the same price? Do I have to start charging more? Some of those lenders, those that perhaps are not as fully engaged in lending may say: well, it's not worth the return, for the risk that we are taking. Others will. This is what I mean when I talk about consolidation and that will happen regardless of CCPs.

Eurex Clearing does not feel that we are competitive towards agent lenders because we have designed our Lending CCP model in such a way as to bring them wholesale into the process. Whereas before (and particularly in the US) in the model that's employed for US equities, agent lenders have to go through a broker-dealer. It is a full clearing member model, which adds cost for them, and agent lenders do not get the benefit of the direct exposure to the CCP. Their exposure is against their broker-dealer clearing member. Eurex Clearing's solution is to introduce a membership model that is directly suited for both agent lenders and beneficial owners.

We sincerely believe Eurex Clearing's model effectively brings the CCP right into the existing business process and is therefore a much greater benefit to them. It gives them the safety and security of the CCP as we guarantee the return of the loan securities to the lender. This supplementary security aspect of the Lending CCP enables the agent lender to maintain the current levels of the business they're doing, as well as retain their existing clients they have, while having the potential to increase their utilisation levels as well as providing a more cost-effective service for their clients.

SEBASTIEN BIETHO: The demand structure for securities is changing due to regulation, including Basel III/Dodd Frank and EMIR. As a result the market needs to adapt to the new requirements, and CCPs is part of the answer to that. Another initiative that will simplify securities lending operations in Europe is Target-2 Securities (T2S). Gerard, you mentioned that there are only about five markets available to you right now, but with T2S coming in, that situation is probably going to change quite rapidly right? That should allow you access to any market: am I right?

GERARD DENHAM: Yes, for equity markets and we are looking at that very closely. That will be a factor in the next phase of development over the next one to three years, given the timeline of T2S coming in. Right now though we are still working on the business of each individual equity market in Europe, and that can be time-consuming and costly. Once T2S is fully implemented, as you suggest, it does make it a lot easier as it provides one central access point via a single CSD, which then, has the right to access multiple markets within Europe. So we will go from five to seven, and then further equity markets in Europe, within a reasonable time-frame. Whereas if we had to work on each one of those markets individually, it would probably take a longer period of time to implement. In addition to this, other markets outside of Europe are also under analysis as our clients would like to view the benefits of the Lending CCP replicated on a global basis.

DAN COPIN: I also would like to add a word or two about the idea that the CCP structure could be a danger for the whole industry. I've worked for more than ten years in this sector; and I believe that this is a hugely important and a very promising market. Why? Because it's a highly flexible product. Look at the market growth, the rise of tri-party agents, and our ability to trade on either a bi-lateral or tri-party basis. I look at CCPs in the same way —it is simply another way to trade. We will be trading on CCP with some of our clients partly because of regulatory requirements, and partly because of various other reasons. That is a side issue as far as I am concerned. I believe that in this industry we have to focus on the individual value a security lending trade can provide.

Now, for some of the reasons already explained, these individual trades might become less interesting in terms of income. However, if we look at the growing volume of trades it becomes increasingly more interesting and important. Taking into account the changes in the market we have to present clients with new ideas that do not involve credit risk, or process risk. I have to present profitable solutions to them and if I am true to the flexibility that this industry offers us all, we can and should discuss with clients the possibility of working through a CCP.

SYSTEMIC RISKS: WHERE SHOULD THEY SIT?

FRANCESCA CARNEVALE: Doesn't the interpolation of CCPs into the securities lending business simply transfer systemic risk from one place to another? Regulation has not eliminated the risk, simply changed where it sits. Is a CCP the right place for this risk to sit? How resilient are CCPs?

RICHARD DEROULEDE: These questions have been widely discussed across the industry in the context of EMIR for derivative products, and the Shadow Banking stream of the FSB for securities lending and repo. Does the introduction of CCPs reduce systemic risk? Common sense dictates a diversification of credit risk, as opposed to high concentration into a single pot. Besides, if going through a CCP is not compulsory for everyone, and there is a chance to end up with institutions of lower credit ratings going on CCPs, reducing the overall quality of the CCP participants. Regulators have chosen a middle route by imposing strict rules to CCPs, and creating capital incentive for banks to concentrate more flows through CCPs.

