

The Significance of the Clearinghouse for Financial Derivatives Markets

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CCP Clearinghouse - Provider of safe and effective post-trade processing

- **Clearing refers to all activities from the time a transaction is concluded until it is finally settled**
- **Main activities in clearing are**
 - Reporting / monitoring
 - Risk margining
 - Netting of trades to single positions
 - Failure handling
- **Clearing in its wider sense involves the management of post-trading, pre-settlement credit exposures, to ensure that trades are settled in accordance with market rules, even if a buyer or seller becomes insolvent prior to settlement**

Clearing Functions and Duties

- Contractual counterparty in all trades
- Automatic posting of trades, premium and fees in members' accounts
- Daily valuation of positions based on settlement prices
- Determination of margins
- Determination of members collateral
- Random selection and allocation of counterparties at exercise of options
- Delivery instructions to CSD(s)

Benefits of Clearing House 1

- Protection against Counterparty Risks
 - The Clearinghouse represents the contractual counterparty of every trade from the moment of its execution.
- Guarantee of Post-Trade Anonymity
 - Pre-Trade Anonymity is extended to Clearing and Settlement providing fair and non-discriminatory transactions.
- Efficient Calculation and Allocation of Collateral
 - Offsetting of Risk Positions reduces Collateral Requirements

Benefits of Clearing House 2

- Extending Trade Management and Delivery Process
 - Delivery Process via a single Interface available directly after Trade Execution.
- Reduction of Settlement Instructions
 - Settlement Netting reduces Settlement Volume
 - Reduced Risk of Failures.

Key Principles

1

1. A single integrated process for clearing and settlement of equity and debt transactions.
2. The process should deliver the following key objectives:
 - Reliability, integrity and scalability
 - Risk reduction
 - Significant reduction in investment and running costs

(Source: www.eurosf.com)

Key Principles

2

- The solution should incorporate
 - the most appropriate technology,
 - capitalize on existing systems where possible,
 - and be capable of processing an exponential increase in transaction volumes.

(Source: www.eurosf.com)

Key Principles

3

- A single clearing and settlement process will require strong governance:
 - No individual organization should have undue influence.
 - Clearing/settlement should have a separate governance process from trading or payments.
 - The process should be largely owned and directed by securities industry users.

(Source: www.eurosf.com)

Clearinghouse Requirements

- Clearinghouse = Guarantor of integrity of the derivative market
- Capitalization of Clearinghouse requires min. EUR 10 Million (= minimum capital for Bank or bank-like institution according to EU standards)
- Capital = 3rd line of defense and is important for clearing members' decision to join a market

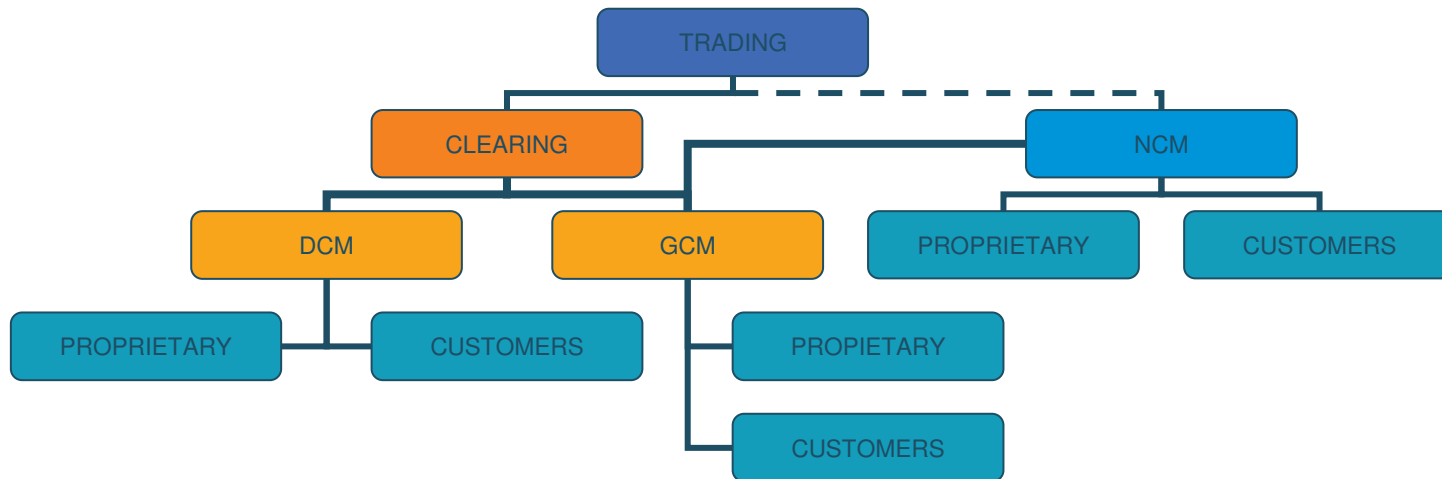
Membership Requirements

- A financial institution admitted to operate custody business, credit operation and receipt of margin by customers in the form of securities and cash
- Membership Types to be defined; e.g.
 - General- Clearing- Member (GCM)
 - Direct- Clearing- Member (DCM)
- Capital Adequacy Rules for Clearing-Members
- Clearing Fund Contribution compulsory
- Cash Component: Direct access to Central Bank Money (preferred)
- Settlement and pledging of Securities: Direct access to CSD

Default Procedure and Defense Lines

1. Closeout Open Position of Defaulting Member
2. Execution of Collateral of Defaulting Member
3. Use of Clearing Fund Contribution of Defaulting Member
4. Use of Clearing Fund Contributions of all other Clearing Members [Clearinghouse 1st line of defense]
5. Clearinghouse accumulated Reserve Funds [2nd line of defense]
6. Capital of Clearinghouse [3rd line of defense]
7. ... over and out...

Example of a Set-up



Conclusions

- Central Counterparty Clearinghouse is vital for Integrity of Derivative Market.
- Apply Standard Procedures – do not reinvent the wheel.
- Global Players' Decision to enter a Market is often tied to the Quality of the Clearinghouse.

Thank you!

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