

## **A CENTRAL COUNTERPARTY IN THE EUROPEAN EQUITY SECURITIES LENDING MARKET? INITIAL REPORT OF AN ISLA WORKING GROUP.**

This initial report has been produced by a working group of borrowers and agent lenders from ISLA member firms. It relates primarily to equities securities loans in European markets. ISLA would welcome comments from member firms, central counterparties and other interested parties to [admin@isla.co.uk](mailto:admin@isla.co.uk). The working group may produce a further, more specific set of requirements in the light of feedback.

### **I General**

1. The group believes that a central counterparty (CCP) model will only be successful in the securities lending market if it preserves many of the key features of the current market model for underlying users.
2. For lenders (eg pension funds, collective investment schemes, sovereign funds):
  - Securities lending is low risk, with exposures collateralized by high-quality securities or cash to a value greater than that of the lent securities (haircut);
  - Lenders are able to recall lent securities on demand in order, for example, to sell them or vote in corporate elections;
  - Lenders continue to receive (manufactured) dividend income and maintain entitlements to corporate actions on lent securities.
  - As far as possible, securities lending is ‘invisible’ to the lender and its fund manager and is a source of incremental income at relatively low risk.
3. For end- borrowers (eg hedge funds, banks, collective investment schemes):
  - Borrowers receive clear title to borrowed securities so that they can be delivered into an outright sale;
  - Notwithstanding lenders’ right of recall, borrowers have confidence in the stability of their

borrowed positions, with intermediaries providing liquidity in most cases;

- Borrowers are able to choose between lenders based on more dimensions to the trade than price eg ability to provide stable lending balances, willingness to accept a wider range of collateral, tax rate received on dividends etc.

4. These features give rise to some characteristics of the securities lending market that make it different to other markets that are currently centrally cleared (eg derivatives, cash equities) and pose challenges for the CCP model:

- Post-trade processes are key in the securities lending market eg recalls of lent securities, collateral substitutions, manufactured dividend payments, corporate actions processing, re-rating of outstanding loans.
- The securities lending market is primarily a 'one-way flow' from lenders of securities to borrowers and opportunities for position netting are low.
- The securities lending market comprises a variety of types of institution in many countries subject to different regulatory frameworks eg banks, collective investment schemes, pension funds, insurance companies, sovereign funds.
- Securities lending requires the movement of securities and collateral between lender and borrower, with title transfer.
- Lenders and borrowers are not homogenous, even if a CCP removes credit differences. For example, borrowers may not be indifferent between two lenders for the same loan at the same rate, depending on other factors such as the likelihood that they will recall lent securities, the tax rate they require on manufactured dividends etc. For this reason, securities loans are not easily standardized.

5. The group has identified the following potential advantages of a CCP model in the international securities lending market model:

- reduced capital requirements for firms subject to financial regulations that transact as principals in the securities lending market;
- lower use of credit lines to other firms;
- being able to trade with a wide group of counterparties; and
- being ahead of any regulatory initiative to encourage a CCP model, in line with other markets eg credit default swaps.

6. These potential advantages (especially lower capital requirements and reduced use of credit limits) are likely to benefit principal intermediaries – borrowing securities as part of, for example a

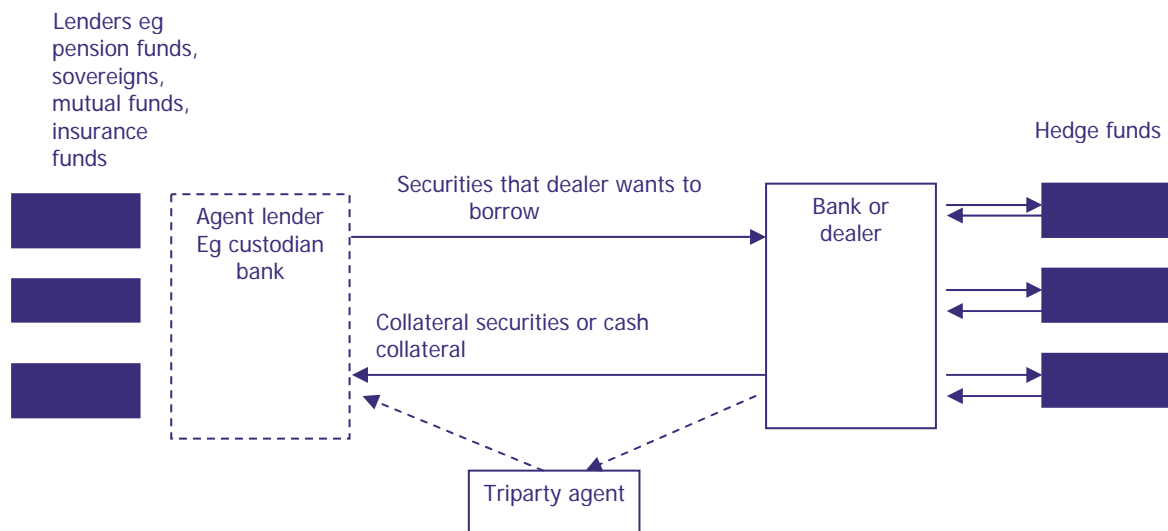
prime brokerage business – more than lenders and their agents. Many lenders are not subject to regulatory capital requirements and are protected from counterparty credit risk by over-collateralisation and, in many cases, indemnities from lending agents. For agent lenders, securities lending is off-balance sheet currently. In order to win support from lenders and their agents, the CCP model will have to provide access to greater and wider borrowing demand without giving rise to significantly higher costs or any increased risk exposure or concentration.