In the particular case of securities lending, one must not forget that the market has organised itself around three safety elements that highly mitigate the credit risk of each transaction. The first is that principal is fully collateralised with a physical transfer of assets; two, haircuts are added depending on the liquidity of the underlying and three, margin calls are performed on a daily basis. In the case of Eurex's securities lending set up, these safety elements have

been retained with even stricter conditions. This doesn't mean the failure of a CCP in a securities lending transaction would have no consequence, but it severely reduces the overall impact for financial markets.

Beyond the question of risk concentration, we must also think about the effects of standardisation and transparency that will be brought by CCPs on the securities lending market. Indeed, trading securities lending through CCPs means that terms and conditions of each transaction must be highly standardised, leaving very little room to operational issues, such as failing settlement, a late margin call or an un-reconciled transaction, that could arise in the OTC world. There is no doubt standardisation will reduce the operational risk. With regards to the transparency that a public order book will provide, we can only hope that it will bring trust and confidence and that will convince highly rated institutions to participate in this market.

TRANSPARENCY, COSTS & PRICE DISCOVERY: A NEW TRINITY FOR MODERN SECURITIES LENDING?

FRANCESCA CARNEVALE: Remy, taking into account everything that Richard says, do you look forward to a world where this standardisation, this transparency, gives you effective price discovery; effective benchmarking of your transactions? Is that one of the key benefits?

REMY FERRARETTO: I strongly believe that transparency is the key point in this business. This is something we have always provided to our customers, via our funds and counterparties. From our vantage point as a lender doing standard collateralised trades, with regard to the cost of quality collateral and the constraints that you already have due to the regulations in force, the costs of the lending business are bigger than a few years ago.

Also, from a lender's point of view, we have not really factored CCPs into our business outlook at the moment. However, as a lender, I must protect the interests of our funds, and one of my responsibilities is to select quality collateral and select the right counterparties. I firmly believe that CCPs provide good service and more security, and that this can help increase the standing of, and volume in, the business overall. However, on start-up trades, where spreads may be sometime lower, the use of a CCP does not mean that there is a big cost involved compared to all other costs that you already have today to monitor this business.

REGIS LAVERGNE: As you all know, over the past five years, the cost of production has increased dramatically in our industry; in part due to regulatory constraints(new ratios), in part due to the costs of compliance and risk linked to those regulatory constraints. For us it has been a key challenge. In the past it was easier certainly to be much more profitable. In the current market environment cost management is vital and cost control is monitored very closely. The involvement of CCPs in the business could be, as Richard says, a very interesting way to add value to transactions and, at the same time, decrease the cost of the ticket. Therefore, any reduction in the cost of production is vital for us.

There are also considerations around initial margin collateral. Clearly we will reduce our Risk Weighted Assets (RWA) by using a CCP. However, we should also have the ability to post a larger asset class of collateral in order to monitor costs. Yet this is not the case, for example, on the Delta One side where we are now posting initial margin versus cash, or government bonds, which is quite expensive. Due to the sophistication that a CCP provides on the monitoring of risk, it could be interesting to have CCPs broaden the scope of assets that they can accept as collateral.

FRANCESCA CARNEVALE: There seems to be a sense of an inherent cost of having the CCP structure in the system. Is that inevitable? When you speak to the providers of asset servicing, the question of cost is something that is always to the fore now. As markets become more complex, as risk is mitigated in various and different ways, it has become like insurance. If you want really good cover, you've got to pay for it. Is that an inherent feature in the system going forward? Or, will we end up with a bifurcated market where, you will end up attracting only certain types of trades, and not others? Gerard?

GERARD DENHAM: We are aware of the fact that market participants think that not every transaction is appropriate for the CCP model. Over time that thinking will evolve and change, particularly when the volume/intensity increases. As Richard points out, there needs to be high volume and a sustainable amount to make it more cost effective. Certainly, if you look at cost in total isolation, yes, the CCP model does bring more cost into the transaction, purely from what you need to do in order to transact via the CCP—that is, additional margin on collateral costs. However, if you offset some of those costs against the benefits that you get from the reduced capital charges, then the calculation becomes quite different. We have done the analysis, along with Oliver Wyman consultants and we produced a study recently that highlights the capital efficiencies and the benefits from going via the CCP outweigh the initial costs from a risk perspective.

We are always reviewing the overall collateral and the appropriate risk appetite that we have as a clearing house; it's constantly being monitored. We are obviously directed by regulation on what we do as a clearing house. We have to balance that out. The debate that has been going on for a long while however and which has become more intensive recently, due to the Basel III regulations coming in, hangs on the question: where is equilibrium as far as economic benefits and costs are concerned? We believe there are still substantial benefits for participants.

