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Time for clearing



Securities finance participants commit to a centrally cleared future



The tipping point

Deutsche Börse's breakfast seminar in London saw experts call on the industry to continue its commitment to the central clearing project

Deutsche Börse's breakfast seminar provided a unique opportunity for securities lending participants to meet and share their experiences of traversing the various stages of connecting with Eurex's Lending CCP.

A panel of industry representatives from BNY Mellon, Morgan Stanley, BlackRock and Barclays, which are all at different stages of implementation, spoke openly and honestly about what attracted them to the central counterparty (CCP) project and the challenges, both internal and external, they are facing in guiding their respective firms through the process.

The session was moderated by Ben Chalice, COO of Pirum Systems, which has partnered with Eurex on voluntary corporate actions services, meaning that, once the introductory speeches were over, there was no direct Deutsche Börse influence on the discussion.

By hosting a panel of CCP converts, the debate was able to avoid getting bogged down in the unanswerable chicken and egg-style debate about necessary volumes that too often dominate conference panels.

During the session it was revealed that panellists had arrived at the same destination by very different paths, and with a variety of motives driving them. However, the obstacles they faced along the way were all too familiar, allowing speakers experienced in implementation to educate audience members and offer solutions that best worked for them.

Concerns around managing the significant IT lift at a time when operations teams were also being asked to produce regulatory compliance solutions were aired, along with legal and compliance issues around collateral visibility, and the age-old question of cost.

The mood of the session was positive. Many early movers are expecting to complete coupling with the CCP in the first half of 2017, and that will likely put to bed many of the criticisms levelled at central clearing models. As was noted during the panel, once firms start to cross the finish line, they will be able to lend valuable clarity and metrics to those behind them.

Ultimately, volumes may still not be where the CCP faithful would like them. But 2016 did see a decisive turning-point in the 'hearts and minds' campaign aimed at the winder securities lending industry. Hardened CCP sceptics, who had until recently been vocal critics of the central clearing model, were willing to go on record during conference panels and acknowledge the inevitability of a CCP's establishment in the market.

For those who have been campaigning for CCPs and those in the vanguard of implementation, 2016 was a watershed year that will add significant momentum to the cause.

Here the day's discussions are repeated in full so that readers can judge for themselves the benefits and drawbacks of the CCP and hopefully learn how to overcome any challenges that they may be facing.

Erik Müller: Deutsche Börse has recently undergone a significant reorganisation focused on allowing all the various segments of the organisation to work in a more integrated way and to increase our proximity to our partners.

We want to understand how to utilise all of these assets in what is now known as our global funding and financing business to solve the industry's issues.

A lot of these challenges are driven by regulation, which is changing the rules of the game as we know them.

The industry will have to adapt, and we want to approach that change hand-in-hand with all our partners going forward.

Deutsche Börse Group has committed tremendous resources over the past few years in extending its geographical reach, asset class coverage and technology base.

Our new T7 trading system, along with our clearing system, C7, which launched in May 2016, and the risk management system, Prisma, are all cutting edge technologies in our industry.

This allows us to present ourselves as a strong partner to anyone in the market. We want to be the best we possibly can be, but we in turn need invested partners to work with us and match our enthusiasm to make new offerings commercially viable.

In the securities lending industry, we are getting very close now to achieving our aim of creating a proposal that solves issues throughout the transaction chain for both sides of the trade.

All of this represents a full body of work that we have achieved in 2016 and I'm very pleased to say we've received full support from our board to further finance these initiatives in 2017. But we still need our partners to be with us every step of the way to guide us and lend us their expertise, and to make sure this is a success for everyone.

In this panel, we have representatives from some of those same partners who are all at different stages of implementation of the Eurex Lending CCP and are willing to share their experiences so far.



Deutsche Börse in 2016

- Building out title transfer with immediate pledge back for compliance with UCITS V
- Connecting with EquiLend as a flow provider
- Partnering with Pirum on voluntary corporate actions
- CCP balances increased to between €2.5 billion and €3 billion

Looking ahead to 2017

- UK market will be added to existing five European markets
- BNY Mellon connection to open in Q1 2017
- Target2-Securities will allow for clearing in Italy, Austria, Denmark and Finland
- Triparty netting solution for beneficial owners expected in November 2017



Ben Challice: What do you see as the key benefits of a CCP?

