CCPs: it's a marathon not a sprint

All the pieces of the puzzle are now in place for the market to judge for itself whether central clearing is vindicated

Drew Nicol reports

The second iteration of Deutsche Boerse's breakfast briefing on the development of its central counterparty (CCP) brought together panellists representing both sides of the transaction chain to offer a candid discussion on where the central clearing odyssey is now and where it's headed.

Just as in the first meeting in 2016, the panel was made up of independent parties, this time representing BNY Mellon, Citi, eSecLending, BlackRock and CCP newcomer PGGM, which are all at varying staging of the onboarding process.

The day opened with an introduction by Erik Müller, Eurex Clearing CEO, who reviewed Eurex's achievements for the year, including the launch of an initiative focused on interest rate swaps clearing in Europe, along with a note of thanks to Eurex's many partners for their support by Marcel Naas, global head funding and financing for Deutsche Boerse.

Following the introductions, panellists presented a warts-and-all debate that updated audience members on a bundle of improvements to the CCP's scope, operational features and streamlined onboarding process, while also laying bare the lingering pain points that Eurex's model is yet to overcome.

The big picture

When the industry first gathered to discuss the Lending CCP, Eurex was given clear marching orders for where it needed to improve in order to allow securities lending participants to cultivate the all-important business case for justifying attaching to Eurex.

In 2016, the industry's primary concerns were for the paperwork to be streamlined, the scope of the product to be broadened, and for UCITS to be further integrated into the solution.

Today, a lot of those concerns have been resolved or have solutions in the pipeline, and 2018 promises to be the year that several major market players, including Citi and PGGM, will begin trading through the platform, with more to follow.

Looking ahead, operational challenges remain to fine-tune the product, with interoperability between vendors and a further lightening of the onboarding lift, along with new markets, chief among them. First and foremost however, the main objective now is to work through the gears of bringing existing partners online and getting enough trades on the board to ramp up liquidity, which stubbornly remains at relatively low levels.

Brian Staunton, managing director at BNY Mellon and panel moderator, summarised the situation in his opening address, saying: "We've gone beyond the point where we are asking if a CCP is relevant now and it's more about how are we actually using a CCP, where the liquidity is coming from and what more needs to be done."

The CCP's outlook is clearly positive, but this doesn't mean it's the beginning of the end for the journey, only the end of the beginning, as all the pieces of the puzzle are now in place for the market to judge for itself whether central clearing is vindicated.

Maintaining momentum

For many, the biggest challenge now is not starting the process but maintaining momentum in the onboarding process, while also fending off resource-heavy regulatory deadlines and other immediate distractions. All speakers on the panel agreed that CCPs offer a long-term solution at a time when the industry is crying out for immediate fixes to today's challenges.

With the second Markets in Financial Instruments Directive (MiFID II) now live and the Securities Financing Transactions Regulation (SFTR) looming on the horizon, mandated allocation of sources and assets will continue to dominate the market's attention for a while yet.

For those that can bring solid metrics to the conversation, the CCP debate is easier to manage in the climate of having to weigh every investment decision against many other equally pressing demands for resources.

Mina Kinsey, Vice President Equity Finance Trading at Citi Prime Finance, said: "For us, the capital savings were quantifiable. Any change is a challenge, however, at Citi we've done most of the heavy lifting and feel we are in a good position to go live across Investor services in 2018. When you have lots of regulatory mandated changes to contend with, having that specific time frame helps a lot."

However, against the sheer volume of incoming compliance deadlines, the difficulty of maintaining focus on onboarding a product that won't immediately provide significant returns is a problem that several on the panel and in the audience could relate to.

Tim McLeod, director of securities lending and finance at BlackRock, commented: "MiFID II isn't going away on 3 January. Resources will be dedicated to fixing certain short-term tactical solutions well into 2018. SFTR is next off the rank for many – it's also going to consume a lot of the firmwide resources that would otherwise be deployed on business growth opportunities, such as developing CCP models."

"Furthermore, when it comes to what our clients want and what ourcounterparties want, CCP access is just one of the many things we're dedicating time to. Improving our trading tools, the noncash pledge model, collateral transformation and optimisation, looking at synthetics, interacting with non-traditional counterparties – all of these are time and resource heavy."

McLeod added: "Right now, the CCP is one of the lowest-revenuebusiness cases, with the highest implementation effort. It's important,therefore, to think about the business case differently – focussing on the long-term value-proposition that it represents rather than the short-term return on investment."

Uncleared pledge is expected to come into play in the first quarter of the year, and panellists agreed that it would cause some repricing to occur, along with the chance to capitalise on some significant risk weighted assets (RWA) savings in the short term. However, it was also noted that, although there was an early-mover advantage on pledge, the market will normalise. The panel agreed that it wasn't a question of either committing to CCP or pledge, and that the CCP model would still be valid in the long-term.

It was highlighted that uncleared pledge hinges on the enforceability of the collateral and that the risk profile of the trade doesn't change. Although building access to a CCP is a heavier lift in the short term, it offers features that pledge does not, such as cross-product netting, improved counterparty credit quality and operational efficiency.

