

Eurex Clearing

OTC Derivatives: Balancing Regulatory Obligations with Efficiency

October 2019

Eurex Clearing – Responding to Change

Clearing significantly improves market safety and efficiency

1

Capital Rules

- Increasing regulatory pressure on capital requirement
 - RWAs and Leverage Ratio (LR)
 - Net Stable Funding Ratio (NSFR), Liquidity Coverage Ratio (LCR)
 - Increase margin, haircut and collateral requirements

2

Concentration

- Traditionally CCPs direct membership was limited to banks
- Clearing member exits and limited new entrants driven by capital rules
- Increasing concentration on a fewer number of clearing firms offering client clearing

3

Porting

- ISA models already increased the porting likelihood over traditional OSA models
- However, operational obstacles and increased capital requirements are significant challenges to effectuate porting under the traditional client clearing arrangements

In order to unlock the full benefit of central clearing, sell and buy-side participants need to unlock capital, margin and collateral efficiencies

(1) Capital Rules

Increased pressure on client clearing

Challenge

- Derivatives and securities financing transactions (SFT) are coming under increased regulatory pressure, substantially increasing costs for participants in offering client clearing directly or indirectly for clients
- Basel III raises capital requirements significantly based on risk weighted assets (RWAs) and a new **leverage ratio requirement** against un-weighted on- and off-balance sheet exposure
- BCBS-IOSCO, LCR, EMIR and other regulations increase **margin, haircut** and **collateral requirements** whilst limiting re-use of collateral, particularly for bilateral transactions, with new Basel III liquidity rules putting additional strain on global collateral balances

Solution

- In order to unlock the full benefits of central clearing, sell and buy-side participants need to look for superior capital, margin and collateral efficiencies, provided only by the most advanced CCP models
- Eurex Clearing has analyzed new direct clearing models across derivatives, repo and securities lending to eliminate bilateral and extra CCP leg exposures, thereby optimizing capital costs, resulting in higher capital efficiencies while maintaining the existing client clearing market structure
- This is achieved by making the buy-side organization a direct legal counterpart of the CCP

(2) Concentration

ISA Direct diversifies the direct member base

Challenge

- As an intermediating risk management mechanism, a CCP and its participants benefit most from a broad and diverse membership since:
- Efficiencies of a CCP in terms of multilateral netting and mutualisation of tail-risk are greatest for large markets, and
- CCP risk management benefits from diversity of membership in both the daily quality of price discovery and trading, as well as the benefit in terms of de-correlated default scenarios
- These benefits are complemented for members and their clients by other features, e.g. the general reduction in concentration risk for positions across both prop and agent accounts
- For regulators the market discipline, transparency and risk mitigation features of CCPs are clear, and the increase in the diversity of members beyond traditional large banks draws the benefit of increasing these features to the new membership

Solution

- With ISA Direct, in particular investment firms, asset managers, and pension funds trading clearable instruments and products will be brought under the CCP's rulebook
- Additionally, by introducing this new direct access model, the safety of the CCP and the integrity of financial markets in general will be supported
- Admission criteria and the risk management framework are amended in certain areas

(3) Porting

ISA Direct increases the likelihood of porting

Challenge

- EMIR requires all CCPs to offer at least one omnibus and one individual segregation model with respective porting structures in place
- The likelihood of porting will drive the overall size of the portfolio to be liquidated and the overall stress to the market and the effected CCP and its clearing members
- Even with such strict regulation the likelihood of porting does not only depend on the quality of the model and the framework for porting offered by the CCP
- The willingness of Clearing Members to onboard clients in such crisis is key and is driven by the quality of the client, the risk appetite and by the additional equity capital necessary to cover the additional exposure under the new capital rules

Solution

- Compared to regular ISA clients, the ISA Direct Members show greater independence with respect to their Clearing Agent
- The greater independence increases the possibility of finding a new Clearing Agent, and further minimizing the overall concentration risk for the CCP

Future Regulatory Trends in Clearing

The amount of centrally cleared trades will further increase

- Driven by regulatory development such as the perspective inclusion of further asset classes to the central clearing mandate as well as the final phase in of uncleared margin rules constitute an incentive to move more volume to central clearing.
- Most importantly the netting gains will also be a drive to move business towards central clearing and prove to be a competitive edge of market places.

