

Discussion of Wu (2021)

“Increasing Corporate Bond Liquidity Premium and Post-Crisis Regulations”

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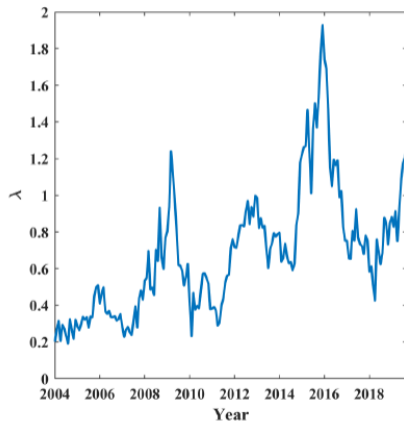
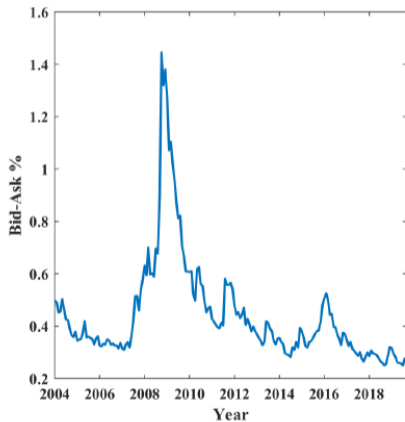
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The Cross-Sectional Regression Coefficient λ_t

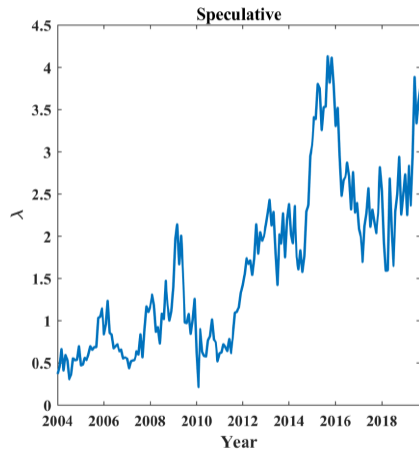
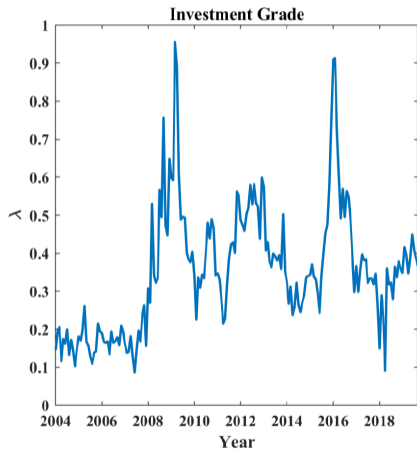
$$\text{Credit Spread}_{it} = a_t + \lambda_t \text{ Bid-Ask Spread}_{it} + \text{Controls}_{it} + \epsilon_{i,t}$$



Key Insights and Main Results

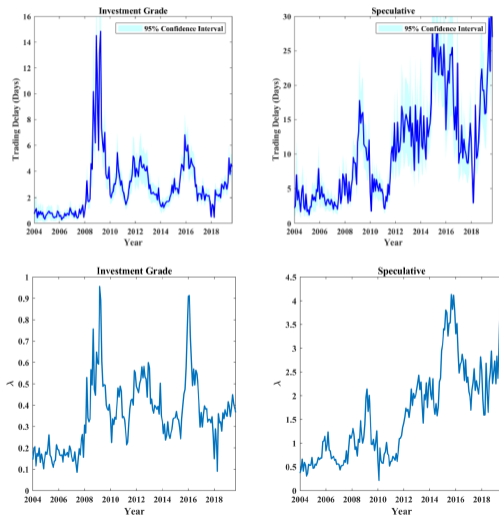
- Dealers can function as
 - ▶ Brokers: matching trades.
 - ▶ Market makers: holding inventory and providing liquidity.
- Basel II.5 (announced on June 7, 2012):
 - ▶ Increase dealers' balance sheet costs for trading corporate bonds.
 - ▶ Disincentivize their willingness to hold inventory.
- Empirical 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 λ_t is Mostly a High-Yield Phenomenon



Trading Delays: Not Directly Estimated

Figure 7: Trading Delays



Fraction of Brokered Trades

Table 2: Variations in λ

Rating	A and above	BBB	Speculative
Pre-Crisis: Jan 2004 - Jun 2007			
$\lambda_{\text{Pre-Crisis}}$	0.110*** (6.90)	0.211*** (15.49)	0.645*** (10.67)
Crisis: Jul 2007 - Apr 2009			
λ_{Crisis}	0.505*** (4.96)	0.370*** (4.32)	1.155*** (8.85)
Post-Crisis: May 2009 - May 2012			
$\lambda_{\text{Post-Crisis}}$	0.402*** (12.27)	0.405*** (14.47)	0.981*** (8.22)
Basel II.5: Jun 2012 - Jun 2013			
$\lambda_{\text{Basel II.5}}$	0.365*** (8.61)	0.553*** (17.77)	2.021*** (22.47)
Basel III: Jul 2013 - Mar 2014			
$\lambda_{\text{Basel III}}$	0.206*** (3.97)	0.453*** (33.14)	1.989*** (23.70)
Post-Volcker: Apr 2014 - Sep 2019			
$\lambda_{\text{Post-Volcker}}$	0.191*** (8.44)	0.472*** (11.35)	2.665*** (15.85)

Table A9: Fraction of Brokered Trades

Rating	A and above	BBB	Speculative
Pre-Crisis: Jan 2004 - Jun 2007			
Brokered Trade (%)	11.522	9.984	13.713
Crisis: Jul 2007 - Apr 2009			
Brokered Trade (%)	17.755	19.604	19.470
Post-Crisis: May 2009 - May 2012			
Brokered Trade (%)	16.284	18.671	19.531
Basel II.5: Jun 2012 - Jun 2013			
Brokered Trade (%)	13.373	15.705	17.423
Basel III: Jul 2013 - Mar 2014			
Brokered Trade (%)	13.667	14.467	15.773
Post-Volcker: Apr 2014 - Sep 2019			
Brokered Trade (%)	20.790	22.573	23.511

Notes: This table provides a summary 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 λ_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 λ 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 λ_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 λ_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.

My Comments and Suggestions

- 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.