Comments on Marsh et al, Longstaff et al

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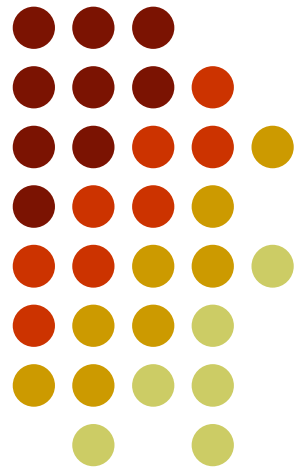
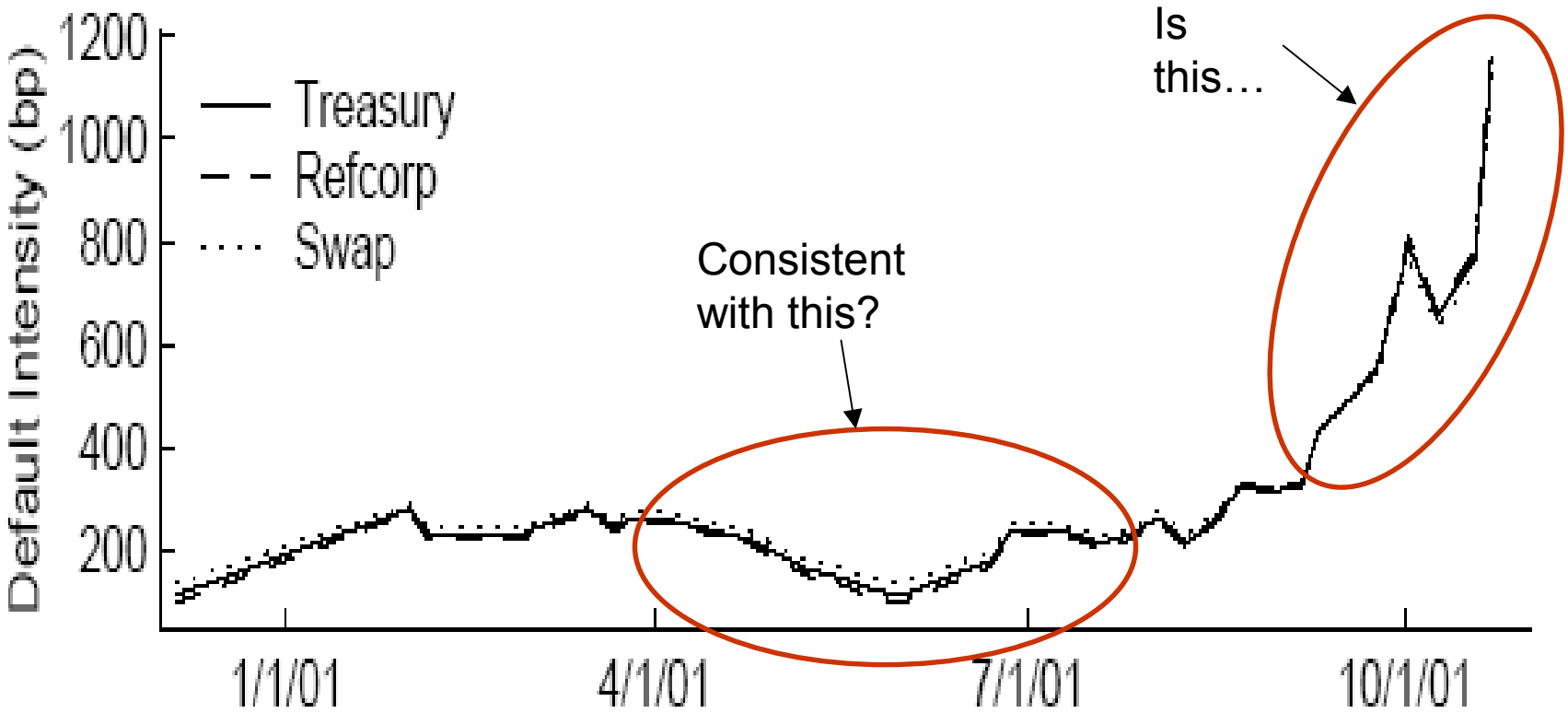
Moody's Corporation & NYU Salomon Center conference on Advances in Credit Risk Research



