Term Structure of Credit Spreads with Dynamic Debt Issuance and Incomplete Information

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May 2018

Research Question

- The “credit spread” puzzle
- Specific focus on short term IG corporate credit spreads

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- Imperfect information model of *Duffie & Lando (2001)*, with
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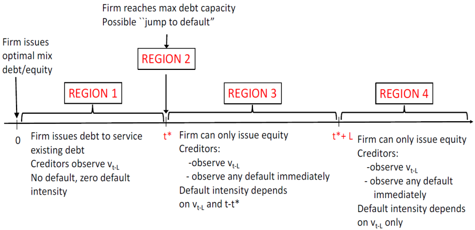
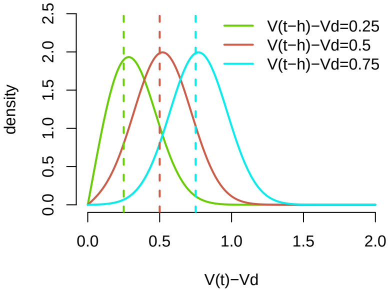
- Model time-line



Key Insight

Incomplete information $\Rightarrow$ characterize $\pi\left(V_t | \tau_d > h, V_{t-h}\right)$



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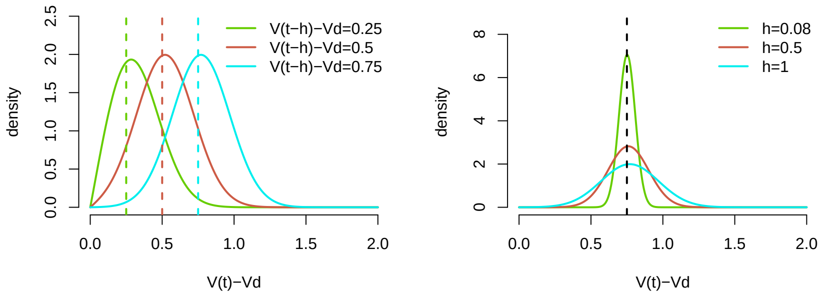

Default intensity $\lambda(V_{-h}) = \frac{\sigma^2}{2}\frac{d}{dV}\left[\pi\left(V | \tau_d > h, V_{-h}\right)\right]\Big|_{V=V_d}$

Thoughts/Suggestions

- Tension introduced by information structure
  - investors' info. set $\mathcal{F}_t \subset \mathcal{G}_t$ (management info. set)
  - Corporate insiders cannot be allowed to trade shares
  - No dividends – how exactly is share price defined?

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- Pushing further
  - Test predictions re: transition rates from IG to "fallen angels"?
  - What about expected excess returns?
  - Spread decomposition – "fundamentals" vs. "information"?

The "Puzzle"

- Is there really a "credit spread" puzzle for IG firms at short horizons?
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  - Should we focus on CDS?
- Funding cost is non-trivial, even for short-dated IG bonds
  - Tri-party repo rates for corporate debt are far above GC repo rates
  - Almost no tri-party repos available for durations > 3 months
  - Holding bond $+$ CDS attracts strictly positive regulatory capital for banks