After crises: banks, central clearing parties and liquidity – what has changed?

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Motivation: never again…

Key takeaways

- Central counterparties (CCPs) stand between banks in OTC derivatives trades now, instead of banks having a (web of) bilateral deals as before the great financial crisis

- CCPs manage counterparty risk
  - Lehman failure: CCP derivative portfolio auctioned, liquidated or transferred within weeks, while bilateral derivative books took years

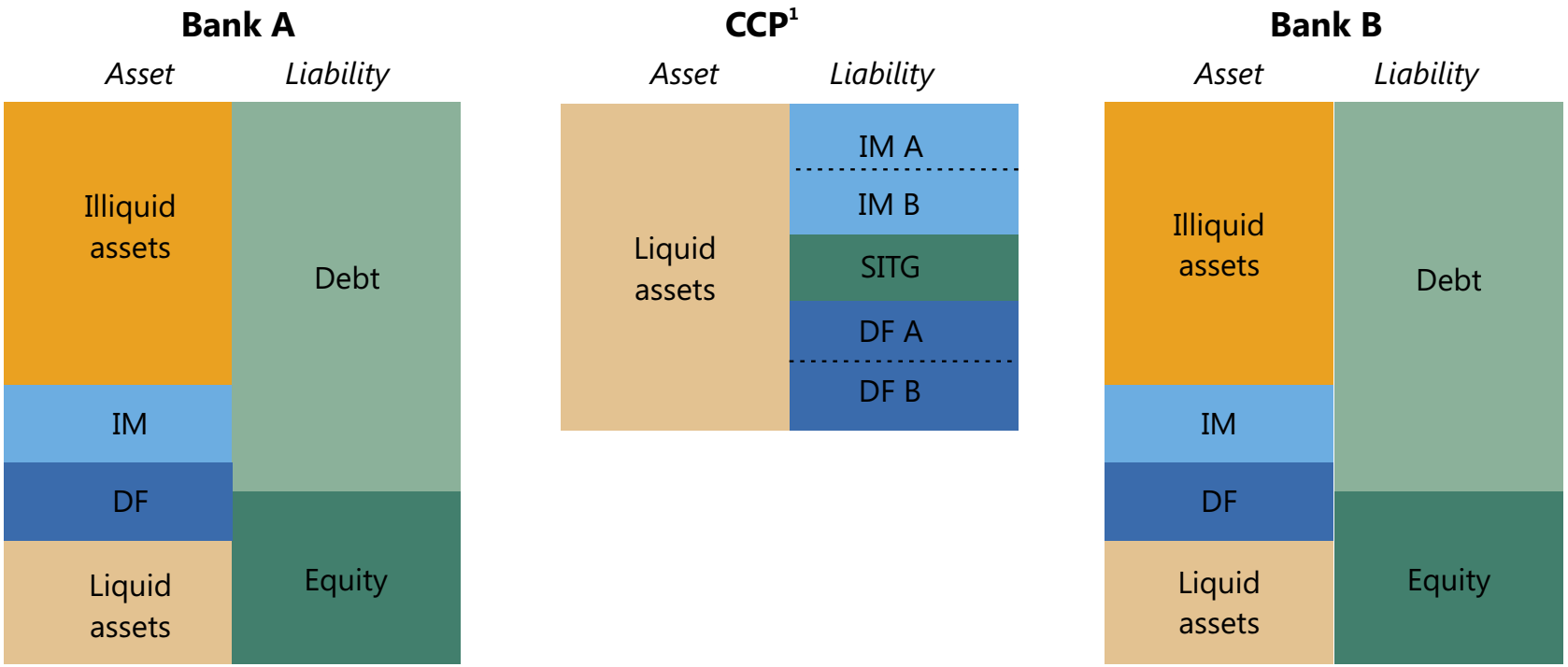
- However, CCPs give rise to new risks, such as liquidity risk
  - Which can affect besides financial stability macroeconomic and energy security

- CCPs morph counterparty risk into liquidity risk
  - No problem when liquidity was plentiful (including during the Covid-19 pandemic)
  - Liquidity risk might matter more now due to monetary policy normalization