Matt Collins: As a firm, we've taken a very top-down approach to how we think about central clearing. That means across the firm, looking at the direct drivers coming through new regulation and the subsequent needs of our clients, to the indirect drivers such as increased use of financial resources in our businesses and capacity reduction in the market. What we see is that a CCP can create that capacity and bring down our resource use at the same time.

Our starting point for this journey, from a securities finance transaction (SFT) perspective, was to address the binding constraints that were starting to hit us, such as leverage, risk-weighted assets (RWAs) and wider capital planning. From there, we started to look more laterally at the secondary benefits.

So what started as a more straightforward leverage and capital solution has evolved into a wider embrace of everything that's on offer. As more stakeholders got involved, we quickly realised there was an opportunity to seize some very significant operational benefits as well. There are upfront costs to moving to a CCP model, but we're predicting benefits that offset that and materially improve how we run our business.

Peter Foley: We definitely didn't start from the top down. My initial reaction was that this might be a good RWA solution. I still see some benefit there but I don't see it being a game changer, given some of the other projects we have going on in that area. In terms of balance sheet optimisation potential, it's the same. I don't see that we're going to get huge netting benefits from this side of our business.

That said, one significant benefit I do see coming from a CCP is greater access to funds. Barclays has always tried to be a leader in the market in terms of netting applicability and this is something that will give me visibility of assets that I wouldn't get otherwise.

Furthermore, when you start to scale this aspect up, it becomes very interesting to me. If Eurex also creates a really efficient product that offers all sorts of operational savings, then I'm even more interested.

Challice: Is it a case of a 'chicken and egg' scenario, in that you're waiting for enough liquidity and scale on the platform but that only comes with active members?

Foley: Yes, absolutely. Personally, I'm convinced, but it makes it a much easier sell when I go to our new product committee if it's as close to a plug-and-play product as possible. I accept it will never be exactly that, but the more liquidity and the closer it is to the finished product, the easier it will be to sell.

> The more liquidity the CCP has and the closer it is to the finished product, the easier it will be to sell to our new product committee

Peter Foley
EMEA head of SBL trading for equities
Barclays



Tim McLeod: For us, it's more than just borrower demand driving our engagement. As an agent lender, we view this as an opportunity to transact with a high-quality counterparty in Eurex, and one that assumes the majority of the operational heavy lifting as well. From a counterparty credit, operational efficiency, scale and risk perspective, it's an attractive proposition. The other aspect for agent lenders to consider is whether lending through a CCP makes for a more cost-effective transaction, which is something we're exploring.

Apart from all the benefits we've mentioned, the other factor to consider is commercial—the risk of not entering the clearing space. This is a multi-year effort and we as an industry have been discussing it for a long time. But there will come a point where the large counterparties that agent lenders trade with bilaterally will only do certain trades through a CCP, and if you're not in that space then you're going to start to see utilisation drop. For me, that is a key incentive to not stand still on this.

Simon Tomlinson: It's certainly been a long process from something that was very sell-side focused at the beginning to what we have now. It was back in March 2015 that BNY Mellon and one of its peers announced a strategic partnership with Eurex to help re-shape the CCP model to better suit the buy side and now we are very close to seeing the benefits of that relationship come to fruition. The key benefit is that the CCP offers an additional route to market for our clients, which is crucial because regulatory changes have led to a constrained market.

Challice: How are the various costs of entering the central clearing space being analysed and absorbed?

Collins: First of all, it's quite difficult to fully analyse something when it is still in its infancy, it's more of a judgement call but we see it as the right thing. The operational lift of connecting was fairly heavy, and at the time, we needed a lot of stakeholders involved. We took a bigger picture view with consensus to pursue this initiative, given its future potential to add capacity to a business that's currently constrained by leverage and capital requirements. Now, looking back, we're seeing the benefits and are extremely pleased that we have invested in this initiative.

Foley: We're not as far down the path as some others and we haven't done that level of analysis. As a firm, we're still there to be convinced. My own thinking is that there is a 'future unknown' factor to consider in terms of the possibility of mandatory clearing. If I knew this was going to be mandated in the future, I'd like to be further down the road than I am now. As I mentioned, I don't see major RWA or netting benefits right now, but that could change. I'm open to the concept. In the meantime, if the margins came down, it would make for a much easier cost/benefit analysis.