**What is a central counterparty?**

The 2004 BIS/IOSCO recommendations for central counterparties<sup>1</sup> define a central counterparty as ‘an entity that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer.’ Actually a central counterparty interposes itself between two of its clearing member firms, which in turn are exposed to their clients, the underlying buyers and sellers.

In securities lending, the current market model (see diagram below) is one in which lenders, such as pension and investment funds, transact with intermediaries, such as banks and dealers, often using agents, such as custodian banks and asset managers, to negotiate and execute transactions on their behalf. The intermediaries may, in turn, lend the securities to clients, such as hedge funds, or other market counterparties. Lent securities are delivered by the lender to the borrower with collateral securities or cash moving in the other direction, perhaps managed by a triparty agent.

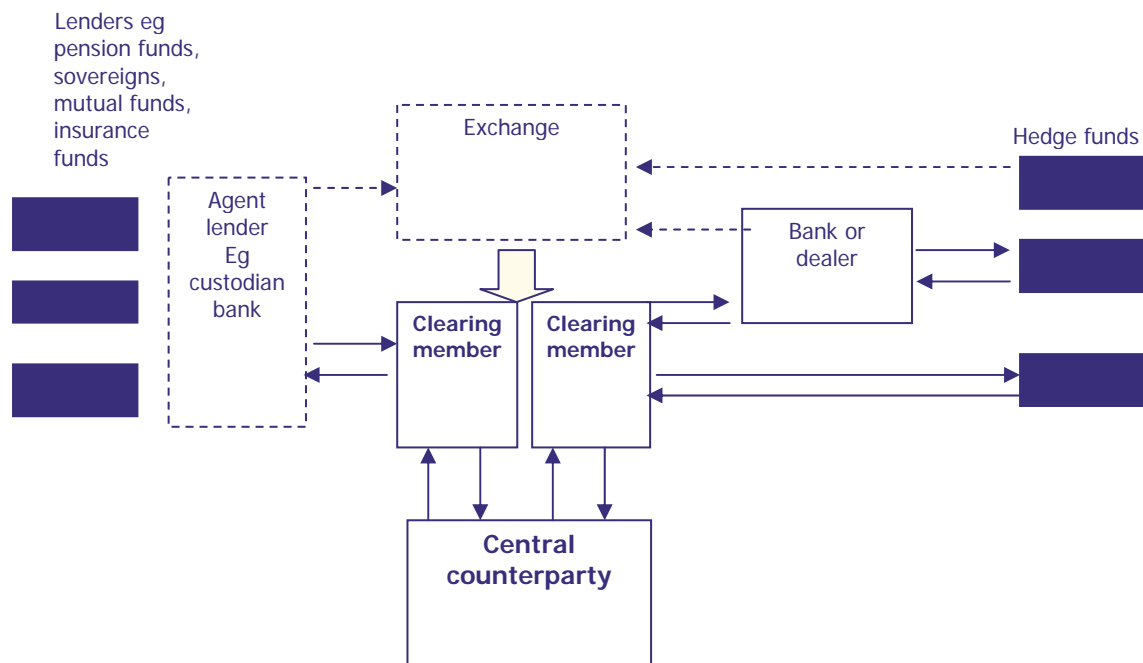
Current Market model



<sup>1</sup> Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD176.pdf> and recently updated for EU member states by the ECB and CESR at [http://www.ecb.int/press/pr/date/2009/html/pr090331\\_1escbcesrconsultationpaper200903en.pdf?5daf3baedb9222698639961b27a58513](http://www.ecb.int/press/pr/date/2009/html/pr090331_1escbcesrconsultationpaper200903en.pdf?5daf3baedb9222698639961b27a58513)

Introducing a central counterparty into the market would mean that the lender has no credit exposure to the borrower and vice versa. In principle, the standardisation of counterparty credit risk through the central counterparty could facilitate wider market access (eg to hedge funds directly provided they could find a clearing member) and the development of a securities lending 'exchange'. Lent securities would be delivered from the lender to the borrower via their respective clearing members and the central counterparty. Collateral securities or cash would move in the opposite direction from the borrower to the central counterparty via the borrower's clearing member. Depending on the arrangements of the central counterparty, those collateral securities might also be available to the lender in the event of the failure of the central counterparty.