SEBASTIEN BIETHO: We are perhaps a little biased, historically, as regards to how securities lending works. If we are talking about lenders, indemnification has been in the mix for a while; but there is potential for evolution in the way lenders will approach securities lending going forward. Regulation around securities lending has had the merit of bringing our business to the forefront, helped bring debate into the open and initiate a shift in the perception of the business across the financial industry. Just in the wording ▸▸

used in discussions these days shows there has been an important evolution in the way securities lending is approached. We have moved from "Shadow Banking" to "Efficient Portfolio Management Technique". That speaks for itself.

Securities lending then is no longer a behind-the-scenes activity, but is now part of the portfolio management business, which is essentially a business of risk and return. In turn, this means that if one is looking at full indemnification, one would get close to zero return. Therefore this concept of being insured for doing lending, at some point will become less important than it has in the past.

I say all this because the primary purpose of a CCP is not to provide guarantees to the individual structure that is using the CCP, but instead it provides guarantees to the market. Basically, its job is to call in margin every day, and make sure that the market is matched up, and that it's not going to collapse tomorrow. Should one party not meet its margin calls, all its positions would be closed immediately and the concerned party would be excluded from the market. It is a little bit more complex when we are talking non-cash collateral, but the general idea is the same. Individual protection is a result of market security.

CCPs also offer efficiencies, both in terms of cost and operations. Right now, the market is carrying a host of legacy costs from the old historical structures that have been in place for a long time and will have to absorb the cost of introducing the new structures. Once this is finalised, then we will be able to leverage operational efficiency and reduce costs.

Gerard is right, the cost of utilising a CCP needs to be balanced with its "return". The very next driver for the broker-dealer community is the full implementation of the Tier 1 Capital ratio in January 2015. Considering the risk weighted assets (RWA) gain in using a CCP (hence the lower cost of equity) it might be worth switching part of the bilateral business into the CCP model. That aside, I would like to know from Remy what he thinks the value of a CCP will be for the lender community. Is the involvement of a CCP in their business something that makes sense? If their borrowers want to use the CCP, would they be keener on the subject?

CCPS AS A CATALYST FOR MARKET CHANGE: FOR BETTER OR BETTER?

REMY FERRARETTO: Clearly we are, as we always seek to be competitive. If our counterparties require us to use CCPs, this is something we must take into account, because we cannot afford to be excluded from the market. So we must have a view, always a view, to remain in the race, and not to be excluded. The most important part of utilising a CCP is the risk coverage. Again, when you are a lender, you must know your risk, and CCPs look like a good solution in this regard.

GERARD DENHAM: Remy, do you think if there are funds and asset managers who don't participate in securities lending right now they will be more encouraged to enter the market, or re-enter the market, if a viable CCP model is in play?

REMY FERRARETTO: From a credit and a risk perspective, having, or being part of, a global CCP is certainly a good thing for most situations and will likely increase the transparency we already provide to clients.

DAN COPIN: To add to Remy's answer, some clients will be encouraged to enter the market, others will leave because they will not find it economic to remain. Others will have different strategies. It will depend on the risk appetite of the client. Some focus on security and therefore they will be drawn to Eurex, whilst others are actively looking for risk. The latter group will continue to work in the bilateral segment, because you don't have to work with excessive haircuts and the collateral policy will be large for them in a way they like and understand.

RICHARD DEROULEDE: If we look at what happened on the stock exchange market, the market was previously highly intermediated, with high entry cost and low transparency. The electronification and standardization of the market has attracted more participants, higher competition and provided more transparency with widely spread real time quotations, forcing actors providing market access to change their model. Focus has therefore been on innovation, advisory as well as integration with other services of the bank like derivatives.

We could draw a parallel with the securities lending market and imagine that the development of CCPs will have the same kind of impact on the market, with vanilla products being highly standardized and traditional actors being forced to develop more valuable services to their customers. Some actors will disappear, because they won't be able to adapt their business model to this new deal. Some others will move on to other types of business, like advisory, structured transactions, etc. Not a bad thing if market participants can dedicate more time on adding value to customers rather than on operational issues!

FRANCESCA CARNEVALE: Will we end up with a bifurcated market? On one side, where higher risk, higher return and more sophisticated OTC structures, will dominate? On the other, a much more plain vanilla market? Is this what you want? Or do you want a universal securities lending market where people can utilise CCPs when relevant and other structures when it's not-relevant?

