

Understanding the Role of Recovery in Default Risk Models: Empirical Comparisons and Implied Recovery Rates

Abstract

This article presents a framework for studying the role of recovery on defaultable debt prices (for a wide class of processes describing recovery rates and default probability). These debt models have the ability to differentiate the impact of recovery rates and default probability, and can be utilized to invert the market expectation of recovery rates implicit in bond prices. Empirical implementation of these models suggests two central findings. First, the recovery concept that specifies recovery as a fraction of the discounted par value has broader empirical support. Second, parametric debt valuation models can provide a useful assessment of recovery rates embedded in bond prices. This article has attempted to model recovery and comprehend their impact on debt values.