## 2. Central counterparty market model



## **II CCP Models**

7. The group discussed two broad models for how a CCP might operate in the securities lending market:

- A 'full service' model. In this model, the relationship between the original lender and borrower would end at the point of trade. Anonymous trading would also be possible. Subsequently, both lender and borrower would manage their securities lending/borrowing positions either with the CCP (in the case of firms that are clearing members) or with their clearing member (in the case of other firms).

- A ‘narrow model’. Securities lending transactions would continue to be managed bilaterally between the original counterparties post trade, notwithstanding the interposition of the CCP and potentially two clearing members as principals between the two original counterparties. The CCP would provide a simple credit enhancement service.

8. Various hybrid models could also be envisaged but the working group thought the ‘full service’ and ‘narrow’ models were most likely to attract users.

9. The ‘full service’ model would bring the most efficiency gains and would be similar to how CCPs and clearing members operate in other markets. But the CCP and clearing members would need large and sophisticated back offices in order to manage post-trade processes such as collateral management, recalls, re-rates, corporate actions, collection of fees and dividend payments. In principle, the ‘full service model’ could enable each firm to manage its position in each security on a net basis vis-à-vis the rest of the market. In this way, an equal and opposite transaction with any other party could be used to close out an existing position – similar to, for example, futures markets. This version of the model would, however, require full standardization of the terms of securities loans (eg collateral, dividend payments, corporate actions etc), which seems unlikely to be consistent with maintaining the key features of the market for end-users. More likely, therefore, the CCP would need to maintain ‘linked’ trades between the original counterparties in order to manage, for example, recalls, returns, re-rates, corporate actions and dividend payments.

10. The ‘narrow model’ seemed more achievable in practice within a reasonable time period. But it would be a different model to that operated by CCPs and clearing members in other markets. Involving potentially six parties in each trade (lender, agent lender, agent lender’s clearing member, CCP, borrower’s clearing member, borrower) implied complexity and additional costs as each party would need to earn some return from what is typically a relatively low margin business.

11. The group also discussed other potential market models, including adopting a CCP model for the equity derivatives market as an alternative to ‘physical’ securities lending.

### **III High level guidelines for a CCP in the securities lending market**

#### **(a) Pre-trade**

- Maximum trade size should not be limited.
- Ideally loans of pre-defined baskets of securities as well as individual securities should be possible.
- Initially, it would be acceptable for a CCP to clear open trades only but there should be a plan to accept term trades in due course.
- A CCP will need to define a standard eligible collateral list according to its own risk management needs. Ideally, this should allow some flexibility. At least, it should include cash, G7 government bonds and major index equities.
- Membership criteria should be transparent and objective, both for non-clearing members and general clearing members. It should be possible for firms to become clearing members for securities lending business only eg agent lenders.
- Costs charged by the CCP and by clearing members will need to be low, probably less than €1 per trade in total, in order to make it cost-effective to use a CCP.
- Fees should ideally be charged on a per transaction basis, although it was recognized that this may be impractical as balances can be outstanding for a long period and post-trade maintenance may be costly.
- Tariffs should be fully transparent.
- CCPs should not be limited to a particular trading platform and should also be able to accept trades negotiated bilaterally between firms.
- Ideally a single CCP should clear all securities lending markets. Failing that, CCPs covering different geographic markets should seek to harmonise as far as possible in order to minimize the cost of duplication for firms.

#### **(b) Post-Trade**

- Ideally CCPs should use triparty collateral management agents and offer a choice of agent to participants.
- Buy-in processes following any settlement fails should allow a reasonable period of time to cure the fail eg three days after settlement date or when initiated by the counterparty (if applicable).
- The CCP should facilitate returns and recalls of lent stock, including partials.

- Firms should be able to substitute eligible collateral daily.
- The CCP should facilitate re-rates, initiated by lender or borrower.
- The CCP should facilitate manufactured dividend payments at tax rates agreed between the counterparties at the point of trade. The CCP should be neutral for tax purposes.
- Billing should be monthly on the same basis as current market practice.
- Cash collateral should be passed through to the lender for reinvestment.

**(c) Risk Management**

- Lenders should not be required to take counterparty credit risk on their clearing member. In the event of the default of a clearing member, the CCP should transfer outstanding securities loans to another clearing member or directly to the CCP.
- Following a default by the CCP, lenders should have an enforceable legal right to take ownership of and sell the collateral delivered to the CCP by the underlying borrowers, including any margin, in order to cover their exposure. Lenders should have a clear line of sight to the collateral accounts. (Some lenders, eg collective investment schemes, insurance companies, are required to be fully collateralized by regulations).
- Lenders should not be required to give margin to their clearing member or the CCP.
- Following a default by the CCP, borrowers should be able to close out their position against the CCP and have an enforceable legal right to the borrowed securities.
- Mark to market processes should operate frequently, as determined by the CCP. But members should have a reasonable period of time in which to deliver collateral following margin calls.
- Default fund contributions should be proportionate to the risks to the CCP arising from securities lending.
- Clearing members should be subject to credit requirements eg minimum capital.
- Preferably, CCPs should be user-owned utilities rather than for-profit entities.

International Securities Lending Association

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