# Contagion in Derivatives Markets[†]

Mark Paddrik[a,*]
Sriram Rajan[b]
H. Peyton Young[c]

March 20, 2019

## Abstract

A major credit shock can induce large intra-day variation margin payments between counterparties in derivatives markets, which may force some participants to default on their payments. These payment shortfalls become amplified as they cascade through the network of exposures. Using detailed DTCC data we model the full network of exposures, shock-induced payments, initial margin collected, and liquidity buffers for about 900 firms operating in the U.S. credit default swaps market. We estimate the total amount of contagion, the marginal contribution of each firm to contagion, and the number of defaulting firms for a systemic shock to credit spreads. A novel feature of the model is that it allows for a range of behavioral responses to balance sheet stress, including delayed or partial payments. The model provides a framework for analyzing the relative effectiveness of different policy options, such as increasing margin requirements or mandating greater liquidity reserves.

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[a,*]Office of Financial Research, U.S. Department of the Treasury, 714 14th Street NW, Washington, DC 20220, phone: 202-927-8511, email: Mark.Paddrik@ofr.treasury.gov, Corresponding Author

[b]Office of Financial Research, U.S. Department of the Treasury, 714 14th Street NW, Washington, DC 20220 , phone: 202-927-8293, email: Sriram.Rajan@ofr.treasury.gov.

[c]Nuffield College, Oxford, UK; London School of Economics, London, UK; Office of Financial Research, U.S. Department of the Treasury, 714 14th Street NW, Washington, DC 20220, phone: 202-927-8289, email: Hobart.Young@ofr.treasury.gov.

# 1 Introduction

The recent financial crisis highlighted the potential risks posed by derivatives markets. As the crisis unfolded, large sellers of protection such as American International Group, Inc. (AIG) became liable for payments on credit default swaps (CDS) contracts they had previously sold to banks and dealers as protection against credit defaults. Until the crisis, these protection sellers received a steady stream of payments from protection buyers and rarely had to pay out claims. When the crisis hit, the sudden calls for payments put great pressure on the sellers, some of which had a thin capital base. In particular, AIG had to be rescued by the U.S. Federal Reserve in order to meet its margin obligations on CDS contracts to dealers, who in turn were threatened if the payments were not made.

This incident casts a spotlight on the potential risks posed by the CDS market to the stability of the financial system. Prior to the crisis this market grew rapidly. From its inception in the 1990s to 2007 the total notional value of CDS contracts rose to about $60 trillion, though it has since declined to about $9.4 trillion (Bank for International Settlements (2018)). Under a shock to credit markets the sellers of CDS protection become liable for payments to the buyers. AIG got into trouble because it had sold protection on large pools of subprime mortgages to a variety of banks and broker-dealers. During the crisis the value of these mortgages deteriorated sharply, which triggered margin calls that AIG was unable to meet (Financial Crisis Inquiry Commission (2011)).

Since the crisis, various reforms have been introduced to mitigate destabilizing risks in the financial system. First, requirements for posting initial margin as security against nonpayment have been strengthened. This has occurred both in the scope of firms that are required to post initial margin and in the segregation of initial margin accounts, so that one counterparty's losses cannot be covered by another counterparty's funds. These developments have facilitated a movement towards exchanging variation margin on a daily basis. Variation margin payments, or bilateral exchanges in contractual value, were more infrequent prior to the financial crisis and were not the subject of regulation.

A second reform prompted by the crisis was to incentivize firms to trade contracts through central counterparties (CCPs). Central clearing has been encouraged through higher capital and margin requirements for non-centrally cleared contracts.[1] An advantage of central clearing is that it fosters contractual standardization and shortens intermediation chains, which can help to reduce network contagion (Cont and Minca (2016)). A disadvantage is that it concentrates risk at a single point of failure and imposes on the CCP's counterparties much shorter variation margin compliance windows than existed before the crisis.

In this paper we model the propagation of losses in derivatives markets through network spillover effects, taking account of the short time frame within which payments must be made (typically a few hours), and also the key role played by the CCP. The focus of our analysis is the CDS market. Given a shock to credit spreads, we estimate the total amount of contagion, and the contribution of individual firms to contagion, under a range of assumptions about their response to balance sheet stress. The model builds on the framework of Eisenberg and Noe (2001), but it has several novel elements that are specific to OTC derivatives markets. In particular, the model incorporates two safety valves that mitigate network spillover effects. One is the posting of initial margin as a security deposit against potential default. The second is the maintenance of in-house cash reserves and dedicated lines of credit to manage daily fluctuations in the demand for variation margin payments. Initial margins and cash reserves vary substantially among firms depending on the risk characteristics of their portfolios, which we observe in the data. The model therefore incorporates heterogeneity in firms' balance sheets as well as their positions in the network.

A second contribution of this paper is to allow for a range of possible strategies to cope with short-term liquidity stress, including delayed or partial payment and payment with illiquid collateral. We show how to accommodate a range of such responses in the model and then explore their implications for contagion using detailed exposure data provided to the Office of Financial Research by the Depository Trust & Clearing Corporation (DTCC).

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[1]However these incentives may not be sufficient to induce firms to clear in all cases; for an analysis of this issue see Ghamami and Glasserman (2016).

The data provide a detailed picture of the network of counterparty exposures in the United States CDS market at particular dates, including exposures between banks, dealers, hedge funds, asset managers, and insurance companies. We also use the data to estimate the initial margin posted by each counterparty and the liquidity buffers that they maintain to manage daily fluctuations in margin calls.

We then apply the framework to estimate the total payment shortfalls that would result from a severe but not implausible market shock, namely, the Federal Reserve's 2015 Comprehensive Capital Analysis and Review (CCAR) trading book shock. This shock was designed to test the robustness of the financial system under severe conditions, while embedding co-movements in the value of credit instruments that we are not in a position to estimate ourselves. The shock implies a sudden decrease in the value of corporate and sovereign debt on which CDS contracts are written, and thus results in large demands for variation margin payments between counterparties to these contracts.

The plan of the paper is as follows. In the next section we provide an overview of the literature on network contagion, including recent papers on CDS markets. In section 3 we introduce the network model and demonstrate the existence of a payments equilibrium under very general conditions on the firms' response functions. In section 4 we discuss specific examples of such response functions. Sections 5-6 describe the DTCC data in detail and show how it can be used to estimate the initial margins posted by counterparties, the amount of cash reserves firms need to manage their own accounts, and the variation margin payments induced by a shock.

In section 7 we bring these elements of the model together and estimate the total amount of contagion that would be produced by the CCAR shock. We also conduct a sensitivity analysis to assess how the amount of contagion is affected by the size of the liquidity buffers, the amount that firms post in initial margin, and the strategies they use to manage balance-sheet stress. We find that even when liquidity buffers are large enough to handle daily fluctuations in variation margin payments with 99.7% probability, and initial margins

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are large enough to cover payment delinquencies with 99.5% probability (based on historical DTCC data), the amount of default contagion under the CCAR shock could be very substantial. In particular, the shortfall in payments is on the order of 5-12% of total payment obligations, and 15-17% of all market participants default. Interestingly, the CCP does *not* default, although it must reach into its guarantee fund to cover its obligations to member firms.

The model also permits a forensic analysis of the sources of contagion. In particular, we can estimate each firm's marginal contribution to contagion by calculating the amount by which payment shortfalls would be reduced throughout the system if that firm's obligations could be fully guaranteed by government intervention. We find that, by this measure, exactly one (non-member) firm is responsible for a very significant proportion of total systemic losses due to its large size and the imbalance between its buy and sell positions. A second key finding is that even though the member firms contribute less to contagion at the margin due to their balanced portfolios, they tend to amplify contagion (through spillover effects) due to their central position in the network. A third finding is that, although the CCP is the most centrally located of the nodes, it contributes relatively little to contagion because it has a perfectly matched buy and sell portfolio, stringent initial margin requirements, and a large guarantee fund that acts as liquidity buffer.

# 2 Related Literature

The financial crisis of 2007-09 has sparked a rapidly growing literature, both theoretical and empirical, on financial networks and systemic risk. A central theme of this literature is the relationship between network structure and the risk of contagion. Network connections can have a positive effect by diversifying the risk exposures of individual market participants, but they can also have a negative effect by creating channels through which shocks can spread. The tension between these two forces has been explored in a variety of papers; see

among others Allen and Gale (2000); Freixas et al. (2000); Gai and Kapadia (2010); Gai et al. (2011); Haldane and May (2011); Blume et al. (2011); Cont et al. (2013); Elliott et al. (2014); Acemoglu et al. (2015).

A key methodology for analyzing how networks propagate contagion is due to Eisenberg and Noe (2001), who show how payment shortfalls that originate at some nodes can cascade through the network causing an ever-widening series of defaults. There is now a substantial literature that builds on their approach (as we do here); see in particular Upper and Worms (2004), Elsinger (2009), Rogers and Veraart (2013), Elliott et al. (2014), Glasserman and Young (2015) and Acemoglu et al. (2015). For general surveys of the literature see Bisias et al. (2012) and Glasserman and Young (2016).

