

Discussion: “Sustaining Trading Relationships with Lemons”

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WFA 2026, Denver

June 21, 2026

Mechanism: Recognizing the Client

Inside (relationship) dealers

non-anonymity: they recognize the client

J.P.Morgan



Client (insurer), uninformed



TWO SIGMA

Anonymous fallback: outside dealers

cannot tell the client from the speculator (Two Sigma)

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Client (insurer), uninformed

$t=2$: lemons ask
 $p_2^o = 100.6$

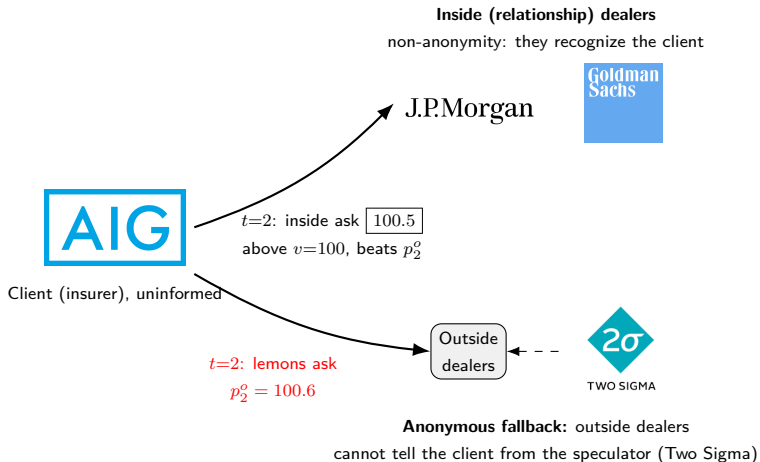
Outside
dealers



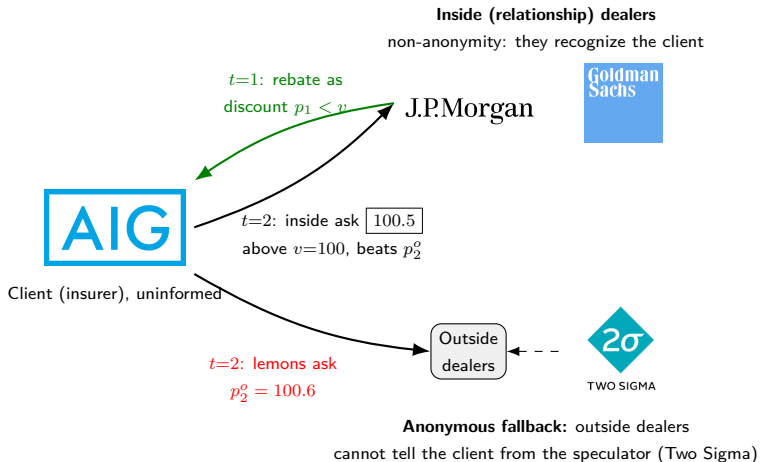
TWO SIGMA

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Mechanism: Recognizing the Client



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Non-anonymity binds the uninformed client to her dealers. Tomorrow's rent is rebated today as a discount.

Suggestion 1: OTC trading is non-anonymous

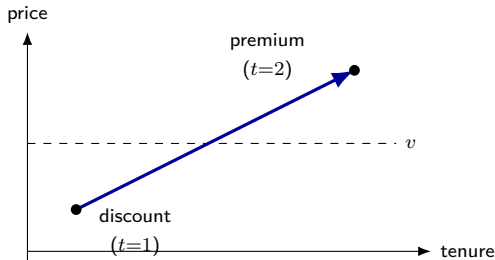
Non-anonymity:
dealer sees client identity
before pricing



Lee & Wang (JF, 2025)
Pinter, Wang & Zou (WP, 2021)
Kuong (this paper)

