Discussion of P. Collin-Dufresne, B. Junge and A. Trolle
“Market Structure and Transaction Costs of Index CDSs”

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The paper in perspective


- **Challenge of the paper:** using anonymized Credit Index trade reports from 3 SDRs to determine transaction costs in the D2C market vs. the D2D market
- **Credit index contracts:** standardized $\rightarrow$ “futurization”

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<table>
<thead>
<tr>
<th>D2D</th>
<th>D2C</th>
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<tbody>
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<td><strong>On-SEF</strong></td>
<td><strong>On-SEF</strong></td>
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<td>voice or electronic order book</td>
<td>85%-89%</td>
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<td>“All-to-all” trading</td>
<td>RFQ for at least 3 brokers (RFQ3+)</td>
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<td>*Mid-market matching, Workup</td>
<td>Limit order book</td>
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<tr>
<td>*Limit order book</td>
<td>Sealed bid auction</td>
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**Pre-trade transparency**
- Anonymity
- Name-disclosed

**Block trades**
- Off-SEF
- RFQ1
The paper: some highlights

▶ CDX.IG and CDX.HY (North America corporate credit risk)
▶ **Time period**: Oct.2, 2013 to Oct.16, 2015 (post Dodd-Frank)
▶ **Data**: 4 sources
  - “on-SEF” trades (anonymized, time-stamped price and size up to a cap): outright trades, index roll trades and package trades
  - Markit intraday mid-quote
  - GFI data
  - (Clarus FT data)
▶ **Main results**
  - Effective spreads and price impacts: higher for D2C than D2D trades, higher for CDX.HY than CDX.IG.
    ▶ Robustness checks (trade-by-trade regression, size-matching analysis)
  - DTC trades Granger cause DTD trades
  - Other results:
    ▶ Market protocol of D2D seems related to smaller price impact estimates
    ▶ Trade size of CDX.IG 5 times higher than CDX.HY,
    ▶ CDX.HY trades more (1.5 times)
Do price impact measure accurately liquidity in this market? Is the adverse selection friction the most important?

- **Very small magnitude of price impact estimates**: < 0.14 bp for CDX.IG and < 0.68 bp for CDX.HY
- 100 times less than U.S. corporate single-name (14 bp according to Biswas et al., 2015)
- Small impact expected?
  - Instrument on a diversified basket of single-name (125 or 100 constituents): low impact of adverse selection (Subrahmanyam, 1991)
- Magnitude of price impact similar to that of ETFs (Marshall et al., 2016). However the size of trades are much larger ($50M for CDX.IG and $10M for CDX.HY).
  - Is the credit index market more like a block market?
  - Why not try to identify price pressure (Hendershott and Menkveld, 2011)? Or a decomposition in temporary vs. permanent price impact as in Keim and Madhavan (1996)?
Comments

- Identification algorithms?
  - Missclassification across SEF? What is the rate of correct classification?
  - Missclassification between buy and sell trades? Recurrent problem in the CDS market
    - Using similar credit index data, similar signing rule (based on Lee and Ready algorithm) and a proprietary dataset, Eisler and Bouchaud (2016) report 28% of incorrect classifications generating a price impact estimate which is biased.

- Lower price impact in the D2D market: is it a question of market protocol (sealed bid auction vs. workup or mid-price matching)? or anonymity? (or both)
  - Reiss and Werner (2004): adverse selection is less prevalent in anonymous brokered market in the former OTC London Stock Exchange.
Other comments

- Inventory management in the D2D market?
  - Contraction in D2D activity (BIS reports). Illustrated in this paper: D2D market is 5 times smaller and 5 times less active than the D2C market.
  - Far from the “hot potato” scenario described in some other OTC markets
    ⇒ How and when do dealers manage inventory (probability to observe a D2D)?

- Why not express transaction costs as basis point of the credit spread itself?
  - Recurrent question in the CDS market: does one use absolute or relative transaction costs as a measure of illiquidity (see Markit illiquidity measure combining both)?
  - Using relative price impact, Bouchaud et al. (2016) find that CDX.HY have less price impact than CDX.IG.

- Some summary statistics are missing
  - Markit bid-ask spread, the mid-quote CDX premium, the implied vol of swaption (liquidity of these markets? how does this volatility compared to the price impact estimates?)
Conclusion

- A very interesting and relevant paper!