

The European Association of Central Counterparty Clearing Houses

Strengthening market integrity and efficiency - The value proposition of central counterparty clearing services for the OTC derivatives markets

February 2009

This paper summarises the value proposition of central counterparty (CCP) clearing for the integrity and efficiency of OTC derivatives market and reflects the common view of all members of the European Association of Central Counterparty Clearing Houses (EACH).

EACH has a vital interest in ensuring that the evolving discussions on post trade services in Europe are fully informed by the expertise and opinions of those responsible for providing central counterparty clearing services. Increasingly, clearing activities are not restricted exclusively to exchange-traded business and are being introduced to new markets and asset classes. Furthermore the central counterparty clearing model has demonstrated itself to be effective for the listed derivatives market. It can serve as part of the blueprint to effectively mitigate counterparty risk and improve operational efficiency in the OTC derivatives market across asset classes and products. In the light of this movement and recent market developments EACH has decided to contribute to the discussion by issuing this paper.

Definition

In general, a clearing house is an organisation that establishes and records obligations that are reported by its users. The clearing house ensures that those obligations are processed according to its relevant rules. A clearing house that is, in addition, a central counterparty interposes itself legally between counterparties to traded instruments (financials and/or commodities), becoming the buyer to every seller and the seller to every buyer, thus providing centralised counterparty credit risk management and default mitigation. This paper is concerned specifically with central counterparty clearing and the benefits it brings to OTC derivatives markets.

Core beliefs for central counterparty clearing of OTC derivatives

In specific regard to central counterparty clearing services for OTC derivatives, EACH has the following core beliefs:

1. Recent market turmoil has highlighted again the importance of sound market infrastructure for the integrity and stability of financial markets – across asset classes and geographies.
2. During the recent turbulence in financial markets, European central counterparty clearing houses have proven reliable, resilient and robust for all asset classes that they serve.
3. The value proposition of central counterparty clearing services is to ensure market integrity by
 - a. the mitigation of counterparty default risk through interposing itself as counterparty to each trade as, the market counterparty of unquestioned creditworthiness,
 - b. the multilateral netting of gross market risk down to significantly lower levels of net market risk,
 - c. the neutral, transparent valuation of open positions, and
 - d. the daily full collateralisation of the remaining net market risk.
4. This is recognised by global regulators who allow that exposures to CCPs may attract a zero value for regulatory capital calculation purposes due to the fully collateralised nature of these credit risk exposures.
5. Central counterparty clearing houses are a key element, together with other market infrastructures and service providers, of an integrated and efficient post-trade process, which serves to increase market efficiency by improved market operations with standardised, electronic processing of transactions.
6. The value proposition of ensuring market integrity has been demonstrated especially significantly by the experiences of the financial market crisis. CCPs have proved that they contribute to market integrity by being able to meet their obligations to all participants throughout an unprecedented set of market-wide events including extreme price volatility and participants' defaults.
7. European CCPs coped successfully with the recent default of Lehman Brothers International (Europe), and the Icelandic banks, by closing-out or transferring the positions of the defaulter, without impacting other participants, and within the collateral amounts and other financial resources available to them.

Recommendations on clearing OTC derivatives

Given that background, EACH makes the following recommendations for the sound market organisation of OTC derivatives:

1. Transparency and effective risk management are key elements to reduce systemic risk in financial markets. Central counterparty risk management services effectively mitigate existing counterparty risk and improve market transparency.
2. Effective risk management is the most important benefit to deliver in clearing derivatives markets as they significantly exceed the amount of counterparty risk to be managed in cash markets.
3. Provided that transparent market data is available to value positions in a sufficient frequency, position valuations become possible on a daily and, if necessary, intra-day basis. Neutral and transparent position valuation is a prerequisite to effective risk management and collateralisation of open market positions. Full collateralisation of exposure on open positions managed by CCPs improves the integrity of the whole market.
4. The central counterparty and clearing house model has proven to be effective for decades in the listed derivatives market segment. It can serve as part of the blueprint to effectively mitigate counterparty risk and improve operational efficiency in OTC derivatives markets across asset classes and products. However, appropriate default management processes and a degree of product standardisation eases the functioning of the CCP clearing model on OTC markets.
5. The value proposition of clearing houses includes the automation of transaction processing, which increases the efficiency of market operations and reduces the likelihood of manual errors. There is a significant trend to use electronic straight through processing services for OTC derivatives which have capitalised on the industry efforts already achieved: the development of master agreements and shared procedures, inter-professional auction processes, and the central depository role for several instruments. The benefits of such efforts should be amplified by the introduction of CCP risk management services. OTC derivative market segments where post trade processing is still largely performed manually and not commonly captured in a trade information warehouse are prone to unsystematic errors.
6. Different CCPs have taken diverse approaches to the risk management model and service portfolio of financial instruments, resulting in different product specifications and service offerings. Therefore any interoperability may be practically difficult to achieve at this point in time and may increase systemic risk for the market.
7. CCPs should not be geographically limited in the range of products or services they offer. Moreover, CCPs should be encouraged to offer cross-border clearing services. Regulation should not place barriers preventing cross-border access and membership. Therefore, US and European regulators should agree on common principles on oversight and supervision.

8. Sound market regulation includes as a guiding principle that the same rules are applied for the same activities in order to avoid regulatory arbitrage. Derivatives markets are global by their nature and product distribution. Therefore, European regulation should consider the global nature of derivatives clearing services and not put European clearing service providers at a disadvantage in global competition.

About EACH:

The European Association of Central Counterparty Clearing Houses (EACH), formed in 1991, aims at ensuring that the discussions on clearing and settlement, in Europe and globally, are fully informed by the expertise and opinions of those responsible for providing central counterparty clearing services. Members of EACH delegate senior executives specialising in clearing and risk management from European CCPs to share knowledge about developments in central counterparty clearing in Europe.

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