There is also a literature that focuses specifically on the network structure of CDS markets. The potential for contagion in these markets was first highlighted by Cont (2010), who emphasized the importance of adequate liquid reserves to cope with large and sudden demand for variation margin. Cont (2010) also analyzed the extent to which a CCP can mitigate contagion, a topic that was subsequently treated by Duffie and Zhu (2011), Cont and Kokholm (2014) and Cont and Minca (2016). Of crucial importance is how the CCP sets margin requirements. Capponi and Cheng (2018) examine the tension between setting member fees and collateral levels and how, if made effectively, these choices limit contagion from portfolio shocks. Various empirical studies examine how CCPs set margin levels in practice (Duffie et al. (2015); Capponi et al. (2017)). These studies find that value-at-risk approaches tend to underestimate CCP collateral levels. For this reason we shall use the CCP's reported collateral instead of attempting to estimate it.

Various authors have studied the structure of CDS exposures and the potential for contagion among European banks; see in particular Brunnermeier et al. (2013), Peltonen et al. (2014), Vuillemey and Peltonen (2015), and Clerc et al. (2014). Cont and Minca (2016) analyze the combined network of exposures in the CDS and interest rate swap markets together, and argue that central clearing in both markets can significantly reduce the probability and

magnitude of illiquidity spirals. Their work differs from the present paper in the methodologies used to study contagion, and in the focus on the European rather than the U.S. market.[2] More recently, Ali et al. (2016) examine the network structure of the CDS market in the United Kingdom. These authors argue, as do Glasserman and Young (2016), that the systemic importance of market participants is not fully captured by conventional measures of centrality. The size and structure of financial firms' balance sheets, in addition to their position in the network, is crucial to understanding how much risk they pose to the system as a whole.

# 3    Network Contagion Model

We take as given the network of CDS contracts that exist between counterparties at a given point in time and study the impact of a sudden shock to credit markets. Such a shock triggers large variation margin (VM) payments from the sellers to the buyers of CDS protection. Suppose, for example, that a firm sold $100 million in protection against the default of corporation C over the next five years. The shock decreases the value of C's debt and correspondingly increases the implied probability that C will default within the contract period. This increases the value of the CDS contract to the buyer, and increases the liability of the seller to the buyer. This change in value must be paid by the seller to the buyer as variation margin; moreover the payment is typically due within one day. The upshot is that shocks to credit markets impose expectations of rapid cash payments between participants in the CDS market.

Let $\bar{p}_{ij}$ denote the VM payment obligation from firm $i$ to firm $j$ that results from a given shock. Let $\bar{p}_i = \sum_{j \neq i} \bar{p}_{ij}$ denote the total payment obligation of $i$ to all other firms. In what follows we shall restrict attention to those firms $i$ such that $\bar{p}_i > 0$. The others do

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[2]There has been less research on the CDS market in the United States, mainly due to limited data access. To get around this difficulty, Markose et al. (2012) use imputation techniques to estimate CDS exposures from publicly reported balance sheet data (see also Markose (2012) and the BIS Macroeconomic Assessment Group on Derivatives (2013)).

not transmit payment shortfalls; instead they act as shock absorbers. In the present context these firms are solely buyers of protection (not sellers) and under a shock they will have no VM obligations.

The *relative liability* of firm $i$ to firm $j$ is

$$a_{ij} = \bar{p}_{ij}/\bar{p}_i. \tag{1}$$

Note that for each $i$, $\sum_{j \neq i} a_{ij} \leq 1$; moreover $\sum_{j \neq i} a_{ij} < 1$ if firm $i$ owes payments to one or more firms with no obligations (which are not indexed). It follows that the matrix $A = (a_{ij})$ is row substochastic.

Consider a node $i$, and let $c_{ki}$ denote the amount of initial margin (IM) it collects from counterparty $k$. The purpose of the IM is to cover the shortfall in VM payments. In particular if counterparty $k$ fails to pay VM to $i$ in a timely manner, the position will be closed out or novated to another firm, and the IM will be applied to any losses that are incurred between the time the payment was due and the time it takes to novate or close out the position.

In addition, each firm $i$ maintains cash reserves and short-term lines of credit that allow it to manage daily fluctuations in VM payments and receipts. These constitute $i$'s *liquidity buffer* $b_i$. In section 5.3 we shall show how to estimate these buffers from the DTCC data.

Given a shock, let $p_{ki} \leq \bar{p}_{ki}$ denote the actual payment made by $k$ to $i$. If $p_{ki} < \bar{p}_{ki}$ the difference will be made up out of the IM sitting in $k$'s account at firm $i$ provided that $\bar{p}_{ki} - p_{ki} \leq c_{ki}$. If $\bar{p}_{ki} - p_{ki} > c_{ki}$, however, then the difference $\bar{p}_{ki} - (p_{ki} + c_{ki})$ must be borne by $i$. We define the *initial stress* at $i$, $s_i^0$, to be the difference between $i$'s payment obligations *to* others and its liquidity buffer plus payment obligations *from* others:

$$s_i^0 = \bar{p}_i - \sum_{k \neq i} \bar{p}_{ki} - b_i. \tag{2}$$

The *stress* at $i$, $s_i$, is the amount in equilibrium by which $i$'s payment obligations exceed its incoming payments (supplemented by the counterparties' initial margins) plus $i$'s liquidity

buffer, that is,

$$s_i = s_i(p) = \bar{p}_i - \sum_{k \neq i} ((p_{ki} + c_{ki}) \wedge \bar{p}_{ki}) - b_i. \tag{3}$$

Note that even when all of $i$'s counterparties pay in full, that is $p_{ki} = \bar{p}_{ki}$ for all $k$, stress will still be positive if $i$'s payments obligations exceed its incoming payments by more than its liquidity buffer $b_i$.

The final element of the model is to specify how balance sheet stress translates into actual payments. We argue that in practice firms will respond to stress in diverse ways, depending on their access to credit, their relationship with counterparties, and their risk management practices. We do not have enough information about individual firms to model these responses explicitly. Instead we shall consider a range of possible responses, and then show how they can be used to bound the total amount of network contagion holding other parameters fixed.

Given a level of stress $s_i$ at firm $i$, let $s_{ij}(p) = a_{ij}s_i(p)$, and let $p_{ij} = f_{ij}(s_{ij}, \bar{p}_{ij}) \in [0, \bar{p}_{ij}]$ be the *expected payment* that $i$ makes to counterparty $j$. We call $f_{ij}$ a *stress response function*.[3] We shall impose two regularity conditions: (i) $f_{ij}$ is monotone nonincreasing in $s_{ij}$, that is higher levels of stress lead to lower (or at least not higher) payments; (ii) $f_{ij}$ is *upper-semicontinuous* in $s_{ij}$, that is, for every convergent sequence $\{s_{ij}^k\} \to s_{ij}^*$ and for every $\bar{p}_{ij}$,

$$\limsup_{s_{ij}^k \to s_{ij}^*} f_{ij}(s_{ij}^k, \bar{p}_{ij}) \leq f_{ij}(s_{ij}^*, \bar{p}_{ij}). \tag{4}$$

In the next section we shall describe specific examples of such stress response functions. Given the functions $f_{ij}$, we are now in a position to define the notion of payments equilibrium. For every payment vector $p = (p_{ij})_{1 \leq i,j \leq n}$ such that $0 \leq p_{ij} \leq \bar{p}_{ij}$, define the function

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[3]Note that $f_{ij}(s_{ij}, \bar{p}_{ij}) \geq \bar{p}_{ij} - s_{ij}$ because the latter is the maximum that $i$ can pay $j$.

$$\forall i \neq j, \quad \Phi(p)_{ij} = f_{ij}(s_{ij}(p), \bar{p}_{ij}) \tag{5}$$

It is straightforward to show that $s_{ij}(p)$ is continuous in $p$, hence $\Phi(p)$ is upper-semicontinuous in $p$. (The composition of a continuous function and an upper-semicontinuous function is upper-semicontinuous.) The function $\Phi(p)$ is monotone and order-preserving on the bounded lattice $L = \Pi_{1 \leq i,j \leq n}[0, \bar{p}_{ij}] \in \mathbb{R}^{n^2}$, where the (partial) order on $L$ is defined by $p \leq p'$ if $p_{ij} \leq p'_{ij}$ for all $i,j$.

