Chapter 13
CCPs: A Challenge for Practical Oversight

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ABSTRACT

As a first step a short summary of the historical development of CCPs is provided, followed by an outline of the concept and core functions CCPs. Then an illustration of the main risk management safeguards of CCPs is provided. This includes an excursus regarding the hier-archical structure of clearing and regarding procyclical considerations with respect to CCPs. The outline of CCP counterparty risk management is complemented by a brief overview of other risks, including liquidity risk, legal risk, and operational risk. The consideration of the risk profile of CCPs is concluded with some insight into the main factors determining the oversight of CCPs' governance. The full picture of CCPs from an oversight perspective is given by placing the CCPs in the clearing process and the outlining the resulting challenges for regulatory oversight. The chapter concludes with a description of the manifold layers of today's oversight of CCPs.

INTRODUCTION

For a long time, central counterparties (CCPs) have been an essential element of the financial market infrastructure and the post-trade processing of financial market transactions[1]. With their growing role in the financial markets CCPs became subject of regulatory debates of increasing intensity. In particular after the financial crisis of 2007, with heightened efforts to guarantee systemic financial stability, CCPs, arguably ensuring operational efficiency and counterparty discipline, have become a focal point of the reform of financial market infrastructure.

International standards now require the use of CCPs also in traditionally bilaterally cleared OTC derivatives markets. Expectations toward CCPs are rather high. Earlier CCPs were praised as an example of private market innovation and self-regulation that can be effective for achieving public policy goals of safety, soundness and broader financial stability (Kroszner, 1999, p. 30; Moskow, 2006, p. 37). Now

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international standards foresee an extensive range of minimum requirements to ensure their safety[2]. In some cases CCPs are even expected to support the management of systemic risk (Bank of England, 2013, p. 2).

In spite of the high expectations, current regulatory developments are ambiguous about the role of CCPs. They do favor CCPs as a solution for major weaknesses in the financial system and worry about their failure constituting a "financial Armageddon" (Green, Jenning-Mares, & Smith, 2013, p. 1). Because all transactions are concentrated in one institution, CCPs can be seen as source of systemic vulnerabilities representing the biggest too-big-to-fail institutions the financial system has ever contained.

Admittedly, CCPs have had a track record of low failure rate in comparison to other financial institutions like banks, financial service providers or insurance companies[3]. Nevertheless, the smooth functioning and financial soundness of CCPs are essential for financial stability and cannot be taken for granted (Bernanke, 2011, p. 1). CCPs have their own vulnerabilities and the importance of these for the entire financial system has only increased with the recently strengthened role of CCPs in the financial architecture.

Given their central role in the financial architecture, it is vital that regulatory oversight of CCPs rests on a clear understanding of the functioning of these institutions, the various mechanisms how they are connected to the financial system, the sources of fragility and the factors influencing a CCP's ability to withstand market disruptions. With this in mind, the primary purpose of this paper is to illustrate the workings of CCPs and the main and recently evolving challenges for their practical oversight[4]. It is intended to show that a mechanical approach to CCP oversight needs to be avoided. While relevant quantitative indicators for regulatory oversight purposes can be identified, the varying nature of CCPs and their vulnerabilities makes it necessary to adopt a CCP-specific and holistic oversight approach. In order to conduct effective regulatory oversight of a CCP an in-depth knowledge of the individual CCP, a clear operationalization of the individual regulatory mandate and the pragmatic application of the relevant requirements are necessary. This naturally contradicts a uniform, granular approach on an international scale.

This chapter is organized as follows:

The three particular phases of historical evolution of clearing of financial instruments (Moser, 1998, p. 8) - alternating between counterparty discipline and operational efficiency – which led to the prevalence of so called true CCPs are explained. This allows for a succinct demonstration of the basic functions and the main principles of virtually all CCPs today (Kroszner, 2006, p. 38).Then an illustration of the main risk management safeguards of CCPs is provided. The full picture of CCPs from an oversight perspective is given by placing the CCPs in the clearing process and outlining the resulting challenges for regulatory oversight. The chapter concludes with a description of the manifold layers of today's regulatory oversight of CCPs.

WHAT DOES THE HISTORICAL EVOLUTION OF CCPS REVEAL ABOUT THEIR FUNCTIONING?

The First Steps: Counterparty Discipline by Restricted Membership and Margining

Originally, only few selected counterparties were allowed trading on an exchange. Membership of an exchange served to provide some certification of the trustworthiness of counterparties. Since membership

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