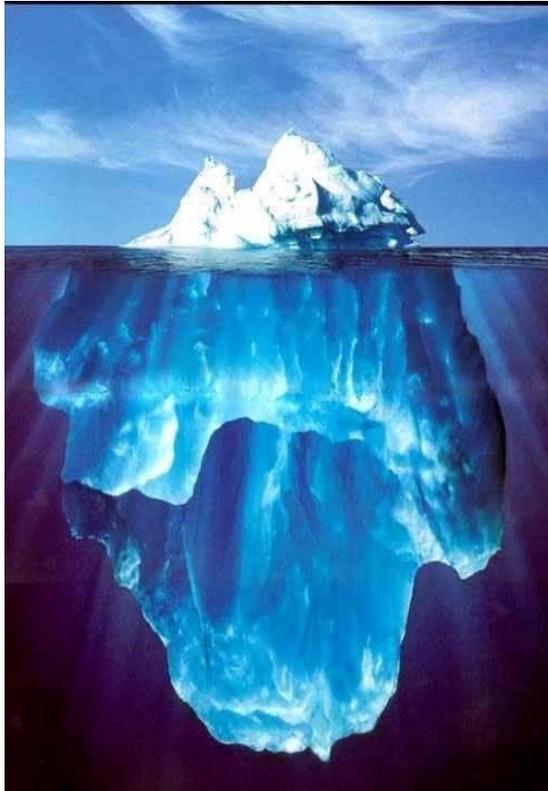


Central Counterparties: the guarantors of market safety

LUISS - Rotman European Trading Competition

Rome, 1 September 2012

Definition of post trading systems



TRADING

The post trading systems represent the hidden part, the most complex and expensive to develop, of the process aimed to build an efficient guarantee system (Central Counterparty Clearing) and to the transfer of financial instruments (and cash) from the seller to the buyer

POST-TRADING

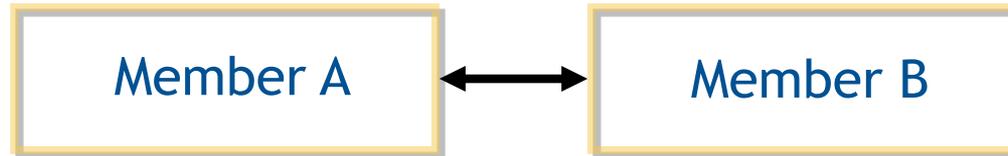
The post trading systems ensure that the trading agreement become effective