REGIS LAVERGNE: You can use CCP for doing much more complex transactions. And at the end of the day, you reduce the cost of the transaction. Indeed, access is simplified and you can easily trade with clients who are not necessarily familiar with the stock lending market. This is because they simply have to open an account with a clearing member. I see the CCP model as a means of reducing transaction costs, and, of course, one that enables us to offer the stock lending product ▸▸

more easily to a wider range of clients. After that, it is how your innovation can introduce added value for your client and make the transaction profitable for you.

SEBASTIEN BIETHO: In the past trades used to be value trades, where there was intrinsic value in the stocks being borrowed. Nowadays the market is different. Today we are essentially looking at collateral trades or liquidity trades and these types of trades will become more predominant over the coming year, driven by the Liquidity Coverage Ratio (LCR) implementation. From a CCP perspective, this development makes sense because we are talking volume trades where operational efficiency matters. Of course the RWA point is still valid in that trade. Are we saying value trades have disappeared forever? I do not know. What I know is that short selling has shrunk since 2008. Now, hedge funds' assets under management are back to pre-2008 levels, setting the potential for specific securities demand to rise. When we are talking standardisation, I think this is more about industrialising operations. When we are talking about trading, we are not talking about just lending securities versus cash or non-cash, right? We are talking about structuring trades. This is where the CCP does help us in terms of what we are doing with our time. So the question for lenders and borrowers is: where do I achieve value? Sure, CCP comes with a cost, but if you spend more time actually building trades that bring better value, then it might be worth it.

GERARD DENHAM: On a positive note, there is light at the end of the tunnel as far as the regulatory side is concerned; at both the national and international level. For example, the Financial Stability Board (FSB) recognises the important role that securities finance transactions bring to the capital markets. The regulator knows that it brings liquidity to the market and then, on top of what Richard says about the encouragement of securitisation and financing, to be led more by the market side, rather than the central banks, that's the direction in which it is going. This also tallies with Sebastian's position that the market is now more about financing trades, rather than just value trades as before.

So where do CCPs fit into all of this? I think the future has much more potential for a new structure than maybe the market thought was possible even three years ago. We are not there yet; we will have to encourage market participants to look at CCPs again and again. We also welcome competition in the CCP space to round it all out and make it work globally. We have posited a lot of questions: we all agree it will take a bit of time before we can fully illustrate how complex financing structures will fit into the whole picture. What I can say is that the Lending CCP simplifies the trade, standardises it and makes it much, much easier for the market to access. The service is available immediately and the market participants who understand the opportunities available now will gain an advantage as first-movers in the market.

REGIONAL ADOPTION OF CCPs: THE DOs & DON'Ts & THE BEST OF THE REST

FRANCESCA CARNEVALE: Do you think that the securities lending market in Europe will increasingly evolve differently to that in the United States and Asia, because in Europe we are taking the CCP model, and the potential of the CCP model, a lot more seriously.

RICHARD DEROULEDE: If I understand things correctly, the netting effect between derivative and securities lending is pretty efficient in the United States. It is too early though to compare the model that works already in the US with the model in Europe, which is still a work in progress, especially with regards to the netting effect between derivatives and securities lending, that is still to be defined by regulators. We can simply keep in mind that a lot of innovation in finance arriving from the US is only taken up in Europe many years later.

GERARD DENHAM: On a wider basis, the CCPs in operation for certain Asian markets are an in-force model, so there is not a lot of option to do anything else but trade via the CCP and that's also the case in Brazil. In the US, it's purely a broker-dealer model involving a limited range of US equities against equity options that they can offset. It is a model that works very well, it is in place, but it doesn't involve the whole chain, as far as beneficial owners and agent lenders; it is purely on a broker-to-broker basis.

HITCHING YOUR STAR TO THE CCP MODEL: MY WAY OR THE HIGHWAY?

FRANCESCA CARNEVALE: Could the European model ultimately become one where everybody accesses the CCP?

GERARD DENHAM: Yes and that's what is evolving, and will evolve over time. In the US, for example, a more open approach is now being evaluated. I understand they are looking at some of the aspects we have introduced in Eurex Clearing's model, which they're trying to replicate in the US. Easier access points for both agent lenders and broker-dealers are essential for a successful and sustainable model.

