OTC*

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PRELIMINARY AND INCOMPLETE

October 23, 2012

Abstract

Search in OTC markets for exotic assets.

*Thanks to ...

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1 Introduction

PLACEHOLDER

2 Baseline model

2.1 Banks

There are a finite number N of infinitely lived banks who discount the future at rate β. At the beginning of each period, bank i is described by two scalars, working capital and risky assets, which we denote by $(D_{i,t}, B_{i,t})$. Banks partition working capital into a liquid form, "money", $M_{i,t}$ which bear no returns, or, an illiquid form, "loans", $L_{i,t}$ which bear constant interest $1 + r$. There are sub-periods in each t. We assume that all information is public. As variables change from period to period, we use t' to denote the first instance where a variable changes within period, t'' to denote the same variable after the second change, and so on.

1. **Wealth shock.** All banks experience IID shock $w_{i,t}$ to $D_{i,t}$.

$$D_{i,t'} = D_{i,t} + w_{i,t}$$

2. **Frictional markets.** One randomly selected bank is allowed to post one TIOLI fixed-for-floating offer. Denote the change in a bank's working capital position from trade by $\Delta^D_{i,t}$ and the change in the risky asset position by $\Delta^B_{i,t}$.

$$D_{i,t''} = D_{i,t'} + \Delta^D_{i,t}$$

$$B_{i,t'} = B_{i,t} + \Delta^B_{i,t}$$

3. **Reallocation.** Banks decide on $M_{i,t}$ and $L_{i,t}$ such that

$$M_{i,t} + L_{i,t} = D_{i,t''}.$$

4. **Risky returns.** With probability λ which is independent across firms, risky assets post returns $r^B_{i,t}$ which may be negative. If risky returns are realized, a banks change in its money holdings is

$$\Delta^M_{i,t} = M_{i,t} + r^B_{i,t} B_{i,t'}.$$

$$M_{i,t'} = \Delta^M_{i,t} + M_{i,t}$$

   If $M_{i,t'} < 0$ a kitten dies.

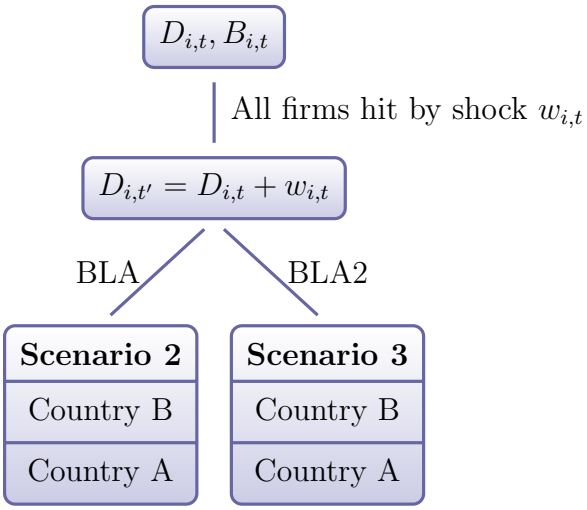
5. **Risk-free return.**

$$L_{i,t'} = (1 + r) L_{i,t}$$

6. **Competitive market.** All banks participate in a competitive fixed-for-floating market.

$$q_t B_{i,t+1} + D_{i,t+1} = q_t B_{i,t'} + L_{i,t'} + M_{i,t'}$$

In graphical form, the events in 1 periods follow



3 Empirics

PLACEHOLDER

4 Conclusion

PLACEHOLDER

5 Extensions

PLACEHOLDER