Central Counterparties

In capital markets, derivatives serve to complete transactions by improving the pricing of risk and helping market participants manage risk that they face. The global financial crisis of 2008, however has brought to light several major systematic risks related to the OTC derivative markets.

In fact, in the 2009 Pittsburgh Summit, G20 leaders pledged to reform the OTC derivatives markets in order to improve their transparency, prevent market abuse and reduce systemic risks.

In the years following this crisis, central counterparties (CCPs) have become an increasingly critical segment of the financial system. The idea of a CCP was further substantiated by the Dodd- Frank Act 2010, that reinforced norms to regulate the OTC derivatives markets of USA and EMIR through a combination of standardized CCP, higher capital requirements and locking up of initial and variation margins of traders for such transactions.

Following these commitments, there has been a drastic rise in CCPs being used for clearing derivative transactions, thereby enhancing financial stability in the market.

Meaning and Functioning

Central Counterparty (CCP) is a corporate entity that reduces counterparty, operational, settlement, market, legal and default risk for traders. CCP becomes the counterparty to the buyer and the seller and guarantees the terms of a trade even if one party defaults on the agreement.

The CCP collects money from each buyer and seller for covering potential losses incurred by not following through on an agreement, resulting in the CCP replacing the trade at the current market price. Monetary requirements are based on each trader's exposures and various other regulatory guidelines of the central banks of respective countries.

Original contract ceases to exist and the CCPs assumes the rights and obligations of the counterparties. The CCP takes the counterparty risk and the market risk remains with the original party to the trade. A well-functioning CCP can improve the safety, transparency and efficiency of the financial system.

With the counterparty risk centralized in a CCP, a single systemic point in the system, it is critical that the CCP has adequate financial resources for risk mitigation. A CCP requires variation margins and initial margins, with the former covering fluctuations (net changes) in the market value of the underlying portfolios and the latter covering the potential costs of replacing the underlying contracts in case the original counterparty defaults.
The variation margin tracks the value prior to the default and the initial margin provides a cushion against potential losses after default. In line with the "defaulter pays" approach, the initial margin is paid upfront and it is taken by the CCP to provide the first defence against potential losses.

Benefits of a CCP

- By acting as a counterparty for all trades, CCPs improve management of counterparty risk in an effective and efficient manner. It increases transparency. Derivative contracts become more standardized and liquid.
- Central counterparties can net positions multilaterally. Netting on a multilateral basis is done by summing each participant's bilateral

net positions with the other participant's position. The resultant is each participant having a position with the CCP.

- A CCP has risk absorption capacity as it has equity which has been infused by its members and margins collected by it from the participants.
- As a rule, the CCP will reject new trades from a member whose initial margin is no longer sufficient.
- Better access to exposure information has important implications, particularly for the CDS market. By raising the cost of taking very large positions, the maintenance of adequate collateral helps lower concentration risk.

Global Developments

Central Counterparties obligation has been introduced by around half of the G20 members. Japan and the USA implemented the first clearing mandate in 2013. The first central clearing obligation in the EU came into effect on 21 June 2016, however it will be introduced for different counterparties only gradually. Most countries have opted for mandatory clearing of interest rate (IR) derivatives, which are the most traded derivative contracts and hence there are a widespread availability of CCPs.

In 2017, the European Commission made a proposal for targeted changed in the European Market Infrastructure Regulation (EMIR) with the aim to enhance the current supervisory arrangement and creating more pan-European approach to the supervision of CCPs. This proposal is motivated by two factors, one is the increased importance of CCPs for financial stability and market functioning and the other is reduce the risk which comes from UK moving out of the EU.

The regulatory push has led to a substantial increase in centrally cleared OTC traded derivative contacts. It is estimated that in 2013, around 35% of interest rate contacts and 12% of credit derivatives were centrally cleared, these numbers increased to 77% and 51% respectively, by mid-2017. The expansion of central clearance has not covered all assets classes and thus has scope for further expansion.

Guidelines issued by the RBI

The RBI issued a policy framework for central counterparties on October 15th, 2018, stating that they play a critical role in the financial system as CCPs provide guaranteed settlement services in the markets served by them and mitigate counterparty risk for the participants, thereby reducing systemic risk.

The following guidelines have been issued by the RBI for CCPs which are seeking authorization from the RBI:

1. The CCPs will be governed under the Payments and Settlements Systems Act, 2007.
2. These directions shall be applicable for all CCPs which are incorporated in India and foreign CCPs which are seeking authorization from the RBI.
3. Every applicant seeking authorization / recognition as a CCP under Section 5 of the Act, shall have a minimum net worth of Rs.3 billion at the time of submitting its application.
4. The authorized CCP shall be a public company limited by shares with the shares of the CCP to be held by persons who are users of the authorized CCP. If a person ceases to be a user, the CCP shall ensure that the person's shares are divested.

The authorized CCP must constitute a risk management committee with members who are sufficiently knowledgeable and must formulate a risk management policy.

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