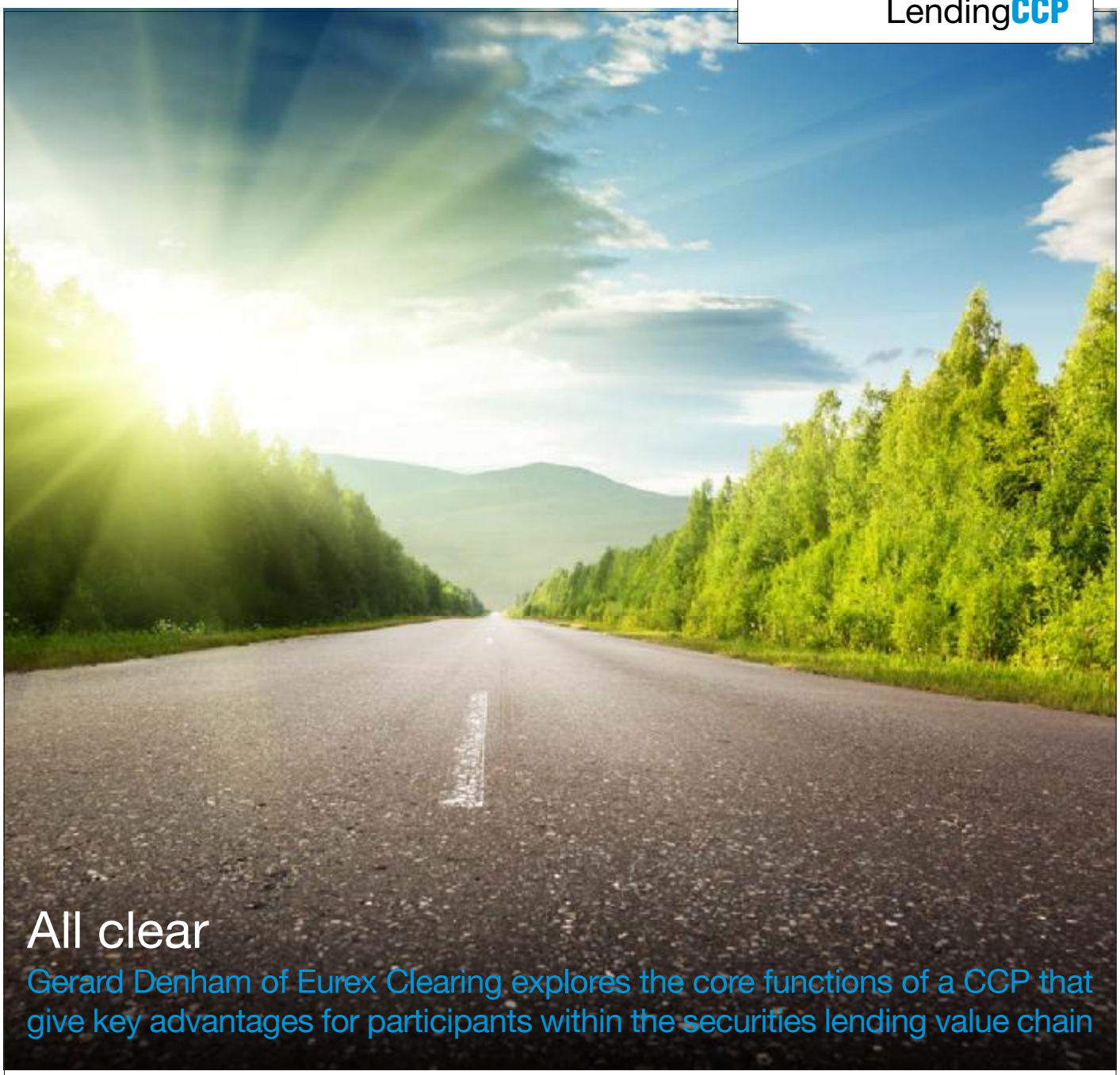


All clear

Gerard Denham of Eurex Clearing explores the core functions of a CCP that give key advantages for participants within the securities lending value chain

A central counterparty (CCP) plays an important role in the global effort to maintain stability in financial markets. At Eurex Clearing, we recognise our responsibility to help mitigate systemic risks in the overall marketplace. We manage financial crises effectively, not least because we have robust procedures in place to deal with a clearing member default and are prepared to act when the need arises. We maintain our readiness to act in these situations by continuously enhancing our risk management techniques and introducing innovative product offerings that increase the safety and reliability of the markets served.

Eurex Clearing ranks as one of the largest clearinghouses globally, offering fully automated, straight-through CCP and post-trade services for derivatives, equities, bonds, secured funding, securities financing and energy transactions. In November last year, our CCP service for the securities lending market was launched. The lending CCP covers international fixed income assets and European equities as well as exchange-traded funds. It preserves the key features of the current bilateral market for both lending and borrowing counterparties while being able to deliver significant operational efficiencies and cost reductions to all market participants.

Increased profitability for beneficial owners

One of the core indicators that beneficial owners use to determine which borrowing counterparts are permitted to engage in their lending programmes is the use of counterparty credit ratings. This observing process, employed by their agent lenders, is a continuous task for the agent lender to monitor and update the risk profile for each borrower and can be a complex and drawn out process. The end result is that a limited number of borrowers can only be allowed to participate in a beneficial owner's lending programme.

This can be overcome with the credit intermediation as delivered by Eurex Clearing's lending CCP. By applying strict membership and margining rules, the CCP is in a position to mitigate the respective counterparty risks efficiently without adding further risk to the overall financial system.

This enables the beneficial owner to open up

to a wider range of borrower counterparts. Additionally, all of the multiple bilateral legal agreements would be replaced by one single agreement with the CCP.