Kinsey explained that Citi is eager to look into any and all routes to market, including pledge and central clearing, but that pledge doesn't offer a future-proof solution in the same way that the CCP does. "Citi believes CCP is more sustainable in the long term, it's operational and regulatory benefits outweigh other structures such as pledge. Other borrowers may have more immediate constraints on what they can spend or do, so CCP has not been a priority. However we believe this is the direction of travel and at some point they will be forced to look at it," she said.

Come one, come all

The fact that the scales have finally begun to tip in favour of CCPs has been helped in no small part by the combined weight of pro-CCP industry heavy-hitters such as Morgan Stanley, Citi and BlackRock, among others; but one voice was conspicuously missing from the chorus—a prominent buy-side member.

That all changed last year. As one of the newest members to the CCP family, PGGM, a Dutch asset manager for pension funds, represents a significant addition to the Eurex roster that may pave the way for more buy-side participants looking to build a business case.

PGGM treasury trading and commodities investment manager Roelof van der Struik, a self-confessed CCP convert who played a central role in his fund's connection to Eurex, explained the reason for his change of heart.

"You have to have a long-term vision of where the market is going. CCPs seem to have the efficient infrastructure to be very future proof and that's why it's part of our collateral roadmap project," he said.

"However, if I take that to my strategy meeting they will say, great, you're first in line for budget allocation in 2022. Therefore, there has to be short-term advantages and, quite simply, that means money. We have to get a strong business case out there."

"In the short term, I'm looking to get a business case live with one fund and one borrower to prove the concept."

McLeod added: "From what we understand, borrowers will realise meaningful capital and netting benefits from participating in the Eurex model and that may well lead to a re-shaping and repricing of their borrowing, if they can gain access to our inventory through the CCP."

Joining the dots

For Eurex, the next operational challenge is to bring together its three flow providers to allow entities attached to only one or two to be able to see counterparties on another. The liquidity challenges of ignoring this limitation are not expected to become acute while volumes remain at their current levels, but as more partners go live this year, a solution will be required. An audience question on the issue prompted the response that it was not a concern right now but that it was definitely a question for the near future.

Currently, the Lending CCP's flow providers are Eurex's F7 SecLend Market, an electronic marketplace; Pirum, whose CCP Gateway transmits bilaterally booked trades among its users directly to Eurex Clearing; and EquiLend, which also electronically directs its trades booked using their Post Trade Services platform. Most banks using the Lending CCP are understood to already use two or all three of these flow providers so their access to agent lenders' inventory is maintained. The problem is the tier-three and tier-four banks with limited connections.

According to Eurex, the potential solution is there for a vendor to plug the gap by being able to offer transformation of trades in order to provide the interoperability. This could be an independent vendor, one of the existing flow providers, or even a joint initiative where collaboration among several providers could perform such a function in the future.

Lighten the legal load

One of the key takeaways from the 2016 panel was the difficulties that the legal documentation aspect of onboarding presented for prospective users. Twelve months later, Eurex's Jonathan Lombardo explained in the pre-panel update how the onboarding process had been sent back to the drawing board to revisit these pain points.

"One of the key achievements of 2016 for Eurex was the re-engineering of the platform to change the ethos around viewing our clients as partners and developing a product offering that not only made sense for them but for the overall industry," said Lombardo.

"By working together with our partners, we have streamlined the admissions process, fine-tuned our legal documentation and we've turned each onboarding partner into a project with a team lead. This means not looking at it as an on-boarding process where the customer stands alone by putting a team together that guides the partner through each stage of the process, especially on the liquidity providing side."

"That initiative has helped us build a much more solid pipeline. These partnerships, which include people on the panel, now have defined go-live dates. This is not a work in progress any more, this is work with an end-date to print live tickets."

According to Eurex, these on-boarding teams are now able to take as much as 70 percent of the legal documentation off the plates of new partners, including the substantial know-your-customer documentation for the underlying beneficial owner. As part of that streamlined process, Eurex allows beneficial owners to grant power of attorney to their agent lender, in partnership with Eurex, to take on the majority of the 32 separate documents that stand between them and central clearing facilities. As a result of this re-imagining, the process can now be completed within three to six months.

McLeod said: "The fact there are now dedicated project teams for each of us is encouraging because when you go through it you realise that every rock you look under is a material piece of work."

"I'll give you an example. When you're talking about re-designing a voluntary corporate actions solution, that's not achieved with a couple of meetings, one nice process-flow document and off we go—you're overhauling the way we manage the intersection of corporate actions and securities lending which, over the years, has been shown to be a high risk area for firms to manage. The CCP shouldn't just tackle counterparty risk but aim to reduce operational risk too, placing an emphasis on the careful design of all post-trade processes."

Don't forget UCITS

In 2017 Eurex introduced the Title Transfer-Pledge Back solution for Luxembourg-based UCITS funds, alongside the current CCP-secured pledge model. The old one-for-one collateral model was considered unscalable and so a new net exposure management tool was introduced in November to remove this hurdle. The new tool allows users to bulk exposures at a triparty required value level at the triparty agent, including Clearstream, Euroclear and BNY Mellon.