SEBASTIEN BIETHO: In the US the model is very different from Europe. At the time it was set up, the point was to allow clearing members to use borrowed/loaned securities to reduce Options Clearing Corporations (OCC) margin requirements. So the usage and participants has been very specific, and the model was built with the primary requirement in mind. Additionally, I believe the OCC is only involved in cash-collateral transactions. This is not very surprising; the stock lending business is very different from that in Europe. In the US it has been a cash-collateral only market, mainly due to regulation. Things have changed a little bit but we are still at a level of about two-thirds of cash-collateral transactions. In Europe non-cash collateral is the dominant form.

RICHARD DEROULEDE: It could change though, very quickly.

SEBASTIEN BIETHO: It could change yes and when you have a CCP structure to work with it is a lot easier to work with cash rather than non-cash. However, the European ▸▸

CCP model has been set-up with the most flexible options available and can adapt to a market shift.

FUTURESCAPE: THE LENDER/COUNTERPARTY RELATIONSHIP WHAT WILL DEFINE IT?

FRANCESCA CARNEVALE: Will the terms of reference focus more on risk management going forward; and would that happen whether CCPs were in the mix or not?

RICHARD DEROULEDE: I don't expect any dramatic change. For sure, the intermediation through CCPs will trigger some evolution, but I expect most of the business to be negotiated OTC and novated through CCPs, maintaining the essence of our market: knowing the counterparty in which you can place your trust.

Will that trigger more focus on risk management? The set up requires some change in the traditional management of a book, but nothing too complex here. More importantly, we need to make sure that the benefits of going through CCPs outweigh the attached cost. We say previously that the benefits are to be found not only on the capital side but also in the reduction of cost linked to operations. The cost of running an OTC business with a high number of counterparties is indeed very high, and has increased with the new regulation. Let's hope that the centralisation of operations towards one CCP will free-up some resources along the operational chain, including the front office, which will enable them to focus more on the additional service they can offer to their clients.

REGIS LAVERGNE: On the client side, when you're discussing the advantages of the business with a client that has never been involved in stock lending or repo business, you have to be aware whether they have the internal back office and accounting means. You also know the difficulties of signing a stock lending contract.

On our side, we need to be able to provide the client with a process that is simple and fool proof. If the client has already an account with the clearer, it is easier: you explain that the set up will be the same, and that it will be a real advantage for us and to them that they enter into the business. However, the client must have the capacity to trade, must have the capacity to post collateral (depending on which side of the transaction he is on), and of course, stump up the collateral if required.

FRANCESCA CARNEVALE: Remy, from the point of view of a beneficial owner, from an asset owner, your commitment to securities lending is not on a single transaction basis, is it? It is on a term commitment, if you lend securities, you do not just lend them for a day, and that's it, be it a short term transaction or a week or a month, it is a long term commitment, relatively, in market terms. Might that have to change? If it does, how will it colour your view of securities lending?

REMY FERRARETTO: Certainly this is a long-term relationship business, on both the market and on the beneficial owner side. Concerning the market side, we work over the long term, that's the only way to exist in this business; anyone without a long-term perspective is ultimately rejected from this market. So the counterparty relationships we have are very important to us and they are relationships that we nurture on a daily basis; in fact, we work very hard to keep our relationships going over the long term.

This brings me to your previous question about regulations. These days, we delegate or outsource quite a lot of business so that we can focus on performance. You will never be able to delegate 100%, because you will always need some people on your side to manage what you delegate. That means constant communication and quality communication and operations (on both sides). If you spend time dealing with issues, it is not a good thing in this business – it means that there is a big problem somewhere; so you are constantly trying to ensure a smooth flow of business in and business out.

SEBASTIEN BIETHO: Will CCPs change the relationship between lenders and borrowers? Well, that's definitely in the hands of lenders, rather than borrowers. Long term relationship is definitely something we need to build trades. Actually knowing your counterparty is what matters, understanding the business structure of your trading counterpart is the basis for profitable trades. That says the nature of the relationship will depend on how CCPs are approached.

Are they approached for the operational efficiency? Or for credit mitigation? If it is operational efficiency, then the market will probably stay the same; with the long term bilateral relationship being essential for building trades. If on the other hand it's from the credit mitigation perspective, then obviously it opens doors to more liquidity in the market, to more liquidity for everybody: both lenders and borrowers. That changes the deal. The way the market is currently structured requires that we build trades for, say, a year, or in a long term relationship. If we have a liquid market in the securities lending business and an efficient operational process, and we know that we can replace our trades instantly, even though they are closed-out, or returned, then it changes the way the market is going to work in the future. That gives us the opportunity to re-allocate our resources to deepen and extend relationships whilst working on the valuable elements of the trades.

