Netting Relationships and Credit Exposures in Payments Systems

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First Version: January 27, 2017
This Version: August 22, 2018

Abstract

We develop an empirical methodology to characterize intraday netting relationships and assess their effect on credit exposures, collateral requirements, and the expected shortfall of operational disruptions. Our methodology is developed in the context of an interbank payment system, which allows us to jointly assess critical features of the financial system that are usually analysed in isolation. We use data from the Canadian Large Value Transfer System (LVTS) and take advantage of its peculiar configuration to gain insights into market participants' preferences between survivor-pay and defaulter-pay arrangements that mimic traditional collateral and capital requirements used extensively in the financial system and in the banking literature. Our results show that netting relationships are determined by the ability of market participants to coordinate the issuance of new credit obligations. Coordination increases when participants are not constrained to issue new obligations. When some participants are constrained, the netting capacity of the entire market decreases. We conclude that operational or market-based disruptions to the marginal netting process could restrict the flow of credit obligations and compromise the ability of a central counterparty to manage credit risks efficiently.

JEL Classification: G20, G28
Keywords: Payment Systems, Netting, Credit Risk, Collateral, Operational Risk.

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Acknowledgements: We thank Payments Canada for providing us with the data used for this paper. We appreciate the feedback and support provided by Francisco Rivadeneira and Antonio Diez de los Rios. We also thank Cyril Monnet, Haoxiang Zhu and seminar attendees at the Bank for International Settlements, Simon Fraser University, University of Ottawa, VU University Amsterdam, as well as participants of the 51st Annual Conference of the Canadian Economics Association, the 4th Joint Bank of Canada and Payments Canada Workshop, and the 2018 2018 Summer Workshop on Money, Banking, Payments and Finance at the Federal Reserve Bank of S. Louis for their valuable comments.

Disclaimer: The views presented in this paper are those of the authors and do not necessarily represent those of the Bank of Canada or the University of Illinois at Urbana-Champaign.