

Repo Client Clearing

ERCC Professional Repo Market and Collateral Management workshop 2021

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CCP Membership - Background

Banks/Broker Dealers

- Traditional CCP members are financial intermediaries such as banks and securities firms
- Highly regulated and generally well capitalized – within risk appetite for CCPs
- Better able to share in risk mutualisation
- Dealers transact both repos and reverse repos with other dealers → netting benefit & reduced exposure
- Transact large volumes and have significant operational capability – commercially sound proposition for CCPs

Clients

- Includes entities such as Pension Funds, Insurance Companies, Investment Funds, Corporates
 - In some cases not subject to same level of regulatory oversight/capital requirements
 - Do not meet traditional membership requirements
 - Unable or unwilling to participate in mutualisation
 - Typically directional portfolios → more risky + reduces scope for netting
 - Transact lower volumes and sometimes do not meet CCP operational requirements – historically seen as less attractive commercially for CCPs
- However, some dealers were keen for CCP membership to be offered to buy-side institutions
- Some buy-side institutions have also pressed for access – incentivisation from dealers

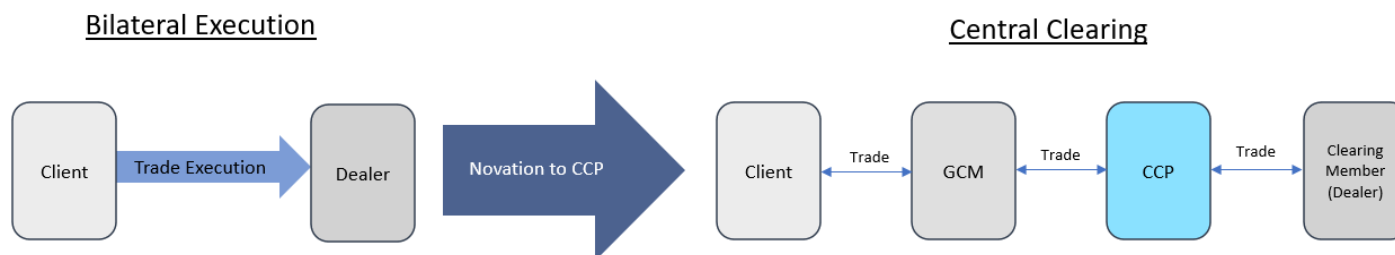
Indirect (Third Party) Clearing

- For a number of years, clients have been able to access CCPs, albeit indirectly

→ Third Party/GCM Model

- The Third Party Model has been most successful in OTC derivatives, particularly where there is a regulatory mandate for central clearing e.g. IRS through LCH SwapClear
 - The Third Party model is a “back-to-back” model whereby the client is not a direct member of the CCP, they access the CCP through a direct member – known as a ‘General Clearing Member’ or ‘GCM’
 - The CCP faces the GCM as principal – without any exposure or risk to the client – and the GCM faces the client via a back-to-back transaction
 - The Third Party model has been rendered largely unviable from a balance sheet perspective for the Clearing Members (explained overleaf)

Illustration of Third Party Model:



Third Party Clearing

Why the model isn't viable for repo

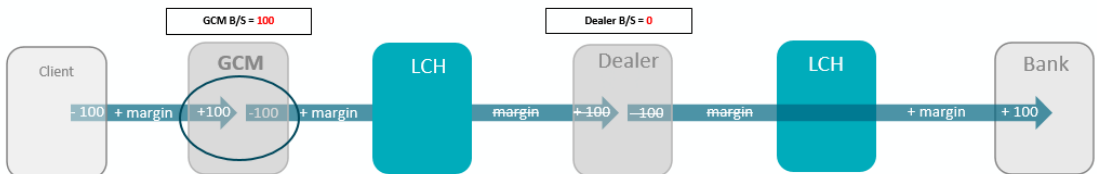
- In Third Party Clearing, the GCM is the clearing member and LCH's principal (LCH has no direct relationship with the client)
- The GCM model is used extensively in derivatives clearing, for example LCH's SwapClear service. The GCM model is appropriate for this business as interest rate derivatives are non-physically settled hedging products and are therefore, compared to physical securities, less capital and balance sheet intensive
- The GCM model is also used in cash equities, which physically settle and are on b/s, but principal amounts are small relative to bonds
- A GCM model for repo would require the GCM to settle directly against LCH and then onwards to their client (a back-to-back transaction). This arrangement has the same grossing up effect for the GCM's balance sheet as for an intermediating bank in a bilateral uncleared transaction → hence the balance-sheet burden is merely relocated, rather than reduced

Illustration of balance sheet effect of client clearing model for a GCM:

Uncleared:



Cleared using Third Party Model:



Repo Client Clearing – Challenges and Innovation

The need for a buy-side solution for Central Clearing

- Extending the benefits of central clearing for repos to the buy-side (*client business*) has required innovation away from incumbent Client Clearing models such as Third Party Clearing
- In addition to ensuring the solution does not generate excessive balance sheet requirements and is a commercially viable proposition, CCPs have had to address a number of other challenges and obstacles:

1. Risk mutualization

- Clients do not want to be exposed through mutualization to the default risk of dealers
- Many are prevented from doing so by regulation
- Dealers don't want to be exposed through mutualization to other dealers' clients, particularly less regulated and less well capitalized clients

2. Client relationships

- CCP access could make it easier for clients to switch their business to other dealer CCP members.
- Opportunity for clients to expand their range of dealer counterparties
- 'One-to-all' model of a CCP - one credit line and a single legal agreement (with the CCP) to trade with other members

3. Operational capacity.

- Central clearing is highly automated
- Clients may not have operational capability to meet CCP margin requirements (margin calls 5-6 times per day) – although many clients have invested significantly in this area in recent years (e.g. driven by UMR)

4. CCP/Clearing Member Regulatory Obligations (under EMIR)

- Clear distinction between definition of 'Client' and 'Member'
- Member responsibility for all financial obligations to clearing house

Summary: RepoClear Sponsored Clearing

UNLOCKING EFFICIENCIES

Sponsored Clearing extends the benefits of direct CCP membership to the broader investor community in a model specifically designed for the buy-side.

