The Term Structure of Recovery Rates*†

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Abstract

There is widespread agreement that corporate recovery rates are time-varying, but empirical work in this area is limited due to the econometric difficulty in isolating default probabilities from recovery rates. In this paper, we identify the dynamics of the term structure of recovery rates by simultaneously using the information from senior and subordinate credit default swaps. We estimate a reduced form model on forty-six firms across different industries and show that recovery rates change rapidly in response to economic events. We find that, on average, the term structure of expected recovery rates is downward sloping. However, an inversion takes place during bad economic times, during which it is upward sloping. Thus, during such periods, the market expects higher recoveries conditional on short-term survival. The inversion of the recovery term structure during economic downturns is more pronounced for firms in distressed industries. Overall, we provide strong empirical evidence for the cyclical nature of recovery.

JEL Classification: G01, G12
Keywords: credit default swap; no-arbitrage; stochastic recovery rate; seniority; term structure

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