Consider the recursively defined sequence

$$p^1 = \Phi(\bar{p}), p^2 = \Phi(p^1), p^3 = \Phi(p^2), \ldots \tag{6}$$

**Proposition 1.** *The sequence in (6) converges to the greatest fixed point of $\Phi$.*

*Proof.* Since $\bar{p}$ is the maximal element in $L$, $p^1 = \Phi(\bar{p}) \leq \bar{p}$. Since $\Phi$ is order-preserving $p^2 = \Phi(p^1) \leq \Phi(\bar{p}) = p^1$. Proceeding inductively we see that the sequence $\{p^k\}$ in (6) is monotone non-increasing. It is also bounded below by the zero-vector. By the monotone convergence theorem, $\{p^k\}$ converges to its greatest lower bound.

We claim that $p^*$ is a fixed point of $\Phi$. Since $\Phi$ is order-preserving and $p^* \leq p^k$ for all $k$, $\Phi(p^*) \leq \lim_{k \to \infty} \Phi(p^k)$. Since $\Phi$ is upper-semicontinuous, $\Phi(p^*) = \Phi(\lim_{k \to \infty} p^k) \geq \lim_{k \to \infty} \Phi(p^k)$. It follows that $\Phi(p^*) = \lim_{k \to \infty} \Phi(p^k)$. By construction $p^{k+1} = \Phi(p^k)$ for all $k$, hence $\Phi(p^*) = \lim_{k \to \infty} \Phi(p^k) = \lim_{k \to \infty} p^{k+1} = p^*$, so $p^*$ is fixed point of $\Phi$.

By Tarski's Theorem (Tarski (1955)), $\Phi$ has a greatest fixed point $p^+ \in L$. Clearly $p^+ \leq \bar{p}$, hence $p^+ = \Phi(p^+) \leq \Phi(\bar{p}) = p^1$. Applying $\Phi$ repeatedly, we conclude that $p^+ \leq p^k$ for all $k$, hence $p^+ \leq p^* = \lim_{k \to \infty} p^k$. By assumption $p^+$ is the maximal fixed point and we have just shown that $p^*$ is also a fixed point, hence $p^+ = p^*$. $\square$

A number of fixed-point results in the literature are particular instances of this proposition; see among others Rogers and Veraart (2013) and Elliott et al. (2014).

To illustrate the recursive computation of payments equilibrium, consider the three-firm

example shown in Figure 1. Each firm collects IM from each of its counterparties, and these amounts are held in separate boxes. In addition each firm has a liquidity buffer that is held in a diamond. The amounts owed are shown next to the corresponding arrows. For example, firm A is owed 120 by C, and owes 80 to B and 40 to D. In what follows we shall assume that when a firm defaults it pays its counterparties the amount it owes them minus the pro rata stress, that is, $f_{ij}(s_{ij}, \bar{p}_{ij}) = \bar{p}_{ij} - s_{ij}$ for all $i$ and $j$.

**Figure 1:** Example Payment Network
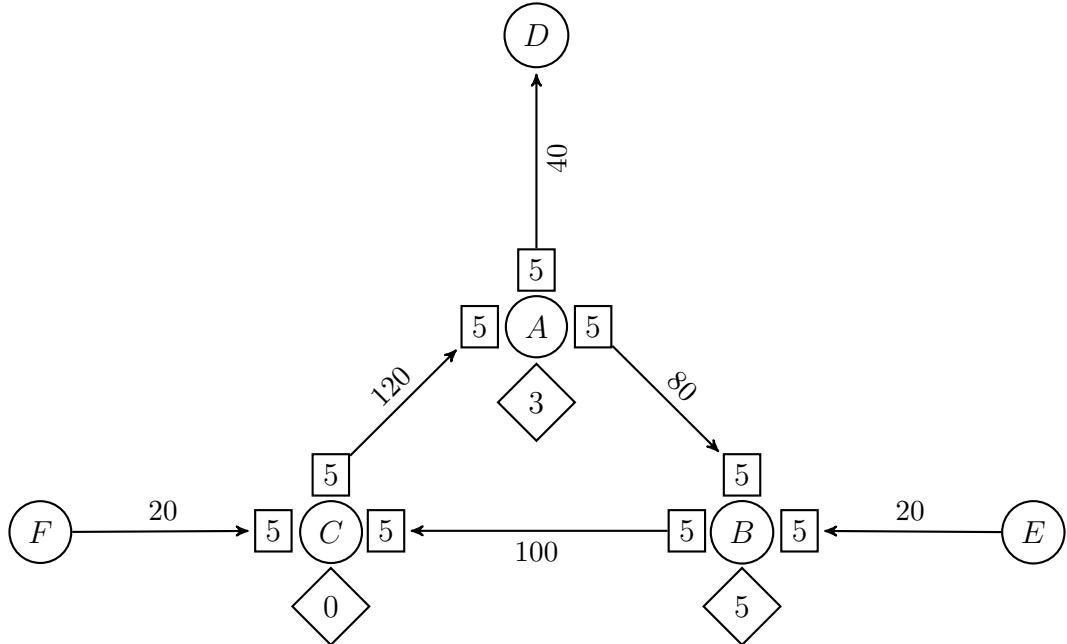


*Note*: Arc labels, diamonds, and squares denote variation margin payment obligations, liquidity buffers, and initial margin stocks, respectively.
*Source*: Authors' creation.

Now suppose that firms E and F default completely. Then B can seize the 5 units of IM posted by E, but not the IM posted by its other two counterparties (A and C). In the first iteration of the algorithm, assume that B pays whatever it can to C: 5 in IM it collected from E, plus 5 in B's liquidity buffer, plus the anticipated 80 in payments from A. Thus in the first round we find that $p_{BC}^1 = 90$. This is less than B owes C, hence C can seize the 5 in IM it collected from B plus the 5 in IM it collected from F (which is in default) plus the

90 in anticipated payments from B, and pay 100 to A: $p^1_{CA} = 100$. This is less than C owes A, hence A seizes the 5 in IM it collected from C, adding 3 from its liquidity diamond, and pays 108 to D and B in the proportions of one to two. Thus at the end of round 1 of the algorithm we have the (hypothetical) payments shown in Figure 2. Note, however that the ingoing and outgoing payments, supplemented by the IM and liquidity buffers, are not in balance. Therefore we need to apply the function $\Phi$ again to determine the next round of payments. This process converges to the payments equilibrium shown in Figure 3.

**Figure 2:** Example Payment Network at the End of Round 1
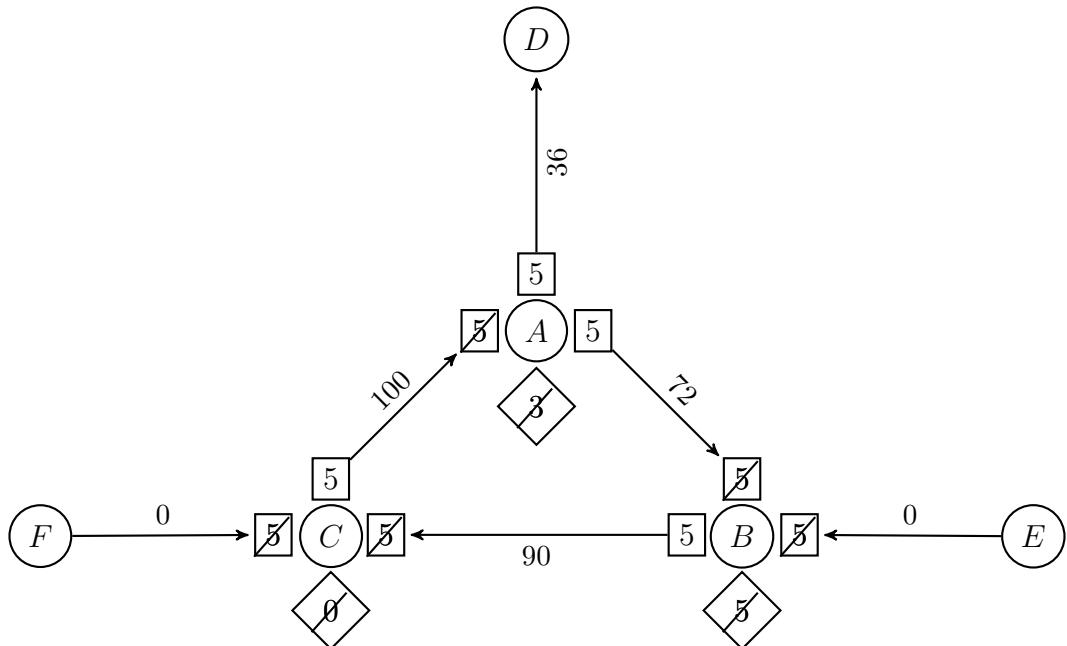


*Note*: Firms E and F default, which results in reduced payments (relative to obligations) from B to C, C to A, and A to B. B and C both seize their failing counterparties' IM stocks and resort to their own liquidity buffers. The resulting payment shortfall generates a corresponding response from A. Exhausted stocks and buffers are indicated with a stricken line.
*Source*: Authors' creation.

