

20 April 2009

How much should you pay for central counterparty clearing?

Diana Chan, Chief Executive Officer

European Central Counterparty is a subsidiary of
The Depository Trust & Clearing Corporation

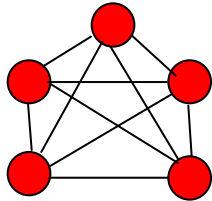


How much should you pay?

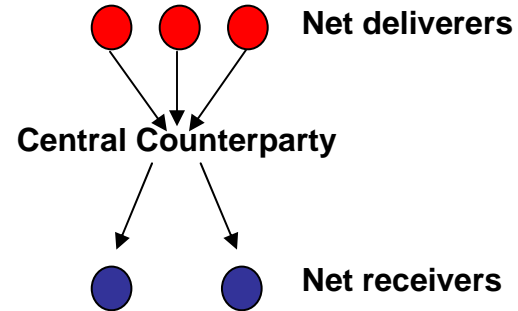
- What services are you paying for?
- What is the value provided?
- How to get costs down?



A central counterparty reduces costs....

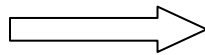


Without CCP,
one settlement per trade,
with many parties



With CCP netting,
one settlement per security,
with one party

100 trades



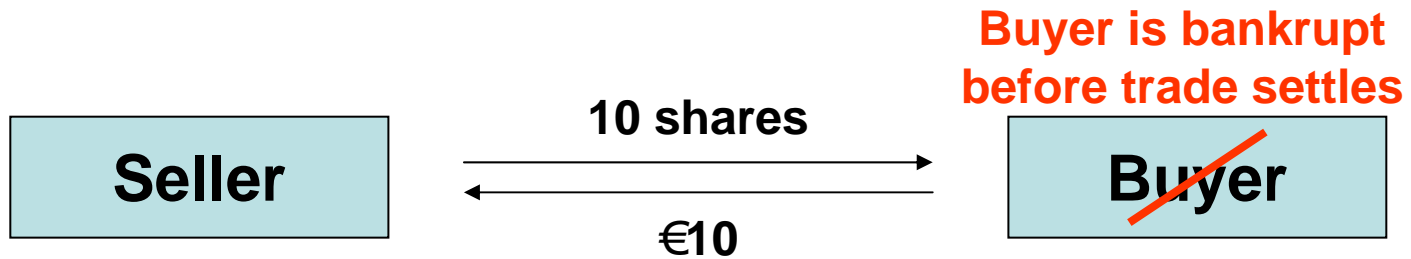
< 5 settlements after netting

=

> 95% savings in settlement



.... and provides protection....



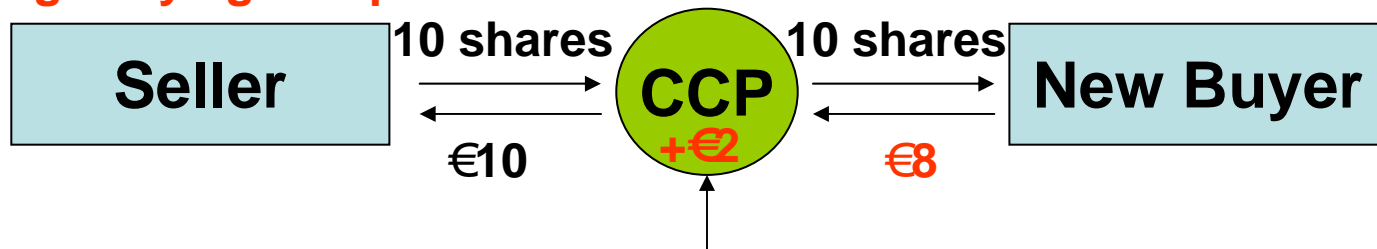
The surviving party has to replace the trade, potentially at an unfavourable price



....against replacement cost risk



With a CCP, trade settles at the originally agreed price



CCP covers market risk with margin collected from Bankrupt Buyer



Value of a CCP: lower costs, lower risks

- Lower costs and operational risk through netting away >95% of settlements
- Lower market risk through guarantee that original price at trade is honoured even if one party becomes bankrupt

Additional benefits:

- Orderly, centralised close-out of market obligations in the event of a bankruptcy
- Transparency for regulators, especially for OTC trades



Paying for value

- Upper bound of “value” from netting is the equivalent settlement cost for all transactions netted away
- Upper bound of “value” from risk mitigation is harder to quantify:
 - The more probable trading counterparties go bankrupt or default, the more valuable a CCP’s service
 - The more certainty that the CCP itself will not become bankrupt, the more value for using that CCP



A CCP can go bankrupt if....

- One or more clearing participant goes bankrupt, *and*
- The CCP has collected insufficient margin to cover its losses from closing out the bankrupt entity's obligations, *and*
- All other safety nets have been exhausted, such as insurance, retained earnings, participant clearing fund (a form of loss sharing), and parent or third-party guarantee



A CCP's robustness is affected by....

