

# Spotlight on: Access models for the buy side



# Foreword

Things are changing. The balance of supply and demand in traditional financial market structures are deteriorating, driven by the changing regulatory framework and increasing capital requirements and costs for banks.

Eurex Clearing is helping you to harness changes by designing integrated solutions to unlock capital and gain operational efficiencies.

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For the buy side especially, this is having the following impact:

- Higher service fees
- Wider bid-ask spreads
- Fewer client clearing services providers
- Reduced likelihood of porting in a default scenario
- And finally missed business opportunities

Things are changing and it is Eurex Clearing that is helping you to harness changes by designing integrated solutions to unlock capital and gain operational efficiencies.

We are launching our direct access model – ISA Direct. It combines elements of a direct clearing membership and the traditional service relationship in client clearing – designed specifically to address the needs of the buy side.

ISA Direct allows for higher capital efficiencies of both derivatives and securities financing transactions. At the same time, it reduces concentration risks and increases portability likelihood. While ISA models already increased the porting likelihood over traditional OSA models, ISA Direct builds on the existing ISA segregation, increasing safety and robustness via reduced concentration and improved portability.

This edition of **Spotlight on: Access models for the buy side** will give you an in-depth overview of our new direct access model and further insights into what we are doing to help our clients gain greater capital efficiencies.

With innovative solutions like ISA Direct, we keep you **clear to trade**.

# ISA Direct – Eurex Clearing's unique buy side membership

With the balance in supply and demand in traditional financial market structure deteriorating, the buy side community is facing a variety of challenges. Increasing costs for the banks driven by new regulatory requirements translate into higher fees, wider spreads or even service reductions for the buy side not only for derivatives, but also for securities financing transactions. Additionally the concentration of banks offering client clearing creates challenges with regards to counterparty risk concerns and porting in case of a Clearing Member default.

In order to unlock the full benefits of central clearing under the new regulatory regime, sell and buy side participants need to look for superior capital, margin and collateral efficiencies. Traditional models are proving restrictive and as such, new solutions need to be explored.

That is why Eurex Clearing has developed a direct access model for the buy side which allows for higher capital efficiencies of both derivatives and securities financing transactions. At the same time, it reduces concentration risks, facilitates access to the CCP and improves portability.

Our new access model – ISA Direct – opens up a new principal client relationship between buy side clients and the CCP, with the regular Clearing Member acting as a Clearing Agent, providing a variety of mandatory and optional service functions.

## Key features at a glance

- Direct membership of buy side firms at the Clearing House facilitated by a Clearing Agent
- The Clearing Agent acts as agent to cover the default fund contribution, default management obligation and optional operation and financing functions
- ISA Direct member maintains legal and beneficial collateral ownership

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*ISA Direct alleviates the regulatory requirement to centrally cleared OTC derivatives in several ways. By enabling us to become a direct member of the CCP, our concerns regarding counterparty credit risks, clearing costs and portability of our assets are much better addressed compared to the traditional client clearing model.*

Swiss Life Switzerland

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*The positive impact of Eurex Clearing's new clearing models for OTC derivatives repo is evident. ISA Direct allows clearing members to continue their operational clearing relationship with clients without requiring the traditional performance guarantee. Therefore, we support a quick roll-out of both products by Eurex Clearing.*

Deutsche Bank

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## Key Benefits

1

### Reduction of capital requirements for banks

- 2% counterparty risk weight for RWA
- Multilateral netting for RWA and leverage ratio and positive impact on the net stable funding ratio

2

### Improved conditions for the buy side

- Reduction in capital requirements vs. bilateral business enables banks to offer better conditions
- Enables to choose from 17,000 eligible ISINs for initial margin collateral
- The risk management standards of Eurex Clearing enable the buy side to accept in circumstances other securities qualities such as shares or corporate bonds instead of government bonds

3

### Enhanced segregation and portability

- Direct delivery of the collateral to the CCP avoiding transit risk
- Easier portability as no positions or assets have to be transferred
- Improved asset protection through pledge instead of title transfer of securities collateral