Efforts at the international level on CCP practices are expected to continue, and to extend to CMs and clients

- Continuation of active discussion between all involved stakeholders to keep the clearing space up to date to changes of the market structure to preserve the effectiveness of the clearing system as a whole (e.g. the latest consultation on DMP and auctions helps to identify potential fields for necessary adaptations and ensures the system is effective and maintains a sound incentive structure).
- The development of a CCP recovery and resolution framework is the missing piece of the puzzle to implementing the G20 stability agenda.

Ongoing competition between CCPs for market share

- Driven by differences in the setup and quality of services of different CCPs: breadth of membership basis, customer services (securities lending, direct membership), recovery tools accepted (VMGH vs, cash calls), etc.
- But also influenced by geopolitical developments such as Brexit and equivalence decisions being used as diplomatic levers.

Industry solutions make adjusting to dynamics in clearing landscape easier

- Industry solutions are being developed to help market participants better cope with the challenges they face due to the evolving / ever changing clearing landscape.
- ISA Direct is an alternative access model developed by Eurex Clearing that creates better access for the buy-side, reduces risk concentration among clearing Members and as such leads to a more equitable and balanced clearing landscape.

Key considerations for Category 3 & 4 Firms

Competition has created choices which need to be evaluated ...



1. COMPLICATED PROBLEM

- Regulatory compliance
- Political uncertainty
- Best Execution obligations
- Cost

2. Evaluate Choices

- Choose a CCP
- Choose a Clearer
- Decide level of segregation
- Choose execution platform

3. To Drive Efficiency

- Operationally efficient
- Cost effective
- Optimise collateral
- Access

Best Execution - Cost of Trading & Clearing

What does it mean?

Article 27 of **MiFID II** sets out these characteristics under the obligation to execute orders on terms most favourable to the client, where firms must consider:

Price

Costs

Speed

Likelihood of
execution and
settlement

Size

Nature

...or any other
relevant
consideration

Day 1 Considerations:

Access to Trade:

- Bilateral or Cleared
- OTC or listed

Price of Trade:

- Bid/Offer spread
- Cost of capital drivers; CCP c-factor, DF efficiency, compression probability
- Dealers' position

Lifetime cost considerations:

- Initial Margin
- Cost of funding
- Collateral eligibility
- Fees
- Operational costs
- Asset safety

Clients need to review their 'Best Execution' policies – It is no longer just about best price

Combining Repo & IRS through Direct CCP Membership

Integrated collateral management under ISA Direct provides access to GC Pooling's repo liquidity

