

# CCPs: A User's Perspective

**DISCUSSION PAPER FOR THE JOINT CONFERENCE OF THE  
EUROPEAN CENTRAL BANK AND THE  
FEDERAL RESERVE BANK OF CHICAGO ON**

**ISSUES RELATED TO CENTRAL COUNTERPARTY CLEARING**

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## Introduction

This discussion paper aims to highlight the issues Citigroup considers as important regarding the efficiency, competition and safety of central counterparties (CCPs) from a user perspective. Citigroup is a direct member of nearly 40 CCPs in the securities and derivatives markets worldwide.<sup>1</sup>

## The Environmental Context

The number of CCPs has increased over the past ten years, with many introduced for the first time in national securities markets. The demand for CCP functions will continue in organised markets where anonymous trading removes a participant's ability to choose the party with whom it trades. We also expect increasing demand from participants in bilateral and non-standardised transactions where it could be cost efficient to leverage established techniques, processes and know-how of an infrastructure to mitigate counterparty risk.

CCPs will remain important in the financial markets as counterparty risk management becomes more critical with continued growth in transaction volumes. CCPs create a virtuous cycle in ever-growing transaction volumes, as they can significantly increase market participants' capacity to trade through netting processes that reduce capital requirements and the number of trades to be settled.

## Efficiency

The proliferation and increased use of CCPs globally result in additional requirements for users, such as more collateral, additional technology resources for connectivity and processing, and more human resources to deal with different rule books, liquidity management, compliance and controls. Users need solutions that enable the market to reduce liquidity costs by deploying collateral more efficiently across markets, and to reduce expenses in operations and technology that are necessitated by market differences.

Among the possible solutions that could reduce costs and increase cross-border efficiency – harmonisation, integration, consolidation, linkages, and competition – no single one stands out as more achievable than others in the short term. All of them raise respective public policy issues that require time to resolve in order to ensure an outcome representing a sustainable and optimal solution for the global market.

**CCP Consolidation** There have recently been fervent calls for a single CCP in Europe by some large investment firms trading actively in multiple markets across the European Union (EU).<sup>2</sup> The calls for a single CCP is driven primarily by the desire for cost reduction, without necessarily taking into full consideration the potential that the disruption of a single CCP could introduce systemic risk to the multitude of markets it serves in the whole region.

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<sup>1</sup> In addition, Citigroup is a direct member of nearly 500 other value transfer networks in over 100 countries. These include payment systems, exchanges, central securities depositories, electronic communication networks and electronic trading systems.

<sup>2</sup> In 2001, a number of these same firms approached Clearnet in France, LCH in the UK and Eurex in Germany and proposed that they jointly develop one single CCP for Europe. (At the time, Clearnet and LCH had not yet merged, LCH and Eurex were just in the process of building CCP capabilities, and CC&G had not yet been created in Italy.) Obviously, this attempt was not successful and now with the multiple infrastructures already built according to different rules and processes, the challenge to convince them to change will be even greater. In February 2006, AFEI, ASSOSIM, FBF and LIBA renewed calls for the creation of a pan-European clearing infrastructure.

Citigroup believes that an intermediate step of consolidation into two CCPs, one for the cash market and one for the derivatives market, should deliver most of the operational and collateral management economies expected. There are several reasons why we advocate consolidation of cash and derivatives clearing into separate CCPs:

- The processes involved in the cash and derivatives markets are very different.
- Using risk offset between the cash and derivatives markets to reduce collateral requirements on a pan-European scale could create additional and unknown risks. When market conditions and dynamics change suddenly, the single pan-European CCP's risk management methodology may not be adjusted in time, potentially leading to significant under-estimation of risk exposure and under-collateralisation.
- Considering that the major cross-border inefficiencies identified in the EU concern equities, the consolidation of securities clearing into a cash market CCP would be a reasonable first priority.
- A structure of two CCPs, each with its own specialisation, could be more achievable given that there are two dominant infrastructures in the EU that co-exist today.

**At what price?** Although it is not yet clear how consolidation into one or two CCPs could be achieved in the EU, it is worthwhile to specify some efficiency-related conditions that the leader of any consolidation drive will need to meet.

Consolidation comes at a price. The challenge of dismantling well-established and automated processes and re-combining them into new end-to-end processes across markets will require important investment and strong commitment from stakeholders due to significant project risks. It is likely that not only the market infrastructure will need to invest heavily to reconfigure its processes and technology, but trading platforms and market participants will also need to change some aspects of their technology and operations. The quantification of benefits for significant investments in infrastructure changes hinges typically on two factors: the reduction in the infrastructures' costs from current levels, and assumptions about the long term reduction in market participants' own costs.

