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UPGRADE INITIATED

OCC’s Renaissance Initiative is in full swing with plans for new term lending and non-cash collateral services

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Renaissance reboot

Scot Warren
Chief operating officer
OCC

The Options Clearing Corporation’s Scot Warren sits down with SLT to talk the Renaissance (no not that one), the approval of the CCP’s capital management policy and the potential for changes to collateral rules

What’s new at OCC?

We are currently undertaking a three-year transformation effort to completely rebuild our technology stack. It’s a project we internally call the Renaissance Initiative. Fundamentally, we’re going to re-do our technology and re-engineer our processes so we can better serve our customers.

We currently have a stock loan clearing programme that’s only available to sell-side participants and has about $80 billion in balances. With the Renaissance Initiative and through our rule filing process, we are working to add new capabilities such as non-cash collateral and term lending, for example.

OCC started stock loan clearing so that firms could get margin benefit for the risk offsets that their stock loan positions have on options portfolios. Now capital efficiency and stability of financing are a greater focus, so bank-owned firms want to bring more of their business into a central counterparty (CCP) like OCC. To meet these goals OCC is looking at ways to support term financing and non-cash lending.

Earlier this year your capital management policy got approved. How important is that for your plans?

It is very important. It gives us the pre-funded financial resources to meet our expectations as a systemically important financial market utility for operational resilience. The approval of this policy allows us to demonstrate that we are well funded and provides transparency to market participants.

We had a great deal of cooperation with the Trading and Markets Division of the US Securities and Exchange Commission (SEC) and through our industry outreach. This was essential to ensure market participants understood what we are doing and why we are doing it. Our effectiveness at communicating our plans was demonstrated by the very few letters received by the SEC as part of its public comment period on our plan and that helped to accelerate the approval process.

Clearing volumes indicate there’s a trend towards moving to a cleared solution beyond what’s mandated. What’s driving this in the US?

From the agent lenders’ point of view, there’s a clear benefit because it would potentially lower the cost or even replace their need to provide indemnification to the beneficial owners they act for. However, the buy side still needs to be convinced of the benefit of clearing. As they see a capacity for better pricing or higher utilisation from dealers they will become more interested.

Reducing the cost or need for indemnity could increase the profitability of general collateral lending so that the buy side can make more of their portfolio available to lend.

Overall, I think the buy side is more aware of clearing than they were a few years ago but they still need more transparency on why they should change their model and how it affects their risk profile.

The question of what’s in it for the buy side comes down to whether they are getting the full potential from their lendable inventory and are they getting the best rate of return on their loans? Broker-dealers that are borrowing from an agent on a bilateral basis can have a 100 percent capital charge and so it costs them more to do it outside of CCP clearing. Therefore, theoretically, buy side participants should start seeing a better rate paid on lending through a cleared solution and that will also create more capacity for borrowing general collateral, not just hard-to-borrow and specials.

Lending revenue in 2019 didn’t live up to bumper profits we saw the year prior. Does clearing become more or less attractive the more earnings pressure grows?
The clearing model becomes more attractive the more pressure revenue is under. Right now a lot of the lending agents cannot profitably manage general collateral so they don’t do it. That means the buy side is sitting on assets they could be lending but aren’t. At the same time, the buy side may not be getting the best possible rates on the hard-to-borrows because a bank has to put up more capital to do that trade bilaterally.

Speaking of collateral, there are rumours that SEC Rule 15c3-3 will finally be amended to allow for the wider acceptance of equities by lenders. Thoughts?

For the broker-dealer community, it’s critically important to effectively manage their assets and regulatory capital requirements. Changing 15c3-3 so that borrowers can post equities as collateral would enable broker dealers to free up more liquid assets and utilise their inventory of equities to collateralise their borrows. This would enable better management of cash flows and reduce regulatory capital for liquidity requirements.

If equities are used to a larger extent, then both lenders and borrowers must carefully consider whether this increases their operational or financial risk.

Regarding operational risk, it’s important to make sure that you have the right staff, systems, and processes to ensure that the collateral is managed in an effective and efficient manner. OCC is entrusted with managing on average $125 billion in equity collateral each day. We have and continue to make significant investments to ensure that our collateral management processes are both effective and efficient.

Regarding financial risk management, it’s important to consider a number of different factors that could lead to shortfalls in a liquidation scenario if they aren’t effectively managed. OCC has developed sophisticated systems to account for a variety of different risk factors such as likely changes in the value of individual securities, volatility, the correlation between equities, potential changes under stress scenarios, and the cost to liquidate a pool of securities just to name a few. The traditional practice of establishing a set percentage that loans must be overcollateralised by may not be sufficient in order to effectively manage the financial risk associated with a pool of equities.

What effect do you think it would have on the market if the rule was changed?

In theory, it would expand the use of non-cash as a collateral type for loans. Non-cash loans are typically less expensive from a capital and liquidity perspective, so allowing dealers to utilise their equity inventories should boost their demand for loans.

What are the challenges to reform?

The SEC has a wide mandate and a lot of issues to deal with. Moreover, the constituency that this affects is small so it’s low down on the SEC’s priorities.

Theoretically, buy side participants should start seeing a better rate paid on lending through a cleared solution

Scot Warren, chief operating officer, OCC
We clear the path

OCC has the largest centrally-cleared stock loan offering in the world with approximately $80 billion in cleared loan balances. Over the last 25 years, OCC has built an innovative and unique U.S. program for securities lending transactions where OCC steps in as the counterparty (with a two percent risk weight) and guarantees the return of stock or collateral. We continue to enhance and expand access to our stock loan program in order to offer clearing solutions and capital efficiencies for our members and the entire securities finance industry.

As the world’s largest equity derivatives clearinghouse, OCC is committed to providing market participants with high quality and efficient clearing, settlement and risk management services. As a Systemically Important Financial Market Utility, we work to enhance our resiliency in order to reduce systemic risk, increase market transparency, and provide capital and collateral efficiencies for the U.S. capital markets.