Discussion of Marsh and Longstaff Papers

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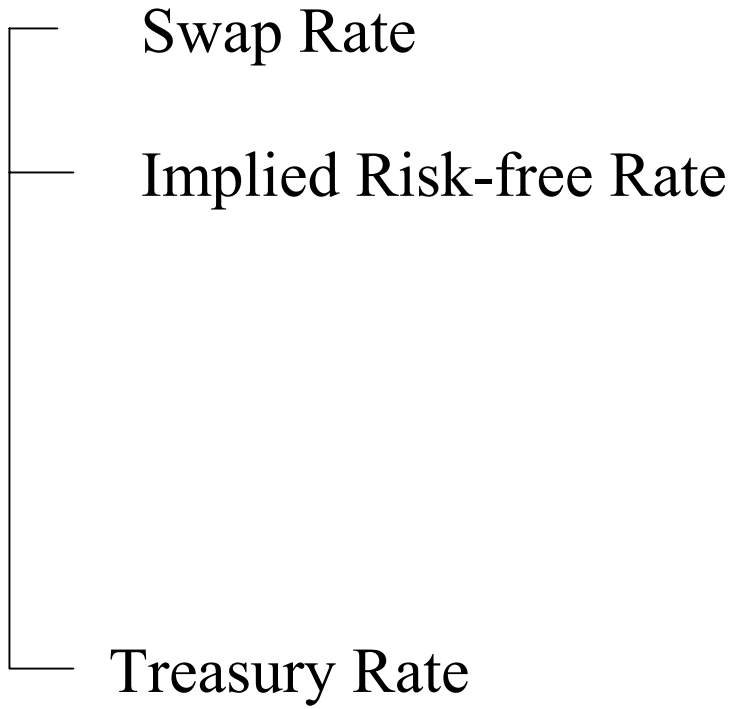
Typical Situation



Our Results (All Data)

	Mean	S.E.
$r_{IMP} - r_{TR}$	62.87	1.38
$r_{SW} - r_{IMP}$	6.51	1.06

Explanations for Results

- Longstaff: Treasury is benchmark risk-free rate. We need explanation for why benchmark is less than implied risk-free rate. Possibilities:
  - Liquidity
  - Taxes
- Marsh: Swap rate is benchmark. We need explanation for why benchmark is greater than implied risk-free rate. Possibilities:
  - Cheapest to deliver bond option
  - Difficulty in shorting corporate bonds

The arbitrage

- If CDS spread is high relative to bond yield spread, sell protection and short bond
- If CDS spread is low relative to bond yield spread, buy protection and buy the bond

But the arbitrage is not perfect because….

- Problems in shorting bonds
- Cheapest to deliver option
- Credit event does not always mean promised payments are not made
- Theoretically need to trade par corporate floater and par riskless floater
- Illiquidity of bond
- Bond holder loses accrued interest in the event of a default
- Counterparty default risk in a CDS

Which market leads?

- Marsh's results indicate that CDS market leads the bond market
- In sovereign market Chan-Lau and Kim report that price discovery occurs in the bond market for countries with low default risk and in the CDS market for countries with high default risk