

Over-the-Counter Financial Markets

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The ongoing financial crisis poses serious challenges to the frictionless market paradigm which assumes that supply and demand shocks to capital have a trivial effect on security prices. Illiquidity, opacity, segmentation, and other financial intermediation frictions have been of first-order importance for financial asset prices and corporate financing during recent years. Financial intermediaries have been found to play a more significant economic role than previously recognized. Yet, the impact of financial market design and the role of the financial intermediation sector on the pricing of financial assets and financial decision making have largely been unexplored. More than 40% of financial securities, including corporate, municipal, and agency debt and, in addition, many derivatives are traded in over-the-counter (OTC) financial markets. Trading in OTC markets occurs through decentralized and opaque networks of financial intermediaries. Despite its prominence and importance, little is known about the functioning of these markets and the advantages and disadvantages to centralized exchanges. This project aims to fill this void by studying various aspects using both theoretical and empirical methods.

One of the main goals of this research project is to study the functioning of existing OTC financial markets and the interrelation between financial market structure, liquidity, and asset price formation. The research project will address the above mentioned questions in a sequence of sub-projects. In the empirical parts of the research project, we employ previously unavailable proprietary data on dealer identities and dealer positions in the US corporate and municipal bond markets-two of the major OTC financial markets.

The ultimate objective of this line of research is to inform market participants and policy makers on the tradeoffs associated with existing market structures and the optimal financial market design as a function of the financial products' characteristics. The research is particularly relevant for policy makers and the general public in light of the recent financial and economic crisis and various regulatory initiatives in Europe (MiFID I & II) and the US (Dodd-Frank).

Research Team

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Fields of Research

Capital Markets

Financial Institutions

Financial Regulation