Market Infrastructure Value Chain



Central Counterparty Netting - 1

Bilateral Trade Without CCP

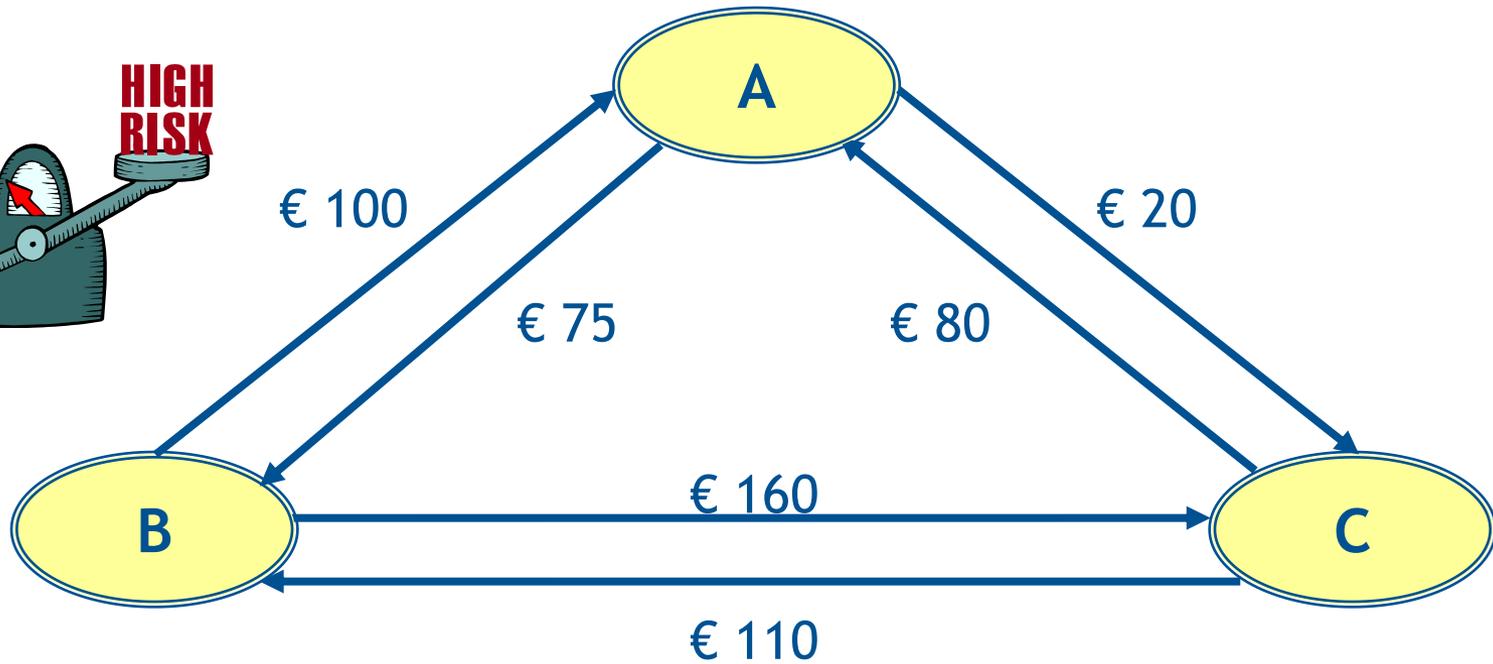
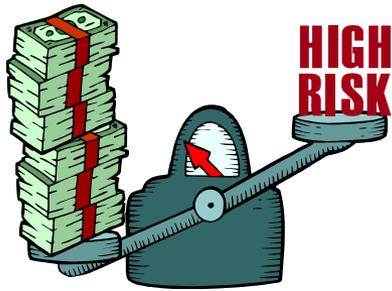


