

Systemic Risk in Clearing Houses: Evidence from the European Repo Market

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Abstract

We examine whether the Centralized-Counterparty Clearinghouse (CCP) behind the General Collateral (GC) repos traded on two large repurchase agreement (repo) platforms potentially suffered from systemic risk during the European sovereign debt crisis in 2008-2011. We find that GC repo rates respond to movements in sovereign risk, in particular at the peak of the crisis in 2011 and in GIIPS countries. This is surprising given that our data are from the safest segment of the European repo market, in which the CCP assumes counterparty default risk. We document that in 2011 the repo market behaved as if the probability of CCP default (conditional on sovereign default) was very large, and did not react to increases in haircuts. The ECB's 36-month long-term refinancing operation of December 2011 alone was able to disconnect the CCP from the sovereign crisis. Overall, our evidence is consistent with CCPs providing some protection in periods of intermediate sovereign stress (2009-2010), but being ineffective at the peak of the sovereign crisis (2011). Our findings have important implications for the increasing role that CCPs, many of which are interconnected, are required to play under the European Market Infrastructure Reform (EMIR) and the Dodd-Frank Act in the USA.

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