- Its experience with CCP participant defaults: know-how in minimising market disruption and its own exposure
- The rigour of its participant admission criteria and process
- Its technical competence in calculating sufficient margin and ability to collect the margin
- The reality, size, and quality of its safety nets in case there is insufficient margin collected from a bankrupt participant



CCPs need to manage other risks

- Legal certainty that its rules can be enforced on a bankrupt participant
- Loss of liquidity and ability to settle
- Insufficient business continuity arrangements for large scale or operational disruptions
- Insufficient capacity to handle peak volumes
- Exposure to other entities – repo counterparties, cash settlement bank



Safety could be illusionary

- Users generally do not have the CCP risk management expertise or sufficient information to distinguish differences in quality and approach of CCP risk management
- Possibly, users and trading venues do not consider that a regulated CCP could be allowed to become bankrupt



Users usually focus on processing costs

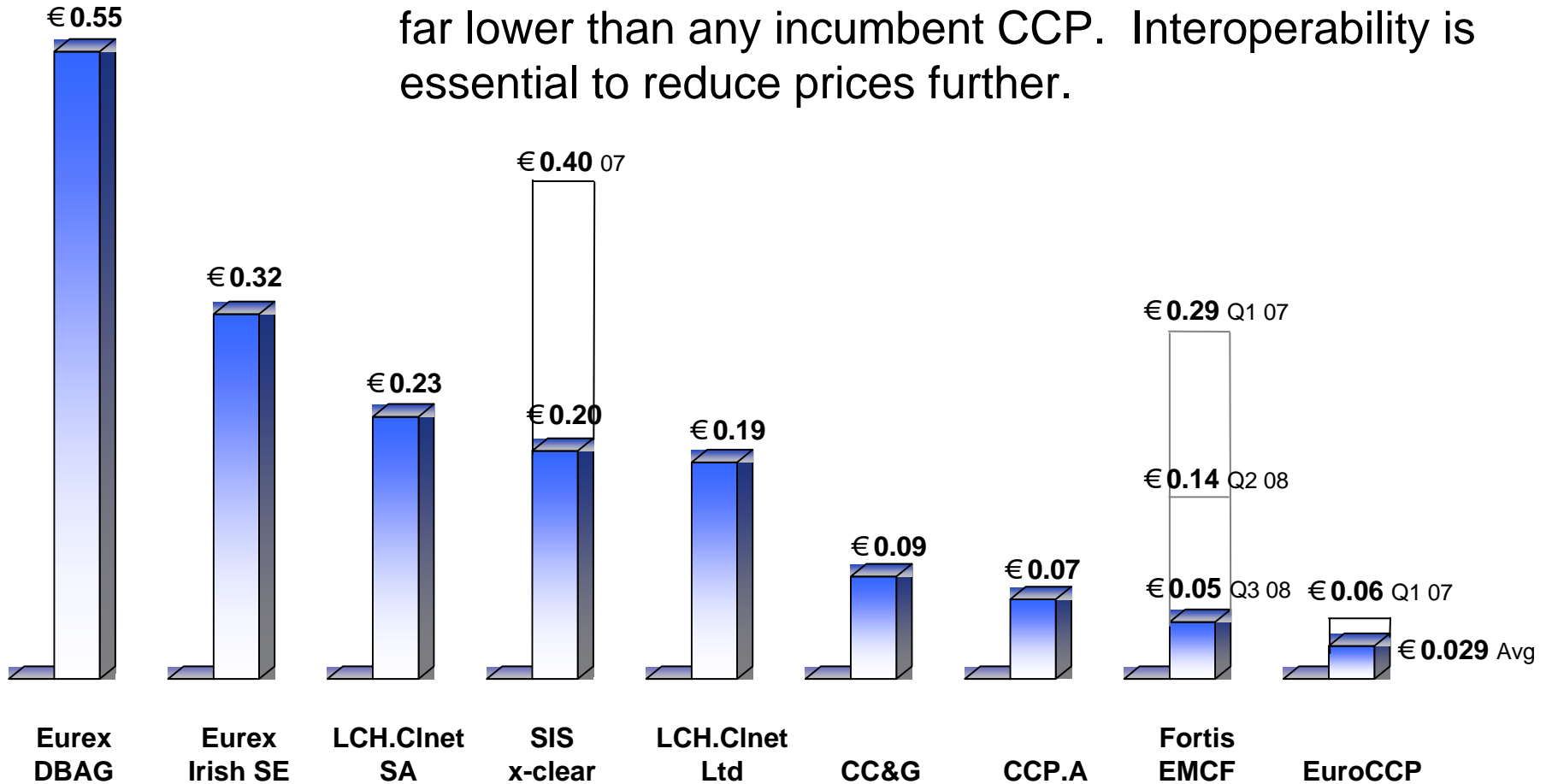
- Unit cost of clearing a trade
- Amount of margin required by the CCP
- Interest paid by CCP on cash margin
- Settlement costs
- Penalties levied on delayed settlement

- Meaningful interoperability is needed to give users meaningful choice, but there are significant obstacles