Bilateral Trade With CCP



Central Counterparty Netting - 2

Market exposure in Euro without CCP netting

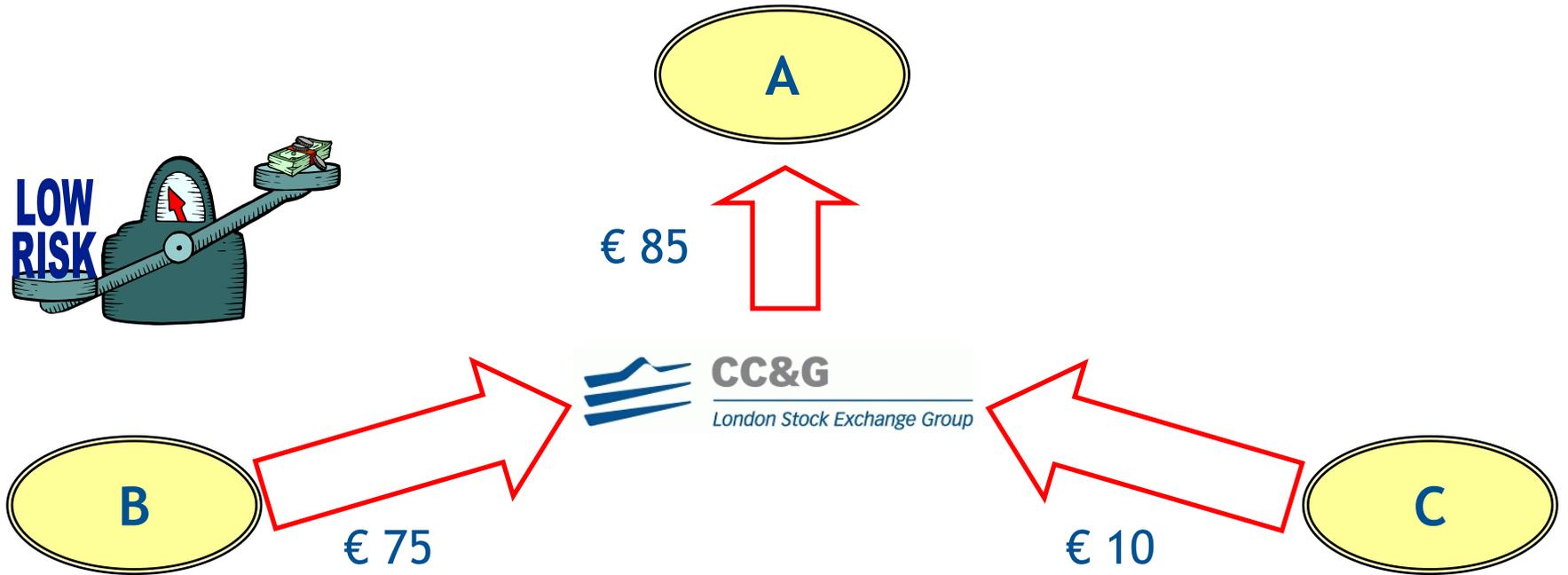


A: net seller
 B and C: net buyers

Total Exposure = € 545
 Number of Open Positions = 6

Central Counterparty Netting - 2

Market exposure in Euro with CCP netting



In reality CCP Netting is about 90%

What is a Central Counterparty doing

1. Interposition in the contract - Legal Netting

- Interposes itself between the counterparties in a transaction assuming the obligations of each one with the other one

2. Netting of the obligations

- Calculates the net obligations assumed by intermediaries against any counterparty or system

3. Guarantee of Performance

- Ensures the contract settlement under the original terms in the event of default of the counterparty, acquiring the necessary guarantees (margin)

4. Replacement Cost Risk Management

- Prevents the accumulation of losses through the daily mark-to-market of open positions; crucial feature for long term contracts

How the Central Counterparty was born

- *A farmer sold his crop forward before his harvest to a grain dealer in Chicago.*
- *The entire grain harvest was huge that year. When time called for the farmer to sell his grain, the price had fallen well below the agreed-upon purchase price in the forward market. The merchant who had agreed to buy the grain then saw that he could buy it more cheaply elsewhere at current prices and reneged the forward contract. The farmer walked up to the merchant and said: “I have a wagon of grain and a shotgun with me. Which should I unload?”*
- *Wishing to mitigate the potential for farmers to show up with loaded weapons to enforce their contracts, members of the Chicago Exchanges wandered if more efficient system may be developed.*
- *23-09-1883: The Chicago Board of Trade Clearing Corporation was born.*

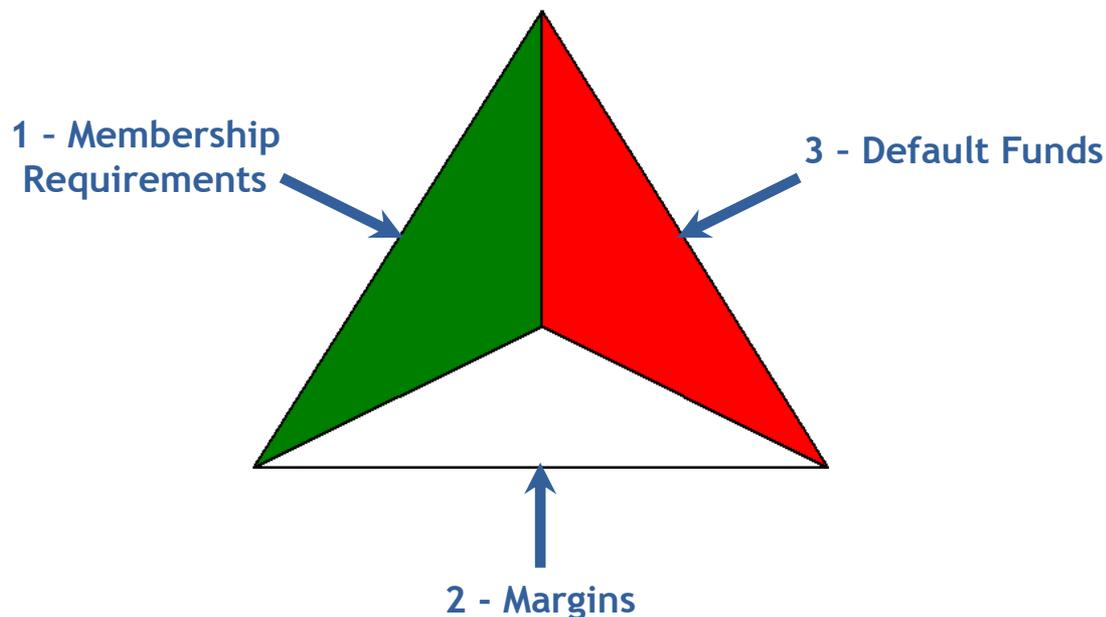
Cfr. Cristopher Culp - The Risk Management Process - Wiley 2000)

