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Clearing Corporations - A Critical Study

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Abstract: ***Clearing corporation is an organisation which has been established to deal with confirmation, settlement, transactions and also ensures whether transactions are made in an appropriate manner. The functions of clearing corporations are very limited to clearing, settlement and risk management. CCP's are the central counter parties. CCP is the post trade activity. CCP's involves specific risks of functioning and also if the participant is unable to meet his trading obligations, then it could bring about liquidity risk also. Thus, this research paper on CLEARING CORPORATIONS - A CRITICAL STUDY suggests some ideas to resolve or overcome these risks in the post trading activity.***

Keywords: Central Counter Parties, derivative markets, variation margins, capital, close out.

I. REVIEW OF LITERATURE

A. EUROPEAN BANK ARTICLE

Boniet Coeure, a member of executive board of ECB concludes that the stability of CCP primarily on the establishment and implementation of robust risk management framework. This was stated in Central Counter Party recovery and resolution.

Whereas this research paper suggests the other way to reduce liquidity risk like transfer of client's position.

B. OFFICE OF FINANCIAL RESEARCH:

Mark Paddrik and H. Peyton Young of office of financial research marks that CCP could be more vulnerable to failure than conventional stress tests have shown.

Whereas this research paper studies the reason for such a failure and gives some solution for such issues through some of the case laws.

C. SAMIM GHAMAMI AND PAUL GLASSERMAN

They have showed that the cost incentiveness in the trade do not bring about central clearing, but it does then that might be due to insufficient guarantee funds, which banks provide to protect CCPs when they are in default.

Whereas this research studies the methods to reduce liquidity risk of CCP.

METHODS

In this research paper, the research method used is doctrinal method of study.

II. INTRODUCTION

The Clearing corporations of India Ltd. (CCIL) was established in April, 2001 to provide effective clearing and settlement functions for transactions in Money, Foreign Exchange and Derivative markets. The introduction of effective clearing settlement has brought about an important improvement in the market such as its efficiency, transparency, liquidity and risk management practices along with factors like reduction in settlement and operational risk, savings on settlement costs, etc,. CCIL also provides non-guaranteed settlement for interest rate derivatives and cross currency transactions with the help of CLS bank. The principles of the operations of clearing corporation of India as a financial market turned it to be a Qualified Central Counter Parties (QCCP) by RBI in 2004.QCCP also established a Trade Repository to make the financial institutions to report their transactions in OTC derivatives. Thus, this research paper on CLEARING CORPORATIONS- A CRITICAL STUDY suggests some ideas to resolve or overcome these risks in the post trading activity.

III. CLEARING CORPORATIONS IN DIFFERENT COUNTRIES

- ✓ In the United States, a relatively homogeneous clearing and settlement infrastructure has been created thanks to the single currency and harmonised regulatory and tax environment.US Treasuries are generally settled on an RTGS basis through the Federal Reserve book entry systems and are held in dematerialised form. Settlement occurs on a rolling TD+1 basis, unless or otherwise communicated at the time of trading. The transfer of securities and capital occurs at the instant upon settlement, on a final and irrevocable basis.
- ✓ In Europe, the introduction of the euro provided important momentum to the rationalisation process of stock exchanges, payment systems and securities clearing and settlement structures. Apart from the single currency, the following developments also accelerated the process:
  - a single integrated and efficient European capital market;
  - an increase in international capital movements;
  - Technological progress;
  - Financial deregulation.
- ✓ Unlike the United States or Europe, Asia does not have a single currency or a single market. This lack of a homogeneous regulatory and operational environment results in a wide range of different market practices and allows "domestic" systems to exist side by side. Where the clearing and settlement systems supporting equity trading in Asia have evolved, the fixed income markets remain significantly less sophisticated, from both an execution and a support perspective. Despite the many differences, however, Asia is subject to the same general trends as the United States and Europe. Technological advances, deregulation and globalisation increase the need to introduce or develop sound capital market and operating systems. The current highly fragmented infrastructure, however, is prone to adverse risk factors and high costs. U.S. financial specialists, acquainted with household markets where shields are set up, may accept that the clearing and settlement of their exchanges an outside market has dangers equivalent to those in the United States, where there are guarantees gave by clearing and settlement organisations.
- ✓ The central points of clearing and settlement in the United States and some different nations are efficiency and wellbeing. The speedier and all the more precisely an exchange can be handled, the sooner a similar capital can be reinvested, and at less cost and hazard to financial specialists. Along these lines, as business sectors wind up noticeably worldwide, one could expect that speculation capital will stream toward business sectors that are most appealing on a hazard return premise, and that additionally have productive and dependable clearing and settlement frameworks.

