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Join Ed Oliver, Senior Vice President, as he Co-Chairs
ISLA's Annual Securities Finance and Collateral Management Conference
June 17-19, 2014 in Berlin, Germany

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Market focus on the Lending CCP

Eurex Clearing recently announced a number of new participants as well as some additional service extensions and enhancements of its Lending CCP service, the first CCP for the bilateral securities lending market in Europe. Three leading market participants discuss the benefits of a CCP for their securities lending business

As committed clients to Eurex Clearing's Lending CCP, can you describe the key business drivers that influenced your decision to use the Lending CCP?

Andy Krangel: We see the central counterparty (CCP) cleared segment of the market growing over the next few years as the focus on capital costs increases. This will force borrowers and agent lenders to focus on counterparty exposure and the resulting balance sheet impact, therefore structures such as CCPs that reduce this will be of greater benefit.

The opportunities for an agent lender are twofold. Firstly it will enable them to maintain balances, or even increase them, with existing counterparties, and secondly, enable loans to be transacted with counterparties that may not currently generate enough revenue to justify the internal risks and credit reviews. The drivers will also come from borrowers, which will almost certainly push towards CCP clearing in order to reduce exposure and therefore capital costs incurred when transacting with certain beneficial owners.

Richard Deroulede: The first objective is to have the option to transfer some of the OTC stock loan trades we have onto the Eurex Clearing platform and benefit from a reduction in the cost of capital as well as in the consumption of balance sheet, thanks to the netting effect on the cash legs. We also expect additional netting benefits on the entire portfolio of products that we have with each CCP.

The second objective is to realise operational gains by reducing the number of clients and counterparties with which we are clearing stock loan trades. Gains will be not only on the day-to-day operations that will be simplified, but also in the on-boarding of new counterparties.

Paul Bradford: There were a number of drivers for ING. Firstly, we believe that the changes in the regulatory environment will make it either mandatory to trade at least some of the securities financing transactions through a CCP, or from a capital usage and risk-weighted assets savings perspective, it will make a compelling argument at some point.

As a result of these, we decided that ING should be in as early as possible in order to have some input into shaping the best model. We also looked at this from a credit perspective. A CCP clearly reduces reliance on individual lines with counterparties.

CCPs for securities lending have been discussed by the industry for many years. Why has Eurex Clearing's Lending CCP model been successful in achieving the recognition and commitment from market participants?

Bradford: We think that the Eurex Clearing model fits very closely to the current business model used in our market today, in that it allows us to maintain bilateral relationships with counterparties, but give them up to the CCP for clearing, credit and risk. It effectively gives the best of both worlds. Maintaining bilateral relationships is a crucial part of the offering for us at ING.

The ease of integration via Pirum was also a big selling point. As ING are real-time users of Pirum already, the CCP flow follows a very similar pattern for us as our normal business, so very few changes needed to be made to our systems infrastructure in order for us to trade on the platform.

Krangel: The key challenge for beneficial owners with previous CCP structures has always been the lack of collateral passed back to the beneficial owners. They are used to holding collateral directly or through their agent lender. For many beneficial owners regulations such as UCITS or internal rules require collateral to be held. Eurex Clearing's model is the first CCP to provide a solution to this need.

Deroulede: The securities lending market is about covering liquidity and short positions, which are simple but extremely important functions for the financial industry. It requires that market participants know each other and more importantly trust each other. Eurex Clearing has understood this key aspect and put in place a set up that preserves relationships while enabling to clear transactions in an efficient manner.

Where do you see opportunity for revenue/pricing for your business by using the Lending CCP as a borrower/lender?

Deroulede: The new regulatory environment is increasingly putting pressure for higher returns on balance sheet, threatening the sustainability of several trades. We view the business through CCP more as a way to maintain current stock loan balances and manage more efficiently the overall collateral posted to CCPs, rather than an a pure opportunity to capture more business.