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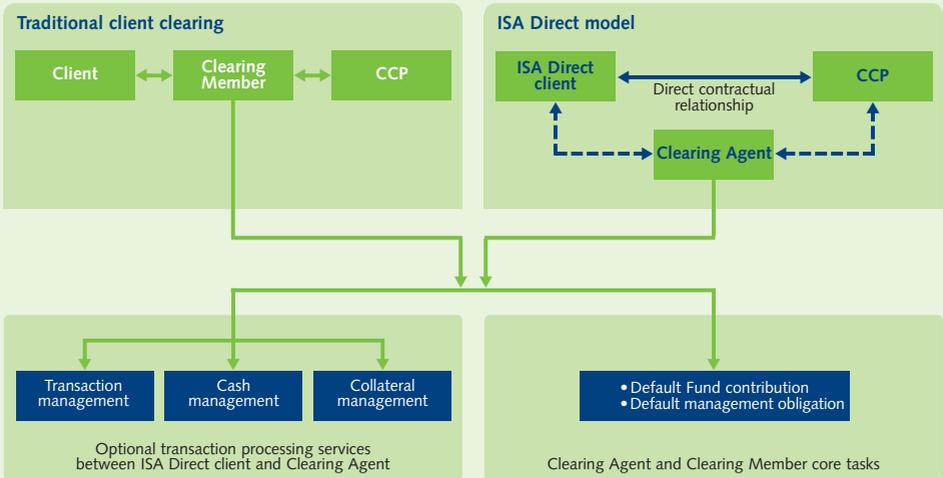
### New business opportunities

- With CCP as counterparty credit lines are relieved and thus have the opportunity to expand business
- Transactions with new counterparties are made possible by the CCP intermediation

## Overview of our ISA Direct Model

Our new ISA Direct model combines elements of direct clearing membership and the traditional service relationship in client clearing, tailored specifically for the buy side.

The principal client relationship moves from the existing Clearing Member directly to the CCP, with the Clearing Member acting as the Clearing Agent, who will provide mandatory core and optional service functions.



There will be no changes needed on the functional level with the ISA Direct clients technically being set up as an ISA client of the Clearing Agent.

The unique set-up will allow an easy upgrade from a traditional ISA client set-up to our new ISA Direct set-up. So if you get started under our ISA structure, you can easily upgrade at a later point in time.

### Who can become an ISA Direct client?

Insurance companies

Financial institutions

Pension funds

Investment Funds

You must be domiciled in the European Union or in Switzerland, supervised by the local competent authority, governmental ministry or governmental institution and be subject to local insurance or banking law, pension act or subject to local investment fund law respectively.

## Who can become a Clearing Agent?

Any General Clearing Member (GCM) admitted to a respective asset class to Eurex Clearing AG can apply to become a Clearing Agent.

## What Asset Classes are covered?

OTC IRS

Listed derivatives

Secured funding  
and financing

The service will initially be launched in summer 2016 for OTC IRS as well as repo transactions offered under the “Select Finance” service in cooperation with Eurex Repo as a trading venue. Listed derivatives and securities lending transactions are to follow.

Our ISA Direct Model provides the best solution to address the industry challenges and significantly improves market safety and integrity. With innovative solutions like ISA Direct, we keep you **clear to trade**.



# Structure of the marketplace

**How Eurex's new buy side membership model (ISA Direct) helps to address structural problems resulting from the changing structure of the marketplace**

by Philip Simons, Global Head of Fixed Income and FX Derivatives Sales, Eurex

**The introduction of buy side clearing models means a potentially radical change in the nature of risk in financial markets, with improvements for all market participants in the new regulatory era.**

