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Does Dodd-Frank affect OTC transaction costs and liquidity? Evidence from real-time CDS trade reports[☆]

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ABSTRACT

This paper examines transaction costs and liquidity in the index CDS market by matching intraday quotes to real-time trade reports made available through the Dodd-Frank reforms. We find that the average relative effective spread is 0.27% of price level or 2.73% of CDS spread. Dodd-Frank does affect transaction costs and liquidity. Liquidity improves after the commencement of public dissemination of OTC derivatives trades. Moreover, cleared trades, trades executed on exchange-like venues, end-user trades, and bespoke trades exhibit lower trading costs, price impact, and price dispersion. These findings improve our understanding of the OTC derivatives market that is undergoing fundamental changes.

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1. Introduction

The cost of trading is a market friction that is of interest to academics, investors, and regulators. Studies have shown that trading costs affect asset prices in a variety of financial markets.² Investors incur trading costs when establishing and liquidating their asset positions, and such costs diminish portfolio value. Regulators are concerned

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² The literature on the relation between trading costs and asset prices covers various markets including the stock market (e.g., Amihud and Mendelson, 1986; Acharya and Pedersen, 2005), the bond market (e.g., Amihud and Mendelson, 1991; Friewald, Jankowitsch, and Subrahmanyam, 2012), and the derivatives market (e.g., Brenner, Eldor, and Hauser, 2001; Deuskar, Gupta, and Subrahmanyam, 2011). See Amihud, Mendelson, and Pedersen (2005) for a survey of this literature.

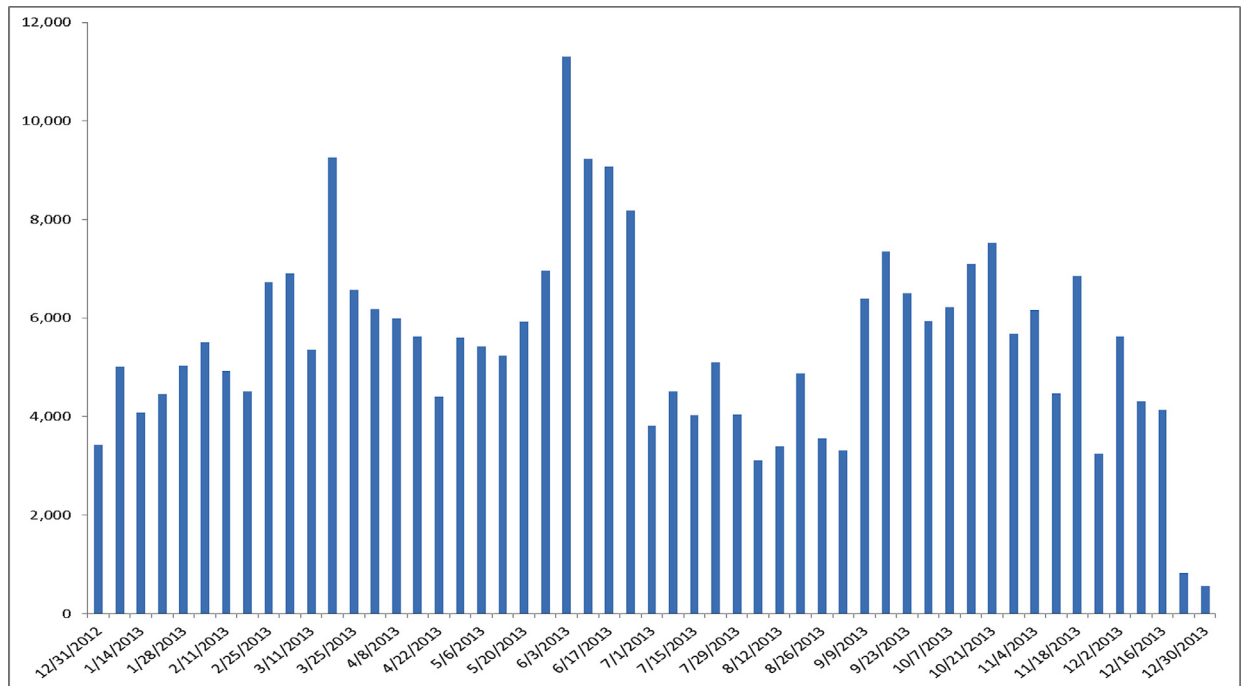


Fig. 1. Weekly credit derivatives trades from DDR reports. This figure presents the weekly number of credit derivatives trades executed between December 31, 2012 and December 31, 2013 and publicly disseminated by DTCC Data Repository (U.S.) LLC (DDR). The sample includes a total of 289,505 trades, of which 267,549 are index CDS trades.

with the functioning of financial markets, and trading costs are important gauges of the ease with which market participants can transact with each other. Furthermore, trading costs and liquidity are linked to systemic risk. A distressed financial institution that conducts a fire sale of securities in an illiquid market with high trading costs can drive significant price declines, which in turn threaten the solvency of other institutions holding the same securities. These compelling reasons notwithstanding, research on the transaction costs and liquidity of the over-the-counter (OTC) derivatives market has been limited, largely due to the lack of publicly available transaction data. In this paper, using real-time trade reports made available by post-financial crisis reforms, we examine the trading costs and liquidity of index credit default swaps (CDSs), an important class of OTC derivatives.³ More importantly, the richness of the disseminated trade reports allows us to analyze how different aspects of regulatory reforms are changing the landscape and thus, the liquidity of the once opaque OTC derivatives market.

As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Commodity Futures Trading Commission (CFTC) implemented mandatory real-time reporting and public dissemination of OTC swap trades on December 31, 2012. Swap transactions have to be reported

to a recordkeeping facility, known as a swap data repository (SDR), which in turn disseminates transaction details (e.g., trade price, trade size, timestamp, and trade characteristics linked to the Dodd-Frank reforms) to the public. We combine publicly disseminated index CDS trades (executed between December 31, 2012 and December 31, 2013) from Depository Trust & Clearing Corporation (DTCC) Data Repository (U.S.) LLC (DDR) with the intraday quote data and end-of-day valuation data from two major CDS data providers, Credit Market Analysis Ltd. (CMA) and Markit Group Ltd. (Markit), to calculate transaction-level relative effective spread and other liquidity measures.⁴ We find substantial trading activity in the index CDS market. On average, 5,462 trades are executed each week (see Fig. 1). The average relative effective spread is about 0.27% of price level or 2.73% of CDS spread, which is in line with the transaction costs reported in other derivatives markets such as the options market.⁵ Moreover, we find that liquidity varies considerably across different families of index CDSs and liquidity is much higher for on-the-run series and the most popular 5-year tenor.

The Dodd-Frank Act fundamentally changes the OTC swap market in several ways. First, it requires real-time

³ The CDS market is important not only because it allows investors to hedge credit risk, but also because it facilitates price discovery of credit risk through informed trading (Acharya and Johnson, 2007). Furthermore, CDSs have been linked to the huge losses sustained by financial institutions in the recent financial crisis and thus have important implications for financial stability.

⁴ Detailed information on real-time trade reporting requirements, descriptions of index CDS contracts, and a description of the data collection and cleaning process are provided in Appendices A, B, and C, respectively.

⁵ See, for example, Goyenko, Ornathanalai, and Tang (2014), Muravyev and Pearson (2014), Augustin, Brenner, Hu, and Subrahmanyam (2015), and Augustin, Brenner, and Subrahmanyam (2015).

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