

On Reliability of a Credit Default Swap Contract during the EMU Debt Crisis

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Abstract : Reliability of the credit default swap market had been questioned repeatedly during the EMU debt crisis. The article examines whether this development influenced sovereign EMU CDS prices in general. We regress the CDS market price on a model risk neutral CDS price obtained from an adopted reduced form valuation model in the 2009-2013 period. We look for a break point in the single-equation and multi-equation econometric models in order to show the changes in relations between CDS market and model prices. Our results differ according to the risk profile of a country. We find that in the case of riskier countries, the relationship between the market and model price changed when market participants started to question the ability of CDS contracts to protect their buyers. Specifically, it weakened after the change. In the case of less risky countries, the change happened earlier and the effect of a weakened relationship is not observed.

Keywords : chow stability test, credit default swap, debt crisis, reduced form valuation model, seemingly unrelated regression

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