



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

Role and benefits

Risks

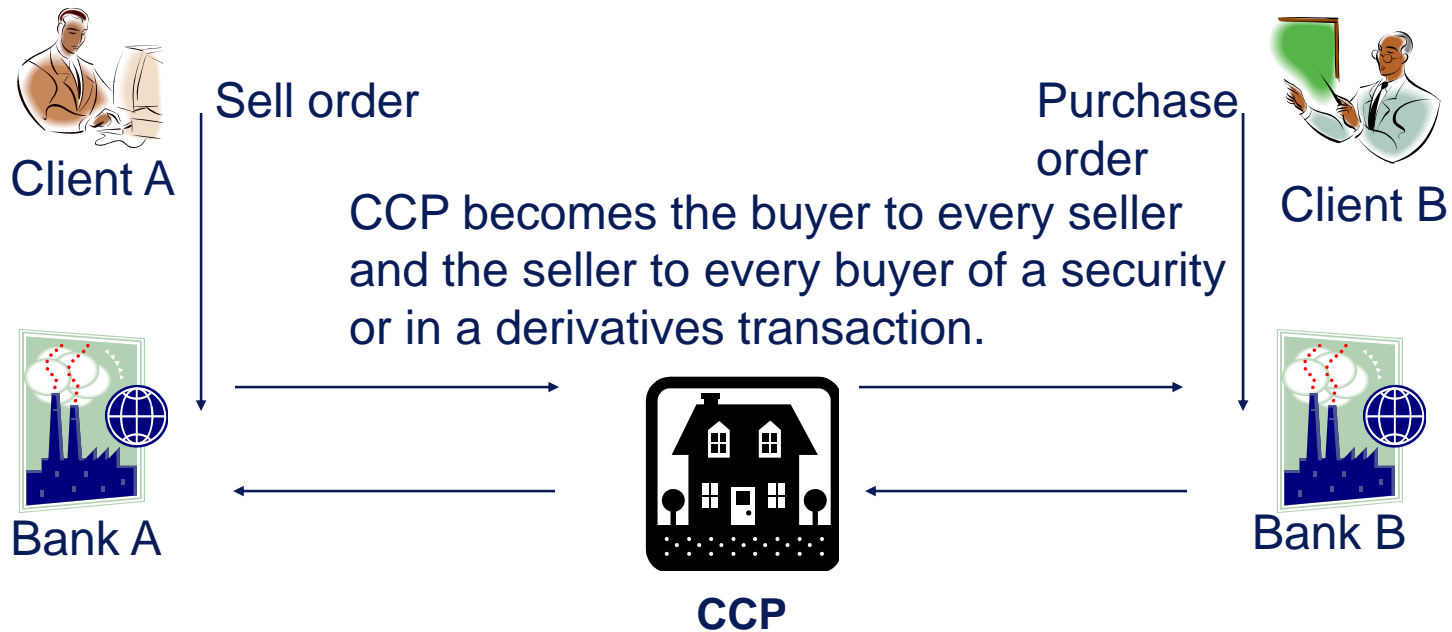
Regulation

Case study:
Switzerland

Challenges
in regulation



The role of CCPs



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|--------------------------|
| Role and benefits |
| Risks |
| Regulation |
| Case study: Switzerland |
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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)

Role and benefits

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'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

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“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)

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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

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CCP robustness is crucial for financial stability

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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 banksdepends on the domestic regulatory set-up

- Close cooperation between authorities required

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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

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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)

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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*

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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?

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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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