

ANALYSING THE IMPACT OF ESTABLISHING A CENTRAL COUNTERPARTY ON THE ROMANIAN CAPITAL MARKET

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Abstract

Through this article, we aim to analyze the impact of setting up a central counterparty (CCP) on the Romanian capital market. At the same time, the current stage of the steps initiated by the authorities in the field for the establishment of the central counterparty will be addressed. The study is based both on theoretical elements from the international bibliography and on a series of reports prepared by various institutions in the field of capital market.

The objectives pursued through this article are to highlight both the positive factors that can bring the value of financial activity on the Romanian capital market and to raise awareness of the risks to which the economic ecosystem is exposed by developing a central counterparty and integrating it into the Romanian financial market. At the same time, aspects regarding the role of the central counterparty in the economy as well as the advantages and disadvantages of setting up a CCP in Romania were addressed.

Keywords: capital market; stock market; central counterparty; economy; financial market.



Issue 1/2021

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Introduction

The capital market plays a key role in a country's economy, both in terms of the possibility of financing the national economy and in terms of attracting investors to develop the economic environment. The central counterparty is an essential element in the operation and organization of the stock exchange, offering, on the one hand, a guarantee to the participants in the capital market from the perspective of completing the assumed transactions and, on the other hand, creating the operating framework of the derivatives market. The current article aims at the impact on the capital market in Romania by setting up a central counterparty to contribute to the development of the domestic stock market and, implicitly, of the national economy. The presence of a central counterparty on the Romanian capital market can have both positive and negative effects on the investment environment but also on the entire national economy.

The importance of a CCP derives, on the one hand, from the need of investors to diversify their portfolio and to be able to trade derivatives, and, on the other hand, from the need of the capital market to provide a higher degree of security to market participants, which generally have a higher appetite for risky transactions. The evolution of the international stock market environment has seen a sharp development in recent years, mainly due to globalization, the needs of investors and traded products being increasingly complex and at an increasingly high level. Considering the international context, as well as the need to develop the capital market in Romania, recently a series of steps have been initiated regarding the establishment of a CCP in Romania. Thus, it is very important to analyze the impact a central counterparty can have both on market participants and the overall national economic environment.

The approach of the proposed topic will aim at analyzing both the functioning of a CCP and the impact, role, risks and benefits involved in setting up a central counterparty in Romania. The approach to the subject will focus on issues reached in specialized works both in Romania and internationally, while highlighting the personal ideas and conclusions of the authors. The research process in the stock market, both at national and international level, is at an advanced stage, being a topical field and with a major impact on the entire national economy. However, the



Issue 1/2021

issue of the impact of setting up a CCP in Romania is in a relatively early stage, largely due to the low level of development of the domestic capital market, compared to other capital markets in Europe, America or Asia. The transition from frontier to emerging market status was one of the key elements in the decision to set up a national CCP.

Literature review

The main role of the CCP is the clearing and settlement of financial transactions on the capital market, being used mainly on derivatives markets. [European Central Bank and Federal Reserve Bank, 2007] Due to the development of the international capital market, CCPs no longer serve only one country/market, but can operate in several markets simultaneously. The most recent topics addressed at international conferences on the role and importance of CCPs include: their efficiency and systemic importance, counterparty risk pooling, risk, operational, legal and liquidity management, costs and benefits of using CCPs, supervisory policies as well as the relationship between the central counterparties and the central banks of the states where they operate. [European Central Bank and Federal Reserve Bank, 2007] Internationally, analyzes of the role of CCPs in the economy place these institutions as being of strategic importance to the capital market and the financial system. Thus, from the perspective of the European Central Bank, central counterparties have a key role to play in the efficient allocation of credit risk and liquidity risk in financial markets. [European Central Bank, 2005] One of the risks to which CCPs are exposed is the inability to meet their clearing obligations in transactions carried out by some investors. If such a situation arises, the effects on the financial ecosystem and implicitly of the respective economy can be devastating, with the risk of financial crises.

At the international level, research in the field has revealed that a large number of CCPs operating in developed markets are directly connected to the economy, financial institutions and capital markets, offering a number of benefits to all market participants. On the other hand, their size and importance have led the financial authorities to consider them “too big to fail”. [Wendt, 2015] This approach aims at an analysis of the risks to which central counterparties are exposed both from the perspective of the operation and establishment of guarantees and from the perspective of interdependence with the real economy, the business environment and relations with other central counterparties and financial markets. Another