Benefits of a Central Counterparty

- The urge for a guarantor of market integrity was first felt on derivatives markets because long term contracts expose counterparties to higher losses, given the longer time span between trading and settlement
- As sensitivity to financial risks increases, the Central counterparty role has been progressively expanded to cash markets
- The certainty of the bargaining terms and of good outcome of the transactions are conditions that have to be necessarily fulfilled in electronic markets because:
 - the market mechanics do not allow the selection of the contractual counterparty; the counterparties are matched through algorithms based on price-time priority of the bids and asks
 - the achieving of the network economies, typical of electronic market, facilitates the gradual geographical dispersion of market participants
- It is therefore necessary to provide the market with some guarantee functions that make redundant the assessment by each individual participant of the reliability of every other participant
- The default is managed by a single entity rather than by every counterpart

Effects of Financial Stability

- A central counterparty, by definition, concentrates and re-allocates risk. As such, it has the potential either to reduce or to increase the systemic risk in a market:
 - Risks are identified and covered by adequate financial resources
 - The legal framework is clear and unambiguous
 - Participants are held responsible for the losses they create in order to discourage imprudent behaviors
 - Operational risks are well managed
 - Risk management procedures are correctly implemented, not only sound in theory



London Stock Exchange Group PLC

Major Rating Factors

Strengths:

- In aggregate, the largest European bourse by turnover.
- Good geographic diversification, with substantial non-volume-related revenues.
- Stable earnings and cash flow generation, with high operating margins.
- Strong risk management and member default protections at CC&G.

Weaknesses:

