

OCC: Laying the foundations for a future-fit CCP securities lending model

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In conversation with Matt Wolfe, vice president of strategic planning and development at OCC

Chicago-based OCC, the world's largest equity derivatives clearing organisation, has been operating stock loan programmes for 27 years. The stock loan/hedge programme was introduced in 1993 for its clearing member firms, while the market loan programme launched in 2009. In both instances, OCC acts as the principal counterparty to both the borrower and lender in the transaction.

Average loan balances for the stock loan/hedge programme reached \$72.5 billion last year. Although this was down on 2018's total (\$83.3 billion), significant growth has been achieved over the last decade. In 2012, for example, average loan balances stood at \$10.9 billion. OCC noted that the continued bull market of 2019 contributed to an industry-wide decline in activity balances. However, the notional value of stock loan ended 2019 very close to when 2018 started. Despite this decline OCC continues to see increased interest in clearing as cost pressures increase; during 2019 OCC had an additional seven members sign up for the stock loan programmes bringing the total to 78 clearing members.

Average loan balances for the market loan programme jumped 70% from \$918 million in 2017 to almost \$1.6 billion in 2018, increasing by a further 52% to \$2.4 billion in 2019.

Matt Wolfe, vice president of securities finance at OCC, points to the 2010 Dodd-Frank Act and establishment of minimum risk-based capital requirements as a key driver of increased CCP usage. More recent regulatory changes, however, may also generate additional interest in the CCP securities lending model.

“As the uncleared margin rules (UMR) for non-cleared derivatives continue to be applied to more and more counterparties, it is possible more firms might look for alternative ways to achieve the same financial outcome of gaining exposure to a security or hedging the risk of financing,” explains Wolfe. “Securities lending through a CCP may provide opportunities to do that in an equivalent way on potentially a lower cost basis.”

The fifth phase of UMR's roll-out will capture firms with an aggregate average notional amount (AANA) of non-centrally cleared derivatives greater than €50 billion from September 2020, and firms with an AANA of more than €8 billion will need to comply with the rules from September 2021. While it has predominantly been sell-side firms and some larger buy-side firms that have been captured by the first four phases of UMR, the upcoming phases are expected to impact more of the buy-side.

Building up the fundamentals and transforming for the future

OCC has been working to further improve its stock loan capabilities and ready its infrastructure and product offerings for the future needs of market participants via a three-step approach that aligns with the organisation's wider five-year plan.

Introduced by OCC's board in 2018, the strategic plan will be implemented in three stages, with the first phase known as 'reinforcing the foundation'. This focuses on strengthening the CCP's resiliency and liquidity resources, tightening its cybersecurity systems, and ensuring its technology is fit for the future.

OCC is also enhancing its risk management framework. In December 2019, the US Securities and Exchange Commission (SEC) approved phase two of OCC's Financial Safeguards Framework (FSF), which included changes to its rules, guarantee fund, stress testing and margin methodology that are designed to increase OCC's resiliency as a systematically important financial market utility (SIFMU). Phase two follows the first round of enhancements implemented in September 2018, which included resizing OCC's guarantee fund resources to cover the simultaneous default of OCC's two largest clearing members.

The second stage of OCC's five-year plan revolves around 'growing the base'. Wolfe says: "With a stronger foundation in place we will be positioned to begin work on enhanced services, new products, and to consider new ways to help our clearing members gain capital savings.

"Once we have grown our base among our clearing members with our products and services, we will then look outside of our typical boundaries to see where OCC could benefit financial markets more broadly in new and possibly different ways." The latter aim embodies the third phase of the strategic plan: 'innovating for the future'.

Advancement of the stock loan programmes will follow the three-step trajectory outlined above. 'Reinforcing the foundation' includes the introduction of a new technology platform for clearing stock loans. OCC is working on a new stock loan system that will continue to support both hedge and market loan transactions in largely the same manner as the current system does but will also support a new enhanced model that will more closely align with market practices and better reflect OCC's role as a counterparty.

"We are also anticipating rule changes to address some of the legacy limitations of the hedge programme in order to capture additional data, including full details of the rates and terms," adds Wolfe.

