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Managing Counterparty Risk in Over-the-counter Markets

We study how banks manage their default risk before bilaterally negotiating the quantities and prices of over-the-counter (OTC) contracts resembling credit default swaps (CDSs). We show that the costly actions exerted by banks to reduce their default probabilities are not socially optimal. Depending on the imposed trade size limits, risk-management costs and sellers' bargaining power, banks may switch from choosing default risk levels above the social optimum to reducing them even below the social optimum. We use a unique and comprehensive data set of bilateral exposures from the CDS market to test the main model implications on the OTC market structure: (i) intermediation is done by low-risk banks with medium credit exposure; (ii) all banks with high credit exposures are net buyers of CDSs, and low-risk banks with low credit exposures are the main net sellers; and (iii) heterogeneity in post-trade credit exposures is higher for riskier banks and smaller for safer banks. The talk is based on joint work with Agostino Capponi (Columbia University) and Celso Brunetti (Federal Reserve Board).