Discussion: *Elimination of Systemic Risk in the Interbanking System*
Meyer

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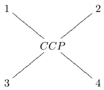
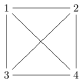
Reaction

- Paper covers important and timely topic: systemic risk[2].
- Compares two different market structures:





Market with CCP   Bilateral OTC market

- What is effect of node (counterparty) default on other nodes?
  - *Counterparty Risk*: Direct effect of default.
  - *Systemic Risk*: Indirect effect of default.
- Considers both interbank lending and OTC derivative markets.
- Question: Cost vs benefit of using central counterparty (CCP).
- Unlike other work, uses data in attempt to quantify risks.

[2] Examples: Continental Illinois, Askin, LTCM, Bear, Lehman.

Motivational, Writing Suggestions

- Mention CCPs reducing systemic risk in commodity markets.
  - Weather killing 10% of a crop is serious systemic risk.
- Deals separately with interbank and OTC derivative markets.
  - But interbank loans may be hedged in derivative markets.
- Effect of Dodd-Frank, other new regulations on assumptions?
- Need to condense, eliminate redundancy to increase clarity.
- Cannot find math nor source of derived figures in tables.
  - Showing a few equations/calculations would help.

Theoretical Suggestions

- Need to look more at other theoretical research:
  - Duffie and Zhu (2009): CCP still has systemic risk.
  - I show CCP effects (mean, variance, distress pervasiveness).
- May care about CDS and LIBOR-OIS spreads *and* volatilities.
- VaR is a poor proxy for distress exposure.
  - Not coherent: lower risk portfolios may have higher VaR.
  - Ignores how bad 5%-worst days are: lose 10%? 99%?
- Set of assumptions are a model; list them in one place.
- Agree: think more about how CCP would change market.

Data Suggestions

- Looks at 54 banks' net exposures, extends to whole market.
  - Are other counterparties similar in capital, risk?
  - *Non-netted* exposures more important for systemic risk.
  - $+\$10$ BB to Lehman[3] $+ -\$10$ BB to Goldman $=$ trouble.
- Non-bank entities (*e.g.* Cargill, IBM) properly accounted for?
- Data from Dec 31: strange, illiquid day; use another day.
- Can data analysis help predict future (rare) crises?
  - Inference is tough; endogeneity of crisis matters.

[3] Worse: $+\$15$ BB to Lehman US, -\$5 BB to Lehman UK?

Conclusion

- Interesting approach to a very important problem.
- What can we learn from a data analysis?
  - Unclear, but this has ingredients for a good first step.
  - Even imperfect answers are better than current ignorance.
- More clarity and condensing would yield great benefits:
  - Gem of an idea; cut away unneeded prose and polish!
- I look forward to final product.