Faculti Summary
https://faculti.net/the-cost-of-clearing-fragmentation/

This video video is a transcript from a presentation discussing central clearing, particularly of over-the-counter (OTC) derivatives, as a response to the financial crisis of 2008-2009. The speaker emphasizes the importance of a disclaimer that the views expressed do not necessarily represent their affiliated policy institutions. Centralized clearing requires market participants to use Central Counterparties (CCPs) to collateralize their derivatives transactions, addressing a significant under-collateralization issue (around $3 trillion) that was observed before the crisis.

Over the years, centralized clearing has gained traction, with major growth in interest rate and credit derivatives volumes. A key aspect of centralized clearing is its facilitation of multilateral netting, which reduces collateral needs, especially beneficial for swap dealers who often have balanced cross positions.

The speaker highlights challenges when clearing is fragmented, such as when similar derivatives contracts are cleared by different houses across jurisdictions, making netting difficult and increasing collateral costs. As a result, dealers might pass these extra costs onto customers, leading to price discrepancies—often termed a "CCP basis"—where identical contracts trade at different prices in different markets.

The discussion references several academic papers that explore these themes, noting the economic significance of the observed price differentials, which, despite being just 1-3 basis points, can translate to substantial daily costs (around $80 million) over large volumes.

The overall conclusion stresses that maintaining centralized clearing in a concentrated manner is vital for economic efficiency, as fragmentation leads to higher collateral costs that can detrimentally affect end users in financial markets.