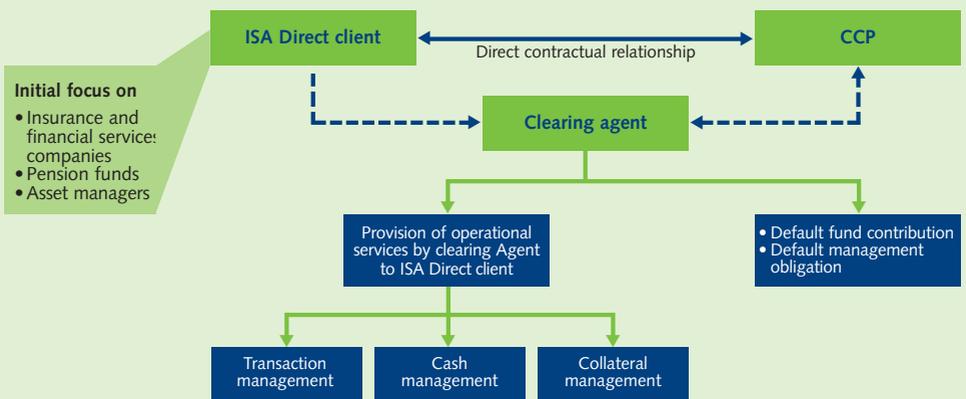
Market structure results from a wide range of inputs, from the preferences of individual firms to the rules that govern each trading venue. At no time in the past however has regulation driven market structure like today: bank risk has been substantially reduced, but at a price. Banks are now more reluctant than in the past to provide services for their buy side clients that involve renting out their balance sheets, or they are providing services but at much higher fees to cover capital costs. In financial markets, this means that liquidity has decreased while volatility has increased. As banks work to meet the next round of Basel III and domestic rules, including the introduction of the Net Stable Funding Ratio (NSFR), these regulations will further tighten trading and clearing conditions.

Eurex's ISA Direct model introduces a new way of doing business that will help reduce bank balance sheet pressures. Our offering is based on Individual Segregated Accounts (ISA) that fully mitigate the risk of default for clearing members. In our model, the buy side creates a direct contractual relationship with Eurex Clearing

as the central counterparty (CCP) (see Exhibit 1). Eurex Clearing members act as the clearing agent, providing mandatory and voluntary services, retaining their client relationships and ability to earn revenues, but are no longer exposed to the counterparty risk of their buy side client as they are not guaranteeing their performance. Eurex Clearing takes on the role of principal in facing off against the buy side, which means that the capital and balance sheet impact is greatly reduced in terms of RWA and leverage ratio for the bank acting as clearing agent. This is an important new model for reducing capital costs across a wide variety of tradable instruments including futures, cleared OTC derivatives, repo and securities lending.

ISA Direct is a new way for clients, clearing firms and Eurex Clearing as CCP to interact that could become a major game changer in financial markets. The added diversification of direct membership will help reduce the concentration risk currently

### Exhibit 1: Overview of ISA Direct model



**Initial focus on**

- Insurance and financial service companies
- Pension funds
- Asset managers

New client model with a new principal client relationship between buy side clients and the CCP

Existing Clearing Member acts as Clearing Agent

ISA Direct clients have to meet admission criteria equivalent to regular Clearing Members with extended servicing functions by the Clearing Agent

Source: Eurex Clearing

being experienced in terms of clearing broker availability and capacity. The impacts stretch far and wide, and affect not just cleared products but the bilateral market as well. The change affects more than clearing and settlement operations; the implications reach deep into trading, investment strategy, collateral transformation and market structure across the financial services industry. We have already identified three areas where ISA Direct is likely to change market structure: swaps pricing, collateral management and cross-product trading.

### **Interest Rate Swaps pricing goes positive**

The swaps pricing market is currently in some disarray – negative swaps spreads, CCP basis and higher capital costs all hurt liquidity and the ability of end users to hedge at attractive levels. There are also issues associated with negative rates as well as the difference between EONIA and the true funding cost, both of which are impacting valuations of OTC IRS.

In the US dollar market, Interest Rate Swaps are currently yielding negative returns to US Treasuries reflecting the fact that regulatory changes have altered the fundamentals of swap pricing. Central clearing has transformed the nature of counterparty credit risk by ensuring that OTC IRS trades continue even if a bank defaults. The removal of credit risk means that the spread between swaps and treasuries is now a reflection of the difference in capital costs plus supply and demand.

This has led to many asset managers and hedge funds withdrawing from one of their traditional investment strategies and hedges against stressed market tail risk, the spread widening trade: buy treasuries, pay fixed swap.

What has made this even less attractive is the negative carry resulting from repos trading higher than LIBOR, which is not how markets are supposed to trade. Secured debt, like a mortgage, is supposed to be less expensive than unsecured debt like credit cards. However, the reliance on bank balance sheets and the real-world impact of regulatory costs has made secured repo more

expensive than unsecured LIBOR, which in many cases is based on a hypothetical rate and not observed transactions. This has severely reduced the bilateral activity in these types of trades, which in turn prevents traders from arbitraging out inefficiencies in bond market pricing.

