”Market structure, counterparty risk and systemic risk” by D W R Rosenthal

Comments by K. Kauko

SUERF/Bank of Finland/CEPR/Journal of Financial Intermediation Conference

The model

- N counterparties, always one contract between any pair of counterparties => network of exposures; exogenous
- Either a central counterparty or a network of bilateral settlement obligations
- But: trading with an outsider, not counterparties among themselves during the phases covered by the analysis
- Market driven bankruptcy => losses, possible bankruptcies and hedging
- Trades affect prices, counterparties aware of the impact
- Information advantage of the CCP, knows all counterparties’ positions
- CCP reduces post-bankruptcy volatility

General comments 1

- Participants' behaviour largely endogenous
  - Economics!
- Would be interesting to read comments on the relationship between this work and previous contributions
  - Reference list exceptionally short (12 papers, only 5 articles in academic journals)
  - What is completely new? What is similar to findings in previous papers?
- Checkmate, hunting…
  - Would it be possible to find real life examples of hunting?
- Trade with outsiders, not among themselves
  - An assumption probably dictated by technical reasons / model needs to be solvable

General comments 2

- Bankruptcy of the CCP not analysed
  - Could it happen? Under which circumstances?
  - Could it become topical as a worst case scenario?
  - More risks concentration in CCP:s – should we be worried?
- Hardly anything about the governance structure of the CCP
  - Is the CCP an “enlightened monarch”?
  - Who controls it? Who benefits / suffers if it makes losses?
  - Common infrastructure becomes market participants’ implicit cartel (Park & Ahn 1999)?
- These kinds of analyses often rely heavily on simulations, this paper is analytical

Minor comments

- Terminology
  - The abbreviation OTC refers above all to trading
- Discussion of the social costs caused by the failure of a financial institution too focused on the industry itself and its employees
  - Useless institutions – no customers need their services? Who pays these institutions and for what if employees only need them?
  - Better to mention ”huge social costs” in general and a good reference
    - Friedman & Schwartz or Bernanke on the Great Depression