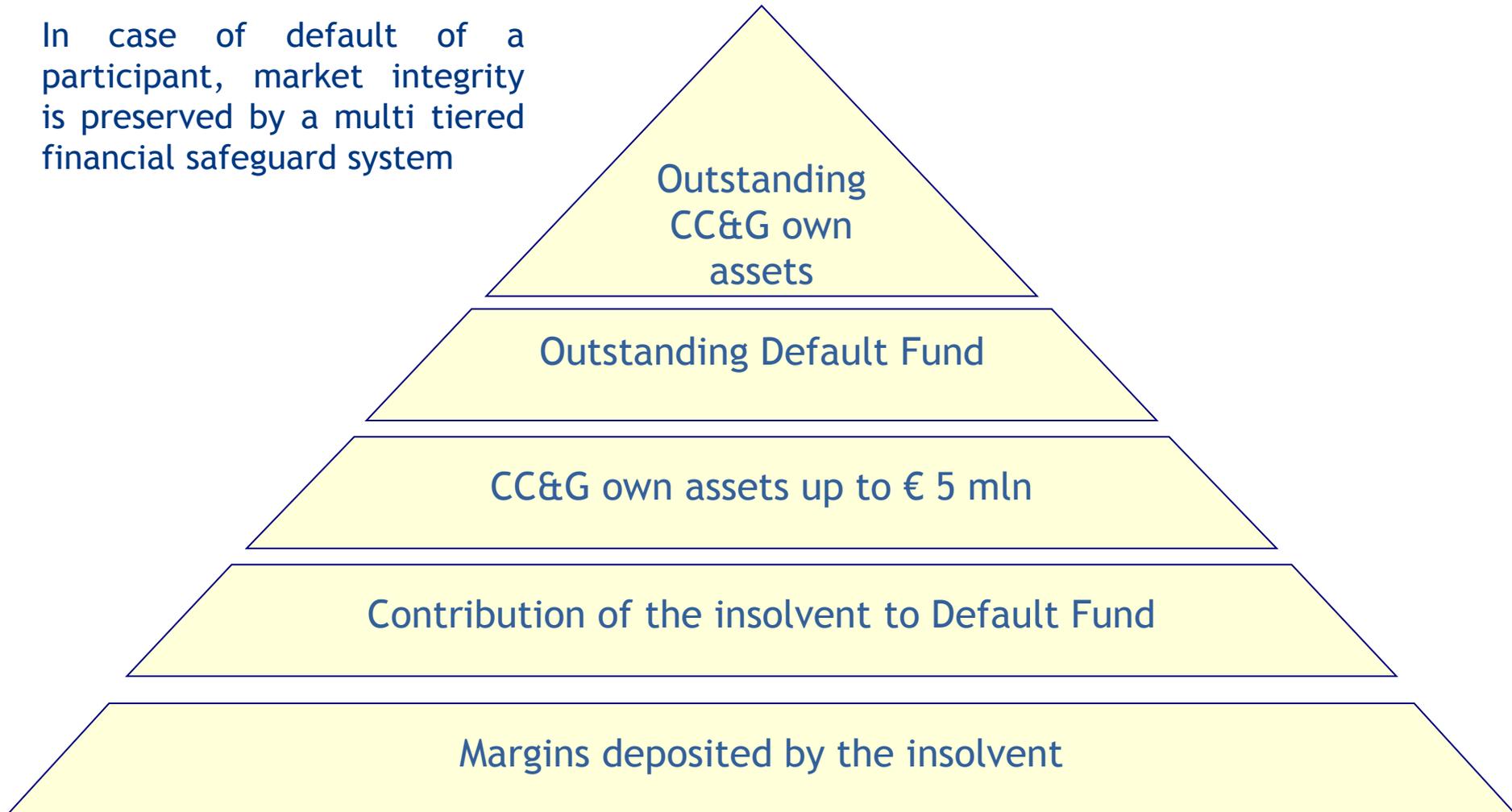
Counterparty Credit Rating

A-/Watch Pos/A-2



Guarantee System

In case of default of a participant, market integrity is preserved by a multi tiered financial safeguard system



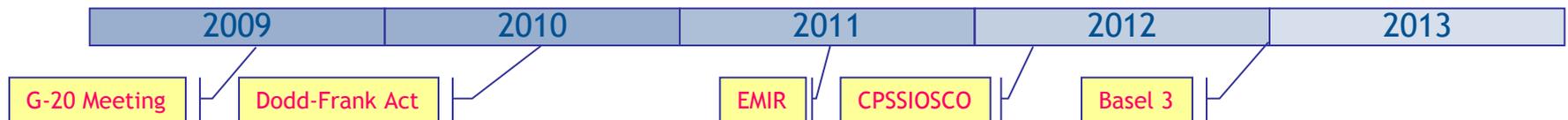
The success of CCPs during Lehman Collapse...

- The collapse of US investment bank Lehman Brothers in late 2008 - one of the largest bankruptcies in financial markets history - precipitated a one-day fall of around five per cent in major equity market indices, and falls of around ten per cent in major banking stocks as well as volatility in yields and credit spreads.
- During this time central counterparties around the world assumed Lehman Brothers' market positions as the bank defaulted on its obligations. **Despite the massive market turmoil, CCPs unwound, hedged, liquidated, and transferred millions of positions** and client accounts worth trillions of dollars largely without loss, providing increased stability and certainty to already fragile markets.
- The rapid but flexible response by CCPs provided stability and certainty to Lehman Brothers' counterparties and to markets in general. This flexibility allowed central counterparties to suspend or limit market access of defaulting Lehman Brothers entities within hours of the default announcement where relevant, while **enabling solvent Lehman Brothers entities to continue trading, reducing market disruption and uncertainty.**
- For underlying clients of Lehman Brothers, actions by CCPs to either transfer or liquidate positions, often under the direction of the client, meant **reduced uncertainty and risk, and prevented potential lengthy delays that might have occurred as a result of the liquidation process.**
- Lehman Brothers positions were liquidated or sold with no loss to the clearing house, and additionally, **"no futures customer lost a penny or suffered any interruption to (their) ability to trade."**

