Discussion on: The Impact of Liquidity on Senior Credit Spreads during the Subprime Crisis

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Summary

- Use the cointegration analysis to establish an equilibrium relationship between CDX spreads (AAA bond index spreads) and certain “structural variables”.

- Then use the ECM to analyze how changes in the CDX spreads (AAA bond index spreads) are related with the changes in the structural and non-structural variables as well as the EC term.

- The study focuses specifically on the pre-crisis and crisis periods.

- The main conclusion is that liquidity and risk-aversion are important drivers of the increase in the CDX spreads.

- Overall, this is a nicely organized paper providing a comprehensive empirical analysis on the relation between liquidity and CDX spreads during the crisis.
Comments and Suggestions

• It is not clear about the benefits of classifying liquidity and risk-aversion as non-structural variables. There are theoretical structural models include liquidity as a structural variables, e.g., He and Xiong (2012); and risk premia (credit or liquidity risk) implicit in CDS spreads are structurally linked with risk aversion.

• Equity value is not a good measure of leverage, DtD (distance to default) is a much better measure; using S&P index seems arbitrary, S&P composition also changes over time. Actually, even just using the current composition of CDX to construct the index would be much better and more relevant than S&P index.
Comments and Suggestions (cont.)

- The author concludes that the increase in CDX spreads during crisis was driven by liquidity and risk aversion but not by the correction of a pre-crisis underpricing. The second part of the conclusion seems lack of solid evidence.