The Challenge

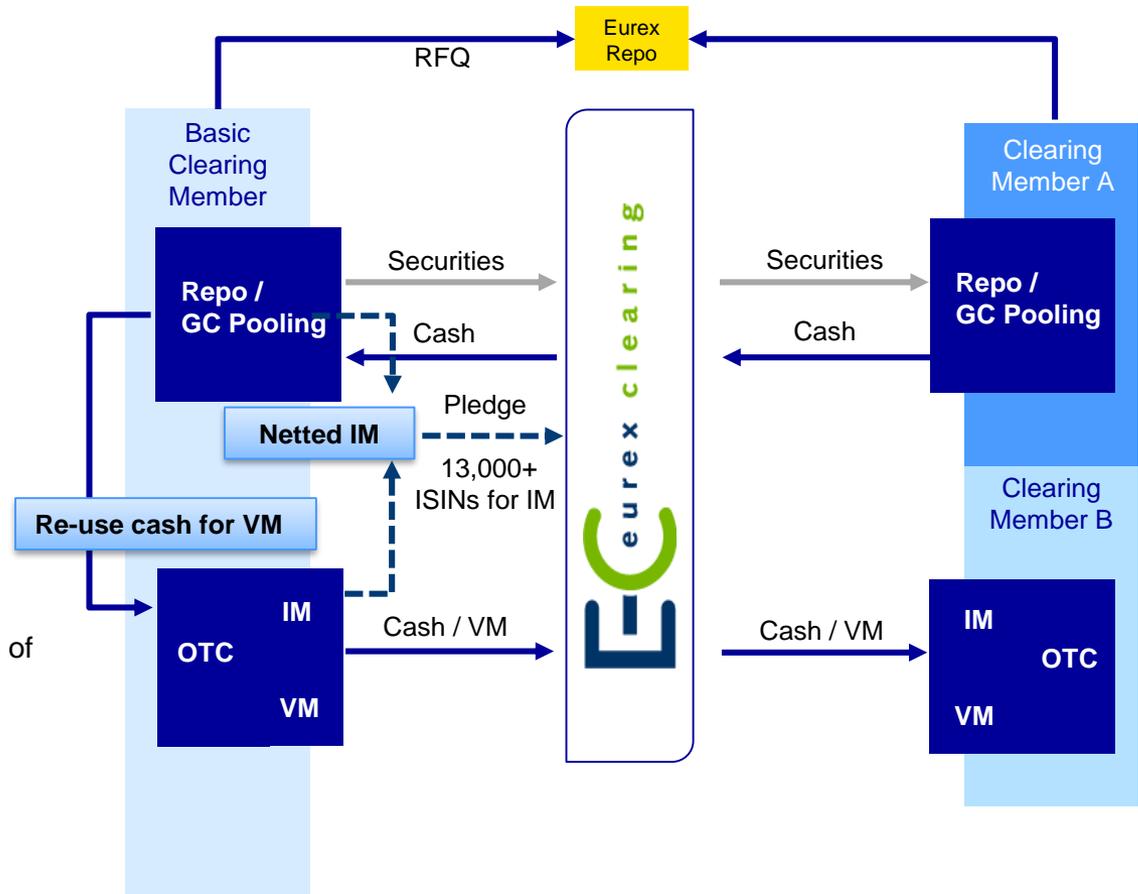
- Cash variation margin
- Access to balance sheet
- Capital rules
- Transforming HQLA