**Figure 3:** Example Network Equilibrium
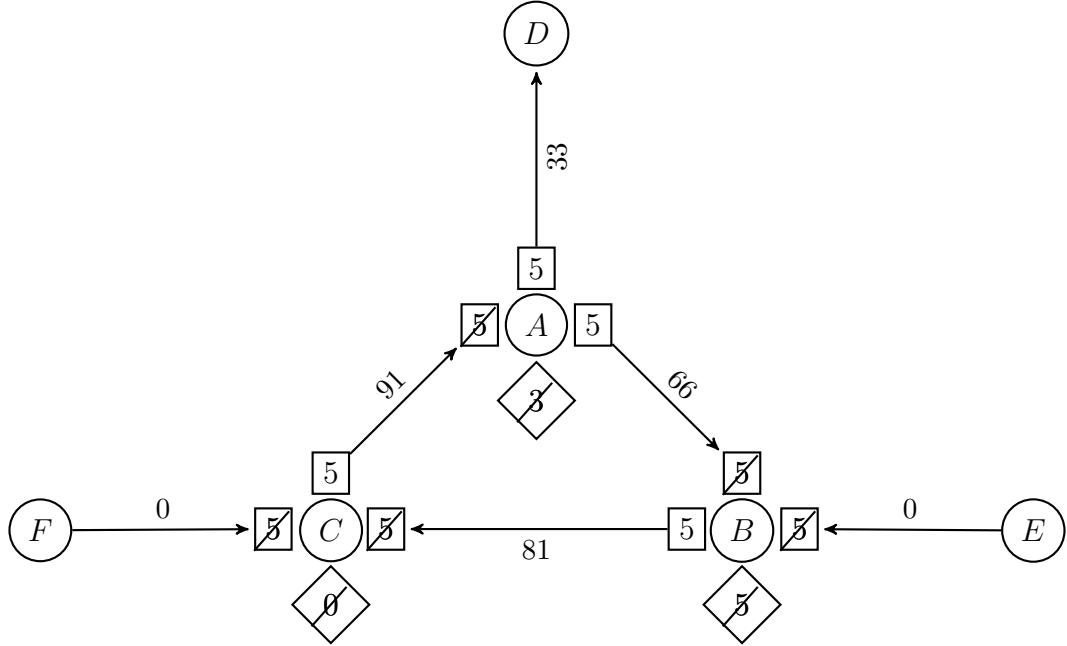
*Note*: In equilibrium every firm's incoming payments, plus IM seizures and liquidity buffer, equal its outgoing payments.
*Source*: Authors' creation.

# 4  Stress Response Functions

We now consider the form of the stress response functions in more detail. Recall that when firm $i$ is under stress $(s_i > 0)$, it is unable to meet its payment obligations in full, even after seizing the IM posted by the counterparties who failed to pay and after exhausting its own liquidity buffer. The question is how much a firm will pay its counterparties (on the day when VM payments are due) and how much it will hold back. In the Eisenberg-Noe model it is assumed that each firm's assets are fully distributed to its counterparties as they would be in resolution. In this case the stress response function takes the form

$$f_{ij}(s_{ij}, \bar{p}_{ij}) = \bar{p}_{ij} - s_{ij}, \tag{7}$$

where $s_{ij} = a_{ij}s_i$ is the pro rata shortfall from $i$ to $j$. We shall call this the *soft default*

option (see Figure 4, left panel).

In the present context, however, this scenario seems overly optimistic: if $i$ is unable to pay in full, it will suffer default – and the consequent reputational loss – even if it pays as much as it can. Thus there would seem to be little benefit to making a partial payment if default is going to ensue in any case. In the extreme, the response would be to pay nothing whenever $s_i > 0$, that is

$$f_{ij}(s_{ij}, \bar{p}_{ij}) = \begin{cases} 0 & \text{whenever } s_{ij} > 0, \\ \bar{p}_{ij} & \text{if } s_{ij} = 0. \end{cases} \tag{8}$$

We call this the *hard default* option (see Figure 4, right panel).

It seems likely that firms' actual stress response functions lie somewhere in between these two extremes. If the anticipated shortfall $s_{ij}$ is sufficiently large (relative to $\bar{p}_{ij}$), $i$ may declare default and pay nothing; if $s_{ij}$ is small, $i$ may make its best effort to close the gap and perhaps receive temporary forbearance from counterparty $j$, who might prefer to receive some payment immediately rather than foreclose on $i$.[4] In this case the stress response function might take the intermediate form shown in Figure 4 (middle panel).

In the empirical applications to follow, we shall not attempt to estimate the response functions for particular firms. Rather we shall treat hard and soft default as bounds on the range of plausible responses, and estimate the amount of contagion produced by each.

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[4]Counterparty $j$'s willingness to extend forbearance to $i$ will depend on how much collateral it collected from $i$, how likely it is that $i$ will be able to close the gap if given extra time, and how much pressure $j$ is under from *its* counterparties. These factors will vary significantly among firms.

**Figure 4:** Stress Response Functions



**(a)** Soft Default      **(b)** Intermediate Default      **(c)** Hard Default
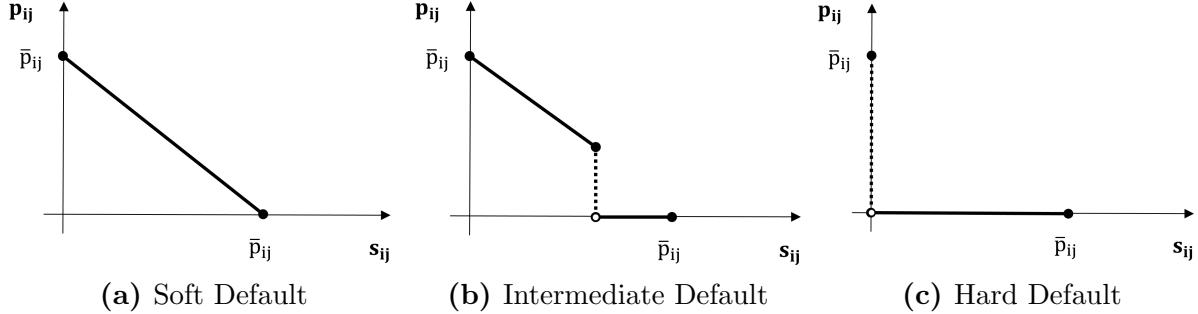
*Note*: Three cases are illustrated: (a) describes the situation where $i$ pays the maximum amount available (as it would in resolution); (c) is the situation where $i$ defaults and pays nothing; (b) is an intermediate situation in which $i$ makes a reduced payment if $s_{ij}$ is not too large, and pays nothing when $s_{ij}$ exceeds a certain threshold.
*Source*: OFR analysis.

# 5   Estimating the Model Parameters

In this section we show how to estimate the key elements of the network contagion model – variation margin, initial margin, and liquidity buffers – from the DTCC data. The data reports the positions on all standardized and confirmed CDS involving U.S. entities since 2010. Positions represent extant swap transactions with comparable risk characteristics between counterparties. They include detailed information about underlying reference entities, notional amount bought and sold, inception and termination dates, and other terms of contracts. We also use data from Markit to estimate single-name credit spreads for all reference entities in the positions we observe.

## 5.1   Variation Margin

Variation margin (VM) payments are cash transfers made by a firm to its counterparties to account for changes in the value of the CDS contracts. These variation margin payments are made on a daily basis. From the protection seller's perspective a CDS derives positive value from premia received until the contract terminates or the underlying reference entity defaults (whichever comes first); in the latter case the seller's contract value is reduced by

the expected protection payment. The sources of value are switched from the standpoint of the protection purchaser: at contract inception, the present value of premia paid is balanced by the expected value of default payments. The value of the contract varies with market credit spreads through their concurrent impact on the present value of premia receipts and the expected value of default payments.

Consider a contract $k$ that is established between counterparties $i$ and $j$ at time $t$, on a set of reference entity characteristics $r_k$ and a notional amount of protection $N_k$. Through the use of a bootstrapping procedure to value CDS contracts using the term structure of credit spreads at $t$, we are able to estimate the net present value of the contract (Luo (2005)). The change in value of contract $k$ between successive periods $t$ and $t+1$ determines the variation margin $\text{VM}_{ij}(N_k, r_k, t, t+1)$ payable on the $k$th contract. The sum of changes across all contracts between $i$ and $j$ is the bilateral variation margin

$$\text{VM}_{ij}(t, t+1) = \sum_k \text{VM}_{ij}(N_k, r_k, t, t+1). \tag{9}$$

We estimate the weekly change in contract values, and the induced VM payments, for each pair of firms in our data set over the period January 1, 2010 to October 21, 2016. The term of the firms' CDS contracts come from DTCC while data on credit spreads and discount rates come from Markit and Bloomberg, respectively. Contracts on indices or portfolios of reference entities are handled by disaggregating them into their single-name equivalents. The details of these calculations are described in the Appendix.