- These paper exploit non-anonymity of OTC trading
- Dealers observe the client's ID before they quote
- This differs from anonymous random-search models (Duffie, Gârleanu, and Pedersen, 2005).
- Lee & Wang (JF, 2025): Adding an OTC market alongside an exchange market reduces welfare
- Pinter, Wang & Zou (WP, 2021): More informed traders receive better prices
- This paper: Non-anonymity rationalizes relationship trading
- Suggestion: Review other papers that exploit non-anonymity of OTC trading

Suggestion 2: The model predicts worsening prices over time



- At $t = 1$, the client receives a discount, $p_1 < v$
- Once recognized, she pays a markup, $p_2 > v$
- Testable: Young relationships show discounts, mature ones premiums
- The data exist: insurance companies' transaction-level data in corporate bonds

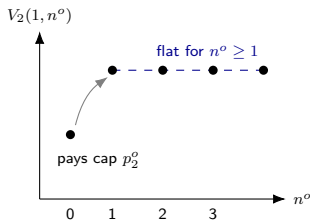
Suggestion 3: Include outside dealers in the auction at $t = 2$?

Setup One inside dealer (available w.p. $1 - q$, recognizes the client), n^o outside dealers (always available, doesn't recognize the client), and an always-available fallback at $p_2^o(1)$. The client pays $P = \min\{P_I, P_O^{(n^o)}, p_2^o(1)\}$, with $P_O^{(0)} = \infty$.

Equilibrium ($n^o \geq 1$) Let $S(p) \equiv q + (1 - q)(1 - H(p))$. Outside zero profit and inside indifference give

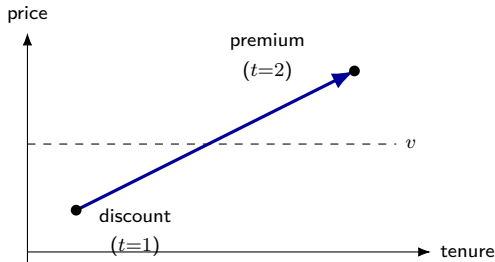
$$S(p) = \frac{\mu(v + \sigma - p)}{2(1 - \mu)(p - v)}, \quad (1 - H^o(p))^{n^o} = \frac{1 - v/\underline{p}}{1 - v/p},$$

where $\underline{p}$ solves $S(\underline{p}) = 1$.



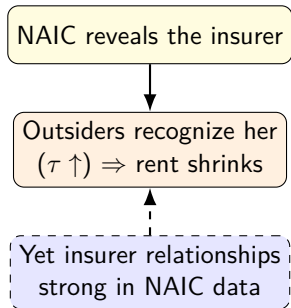
- $n^o = 0$: $V_2(1, 0)$ is solved in the paper
- $V_2(1, 0) < V_2(1, 1) = V_2(1, 2) = \dots$

Suggestion 4: The implicit loan is the bid-ask spread



- Discount at $t = 1$ equals rent at $t = 2$
- That rent is just the inside dealers' bid-ask spread, selling above v
- Size of the implicit loan is on the same order of magnitude as bid-ask spread
- OTC spreads are tens of basis points, so the loan is small and spread-sized

Suggestion 5: Identity transparency weakens relationship trading



- Section 4.3: transparency that reveals client identity bites, letting outsiders infer her type ($\tau \uparrow$)
- Identity-revealing data, like NAIC for insurers, weakens relationship
- Tension: the strongest evidence for exclusive insurer relationships (Hendershott et al., 2020) is from NAIC, the most identity-transparent setting

Summary

- Nice mechanism. Non-anonymity plus adverse selection acts as relationship glue and turns future rent into an up-front discount
- Suggestion 1: review other papers that exploit the non-anonymity of OTC trading
- Suggestion 2: the model predicts worsening prices over a relationship
- Suggestion 3: solve the $t = 2$ auction with outside dealers included, and check whether the mechanism survives
- Suggestion 4: the implicit loan is small, re-frame?
- Suggestion 5: Identity-revealing transparency (NAIC) weakens relationship trading