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> **Simon Tomlinson**
> **Regional head of EMEA equity trading**
> **BNY Mellon**



Challice: Simon and Tim, what is the buy-side level of interest from your clients?

Tomlinson: At this time I would say it is mixed. Some clients are very engaged and can see the advantages that a CCP can bring to their lending programme, while others are watching the developments with interest but are not willing to make any commitments at this time. We have a handful of early adoption clients that are on track to go live in Q1 2017. However, for example, due to jurisdiction or fund type restrictions some of our clients will be more applicable than others.

Beyond that, we're hopeful that once there is an established 'proof of concept', more clients will be able to see the benefits.

McLeod: Because of the nature of the majority of clients that we lend on behalf of, namely large pooled funds, a key part of our job is to help explain the CCP to the appropriate fund boards, focusing not only on the benefits but also ensuring that we remain focused on how the risk profile of their securities lending activities might be changing. We are very early on in that process.

Challice: How did you get the process started?

Collins: Our first step was to model exactly what this new product would look like. We had our technologists involved to assess the product from a connectivity point of view and they spent time with the flow providers to make sure we could clearly see how the process would work. Then we worked with our operations team on the detail.

Secondly, we engaged our corporate actions group, legal counsel and tax advisers who worked with Eurex and our partners in the market on the rule book. We needed to fully separate the idea of the legal counterparty, Eurex, with the order placer, because that needed to be more clearly defined, then to look at the tax perspective. It needs to feel similar to a global master securities lending agreement from a risk perspective, yet reflect the new legal arrangement with the CCP. This will evolve and be refined with time, but represents a new chapter in how we think about standardisation.

Challice: How will your operations teams tackle the margin and processing challenges?

Tomlinson: At the outset we will be going down the non-cash route, so there won't be a requirement to post margin. From an operational processing perspective there is no doubt this will be challenging depending on which vendor platform you use and the real-time processing requirements placed on internal platforms.

At this time we are currently working on creating the models that will allow us to use the CCP through the specific lender licence.

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Matt Collins
EMEA head of securities lending and bank resource management
Morgan Stanley



McLeod: The plan is to use the specific lender licence, but first and foremost, we're spending a lot of time with our legal and compliance departments getting a firm hold on whether we can actually contract with the CCP under the proposed model before getting too far down the path of building out the operating model.

The regulatory framework can vary significantly—for example, UCITS funds compared to insurance companies—and we're trying to figure out which of our clients will be in a position to avail of CCP connectivity. Bearing in mind, for example, the title transfer with security interest collateral proposal, or certain alternative investment fund or UCITS depository obligations, which may not yet sit perfectly within the CCP model.

Once we secure a subset of our client base that can enter the cleared space we can accelerate the operations and technology phase. Our operations teams will need to embed the CCP model into their existing process, and develop more of an oversight role bearing in mind Eurex's management of the lifecycle events. In terms of technology, like everyone in the market, we have competing priorities to consider, such as our Securities Financing Transactions Regulation solution, which may affect our timeline. Our third key workstream involves our risk teams, who are looking into the default waterfall model to learn exactly how that would work in the event of clearing member insolvencies.

Challice: How are you feeling about CCPs going forward?

Foley: A huge amount of progress has been made and the fact that firms are deep into the research and are likely to begin implementation next year means that we can really start to build momentum.

Collins: We are now at the stage where people have already been through the process and can now offer guidance to those behind them, which is a big help for people in my position.

Tomlinson: We are in phase one of the evolution right now and we at BNY Mellon have invested a lot of time in this. It has been very encouraging to see the number of people who have come into the CCP conversation this year and this will ensure more engagement and ideas will be shared as we move closer to a 'buy-side' SFT clearing reality. There's already a clear benefit, but for us the biggest positives are yet to come. The addition of the UK in 2017 will be a big win for this community and will provide an outlet for this traditionally low-margin market to see more volume.

Another crucial point about the CCP initiative is the anticipated move to a multi-allocation model.

This will ensure more scalability and stability in the supply available and lead to a real gear shift in the level of clearing. **SLT**

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>
> **Tim McLeod**
> **E-trading and market structure**
> **BlackRock**

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