IV. CENTRAL COUNTER PARTIES IN CLEARING CORPORATIONS

A Central Counter Parties is an entity that interposes itself between the two counter parties in a financial transaction. After the parties have agreed to a trade, the Central Counter Parties becomes the buyer to every seller and the seller to every buyer. In doing so, the Central Counter Parties reduces counter party credit and liquidity risk exposures through netting. It also provides standardised and transparent risk management.

Central clearing basically changes the connections and outcomes in the financial system. It replaces the bilateral trading system which was actually between market participants with a centralised network of exposures between clearing participants and the Central Counter Parties .This implies that:

- ✓ The Central Counter Parties connects the outcomes to all clearing members in its balance sheet. If all clearing members can fulfil their responsibilities, the Central Counter Parties runs properly and formally. But if a participant fails, it assumes the rights and responsibilities of the failed clearing participant; and
- ✓ Instead of being faced with many exposures to a range of counter parties, each market participant could maintain a single trading exposure to "the Central Counter Parties. Because of multiple connections, the size of this responsibility is equal to the net position vis-à-vis all other clearing members.

Indeed, even in everyday activities, contrasts in clearing and settlement frameworks and in their per-formances oblige a few sorts of exchanging. For instance, in Japan, settlement in values and bonds is regularly on the third day after an exchange (T+3) and in the United States it is ordinarily on the fifth day (T+5). A speculator exchanging General Motors (GM) stock on both the New York Stock Exchange (NYSE) and the Tokyo Stock Exchange (TSE) would experience difficulty impeccably arbitraging his hold-ings. On the off chance that the speculator were to purchase GM shares on the NYSE and all the while offer them on the TSE, on the grounds that the U.S. settlement period is 2 days longer, the GM offers would be deferred by 2 business days for the Japanese settlement. On the off chance that the financial specialist were to purchase GM stock on the TSE and offer GM stock that same day on the NYSE, the offers could be accessible for the NYSE settlement since that is 2 days after the fact than Tokyo's. The Japan Securities Clearing Corp. (JSCC)- -through its connection with International Securi-ties Clearing Corp. (ISCC) in the United States—holds the U.S. shares at The Depository Trust Co. (DTC); along these lines rather than physical development of authentications there just would be a book section conveyance at DTC.

V. CCP RISKS AND RISKS MANAGEMENT

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The concentration of trading outcomes in CCPs involves two set of risks. One set of risks deals with the functioning of the CCP itself, which is including those risks from the management of its activities like the ordinary business and the other operational risks. Another set of risks arises when a participant is unable to meet its trading requirements. This may bring about liquidity risk, if the CCP has to advance payments that a participant cannot make, and to counter party investment risk, if the participant is unable to recover losses on its positions because of its inability.

To compensate the risks which has been resulting from a participant's inability, a CCP marks positions to market and requires participants to settle losses and profits at least once a day by calling or paying "variation margins" (and in this way it runs regularly matched books). Should a participant be unable to meet its responsibilities, a Central Counter Parties has a clear process as either to transfer the participant's positions in the place of other participants or to liquidate them ("close out"). The separation of a participant's unique positions from those of its clients ("indirect CCP participants") makes it possible to transfer participants positions to other participants ("portability").

If a clearing participant fails, a Central Counter Parties typically has three ways of defence to cover the resulting losses: (i) margins (initial and variation); (ii) default fund contributions; and (iii) the CCP's actual financial resources (capital). The size of the aggregate margin changes on a every day basis which depends upon prices and participants' positions. In contrast, the contributions to the default fund are defined less frequently, actually through the stress testing. These amounts are therefore more stable and less volatile, but at the same time lesser risk-sensitive when compared with margin payments.

The order of resources to be used in the case of losses follows a defined "waterfall" (graph 1 right hand panel). It actually starts from the participant's own contributions: first the initial and variation, then the default fund. Then, if needed, the Central Counter Parties moves on to others' resources: the contributions to the mutualised default fund and the Central Counter Parties' own capital, with a order that depends on each CCP's specific internal rules. In the extreme case that pre funded resources are not sufficient to cover losses, the Central Counter Parties depends on pre-agreed unfunded contributions. These resources are ring-fenced in order to keep them available even if contributors fail.

