



Counterparty risk externality: Centralized versus over-the-counter markets [☆]

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Abstract

We study financial markets where agents share risks, but have incentives to default and their financial positions might not be transparent, that is, might not be mutually observable. We show that a lack of position transparency results in a *counterparty risk externality*, that manifests itself in the form of excess “leverage,” in that parties take on short positions that lead to levels of default risk that are higher than Pareto efficient ones. This externality is absent when trading is organized via a centralized clearing mechanism that provides transparency of trade positions. Collateral requirements and especially subordination of non-transparent positions in bankruptcy can ameliorate the counterparty risk externality in market settings such as over-the-counter (OTC) markets which feature a lack of position transparency.

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