Estimating Loss Given Default from CDS under Weak Identification

Job Market Paper

Lily Y. Liu *

Duke University

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Abstract

This paper combines a term structure model of credit default swaps (CDS) with weak-identification robust methods to jointly estimate the probability of default and the loss given default of the underlying firm. The model is not globally identified because it forgoes parametric time series restrictions that existing studies rely on to guarantee identification, but that are difficult to verify in the data. The empirical results show that informative (small) confidence sets for loss given default are estimated for half of the firm-months in the sample, and most of these do not include the conventional value of 0.60. In addition, risk-neutral default probabilities, and hence risk premia on default probabilities, are underestimated when loss given default is exogenously fixed at the conventional value instead of estimated from the data.

JEL Codes: G12, G13, C58, C13, C14

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