FRANCESCA CARNEVALE: Listening to everyone Gerard, it is clear the securities lending market is replete with nuances and everyone seems to be looking at the business and CCPs in a very different way. How do you manage all these different views and make an economic case out of it?

GERARD DENHAM: That's exactly it. That is why it's been a long process to get where we are today. There has been a few years of consultation, then the development, then the implementation, now we are at the first step as far as generating the volume and the interest. Sebastien is right: there are two steps involved and at the moment, it's not known how long the first phase will last for, and when the second phase of the evolution will even begin.

One common element is that everybody has noted how key relationships are. We are in sympathy with that and it has been a core guiding principle with us from day one.

Having been involved in both lending and borrowing, I know how key this aspect is. I will say that I think roles will essentially stay the same, because everyone provides a specialist role. The beneficial owners need their agents acting on their behalf to provide that specialist information on a very sustainable and also a very stable model.

Likewise on the borrower side, there needs to be that constant demand and that constant expertise and information being fed throughout the market. That will remain regardless, everyone respects the specialist role that everybody has and the relationship aspect will stay. It is too early to say how far that will evolve into a future state at the moment. As you say, we are here to facilitate, we think that what we have done so far is the right approach, and we know that we'll be asked to react continuously as the market changes.

THE MACRO-OUTLOOK & ITS IMPACT ON VOLUMES AND TRANSACTIONS

FRANCESCA CARNEVALE: This year seems to be something of a swing year, in terms of outlook, where we have the promise of the speeding up of tapering in the US; we have a realisation and a growing debate in the UK of the need to return to a real interest rate environment and real economics. Do you think that the return of interest rates, the return of a much more confident hedge fund sector, the slow return of the money markets, is something to look forward to next year, or do you think that we will all continue to live in the moribund shadow of the global recession for another year?

GERARD DENHAM: It is too early to say, but the outlook is more positive.

SEBASTIEN BIETHO: It is definitely too soon to make meaningful comment about the interest rate environment. However, Francesca you made a reference to money markets. One interesting thing that happened in the last few years is that what we used to call the money markets is now the securities finance market. Basically, whether you are a broker dealer or beneficial owner, they all need to begin centralising the use of their securities. We are starting to see the emergence of collateral funding desk within broker-dealer institutions to help optimise the use of the assets. Most likely this trend will gain momentum in the coming years, driven by capital cost and liquidity requirements.

In turn, that has an impact on how we use CCPs to do that, how we use the tri-party agent structure, the new market infrastructure, to be able to build that desk and get all the relevant guys to work together. From the lender perspective there's ESMA – defining acceptable collateral for UCITs – and more latterly EMIR, which requires the asset management industry to now collateralise their OTC business. Generally speaking, that means these funds need to find eligible collateral for this type of transactions. This is creating a need for collateral transformation and this is an area in which a lot of new work and thinking has to be done.

SECURITIES LENDING: A MORE SOPHISTICATED PRODUCT SET IN STORE?

FRANCESCA CARNEVALE: Do you see the securities lending product set as a whole becoming much more sophisticated, then, over the next year to two years, to take account of increasing cross-fertilisation or use of assets in a firm?

RICHARD DEROULEDE: Yes, for sure. The securities lending industry has been impacted by many new regulations, concerning not only banks but also UCITS funds. Funds have to report more details to their shareholders. Banks have to manage more carefully the liquidity and capital utilised by securities lending transactions. In many banks, securities financing desks are doing both stock loan and derivatives, which increase complexity as some regulations apply only to one or the other. Securities lending traders have to master these new constraints for their day to day business, but also when they want to innovate or answer to non-standard client requests.

New regulation is also contributing to the emergence of a new type of securities financing business, the so-called collateral trading activities, in which the front office has to price collateral schedules, get more involved in systems and solutions to transfer more efficiently and more quickly assets from one place to the other, secure non-cash margin calls, etc. In other words, the securities lending product is becoming more sophisticated not only on the principal of the transaction but also on the collateral utilised.