## 5.2 Initial Margin

The role of initial margin (IM) is to cover potential shortfall in VM payments by a firm's counterparties, including the cost of closing out or transforming the position in case of default. Initial margins collected from counterparties are held in segregated accounts and can only be used to cover losses induced by a given counterparty's failure to pay. A portion

of the IM is typically held in cash or cash equivalents, and the remainder is held in assets that can be liquidated on short notice but not necessarily at full value. Not all counterparties are required to post IM. For example broker-dealers only need to post IM on contracts with other broker-dealers and the CCP. Other market participants, such as hedge funds and asset managers, need to post IM with broker-dealers, commercial banks, and the CCP but not with each other.

To determine the amount of IM posted (where IM is required) we adopt a conventional portfolio-at-risk measure, namely a 99.5 percent value-at-risk (VaR) with a 10-day margin period of risk (BCBS and IOSCO (2015)). For each pair of firms $i$ and $j$, the DTCC data report the portfolio of CDS contracts for which $i$ and $j$ were the counterparties on the date of the shock. Using Markit data we can infer the price changes, and hence the VM that would have been exchanged between $i$ and $j$, if they had held this same portfolio over the prior 1,000 days. We then find the amount $c_{ij}$ such that on all but five days out of 1,000 the net amount of VM that $i$ owed $j$ was less than $c_{ij}$.

In the case of the CCP, VaR approaches tend to underestimate CCP collateral levels (Duffie et al. (2015); Capponi et al. (2017)). Hence in this case we estimate the IM that would be required to meet a 10-day 99.5 percent VaR bilaterally for each of its counterparties, and then scale up the estimates by a common factor so that the total IM collected corresponds to the CCP's total reported IM at the end of 2014 (ICE (2016)).

## 5.3   Liquidity Buffers

The IM collected by firm $i$ from its counterparties is dedicated to covering shortfalls in payments to $i$ *from* its counterparties; it cannot be accessed to meet $i$'s obligations *to* others. To cover its own obligations the firm maintains a liquidity buffer $b_i$, which includes cash or cash-equivalents and short-term lines of credit. These buffers are not part of the DTCC data, nor are they available from public data sources. Instead we estimate their magnitude by considering how much cash a prudently managed firm would need to manage its *net* VM

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obligations. These numbers can be estimated from the weekly inflows and outflows of VM at the firm level, which are derived from DTCC data as described above.[5]

Fix a firm $i$ and let $X_i(t)$ denote the total net VM payment that $i$ owes to all of its counterparties on a given day $t$. If $X_i(t) > 0$ then $i$ owes more than it is owed; the reverse holds if $X_i(t) < 0$. Let $N_i(t)$ be the gross notional value of $i$'s CDS contracts at time $t$ and let $\tilde{X}_i(t) = X_i(t)/N_i(t)$. There is considerable heterogeneity in the volatility of $\tilde{X}_i(t)$ between different types of firms, reflecting differences in their overall risk management policy and degree of hedging (see Table 1). In particular, the members of the CCP have an average portfolio volatility that is an order of magnitude smaller than the portfolio volatility of non-member commercial banks. Moreover, the latter are less than half as volatile as the holdings of hedge funds, asset managers, and insurance companies.

**Table 1:** Average Portfolio Volatility by Type of Firm

| Firm Type | Standard Deviation |
|---:|:---:|
| Members | 0.0009 |
| Non-members: | |
| *Commercial Banks* | 0.0106 |
| *HF/Asset Managers* | 0.0235 |
| *Insurance & Pensions* | 0.0224 |

*Note*: For each firm we compute the standard deviation of $\tilde{X}_i(t)$ over the period January 1, 2010 to October 21, 2016 using weekly data from DTCC, and take the average of those standard derivations over all firms of a given type.
*Source*: Authors' calculations using data provided by Depository Trust & Clearing Corporation and Markit.

To estimate the size of $i$'s liquidity buffer, we employ a portfolio value-at-risk (VaR) measure. Let $F_i(\tilde{X})$ be the CDF of $\tilde{X}_i$ over the period of observation, and let $\theta$ be a VaR level such as $\theta = 0.99$ or $\theta = 0.997$. In particular, $\theta = 0.99$ corresponds to the third largest net negative change in VM, and $\theta = 0.997$ to the largest net negative change in VM over the period of observation. Let $\tilde{x}_{i,\theta}$ be the value such that $F_i(\tilde{x}_{i,\theta}) = \theta$. At a given date

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[5]Similarly, bank holding companies compute their liquidity coverage ratios by estimating the largest net outflow of funds they would have incurred over a look-back period of several years.

$t^* \in [0, T]$, we estimate $i$'s liquidity buffer to be $b_{i,\theta} = \tilde{x}_{i,\theta} N_i(t^*)$.

In the case of the CCP, we use the actual size of the guarantee fund, reported for the quarter, instead of estimating its liquidity buffer. At the date of this study, ICE Clear Credit's guarantee fund had assets worth about \$2.4 billion (ICE (2016)).

Although the portfolio volatility of CCP members is on average much smaller than that of non-members, the size of their portfolios is so much larger that many of them require higher absolute amounts to manage their VM payments at a given level of risk (see Table 2).

**Table 2:** Average Liquidity Buffer by Type of Firm (in millions of dollars).

| Firm Type | $\theta = 0.95$ | $\theta = 0.99$ | $\theta = 0.997$ |
|---|---|---|---|
| Members | 35.4 | 91.4 | 334 |
| Non-members: | | | |
| *Commercial Banks* | 1.1 | 3.2 | 9.1 |
| *HF/Asset Managers* | 4.0 | 11.0 | 41.0 |
| *Insurance & Pensions* | 5.8 | 13.7 | 34.7 |
| CCP | 2,400 | 2,400 | 2,400 |

*Source*: Authors' calculations using data provided by Depository Trust & Clearing Corporation and Markit.

In what follows we shall adopt the most conservative of these scenarios ($\theta = 0.997$) as our estimate of firms' liquidity buffers.

# 6 VM Payments Induced by the CCAR Shock

The Federal Reserve's 2015 CCAR severely adverse global market trading shock prescribes a sudden widening of credit spreads for corporate, state, municipal, and sovereign debt according to their rating class (Federal Reserve Board (2016)). The shock is applied to all outstanding positions as of October 6, 2014. The change in credit spreads alters the value of the premium and payment legs of CDS contracts that reference various classes of debt. These changes in CDS contract values induce variation margin (VM) payment obligations

between counterparties. The methodology for estimating these VM payments is described in detail in the Appendix.

Figure 5 shows the net VM payment obligations between the CCP, members of the CCP, and other non-member firms on the CCAR shock date.[6] In addition, there are many non-member firms that have positions directly with members, as well as positions with the CCP that are guaranteed by members. There are over 900 such firms, including a wide variety of hedge funds, asset managers, and insurance companies.

Two key features of the network are: (i) non-members tend to owe members rather than each other; (ii) the largest non-members contribute substantially more stress than the largest members because they are large net sellers of CDS protection. These points are highlighted in Table 3, which shows the average VM owed by the top five members versus the average VM owed by the top five commercial banks, the top five hedge funds and asset managers, and the top five insurance companies, ordered by the amount of VM owed. The market structure described here affects the results described in Section 7 in several critical ways. First, liquidity buffers (and additionally for the CCP its default fund) will play critical roles in resolving stress in the network. The exhaustion of such resources for members and the CCP leads to payments contagion. Second, the initial channel for stress are payments due from non-members to members, which in some cases are several times larger than their liquidity buffers.

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[6]For each pair of firms, payments are bilaterally netted, e.g. if A owes B 100 and B owes A 90, then the net payment is 10 from A to B.

[6]The CCP actually has 30 members but the exposures of several of them are aggregated in the data at the bank holding company level, which leads to 26 observable members.