The Solution

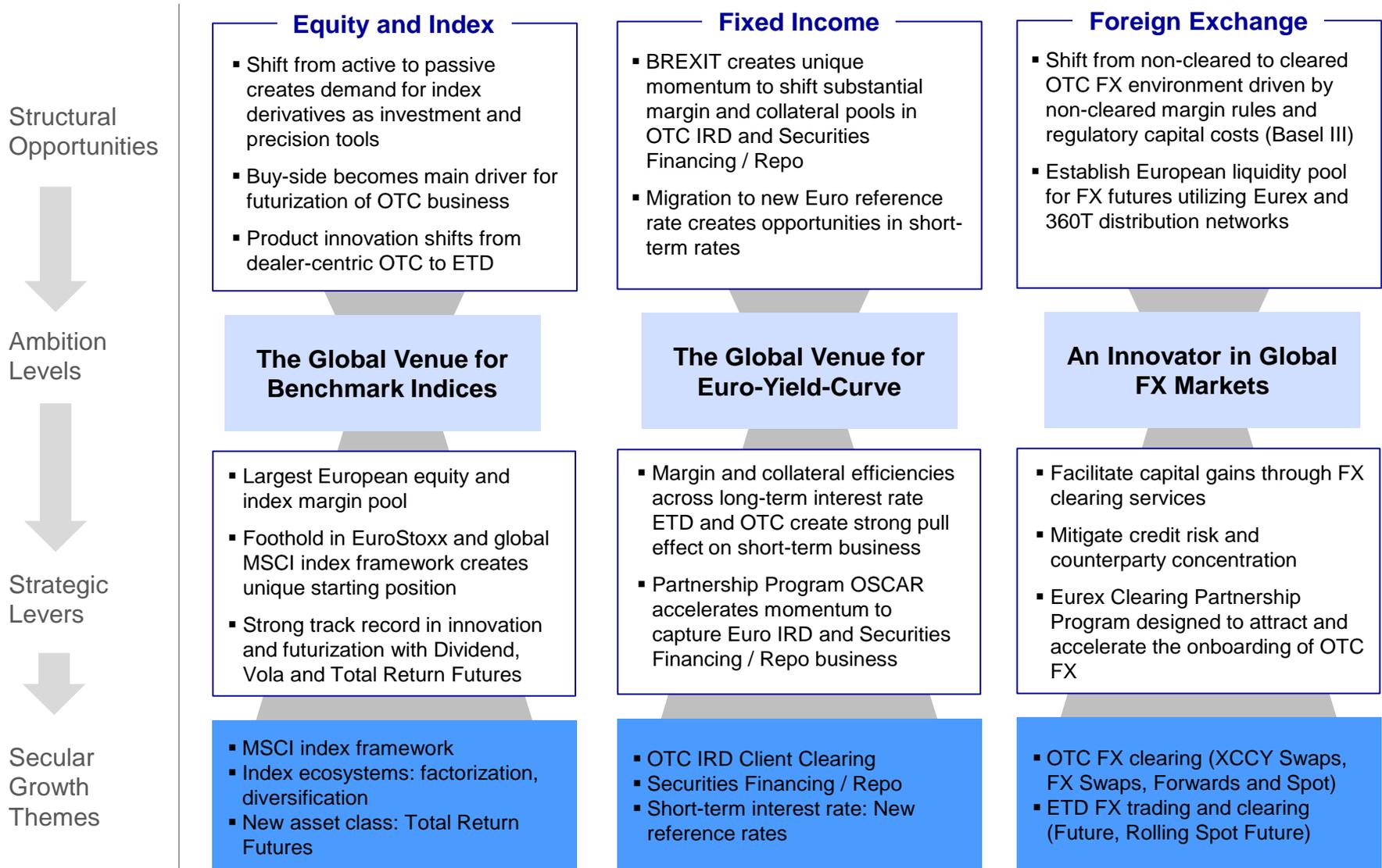
- Select Finance – ISA Direct for Repo
- Re-use cash from repo for VM
- Re-use reverse repo collateral for IM

Benefits

-  Access to interbank repo liquidity
-  Reduce operational risks and cost by utilising single infrastructure
-  Maximise eligible set of assets for posting of IM and use in repo
-  Net margin requirements between Repo and IRS
-  Limit counterparty risk by facing Eurex Clearing (CCP) directly



Eurex strategic growth themes across asset classes



Clearing generates significant benefits

- 1** Reduction of capital requirements for banks
- 2** Improved conditions for the buy-side
- 3** Reduced risk and enhanced protection



Additional benefits provided by Eurex Clearing

- 4** Integrated x-product work flow and cross margin potential
- 5** Single collateral pool provides greater efficiency
- 6** Interlinking derivatives and securities finance for funding optimisation

