The Financialization of Event Risk

From Risk Warehousing to Risk Intermediation

Part II of III: The Financialization of Event Risk Series

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ABSTRACT

Part I of this series argued that the central legal issue in the prediction markets debate is whether a contract transfers risk (derivative) or merely creates risk (gambling).[1] This paper accepts that distinction and asks the next question: if prediction markets survive legal scrutiny and scale liquidity, will they compete with sportsbooks or transform them? Drawing on the historical evolution of equity dealers, OTC derivatives, and insurance markets, this paper argues that large risk markets follow a consistent pattern — from warehousing to distribution — and that prediction markets, if legally durable and sufficiently liquid, will become wholesale risk-transfer infrastructure for a subset of qualifying event-based contracts. This transformation would alter the competitive structure of sports betting, compress sportsbook earnings volatility, and shift the strategic question from whether to use prediction markets to who controls the wholesale rail.

A. RISK WAREHOUSE VS. RISK DISTRIBUTOR

Large markets follow a recognizable pattern. They begin as localized systems where intermediaries warehouse risk. Once infrastructure deepens, they evolve into systems in which intermediaries distribute that risk. Risk warehouses profit by being exposed to risk. Risk distributors profit by transferring risk.[2]

Sportsbooks today are risk warehouses. Prediction markets, if legally durable and sufficiently liquid, will likely become wholesale risk-transfer rails for a subset of qualifying, event-based contracts.[3]

B. HISTORICAL PRECEDENTS

1. Equity Dealers → Electronic Exchanges

Early equity markets were dominated by dealers who warehoused inventory and earned wide spreads. Price discovery was opaque and episodic. The migration to electronic exchanges and ECNs compressed spreads dramatically. Dealers no longer profited primarily from holding

inventory; rather, they hedged continuously and monetized flow. As a result, margins compressed, volatility declined, and infrastructure deepened. The system financialized.[4]

2. OTC Derivatives → Central Clearing

Pre-2008 derivatives markets concentrated counterparty exposure inside large institutions. Risk was bilateral and opaque. Post-GFC reforms pushed standardized contracts into central clearing. Margining and netting became systematic, and risk distribution replaced bilateral warehousing. The business model evolved from absorbing exposure to managing risk.[5]

3. Insurance → Reinsurance → Catastrophe Bonds

Primary insurers historically absorbed catastrophe risk directly on balance sheet. Over time, reinsurance markets emerged. Later, catastrophe bonds transferred extreme event exposure into capital markets. As the market evolved, primary carriers did not disappear; they evolved into originators and allocators of risk, enabled by a new wholesale risk-transfer layer.[6]

C. SPORTSBOOKS TODAY

Sportsbooks today resemble pre-financialized intermediaries. They accept imbalanced exposure, monetize behavioral skew (favorites, overs, parlays), tolerate outcome volatility, and manage risk through line movement and limits. Just like dealers in early equity markets and insurers in early primary markets, sportsbooks originate retail exposure and are compensated for warehousing that risk.[7]

But there has never been deep, standardized, legally durable wholesale infrastructure for sportsbooks to consistently offload and mitigate that risk.

If prediction markets offer continuous pricing, provide reliable settlement, absorb institutional size, and survive doctrinal scrutiny, then prediction markets will evolve into wholesale risk-transfer infrastructure.[8]

D. THE FINANCIALIZATION OF SPORTS BETTING

Once a durable wholesale risk-transfer venue exists, incentives in sports betting markets will change. At that point, sportsbooks face a structural option: continue warehousing concentrated exposure, or transfer net liabilities into a deeper venue.[9]

Consider a simple illustration. A sportsbook carrying 00 million in net exposure on one side of a major event can experience nearly 90 million in earnings swing depending on outcome. This is extreme risk concentration, and systematic hedging would compress the variance. Yes, hedging would narrow margins, but volatility would also decline.[10]

With the option to offload risk onto wholesale infrastructure, the sportsbook business begins to resemble a dealer or clearing intermediary rather than a casino-style risk warehouse. Markets consistently reward predictability. Despite lower margins, companies with lower earnings variance typically trade better than companies with higher margins but more unpredictable earnings swings — controlling for growth.[10a]

E. THREE POTENTIAL OUTCOMES

If prediction markets remain shallow or legally fragile, none of this will materialize. But if they survive and scale, only three stable outcomes exist:

Replacement — prediction markets displace sportsbooks at retail.

Financialization — sportsbooks hedge through prediction markets.

Integration — sportsbooks invest in or acquire the wholesale rail.

There is no stable equilibrium in which a durable wholesale transfer venue exists and incumbents remain pure risk warehouses indefinitely. Markets do not tolerate redundant concentration of risk.[11]

F. THE PARADOX

Financialization brings into focus the strategic tension sportsbooks face with prediction markets.

If sportsbooks hedge through prediction markets, they legitimize prediction markets, deepen their liquidity, improve price discovery, and strengthen a retail competitor.

At the same time, ignoring a durable opportunity to mitigate earnings risk by hedging on prediction markets will simply leave incumbent sportsbooks exposed financially while a customer-facing wholesale layer scales without them. For sportsbooks, margin compression is survivable but full disintermediation is not. A sportsbook that loses its retail customers to a direct-to-consumer prediction market platform retains no residual revenue stream; a sportsbook that hedges through prediction markets at compressed margins still earns flow. History suggests that incumbents facing wholesale competition are better served integrating the new layer into their business model than defending against it from the outside.

