Discussion of Wu (2021)

"Increasing Corporate Bond Liquidity Premium and Post-Crisis Regulations"

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NBFI Conference, FSB

June 9, 2022
The Cross-Sectional Regression Coefficient $\lambda_t$

Credit Spread$_{it} = a_t + \lambda_t$ Bid-Ask Spread$_{it} + Controls_{it} + \epsilon_{i,t}$
Key Insights and Main Results

- Dealers can function as
  - Brokers: matching trades.
  - Market makers: holding inventory and providing liquidity.

- Basel II.5 (announced on June 7, 2012):
  - Increase dealers’ balance sheet costs for trading corporate bonds.
  - Disincentivize their willingness to hold inventory.

- Empirical results:
  - The liquidity premium increased since the financial crisis.
  - Longer trading delays due to dealers’ unwillingness to provide immediacy.
  - Diff-in-diff: Basel II.5 interacted with affected bonds (yield change volatility).
  - Diff-in-diff: Volcker Rule interacted with affected dealers (lead underwriters).
The Post-2012 Increase of $\lambda_t$ is Mostly a High-Yield Phenomenon

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Trading Delays: Not Directly Estimated

Figure 7: Trading Delays

Investment Grade

Speculative

Investment Grade

Speculative

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## Fraction of Brokered Trades

### Table 2: Variations in $\lambda$

<table>
<thead>
<tr>
<th>Rating</th>
<th>A and above</th>
<th>BBB</th>
<th>Speculative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-Crisis: Jan 2004 - Jun 2007</td>
<td>$\lambda_{Pre-Crisis}$</td>
<td>0.110*** (6.90)</td>
<td>0.211*** (15.49)</td>
</tr>
<tr>
<td>Crisis: Jul 2007 - Apr 2009</td>
<td>$\lambda_{Crisis}$</td>
<td>0.505*** (4.96)</td>
<td>0.370*** (4.32)</td>
</tr>
<tr>
<td>Post-Crisis: May 2009 - May 2012</td>
<td>$\lambda_{Post-Crisis}$</td>
<td>0.402*** (12.27)</td>
<td>0.405*** (14.47)</td>
</tr>
<tr>
<td>Basel II.5: Jun 2012 - Jun 2013</td>
<td>$\lambda_{Basel II.5}$</td>
<td>0.365*** (8.61)</td>
<td>0.553*** (17.77)</td>
</tr>
<tr>
<td>Basel III: Jul 2013 - Mar 2014</td>
<td>$\lambda_{Basel III}$</td>
<td>0.206*** (3.97)</td>
<td>0.453*** (33.14)</td>
</tr>
<tr>
<td>Post-Volcker: Apr 2014 - Sep 2019</td>
<td>$\lambda_{Post-Volcker}$</td>
<td>0.191*** (8.44)</td>
<td>0.472*** (11.35)</td>
</tr>
</tbody>
</table>

### Table A9: Fraction of Brokered Trades

<table>
<thead>
<tr>
<th>Rating</th>
<th>A and above</th>
<th>BBB</th>
<th>Speculative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Crisis: Jul 2007 - Apr 2009</td>
<td>Brokered Trade (%)</td>
<td>13.373</td>
<td>15.705</td>
</tr>
<tr>
<td>Post-Crisis: May 2009 - May 2012</td>
<td>Brokered Trade (%)</td>
<td>15.607</td>
<td>14.467</td>
</tr>
</tbody>
</table>

**Notes:** This table provides a summary of the fraction of the total customer-dealer dollar trading volume that is immediately matched within one minute and with the same quantity.
My Thoughts on $\lambda_t$

- Not a standard test of liquidity risk premium. Used to measure liquidity:
  - Dealers’ reducing provision of liquidity: This Paper.
  - Investors’ increasing demand for liquidity: Li and Yu (2021).
- A positive and significant $\lambda$ is a well established empirical fact (e.g., Bao, Pan, and Wang (2011)) – an indication that liquidity matters for credit pricing.
- But the time-series variation of $\lambda_t$ can be driven by many factors. For example,
  - Increased cross-sectional variation in credit spreads driven by
    - A market-wide credit concern.
    - A group of distressed bonds with explosive credit spreads.
  - while bid/ask spreads do not increase by the same proportion.
- Without timely controls of credit risk, the cross-sectional regression would yield a higher $\lambda_t$, driven by increases in credit risk (either market-wide or by a few bonds).
- A growing bond sample might also expand the cross-sectional variation in credit spreads without the same effect on bid/ask spreads.
An interesting topic:
- Decreasing transaction costs (e.g., bid/ask spreads).
- Increasing concerns over liquidity – the “retreat” of dealers (Duffie 2012).

I agree with the hypothesis:
- Increased trading delays due to dealers’ unwillingness to provide immediacy.
- Similar to the findings of Choi, Huh, and Shin (2022): increased cost of immediacy due to dealers’ retreat and the rise of customer liquidity provision.
- Also consistent with the findings of Bao, O’Hara, and Zhou (2018): increased illiquidity of stressed bonds post Volcker Rule.

Central to the empirical analysis is the cross-sectional sensitivity of credit spreads to bid/ask spreads as a measure of liquidity premium: not yet convinced.

Suggestions: look for direct evidences of trading delays, cost of immediacy, and dealers’ retreat.