What is essential, in addition to these two factors, is the up-front disclosure of a full set of financial pro-formas: a quantification of the infrastructure's total investment, a fee structure that demonstrates which savings will be passed on to the benefit of users in the form of lower fees, and clarity regarding the assumptions used to derive users' up-front investment cost versus long-term savings. It is furthermore essential for the market infrastructure to be transparent about its pricing policy and the composition of revenues to demonstrate to different user segments that the pricing policy is equitable.

We welcome the governance and transparency provisions in the CPSS-IOSCO Recommendations for Central Counterparties, which require high standards of accountability and transparency to users regardless of whether a CCP is a mutual or a for-profit entity.

## **Competition**

An alternative to consolidation is an environment that allows fair competition, the presence of which will serve to drive down costs and encourage innovation. It may be legally possible for CCPs to compete, but in practice network effects cause CCPs to be monopolies in each market they serve. It is most efficient for one CCP to serve all the participants in one market at the same time. CCPs may be able to compete sequentially by displacing an incumbent, but the high switching costs for all members act as an effective barrier to change.

Where more than one CCP serve a market, it is typically by each CCP becoming a member of the other, resulting in two consequences. First, it potentially jeopardizes both CCPs' risk management, as each is exposed to the other's risk management methodology. Secondly, it causes each CCP to perform as a General Clearing Member in competition with commercial service providers, which may present competition risk.

***Freedom of choice*** Advocates of the ability of users to choose among CCPs could be referring to two situations:

- Organised markets must put the clearing rights for their trade flow periodically out to tender by multiple CCPs, and award the clearing rights for a period of time to one of them according to trading member firms' selection criteria;
- A CCP holding the rights to the trade flow of an organised market must grant other CCPs membership rights so that users could concentrate activities with the CCP of their choice if they wish.

In order to enable a CCP to compete for customers cross-border, it needs to be granted the right to operate in a foreign country where there is already an incumbent.<sup>3</sup> However, the prerequisite for cross-border recognition and competition – uniform regulatory standards that define minimum standards of safety and soundness for CCPs – currently does not exist.

***Need for uniform regulatory standards*** The lack of uniformity in CCP regulation adversely affects the ability of CCPs to compete cross-border. It also prevents CCP members and users from understanding their responsibilities and liabilities with legal certainty across markets. CCPs regulated as *credit institutions* (banks) have passporting rights in the EU which implies the right to carry out business in all EU Member States without the need for separate or additional licences outside their home state. CCPs regulated as entities other than *credit institutions* or *investment firms* do not have passporting rights. Article 34 of MiFID (Directive 2004/39/EC) requires Member States to allow firms to designate CCPs of their choice, but does not require Member States to recognise foreign CCPs and allows conditions to be imposed.

Citigroup believes that uniform regulatory standards should be established for market infrastructures. CCPs should be subject to regulatory standards based on the functions they carry out rather than the institutional status which they have chosen. CCPs that conform to such standards should also be permitted to carry out business in any country, free from discrimination such as supplementary licensing conditions.

## **Safety**

The lack of uniformity in the manner in which CCPs are regulated has implications not only on competition but also on safety.

Membership of market infrastructures is typically a necessary condition for financial institutions to participate in the respective markets that the infrastructures serve. Even if participation involves financial exposure, such exposure cannot be avoided, nor is there meaningful choice of alternative service providers – such is the nature of market infrastructures including CCPs. Although we actively identify, monitor and measure exposure to all value transfer networks, we would prefer that compliance with the highest safety standards is publicly supervised in the first place.

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<sup>3</sup> This could mean: (1) CCPs can accept business originating from foreign markets, or (2) CCPs can offer membership rights to participants in foreign countries.

Given their critical role in the market as central managers of counterparty risk, Citigroup believes CCPs should be as robust as top tier banks, which essentially means they should be subject to capital adequacy requirements comparable to those applicable under the Basel Accord.

**Capital requirements** Different regulatory standards translate into differences in the way in which CCPs are capitalised and how they manage their risks. For example, LCH.Clearnet SA (the French CCP) is regulated as a *credit institution* (a bank) under French law and is subject to quantitative regulatory capital requirements. LCH.Clearnet Ltd (the UK CCP) is a *recognised clearing house* under UK law, which although requires it to have sufficient financial resources does not impose quantitative rules on regulatory capital. This points to the need for clearly disclosed risks that users need to know when dealing with a CCP as their legal counterpart.

**Insolvency protection** The risks assumed by CCPs are predominantly counterparty risks regardless of the type of business cleared. Uniform regulatory standards for CCPs should automatically exempt CCPs that meet the standards from the effects of insolvency legislation. Otherwise, the effect of such laws on CCPs in the case of default of a CCP member could undermine contractual certainty, the ability to close out, net obligations or liquidate collateral. At present, some laws already exist to this end, but they are available to CCPs only if they adopt particular legal structures and governing laws, or if certain conditions as to types of counterparty or types of transaction are met. The full range of protections is currently unlikely to be available to CCPs with a wide portfolio of business types.