A third point is about the type of underlying assets that are coming into our business and the various wrappers utilised. On top of government bonds and main index equities, one has also to deal with corporate bonds, convertible bonds, and shares of funds; each underlying having the possibility to trade not only through stock loan and derivatives, but also repo and pledge structures.

We have a lot on our plate to play with. It all adds up to new set up, new risk models, including some fairly complex valuation models, to handle all these developments properly. It is also good news because it offers additional business opportunities (advisory, new trading ideas, new products) to generate revenues.

REGIS LAVERGNE: We have, as Richard says, plenty of new opportunities and new assets which are coming in to the market. We have of course to be completely client focused, but in another way, we have to reduce RWA, and use a clearing and CCP. Of course, in stock lending you can demonstrate that you are facing one particular client, which is not as easy for some other transactions, such as futures.

Another constraint on the perfect world ahead could be the tax constraints which are coming, especially the financial transaction tax (FTT). It affects the client more than the bank. But the net effect is the same, indeed, it will constrain volume. With these constraints in mind, it's becoming more and more difficult to manage and to retain our profitability however those regulations are bringing new opportunities. That said, in reality, we have much more business which is bringing in more assets to work with. So, who knows how it will develop.

FRANCESCA CARNEVALE: Remy: one provider thinks a golden age of securities lending lies ahead. Another, that the world is a continuation of where we are now, but more complex and one hampered by regulation and tax? Which world view are you looking forward to?

REMY FERRARETTO: Certainly one that is much more complex, with regard to all the regulations, including those still to be defined. I think a golden age is light years away but it can come back at any time as it depends a lot of the market changes. The securities lending, which is still well profitable, has a lower profitability than ten years ago, and this constant change in the market is good in one way and bad in another. Today you have more players to deal with, as well as complex regulations and, honestly, I do not believe it is always in the interest of the market. It has been said that regulations will provide new business opportunities, certainly but for example with LCR, it is difficult to combine it with the obligation that you have, as a lender, to be liquid at all times. I am hoping for some new regulations and for the brilliant people that work in the market to come up with new solutions and innovations to help us out and make the business profitable for some time to come.

DAN COPIN: The challenge, as everyone is alluding to, is not just change, but the frequency of change. Indeed, new regulations, new processes, new products and our working lives right now are one of continual adjustment to new circumstance.

SEBASTIEN BIETHO: I think the future is about how you want to take the opportunities that are in front of you as a result of market change. This includes the new look CCPs, electronic trading platforms, tri-party agents and, of course, T2S. Regulation really does provide opportunities on the basis that you are set up and ready to build the trades that regulations require. AIFM Directive does change the game a little bit, as it opens doors to everything that is not a UCITs fund to gain a European passport. ESMA regulation would not apply as such to those funds and maybe there is potential there for new business. Also there is a growing business set around collateral, and collateral management that has evolved massively over the last ten years. So there is plenty of scope to extract value from the market and the new environment of the business, as long as you are efficiently set-up. That's why we all agree that the market will be a mix or hybrid of the older and newer structures. To optimise asset usage, one will need to be able to work efficiently with the several types of structures.

FRANCESCA CARNEVALE: Gerard, clearly the market, whether you intended it or otherwise, is, or at least a portion of the market is moving in your direction. This must surely put tremendous strain on you developing a business model, and the proper risk management systems to handle that demand, and to provide a straight through processing and market efficiency. Is it a boon, or is it a pain?

GERARD DENHAM: Obviously it's a boon. At the recent ISLA conference in Berlin, regulation was a key theme and what was important was the response among the audience and the market at large. Over the years, it has evolved, it has been innovative in its development; and there is resilience. This is why securities lending is such a great industry to be in. It was clear at the conference that everyone is looking for new ways to maintain their existing levels of business, and still look for new ways to develop and grow. We have only scratched the surface of a number of related asset types and market segments such as ETFs, money market funds and derivatives that cross over with securities lending, I see scope there for the future.

Collateral optimisation is obviously a big segment, and how we all develop that will be valuable and interesting for all of the market. We are fortunate that Eurex Clearing has introduced a CCP service model that is responsive, flexible and sustainable. In that light, it does bring a positive aspect to the market, not only in its current state, but in the future as well. As I said, not everyone at the moment is looking towards CCPs, and some will only move a certain proportion of their current business to a CCP. Either way, we have to ensure that it is a smooth transition, and the right procedures and processes are in place to ensure we can support a future that presages growth in the market. I think it is an extremely positive outlook ■

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