What if instead of bilateral repo as the hedge, a centrally cleared repo or equivalent risk-based transaction could occur that did not take up bank balance sheet? In this case the extra capital cost of the repo would be reduced and allow repo to be below LIBOR, where it belongs (see Exhibit 2). Since repo is currently more expensive than LIBOR because of the added balance sheet cost, removing this encumbrance should solve the pricing problem.

In the ISA Direct model, buy side firms and the CCP are principals to the trade with the bank playing a service provider role. While there are still some costs to the bank in trading derivatives and repo through an exchange/CCP, these costs are much lower than in the bilateral market. It stands to reason then that derivatives and repo with ISA Direct should allow Interest Rate Swaps and repos to be profitable again.

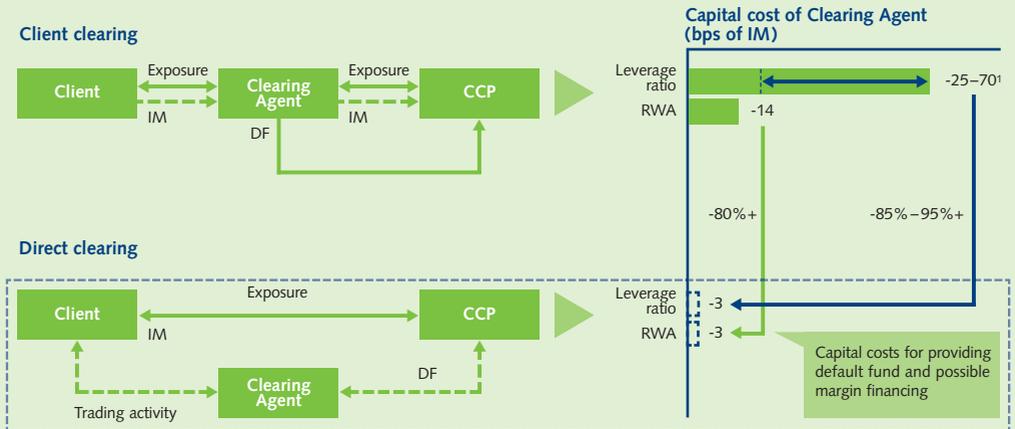
ISA Direct should not only help reduce the amount of balance sheet required, it should also improve pricing due to lower capital costs.

### **Reduced collateral requirements**

Arguably, lower balance sheet costs for banks mean less friction in the markets and more transactional volume. When looking at futures, OTC derivatives, repo and securities lending as one basket of collateralized trading opportunities, the ISA Direct model shows immediate benefits when clearing firms can help clients minimize collateral exposure on the CCP. This is the basic idea of a CCP that clears across multiple products.

As more derivatives trading activity occurs, both buyers and sellers have higher collateral demands. Repo and securities lending on the other hand deliver collateral supply to the market.

## Exhibit 2: Derivatives clearing models and corresponding annual capital costs for a Clearing Agent



Source: Eurex Clearing

Note: example based on ~5-year duration, directional EUR IRS swap portfolio

- <sup>1</sup> Depends on final leverage ratio rule (use of SA-CCR with collateral offset leads to reduced costs of ~25 bps. vs. ~70 bps based on current proposal with CEM)

Being able to generate cash from securities to cover variation margin or being able to invest cash secured against securities that can be reused to cover initial margin help to make the market more efficient. This is one of the most significant practical challenges that many buy side firms face with the introduction of mandatory clearing and collateralisation of non-cleared derivatives. By keeping the collateral within the same clearing ecosystem, not only does it reduce settlement failures and transit risk, but will also reduce settlement fees. For banks, the ability to net these transactions through a single counterparty – the CCP, with matching currency, security and settlement system – allows them to benefit from lower collateral requirements and lower capital exposures.

