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Liquidity and Credit Default Swap Spreads

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Posted: 22 Aug 2007

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Date Written: August 20, 2007

Abstract

We propose an empirical study on the pricing effect of liquidity level and liquidity risk in the credit default swaps (CDS) market. CDS is the key constituent of the fast growing credit derivatives market that has \$34.4 trillion in total notional value by the end of 2006. Credit derivatives play an important role in today's financial market by facilitating the transfer of credit risk. Credit derivatives are over-the-counter contracts executed through bilateral search. Trading motives include both credit risk management and, probably more notably, informed speculation. Government regulators around the globe have repeatedly expressed their concerns over the opacity and lack of comprehension of the credit derivatives market. A better understanding of the liquidity structure and its impact on the pricing of credit derivatives is critical to improving the efficiency and stability of financial markets and the overall health of the economy, as evidenced by the ongoing subprime mortgage crisis.

Our study represents the first systematic investigation of the effect of CDS liquidity characteristics and liquidity risk on CDS spreads, above and beyond the credit risk component. We first construct a set of liquidity proxies to capture various facets of CDS liquidity, such as adverse selection, search frictions, and inventory costs, using a comprehensive database on CDS transactions. We carefully analyze the determinants and interactions of the liquidity proxies to validate that they reflect aspects of bilateral matching, funding constraints, and informed speculation in CDS trading. Then we analyze the effect of these liquidity characteristics on CDS spreads. Our analysis completed thus far shows that the liquidity effect on CDS spreads is significant with an estimated liquidity premium on par with those of Treasury bonds and corporate bonds. We also find cross-sectional variations in the liquidity effect highlighting the interplay between search friction and adverse selection in the CDS market. Furthermore, using liquidity betas and volume respectively to measure liquidity risk, we provide supporting evidence for liquidity risk being positively priced beyond liquidity characteristics in CDS spreads. Our estimates indicate that liquidity characteristics and liquidity risk together could on average account for about 20% of CDS spreads.

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