Issue 1/2021

relevant issue, the subject of scientific research in the field, is the international approach of central counterparties as well as their relations from the perspective of international policies, in order to reduce the risk of failure and the spread of negative effects internationally. [Wendt, 2015] However, the most important work in the field aims to analyze from various perspectives the functioning and organization of CCPs, as well as the effects they have on financial markets. [Pirrong, 2011] Due to the phenomenon of globalization and, implicitly, the expansion of capital markets at the international level, the process of regulating the functioning of central counterparties worldwide is of interest, taking into account the contagion factor, the most relevant example being the propagation of the economic crisis since 2008. From a national perspective, the progress registered in the last years by the Romanian capital market has determined an increased interest for analyzing the impact that a possible central counterparty can have both on the financial market and on the national economy. The need to establish a CCP in Romania derives both from the need to develop a market for derivatives and from the need to connect to international trends, in order to attract foreign investors, in order to develop the Romanian stock market ecosystem. Research in the field is focused both on the elements of impact at the national level, in the case of setting up a CCP and in relation to the already existing and functional CCPs in the Central and Eastern European region, exemplary being the CCPs in Hungary and Poland. [Stanciu, 2019]

Presentation of the General Framework on the Romanian Capital Market

The need to establish a central counterparty on the Romanian capital market derives from the need to develop products offered for trading on the Bucharest Stock Exchange (BVB) as well as from the evolution of trends on international financial markets. Trading derivatives has become a significant part of financial markets ensuring a diversity of marketable securities as well as a high degree of liquidity. In the context in which the Romanian authorities intend to continue the process of developing the capital market and, implicitly, the domestic economic environment, it was found that, in order to attract new investors to the stock market, new marketable products are needed to cover the needs of investors. The decision to set up a central counterparty in Romania was based on its main role: the development of the derivatives market while managing the related credit risk, in order to increase investor confidence and the level of stability of derivatives



Issue 1/2021

transactions. One of the effects of making a CCP operational is related to increasing market liquidity by increasing the number of transactions and the values traded. [Stanciu, 2019] Reducing the risks of participants in the derivatives market is one of the elements with a direct impact on investors and is one of the objectives of the CCP. [Finance Intelligence, 2020]

The Central Counterparty is a legal entity, established in the form of a joint stock company, issuing registered shares, which interposes itself between the counterparties to contracts traded on one or more financial markets, thus becoming a buyer for each seller and a seller for each buyer. [Legea nr. 5/2021] The CCP is an entity that facilitates the conduct of transactions by investors in derivative financial products in various capital markets. In general, CCPs are owned and used by market operators or central banks of the countries in which those transactions take place, through which efforts are made to create a stable and efficient capital market environment. The main functions of the CCP are to clear and settle financial transactions. In the first case, the CCP's role is to act as a buyer for the investor wishing to sell securities (or contracts) and similarly for the seller, the CCP having the role of buyer. In the second case, the role of the CCP is to ensure that both the buyer and the seller fulfil their contractual obligations, consisting in the collection of securities by the seller and the transfer of securities to the buyer. The most relevant example of the importance and role of a CCP in the capital market is in the case of derivative transactions, when the gap between the time of the start of the transaction and the time of its completion is of the order of months. Due to price developments over a longer period, unfavourable losses for one party may result in large losses which cannot be covered at the time of settlement by the party concerned. [Bursa de Valori București, 2020] This is when the central counterparty intervenes by paying the value of the transaction to the seller and closing the position, simultaneously with the recovery of price differences from the buyer. Through this mechanism, transactions in derivatives are not blocked and the contractual conditions are met. From the perspective of how to recover the differences from the buyer, it should be noted that each participant in the derivatives market is obliged to provide an initial guarantee in favour of CCP, while depositing a margin of the contract value at the time of initiating each transaction. The determination of the guarantee to be submitted as well as the value of the margin are calculated by the CCP, depending on the type of investor, the traded products as well as the value and maturity of the contracts. This reduces the



Issue 1/2021

credit risk to which participants are exposed, while concluding transactions in a favourable manner. Thus, it can be stated that, in order to develop a functional derivatives market, it is necessary to set up and operate a central counterparty, which guarantees participants, completes transactions, establishes a sense of certainty in the market and reduces the risks to which investors are exposed.

Risks Related to the Operationalization of a CCP:

With the decision to implement a CCP and to determine how to organize and operate it, as well as the impact that a CCP may have on the investment ecosystem and the economy, it is necessary to analyze the risks to which the CCP is exposed. From this point of view, one of the CCP risk classifications concerns:

➤ Counterparty risk: it is represented by the inability of one of the contracting parties to fulfil its tasks on time. Whether it is the seller's inability to make the securities in question available to the buyer at maturity, or whether the buyer is unable to pay the value of the contract.

➤ Liquidity risk: manifests itself if one of the parties does not have at maturity the financial resources to pay the contractual obligations, which can affect the completion of transactions, or even create blockages in the market.

➤ Operational risk: it is closely related to the operation of the CCP. This risk may occur if the operating mechanisms of the CCP encounter difficulties in operation, resulting in a number of bottlenecks in the operation.