Onboarding with Eurex is a no regret move

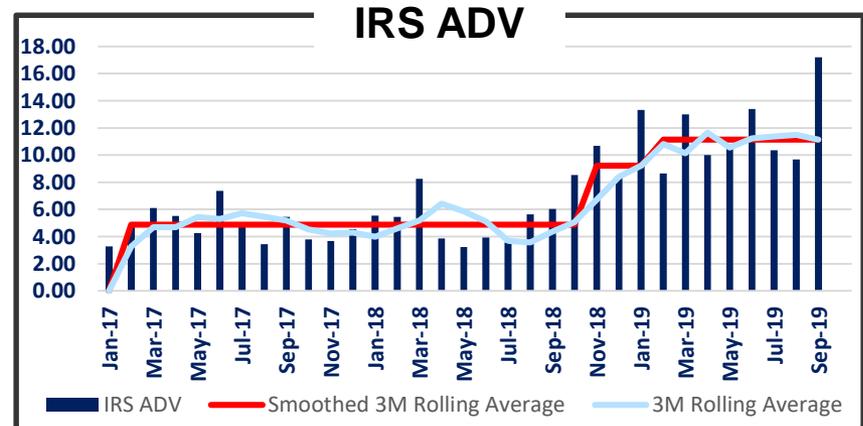
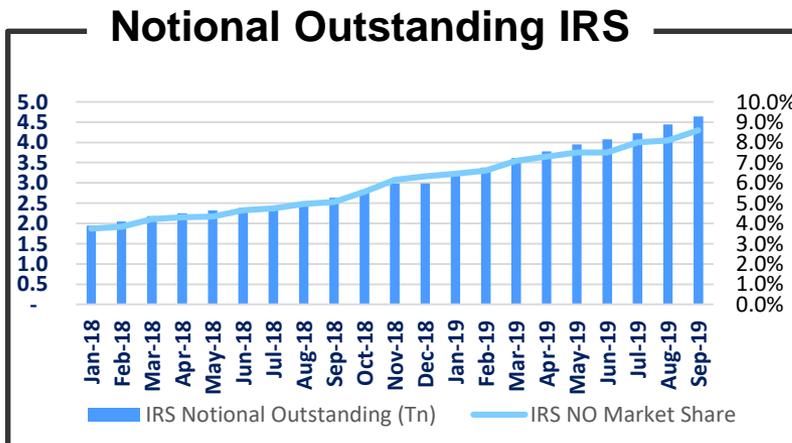
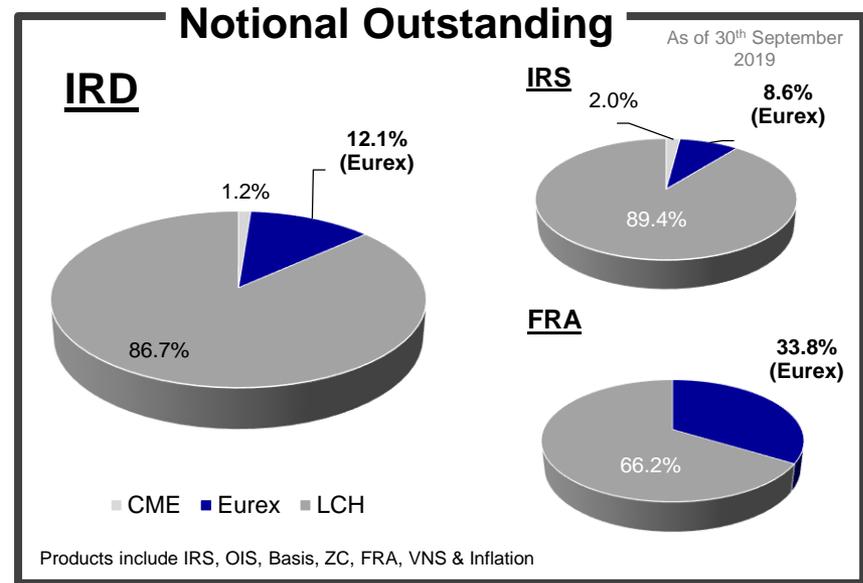
- 7** IRS Liquidity at the same bid/offer and size as other CCPs
- 8** EU 27 solution removing geo-political risks
- 9** Increased competition and innovation

OTC IRD Market Share Continues to Grow

EUR Market Share – by CCP and by product

Key Points

- Increase in IRS market share from 3.7% to **8.6%** January 2018 to September 2019
- Increase in FRA market share from 3.2% to **33.8%** January 2018 to September 2019
- Increase in IRD market share from 2.6% to **12.1%** January 2018 to September 2019

