Market & Investment Banking

CENTRAL COUNTERPARTY CLEARING REDUCES MARKET RISK

A Central Counterparty Clearing (CCP) interposes itself as legal counterparty to both sides of transactions in a market. Contracts are entered into bilaterally and then transferred by novation to the clearing house, which becomes the buyer to every seller and the seller to every buyer.

CCPs have long been used by derivatives exchanges and a few securities exchanges and trading systems.

In recent years CCPs have been introduced by many more security exchanges and have begun to provide their services to over-the-counter markets. A CCP has the potential to reduce significant risks to market participants, by imposing more robust risk control on all participants, by achieving multilateral netting of trades.

A Central counterparty does not remove credit risk by itself from a market. If a market participant becomes insolvent its loss will still be borne by some or all its creditors in some manner. Instead a Central Counterparty redistributes counterparty risk replacing a firm's exposure to bilateral credit risk (of variable quality) with the standard credit risk on the Central Counterparty.

In order to reduce risk the CCPs adopts collateral policies and monitors the robustness of their clearing members and risks from the business that they are bringing to the CCP.

This means collecting and analyzing information, from clearing members on large positions taken by their customers.

A CCP also tends to enhance the liquidity of the markets that it serves, not only because it tends to reduce risks to participants but also because it facilitates anonymous trading. This can be attractive to firms that, for example, may not want to reveal that they are large buyers or sellers because they fear a market impact.

The role of CCP is very important as a risk management failure has the potential to disrupt the markets that it serves. A Central Counterparty by definition concentrates and re-allocates risk. As such, it has the potential either to reduce or to increase the systemic risk in a market.

As a consequence security regulators and central banks have a strong interest in CCP risk management.

The CCP are de facto regulators and supervisors and impose financial discipline on the clearing members.

In this scenario we are working with our client to support and help them to improve their operational processes and the interests of Front Office trading system implementing the rules concerning regulation of Over-the-Counter (OTC) derivatives markets as follows:

1. Standardized highly liquid OTC derivatives are to be cleared via Central Counterparties (CCPs);
2. Standardized OTC derivatives are to be traded via electronic trading platforms;
3. Trades in all OTC derivatives are to be reported to central data repositories.