Risk-sharing or risk-taking? Hedging, margins and incentives*

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Abstract

We develop an incentive-based theory of margins in the context of a tradeoff between the benefits of hedging in terms of enhanced risk-sharing and its costs in terms of financial instability. We model hedging as the design of a contract between a protection buyer, seeking to reduce his risk exposure, and a protection seller. If the seller learns that the hedge is likely to be loss-making for her even though actual losses have not materialized yet, her incentives to control the risk of her other positions (balance sheet risk) diminish. The seller's risk-taking incentives limit hedging and generate endogenous counterparty risk. Margins improve incentives to control balance sheet risk and thus enhance the scope of hedging.

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