➤ Market risk: the increased volatility of a market in a certain period can generate major fluctuations in securities quotations, interest rates or exchange rates, which can cause in the short term a series of blockages in the clearing activity and settlement of transactions by the CCP.

➤ Settlement bank risk: the process of settlement of transactions by central counterparties is carried out through credit institutions, which in turn may encounter a number of problems in the conduct of business, which may have a major impact on the CCP.

➤ Legal risk: it can materialize in the context of some deficiencies of a legislative nature or in the context of the deficient application of the legal provisions regarding the functioning of the central counterparty.

The lack of a central counterparty on the Romanian capital market can have negative effects on the stock market environment, being identified a series of elements that can influence the stock market development process. Among the



Issue 1/2021

most relevant in this regard are: the lack of a derivatives market, the inability to attract new investors to the market, the low level of values and volumes traded, a low level of liquidity and a low visibility of the Romanian stock market internationally. [Stanciu, 2019]

The central counterparty is a link between various institutions participating in the entire financial system, and can be considered as of systemic importance. In this context, the activity of the CCP is closely correlated with the systemic risk, through the functioning of the applied policies, the central counterparty can be a mitigating factor of the systemic risk, but also a generating one. [Pirrong, 2011]

How a CCP Works and Operates

The complexity of financial transactions and those on the capital market have generated the need to establish operating principles and specific procedures, on the basis of which the CCP should operate. Starting from the idea of the main purpose of a CCP, and that of reducing counterparty risk by ensuring that the participants in the transactions meet the contractual conditions, it is necessary for the CCP to be able to provide its own protection against possible negative elements that may influence its activity.

One of the main measures taken by a CCP is to ensure a number of safeguards in order to limit exposure to various risk categories. The correlation of the different investor trading contracts, based on the type of products, the associated risk and the maturity term, in order to complete the contracts is known in the specialized environment as “novation”. [Pirrong, 2011]

The collateral margin requested by the CCP is another safeguard used to limit credit risk exposure. In the event of significant losses of one of the parties to the transaction, in particular in the case of derivatives, the margin deposited by the investor is used to cover the loss, thus reducing the risk that the transaction may not be completed. In this case, the role of the CCP shall be to determine the size of the margin as well as its use if at maturity the affected party does not have the capacity to meet its financial obligations. In order for the margin value to be discounted, the CCP shall permanently recalculate its value by “marking on the market”, with the possibility of requesting additional margin, if it is found that the difference between the market value of the contract and that established in the contract is a significant one and exceeds the value originally established. The value of the margin is also determined according to the values traded by the parties, the volatility of the



Issue 1/2021

contracts subject to transactions as well as the level of liquidity of the traded products. [Pirrong, 2011]

One of the safeguards used by the CCP is the insurance process. The CCP may require insurance to cover risks of failure or operations, in general, the role of insurer being held by other equity holders in the financial area, exemplified by the case of central banks. Given all the security measures that a CCP can apply, there are other elements that can be used by the CCP to ensure a high degree of protection against risks. The establishment of a mutual fund, in which all entities using the services of the CCP participate, is one of the best-known methods of insurance against risks. This mutual fund is permanently updated based on the values traded and the number of participants in derivative transactions. The higher the value of the transactions brokered by the CCP, the higher the value of the guarantees submitted by the participants in the fund, similar to the number of investors, who in the case of transactions through the CCP are obliged to set up guarantees, in addition to collateral margins. In this way, the risks are distributed fairly to all market participants, but such an initiative cannot eliminate the existing risks, but rather has the role of reallocating them.

The Benefits of Implementing a Central Counterparty in Romania

In view of the central counterparty's role of acting as a buyer for each seller and as a seller for each buyer, it ensures the completion of ongoing contracts in optimal conditions from both an operational and financial perspective. [Wendt, 2015] A functional CCP can contribute to the stability, efficiency, transparency and security of the entire financial ecosystem. In a market in which a central counterparty operates, market participants are no longer exposed to a multitude of open positions, but have as counterparty a single entity – CCP, regardless of the risk profile. A CCP provides increased liquidity in the capital market in terms of trading volumes and the fact that each buyer or seller benefits from a counterparty, provided that the transactions are completed in a fair manner. For example, the lack of a derivatives market in Romania limits stock market transactions and the level of market liquidity. The establishment of a CCP and the operationalization of the derivatives market will generate both an increase in the value of transactions and one of the volumes traded. Moreover, investors who until now traded derivative products on other markets will have the opportunity to use the derivative market in Romania. This aspect, cumulated with the attraction of foreign investors, can



Issue 1/2021

generate an increase of investments on the domestic capital market, implicitly of the stock market capitalization. Directly, the development of the Romanian capital market also has effects on the development of the domestic business environment and implicitly of the national economy.

