



Central counterparties for over-the-counter derivatives

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1



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The article is joint work with Stephen G. Cecchetti and Marc Hollanders.

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2

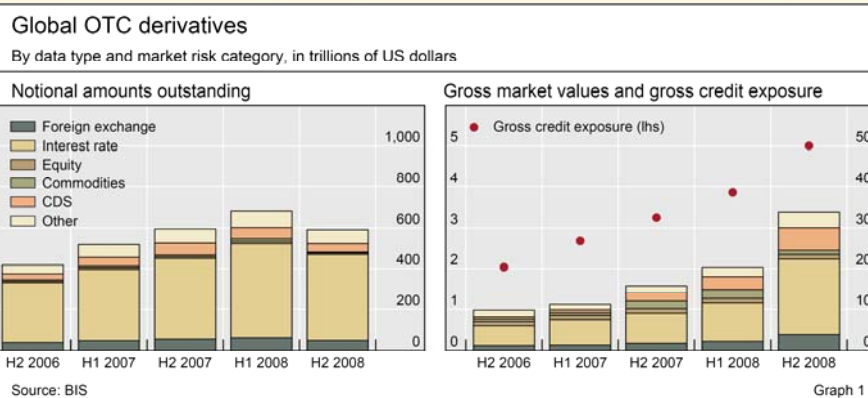


Motivation

- Before the crisis there were concerns about risk related OTC derivatives activities
- Most OTC derivatives markets continued to function during the crisis
- Crisis did not “originate” in OTC derivatives markets !
- Crisis did however show that risks related to OTC derivatives activities were much larger than expected
- Renewed calls for revision of regulatory frameworks and improved derivatives market organisation



The growth of OTC derivatives markets





Three forms of market organisation for derivatives, by market characteristic

Selected characteristic	Bilateral OTC	CCP	Exchange-based
Trading	Bilateral	Bilateral	Centralised
Clearing	Bilateral	Centralised	Centralised
Counterparty	Initial buyer or seller	CCP	CCP
Product features	All	Standardised and liquid	Standardised and liquid
Product examples	Foreign exchange swaps Interest rate swaps Credit default swaps	Plain vanilla interest rate swaps	Commodities Exchange rate futures Government bond futures
Participants	All	Typically larger dealers and higher-rated market participants	Typically larger dealers and higher-rated market participants
Market maker importance	Significant	Significant	Limited
Collateral practices	Bilateral posting of collateral	Margin requirements uniform for all	Margin requirements uniform for all
Margin movement	Decentralised and disputable	Centralised enforcement by CCP	Centralised enforcement by CCP
Risk buffers	Regulatory capital	Equity and margins	Equity and margins
Clearing and settlement	Bilateral	Centralised	Centralised
Netting	Some gross exposures netted bilaterally and some ad hoc multilateral netting	Exposures are netted multilaterally and position is against a CCP	Exposures are netted multilaterally and position is against a CCP
Regulation	Self-regulation and reliance on "market practices"	Self-regulation, reliance on "market practices" and public sector regulation of CCP	Self-regulation as well as public sector regulation of the exchanges and CCP
Transparency of exposures and activity	Limited or none	Detailed information available but not disseminated	Detailed information available but not disseminated
Transparency of prices	Pre-trade prices are non-binding quotes Actual transaction prices typically not published	Pre-trade prices are non-binding quotes No automatic publication of transaction prices	Pre-trade prices are binding quotes Actual transaction prices published

Table 1

**Central counterparties and financial stability**

- Lack of transparency
 - Easier to collection information
 - More level playing field
- Insufficient financial resources to cover potential losses
 - Stricter risk management results in more capital
 - May explain resistance from parts of industry
- Increased pro-cyclicality
 - Lower counterparty risk concerns in stress periods
 - More efficient netting means less collateral used
 - Less down-grade induced jumps in collateral



Recent developments

- Interest rate swaps
 - CCPs for interest swaps have existed for many years
 - More market participants are seeking access to existing CCPs
 - New CCPs coming in ?
- Credit default swaps
 - New initiatives which facilitate introduction/use of CCPs
 - Data ware-house
 - Recently several CCPs have started operating in the US and European CDS markets



Challenges

- Very strong risk management needed as CCPs by definition concentrate risks
- Existing CCPs performed well during recent crisis
- May be a need for public support to ensure CCPs continue to operate even if several market participants fail
- Coordination of public support and oversight key
- Multiple CCPs
 - Additional posting of capital by large players
 - Regulatory consistency across jurisdictions
 - Dilutes netting benefits



Concluding remarks

- CCPs one tool which can help lower systemic risks
- CCPs can help lowering counterparty risk and increase transparency
- The introduction of CCPs alone is not sufficient
 - Better trading/settlements infrastructure desirable
- CCPs for non-standard derivative contracts not a good idea
 - Important to preserve incentives for innovation
 - As contracts become widely used they should move to CCP