The Rise and Decline of Market Making

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March 4, 2019

Abstract

We develop a tractable framework that allows agents to choose their trading networks as well as access to the multilateral trading platform in the over-the-counter market. Even though all agents are ex-ante identical and risk-averse, the optimal market structure concentrates risks to a few agents, who make the market and net positions through the multilateral trading platform. We use this framework to analyse how recent reforms that promote central clearing and discourage risk bearing, such as the Volcker Rule, affect market liquidity and risk allocation. When it is more costly to bear risks, market making services decline, the risk distribution becomes less concentrated, and customer banks have more unhedged positions. The decreased market liquidity, however, may not manifest an increase in the bid-ask spread, reconciling with a puzzling empirical finding in the post-Volcker Rule era.