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Assessing the Safety of Central Counterparties

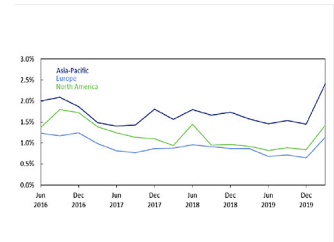
BY [Mark Paddrik](#) and [H. Peyton Young](#)

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Under central clearing, parties to a financial contract enter into two matched contracts with the central counterparty that offset one another. Central clearing protects against defaults among counterparties that could threaten financial stability, but also concentrates the risk of default at the central counterparty. This working paper shows how to estimate the probability that a central counterparty could cover any specified fraction of payment defaults by its members using public disclosure data. The framework supplements conventional risk management approaches predicated on a specific number of member defaults. The paper applies the approach to assessing the safety of a wide range of central counterparties located in different geographical regions and specializing in different asset classes (Working Paper no. 21-02).

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Abstract

We propose a general framework for empirically assessing a central counterparty's capacity to cope with severe financial stress. Using public disclosures data for global central counterparties (CCPs), we show how to estimate the probability that a CCP could cover any specified fraction of payment defaults by its members. This framework supplements conventional standards of risk management such as Cover 2 and provides a comparative and comprehensive approach to assessing risk protection across CCPs that is not predicated on a specific number of member defaults. We apply the approach to a wide range of CCPs in different geographical jurisdictions and asset classes and find that there are substantial differences in protection coverage. In particular, large European CCPs appear to be significantly safer than their counterparts in Asia-Pacific and North America. These differences are also reflected in supervisory data that provide CCP members' risk assessments of the CCPs to which they belong.

Keywords: central counterparty, default waterfall, guarantee fund, default probability

JEL Classifications: G10, G23, G28, L14

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