Cambridge Judge Business School

Finance & Accounting Seminar Series

THE CREDIT SPREAD PUZZLE - MYTH OR REALITY?

Speaker: Dr Peter Feldhutter, London Business School
Date: 21 January 2014
Time: 10:30-12:00
Venue: Cambridge Judge Business School (W2.01)

Abstract

A number of papers find that standard structural models predict corporate bond spreads that are too low compared to actual spreads, giving rise to the so-called credit spread puzzle. In this paper we examine the existing literature documenting the credit spread puzzle and find that common approaches to testing structural models suffer from strong biases and low statistical power. We then test the Merton model in a bias-free approach using more than half a million transactions in the period 2002-2012. We find that the Merton model captures both the average level and time series variation of 10-year BBB-AAA spreads. However, the Merton model under-predicts long-term AAA/AA spreads by 30 basis points on average.

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