**Legal certainty** The CPSS-IOSCO Recommendations for Central Counterparties rightly point to the need for enforceability of laws.<sup>4</sup> We fully support the creation of a robust legal framework that confers certainty. In our experience, the areas where legal enforceability is most challenging (besides default) include legal finality, novation, and netting.

In addition, we believe that the specific situation in the EU requires additional efforts as multiple pieces of EU legislation (as well as the absence of legislation in certain instances) cause confusion in the determination of applicable law, the treatment of collateral, and the relevant legal system for determining rights in relation to securities.<sup>5</sup> The rules for a consolidated CCP model need to be supported by legal frameworks in each market that allow such rules to be clearly enforceable.

**More safety concerns** The CPSS-IOSCO Recommendations for Central Counterparties include extensive provisions for best practices in risk management, and should help market participants recognise their credit exposure to CCPs. We highlight below a few additional items which we believe are important in users' assessment of their exposure.

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<sup>4</sup> Recommendation 1 on Legal Risk states that, "A well founded legal framework should support each aspect of a CCP's risk management and operations. The legal system (including bankruptcy laws) should clearly support: novation or open offer, netting, default procedures, collateral and clearing fund arrangements, enforceability of a CCP's rules with regard to its participants, insolvency of the CCP, conflict of laws determinations, and a CCP's access to information about participants and, directly or indirectly, about underlying customers."

<sup>5</sup> In particular, the positions of CCPs in relation to Article 9 of the EU Insolvency Regulation (EC Regulation No. 1346/2000) and Article 27 of the Credit Institutions Winding Up Directive (2001/24/EC) should be clarified and the effect of these articles should be spelt out more clearly. There should be an equivalent legislative measure covering investment firms' insolvencies. The ability of CCPs to apply collateral, regardless of where the collateral is "located", should be put beyond doubt.

- **Financial robustness** – In addition to capital adequacy standards as articulated above, we would further prefer that CCPs disclose the financial statements of consolidated subsidiaries, be subject to independent public audits, be rated by the major rating agencies, and disclose all liquidity facilities and collateral investment programs.  
  
A CCP's financial resources should be adequate to protect it from insolvency if the largest participant in the market were to default or if users representing 5% of the obligations towards the CCP were to default in extreme but plausible market conditions.
- **Choice of opt-out** – Organised markets and CCPs should be designed to allow market participants to opt out of a CCP for specific transactions where they deem the trading counterparty's credit worthiness acceptable. This option allows users to take bilateral counterparty risk at their discretion, and eliminates the costs for counterparty protection that they do not need. It also provides for more effective contingencies in the event of an extended operation outage at a CCP – in that event there would then be an alternative mechanism in place for settling new trades. Lastly, this option allows users to limit their exposure to the CCP if they wish.
- **Anonymous trading** – Where trading is anonymous, legal novation should occur at a defined time at which counterparty risk is clearly identified as belonging to the CCP. The defined time should preferably be at the moment of trade in order to eliminate any period of exposure to an undisclosed trading party. If a CCP does not define the moment of legal novation, then it should disclose to members the identity of the other member firm with whom the trading system has matched it against. If members take bilateral risk on each other, then they should be permitted to specify which members the trading system can match them with as well as restrictions on how much exposure a member wants to take on other members.
- **Capped loss sharing** – There should not be undue legal liabilities and indemnifications associated with CCP membership. In order to avoid moral hazard, a CCP should not have an open-ended loss sharing provision among its membership. The ability of a CCP to use non-defaulting members' funds to cover shortfalls should be limited to a cap defined in membership rules which every member is aware of and has agreed to.
- **Default fire walls** - Where a CCP clears multiple major product segments (e.g. financial derivatives, energy derivatives, on-exchange equities, repos, etc.), default funds should be segregated so that clearing members that are not active in one of the major product segments cannot be obliged to contribute to loss sharing after a default in that segment.
- **CCP Default** – If the CCP itself defaults, there should be clear rules on how this would be handled and full disclosure of what risks participants would face should this happen.
- **Provisions for General Clearing Members** – CCP rules often do not give this category of members sufficient differentiation in rules and conditions that reflects this segment's specific risk management needs. These include provisions such as the ability to limit or reduce exposure to clients which may cause credit risk concerns, requirement that a GCM collects collateral from its underlying clients, accelerated reporting capabilities for intraday margin top ups, and protection from cross-product liabilities.

## Conclusion

Most users' main focus is typically on cost efficiency. Citigroup supports market infrastructure consolidation that ensures long term benefits that accrue to users. CCPs are by nature risk concentrators, and the role of policy makers is to ensure that there are adequate safety standards. Participants of market infrastructures have credit exposure to the infrastructure; these risks should be well understood and users should insist on their mitigation.