



An empirical analysis of the structure of credit risk premiums in the Eurobond market

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Abstract

This research finds some empirical evidence of a rising term structure of credit risk premiums for high-grade Eurobonds and a declining term structure for low-grade Eurobonds. However, the results are discovered to vary somewhat across individual issuers. Perhaps most importantly, evidence is found that credit risk premiums on bonds with the same credit rating vary significantly across currencies. The latter finding holds true even for Eurobonds from the same issuer.

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1. Introduction

Although bond pricing in domestic markets has been widely investigated (Helwege and Turner, 1999), there has been little academic research into the multi-trillion dollar Eurobond market (Fabozzi, 2000). This market is important not only for its size, but also for the opportunity to examine bond yields across currencies in a single market. While many different aspects of this huge market could be explored, this research focuses on empirically evaluating the pricing of credit risk in the Eurobond market. In particular, the structure of credit risk premiums across different maturities and currencies is examined.

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1.1. Credit risk premiums varying across currencies

Elton et al. (2001) have found empirical evidence that a large component of credit risk premiums on US corporate bonds consists of compensation for their systematic risk or return covariation with diversified equity portfolios. The researchers found the yield required to compensate investors for expected default losses to be relatively small. Since Vine (1997) has previously cited some general evidence of different credit risk premiums being required across different currencies, and since the yield required to cover default losses should be the same regardless of the currency, an investigation of Eurobond yields offers the opportunity to uncover evidence of systematic risk premiums varying across currencies.

Theoretically, in a perfect market, the additional yield required by investors for credit risk should be the same, regardless of the currency of the debt payments, especially since swaps can be arranged to easily turn payments in one currency into another (Abken, 1998). Except for the more customized swaptions that permit arbitrage of callable debt (Bhattacharya and Fabozzi, 1997), the transaction costs of major currency swaps are typically very small (Beidleman, 1992), so that differing yield premiums on Eurobonds denominated in different currencies but with the same credit risk may be cheaply arbitrated with swaps.

However, it may not be possible to implement such arbitrage in practice due to the transaction costs of trading the Eurobonds. In particular, because of the large portion of buy-and-hold retail investors (almost 50%) in the Eurobond market, there is substantial trading illiquidity (Steward and Greshin, 1997). As a result, given the existence of differing perceptions of default risk across countries and banks that effectively determine Eurobond prices in a market with a shortage of qualified credit analysts (Lee, 1999), systematically different expectations of default losses among investors with heterogeneous preferred currency habitats might cause differing yield spreads across currencies. Market imperfections, such as information-gathering costs (Merton, 1987), and investor consumption and risk preferences (Stulz, 1981) can indeed result in investors preferring risky issues in one currency or the other, and so different yield premiums may be required in different currencies for the same credit risk, just as different systematic risk premiums have been found on equity investments in different countries (Solnik, 1974). For instance, Goldman (1999a) reports a case of two issues of a bank's senior unsecured bonds denominated in different currencies trading at different premiums above the respective risk-free Treasury yields in those currencies.

The existence of heterogeneous expectations of default risk amongst investors can result in swapped funding costs for issuers that effectively vary by the currency of issue. In particular, many organizations claim that they can save on the interest costs of borrowing by issuing bonds in one particular currency with a relatively low rate, even after engaging in swaps in order to enable debt repayments to be effectively made in the currency that the issuer would prefer (Singer, 2001). As cited by Lee (1999), investors themselves prefer not to arbitrage such situations with swaps because of the illiquidity of the positions. In particular, unlike issuers who almost invariably hold on to their Eurobond liability position until maturity, some investors

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