Roadmap

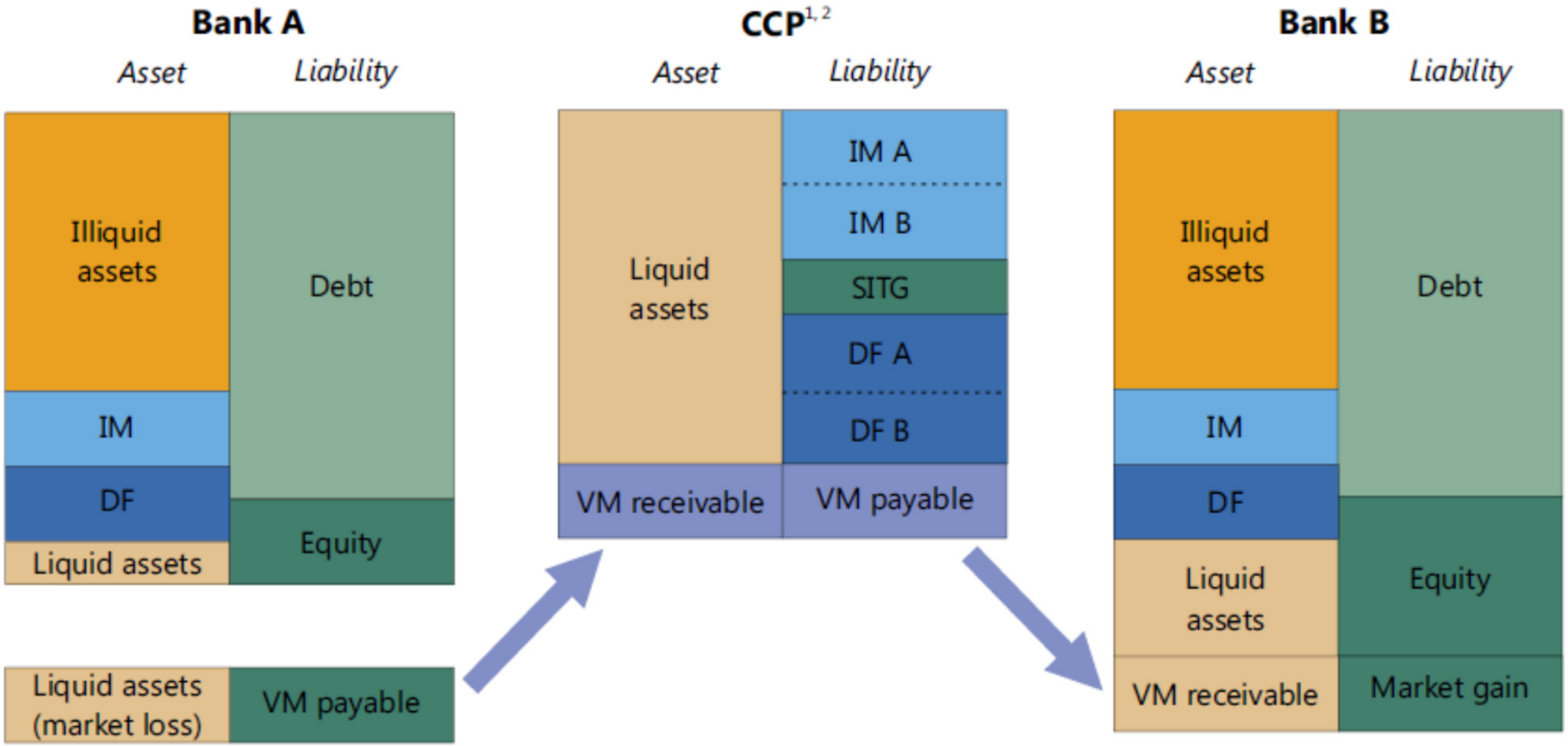
1. Motivation
2. Key takeaways
3. CCPs vs banks
4. Default waterfall
5. CCP stress scenarios
6. Gas/electricity markets in 2022
7. Conclusion

How do CCPs' and banks' balance sheet differ?



