Central Counterparties: The authorities’ view

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Agenda

- Role and benefits of CCPs
- Risks in CCPs
- Regulation
- Case Study: CCP Regulation in Switzerland
- Outlook: Challenges in regulating CCPs
The role of CCPs

CCP becomes the buyer to every seller and the seller to every buyer of a security or in a derivatives transaction.
Expanding use of CCPs

Selected Examples:
- BM&F
- Chicago Mercantile Exchange
- Eurex Clearing
- Brazilian Clearing and Depository Corporation
- SIS x-clear
- LCH.Clearnet
- SwapClear (part of LCH.Clearnet)

‘Guarantee funds’ share some similarities with CCPs (often operated by exchanges or the CSDs)
Benefits of CCPs

- Management of counterparty credit risk simplified
- Potentially reduced minimal capital requirements (Basel II)
- Multilateral netting of settlement possible
- Counterparty of transaction known in advance
- Post trade anonymity of counterparty assured

“The benefits and costs of a CCP should be evaluated”
(CPSS-IOSCO, Recommendations for Securities Settlement Systems Nr. 4, Nov 2001)
Risks in a CCP

A CCP aggregates the credit risk in a market and employs a variety of tools to manage this risk, including:

- Membership requirements
- Collateral (margins) requirements and regular mark-to-market
- Loss-sharing arrangements (e.g., default fund)

Gertrude Tumpell-Gugerell, ECB Executive Board (2007):

“Risk management may be the single most important function of CCPs, because they are a substitute for active risk evaluation and management by users of the CCP”
Other risks in a CCP

- Liquidity risk
- Settlement bank risk
- Custody risk
- Investment risk
- Operational risk
- Legal risk
CCP robustness is crucial for financial stability

Jean-Claude Trichet, President ECB (2007): “The failure of a central counterparty can severely disrupt financial markets”

Ben Bernanke, Chairman Federal Reserve Board (1990): “Rumors about possible clearinghouse failures added to the sense of panic in the market [in October 1987]”

Agreement among central banks and securities regulators that some form of regulation of CCPs is required: “A CCP should be subject to transparent and effective regulation and oversight”

(CPSS-IOSCO, Recommendations for Central Counterparties Nr. 15, November 2004)
Who should regulate?

- Division of responsibilities between banking supervisors,
  securities regulators, and central banks
  depends on the domestic regulatory set-up

- Close cooperation between authorities required
Against what standards?

**CPSS-IOSCO (November 2004): Recommendations for CCPs**

- 15 Recommendations, including
  - Margin requirements (incl. back-testing)
  - Financial resources (incl. stress scenarios)
  - Default procedures
  - Mitigation of legal risk
  - Participation requirements
  - Operational risk

 Application of recommendations for Guarantee Funds also discussed in the CPSS-IOSCO report
Case Study Switzerland (1)

Key characteristics of the Swiss CCP SIS x-clear:
- CCP for equity transactions on virt-x, SWX and (from Jan 2008) LSE
- Approx. 60 direct participants

Regulatory Status of SIS x-clear:
- Licensed as a bank and supervised by the Swiss Federal Banking Commission (SFBC)
- Overseen by the Swiss National Bank
- Regulatory requirements based on CPSS-IOSCO standards and banking law

Risk Management based on (amongst others):
- Initial margins and variation margins (defaulter-pays principle)
- Default Fund (survivors-pay principle)
Case Study Switzerland (2)

How do we assess SIS x-clear’s risk management?

1. Back-testing of Margins
   - Back-testing assumptions: Margins should cover the potential 2-day losses of participants from market movements in 99% of all cases
   - Back-testing conducted by SIS x-clear based on specifications of SFBC and SNB

2. Stress-testing of Default Fund
   - Sufficient (in combination with Margins) to withstand a simultaneous default by the two participants to which the CCP has the largest exposure in extreme but plausible market conditions
Challenges in regulation

- CCP regulation typically requires in-depth understanding of complex risk management models.

- CCP regulation typically requires close cooperation between different authorities (both domestically and internationally).

- In Europe: New entrants and international expansion of existing CCPS challenge current oversight arrangements:
  - How to cooperate with foreign authorities?
  - How to regulate if commercial banks provide CCP services?
Useful resources

- CPSS-IOSCO (November 2004): Recommendations for Central Counterparties

- ECB and Fed Chicago (July 2007): The role of central counterparties, July 2007

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