**Figure 5:** Variation Margin Payment Network for CCP Members and a subsample of Non-members, based on the 2015 CCAR Shock.
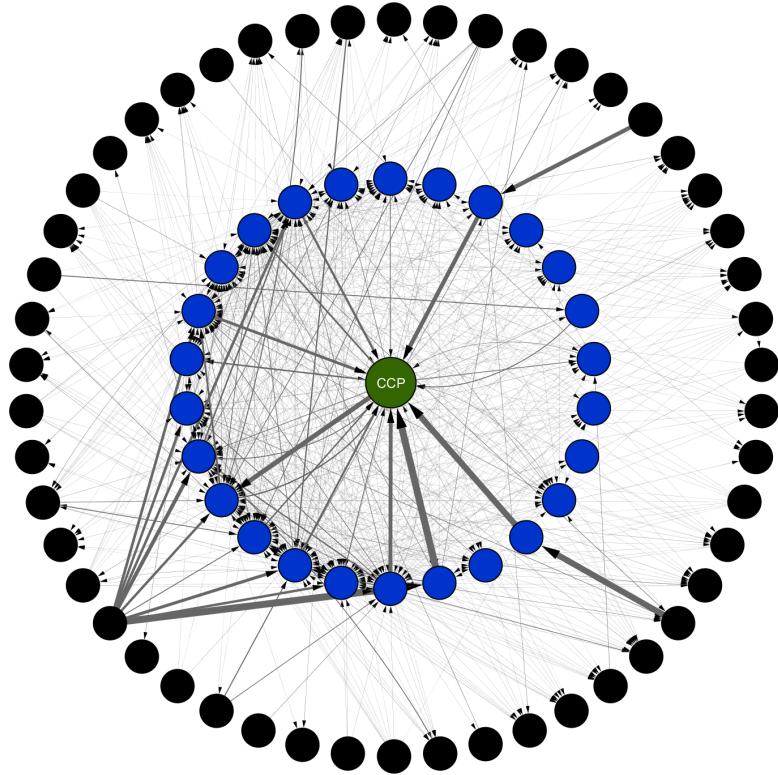


*Note*: The network diagram plots the central counterparty clearing house (CCP) (in green), CCP members (in blue), and a sample of CCP non-members (in black). The width and direction of each arrow indicate the relative size of the net VM payment owed bilaterally between counterparties.
*Source*: Authors' calculations using data provided by Depository Trust & Clearing Corporation and Markit.

**Table 3:** Aggregate Variation Margin Payments under the CCAR Shock

| Firms | Gross Notional Exposure($b) | Variation Margin Owed By($m) | Variation Margin Owed To($m) | Net Variation Margin Owed($m) | Liquidity Buffer($m) |
|---|---|---|---|---|---|
| Top 5 Members | 7,151 | 8,396 | 5,510 | 2,886 | 2,276 |
| Non-members: | | | | | |
| *Top 5 Commercial Banks* | 31 | 268 | 8 | 259 | 80 |
| *Top 5 HF/Asset Managers* | 296 | 9,730 | 263 | 9,466 | 1,742 |
| *Top 5 Insurance & Pensions* | 30 | 557 | 48 | 509 | 184 |
| CCP | 3,344 | 8,747 | 8,747 | - | 2,400 |

*Source*: Authors' calculations using data provided by Depository Trust & Clearing Corporation and Markit.

# 7 Empirical Analysis

We now apply this framework to estimate the total amount of contagion that would be produced by a large and sudden credit shock, as well as the amount that each individual firm contributes to contagion at the margin. Define the *impact* of a credit shock to be the total shortfall in VM payments, net of initial margin seized, over all pairs of counterparties in the network. Specifically, if $p_{ij}$ is the equilibrium payment from $i$ to $j$, then the *payment shortfall* from $i$ to $j$ is $d_{ij} = (\bar{p}_{ij} - p_{ij} - c_{ij})_+$, and the total shortfall is

$$D = \sum_{1 \leq i,j \leq n} d_{ij}. \tag{10}$$

An alternative measure of impact is the *proportion* of firms who default on their payments. We provide estimates of both measures of impact in the subsequent analysis, although our preferred measure is (10) because it accounts for the magnitude, and not just the number, of defaults.

Table 4 shows the percentage of firms in default in each of five categories: (i) CCP members (broker-dealers), (ii) commercial banks, (iii) hedge funds and asset managers, (iv) insurance companies and pension funds, and (v) the CCP itself. Over the entire population of firms, 15 percent are in default under the soft default scenario and 17 percent under the hard default scenario. Thus, there is surprisingly little difference between the two scenarios in the overall number of firms that default, although there is a marked increase in the number of *members* that default.

Table 5 shows the aggregate payment shortfall for each type of firm. Observe first that the CCP does not default under either scenario, although it must dip into its guarantee fund in order to meet its payment obligations. A notable difference between the two scenarios is that under hard default the members' payment shortfalls are more than seven times larger than under soft default; moreover in the hard default case these shortfalls represent over half the total shortfall of all firms.

**Table 4:** Percentage of Firms with Payment Shortfall under the 2015 CCAR Shock

|  | Soft Default | Hard Default |
|---|---|---|
| Total | 15 | 17 |
| Members | 35 | 58 |
| Non-members: | | |
| *Commercial Banks* | 24 | 29 |
| *HF/Asset Managers* | 12 | 13 |
| *Insurance & Pensions* | 19 | 26 |
| CCP | 0.0 | 0.0 |

*Source*: Authors' calculations using data provided by Depository Trust & Clearing Corporation and Markit.

**Table 5:** Initial Stress and Equilibrium Payment Shortfall under the 2015 CCAR Shock

|  | Initial Stress | Soft Default | SD Amplification | Hard Default | HD Amplification |
|---|---|---|---|---|---|
| Total | 9,985 | 11,215 | 1.12 | 27,112 | 2.72 |
| Members | 812 | 2,004 | 2.46 | 15,285 | 18.82 |
| Non-members: | | | | | |
| *Commercial Banks* | 244 | 246 | 1.01 | 432 | 1.77 |
| *HF/Asset Managers* | 8,577 | 8,602 | 1.00 | 11,292 | 1.32 |
| *Insurance & Pensions* | 334 | 345 | 1.04 | 968 | 2.90 |
| CCP | - | - | - | - | - |

*Source*: Authors' calculations using data provided by Depository Trust & Clearing Corporation and Markit.

Table 5 also clarifies the extent to which network spillover effects amplify the initial shock. Recall from expression (2) that the initial stress to a firm's balance sheet is the amount of outgoing payments due, less the incoming payments due plus the firm's liquidity buffer. These figures are given in the first column of Table 5. In equilibrium, however, the incoming payments are often less than the payments due, which increases balance sheet stress. The ratio of equilibrium stress to initial stress is the *amplification factor* due to network effects. Observe that the amplification factor is especially large for the CCP members. There are two reasons for this effect: (i) members have fairly balanced initial positions, so their initial stress is low relative to the extent of their exposure, and (ii) members are central to the network and hence are particularly vulnerable to waves of defaults that cascade through the network and inundate them with payment shortfalls by their counterparties.

The model can also be used to assess the amount that individual firms contribute to contagion at the margin. Given a default scenario (hard or soft), let $D = \sum_{1 \leq i,j \leq n} d_{ij}$ be the total shortfall in payments summed over all firms. Now choose a particular firm $i$ and suppose (hypothetically) that its payment obligations to all counterparties could be guaranteed, say by giving $i$ access to an emergency central bank loan. Let $D_i$ be the total payment shortfalls over all firms in the network under this scenario. We define $i$'s *marginal contribution to contagion* to be the relative difference $(D - D_i)/D$, that is, the percentage by which total payment shortfalls are reduced when $i$'s payments are guaranteed.

**Figure 6:** Distribution of Firms' Marginal Contributions to Contagion
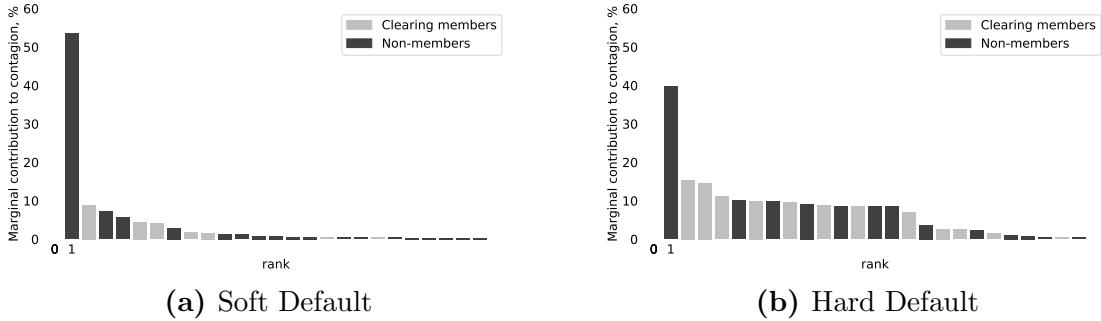


**(a)** Soft Default        **(b)** Hard Default

*Source*: Authors' calculations using data provided by Depository Trust & Clearing Corporation and Markit.

Figure 6 shows the marginal contribution of the largest contributors to contagion under hard and soft default. In both cases, the largest single contributor to contagion is an asset manager that is a large net seller of protection. Under the CCAR shock this firm owes much more than its is owed, and the resulting shortfall in payments to its counterparties triggers contagion throughout the system. Figure 6 demonstrates that if this firm's obligations could be guaranteed, total payment shortfalls would be greatly reduced under either soft or hard default.[7] Figure 6 also shows that several clearing members each contribute over 10% to systemic risk in the hard default scenario. These firms have fairly balanced portfolios, but

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[7]It is an interesting fact that, although this firm triggers a great deal of contagion in the system, its initial stress is very nearly the same as its final equilibrium stress, that is, the stress at this particular firm is not greatly amplified. The reason is that it is relatively peripheral to the network and does not suffer much in the way of payment shortfalls by its counterparties.

unlike the large asset manager they are quite central to the network and therefore amplify payment defaults by their counterparties.

