

Estimating liquidity premium of corporate bonds using the spread information in on- and off-the-run Treasury securities

Haitao Li; Chunchi Wu; Jian Shi

✚ Author & Article Information

China Finance Review International (2017) 7 (2): 134–162.

<https://doi.org/10.1108/CFRI-11-2016-0125> Article history 

Purpose

The purpose of this paper is to estimate the effects of liquidity on corporate bond spreads.

Design/methodology/approach

Using a systematic liquidity factor extracted from the yield spreads between on- and off-the-run Treasury issues as a state variable, the authors jointly estimate the default and liquidity spreads from corporate bond prices.

Findings

The authors find that the liquidity factor is strongly related to conventional liquidity measures such as bid-ask spread, volume, order imbalance, and depth. Empirical evidence shows that the liquidity component of corporate bond yield spreads is sizable and increases with maturity and credit risk. On average the liquidity spread accounts for about 25 percent of the spread for investment-grade bonds and one-third of the spread for speculative-grade bonds.

Research limitations/implications

The results show that a significant part of corporate bond spreads are due to liquidity, which implies that it is not necessary for credit risk to explain the entire corporate bond spread.

Practical implications

The results show that returns from investments in corporate bonds represent compensations for bearing both credit and liquidity risks.

Originality/value

It is a novel approach to extract a liquidity factor from on- and off-the-run Treasury issues and use it to disentangle liquidity and credit spreads for corporate bonds

Keywords: [G01](#), [G1](#), [Liquidity premium](#), [Kalman filter](#), [Equivalent martingale measure](#), [On- and off-the-run spreads](#), [Reduced-form model](#)

© Emerald Publishing Limited

Licensed re-use rights only

You do not currently have access to this content.

Sign in

Don't already have an account? [Register](#)

Client Account

Email address / Username

Password

[Reset password](#)

[Register](#)

ICE Member Sign In

Log in



Access through your institution

Purchased this content as a guest? Enter your email address to restore access.

We use cookies to optimize site functionality and targeting cookies to give you the best possible experience. Your experience, your choice. Learn more here:

[Visit our cookie policy page](#)

Pay-Per-View Access €35.00

 Buy This Article

Rental

This article is also available for rental through DeepDyve.

