

Box 20

THE CPSS-IOSCO RECOMMENDATIONS FOR CENTRAL COUNTERPARTIES

In November 2004, the CPSS of the central banks of the G10 countries and the Technical Committee of IOSCO published a report entitled “Recommendations for Central Counterparties”, which contains 15 recommendations for CCP clearing houses. Most of the recommendations aim at reducing risks that CCPs may be exposed to. As CCPs are systemically important institutions for the financial markets that they serve, these recommendations also contribute to strengthening financial stability. This Box briefly describes some of the aspects addressed by the recommendations with respect to the most important risks faced by CCPs that are particularly relevant from a financial stability perspective.¹

Counterparty credit and liquidity risks

The most important types of risk for a CCP are counterparty credit risk and liquidity risk. Counterparty credit risk is the risk that a CCP participant cannot fulfil an obligation to deliver assets to the CCP, typically due to insolvency. Liquidity risk is the risk that the participant cannot fulfil such an obligation in time, but only at a later stage, for example owing to operational problems.

Recommendation 2 advises CCPs to select their participants carefully. In particular, participants should fulfil adequate capital requirements and should have robust operational facilities in place to ensure timely settlement of obligations.

Recommendation 2 aims at reducing the risk that a CCP participant could fail to fulfil an obligation towards the CCP. Other recommendations aim at ensuring that the CCP will not itself fail to fulfil its own obligations even if its participants fail to fulfil their obligations towards the CCP. Recommendation 10, for example, asks CCPs to use delivery-versus-payment (DVP) facilities to settle transactions with its participants. DVP implies that assets are transferred from the seller to the buyer if and only if the payment is transferred from the buyer to the seller. If, for example, the CCP is the seller to a defaulting participant and DVP is not used, then the CCP is in danger of delivering the assets to the participant without receiving payment, i.e. the CCP risks losing the full principal value of the assets. Recommendations 3, 4 and 5 urge CCPs to have adequate and sufficiently liquid financial resources available, in particular collateral posted by CCP participants, so that the CCP can be used in case of default

¹ For additional information, see Special Feature F on “Central counterparty clearing houses and financial stability” in this FSR.

by participants. It should be noted, however, that a CCP incurs liquidity risk even when all participants pay or deliver in time, as there is not always an obligation for CCP participants to pay or deliver at the same moment, for instance because of a lack of DVP during settlement.

Settlement bank risk and custody risk

CCPs use various settlement service providers to settle transactions with their participants. They use settlement banks to settle payment obligations. Payments are transferred from a participant's cash account with the settlement bank to the CCP's cash account or vice versa. Settlement bank risk is the risk that the settlement bank could fail. As cash on the CCP's cash account is a liability of the settlement bank towards the CCP, the CCP may lose up to the full amount of cash on such an account if the settlement bank fails. In addition, the CCP would need to appoint a new settlement bank, a process that may delay clearing activities. It is therefore advisable, as per Recommendation 9, that the CCP carefully selects its money settlement arrangements. In particular, the use of central banks is suggested.

Similarly, CCPs use CSDs and custodians to hold and settle other assets, for example securities posted to the CCP as collateral. Custody risk is the risk that assets could be lost while held on accounts with CSDs or custodians. Recommendation 7, among others, emphasises that these assets should be protected against the claims of creditors of the CSD or custodian.

Investment risk

CCPs typically invest their own financial resources and cash posted by their participants as collateral in one way or another. Again, Recommendation 7 emphasises the need to invest in sound assets so as to limit the losses the CCP could incur from its investment strategies. Moreover, financial resources should be invested in relatively liquid assets to enable the CCP to make swift use of these resources in case of urgent need.

Operational risks

CCPs, CCP participants, and the CCPs' settlement banks, CSDs and custodians use a variety of technical systems that must not be prone to operational problems. Recommendation 8, dealing with operational risks, explains that all systems involved should be reliable and secure and should have adequate capacity. Furthermore, business continuity arrangements should be in place to permit a timely resumption of activities.

Legal risks

Finally, Recommendation 1 addresses legal risks. The legal framework should be well-founded and transparent. With a view to cross-border clearing activities as well, Recommendation 1 furthermore emphasises the need for the legal framework to be enforceable in all relevant jurisdictions.