Clearinghouse Over-Confidence

By Mark Roe

To reduce the chance that a financial meltdown like that of 2007-2008 will recur, regulators are now seeking to buttress institutions for the longer-run – at least when they can turn their attention from immediate crises like those of Greece’s debt, America’s ceiling on governmental borrowing, and the potential eurozone contagion from sovereign debt to bank debt. Central to their effort has been to bolster clearinghouses for derivatives – instruments that exacerbated the implosion at AIG and others in the last financial crisis. But a clearinghouse is no panacea, and its limits, although easy to miss, are far-reaching.

When a company seeks to protect itself from currency fluctuation, it can reduce its exposure to the target currency with a derivative (for example, it promises to pay its trading partner if the euro rises, but gets paid if it falls). Although the company using the derivative reduces its exposure to the risk of a failing euro, the derivative comes packaged with a new risk – counterparty risk. The company risks that if its trading partner fails – as AIG, Bear Stearns, and Lehman did – it won’t be paid if the euro falls.

Worse, as we saw in the financial crisis, if many financial institutions have many such contracts, a rumor of insolvency can induce all of one institution’s derivative counterparties to demand collateral or payment simultaneously, triggering a run that resembles a classic bank run, which could then spread to other firms.

To reduce the risk of runs in derivatives markets, regulators around the world are poised to require that derivatives trades be carried out through clearinghouses or exchanges. The clearinghouses will have many advantages, but not as many as regulators might think.

But, first, how does a clearinghouse work?

After the company needing currency-risk protection makes its euro-dollar trade with a bank, each of them turns its side of the trade over to the clearinghouse. The resulting obligations between the company and bank become obligations to and from a middleman, the clearinghouse.

The clearinghouse protects itself by getting an up-front deposit from the bank (in case the bank fails in, say, 2015), and by monitoring the bank’s total “book” with the clearinghouse. When the bank wins on a derivatives trade, the clearinghouse pays the bank; when the bank loses, it pays the clearinghouse. When the bank has many trades on the clearinghouse’s books, the clearinghouse is fine if these trades net out to about zero; systemic risk, regulators insist, is thereby reduced, because the financial system needn’t worry about collecting the debts, one-by-one. This is true, but only for as far as the netting process goes.

The clearinghouse also enhances transparency, because it can report its aggregate exposures to the regulator, who is better positioned to regulate a central clearinghouse than to regulate many opaque banks. This, too, this should strengthen the financial system.

But risks – many of them systemic, and many of them big – remain. Unfortunately, the clearinghouse structure obscures them.
Most obviously, as many trades move from the banks to the clearinghouse, the clearinghouse itself will become a systemically vital institution. It will be too big to fail.

Equally problematic is the fact that, while the clearinghouse and its participants can net wins and losses to reduce risk for those inside the clearinghouse, the clearinghouse does not assuredly eliminate the basic risk facing the entire financial system. Often, it merely transfers that risk to creditors outside the clearinghouse.

Here’s why: Let’s imagine that a weak financial institution (say, Bank of America), has two separate contracts, one with AIG and one with Citibank. BofA owes $100 million to each. The contract with AIG is a derivatives contract, which goes through the clearinghouse; but the contract with Citibank is another kind of contract, maybe just a regular loan, and does not go through the clearinghouse. BofA also has a contract with, say, Bear Stearns through the clearinghouse for $100 million, with Bear Stearns on the losing end.

Without a clearinghouse, BofA has a $100 million asset (the $100 million that Bear owes it) and owes $200 million. Having only $100 million (if these obligations are its only assets and liabilities), BofA would have to pay AIG and Citibank $50 million each. Each would suffer a $50 million loss.

If AIG is systemically vital, its inability to collect the full $100 million could cause it to fail. This is where the clearinghouse protects AIG, whose winning contract with BofA nets out against Bear’s losing contract with BofA. The clearinghouse here eliminates counterparty risk for these three, but only by transferring the risk to Citibank, which, instead of losing $50 million, ends up losing the full $100 million.

In this stripped-down example, AIG, Bear Stearns, and BofA – as well as their attorneys, lobbyists, and supportive policymakers – promote the clearinghouse on the grounds that it reduces risk for its participants. And, as advertised, it does — but only for its participants. Citibank, however, now loses $50 million more, because it can’t crack into the clearinghouse’s assets. If that extra loss pushes a systemically vital Citibank over the precipice, the clearinghouse has not reduced systemic risk as advertised.

Whether the clearinghouse reduces systemic risk depends on the relative systemic importance of those inside and those outside the clearinghouse – AIG versus Citibank in this basic example – not on the clearinghouse’s capacity to reduce risk among its members. In this example, if Citibank is precarious and is as systemically vital as AIG, the clearinghouse has obscured that it has saved AIG only by transferring risk from the clearinghouse to Citibank, which then fails.

Much recent regulatory activity has focused on enabling, enhancing, and requiring clearinghouses for these kinds of financing arrangements. Yes, clearinghouses offer many benefits, including greater transparency, better pricing, and better regulatory focus, and we should try to make them viable. But regulators world have overestimated their overall benefit. Too much of what is justified as reducing systemic risk is really just offloading risk onto others.

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