Faruqi, Huang and Takats (2018 BIS QR)

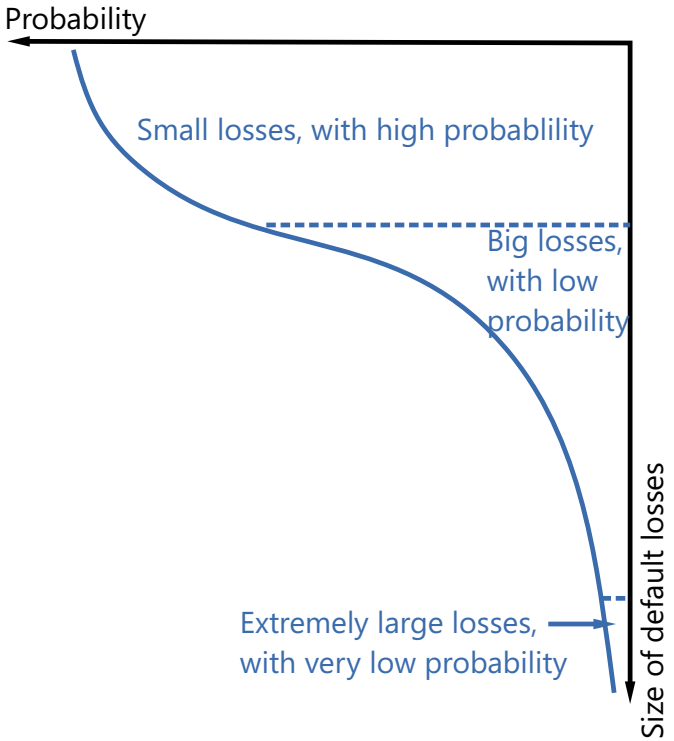
What happens when the market prices moves?

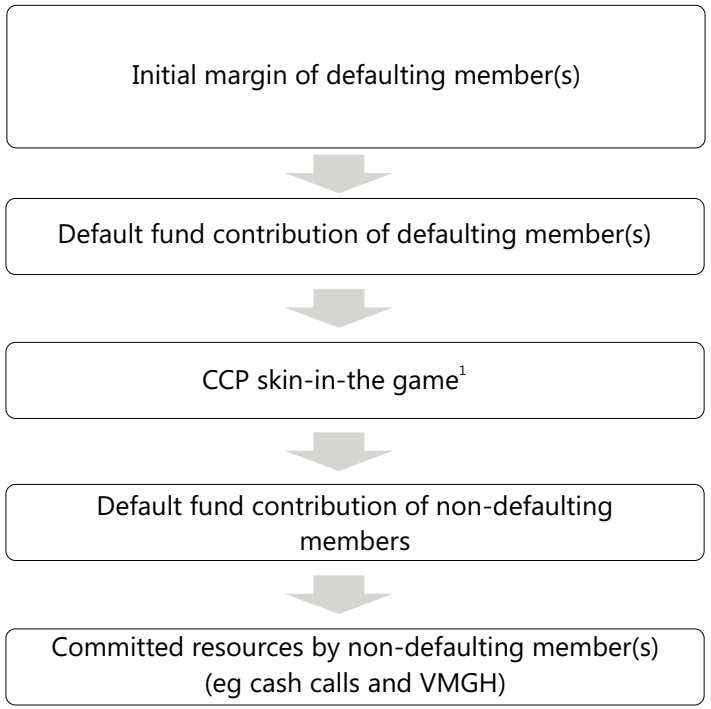


Faruqi, Huang and Takats (2018 BIS QR)

