It's better to have and not need

OCC remains innovative in the face of external pressures, says John Fennell

What was the aim of the CalPERs partnership?

We developed the committed liquidity facility with US pension fund CalPERS to increase our overall resources from $2 billion to $3 billion, while diversifying our pool of committed lenders to be less bank-focused. The partnership made Options Clearing Corporation (OCC) the first central counterparty (CCP) to establish a committed liquidity facility with a non-bank, all for the purpose of mitigating concentration risk. We already have a lot of bank risk and the way regulations are evolving and being implemented has put a lot of pressure on the costs of these kinds of facilities and more importantly the long term supply.

Also precipitating this change where the changes under Basel III related to the liquidity coverage ratio are making these facilities costlier for banks. We saw that as a potential problem in the future, so we moved to expand our pool of committed lenders and diversify beyond banks.

How has the partnership gone since its inception?

We used a potential disruption as an opportunity to collaborate with CalPERS and develop a really innovative solution by entering into the committed liquidity facility with us. It's worked well so far, with several tests proving that, operationally, it's running excellently.

Subsequently, we were able to also diversify the maturities of our current committed liquidity facilities and by working with CalPERS spread our lines out so we had portions maturing at different times throughout the year. That's a new innovation for us.

Why were the facilities due to expire at the same time?

Our committed credit facilities were comprised of one syndicated line, usually lasting for 365 days, so when that line matures there is a risk that one or more of the banks in the syndicate do not want to renew due to market conditions or other business related issues. Trying to ladder out a syndicated credit facility when there are 10 to 20 banks involved becomes complicated and if market conditions change, it can put a lot of pressure on the renewal day if banks don't subscribe.

The advantage of the CalPERS facility is that we're dealing with one counterparty, so it's a lot easier to move the battleship. Working with them we were able to reduce a portion in one term and then increase it in a different term spreading out the maturity of our liquidity which was much easier logistically.

How do you see your pool of facilities increasing in the future?

When we set up the CalPERS facility, it was all about forward thinking. This would lay the foundations, so in the future we will be able to set up other facilities with other pension funds. That forward thinking has worked out, because other pension funds have seen the trade and expressed an interest, and so we're talking to them.

At the same time, we're evaluating our overall resources and, whether it's through our stress tests or some other means, we're also looking at how much liquidity we need. We always look at whether these pension funds provide a good supply for us, while trying to strike a balance between wanting some exposure to the banks and alternative sources. It's about finding the right mix. We have worked on mitigating our counterparty risk, through moving to more non-banks. Then came the concentration risk, which we have diversified by spreading out the line so it matures at different times. Next, we'll work on bank-sponsored versus pension fund-sponsored and try to optimise the mix.

How do pension funds view this?

For the banks, these committed liquidity facilities take up their balance sheet, whereas pension funds look at them as a reinvestment opportunity for their stock lending collateral. After the financial crisis, pension funds were more cautious about their reinvestment cash and what the counterparty risk was on the cash reinvestment side. I think they look at CCPs such as OCC and see high-quality, high creditworthy counterparties to trade against. Pension funds are getting a good return for the risk trade-off and it's hard to find other assets on that risk spectrum to invest in.

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> **John Fennell**, Executive vice president, financial risk management, OCC

This is particularly true with the advent of money market reform in the US. We're seeing a lot of mutual funds having to buy up short-term US treasury securities as a result. Even from our perspective, we're always looking to protect our cash through reverse repo transactions and we're finding it very difficult to secure enough good quality collateral. I think you see that on the pension fund side and CCPs just give another good option for collateral.

What's in store for the rest of the year?

Money market reform is another event we're focused on. In terms of protecting our cash investments, it's a regulatory event that we really need to plan around. I think money market reform is going to make it more difficult, for ourselves and our clearing members, to secure US treasuries as collateral, because they are going to be so in demand. Treasuries are our second most popular type of collateral, so if we see that moving away, especially in the low interest rate environment, you can see cash increasing in importance as a collateral type.

We're also focused on various other bank regulations, such as risk-weighted assets calculations, that make banks engaging in capital markets significantly more capital intensive. The current exposure method calculation is causing stress because banks are having to cover what we would call punitive capital requirements. We are pushing hard for the US regulators to adopt an alternative method to the standardised approach for measuring counterparty credit (SA-CCR) more quickly. From our perspective, the current exposure method calculation is punitive, especially for options, because it uses a notional value as a proxy for risk. There's no delta-adjusted component, whereas SA-CCR incorporates this, which brings those capital charges to a more reasonable risk-based level. **SLT**