By inviting Member banks to sponsor buy-side direct access to the CCP, LCH supports the growth of an innovative way of doing business that enhances existing transactional and clearing relationships.

The Sponsored Clearing model seeks to deliver capital, balance sheet and margin efficiencies for our membership by increasing netting opportunities.

KEY FEATURES

- Sponsored Members (Investors) have direct full Membership of the CCP, sponsored by an Agent Member (Bank)
- Agent Members provide a range of services for their Sponsored Member, including provision of Default Fund and margin management
- Sponsored Members are ultimately responsible for margin payments and trade settlement
- Agent Members confirm sponsorship of each Sponsored Member trade prior to clearing

Broader market participation in clearing benefits the whole membership

FOR BANKS, SPONSORED CLEARING INTRODUCES:

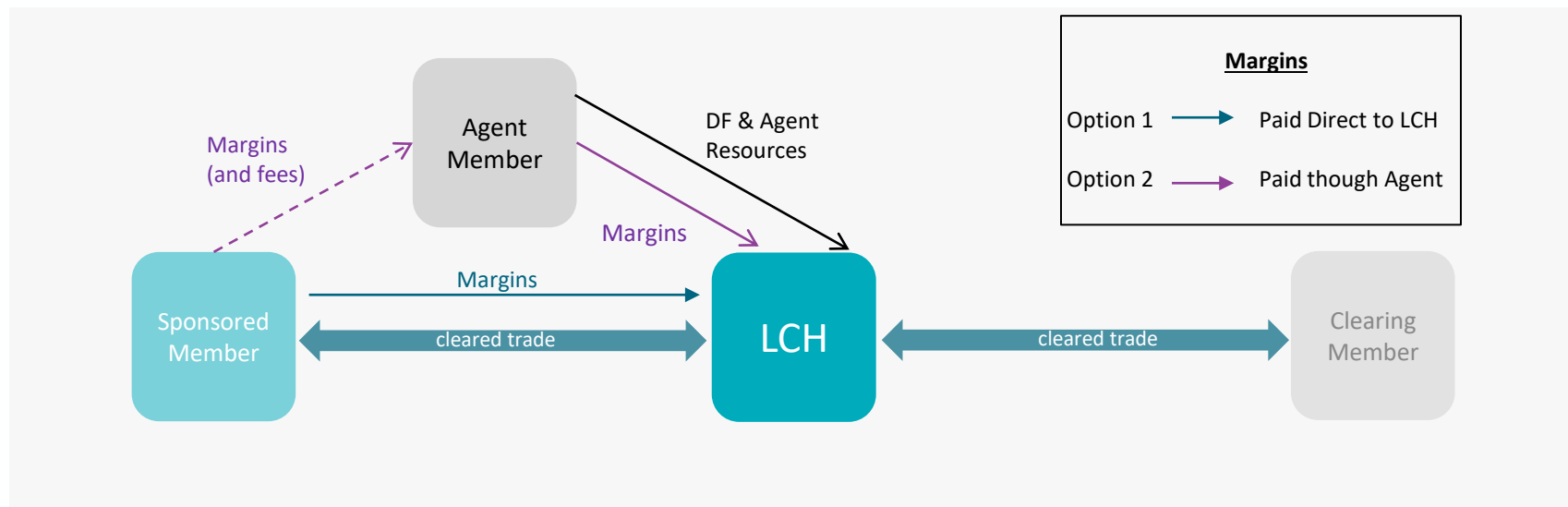
01. Opportunities for increased balance sheet optimization and capital efficiencies
02. Enhanced transactional relationships with customers: banks can sponsor their customers' access to the service
03. Increased operational efficiencies through settlement netting (for Banks acting as Dealers)

FOR SPONSORED MEMBERS, BENEFITS INCLUDE:

01. Potential for bank capital savings to be reflected in more capacity for Sponsored Member activity
02. A reduction in bilateral credit risk and default exposures through LCH's world-class risk management of cleared trades
03. Increased operational efficiencies through settlement netting

LCH Sponsored Clearing

Model Overview



Sponsored Member Responsibilities

- **Direct transactional relationship with LCH**
The SM is LCH's direct counterparty for each cleared trade
- **Trade Settlement**
The SM settles directly with LCH (or through their Custodian/Settlement Agent) - the Agent does not guarantee performance
- **Margin Liability**
The SM is responsible for all margins to the CCP – margin payments are facilitated by the Agent Member or may be paid directly

Agent Member Responsibilities

- **Default Fund Contributions / Waterfall**
The Agent Member provides Default Fund Contributions
- **Agent Resources**
The Agent provides an Agent Buffer as a pre-funded resource for margin payments, and an ARC as an additional layer in the default waterfall
- **Margin Management ('Paying Agent')**
The Agent facilitates the payment of the Sponsored Member's margins in a Paying Agent capacity via its PPS/Target2 account

An LSEG Business

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