G. THE RULES MATTER

In Part I, the central legal issue was framed as whether these contracts transfer risk (derivatives) or simply create risk (gambling).[12]

With this view, prediction market contracts that merely generate speculative novelty exposure are legally vulnerable to state regulatory oversight; whereas contracts that facilitate the transfer of economically meaningful exposure (true hedging instruments) are far more defensible under federal derivatives doctrine.[13,16]

If prediction markets are legally constrained to contracts that transfer real economic risk, the contracts most likely to endure are precisely those that facilitate institutional hedging.[14] Prediction markets that survive will do so primarily as risk-transfer infrastructure.

And once wholesale risk-transfer infrastructure exists at scale, sportsbooks will have incentive to use it because, as we have seen repeatedly throughout history, markets evolve toward the distribution of concentrated risks.

H. CONCLUSION

The economically important issue is whether a wholesale layer of event risk-transfer infrastructure is emerging in U.S. markets. If it does, then sports betting will evolve from risk warehousing to risk distribution. Once this evolutionary shift begins, the most impactful issue will be who controls prediction market rails.

This paper is Part II of a three-part series. Part III — *Event Contracts and the Liquidity Threshold: Risk Transfer, Sportsbook Exposure, and the Derivatives Case for Event Markets* — develops a quantitative liquidity-threshold framework and introduces the Liquidity-Constrained Event Risk Transfer Curve. It is available at eventrisk.ai.[15]

NOTES AND AUTHORITIES

1. David Kuhn, *Prediction Markets and the Economic Purpose Test* (Part I of III: The Financialization of Event Risk Series) (Mar. 2026); William Bunting, *A Better Legal Definition of Gambling: With Applications to Synthetic Financial Instruments and Cryptocurrency*, 86 Albany Law Review 257 (2023).

2. Holbrook Working, *Hedging Reconsidered*, 35 American Journal of Agricultural Economics 544 (1953); Ilya Beylin, *Event Contracts Are a Step Too Far for Derivatives Regulation*, 4 University of Chicago Business Law Review 77 (2025).

3. David Kuhn, *Prediction Markets and the Economic Purpose Test* (Part I of III: The Financialization of Event Risk Series) (Mar. 2026).

4. General authority on the transition from dealer-dominated equity markets to electronic exchanges and ECNs, including spread compression and continuous hedging effects of electronic market structure.

5. General authority on post-2008 reforms to standardized OTC derivatives markets and mandatory central clearing under Dodd-Frank.

6. General authority on the evolution from primary insurance to reinsurance and catastrophe bonds / insurance-linked securities.

7. David Kuhn, *Prediction Markets and the Economic Purpose Test* (Part I of III: The Financialization of Event Risk Series) (Mar. 2026); Ilya Beylin, *Event Contracts Are a Step Too Far for Derivatives Regulation*, 4 University of Chicago Business Law Review 77 (2025).

8. David Kuhn, *Prediction Markets and the Economic Purpose Test* (Part I of III: The Financialization of Event Risk Series) (Mar. 2026).

9. Holbrook Working, *Hedging Reconsidered*, 35 American Journal of Agricultural Economics 544 (1953); Ilya Beylin, *Event Contracts Are a Step Too Far for Derivatives Regulation*, 4 University of Chicago Business Law Review 77 (2025).

10. Author's illustration.

10a. General authority on earnings multiple compression and the valuation premium associated with earnings predictability; see, e.g., research on EV/EBITDA multiples for companies with stable versus volatile earnings in capital-intensive consumer-facing industries, including academic finance literature on earnings quality and its relationship to price-to-earnings ratios.

11. Cf. Ilya Beylin, *Event Contracts Are a Step Too Far for Derivatives Regulation*, 4 University of Chicago Business Law Review 77 (2025).

12. David Kuhn, *Prediction Markets and the Economic Purpose Test* (Part I of III: The Financialization of Event Risk Series) (Mar. 2026); William Bunting, *A Better Legal Definition of Gambling: With Applications to Synthetic Financial Instruments and Cryptocurrency*, 86 Albany Law Review 257 (2023).

13. Ilya Beylin, *Event Contracts Are a Step Too Far for Derivatives Regulation*, 4 University of Chicago Business Law Review 77 (2025).

14. David Kuhn, *Prediction Markets and the Economic Purpose Test* (Part I of III: The Financialization of Event Risk Series) (Mar. 2026); Statement of Commissioner Dan M. Berkovitz Related to Review of ErisX Certification of NFL Futures Contracts (Apr. 7, 2021), Commodity Futures Trading Commission.

15. This paper is Part II of a three-part series. Part I — David Kuhn, *Prediction Markets and the Economic Purpose Test* (Mar. 2026) — develops the risk-transfer/risk-creation distinction and proposes a targeted fix to CEA § 5c(c)(5)(C). Part III — David Kuhn, *Event Contracts and the Liquidity Threshold: Risk Transfer, Sportsbook Exposure, and the Derivatives Case for Event Markets* (Mar. 2026) — introduces the Liquidity-Constrained Event Risk Transfer Curve and develops a quantitative framework for assessing when event contracts can support economically meaningful risk transfer. All three papers are available at eventrisk.ai.

16. Rob Schwartz, *Federal Preemption in Sports Prediction Market Litigation: This Shouldn't Be a Jump Ball*, 46 Futures & Derivatives L. Rep. 3 (Mar. 2026). Schwartz argues that exchange-traded sports event contracts are independently cognizable as "commonly known to the trade as a swap" under CEA § 1a(47)(A)(iv), given that DCMs list them as swaps, FCMs offer them as swaps, and DCOs clear them accordingly — a basis for CFTC jurisdiction that operates independently of the "event or contingency" provision that has been contested in ongoing litigation. On that reading, the contracts at issue in Part G are analytically defensible under federal derivatives doctrine on a ground that does not depend on resolving whether they transfer economically meaningful risk.

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