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Market Illiquidity and Pricing Errors in the Term Structure of CDS

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Abstract : This paper studies the informational content of pricing errors in the term structure of sovereign CDS spreads. The residuals from a non-arbitrage model are employed to construct a Price discrepancy estimate, or noise measure. The noise estimate is understood as an indicator of market distress and reflects frictions such as illiquidity. Empirically, the noise measure is computed for an extensive panel of CDS spreads. Our results reveal an important fraction of systematic risk is not priced in default swap contracts. When projecting the noise measure onto a set of financial variables, the panel-data estimates show that greater price discrepancies are systematically related to a higher level of offsetting transactions of CDS contracts. This evidence suggests that arbitrage capital flows exit the marketplace during time of distress, and this consistent with a market segmentation among investors and arbitrageurs where professional arbitrageurs are particularly ineffective at bringing prices to their fundamental values during turbulent periods. Our empirical findings are robust for the most common CDS pricing models employed in the industry.

Keywords : credit default swaps, noise measure, illiquidity, capital arbitrage
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