Our framework can also be used to evaluate the effectiveness of tightening initial margin requirements or increasing firms' liquidity buffers. Table 6 shows the total amount of initial margin posted by all firms under the standards prevailing in 2015. We conduct a sensitivity analysis by computing the equilibrium payments shortfall that would result if all IM requirements were boosted by 50 percent or by 100 percent.[8] In the soft default scenario the impact of doubling IM requirements is quite small, whether measured by the reduction in payment shortfall ($0.8 billion) or by the number of firms in default (0.1 percent). In the hard default scenario the impact is still relatively moderate. When IM is doubled the shortfall is reduced by $2.8 billion, but this comes at a system-wide cost of posting an additional $20.2 billion in collateral; moreover the percentage of firms in default is only reduced by 0.2 percent.

**Table 6:** Payment Shortfall and Firms in Default under Increased Initial Margins

|  | Total Initial | Soft Default | | Hard Default | |
|---|---|---|---|---|---|
|  | Margin($b) | Shortfall($b) | Firms in Default(%) | Shortfall($b) | Firms in Default(%) |
| Current | 20.3 | 11.1 | 14.7 | 27.1 | 16.8 |
| Plus 50% | 30.4 | 10.7 | 14.6 | 25.6 | 16.7 |
| Plus 100% | 40.5 | 10.3 | 14.6 | 24.3 | 16.6 |

*Source*: Authors' calculations using data provided by Depository Trust & Clearing Corporation and Markit.

We now conduct a similar analysis for increases in liquidity buffers. In theory each dollar added to a firm's liquidity buffer should go further than a dollar of additional IM posted to one of its counterparties, because the former can be applied to all of its payment obligations, whereas the latter can only be applied to payments to that particular counterparty. Table 7 shows the impact of increasing liquidity buffers at all firms (and the CCP's guarantee fund) by 50 percent and also by 100 percent. Note that the absolute dollar amounts are roughly twice that of the corresponding increases in IM in Table 6.

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[8]Since the CCP does not post IM to anyone, its posted margin is not affected. However members' posted margin to the CCP is increased by 50 percent and 100 percent, so the CCP *collects* more IM.

**Table 7:** Payment Shortfall and Firms in Default under Increased Liquidity Buffers

| | Total Liquidity | Soft Default | | Hard Default | |
|---|---|---|---|---|---|
| | Buffer($b) | Shortfall($b) | Firms in Default(%) | Shortfall($b) | Firms in Default(%) |
| Current | 42.1 | 11.1 | 14.7 | 27.1 | 16.8 |
| Plus 50% | 63.7 | 8.6 | 11.4 | 24.1 | 12.4 |
| Plus 100% | 84.2 | 7.0 | 9.0 | 21.3 | 9.3 |

*Source*: Authors' calculations using data provided by Depository Trust & Clearing Corporation and Markit.

In the soft default scenario the shortfall is reduced by about $4.1 billion when liquidity buffers are doubled. In the hard default scenario the shortfall is reduced by about $5.8 billion. Thus, on a dollar for dollar basis, there is not much difference in the effectiveness of liquidity buffers versus initial margin in reducing the shortfall.[9] Moreover, in both cases the benefit (in reduced shortfall) is quite modest given the large amount of additional liquid collateral that would be required.

What is the explanation for this somewhat surprising result? It turns out that, even when liquidity buffers are doubled, there is still one non-member firm that is under severe stress and triggers a great deal of contagion; moreover there are still several members that amplify contagion due to their central position in the network. The basic problem is that even when liquidity buffers are set at a very high level, they may be insufficient to handle extreme tail events (such as CCAR) and their network spillover effects. Whether this warrants an increase in liquidity buffers (or initial margins) is for policy makers to decide, but our results suggest that the adequacy of these safety valves can only be fully evaluated by constructing stress tests within the framework of a network model.

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[9]Doubling of IM "costs" an additional $20.2 billion in collateral and "saves" $2.8 billion in reduced contagion, whereas a doubling of liquidity buffers costs an additional $42.1 billion and saves $5.8 billion. These results are nearly identical on a dollar for dollar basis.

# 8   Conclusion

In this paper, we have analyzed the network of counterparty exposures in the CDS market. In contrast to much of the prior work on stress testing, contagion, and fire sales, we track the potential effects of a shock using actual financial exposures and the Federal Reserve's supervisory stress scenario as of a particular date. We estimate the impact of the shock on the value of market participants' portfolios, and by implication the variation margin (VM) owed between the contracting parties. A significant feature of this market is that demands for VM must be met over very short time horizons. A failure to meet these demands leads to payment shortfalls that become amplified as they cascade through the network.

We have examined the potential contribution to network contagion of the 30 members of the major CCP in this market (ICE Clear Credit), and also the potential contribution of the major non-members. We find that network exposures significantly increase the amount of contagion. Furthermore there are many members (and some non-members) that contribute substantially more to contagion than does the CCP. Our analysis suggests that more attention should be paid to firms that are very large, have highly unbalanced CDS positions, and whose failure can trigger large systemic losses, as happened with AIG in 2008. It also highlights the key role of initial margin and liquidity buffers in coping with large and sudden demands for variation margin that result from a credit shock.

Our study is limited to the analysis of a specific part of the derivatives market and does not encompass the full range of shocks to which firms may be exposed. In particular, we have not included exposures to interest rate swaps, which form a substantially larger market (in notional terms) than the CDS market, but which are not part of our data set. Under a severe credit shock, firms may be subjected to simultaneous payment demands over multiple lines of business, increasing the stress on their resources and possibly leading to even higher losses than we have estimated here.

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# Appendix – Evaluating CDS Portfolios

Here we describe the methodology for estimating the mark-to-market value of each counterparty's exposures at a given date for both single-name and index positions. We describe a bootstrap procedure to generate a schedule of hazard rates consistent with the market for all traded credit curves. We then describe the process of index disaggregation to single-name equivalents. Finally, we describe how we arrive at expressions for variation margin payments under stress.

## A.1 Bootstrapping Credit Curves

We calibrate hazard rate schedules associated with each of the reference entities in the contracts we observe. The CDS market quotes credit spreads through a range of standard terms: 1-year, 3-year, 5-year, 7-year, and 10-year, and sometimes longer maturities. Each additional term generates a hazard rate over a corresponding increment: the 3-year term generates a 1-3 year increment, the 5-year term generates a 3-5 year increment, and so on through 10 years. The bootstrapping technique we employ here generates a piecewise constant schedule of hazard rates. A CDS contract struck at inception at the market spread for a standard maturity, and valued using the schedule of hazard rates through that maturity, will have equal default and premium legs. Bootstrapping permits us to value any position whose remaining maturity at the time of stress may not correspond to market-quoted maturities.

The CDS payment and premium legs are implicit functions of a hazard rate, $\lambda$, which enters the expression for the survival probability $S(0, t, \lambda)$ through its definition as $exp\left(-\int_t^u \lambda ds\right)$. Let $Z(0, t_i)$ denote the risk-free discount factor through period $i$, which we compute from LIBOR rates from 1 through 6 months and swap rates from 9 months through 30 years. We assume CDS premia are paid on International Money Market (IMM) payment dates, consistent with market convention. Finally, to allow for the possibility that a default occurs intra-period, CDS premia are pro-rated to the time of default. For simplicity assume

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that $\alpha = 0.5$ (i.e., that any default occurs at the inter-period halfway point). In subsequent notation, $\Delta_t$ represents the daycount fraction for the time interval $(t - 1, t)$ such that $\sum_{t=1}^{T} \Delta_t = T$. We use the ACT/365 convention standard in the CDS market.

We express the CDS premium leg through maturity $T$ as follows:

$$V_{prem}^{0 \to T}(\lambda, \ s_T) = s_T \sum_{t=1}^{T} Z(0,t)\Delta_t \left((1 - \alpha)S(0,t) + \alpha S(0, t - 1)\right). \tag{A1}$$

In any period, the payment leg derives its value from the incremental default probability over that time. Given the relationship between the default probability $P(t, u, \lambda)$ and the survival probability $S(t, u, \lambda)$, $S(t, u, \lambda) = 1 - P(t, u, \lambda)$, we express the payment leg as follows:

$$V_{pay}^{0 \to T}(\lambda) = (1 - R) \sum_{t=1}^{T} Z(0,t) \left(P(0,t) - P(0, t - 1)\right). \tag{A2}$$

Let $\lambda^*$ be the solution that sets the CDS payment and premia legs to fair value (equality) at inception, that is $V_{contract}^{0 \to T}(\lambda^*, \ s_T) = V_{pay}^{0 \to T}(\lambda) - V_{prem}^{0 \to T}(\lambda, \ s_T) = 0$.