Ed Oliver, managing director of product development at eSecLending, said: "We are not in the deep dive with Eurex yet, we've done some workshops and looked at the legal documentation, but really we are waiting for the collateral solution to be presented to us in a nice regulatory document that we can present to our UCITS funds. When we have the title transfer with the pledge model then we are ready to go."

The issue of building a UCITS-friendly solution that would bring these highly-regulated funds into the fold of central clearing is a puzzle that is yet to be fully solved going into 2018, but one that will prove to be particularly fruitful for Eurex once complete.

In the panel discussion, Eurex's new pledge solution was acknowledged as a major step forward for the likes of BlackRock and eSecLending, which both have a significant UCITS client base.

When asked what first attracted BlackRock to a CCP solution, McLeod said: "Balance sheet and capital pressures are changing borrowing behaviours and, as a lender, we want to ensure our funds can continue to bring liquidity to the market and benefit from sec lending revenues."

"A CCP is another route to market—and in particular, where certain lenders are arguably less attractive in the general collateral (GC) space than other product types, a CCP would be a place where those funds can remain competitive."

McLeod added: "The introduction of the Special Lender Licence, that gave beneficial owners the ability to participate without pledging margin, which was going to be extremely complicated for them, was also very important."

Oliver added: "The Special Lender Licence was clearly key. At the same time, a lot of the work that happened in 2016 around improving operating models made this more attractive. For us, as a non-bank, the operational efficiency is a key benefit for us."

"Unlike the banks that partner with Eurex, we don't get the RWA and balance sheet advantages from going with the CCP model but we see it as a distribution opportunity for our clients."

"If we move from today's model where we have a traditional middle and back office supporting all the lifecycle events and give that to the CCP then that's fantastic and it frees up headcount that I can re-purpose into some of the more complex initiatives that are coming out."

However, according to Oliver, despite the efforts of Eurex and its vocal supporters, there is still an educational hurdle to be conquered that may hold back UCITS involvement for a while yet. Specifically, the reaction of depositories.

"The biggest unknown in all this for our UCITS funds is the reaction of the depositories to CCPs. Right now we have to work very closely with depositories just in a standard securities lending programme to arrange triparty collateral. That's already enormously complicated and now we are going to lob a CCP into the mix, that's going to be interesting," Oliver said.

Broadening your horizons

The need to expand the scope of the Lending CCP will inevitably be a long-term challenge for Eurex as its partners compete to dictate the direction of the product's expansion.

According to those in attendance in 2016, the UK was undisputedly top of the list of required new markets. Since then, Eurex has delivered three additional markets: the UK, Austria and Italy—but the job isn't done. During the latest meeting, when asked for a wish list of product developments for the future, panellists unanimously pointed the addition of even more markets, specifically the US.

As part of its expansion strategy, Eurex allows itself to be directed by client demand for new markets, along with a desire to align with the Target2-Securities settlement initiative and those markets that could be supported via Clearstream's infrastructure.

Speaking after the panel, Lombardo said: "European coverage is essential for obtaining critical mass from our members. As volumes continue to grow, we will look to the market for further direction as to where in Europe is critical for their businesses."

"The US markets have always been in focus and we are presently working on admitting US buy-side clients via their agent lenders to lend European assets as well as obtaining a DTCC licence that will enable US securities to be lent from European asset holders."

Lombardo added: "Clearing Asian securities, while interesting, is a bit further down the pipeline, but Scandinavia in general looks interesting for our next phase."

Let's talk volumes

Regular securities lending conference attendees will know that the debate around CCPs often quickly devolves into a chicken-and-egg debate around volumes, but among those panellists that had already committed to pursue central clearing opinions were united.

McLeod estimated that around 5 percent of his GC book in the markets Eurex support could be diverted into a CCP by the end of 2018 if all of the services in the pipeline come to fruition and remaining regulatory issues are resolved—especially those affecting UCITS funds. "We've historically seen this as a GC platform because that's where return on capital doesn't always make sense for the borrowers today, and consequently lender revenue is declining," McLeod explained.

Van de Struik stated that through his agent lender the volume would be very small. Through the direct licence PGGM expects to put 10 percent of the book through the CCP, which will also mostly be made up of GC.

Kinsey and Oliver could not be drawn on a specific percentage but Oliver seconded McLeod's prediction that volumes would increase in line with their ability to bring in UCITS clients. Oliver said: "I'd be very happy if we had a single digit going through the CCP in two years' time. When asked if there was a game changers that any panellists were waiting for to boost their commitment to the CCP cause, Kinsey said: "We are committed to go live next year. With any new product coming to market it has to have a chance to enjoy organic growth. The expectations of some market participants perhaps needs to be lowered when it comes to CCPs as you would be naive to think it will all go perfectly from day one. We think the product is viable and it works."

Van de Struik concluded: "We should let it evolve naturally but we also shouldn't be complacent. We have a very good beginning and we have to aggressively keep this growing with the community and make sure this becomes a relevant platform. We need to be proactive and now we have traction we have to keep pushing." **SLT**


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