

Discussion of “OTC Intermediaries”
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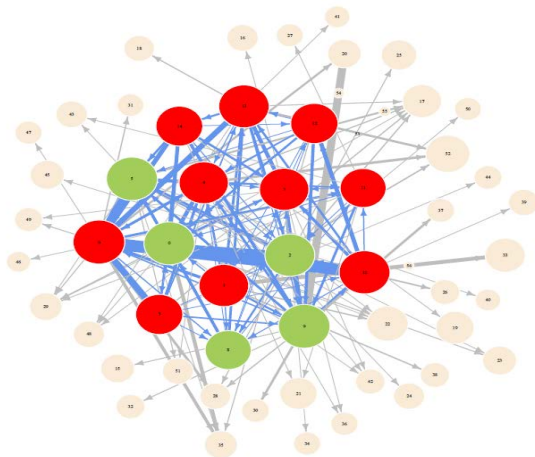
How do network frictions affect spreads & risk allocations in an OTC CDS market?

- Document facts about OTC CDS markets
 - Core periphery structure: 14 dealers core
 - On average dealer sell insurance against default
 - Driven by only a few dealers
 - Dealer-dealer spreads < Dealer-customer spreads
- Calibrated static core-periphery trading network model
- Results from calibrated model
 - Complete network: possb avg. CDS price = pf risk-sharing
 - $\bar{R}^d < \bar{R}^c < \bar{R}^{\text{no frictions}}$ to compensate cparty risk-aversion
 - Effect from dealer removal depends on distribution of risk-bearing capacity

Core Periphery Network

Brunnermeier et al 2013

Figure 8: A "15 x 10" approach to identifying systemic players



Sources: DTCC, ESRB calculations.

Model

- agg. default shock - CDS contract trades exposures
- exog. core-periphery network w/ random counterparty risk
- ex-ante default exp. proxy for risk-bearing capacity
- Risk aversion increases risk-sharing motive - increases willingness to trade
- Counterparty risk aversion decreases willingness to trade
- Calibration
Back out risk-aversion, counterparty risk-aversion & $\bar{R}^{\text{no frictions}}$ from spreads, # dealers, avg dealer exposure

Removal of dealer

- Dealers w/ less ex-ante exposure are highest net-sellers
- Removal of large net seller dealer
 - (1) reduces network's risk-bearing capacity
 - (2) reduces counter-party exposure
- Both effects increase spreads
- Net-dealer exposure becomes net-buyers

Discussion

(1) Understanding the mechanism

(2) Monopoly rents

Understanding the mechanism

- Removal of largest net-seller lowers effective counter-party exposure & risk-bearing capacity
- Reduction in effective counter-party exposure could be interpreted as a good thing
- Reduction in risk-bearing not
- Both effects drive prices up
- What is quantitatively the driving force?
- Decompose the price increase coming from reduction in counterparty risk-exposure through reduction in concentration & reduction in risk-bearing capacity
- Example: start initial exposure distribution not at empirical but at uniform over dealers vs shock to risk-bearing capacity

Effects of Market Power in Core-Network

- Core dealers earn bid-ask spread
Here interpreted as reflection of risk-bearing capacity
Alternative: monopoly rent
- Matters for interpretation: e.g. core with large market power
removal of dealer may increase spreads because market power
of remaining dealers increases
- Anecdotal: dealers averse to structural changes that would
have limited their ability to extract rents

Policy implications

- Should we restrict or encourage concentrated market positions?
- Which network structure is optimal? And which tool might help us to move there (e.g. leverage constraints?)
 - Can you compute welfare for each experiment?

In sum

- Cool paper on important question w/ impressive empirical work in the background
- More clarity on mechanism and quantitative effects would be helpful