He continues: "Once we have that new programme and technology in place, we will begin taking steps toward introducing services such as support for baskets of loans for term financing, as well as non-cash loans, as part of the 'growing the base' phase of OCC's broader corporate strategy."

When it comes to 'innovating for the future' and expanding beyond its current boundaries, the clear target is engaging the buy-side, points out Wolfe. For buy-side firms, CCP securities lending creates potential for higher utilisation, lower costs, and improved pricing, he notes.

"The majority of buy-side firms' securities lending activities are facilitated by agent lenders, but banks are subject to capital requirements, as are the majority of borrowers," Wolfe says. "Clearing transactions through a CCP means that the regulatory capital requirements are typically about 95% less than uncleared bilateral transactions. Not only could that reduce the costs of agent lenders, it could also create potential for borrowers to be able to borrow greater amounts of securities or offer better pricing for the securities they are already borrowing."

One question that emerges around the take-up of CCP securities lending among the buy-side is the impact it may have on the traditional role of agent lenders and indemnification.

Wolfe says: "Indemnification is a key risk management tool for almost all beneficial owners. Once you come into a clearing structure, many of the risk management features that we introduce make indemnification somewhat redundant, but I do not believe there will be a sudden decrease in the number of firms looking for indemnification from their agent lenders. However, OCC's credit rating and risk management framework could lower the cost of indemnification relative to existing counterparties."

As part of its efforts to widen access to its stock loan programmes, OCC has been designing a clearing framework that will suit the requirements of most market participants. "We have a lot of work to do around implementing new technology and working with regulators and the industry to bring that model to fruition," notes Wolfe. He goes on to explain that the organisation is working towards having the

technology and framework in place that will enable agent lenders and beneficial owners to have better informed conversations about CCP lending and the OCC's role as a central counterparty.

He adds: "The core of what we do is stepping in and becoming the counterparty for lenders and borrowers, providing a guarantee of performance and mitigating the risk of loss because of failure by the original lender or borrower. That is not to say that there isn't an ongoing relationship between the borrower and lender, but this relationship exists against a much sounder foundation that is guaranteed by OCC. This enables market participants to engage with counterparties that they might not be comfortable dealing with on a bilateral basis and means that they may be willing to take much larger positions under the umbrella of protections that OCC provides."

Modernising technology platforms and leveraging data tools

At the heart of the significant amount of work OCC is currently carrying out to achieve its goals for the future and complete the first step of 'reinforcing the foundation' lies the Renaissance Initiative. "The Renaissance Initiative is OCC's largest undertaking in at least 20 years," says Wolfe.

Announced in January 2019, this multi-year initiative will see OCC modernise its risk management, clearing, and data systems. In addition to the clearing system being developed with Nasdaq, new risk management features aim to deliver increased transparency for clearing members, while a new cloud-based data platform will be populated with at least 10 years' worth of historical data to allow for greater insight and intelligence capabilities for both OCC and its members. An extensive period of internal and external testing will take place to provide clearing members with the opportunity to ensure that their current systems will continue to operate alongside OCC's new systems and to try out the new features being introduced.

"The point of the Renaissance Initiative is to make sure we are delivering on what the industry needs. We are closely collaborating with our clearing members to understand what it is they need in the short term and also thinking about what we can do now to ensure we are addressing needs that may be unidentified, perhaps five or 10 years down the road," says Wolfe.

To support the introduction of its new systems, OCC is working with staff to develop their skills and enable them to leverage its new technology and tools. Wolfe adds: "We also have a team of process engineers who are going through OCC's processes and looking at ways to streamline them, introduce automation, and make them more efficient so we can better serve the users of our markets."

Beyond improvements to its own systems, Wolfe sees emerging technologies, such as smart contracts and distributed ledger technology, as creating opportunities for the industry to address some of the current pain points, namely, escalating costs, errors, and manual processing. "The immutability of changes to contracts with distributed ledger technology will reduce errors and reduce the amount of manual processing and the associated cost of reconciliation," he explains. "There are a lot of ways that technology could be employed in the industry that we haven't even envisioned yet."