Risk-sharing or risk-taking? An incentive theory of counterparty risk, clearing and margins*

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Abstract

Derivatives trading, motivated by risk–sharing, can breed risk–taking. Bad news about the hedged risk increases the expected liability of the protection seller, undermining her risk–prevention incentives. This creates endogenous counterparty risk and contagion from news about the hedged risk to the balance sheet of the protection seller. Margin calls after bad news can improve protection sellers' incentives and enhance the ability to share risk. Central clearing can provide insurance against counterparty risk but must be designed to preserve risk–prevention incentives.

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