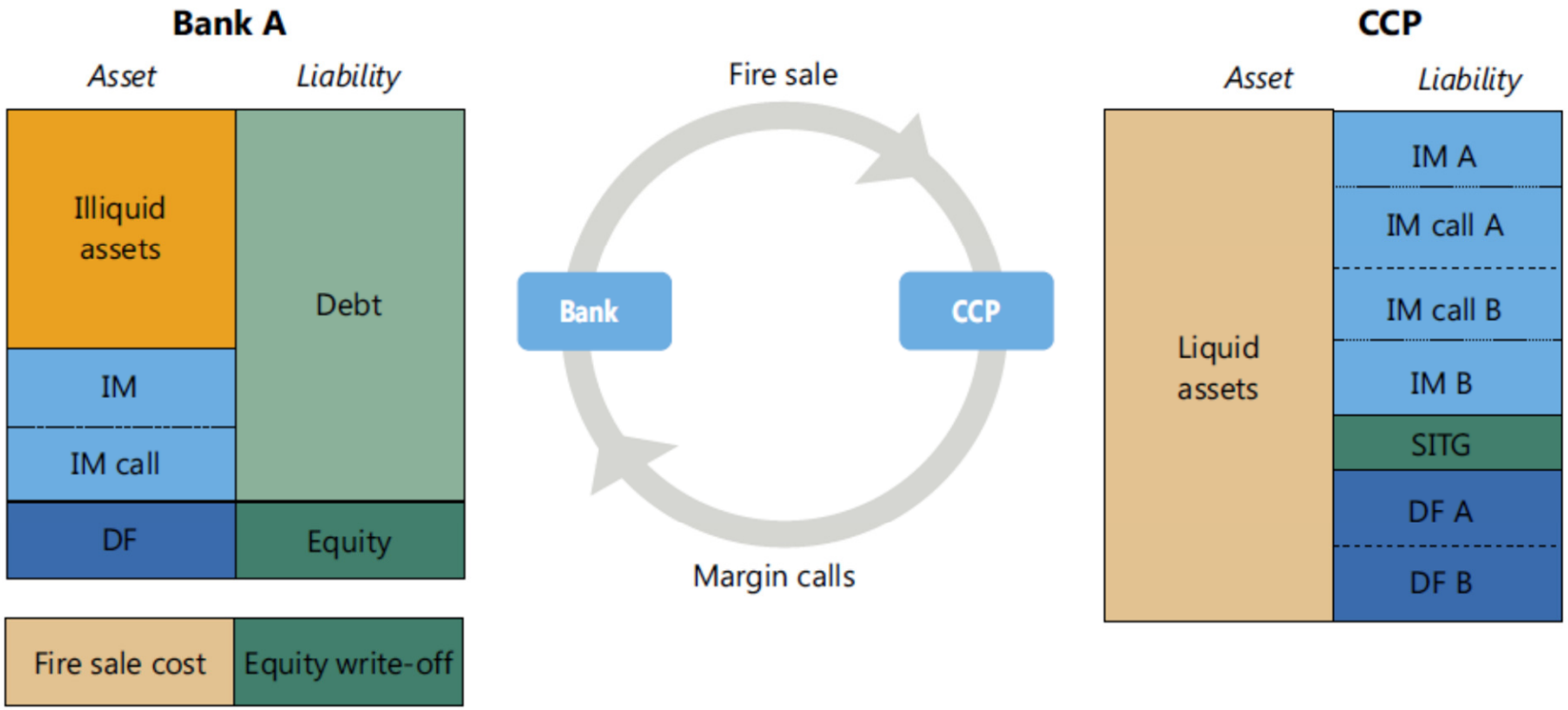
Default waterfall: counterparty risk solved?

- Capital is special: skin-in-the-game for credit risk / other capital for operational risk





