Key messages about CCPs

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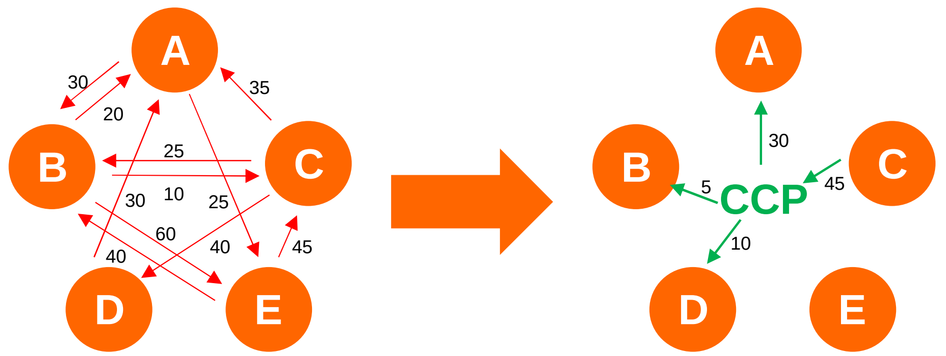
CCPs diminish risk in financial markets

- CCPs diminish and manage risks in financial markets by becoming the buyer to every seller and the seller to every buyer. CCPs prevent that a network of debts between market members builds up, ensuring that if one goes bust, the rest continue business as usual and market remains open.



Risk diminishes

- **Credit risk**
  - Credit risk exposures significantly reduced through multilateral netting (netting ratio approaching 99%)
- **Market risk**
  - The CCP has no market exposure and it is therefore market neutral provided no counterparty goes in default
- **Contagion risk**
  - Number of settlements is reduced as well as its associated risks and costs.

Risk is managed

- **Credit risk**
  - Counterparty credit risk is borne by the clearing house
  - Counterparty credit risk is accurately calculated
- **Market risk**
  - The CCP marks to market the exposure of members
- **Contagion risk**
  - The parties can net transactions with different counterparties.

Efficiency increases

- **Lower number of movements**
  - In our example, the number of settlements is compressed from 11 to 4 (in reality the number of trades will have been significantly greater, and netting ratios approach 99%)
  - The quantity of cash and securities to be moved is compressed
- **Centralisation of core functions**
  - Calculation of positions
  - Risk management
  - Settlement margin

CCPs are financially sound market infrastructures (I)

- The CCPs' lines of defense ensure that CCPs are robust infrastructures that effectively decrease risk in financial markets

Admission criteria

- Non-discriminatory, transparent and objective
- CM with sufficient financial resources
- Additional obligations (e.g. participation in auction)

+

MARGINS – Initial margin

+

MARGINS – Variation margin

- Highly liquid collateral with minimal credit and market risk (e.g. government bonds)

+

CCPs' own contribution (*Skin in the game*)

Default fund (DF)

≥ Default of 2 CMs with largest exposures

- Contributions to the DF are proportional to the exposures of each CM
- ≥ Default of CM with largest exposure OR 2nd + 3rd CMs if exposure is larger
- Capped additional DF contributions

+

Additional resources

1.- Own resources in excess of Regulatory Capital

2.- Other recovery tools

3.- Third party financial guarantees

CCPs are financially sound market infrastructures (II)

- CCPs use their own capital as skin-in-the-game. This incentivises prudent risk management.

1.- Skin in the game

- At least 25% of minimum required regulatory capital

+

+

2.- Minimum required regulatory capital according to EMIR

- To ensure wind down of operations, AND
- To cover all types of risks if not already covered by the initial margin and the default fund (or other financial resources): credit, counterparty, market, operational, legal and business risks

CCPs can successfully deal with members' default

- Some CCPs have successfully been clearing OTC derivatives for years.
- CCPs will clear standardised OTC derivatives only, which are liquid, easy to price and therefore safe to clear
- The Lehman bankruptcy demonstrated that CCPs can cope with the default of a large member active in OTC derivatives

Use of CCP's waterfall during Lehman's bankruptcy by the largest CCP

1.- MARGINS – Variation margin defaulting clearing member

2.- MARGINS – Initial margin defaulting clearing member

3.- DF - Defaulting clearing member DF contribution

4.- CCP's skin-in-the-game

5.- DF - Non defaulting members pre-funded contributions + other pre-funded contributions

6.- Optional loss allocation tools (e.g. variation margin haircutting, assessments)

7.- Regulatory capital + own resources in excess of Regulatory Capital

Only 35% of initial margin used

Only 35% of Lehman's US$ 2 bn initial margin used

No use of default fund or CCP's own resources

Differences between a CCP and a Bank

Issue	CCPs	Banks
Business objective	Exclusively risk management	Various businesses related to risk taking: fractional reserve banking, investing on own account, investing on the account of its clients, securitisation, provision of loans, maturity transformation etc.
Leverage	CCPs invest exclusively in highly safe assets incurring low leverage	As risk-takers, banks invest their money and that of their clients in a range of assets incurring high leverage
Risk management	Conservative risk modelling as demonstrated during the crisis	Risk management models challenged during the crisis
Transparency	CCPs bring transparency to the risks they manage	Transparency of risk management challenged during the crisis
Lines of defence	Capital, Variation Margins, Initial Margins, Default funds	Capital only
Collateralisation	Exposures fully collateralised	Collateralisation models challenged during the crisis
Economising collateral	Yes, multilateral netting allows less collateral to bet set against risks	No
Derivatives activity	Only standardised derivatives cleared	Enter into both standardised and non-standardised derivatives
Time taken to close the Lehman positions	1 to 3 weeks	Months/Years