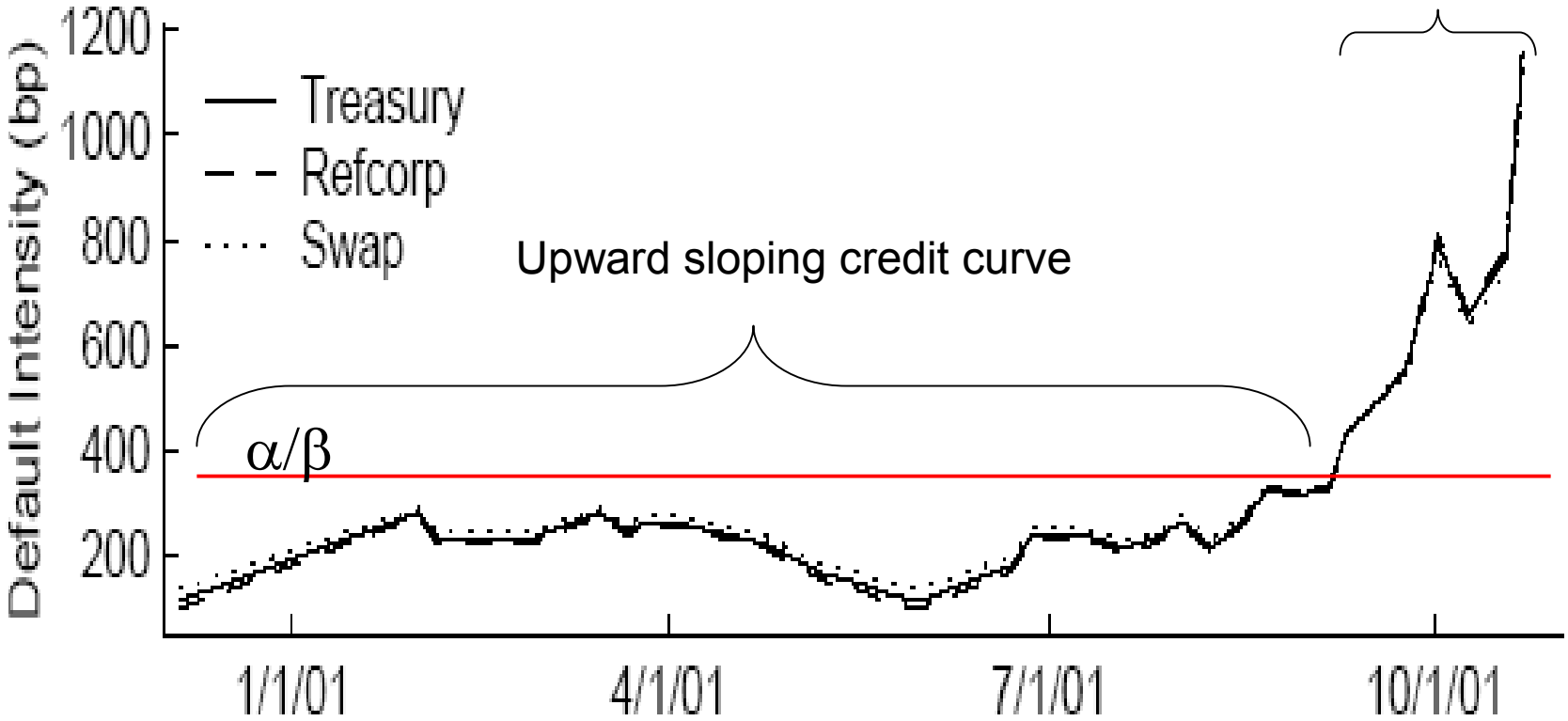
Some Preliminaries - I

$$d\lambda = (\alpha - \beta\lambda)\,dt + \sigma\sqrt{\lambda}\,dZ_\lambda$$

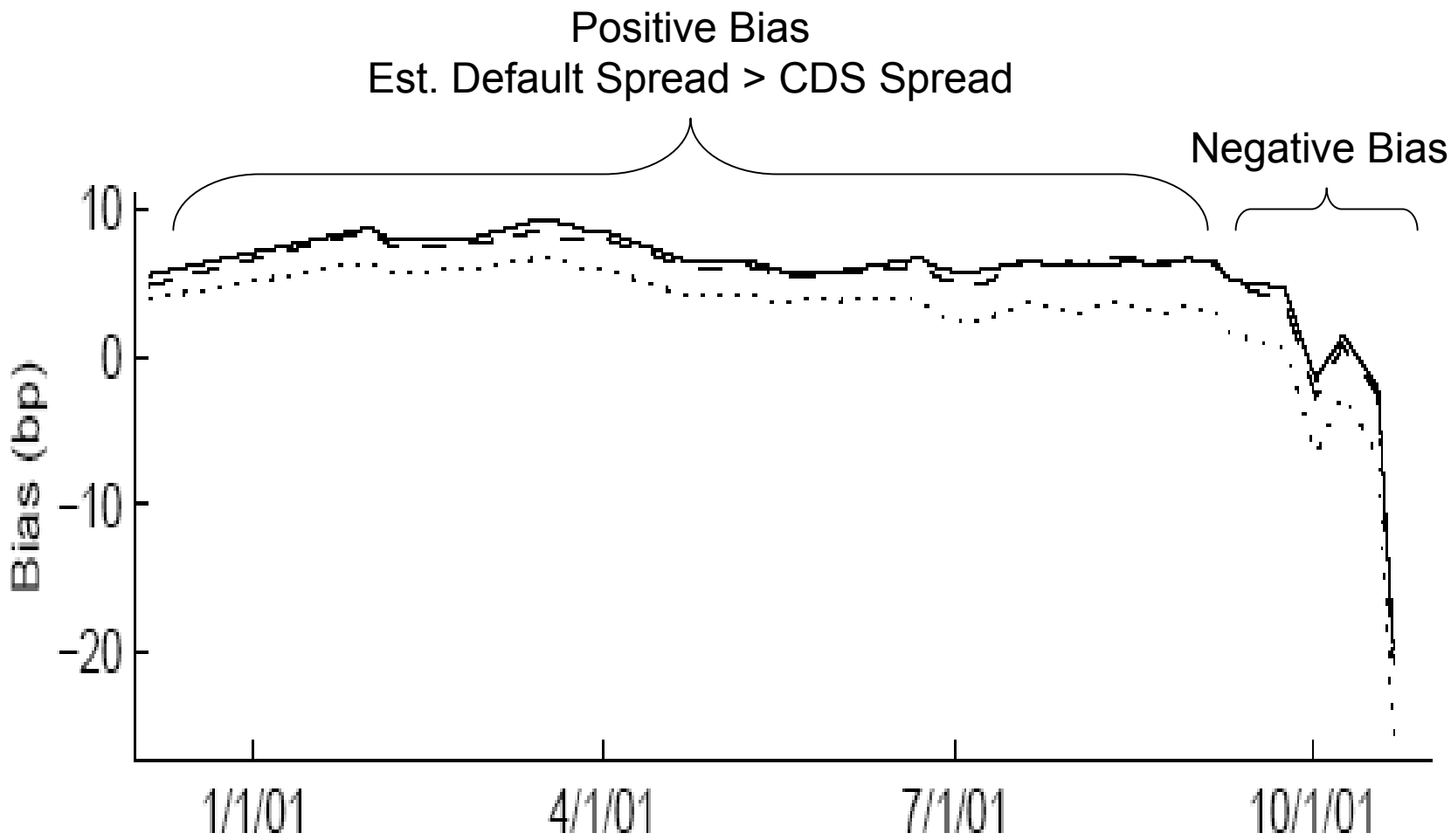


Some Preliminaries - II

$$d\lambda = (\alpha - \beta\lambda)\,dt + \sigma\sqrt{\lambda}\,dZ_\lambda$$



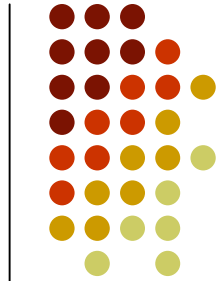
Some Preliminaries - III



Main Results

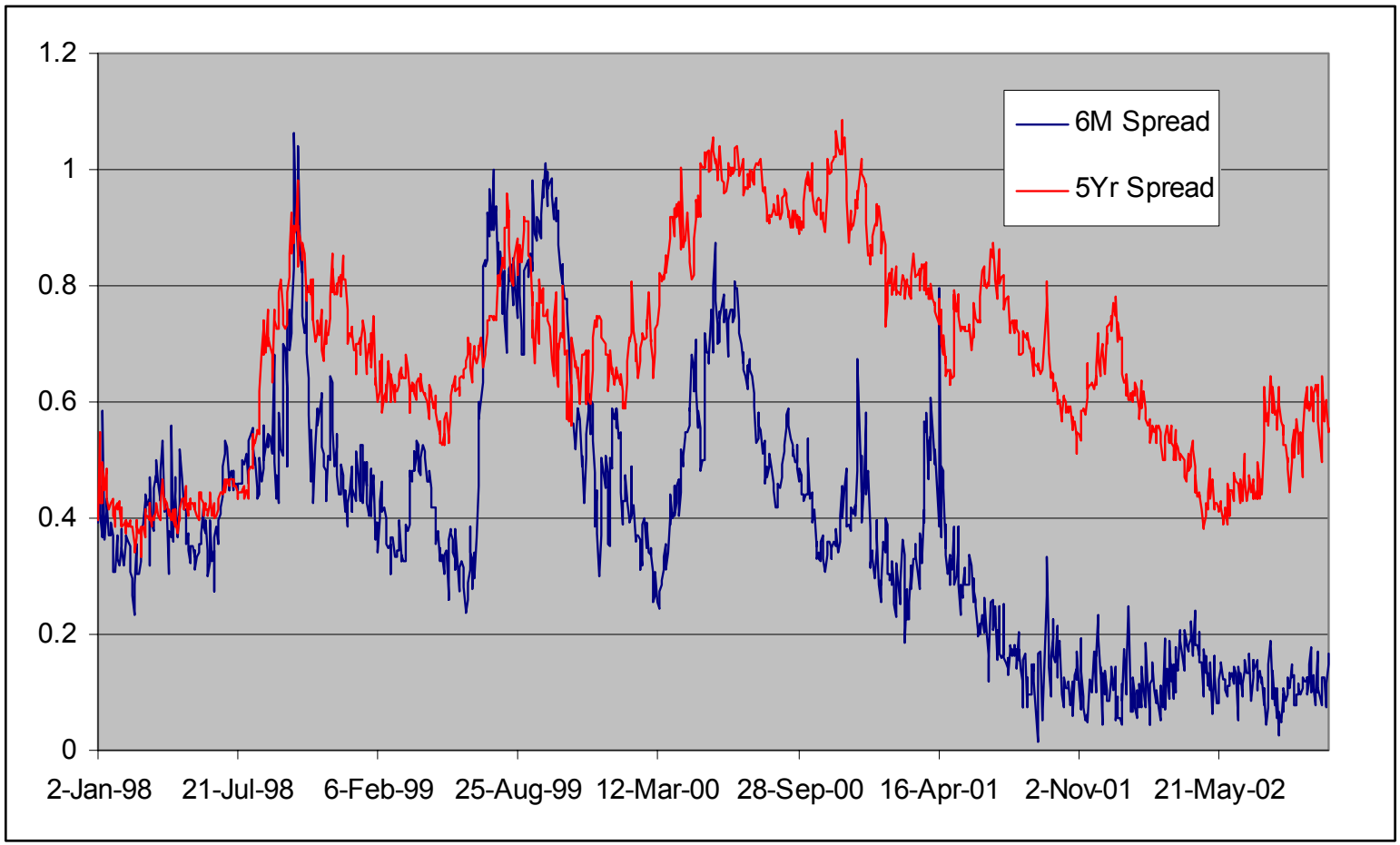
- Longstaff et al
  - Y – CDS = Swap – 5 bp (Aaa/Aa)
  - Y – CDS = Swap + 13.4 bp (A)
- Marsh et al
  - Y – CDS = Swap – 6.9 bp (Aaa/Aa)
  - Y – CDS = Swap – 0.5 bp (A)
- What does it mean?

The Benchmark?



- Treasuries?
  - Taxation effects
  - Regulatory effects
- Swap Rates?
  - Yield on perpetual Aa bond (historic 12-month Aa default experience < 2 bp)
  - Swap counterparty credit risk < 2 bp
  - No liquidity problems

Recent ‘Credit’ Spreads: Swap – Treasuries



Some questions

- Why does the spread vary so widely over time?
- Why is the 6-month spread so different from the 5-year spread?
- Until the reasons underlying the swap spread are resolved it will be difficult to interpret the CDS results that are tied to one benchmark or the other

Some Observations

- The Huang and Huang results reported by Schaefer in which the Merton's model spreads are too low may be driven by the selection of benchmark
- The risk-free rate suggested by Kealhofer is consistent with a credit adjusted swap benchmark