Systemic risk and competition in OTC derivatives dealing: Evidence from client failures

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Abstract

We examine the extent of systemic risk and competitive interaction in a segment of the financial services industry: over-the-counter derivatives dealers. Using an extended series of derivatives-related failures in the 1990s, we analyze the investor reaction to the clients' losses for the directly-involved and non-involved derivatives dealers. We find that the involved dealers experience significantly negative stock returns around the announcements of losses by their clients. In contrast, non-involved dealers experience positive event period returns, revealing a competitive effect. Over time, as new losses are revealed, the competitive effect for the still non-involved dealers becomes more pronounced. An expanded industry definition including securities brokers, dealers, and advisors results in a significant and negative reaction. This finding provides support for the existence of industry contagion. A cross-sectional analysis of the determinants of the abnormal returns provides evidence for the existence of information contagion and against pure contagion and systemic risk. Some evidence of moral hazard related to potential government intervention is also detected. Our findings have important implications for the financial services industry in general and government sponsored enterprises and hedge funds in particular.

Keywords: OTC derivatives; Industry contagion; Dealers
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