



## CPSS – IOSCO Recommendations for Central Counterparties

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**Western Hemisphere Payments and  
Securities Settlement Forum**

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### Trends: Securities Settlement Systems (SSS)

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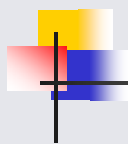
- **In many countries SSS and funds transfer (payment) systems are not adequately integrated creating disruptions to the payments system as a whole**
- **Many SSS around the world do not comply with the CPSS-IOSCO Recommendations for SSS**
- **Some countries are considering the introduction of Central Counterparties (CCPs)**



## Definition of CCP

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**A Central Counterparty interposes itself between counterparties to financial contracts traded in one or more markets, becoming the buyer to every seller and the seller to every buyer**

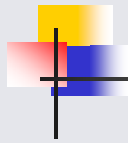


## CPSS-IOSCO Recommendations for SSS

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- o CPSS-IOSCO Recommendation 4 for Securities Settlement Systems states that:

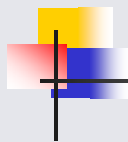
**“The benefits and costs of a central counterparty should be evaluated. Where such a mechanism is introduced, the central counterparty should rigorously control the risks it assumes.”**



## CPSS-IOSCO Task Force

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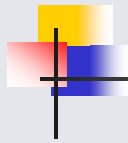
- Recommendation 4 does not set out detailed or comprehensive standards for CCP risk management
- The CPSS and IOSCO Technical Committee then concluded that international standards for CCP risk management are essential because of CCP's large and growing role in SSSs and the potential for risk management failure by the CCPs to disrupt markets and payment and securities settlement systems



## CPSS-IOSCO Task Force

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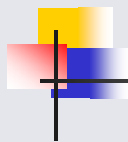
- In February 2003, the Task Force started developed standards specifically directed to CCPs
- In March 2004 the Report was published for public comments (until June 9, 2004)
- The Report is available at [www.bis.org](http://www.bis.org)
- The final report should be completed by November 2004



## CCP: Scope

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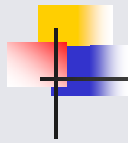
- CCPs have long been used by derivatives exchanges and a few securities exchanges and trading systems
- In recent years they have been introduced by many more securities exchanges
- In recent years they have begun to provide their services to over-the-counter markets, including markets for securities repos and derivatives



## Payment Systems: legal framework

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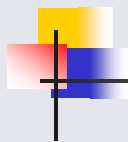
- **1. Legal risk:** A CCP should have a well-founded, transparent and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.
- **2. Participation requirements :** A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an ongoing basis. A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access.



## Payment Systems: legal framework

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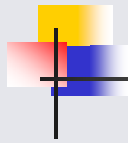
- **3. Collateral requirements:** A CCP should calculate its credit exposures to participants on a daily basis and hold collateral that in normal market conditions fully covers its potential losses from closing out positions held by a defaulting participant.
- **4. Financial resources:** A CCP should maintain sufficient financial resources to withstand a default by the participant to which it has the largest exposure in extreme but plausible market conditions that produce losses not fully covered by collateral requirements.



## Payment Systems: legal framework

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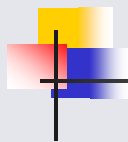
- **5. Default procedures:** A CCP's default procedures should be clear and transparent, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations.
- **6. Custody and investment risk:** A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimised. Assets invested by a CCP should be held in instruments with minimal credit, market and liquidity risk.



## Recommendations for CCP

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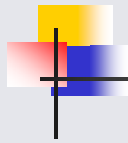
- **7. Operational risk:** A CCP should identify sources of operational risk and minimise them through the development of appropriate systems, control and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Business continuity plans should allow for timely recovery of operations and fulfillment of a CCP's obligations.
- **8. Money settlements:** A CCP should employ money settlement arrangements that eliminate or strictly limit its settlement bank risks, that is, its credit and liquidity risks from use of banks to effect money settlements with its participants. Funds transfers to the CCP should be final when effected.



## Recommendations for CCP

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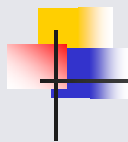
- **9. Physical deliveries:** A CCP should clearly state its obligations with respect to physical deliveries. The risks from these obligations should be identified and managed.
- **10. Risks in links between CCPs:** CPs that establish links either cross-border or domestically to clear trades should design and operate such links in ways that observe the other recommendations in this report.



## Recommendations for CCP

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- **11. Efficiency:** While maintaining safe and secure operations, CCPs should be cost-effective in meeting the requirements of users.
- **12. Governance:** Governance arrangements for a CCP should be effective, clear, and transparent to fulfill public interest requirements and to support the objectives of owners and users. In particular, they should promote the effectiveness of the CCP's risk management procedures.



## Recommendations for CCP

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- **13. Transparency:** A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.
- **14. Regulation and oversight:** A CCP should be subject to transparent and effective regulation and oversight. In both a domestic and international context, central banks and securities regulators should have consistent regulatory objectives and cooperate with each other and with other relevant authorities.

SPECIAL CONSIDERATION OF CCPs



➤ Benefits

➤ Attributed to multilateral netting

- Reduction in the number of settlements
- Reduction in individual contractual obligations
- May help reduce the margins required to collateralize current and potential future credit exposures
- May help to reduce the capital required to support participant's trading activity
- Helps to sustain anonymity where trade execution process itself is anonymous

SPECIAL CONSIDERATION OF CCPs



➤ Benefits

➤ Provides risk management services

- Replaces exposures to multiple counterparties with a single exposure to a single counterparty
- No worry about the creditworthiness to a single counterparty
- Does not eliminate counterparty credit risk, but redistribute it much more efficiently than market participants could do in isolation



## SPECIAL CONSIDERATION OF CCPs



### ➤ Risks

- **Legal and technical risks** (not specific to CCPs but higher potential systemic impact)
- **Principal risk** (reduction but concentration)
- **Replacement cost risks** (not specific to CCPs but higher potential systemic impact)

### ➤ Risk management tools

- **Financial and operational requirements** (to minimize probability of failure of a market participant)
- **Margins** (to minimize the loss if a participant fails)
- **Limit build-up of exposures by means of periodic settlement of positions** (normally used in derivative markets)

## SPECIAL CONSIDERATION OF CCPs



### ➤ Main concerns

- Concentration of risk
- Moral hazard (too big to fail)
- Information asymmetry is reduced but only if CCP is perceived to be solvent
- Competition between CCPs could negatively affect risk management standards
- A single CCP would maximize externalities and economies of scale but could produce potential inefficiencies (lack of innovation). Need of appropriate governance rules
- Contagion effects (cross-process, cross-products, cross currencies)

## SPECIAL CONSIDERATION OF CCPs



### ➤ Main issues to be considered

- Legal Framework
- Participation Requirements
- Understanding Risks
- Novation

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- Settlement
- Default Procedures
- Risk Controls
  - Margins/Guarantee fund/Loss Sharing
- Governance
- Operational Risk
- Regulatory Reporting

## Next Steps

**The World Bank, in agreement with the CPSS-IOSCO Task Force, will prepare a discussion document on costs and benefits of implementing CCPs in the emerging markets**