



Media Release

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Colombo:

The Need for a Central Counterparty (CCP) Framework for the CSE.

Ms. Dulani Warnakulasooriya, Senior Vice President of Enterprise Risk Management and Post Trade Settlement at the Colombo Stock Exchange (CSE), shares insights into the need for a Central Counterparty (CCP) clearing in Sri Lanka, a landmark development aimed at strengthening market stability, reducing systemic risk, and aligning with international best practices.

01. What is a Central Counter Party or CCP?

A Central Counterparty (CCP) is a financial institution that guarantees the completion of trades in exchange by becoming the buyer to every seller and the seller to every buyer in a transaction and guarantees the settlement of trades. Replacing the original contracts between buyers and sellers with two separate contracts - one between the buyer and CSE Clear, and the other between CSE Clear and the seller. This process, known as 'novation', reduces the counterparty risk, as CSE clear being the counterpart for all trades. On the settlement day, the CCP ensures the exchange of cash and securities, even if one party defaults.

In the current settlement model, there is no guarantee of settlement; if one party defaults, all other parties are exposed, which can lead to cascading failures in the market. In summary, a CCP plays a critical role in modern financial markets - acting as an intermediary between trading parties, guaranteeing trades, managing risks, and providing the infrastructure to keep exchanges operating safely and efficiently even during times of market stress.

02. Who serves as the Central Counterparty (CCP) in Sri Lanka?

The Colombo Stock Exchange (CSE) has incorporated a new company, CSE Clear (Pvt) Limited, which is a fully owned subsidiary of the CSE. CSE Clear will act as the CCP for all equity transactions executed in the CSE. It is a licensed clearing house, regulated by the Securities and Exchange Commission of Sri Lanka (SEC).

03. Why is a CCP required and what are its benefits?

A CCP enhances the safety, efficiency, and transparency of financial markets by ensuring the smooth settlement of trades through the following:

- **Risk Mitigation:** By guaranteeing trades, the CCP eliminates the risk of a party failing to deliver securities or payments.
- **Operational Efficiency:** CCPs streamline settlement processes by enabling netting of trades, thereby reducing the number of transactions that need to be settled.
- **Increased Liquidity:** Improves the availability of funds and trading activities in the market.
- **Market Confidence:** With a trusted central party managing settlements, market participants have greater confidence in the integrity, stability and reliability of the system.
- **Default Management:** CCPs have robust risk management frameworks and default funds to handle participant failures without disrupting the broader market.
- **International Compliance and Recognition:** Adheres to global standards and practices.

04. What is the global importance of a CCP?

- **Systemic Risk Reduction Across Borders:** In global capital markets, trades often span multiple jurisdictions and currencies. A CCP acts as a centralized risk buffer, reducing the likelihood that a single default could trigger broader financial contagion across markets.
- **Standardization and Harmonization:** CCPs promote global standards for trade clearing, margining, and risk management. This harmonization is essential for cross-border trading and attracting international investors. In fact, many international investors and custodians require CCP clearing for market access.
- **Regulatory Alignment and Oversight:** Global regulators (e.g., BIS, IOSCO, ESMA) recognize CCPs as systemically important financial institutions.
- **Resilience in Crises:** CCPs are designed with robust default management frameworks. In times of market stress, CCPs absorb shocks that could otherwise impact multiple financial institutions.

05. How does CCP ensure the guarantee of the settlement model?

CSE Clear employs a margin methodology that includes Base Margin Requirements and Daily Margin Requirements, ensuring that Clearing Members maintain sufficient collateral to cover any potential losses. This also instills discipline, as Clearing Members must be financially committed to their positions, discouraging irresponsible trading behavior. Margins are the CCP's first line of defense against market and default risk protecting the entire market by ensuring that everyone has "skin in the game" and that trades can be completed even under stress.

In addition, the CCP will maintain a Guarantee Fund as a financial safeguard to cover shortfalls in the event of a Clearing Member's default. This fund consists of contributions from both CSE Clear and the Clearing Members.

06. What are the key changes CSE brings in with CCP implementation?

CSE Clear will introduce different membership categories as follows:

- **Self-Clearing Members:** Clear and settle their own transactions.
- **Professional Clearing Members:** Settle their own transactions and those of other Trading Participants/Custodian Banks (Limited Clearing Members).

The trading experience will remain unchanged for investors. However, back-end clearing and settlement will be handled by the CCP, introducing greater safety and efficiency to the process.

07. How did the CSE transition from the DvP model to a CCP framework?

The CSE implemented a Delivery versus Payment (DvP) settlement mechanism in August 2021, ensuring that securities are delivered to the buyer only when payment is made - as a phased approach towards CCP implementation. This mechanism minimizes settlement risk and asset commitment risk by synchronizing the exchange of securities and funds. A comprehensive margin framework was also introduced with the DvP implementation.

However, when the trading volumes grew, the bilateral nature of DvP could pose issues such as higher operational complexity and increased credit and settlement risk. To address these inefficiencies, the CSE progressively worked towards CCP implementation by establishing a separate entity, obtaining the necessary regulatory approvals, making system modifications, and creating stakeholder awareness. These progressive steps mark the journey from a simple DvP model to a sophisticated, CCP-led settlement ecosystem.

08. What are the future developments with the CCP?

With a CCP in place, a market becomes more resilient, trustworthy, and globally competitive. It serves as a foundation for deeper market development enabling higher volumes, more sophisticated instruments, and broader investor participation. This will support the CSE in introducing new products to the market, such as derivatives (futures and options) and other complex instruments. Furthermore, the robust risk management framework of a CCP provides investors with the confidence to engage in more advanced trading strategies, such as short selling.

Photograph.



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About CSE

The Colombo Stock Exchange (CSE) operates the only stock market in Sri Lanka and is responsible for providing a transparent and regulated environment where companies and investors can come together. The CSE is a company that is limited by guarantee established under the Laws of Sri Lanka. The CSE is licensed by the Securities and Exchange Commission of Sri Lanka (SEC) and is a mutual exchange consisting of 15 Members and 13 Trading Members. All Members and Trading Members are licensed by the SEC to operate as Stockbrokers. For more information, please visit: www.cse.lk.

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