(Central Counterparty Default Management and the Collapse of Lehman Brothers – CCP-12 April 2009)

Evolution of CCP Regulation

- United States → Dodd-Frank Act
 - CCPs are Systemically Important Financial Infrastructures - SIFI
- European Union → European Market Infrastructures Regulation (EMIR)
- CPSS-IOSCO → 24 Principles on World Financial Markets Infrastructures to ensure a safe and efficient *level playing field*
- Basel3 → increase of capital requirements for bilateral exposures (without CCP)
 - Reduced capital requirements for exposures against Qualifying CCPs (i.e. CPSS-IOSCO Compliant)
 - Normal capital requirements for exposures against non-Qualifying CCPs



Effects of financial stability

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Thank you!!

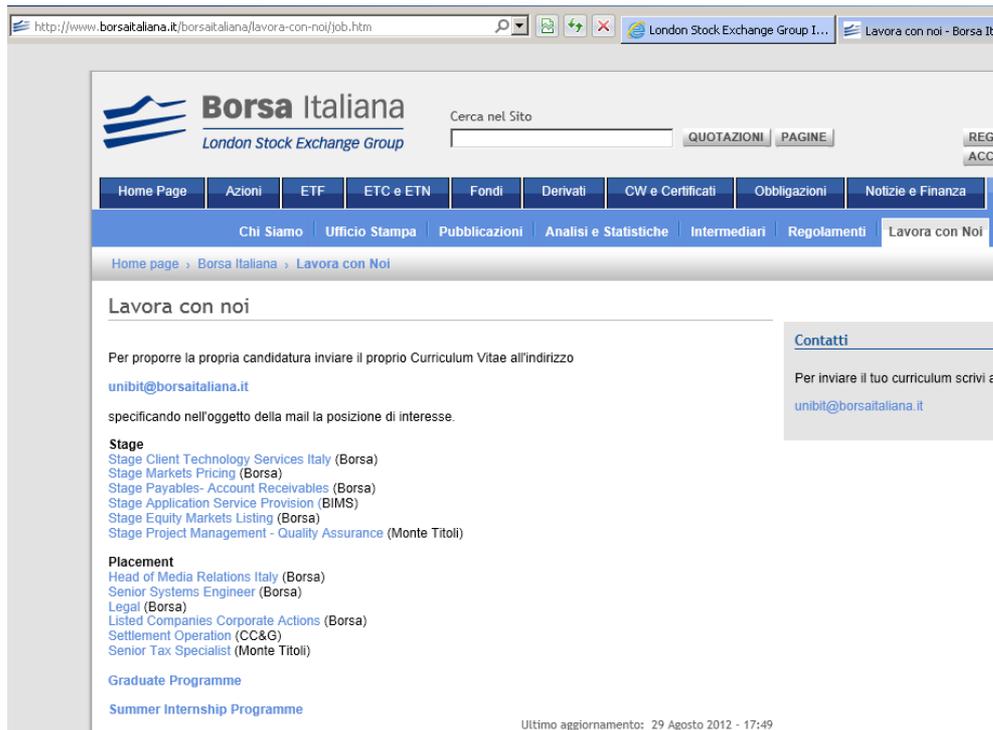
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Ultimo aggiornamento: 29 Agosto 2012 - 17:49

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The skills you'll develop



You will ...

- deal with international financial clients, often in English - and travel
- seek innovation opportunities, business modelling them and translating them into projects
- manage product development projects (IT, finance and marketing side)
- manage relationships with all stakeholders: technology providers, Group team members
- do business analysis by reviewing benchmark surveys to optimize service and pricing models
- do business process engineering

The Recruitment Process

1. **Job adv:** Institutional web site, Carrer Fair, Job Gate, Partnership with Universities and other Institutions, dedicated web-sites etc...

2. **Screening CV**

3. **Telephone Interviews**

4. **One-to-One Interview**

Or Group Assessment with HR

English Test

Finance Test

English Test

Business Case presentation

5. **One-to-One Interview with Manager**

6. **One-to-One Interview with Head of HR Italy**

7. **Feedback negative or positive, within 3 weeks**