Credit spreads are quoted for a sequence of maturities $T_1$, $T_2$, ... $T_k$. Quotes consistent across the term structure require that for each $T_i \geq T$, a vector of hazard rates $\boldsymbol{\lambda}^* = \{\lambda_{0,T_i}^*, \lambda_{T_i,T_{i+k}}^*\}$ exists such that $V_{contract}^{0 \to T_{i+k}}(\boldsymbol{\lambda}^*, \ s_{T_{i+k}}) = V_{contract}^{0 \to T_i}(\lambda_{0,T_i}^*, \ s_{T_{i+k}}) + V_{contract}^{T_i \to T_{i+k}}(\lambda_{T_i,T_{i+k}}^*, \ s_{T_{i+k}})$ for all $k$. We adopt a bootstrap procedure from Luo (2005) that ensures this by construction. The procedure generates hazard rates $\left\{\lambda_{0,T_1}^*, \ \lambda_{T_1,T_2}^*, \ ... \lambda_{T_{k-1},T_k}^*\right\}$ that correspond to quoted maturities of $\{T_1, T_2, ... T_k\}$. The default probability at any time $t$ such that $T_k \leq t \leq T_m$, can be expressed as a function of bootstrapped hazard rates as follows:

$$P(0, t, \boldsymbol{\lambda}^*) = P(0, T_k, \lambda_{0,T_k}^*)P(T_k, t, \lambda_{T_k,T_m}^*). \tag{A3}$$

For notational convenience we will refer to $P(0, t, \boldsymbol{\lambda}^*)$ from here on as $P(t)$. We make the simplifying assumption that maturity dates fall upon IMM payment dates. We start from the premise that $\boldsymbol{\lambda}_{0,T_k}^*$ is known and is either a) the solution that equates (A1) and (A2), or

b) is the bootstrapped solution vector described by the preceding recursive procedure. The parameters $s_{T_m}$ are derived from market quotes. The conditional premia and payment legs are given as follows:

$$V_{prem}^{0 \to T_m}(\lambda_{T_k,T_m};\ s_{T_m},\ \boldsymbol{\lambda^*_{0,T_k}}) = s_{T_m}\Bigg\{ C(\boldsymbol{\lambda^*_{0,T_k}}) + D(\lambda_{T_k,T_m})$$
$$- \sum_{t=T_k+1}^{T_m} Z(0,t)\Delta_t\bigg( P(t) - P(T_k) - \alpha\frac{P(t) - P(t-1)}{2} \bigg)\Bigg\}, \tag{A4}$$

where

$$C(\boldsymbol{\lambda^*_{0,T_k}}) = \sum_{\substack{(T_i,T_j)\in \\ \{(0,T_1)... \\ (T_{k-1},T_k)\}}} \sum_{t=T_i}^{T_j} Z(0,t)\Delta_t\bigg[ (1 - P(t)) + \alpha\frac{(P(t) - P(t-1))}{2} \bigg],$$

$$D(\lambda_{T_k,T_m}) = \sum_{t=T_k}^{T_m} Z(0,t)\Delta_t(1 - P(T_k)).$$

Similarly,

$$V_{pay}^{0 \to T_m}(\lambda_{T_k,T_m};\ \boldsymbol{\lambda^*_{0,T_k}}) = A(\boldsymbol{\lambda^*_{0,T_k}}) + \sum_{t=T_k+1}^{T_m} (1 - R)Z(0,t)\bigg( P(t) - P(t-1) \bigg), \tag{A5}$$

where

$$A(\boldsymbol{\lambda^*_{0,T_k}}) = \sum_{\substack{(T_i,T_j)\in \\ \{(0,T_1)... \\ (T_{k-1},T_k)\}}} \sum_{t=T_i}^{T_j} (1 - R)Z(0,t)\left( P(t) - P(t-1) \right).$$

Here $\lambda^*_{T_k,T_m}$ is the value that sets Equations (A4) and (A5) to parity. Once this value is determined, the hazard rate vector $\boldsymbol{\lambda^*_{0,T_m}}$ can be derived for subsequent stages of the bootstrap recursion. The resulting bootstrapped hazard rate schedule allows us to value

a contract of any term by applying its contracted spread and the hazard rate schedule associated with its term.

## A.2 Portfolios of Single Name Equivalents

We disaggregate Markit credit indices to single-name constituents. For each position referencing a Markit credit index, we decompose the index using *Markit RED* data. This source provides the composition of the index at any point in time, taking into account index revisions and defaults. We employ the disaggregation technique described by Siriwardane (2015) in Section 2.

Each Markit credit index is described by its series and version. A series may have one or more versions. An index series factor, $f_i$ is defined for every version $i$ as $f_i = 1 - \frac{D_i}{N}$, where $D_i$ is the number of defaults for an index series version $i \in \{1, 2, 3 \ldots\}$. Version 1 is characterized by $D_1 = 0$, so $f_1 = 1$. The weight of a constituent within a version must be computed on a given valuation date and is a function of the index composition on the date the position was established (trade date). In general, the index composition at the trade date may not be its composition at inception. The constituent $u$'s weight in index version $i$ can be expressed by $w_i(u)$, and its weight at inception is given as $w_1(u) = \frac{1}{N}$. Subsequent versions' weights are given by

$$w_i(u) = \frac{w_1(u)}{f_i} \quad \forall \ i \geq 1. \tag{A6}$$

As an example, an index with 43 original constituents at inception would have a per-constituent weight of $w_1(u) = \frac{\frac{1}{43}}{1} = 0.0233$. Following the default of one constituent, version 2 of the index would have a per-constituent weight of $w_2(u) = \frac{\frac{1}{43}}{0.977} = 0.0238$. The per-constituent weight is scaled by the notional value of the index position to arrive at the effective single-name notional equivalent. We perform all calculations in this paper on firms' single-name equivalent CDS positions.

## A.3 Estimating Variation Margin

At the CCAR valuation date, we generate stressed portfolio values using the following approach. The change in the value of exposures under stress follows from their valuation at baseline and revaluation after the market shock, which specifies an increase in credit spreads. These increases are shown in Table A1 for various classes of debt.

**Table A1:** The Impact of the 2015 CCAR Severely Adverse Global Market Trading Shock.

| | Corporate Credit | | | | | | |
|---|---|---|---|---|---|---|---|
| | *Advanced Economies* | | | | | | |
| | AAA | AA | A | BBB | BB | B | <B or Not Rated |
| Spread Widening (%) | 130 | 133 | 110 | 202 | 269 | 265 | 265 |
| | *Emerging Markets* | | | | | | |
| | AAA | AA | A | BBB | BB | B | <B or Not Rated |
| Spread Widening (%) | 192 | 217 | 243 | 278 | 402 | 436 | 466 |

| | State & Municipal Credit | | | | | | |
|---|---|---|---|---|---|---|---|
| | AAA | AA | A | BBB | BB | B | <B or Not Rated |
| Spread Widening (bps) | 12 | 17 | 37 | 158 | 236 | 315 | 393 |

| Sovereign & Supra Credit |
|---|
| See FRB worksheet: CCAR-2015-Severely-Adverse-Market-Shocks-data.xlsx |

*Source*: Federal Reserve Board (2016)

We incorporate counterparty flows in the description of the net present value (NPV) as follows. Suppose that firm $x$ writes the payment leg, while firm $y$ writes the premium leg. Incorporating such flows and suppressing some earlier notation, we express $V_{prem}^{0 \to T}(\lambda_m{}^*;\ s,\ \boldsymbol{\lambda_{m-1}}^*)$ as $V_x^{prem}(\boldsymbol{\lambda}; s,\ T)$ and similarly the payment leg as $V_y^{pay}(\boldsymbol{\lambda},\ T_m)$. The hazard rate environment that exists at valuation date $t$ is given by $\boldsymbol{\lambda^t}$. Analogously, the environment at $t$ under stress is $\boldsymbol{\lambda^{shock}}$.

The NPV of a swap of \$$N$ notional on the as-of-date $T$ is defined as follows:

$$NPV_{xy}(N,\ \boldsymbol{\lambda^T},\ s,\ T) = N\left[V_x^{prem}(\boldsymbol{\lambda^T};\ s,\ T) - V_y^{pay}(\boldsymbol{\lambda^T},\ T)\right]. \tag{A7}$$

Similarly, the NPV of the swap under stress is:

$$NPV_{xy}(N, \boldsymbol{\lambda}^{shock}, s, T) = N \left[ V_x^{prem}(\boldsymbol{\lambda}^{shock}, s, T) - V_y^{pay}(\boldsymbol{\lambda}^{shock}, T) \right]. \qquad \text{(A8)}$$

The difference between these values determines the shock-induced variation margin payment due from $x$ to $y$ for each contract, from which we deduce the net payment due by summing over all contracts between the two parties.