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Does a Central Clearing Counterparty Reduce Counterparty Risk?

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Abstract

We show whether central clearing of a particular class of derivatives lowers counterparty risk. For plausible cases, adding a central clearing counterparty (CCP) for a class of derivatives such as credit default swaps reduces netting efficiency, leading to an increase in average exposure to counterparty default. Further, clearing different classes of derivatives in separate CCPs always increases counterparty exposures relative to clearing the combined set of derivatives in a single CCP. We provide theory as well as illustrative numerical examples of these results that are calibrated to notional derivatives position data for major banks.



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