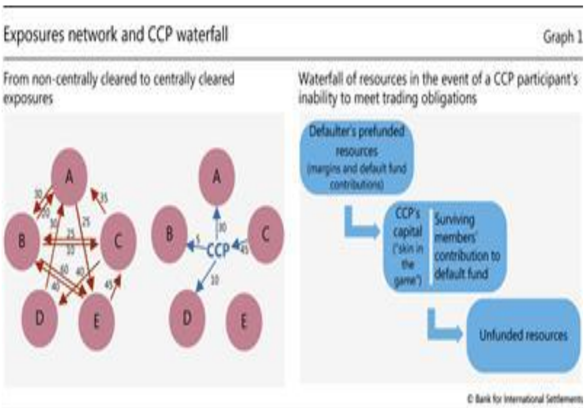

Figure 1

The design of these three ways of defence has important applications for the functioning of a financial system in which central clearing is dominant. In specific manner, their design also affects the incentives of clearing participants and the Central Counter Parties itself. The mix of the provision for own outcomes through margin payments, the mutualisation of losses among clients through default fund contributions and the "skin in the game" of Central Counter Parties' owners is forced to limit moral hazard and reduce asymmetric information issues. At the same time, such measures create connections between Central Counter Parties and banks (and other financial institutions) that go beyond the basic trading network described in the left-hand panel of graph 1

In prospects markets contrasts exist both domestically and globally. There is some commonality, in any case, for monetary protects in U.S. arches tic prospects markets. These shields include: original edges for clearing individuals in light of exchanges conveyed for their clients and their exclusive records; every day and intra-day stamping to-market and calling of variety edges; starting and upkeep edges for clients; clearinghouses filling in as underwriters of exchanges; posting stores by clearing individuals, which are callable by the clearinghouse; frameworks for observing the hazard places of both clearing individuals and clients; and huge broker revealing.

VI. LINKAGES WITH CCP'S AND ASSOCIATED RISKS

The connections between Central Counter Parties and financial institutions take different forms, and create many layers of interlinks.

First, at the most basic level, banks are Central Counter Parties' participants, namely subscribers of central clearing services. Every systemically important bank is the user in many Central Counter Parties, often in several jurisdictions. The overall number of direct clients in Central Counter Parties has been quite stable in recent years, although it varies considerably between Central Counter Parties (Graph 2, centre panel). The large Central Clearing Parties that clear most of the existing over-the-counter (OTC) derivatives have a comparatively lesser number of clearing members, and least still that offer clearing to their clients. Wide direct access to Central Counter Parties facilitates widespread technique of central clearing and increases the scope for multilateral netting, but at the same time it multiplies interconnections with banks.

Second, banks are basic providers of financial resources to Central Counter Parties. As direct clearing clients, they provide default fund contributions. Banks also provide liquidity lines or other backup facilities. If the ones who have committed to provide liquidity lines fail in their obligation, Central Counter Parties may be exposed to liquidity risk. Third, banks are key providers of financial services to Central Counter Parties. For instance, Central Counter Parties typically rely on major banks to manage cash margins (mostly in repo transactions), and a Central Counter Parties might need a custodian bank (or alternatively an operator of securities settlement systems) in order to deposit financial instruments posted as margin or as default fund contributions.

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Finally, banks may also be the owners of Central Counter Parties. At the end of 2014, 14% of Central Counter Parties were directly owned or managed by commercial banks (Graph 2, right-hand panel). The leadership structures could affect risk behaviour. In the case of a *user-owned Central Counter Parties*, the main aim for the leaders is to reduce the cost for users and to maintain a similar and high-quality participation base. Conversely, the main objective for a *non-user-owned Central Counter Parties* is to maximise profits and increase participation (CPSS (2010)). Exogenous powers could demonstrate overpowering, e.g., either a general emergency in the monetary markets, or a disappointment of at least one huge banks or intermediary/merchants for reasons inconsequential to the money related markets themselves. In such a case the capacity of a clearing-house to evaluate its individuals, after it depleted the majority of its edge and certification reserves, would be ineffective.

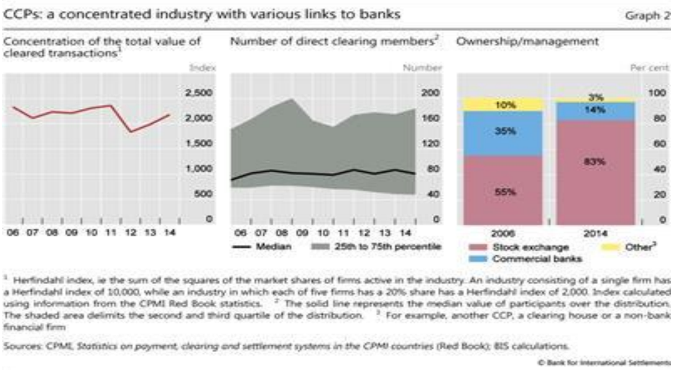

Figure 2

Thus, the banks are the subscribers of central Counter Parties, providers of financial resources and also they are considered to be the owners of Central Counter Parties as per the record of 2014.

VII. CONCLUSION

Thus, the research paper studied the various risks that are faced by Central Counter Parties.

The transfer of clients will decrease the liquidity risks, and moreover the issues that are related to the clearing corporations cannot be settled with the companies act since Central Counter Parties are the part of Clearing Corporations and they have separate enactments. Hence, the research paper explains risks and management and also the interconnections between commercial banks and Central Counter Parties.

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