EUROPEAN CENTRAL BANK

EUROSYSTEM

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Discussion on ‘The pitfalls of central clearing in the presence of systematic risk’

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The authors’ central question

The authors, as well as other regulators and academics, state. . .

- **Counterparty risk exposure** should be taken into account by **market participants** in deciding whether to centrally clear and by **regulators** in evaluating incentives for and benefits of central clearing.

As such, the authors’ research question can be formulated. . .

- From the perspective of a market participant attempting to minimize counterparty risk exposure, what are the pros and cons of central versus bilateral clearing and under what conditions are the (dis)advantages valid?

Central vs bilateral clearing

The authors build on Duffie's and Zhu's model by considering three elements that can render central clearing harmful:

i. Correlation across and within derivatives classes

ii. Collateralization of derivatives claims

iii. Loss sharing

Authors' theoretical model shows that market participants do not necessarily reduce counterparty risk. . .

i. during market-wide stress events;

ii. if margins in the cleared space are low when compared to the bilateral space;

iii. if exposure is positively correlated with systematic risk.

Central vs bilateral clearing

Considering only netting. . .

- Higher systematic risk renders multilateral netting **less beneficial** to market participants than bilateral netting

Considering margin levels in addition. . .

- If cleared margins << bilateral margins, then multilateral netting *always* results in **higher counterparty risk exposure**

Considering loss sharing in addition. . .

- **Portfolio directionality** can lead to **distorted incentives** for market participants in evaluating benefit from loss sharing

Conclusions and Discussion

- Authors evaluate the incentives for central clearing from the view of a market participant attempting to minimize counterparty risk exposure
- Authors argue that central clearing is not always the most beneficial avenue when viewed from a single market participant's perspective
- Authors suggest some possible remedies:
  - Cross-netting
  - Aligning bilateral and cleared margins
  - Taking CMs' portfolio directionality into account when allocating losses

- How does this fit into the bigger picture when taking a high-level view of safeguarding financial stability???