

Credit risk signals in CDS market vs agency ratings

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Abstract

Purpose – This research aims to model the relationship between the credit risk signals in the credit default swap (CDS) market and agency credit ratings, and determines the factors that help explain the variation in such signals.

Design/methodology/approach – A comprehensive analysis of the differences in the relative credit risk assessments of CDS-based risk signals and agency ratings is provided. It is shown that the divergence between credit risk signals in the CDS market and agency ratings is explained by factors which the rating agencies may consider differently than credit market participants.

Findings – The results suggest that agency credit ratings of relative riskiness of a reference entity do not always correspond with assessments by CDS spreads, as the price of risk is a function of additional macro and micro factors that can be explained using statistical analysis.

Originality/value – This research is unique in modeling the relationship between the credit risk assessments of the CDS market and the agency ratings, which to the best of the authors' knowledge has not been analyzed before in terms of their agreement and the level of discrepancy between them. This model can be used by investors in debt instruments that are not explicitly CDSs or which have illiquid CDS contracts, to replicate market-based, point-in-time credit risk signals. Based on both market-based and firm-specific factors in this model, the results can be used to augment through-the-cycle credit risk assessments, analyze issues surrounding the pricing of CDSs and examine the policies of credit rating agencies.

Keywords CDS, Credit rating agencies, Credit risk, Credit default swap, Credit ratings

Paper type Research paper



1. Introduction

The primary purpose of a credit default swap (CDS) contract is to provide protection to the purchaser of a debt instrument in case of default or a related credit event, serving as

JEL classification – G10, G20, G24, G28, G32

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