Issues related to central counterparty clearing: Concluding remarks

Jean-Claude Trichet

I have the pleasure to conclude a very successful conference, a conference that has been special in many respects. First, this conference was jointly organized by the European Central Bank (ECB) and the Federal Reserve Bank of Chicago (Chicago Fed). As such, it marks another fruitful example of cooperation among central banks across the Atlantic. Second, it has featured research on central counterparties (CCPs), a topic that has not yet received a great deal of attention from academic researchers. I hope that this conference has contributed to stimulating more research on this very important subject. Finally, it has brought together market participants, public authorities, and academics. I am in no doubt that discussions involving people from these very different groups are beneficial for all of them. However, I am also aware that it is not always easy to initiate such discussions. This conference has also been very successful in this respect. I wish to thank the organizers of this conference at the Chicago Fed and the ECB for all their hard work.

Central counterparties play an important role in many financial markets. They interpose themselves between the buyer and the seller of financial assets, acting as the buyer to every seller and as the seller to every buyer of a specified set of contracts. This process mitigates counterparty credit risk, which is the risk that one party of a trade suffers losses because the other party cannot fulfill its obligations from the trade. Through multilateral netting, central counterparties enhance liquidity and reduce liquidity costs. Finally, central counterparties ensure post-trade anonymity.

Central banks are interested in the smooth functioning of central counterparties for three reasons:

- Central counterparties can enhance financial stability as long as they function smoothly. The failure of a central counterparty, however, can significantly destabilize financial markets. It is therefore important that central counterparties have appropriate risk-management procedures in place;
- Links between central counterparties operating in different countries can foster financial integration across those countries by allowing the participants to trade in a foreign market and to clear that trade through existing national arrangements. Links between CCPs can take a variety of forms, ranging from the establishment of direct relations between two CCPs to arrangements between central counterparties that allow their participants to mitigate the costs associated with risk control measures (for example, cross-margining); and
- Central counterparties use payment systems and other infrastructures operated by central banks to carry out their activities.

For these reasons, central banks closely follow and contribute to the discussions related to central counterparty clearing. This conference is an important element in this respect.

Let me now outline a few central points of this discussion.

Central counterparties must have adequate risk-management procedures

Central counterparties play a systemically important role in many financial markets. The failure of a central counterparty can severely disrupt financial markets. Central counterparties are highly specialized in managing risks, and failures have been rare. Nevertheless, there is no room for complacency, and any

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efforts to improve risk-management methods are most welcome. As mentioned already several times in this conference, in November 2004 the Group of Ten (G-10) central banks and the International Organization of Securities Commissions (IOSCO) issued a report that set out 15 comprehensive international recommendations for promoting the safety and efficiency of central counterparties. The European System of Central Banks–Committee of European Securities Regulators (ESCB–CESR) working group is working in close cooperation with European Union CCPs to adapt these recommendations to the European context. Academic research can provide additional hints on the specific situations that are targeted by the recommendations. This has been shown at this conference by Alejandro García and Ramo Gençay or John Cotter and Kevin Dowd with their approaches to extreme market events and by Froukelien Wendt in her survey on intraday margining.

The governance structure of central counterparties should in principle be market driven

The governance structure may have a significant influence on, for example, risk-management and other strategic decisions of central counterparties, as pointed out by Thorsten Koeppl and Cyril Monnet. Although the optimal governance structure cannot be defined ex ante, the markets may in many cases be in a good position to identify and produce it. Public authorities must, however, step in whenever market failures become significant. In this respect, the ECB supports the views expressed in the recommendations by the Committee on Payment and Settlement Systems–International Organization of Securities Commissions (CPSS–IOSCO), according to which governance arrangements for a CCP should be clear and transparent in order to fulfill public interest requirements, support the objectives of owners and participants, and, in particular, promote the effectiveness of a CCP's risk-management procedures.

The features of post-trading structure should also in principle be market driven

We are witnessing fast developments in the field of financial market infrastructures, especially in Europe, but also in other parts of the world. With respect to central counterparties, I would like to mention four major developments:

Consolidation of central counterparties

Since the start of the European Monetary Union (EMU), the number of central counterparties for financial instruments has fallen from 14 to seven in the euro area. This process of consolidation may have a positive impact on financial stability as larger central counterparties may find it easier to diversify risks. It may also have a positive impact on the efficiency of post-trading arrangements due to network effects and issues related to interoperability. However, the failure of large central counterparties could have an even more disastrous impact on financial markets. Moreover, consolidation may eventually lead to a reduction in competitive pressures with a negative impact on efficiency. The Eurosystem has formulated this position in a policy statement on consolidation in central counterparty clearing, which was published as early as September 2001. As set forth in the policy statement, the ECB supports any form of market-led integration or consolidation process that fulfills the ECB's requirements in terms of financial stability, open access, price transparency, and efficiency.

