FIXED INCOME

Asset-Measurement Uncertainty and Credit-Term Structure

April 5, 2011

Working paper

In this paper, we test whether credit investors' uncertainty about a company's asset values affects short-term credit spreads and the underlying credit term-structure. There are three main reasons why we think that the time period studied in this paper provides a powerful setting to test this hypothesis.

First, the growth of a liquid credit default swap market provides a rich cross-section and time-series of clean and reliable data on credit term-structure. Second, regulators began requiring firms to improve disclosures for difficult-to-sell financial assets. Third, the spike in financial market volatility 2007 allowed for more powerful tests to discriminate between potential determinants of short-horizon credit spreads.

Our results suggest that the credit term-structure is flatter at the short end for firms with higher asset measurement uncertainty as captured by larger magnitudes of difficult-to-sell Level 2 and Level 3 assets, which are assets with values based partly on internal estimates, relative to total assets. Our findings are robust to a variety of control variables and sensitivity analyses and are consistent with our predictions, which are guided by a theory that Darrell Duffie and David Lando first published in 2001.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.