Press Points for Chapter 3:
Making OTC Derivatives Safer: The Role of Central Counterparties

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Key Points

- Soundly run and regulated over-the-counter (OTC) derivative central counterparties (CCPs) will reduce counterparty risk among dealers and minimize the systemic risk associated with cascading counterparty failures.
- However, the costs to OTC derivatives dealers to moving contracts to CCPs is likely to be high as the amount of collateral that would need to be posed is large and hence the transition should be gradual.
- Given the global nature of OTC derivatives markets, close cross-border coordination of regulatory and supervisory frameworks is required to avoid regulatory arbitrage and mitigate systemic risk and adverse spillovers across countries.
- All OTC derivative transactions should be recorded and stored in regulated and supervised trade repositories, and detailed individual counterparty data should be available to all relevant regulators and supervisors.

OTC derivatives markets have grown considerably in recent years, with total notional outstanding amounts now exceeding $600 trillion. During the financial crisis, the credit default swap market, a part of the OTC derivatives market, took center stage as difficulties in financial markets began to intensify and the counterparty risk involved in a largely bilaterally-cleared market became apparent. Authorities had to make expensive decisions regarding Lehman Brothers and AIG based on only partially informed views of potential knock-on effects of the firms' failures.

CCPs are being put forth as a way to make OTC derivatives markets safer, sounder, more transparent, and to help mitigate systemic risk. This chapter provides a primer on this topic, and shows that soundly run and properly regulated CCPs reduce counterparty risk among dealers and reduce the systemic risk associated with cascading counterparty failures. CCPs can also provide the opportunity to improve transparency because of their collection of information on all contract cleared.

However, since CCPs concentrate credit and operational risk related to their own failure, they should be financially sound, subject to prudent risk management procedures, and be effectively regulated and supervised. Moreover, given the global nature of OTC derivatives markets, close cross-border coordination of regulatory and supervisory frameworks is required. This would help avoid regulatory arbitrage and mitigate systemic risk and adverse spillovers across countries.

Also, the benefits of central clearing at both the individual counterparty and systemic levels can only be achieved if a critical mass of contracts is moved to CCPs. In that regard, there remain some potential challenges, including enhancing the degree of product standardization and liquidity, and potentially large up-front capital and collateral costs in the form of initial margin requirements.

If dealers require extra incentives to move bilateral contracts to CCPs, the chapter puts forward the idea of a levy tied to the risks that their derivative books impose on their counterparties. A mandate to centrally clear standardized contracts is a less desirable solution because the need to post potentially large amounts of margin will be disruptive if done at once. Moreover, there are significant infrastructure development costs, including the development of information systems, new rules and procedures. However, if other incentives do not generate enough movement, a mandate may be necessary to overcome market participant fears of being first movers. Although it appears that derivatives dealers are indeed moving those contracts that can be cleared to CCPs, if authorities judge that a mandate is necessary, then it should be phased in gradually.

Policy proposals:

A number of policy proposals arise from the chapter, many of which are already in the legislative and regulatory pipeline. The key ones include the following:

- A global CCP oversight framework should level the playing field at a high minimum level, and discourage regulatory arbitrage. Authorities should have in place contingency plans and appropriate powers to deal with a CCP failure on a globally coordinated basis.

- Regulatory authorities should ensure that a CCP has adequate risk mitigation and management procedures and tools to protect the integrity of all related markets and the interests of its participants, and complies with the upcoming Committee on Payments and Settlement Systems and International Organization of Securities Commissions' standards for central counterparties when issued.

- For each jurisdiction, there should be a clear legal basis that assigns a lead authority to regulate CCPs, in order to ensure effective regulation and oversight. For systemically important CCPs the lead regulator should be a systemic risk regulator.

- Central banks should put in place the ability to supply emergency liquidity to systemically important CCPs in cases of extreme liquidity shortages.