The Importance of the CCPs Clearing & Risk Management

As entities designed to safeguard market integrity and facilitate financial stability, the track record of CCPs (Central Counterparty Clearing houses) has been excellent. Notwithstanding their success in winding down a failing Lehman Brothers during the 2008 crisis, CCPs proved extraordinary resilient during COVID-19 when market volatility and trading volumes spiked exponentially.

So how exactly have CCPs managed to flourish despite the tough circumstances?

Risk management and product diversification
Underpinning CCPs are their sound risk management practices. In addition to the tough initial and variation margin requirements that participants are required to post on their trades, CCPs adopt stringent default waterfall measures, which are designed to mitigate the threat of a clearing member failure. In the case of BME Clearing, the default waterfall includes contributions from the defaulting member; BME's skin in the game; contributions from non-defaulting clearing members, voluntary contributions and BME's own equity. In terms of CCP risk measurement tools, there also appears to be a move towards risk margining models which provide a better cross-margin ratio (such as HVaR). Such strict checks and balances are integral in ensuring robust CCP risk management.

Since the 2008 financial crisis, regulators have also introduced effective risk controls including EMIR (European Market Infrastructure Regulation) and the CPMI-IOSCO Principles – which subjects CCPs to enhanced transparency obligations and regulatory oversight. EU regulators have also insisted that CCPs up the amount of skin in the game they hold – which is likely to further strengthen risk controls in centralized clearing.

With all these policies in place, the stability provided by CCPs has gradually increased over time, allowing them to clear a wider range of products, including those that fall under EMIR's clearing obligations such as OTCs. However, some CCPs are now becoming more open to clearing higher volatility products, such as those with crypto-assets as underlying. SIX x-Clear, for example, recently cleared ETC Group Physical Bitcoin, a crypto-currency focused exchange traded product (ETP) operated by ETC Group. This comes as a growing number of investors start to build up exposures to crypto assets through ETP wrappers.

Regulations accelerate CCP usage
Elsewhere, EMIR is also likely to spark renewed appetite for centralized clearing once all of its phases are fully implemented in September 2022. Under phase 5 of EMIR, financial institutions with an AANA (Aggregate Average Notional Amount) of non-centrally cleared OTCs totalling more than €50 billion will be subject to stricter margining obligations from September 2021. With the introduction of Phase 6 of EMIR from September 2022, the AANA threshold will reduce to €8 billion capturing around 1,000+ entities from across the buy-side and sell-side. This is likely to result in several non-standardised, bilaterally traded OTCs being pushed into centralised clearing.

Planning for the future
Amid all the volatility and rapidly changing market conditions, the role of the CCP is pivotal. Consequentially, CCPs are likely to play a vital part in protecting market stability for some time to come.

Javier Hernani
Head Securities Services, SIX