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
  - $\bar{R}^d < \bar{R}^c < \bar{R}^{no\; frictions}$ to compensate cparty risk-aversion
  - Effect from dealer removal depends on distribution of risk-bearing capacity
Figure 8: A “15 x 10” approach to identifying systemic players

Sources: DTCC, ESRB calculations.

Overall, the chart gives a concise description of the network structure, indicating that the network is quite concentrated. Among the core traders, a large majority (ten) has in aggregate a net selling position. Many of the second-tier counterparties have links to several of the top-15 entities. Furthermore, the top 15 have large net exposures among themselves (multilateral netting is considered at the reference entity level).

Overall, a key result is the significant impact of the characteristics of the underlying bond exposure (size, collateralisation) and of the risk characteristics of the CDS (volatility, commonality in returns) on the CDS market size and activity. Whereas the distinction between sovereign and financial reference entities matters for the network structure, there are almost no significant differences in structural properties between European and non-European reference entities. Concentration, on the other hand, is largely explained by proxies for a CDS contract’s activity and beta.

In sum, the CDS network displays properties of a scale-free structure with a small-world characteristic.

The financial stability implications are the following: first, such a structure strongly correlates with network resilience to failure. In effect, if failures occur randomly and the vast majority
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