

Trading Financial Innovation

Ana Babus

Washington University in St. Louis

Kinda Hachem

Chicago Booth & NBER

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Very preliminary. Do not circulate.

Abstract

Standardized financial securities are frequently traded in over-the-counter markets. This is difficult to reconcile with the view that these markets exist to facilitate the trade of customized contracts. We build a model of financial innovation to explain why standardized securities can be traded in decentralized markets. In our set-up, each dealer designs a security which specifies a payoff for every state of the world. The dealer chooses the states in which the payoff is flat and the states in which the payoff is contingent on the realized state of the world. Investors choose which securities to trade, taking into account how their trades may impact the price of each security. The market structure in which a given security is traded is determined endogenously. We characterize which securities are traded in decentralized rather than centralized markets. Our results also have implications for regulations that force all trade to take place in centralized markets.

JEL Classifications: G14, G21, D82, D43

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