## Cross-product trading

Each financial product has its own role to play in the markets. Futures are best for highly standardized products while OTC derivatives fare best for more client-specific trading and hedging opportunities. Repo meets the needs of both cash borrowers and collateral borrowers, while securities loans deliver high quality collateral and enable short selling opportunities. There is no reason to think that one product should win out over another, but rather they are all part of a working whole. The responsibility of banks and investors is finding the right model and the right trading instrument to meet an investment strategy.

ISA Direct helps by maintaining and widening access to a variety of traded products, each of which has a valuable and legitimate role for investor strategies. Some bilateral products may be difficult for bank balance sheets, but by reducing capital constraints on a CCP, a clearer picture of the costs and benefits emerges. Swap futures won't replace OTC derivatives but they do have a role to play in helping banks hedge gap risk, and as a warehouse for investors switching positions. Basis trades on bond futures help maintain efficient markets. Banks looking to finance illiquid assets already know that these products do not clear well, but a range of products on a CCP can help bridge the gap between traditional listed products and the OTC derivatives world, and between on-exchange and off-exchange. ISA Direct not only takes this existing role of the CCP and makes it less expensive for banks and their clearing clients, it also enables a wider variety of clients to trade with each other across all product lines because they can use a single membership with a single operational, legal and risk framework.

## ISA Direct builds healthy markets

ISA Direct is really about building healthy, robust markets that work in a new market structure defined by regulation. Healthy markets are not just talk; they are critical for the functioning of governments and private companies. In Europe, we have 23 bond markets that operate as part of the European Union, reliant on each domestic market functioning as best it can. When one part of these markets does not work, that creates a potential lack of liquidity that can threaten the underlying health of the whole.

In European bond markets specifically, each individual domestic market needs a mix of cash, repo, futures and OTC derivatives, as well as domestic collateral to cover initial margin. There also needs to be access for domestic and international market participants across these products. Eurex Clearing works with domestic Central Banks, government agencies and local market participants to build up each individual market structure; strong domestic markets are the building blocks for a strong European market.

By keeping the functional role of a bank intact while reducing balance sheet costs, ISA Direct supports the growth of a new way to look at market structure. Balance sheet costs have already changed important dynamics in pricing, trading and liquidity for both bilateral and exchange-traded products. Arguably, this has not been beneficial for issuers, investors or banks themselves and has been in part responsible for reducing liquidity in the markets as banks have withdrawn from market making and reduced their balance sheets. Given the high costs of client clearing coupled with the withdrawal of a number of firms, we have also seen an increase in concentration risk to the largest banks with 70% of client money in the US held by the top five FCMs. ISA Direct helps to solve the problems of liquidity and concentration risk by bringing more trading counterparties directly together at a reasonable economic price in a way that utilizes less capital and balance sheet.

A healthy market needs a balance of buyers, sellers and liquidity providers. By supporting this fundamental restructuring in the market, where cost and pricing reflects capital costs and counterparty exposure, ISA Direct is working to build a successful future market structure. ◀

This article originally appeared in [Securities Finance Monitor](#).



**Philip Simons** has 30 years of experience in the financial industry where he started life as a swaps trader before moving to the clearing world, initially heading up the clearing business at UBS followed by Cargill. Philip later moved into the custody and collateral management space at J.P.Morgan before joining Deutsche Börse Group. Philip initially joined as head of the Clearing Sales and Relationship Management Section and is now Global Head of Fixed Income Trading & Clearing Sales for Eurex covering both the Exchange and the Clearing House. Philip is responsible for building strong relationships with clients, attracting new trading and clearing members and promoting new products and services.

# A path to greater capital efficiency

Q&A with Matthias Graulich of Eurex Clearing

**Capital efficiency is now at the top of the agenda for clearing firms and their clients as a result of Basel III and other changes in the regulatory environment. How is Eurex Clearing responding to this need?**

*Our industry is facing many challenges. There is increasing regulatory pressure and uncertainty on client clearing on multiple fronts, from Basel III to the European Market Infrastructure Regulation (EMIR) and MiFID II. Overall we are seeing an increase in capital requirements and the demand for collateral, while at the same time the supply of collateral is tightening and the need for clearing is rising.*