Medium stress: fire sale // Brexit or 2022 UK guilt market

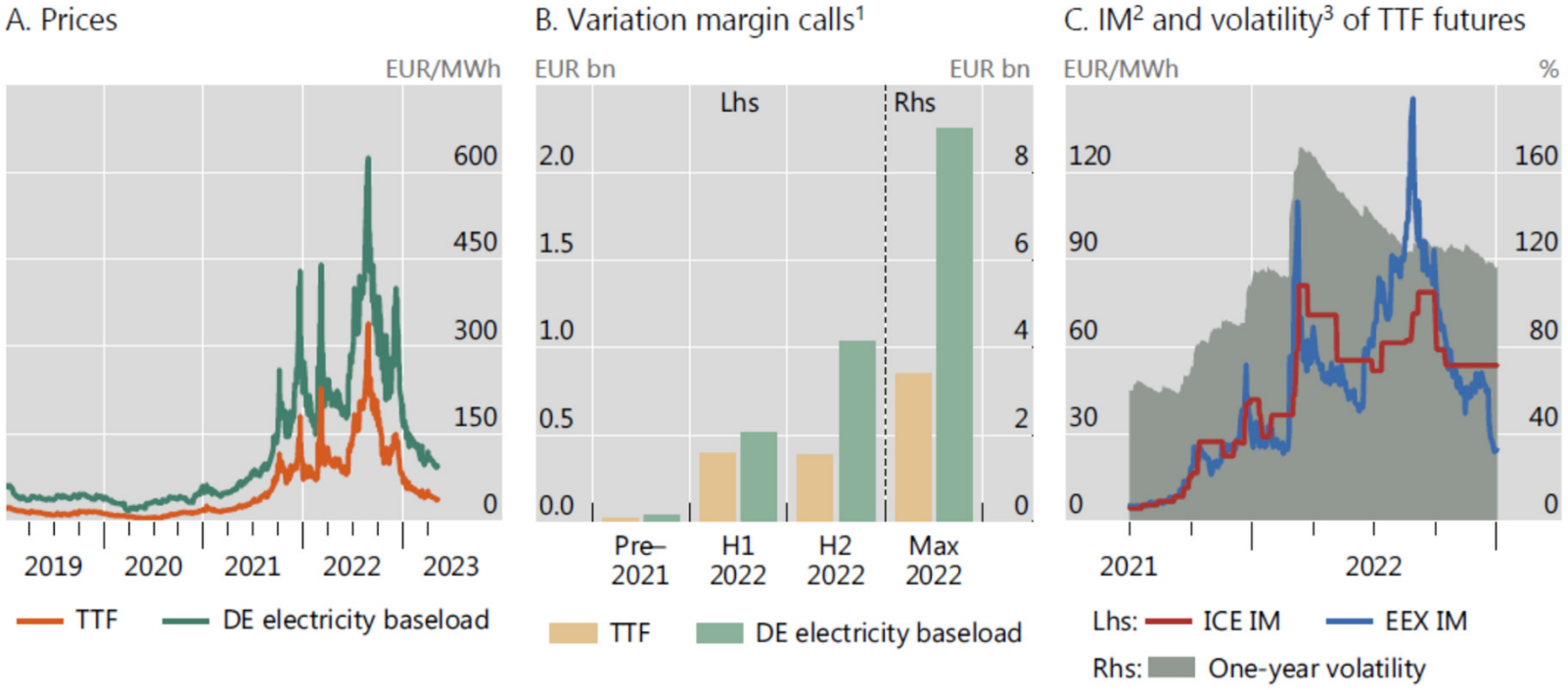


Faruqi, Huang and Takats (2018 BIS QR)

European gas prices: Price increases to margin calls to further price increases…

As prices and volatility jumped, margins rose sharply

Graph 1



[1] Margin calls are estimated using front-month futures. [2] IM per MWh. [3] Based on a one-year moving window where more weight is given to the most recent events (ie exponentially weighted moving average).

Sources: Bloomberg; EEX; ICE (the data have been made available in accordance with the terms of use); BIS.

Avalos, Huang and Tracol (2022 BIS Bulletin)

Conclusion

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- CCPs manage counterparty risk
- However, CCPs give rise to new risks, such as liquidity risk
  - Which can affect not only financial stability but also energy security
- CCPs morph counterparty risk into liquidity risk
  - No problem when liquidity was plentiful (including during the Covid-19 pandemic)
  - Liquidity risk might matter more now due to monetary policy normalization
- Given CCPs are systemic and matter outside of finance (think 2022 gas price hike), we need to understand them better