Discussion of « The Demand for Central Clearing: To Clear or Not to Clear? » by Mario Bellia, Roberto Panzica, Loriana Pelizzon and Tuomas Peltonen

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Views are my own and shall not be interpreted as reflecting those of Bank of France or the Eurosystem

The paper in a nutschell

- Empirical paper on decision to clear
  - IT CDS trades (2/3) > FR CDS trades (22%) > DE CDS trades
  - 50% of contracts are cleared, 10% non-eligible, 40% uncleared
  - CDS markets is highly concentrated among a small # of dealers (15, 80%) but they have low net exposure
  - Clearing is mostly used by clearing members (CCP ressembles early CB: they benefit a small # of agents)
- Main results:
  - **Clearing decision** is (reassuringly and as expected by regulators) higher for riskier CDS entity, less liquid contracts, higher counterparty risk
  - **Policy-implication:** Clearing should limit contagion provided CCP default is not more likely
- My discussion
  - Robustness
  - Implication for CCP default proba & recovery and resolution (R&R) procedure

Empirical exercises

- Estimate a probit model (=1 if contract cleared/ 0 else) on three hypothesis:
  - **Hypothesis 1:** Clearing is larger if the CDS contract is less liquid and the reference entity is relatively risky
    - **Likely non-linear and more likely when entity is risky** enough (level & marginal changes of CDS spread, for larger trades (counterparty risk higher), and higher margins reduced clearance)
  - **Hypothesis 2:** Clearing is larger if the transaction reduces the amount of collateral to be posted because it reduces the exposure to the CCP
    - **Cost of clearing matters: trade-off btw limiting contagion & cost**
  - **Hypothesis 3:** Clearing is larger when the counterparty risk is larger
    - Truer for net sellers of CDS to CCP & riskier entities: **consistent w/ CCPs charging add-on margins on riskier counterparties**

How robust are the correlations?

- You show that decision to clear is endogenous to
  - liquidity risk, credit risk, concentration of trades
  - Margin calls, price of collateral
- And maybe non-linear:
  - changes in CDS spread reduce proba of clearing for France and Germany (bc/ of margins) but increases for Italy
- Can you implement « more robust » exercises using « natural experiment » like Brexit exploiting
  - Brexit is likely unexpected and exogenous (to finance) and not impacting default of continental European sovereigns
  - But it has a sizable impact on prices of collateral used to pay margins and on the liquidity situation of market participants,
    - you can exploit both changes in prices & liquidity situation of dealers depending on exposure to shock to see how clearing decision is impacted

Implications of CCPs clearing the riskier trades of the market

- Clearing increases with reduced liquidity, higher credit risk, and if trades are more concentrated among CMs

$\Rightarrow$ CCP-cleared trades will be more and more skewed towards the riskier ones when risk will rise or prices swing downward, leaving the CCP more and more exposed to default risk

- **Implications for ex-ante risk management:** When contracts are mandatory cleared, the risk exposure of CCP is less skewed towards riskier trades, reducing the average CCP risk exposure
  - **Should mandatory clearing be conditional on level of risk?**
- **Implications for the management of derivatives exposures of non-mandatory-cleared trades:** Underlying default probability of CCP likely increases w/ risks
  - **Reasonable to condition mandatory clearing on volume cleared**

On CCP default and R&R procedures

- **Consequence on likelyhood of CCP defaut:** Clearing likely increase on risky markets, effect likely non-linear (IT vs DE), and this *at the same time*
  - increase CCP revenues **AND** its proba of default
  - ⇒ **may trigger difference in CCP risk management btw normal and stressed times** (amplified by risk-shifting by CCPs, Bignon & Vuillemey, 2018)
  - ⇒ **Careful scrutiny of detailed CCP exposure in stresser times & allowing for early intervention**
- **Each R&R tools will not have the same effect**
  - **Partial tear-up may be especially helpful on non-mandatory-cleared market segments,** as suggested in Biais, Heider and Hoerova (2018) to align incentives of CCPs w/ members

Take aways

- **Very nice paper contributing with numbers to a (disputed) reform aimed at improving financial stability**
- **Data are great, result is reassuring**
  - the riskier a contract, the more likely participants will "purchase an insurance against default
  - Exploit Brexit as a natural experiment
- **Fascinating (potential) policy implications**
  - In terms of regulation of margining policy
  - In terms of when mandatory clearing must applied
  - In terms of design of R&R procedure