

Discussion of
“Passing the *hot potato*:
how does risk flow in the CDS market?”

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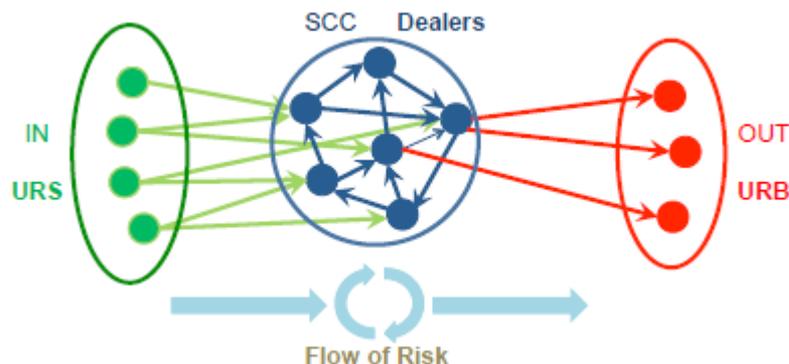
3rd BIS Research Network meeting on Global Financial Interconnectedness

Relevant

- CDS market in the recent financial crisis – propagated stress from Lehman Brothers to many, brought down AIG
- Lehman and main dealers ran matched books (ie intermediation only)
AIG had built a one-way book focussed on selling protection (ie buying risk)
- By hoarding fundamental credit risk, AIG became a source of counterparty risk

Contributions: 1) Methodological

- Novel visualization of the CDS derivatives network: **Bow-tie structure**
- Builds on the core-periphery model of Craig and von Peter (2010) and expands it significantly – expect many attempts at replicating it
- Gives a functional meaning to the entities in the network, who ultimately buys/sells/intermediates → identify location of risk, how risk flows between entities and concentrations
- Implications for financial stability: a loss at an Ultimate Risk Buyer has the potential to propagate downstream to all dealers and all ultimate risk seller



2) Novel insights on structure of CDS market

- Quantifies the role of dealers in doing pure intermediation (hot potato trading): 50 - 90% (average 70%) of gross notional traded
- Few Ultimate Risk Sellers and even fewer Ultimate Risk Buyers [AIG was a URB]
- Who are Ultimate Risk Sellers and Buyers – role of asset managers vs hedge funds vs banks
- High concentration: few entities buy 70%+ of some risks
- Despite fall in derivatives notionals, compression, costs of regulation, etc – size of pure-intermediation flows still very large, with a lot of complexity and overlapping bilateral exposures
- Begs the question, why is intermediation so large – to reap fees? Analyse pricing data?

What could the authors do more of?

A lot of insights densely packed in the graphs

- Size of dealers
- Size and direction of flows
- Sector of reference entity
- Sector of entity trading the risk

Could unpack the results more

- More extensive description of the CDS market structure
- How many times are 'hot potatoes' being passed around by dealers
- How does the pricing changes when it enters the intermediation black box

Possible to expand this work to understand other derivatives networks?

Neat exercise for CDS market - TR data give a clean reading of the credit risk exposure via derivatives. Net positions via URBs/URSs likely matched by credit risk via bonds/loans

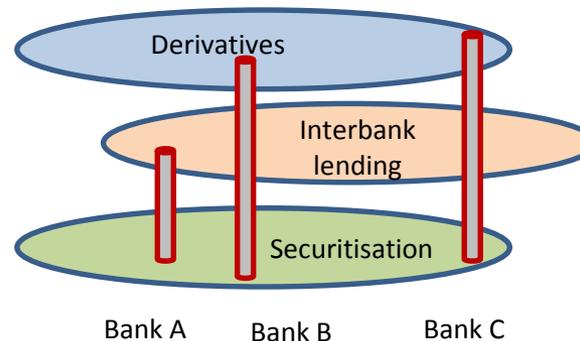
But CDS a small part of the derivatives market (~2-3% of gross notional)

Would be interesting to expand the methodology to apply to Interest Rate and FX derivatives (~80% and ~10% of gross notional in the market)

Is that possible for risks dispersed across various instruments on the balance sheet?

Challenges in using horizontal data

- * How to integrate network analysis with supervisory analysis focussed on entities?
 - Horizontal data map the layers of activities that link institutions in networks
 - Each network has different key institutions
 - Interlinkages (between institutions, between layers) allow stress to migrate and amplify



Focus on network around an activity and away from balance sheet of institutions

Challenge: TR data offer the view of only one layer of interaction

Hard to understand net balance sheet positions in interest rate and FX risk, who are the ultimate buyers and sellers of risk. Risk positions via derivatives have more complex interaction with risk taken on via loans/bonds/deposits.