Department of Accounting

Asset Management Uncertainty and Credit Term-Structure

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Abstract

In this study, we test the impact of uncertainty in asset measurementon credit term-structure. The theory of Duffie and Lando (2001) suggests that the inability of creditors to assess asset values precisely will support the existence of non-zero short term credit spreads. Developments in recent years enable us to directly test this theory. First, the development of the credit default swap market allows for examination of more precise and cross-sectionally comparable short term credit spreads. Second, FAS 157, which requires detailed disclosures of the fair values of financial assets to be included in financial statements, provides us a proxy for asset measurement uncertainty. Third, the financial crisis over the last two years presents a natural setting where asset measurement uncertainty was in focus, allowing for powerful tests of the theory. For a sample of U.S. financial institutions over the period August 2007 to March 2009, we find strong support for the Duffie and Lando (2001) theory. Specifically, we find that asset measurement uncertainty, attributable to Level 2 and Level 3 financial assets, is a significant determinant of short term credit spreads. Our findings are robust to a variety of control variables and research design choices.