Krangel: This remains to be seen. There may be an opportunity for an expansion of

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> Richard Deroulede, head of equity finance Europe
> **Société Générale Corporate and Investment Banking**

> "The number of markets that CCPs can clear for should be expanded, because this will make the operational benefits of a CCP more obvious"

Andy Krangel, director, agency securities finance, and EMEA head of business management
Citi Investor Services

borrowers for the CCP markets without the need to go through a documentation process and internal credit review. Whether this gives a significant revenue opportunity, however, is debateable.

More important may be revenue protection. In the future borrowers may push for a certain proportion of business to be routed through CCPs to reduce capital charges. They may even target loans with certain lenders. Without a CCP some of this business may become uneconomical in the future.

Bradford: There is still a lot of work to be done here on the financial benefits of trading on a CCP, as there is still a lot of debate around whether the specified savings from an risk weighted assets and capital charge perspective will outweigh the costs introduced. There is also more work to be done to understand a CCP's impact in the context of the new liquidity ratios and capital rules under Basel III. Once this is all understood and clearly documented, I think the correct pricing for use of a CCP will swiftly follow, or there just won't be enough pick-up of users.

What are the main regulatory topics leading the market towards greater use of CCPs for securities lending?

Deroulede: Most of the drivers are coming from the Basel III regulation, and in particular the introduction of: (i) the leverage exposure ratio, which creates negative bias on business with high balance sheet consumptions but low risk weighted assets such as stock loan and repo transactions; and (ii) the increased cost of credit for OTC transactions through the change in weights and the introduction of value at risk on credit valuation adjustments. The aim of the regulator is clear: it wants more centrally cleared transactions.

Bradford: I think a lot depends on whether the use of a CCP will at some stage become mandatory for parts of the business. The other big driver for ING is the impact that using a CCP will have in terms of real savings on balance sheet and leverage ratios, especially as we move into the world of Basel III. Some banks are further ahead in the adoption of Basel III metrics and therefore are being more proactive in reducing the impact. Those that are making the changes now, such as ING, should see the benefits materialise much quicker.

Krangel: The regulatory drivers continue to be Basel III and the impact it will have on capital availability and deal profitability. For US agent lenders, the Dodd-Frank Act will have an impact on the allowable exposure level with other banks and financial institutions, which will include indemnification risk.

These combined will potentially lead to greater use of CCP for securities lending.

What should CCPs focus on for the medium to long term so that they can assist the market further?

Krangel: There are two key areas the CCPs should focus on. Firstly, the number of markets that CCPs can clear for should be expanded, because this will make the operational benefits of a CCP more obvious. While the number of cleared markets is limited, the use of CCP will by its nature remain limited. Focus should be on the large markets where the bulk of lending occurs and should not be limited to Europe, the Middle East and Africa.

Secondly, the cost of using CCP services needs to be driven down over time, though CCPs will probably only be able to achieve this if volumes of CCP-cleared transactions grow significantly. Without this, CCP activity may be limited to loans that generate a higher basis points return. Typically, beneficial owners are used to their agents absorbing transaction costs and it will be a challenge to convince beneficial owners to absorb expense unless returns justify this.

For CCP volumes to increase, either beneficial owners will have to accept some of the costs or loan rates for trades in the general collateral/warm space may have to increase to offset the costs.

Deroulede: The main issue is on the cost of the CCP, especially with regards to the haircuts that will be charged. It will all depend on what will be the overall margin required by the CCP for the different products cleared. The key differentiation factor between CCPs will probably become sooner or later the efficiency offered by their cross-margining model.

Bradford: Helping people to understand their real costs now in terms of capital, how that will change under Basel III, and how a CCP will change things in real terms. The analysis to date has been based around average costs and we think that these will differ greatly from firm to firm. Once this can be ascertained, more firms will be likely to join the platform. Understanding all of the costs involved in trading on a CCP is also imperative because clearly, if the costs outweigh the benefits, or are very similar, it's going to be a hard sell.

We do, however, believe that as the product matures the costs should become much more of a secondary issue. **SLT**

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Paul Bradford, head of European equity financing
ING Commercial Banking, Financial Markets - Global Securities Finance

ISLA 2014 – meet us at booth 7.

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We were one of the first electronic, cross-border CCPs. And we were first to offer real-time risk monitoring.

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Now available: CCP service for securities lending

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