Expansion of activities of central counterparties

While in the past most European central counterparties only cleared derivatives, many of them also now clear securities transactions. The effects of such an expansion have been assessed differently by different speakers at this conference. On the one hand, John Jackson and Mark Manning have found that central counterparties that diversify their activities across imperfectly correlated assets may often be able to better manage their risks than single-product clearers. At the same time, securities market participants have benefited as their exposure to counterparty credit risk is reduced. This trend towards multiproduct central counterparties could therefore be beneficial from a financial stability perspective. On the other hand, in the first panel yesterday, Diana Chan had mentioned that central counterparties that diversify their activities across imperfectly correlated assets and reduce the collateral requirements for their participants by offsetting margins related to these different activities could significantly underestimate risk exposure and collateralization requirements, thereby creating additional and unknown risks. These developments need, therefore, to be carefully observed by market participants and relevant authorities.

Creation and dismantling of vertical "silos"

In Europe, vertical silos encompassing trading, clearing, and settlement infrastructures have been created, while other silos have been dismantled. The discussion on which structure is preferable is ongoing, and the answer may be different for different markets. While silos may help infrastructure providers to reduce operating costs and to better coordinate the prices of the different integrated services (for example, trading, clearing, and settlement), they may reduce competition when they are misused, for example, to favor a central counterparty in the silo over its competitors outside of the silo. As the Eurosystem explained in its policy statement of September 2001, the disadvantages of vertical silos "can be overcome provided that customers can choose between systems along the value chain.… It is therefore crucial that access to essential facilities, whether vertically integrated or not, should not be unfairly impeded."

Growing need for adequate infrastructure in the field of credit derivatives

Volume growth in derivatives—especially over-the-counter (OTC) derivatives—outpaces the cash markets, spurred on by increased interest in hedge funds and the ongoing innovation in the types of contract offered. While the interest rate contract remains the key hedge instrument (US$187 trillion outstanding), the credit default contract (US$6.3 trillion outstanding) is growing approximately 90 percent per year, now reaching 10,000 trades per day. Volume growth is expected to continue over the coming years, causing some concern among operations managers on the OTC market, given the lack of straight through processing and hence capacity to manage the volumes. This rapid multidimensional growth (that is, in terms of products, volumes, market participants, and secondary markets) calls for an enhancement of the post-trading infrastructure that may support more careful risk control by the various participants. As mentioned by Governor Kroszner, enhancing the post-trading infrastructure does not automatically mean to introduce *telles quelles* ["just as they are"] the same techniques that CCPs use in exchanged-traded derivatives but rather to identify the solutions that are equally effective and take into account the different features of OTC markets.

All these developments refer to the market structure that surrounds central counterparties and are highly relevant for the interests of central banks in the fields of financial stability and financial integration. As central banks, we believe that the market structure should be market driven as long as market failures are not observed. Significant market failures, however, must be identified and, in many cases, require appropriate public intervention.

This brings me to my last point.

What is the role of public authorities and, in particular, central banks?

Market forces need a sound legal, regulatory, and oversight basis to work efficiently. In the euro area with its 12 countries, and in the European Union with its 25 countries, the creation of such a sound basis requires first and foremost a certain degree of harmonization of public principles and standards across countries. Efforts in this direction are ongoing and the Eurosystem provides active support. Here I should mention the joint work by the European System of Central Banks and the Commission of European Securities Regulators toward establishing standards for securities clearing and settlement in the European Union. As indicated in the ECB policy statement of 2001, standards are to be carefully set and then implemented by public authorities with a clear interest and expertise in the respective field. It appears evident that the Eurosystem, for example, should be involved in the oversight of any major infrastructure for euro-denominated assets with a view to being able to properly address serious threats to financial stability. A paper, authored by a professor at the Woodrow Wilson School at Princeton University in 1990, addressing the performance of the derivatives clearing and settlement systems during the 1987 stock market break, concluded, *inter alia*, that "the Federal Reserve played a vital job in protecting the integrity of the clearing and settlement systems."[1] The name of that professor is Ben Bernanke.

Finally, it is important that cross-fertilization of experiences and expertise of market participants, academics, and public authorities in this field continues, and as I said before, this conference has certainly contributed in this respect.

NOTE

[1]Ben S. Bernanke, 1990, "Clearing and settlement during the crash," *Review of Financial Studies*, Vol. 3, No. 1, pp. 133–151.