

GSL 04 PANEL DEBATE: SECURITIES LENDING CENTRAL COUNTERPARTIES (CCPs)

Would a CCP sufficiently reduce counterparty risk to make it a worthwhile project?

Beauty is always in the eye of the beholder or in this case, your relative position in the marketplace. CCP's in other securities markets have helped to reduce counterparty risk and in time increased volumes due to increased liquidity. CCP's level the playing field and can allow smaller less capitalized firms to play on equal footing with their larger counterparts. In this scenario, lower capitalized participants realize



the benefit of the CCP through increased credit that would not have been available in a bi-lateral relationship. One could also argue that increased or unlimited credit to smaller firms could lead to greater market exposure. The larger well capitalized firms do not necessarily like this position and view their size and credit worthiness as a competitive advantage. By levelling the playing field through the CCP's credit intermediation, their advantage is diminished.

The key question is how the CCP is structured or funded to function in the role of guarantor. Another key question is how the CCP will margin the positions to reduce market exposure. Clearing Corp or Exchanged based CCP's typically utilize their participant/member fund to provide the guarantee. However in the event of a failure, the entire membership is subject to the market risk (albeit lessened), since the participant fund is guaranteeing the trades. CCP's certainly go a long way in reducing counterparty risk but do not eliminate it completely.

Would a CCP have lessened the impact on the operation of the securities lending industry after the Lehman Brothers default?

If the entire marketplace did business through a CCP facility then a bankruptcy by one of the market participants would have potentially spread the market risk/exposure across the entire industry. Certainly it would have allowed for the unwinding of the positions in an orderly fashion. That in and of itself, could have helped to reduce or lessen the resulting losses. For trades done outside the CCP on a bilateral basis, the presence of a CCP would have done nothing to lessen the impact of a failing participant.

In what ways would CCPs increase or decrease transparency?

CCP's in and of themselves do not necessary aid or hinder transparency. CCP's that function with an electronic marketplace will bring transparency to the market. The existence of an electronic marketplace where participants can enter bids (offers to borrow) and asks (offers to lend) anonymously by definition will enable the marketplace to achieve transparency and price discovery. CCP's who operate with bi-lateral negotiation trading will not necessarily bring transparency to the marketplace. In this scenario the CCP's role is primarily settlement and credit intermediation.

Would a functional CCP rely on the elimination of the current custodial lending model?

We do not believe this to be the case. Unless the beneficial owners are going to enter the marketplace directly, there will always be the need for a custodial or agent lender. We believe it would be highly unlikely for them to go direct. Certainly there are always exceptions to the rule, but that would only be those beneficial owners that have size and the wherewithal to build the required infrastructure. It is not in their nature to participate directly in the markets whether they are buying or lending securities. They have portfolio managers to manage their investments and agent/custodians to manage their securities lending portfolio. Custodial/Agent lenders will continue to participate even in a CCP based securities lending world.

CCPs would enable beneficial owners, practitioners and other market participants to benchmark prices and streamline price discovery in a way only possible through comparison to peer groups before – in what ways would this transform the securities lending industry?

As mentioned before, CCP's that function with an electronic marketplace where orders are entered anonymously will bring additional transparency to the marketplace. If adopted and the industry utilizes such a vehicle to conduct a portion of their business, then one would expect spreads to narrow over time. Not so much in the GC market, but with the specials. Of course the economics of supply and demand will still continue to have some influence on spreads. Prime Brokers borrowing on behalf of their Hedge Fund clients will have additional benchmarks that will impact pricing. The true value of a security will be more available to all market participants. Primes may need to transform their business model as a result.

Some have said that CCPs only work for industries where the transaction ends at the time of execution – do you think this is true?

One could argue that there are a lot more complexities in an environment where the transaction has a lifecycle, and this is what makes securities lending very different to other markets with CCP's. These are the challenges for the CCP solution provider, in addition to, the additional integration required between the electronic marketplace/CCP and their customers. The key to success is the ability of the CCP to integrate with participants systems to support the activity post execution. Seamless straight-through processing is an absolute must for success. This will certainly be one of the greatest challenges, but an area that could deliver great efficiency benefits if done correctly.

Do you see securities lending CCPs as an integral part of the market infrastructure in ten years time and why?

Certainly if there was any time in which a CCP was going to succeed in the securities lending market, now is that time. The conditions are right and the market is willing to entertain change as the competitive landscape changes. The CCP/Electronic trading venue will have its place in the market. As with most markets that have CCP/Exchanges, an over-the-counter (bi-lateral) market will also exist. Securities Lending will be no different. Without a doubt there are benefits in having a central counterparty, but I anticipate that those benefits will be governed by the sophistication of the CCP implementation. One thing is for sure, everyone's eyes are currently focused on reducing risk and enhancing efficiency, and a CCP has the capability to do both. So yes, I think there will be adoption, but I suspect that it will not be an overnight result.