

Box 17

CPSS REPORT ON “NEW DEVELOPMENTS IN CLEARING AND SETTLEMENT ARRANGEMENTS FOR OTC DERIVATIVES”

This box refers to a CPSS report based on interviews with 35 major dealers worldwide. This report concludes inter alia that any post-trading infrastructure for OTC derivatives should ensure that other service providers, clearing houses, payment and settlement systems have open and fair access to its services and should aim to achieve interoperability with other types of infrastructure.¹

The report addresses inter alia the following six topics:

1. Unsigned master agreements and outstanding confirmations

The report has established that the market has abandoned the practice of trading without written evidence because of the growth in this business. The number of unsigned masters has, as a result, been significantly reduced, as enforcing closeout netting and collateral is endangered when agreements are not in place. The market has also been working towards improving business practices and reducing the number of outstanding confirmations of credit derivative transactions.

¹ Committee on Payment and Settlement Systems (CPSS) (2007), “New developments in clearing and settlement arrangements for OTC derivatives”, March.

The same commitments used to reduce backlogs in confirming credit derivatives must be extended to other OTC products so that all OTC derivatives are confirmed promptly after the trade date.

2. Use of collateral

The use of collateral has considerably increased since 1998, with reportedly up to 60% of dealers' open positions with cash now the preferred type of collateral. The report warns against associated liquidity, custody, legal and operational risks, which need to be managed effectively for the benefits of collateral to be realised.

3. Central counterparties (CCPs)

The CCP section describes in detail the default procedures within LCH.Clearnet, the only CCP that clears OTC derivatives, accounting for 40% of the global OTC interest rate swaps. The advantage of CCPs are their operational efficiency and network externalities, as well as novation and the accompanying mitigation of credit risk.

4. The valuation of outstanding positions in the case of default

In 2005 the Counterparty Risk Management Policy Group II, a market group, raised concerns with respect to orderly closeout during market stress or for illiquid products in a report examining the private sector perspective with regard to financial stability.² Regardless of the valuation method specified, the non-defaulting party has a strong incentive to terminate and replace its contracts with an insolvent counterparty as soon as possible rather than delay until market quotations are feasible and thus expose itself to additional losses. The report recommends that a) counterparties should discuss ex ante and on a bilateral basis, as well as within their market associations, how they would implement the chosen closeout methodology they have agreed on, so that they can reach a common understanding of the implications of their choice; and b) market participants should work together to identify further steps that can be taken to mitigate the potential impact of the closeout of a major market participant. The report invites market participants to reflect ahead (e.g. to test their internal procedures) and to identify practices to use in times of stress.

5. Prime brokers

Hedge funds centralise their trades upon conclusion with a prime broker, and thus primarily gain operational efficiencies from portfolio margin and collateral set-off. Supervisors should monitor any legal issues with respect to brokerage agreements as well as the robustness of the back offices of regulated firms offering prime brokerage services.

6. Assignments (or novation)

The market has largely abandoned the practice of unilaterally transferring trades to other parties without the written consent of the remaining party in the trade which had an impact on credit and operational risks. In this regard, ISDA's "novation protocol" has provided the market with an efficient way of documenting assignments properly and on a timely basis.

² Counterparty Risk Management Policy Group II (2005), "Towards Greater Financial Stability: A Private Sector Perspective", July.