*Eurex Clearing's objective is to help clients address these challenges by offering solutions and services to mitigate these regulatory impacts. Our integrated CCP model allows for capital, margin and collateral efficiencies while at the same time offering superior client protection and a solid default management process. By offering solutions like cross margining through Eurex Clearing Prisma across listed and OTC derivatives, we provide the tools for our clients to optimize their margin requirements.*

*Our latest solution is ISA Direct, which provides direct access to the CCP for buy side clients. It allows for higher capital efficiencies with both derivatives and securities financing transactions while at the same time it increases the safety and integrity of the market by reducing concentration risks, increasing asset protection, and improving likelihood for portability. We are currently working with clients in a pilot phase and the full service will launch this summer.*



**By Matthias Graulich**  
Chief Strategy Officer,  
Member of the Eurex  
Clearing Executive  
Board and Head of  
Cross-Market Strategy,  
Deutsche Börse Group

## The clearing mandate for the European swaps market will start taking effect in June 2016. What steps are you taking to prepare for this?

*We launched our EurexOTC Clear service for interest rate swaps a few years ago, talking with clients to meet the market needs for the clearing of OTC transactions by reducing counterparty risk, margin and collateral requirements and at the same time providing client asset segregation and legal certainty.*

*For instance, we were the first CCP to launch an EMIR compliant Individual Segregated Clearing Model. Our Individual Segregated Account (ISA) model offers full physical segregation of a disclosed client's positions and collateral. This differs from value-based models where only a value equivalent is protected instead of the client's actual assets.*

*On-boarding and business activity has made good progress over the last 18 months. Today, we have 50 clearing members and 105 registered customers, with many more in the on-boarding process. Over 70% of our registered customers have on-boarded under the ISA model.*

*With mandatory clearing of interest rate swaps for category 1 firms starting in June, we are seeing a significant increase in volume in cleared notional outstanding as well as monthly cleared notional. In April alone, we cleared an average daily volume of EUR 6.2 billion with a notional amount outstanding of EUR 451.8 billion at the end of April, and we are confident that we will continue to build critical mass.*

## Eurex Clearing now offers portfolio margining for interest rate futures and swaps through Eurex Clearing Prisma. What types of members and clients are most likely to benefit from this service?

*Sell side and buy side clients alike can benefit from cross margining at Eurex Clearing. Eurex Clearing Prisma permits cross margining between products as well as across markets. Prisma*

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*Sell side and buy side clients alike can benefit from cross margining at Eurex Clearing.*

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*calculates risk and margin on a portfolio basis segmented by pre-defined Liquidation Groups each comprising closely correlated products. Our default management process, by the way, is also aligned to these product groups.*

*Since February, our Italian and Spanish interest rate derivatives (FBTS, FBTM, FBTP and FBON) are part of the cross margining optimizer, giving our members a broader ETD product range in order to offset OTC exposure to reduce their initial margin requirements.*

*Of course clients with offsetting positions in listed and OTC derivatives, such as firms running relative value strategies or firms using futures to hedge or warehouse their OTC exposures, benefit the most. However all clients benefit from a single risk management approach across all derivatives products, with payment netting across all cleared products.*

*Overall I believe that the full potential for cross-product margining – including listed, OTC and hybrid products like the deliverable swap future – will unfold in the coming 12–24 months as banks become more accustomed to using the full suite of derivatives products more flexibly to manage their risks.*

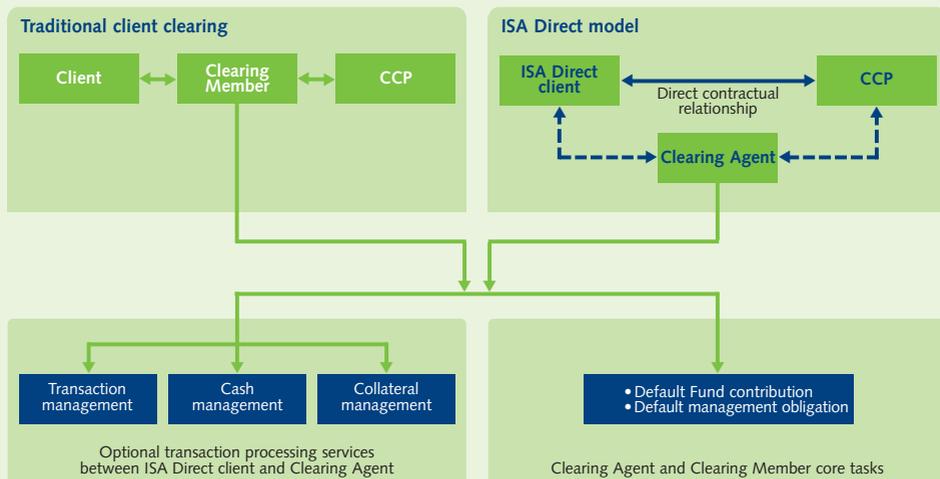
**Eurex Clearing is introducing a new account structure called ISA Direct. How does this differ from existing models for clearinghouse membership?**