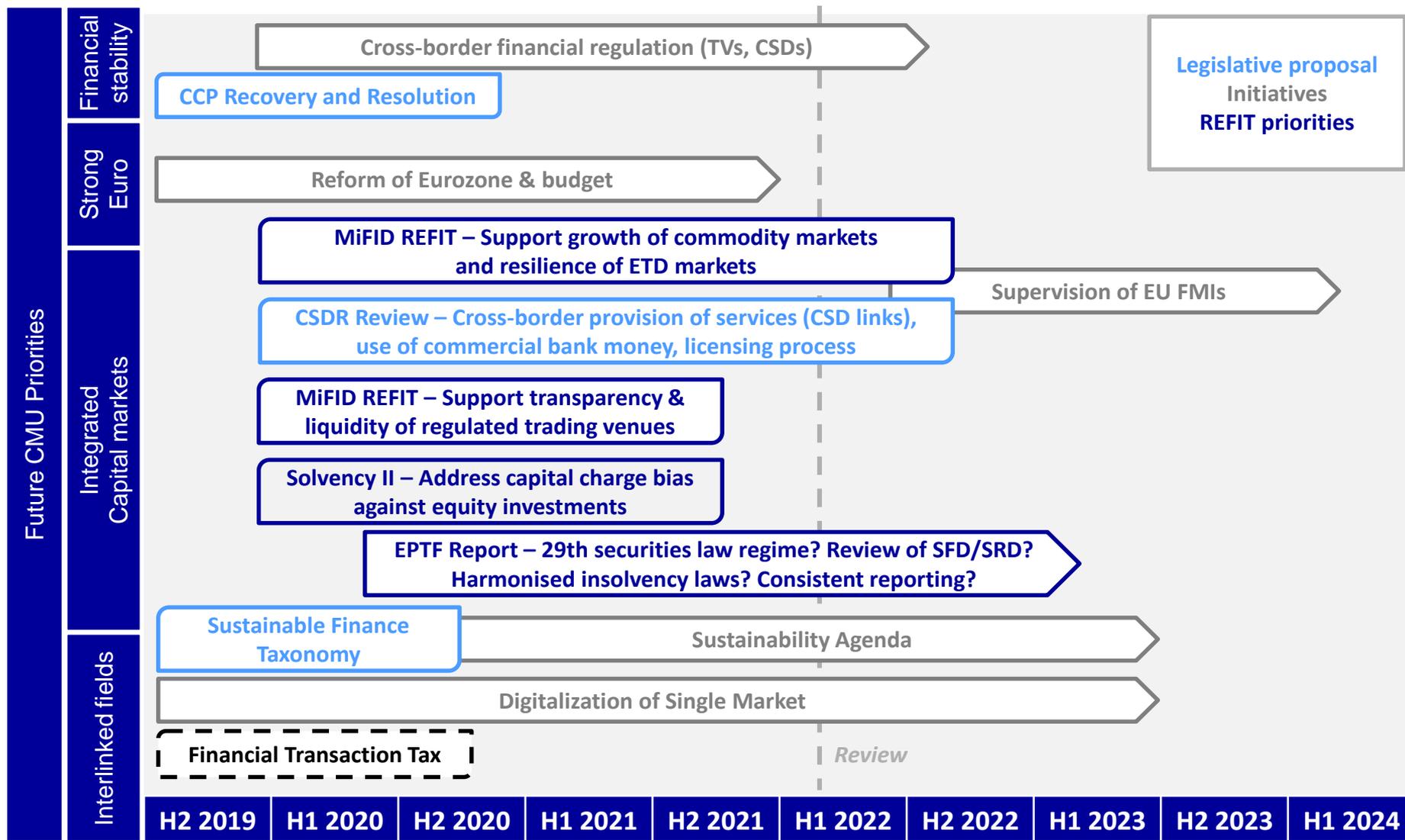


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Appendix

2019-2024: Priorities for new legislative cycle



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