The benefits of competition are clear

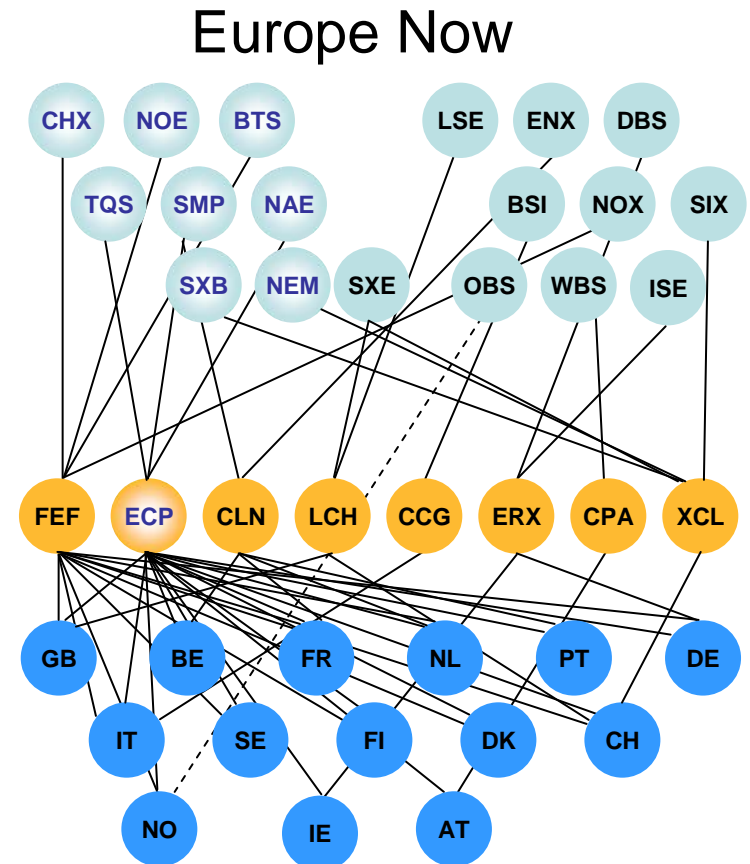
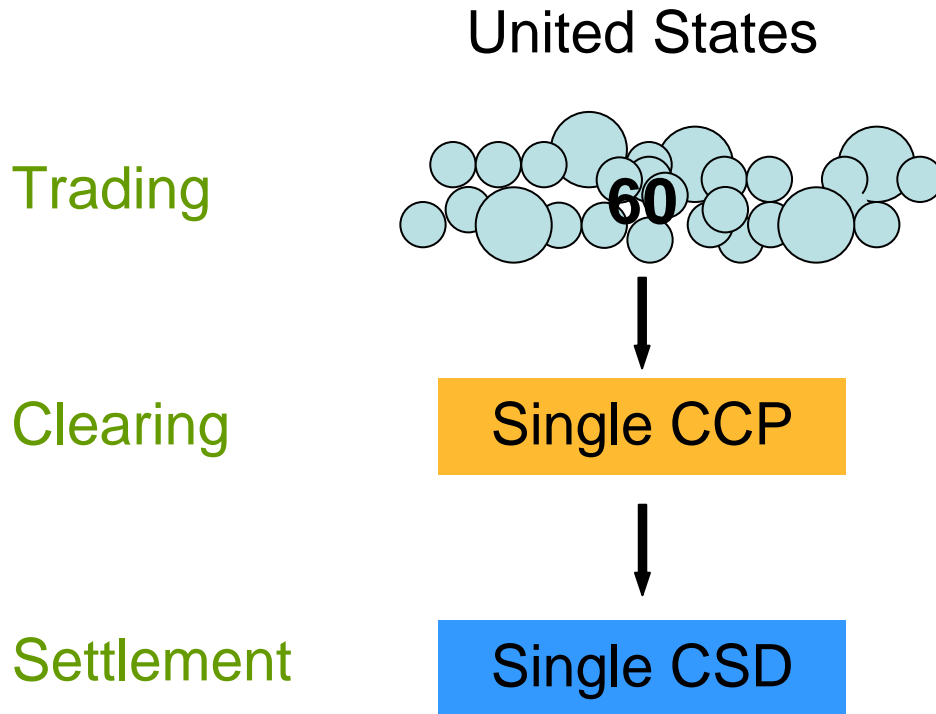
In Q1 2007, EuroCCP arrived in Europe with a price far lower than any incumbent CCP. Interoperability is essential to reduce prices further.



Average unit cost to clear one side of a transaction, as of July 2008
Source: EuroCCP analysis based on publicly available information



Market structure affects cost



Clearing cost
per side

\$ 0.003
€ 0.002

\$ 0.34
€ 0.26

Exchange rate €0.77 to \$ as of 20 Apr 09



How users can get more, pay less

1. Insist on CCP price transparency *and* price comparability
2. Insist on incumbent CCPs interoperating with meaningful competition
3. Have a vision on future consolidation – what characteristics do you want:
 - a for-profit monopoly or duopoly, *or*
 - a true user governed, at-cost utility, *or*
 - something else....