



The Importance of Central Counterparty Clearing

CADC 2014

Themes for Discussion

- Who thinks CCP's are important and why you should care?
- If CCP's are important, how should we make sure they work well?
- What are the impacts of these changes on my business?
- If they worked well in the past, why are we changing things?
- Important Questions?

CCP Background

- Historically, CCP's have provided a safe harbour to members and clients through major market disruptive events and member defaults.
- Importantly, they performed very well through the most recent credit crisis.
- Policy makers of the G20, recognizing this, and the issues associated with the inter-connectedness of global markets generally, have mandated a greater use of the clearing framework to encompass a broader set of financial products.
- Through the legal process known as novation, the parties to an original transaction, either on Exchange or over-the-counter that are presented for clearing, are replaced by the CCP as a counterparty to each side of the transaction.
- The CCP is designed to ensure performance against each transaction, removing the financial risk of a defaulting member against its original counterparty

How does the CCP provide its assurance?

- Three lines of defence:
 - ▶ The CCP creates minimum standards for participation, and actively monitors the financial and operational health of its members. In the event that these conditions deteriorate, the CCP can and will take proactive steps to protect other members from this increased risk.
 - ▶ The CCP collects and holds in its accounts, financial resources pledged by members (margin) in an amount sufficient to insure that potential losses brought by a defaulting member do not cause losses to other members in extreme but plausible scenarios. Additional resources are available from CCP contributions and loss sharing member funds to protect against the risk of losses in extreme tail events.
 - ▶ The CCP has a transparent and effective default management process designed to manage the outstanding exposures and minimize losses.

How do we insure that these lines of defence work?

- CCP's are highly regulated, and are subject to meeting global standards for performance.
- The 2012 Principles for Financial Market Infrastructures (PFMI) were enhanced to reflect the increase importance of CCP's, and other financial markets infrastructures.
- CCP's are required to demonstrate that they meet these standards on an ongoing basis as part of the regulatory oversight basis.
- Infrastructures that are not established, managed, and regulated under this framework are not deemed to be "qualified" and participants (banks only) using these systems must take a higher capital charge to reflect this situation.
- CCP's globally are introducing changes to their operations to reflect the higher standards, and while the impact will vary by jurisdiction, there is an ongoing effort to harmonize outcomes around the PFMI's

What are the major changes for CDCC members and clients from new PFMI's?

➤ General Organization

- ▶ Limited direct impact on members and clients; generally deals with internal framework for legal basis, governance, and CDCC's enterprise risk framework.

➤ Credit and Liquidity management

- ▶ Material changes for members and participants. Changes margining methodology and clearing fund calculation resulting from the new standards will result in higher margin requirements to reflect charges for, or changes to:
 - Concentration risk
 - Procyclicality
 - Collateral Policy
 - Liquidity risk (both trading and funding)
 - Wrong-way risk

What are the major changes for CDCC members and clients from new PFMI's?

➤ Settlement

- ▶ There may be minor operational changes associated with changes addressing settlement finality, money settlements, and physical deliveries.

➤ Default Management

- ▶ The rules and procedure will be modified to provide greater transparency about the steps taken by CDCC in a member default, and the governance associated with the process.
- ▶ There is a major change that is being considered to modify the client segregation model for CDCC to improve the likelihood of effective portability arrangements.

➤ General business and operational risk management

- ▶ Recovery and resolution frameworks are being established for CCP's, and the tools that may be employed at the "end of the waterfall" will be subject to public consultation.
- ▶ Increasingly complex DRP/BCP and default simulations will require more direct member participation.

What are the major changes for CDCC members and clients from new PFMI's?

- Access and participation requirements
 - ▶ CDCC is going to be increasingly interested in the operational capacity of its members.
- Transparency
 - ▶ CDCC will be providing periodic and timely, publically disseminated, risk based reporting, as well as our qualitative assessment of how the PFMI standards are met.

What is the net impact of these changes?

- As risk becomes concentrated in CCP's, it is critical that they are designed so that the "too big to fail" question is minimized.
- Governance, improved stress testing, additional financial resources, and increased transparency are designed to provide the users of the system with the confidence that in times of stress, the system will act as designed.

When will these changes happen?

- A brief timeline.
 - ▶ 2012 - PFMI's published
 - ▶ 2013 - CDCC gaps identified, reviewed, and prioritized with regulators
 - ▶ 2014 - Work initiated to close priority gaps.
 - ERM framework established
 - Policies developed and systems being built to measure and monitor required changes in credit, collateral, margin, and liquidity risk management
 - ▶ 2015 - Priority gaps are closed
 - All changes targeted for implementation by end of Q1 2015
 - Default simulations are expanded to include more participants
 - Industry consultation on segregation model complete
 - ▶ 2016
 - Recovery and resolution
 - Industry engagement with any changes required for segregation changes
 - CDCC reporting
 - ▶ 2017
 - Segregation model changes in production
 - Industry wide integrated default management simulations

Is there anything else important in the CCP world happening that we need to know?

- Basle III is having material intended/unintended consequences
 - ▶ The listed derivatives market will be affected by changes being proposed for NSFR (net stable funding ratio) and liquidity ratios - however - it is not clear to what extent. Implementation varies by jurisdiction.
- Participation models in CCP's is changing for members
 - ▶ Basle and PFMI changes are increasing the cost to be a clearing member, which will likely reduce the number of clearers globally. CCP's are being asked to consider alternative participation models as one approach to mitigate this risk.
- The "Q" process matters.
 - ▶ Being designated as a qualified CCP has real business impacts.
- International interpretation of the application of PFMI's matter.
 - ▶ If you agree that a CCP is important, then it is important that you understand how your CCP works.

Any questions?