In a nutshell, the lending CCP effectively protects the beneficial owner from the risk of the borrower defaulting and saves the beneficial owner and agent lender a lot of operational burden.

And, a wider range of borrowers transacting with the beneficial owners increases volumes, utilisation rates and ultimately profitability for their securities lending activity.

A further innovation is Eurex Clearing's pioneering specific lender licence, by which beneficial owners have direct access to the lending CCP. They can participate as CCP members by using a non-cash collateral pledge model, and they will not have any margin obligations towards the CCP, nor will they contribute to the clearing fund. As the CCP is able to adopt their existing bilaterally agreed collateral eligibility schedules, which are maintained by agent lenders and managed by triparty collateral agents, the beneficial owners are able to tap into the benefits of the lending CCP without any changes to their existing relationship or setup.

Enhanced efficiencies for agent lenders

There are a number of aspects that highlight the vital role that agent lenders play in the securities lending value chain. Firstly, bringing the supply to the market via their beneficial owners and providing the expertise, market contacts and infrastructure available on behalf of its client base.

Two of the key areas in which agent lenders can make significant cost savings and efficiencies for their clients are in the provision of indemnification and also an increase in their beneficial owners' utilisation rates.

The lending CCP acts as a credit intermediary and takes over the counterparty risk. It guarantees the return of the loan securities and the collateral backed by a highly sophisticated and stringent margining regime and its lines of defence. This releases the agent lender from the need to offer indemnifications to beneficial owners—a very important aspect given the currently discussed capital cost increases enforced by regulators around the globe.

Additionally, a key aspect is improving utilisation of the beneficial owners' lending programmes. There are numerous funds or types of beneficial owners (eg, sovereign wealth funds) that can not be approved by borrowers, either from a legal or credit perspective, or the complex and time consuming nature of the approval process. With the lending CCP acting as the central counterparty, a wider range of lending participants are made available to the borrowers—thus increasing the utilisation and profitability for beneficial owners as well as their agent lenders.

Capital cost savings for borrowers

In addition to the increase in the liquidity for the market, there are a number of features that borrowers are able to benefit from when using the lending CCP. Globally, banks are now facing the very real demands of capital regulatory directives and liquidity capital ratios. Banks' risk weighted averages are being pressured by the type and level of activities that they are currently engaged in. Under existing Basel II regulations, there is a 0 percent risk weighting for transactions cleared via a CCP. When new Basel III regulations begin to take effect, the existing OTC transactions will face much higher stringent capital charges than the 2 percent charge that will be applicable for exposures towards a CCP. This enables borrowers, by making use of centrally cleared transactions, to free-up capital currently used for securities lending transactions and optimise their use of capital across other business lines.

Sophisticated risk and collateral management

One of the core functions of a CCP is to minimise counterparty risks and credit exposures for individual market participants. For the securities lending market, the lending CCP reduces the potential secondary effects of the failure of a major counterparty as the impact is mitigated and absorbed by the CCP's default protections.

As part of the service, Eurex Clearing's lending CCP—after novation—becomes the guarantor of the loan and collateral securities and as such is offering protection from counterparty default. Securities lending transactions are incorporated into Eurex Clearing's risk management methodology, which provides a robust and safe environment leading to an overall reduction in systemic risk for the market. The lending CCP undertakes near-time intraday risk calculations to ensure coverage of mark-to-market exposure, and in case of collateral shortfalls, intraday margin calls are initiated.

Also included in the offering are the services of triparty collateral agents. These specialist service providers are connected to the lending CCP in order to manage the collateralisation process for non-cash collateral on behalf of counterparties. This enables users of those triparty collateral agents to optimise their collateral usage to a further extent by adding CCP-novated loans. A wide range of equity and fixed income securities is accepted as loan collateral by Eurex Clearing, while the beneficial owner can still define its own collateral eligibility (as a subset of the CCP's collateral universe). The lender can re-use the non-cash collateral securities received according to the rules and regulations of the triparty collateral agent and the borrower still has the ability to substitute collateral.

Comprehensive advantages for the customers of the lending CCP

Besides risk mitigation, Eurex Clearing's main objective is to reduce the post-trade complexity, through its integrated trade and position management process, the lending CCP delivers enhanced functionality for trade capture, loan management, billing and reporting services.

Increased operational efficiency is realised through the automated flows between the trade capture, clearing and settlement platforms that the lending CCP includes. In particular, links to leading service providers for the securities lending market have been incorporated with triparty collateral agents, electronic trading markets and real-time post-trade automation service providers.

The lending CCP is instrumental in achieving a strong and robust securities lending franchise and facilitates through its innovative and pioneering development a cost-effective structure to improve and optimise securities lending activity through:

- Enhanced efficiency and safety for the entire market place;
- An increase in supply to the market, improving liquidity;
- Standardised and transparent risk and collateral management methods;
- Improved efficiencies on trading and operations of securities lending transactions;
- Reduction of the overall legal and documentation workload;
- Integrated cross-product service offering, allowing for the netting of regulatory capital across all cleared products;
- Collateral efficiency—a wide range of customised choice on collateral eligibility paired with re-use capabilities; and
- Capital efficiency—0 percent weighting under Basel II, 2 percent weighting under Basel III.

The lending CCP has been developed to meet the new demands of the securities financing markets, further reducing credit and systemic risk and further increasing operational efficiencies while maintaining important bilateral market characteristics.

As we fulfill the ongoing commitment of safeguarding the marketplace, we continue to play an important role in helping the financial markets deliver their full economic benefits, thereby ensuring that our customers are always in a position to be clear to trade. **SLT**



Gerard Denham
Clearing business relations responsible for securities lending
Eurex Clearing