*This type of account structure combines elements of a direct clearing membership and the traditional service relationship in client clearing. Our regular clearing members will continue to act as a clearing agent, providing a variety of mandatory and optional service functions, but the client becomes a direct member of the clearinghouse. We think this will reduce the impact of the Basel III capital requirements on the cost of clearing and expand access to clearing for buy side firms such as fund managers and insurance companies.*

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*All clients benefit from a single risk management approach across all derivatives products.*

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### What are the main benefits for clients?

*One important benefit is that this model will enhance portability. In other words, it will be easier for clients to move their positions and assets from one clearing firm to another. This is especially important given the declining number of firms that are willing to provide clearing services. Another important benefit is cost. We expect that this account structure will reduce the capital requirements for banks that provide clearing services, and that will enable the banks to offer better terms to their clients. There is also a benefit in collateral management. Once a client becomes a member of Eurex Clearing, it will be able to take advantage of the integration between our clearinghouse and Clearstream. For example, an asset manager with an ISA Direct account will be able to use our Repo and GC pooling services.*

### What types of products will be clearable through ISA Direct accounts, and what types of clients do you expect to use this type of account?

*When we launch this summer, we will limit the product range to interest rate swaps and repo transactions. Our view is that this is where the potential demand for direct access is especially urgent. But we plan to extend the new account structure over time to all asset classes that we clear, including listed futures and options.*

*We mainly expect insurance companies, pension funds, investment funds and other financial institutions to show the most interest. Another group of potential clients would be banks that are not clearing members and need to clear their derivatives trades. I should caution that firms must be domiciled in the European Union or Switzerland in order to become an ISA Direct client.*

### **What responsibilities will clients have if they become direct members of Eurex Clearing?**

*They will be responsible for meeting margin requirements by posting collateral under the same conditions and deadlines as with our other account structures. They can opt to do this themselves, or rely on their clearing member to handle this on their behalf. That is up to each ISA Direct client to decide in negotiation with its clearing firm. They will not be responsible, however, for contributions to the Eurex Clearing default fund or any of the functions that clearing members must undertake whenever there is a default. For example, an ISA Direct client will not be required to participate in an auction for the assets of a defaulted member.*

### **What would be the role of the clearing member in this type of account structure?**

*In some ways, the role is not that different from the traditional role. The clearing member covers the default fund contribution and the default management obligation for its clients. The clearing member also handles certain operational and financing functions for its clients, such as cash management and the movement of collateral, if the client decides to delegate those functions to its clearing firm. What is different is that the client has a direct contractual relationship with Eurex Clearing and maintains legal and beneficial ownership of all collateral. ◀*

*This article originally appeared in MarketVoice Magazine.*



**Matthias Graulich** has been a Member of the Executive Board of Eurex Clearing AG since August 2014 and Chief Client Officer since February 2014.

Matthias Graulich joined Eurex Clearing in 2010. Since April 2013 he established and developed as Global Head of Clients & Markets a dedicated client facing organizational unit of Eurex Clearing. Before that he took responsibility as Head of Clearing Initiatives for the implementation of Eurex Clearing's strategic project portfolio and regulatory affairs. Since joining the Deutsche Börse Group in 2001, he has held a number of leadership and project management positions at Deutsche Börse and Eurex for various strategic projects, amongst others, the introduction of EurexOTC Clear as well as the merger and integration of the International Securities Exchange.

Matthias holds a Master of Business Administration degree from the Fuqua School of Business at Duke University in North Carolina.

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