CONCLUSION

The OTC derivative markets play a critical role in the worldwide financial system. They have coexisted for many years with exchanges and will continue doing so as long as they keep offering an attractive alternative for hedgers, speculators and arbitrageurs. The overall size of the market, the high concentration of notional amounts and gross market exposure in a few categories of derivatives combined with the systemic importance of some market participants that concentrate high counterparty credit risk, place fundamental importance in the need of robust and strong risk management practices that delimit the parameters of the future growth of OTC markets, the levels of risk concentration and the way those risks should be mitigated.

Counterparty credit risk is the focus of concerns and regulative approaches due to the systemic importance posed on OTC dealers that concentrate high risk exposures without the adequate risk management practices in place that mitigate the contagious effects of a default. Netting practices, collateralization and centralization of risk in a CCP are an effective way to protect the OTC derivatives markets from counterparty credit risk. However, the use of any of these practices entails effects that increase costs and other type of risks, being systemic, legal, liquidity, market, operational and wrong way risk those with significant importance.

Bilateral and multilateral netting are justified when the reduction of counterparty credit risk and cost advantages obtained from closing-out positions are greater than the legal risk that arise from questionable enforceability and the increase of operational risk from unpredictable operational flows and confidentiality issues. Furthermore, multilateral netting is a better alternative than bilateral when there is more than one class of underlying with greater opportunities of netting than those obtained from bilateral netting.

Risks and costs from collateral management are justified when there is a clear reduction of counterparty credit risk and capital requirements; when the collateral is well segregated from other companies' assets and liquid enough to cover exposure; and when there are already risk management practices in place that control the increase of other risks. It is not justified if any of those requirements are

not fulfilled or if there are other alternatives to mitigate counterparty credit risk with a better cost-benefit relation where no placement of capital is necessary.

The decision of centralizing OTC derivative transactions in CCPs is justified if the reduction of counterparty risk by mutualising losses of counterparties is greater than the potential systemic risk from the centralization of trading and if the reduction of operational risk, market risk, legal risk, capital requirements, costs and time invested in management practices are greater than the potential benefits obtained in bilateral agreements outside of a CCP.

As highlighted throughout this work, altogether represent a relation of cost-benefit. As long as the benefits of introducing any of those practices are greater than the costs and risks involved, the transition is plausible. While it is true significant strides have been made regarding the wider use of Master Agreements for bilateral and multilateral netting, collateralization practices among dealers and the range of OTC derivatives that are cleared through CCPs, there is still a lot of work to do that will bring the transparency and regulation needed only if there is coordination of efforts between international regulatory authorities, governments and market participants. Collective work to place adequate risk mitigation practices can avoid not only the buildup and concentration of counterparty risk in OTC derivative markets but protect the overall financial system and ensure the stability of economies across nations.