From the perspective of risks assimilated to securities transactions, the establishment and operationalization of a CCP can generate a reduction of specific risks by implementing security measures related to the CCP, improving risk management and filtering operations with a high degree of risk. Operational efficiency can make significant progress by reducing the number of contracts between participants (this is implemented through the CCP) and simplifying derivative trading processes. It is important to note that the establishment of a central counterparty generates direct benefits to the entire stock market ecosystem, both in terms of increasing market liquidity and the level of transparency. [Wendt, 2015] From the perspective of the opportunities offered to investors, they will be able to bet on decreasing the price of an asset (short operations), they will be able to implement various hedging strategies or carry out some arbitrage operations.

The Current Stage of the Process of Setting up a CCP in Romania

On November 4, 2019, the joint stock company CCP.RO BUCHAREST S.A. was established, with an initial share capital of 17 million Euros, which will be the basis of the new central counterparty in Romania. [Bursa de Valori București, 2020] The majority shareholder of CCP.RO BUCHAREST S.A. is the Bucharest Stock Exchange, with a holding of 59.52%, together with which they also subscribed to the Electricity and Natural Gas Market Operator “OPCOM” S.A. (OPCOM) with a holding of 19.06%, as well as other shareholders such as: Enel România S.A., Banca Transilvania S.A., Tinmar Energy S.A., Societatea de Investiții Financiare Banat-Crișana S.A., Societatea de Investiții Financiare Transilvania S.A., Societatea de Investiții Financiare Muntenia S.A. and SSIF BRK Financial Group S.A. [Bursa de Valori București, 2020]

The main characteristics of the future CCP should reflect its ability to ensure risk mitigation and transfer mechanisms in the markets served and to have the necessary infrastructure to relaunch and develop the Romanian derivatives market. Regarding the development of the derivatives market through CCP, the representatives of the Bucharest Stock Exchange consider that it should be operationalized gradually, the starting point being the spot market. One of the



Issue 1/2021

specific elements of the new central counterparty in Romania will be represented by its compensation attributions in the energy field as well. Thus, CCP will provide clearing services for forward contracts concluded on the Centralized Market of Bilateral Contracts – Continuous Negotiation Mechanism (PCCB-NC), market managed by OPCOM [OPCOM 2020].

In order for the project of establishment, authorization, implementation and operationalization of the new central counterparty in Romania to be successful, the representatives of CCP.RO BUCHAREST SA will benefit from the support of Cassa di Compensazione e Garanzia (CC&G), which will provide specific technological assistance to clearing services and risk management. [Economica Net, 2021] Given that CC&G is part of the London Stock Exchange (LSE) group, it is important that the entire process of developing and operationalizing the CCP be carried out to international standards, so that it can be accessible to foreign investors already familiar with the benefits of using a central counterparty. However, the process of operationalization and operation of the CCP needs to be supported by all market participants. The functioning framework of the CCP, both from a technical, human and regulatory perspective, should be correlated with functional examples of central counterparties in the European space, thus providing the possibility of offering quality services at a high standard. [Bursa de Valori București, 2020].

Conclusions

The establishment and operationalization of a central counterparty in Romania is necessary both from the perspective of capital market development and from the perspective of developing the portfolio of products available for trading and accessible to investors. The administration of the derivatives market by the new CCP will generate both a high level of traded values and volumes and an increase in the number of investors on the Romanian capital market.

The role of the CCP is essential both for the capital market and for the entire national economy. From a capital market perspective, it can provide stability to investors and effectively manage the risks associated with securities transactions, especially those with derivatives. On the other hand, regulators and institutions with responsibilities in the area of the financial market must also take into account the impact of the activity of the central counterparty on the entire national economic ecosystem, mainly on the systemic risks to which the CCP may be



Issue 1/2021

exposed. It is recommended to implement, update and permanently correlate the activity of the central counterparty with Romania's financial and monetary policies, so that there is a permanent correlation between the capital market and the needs of the national economy. At the international level, it was possible to observe both the positive effects of CCP activity on the economic environment, but also the negative impact generated by the financial crises and amplified by the contagion factor, with effects on the entire global financial market. We can conclude that the establishment of a CCP in Romania will have effects not only on the capital market but also on the entire national economic environment.

Given that at the level of the Romanian capital market, the process of operationalization of the central counterparty is still ongoing, we consider it appropriate to continue research in this field, mainly in the context of the impact of the Coronavirus pandemic on the capital market and the entire economic environment. It is important to analyze the reactions of the investment environment in Romania and abroad after the operationalization of CCP.RO BUCHAREST S.A., considering the new status of the capital market in Romania, as well as the current pandemic context.

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Issue 1/2021

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