

Contents

Preface	xi
Acknowledgments	xiii
1 Introduction	1
1.1. A Brief Zoology of Risks	3
1.2. Organization of Topics	7
2 Economic Principles of Risk Management	12
2.1. What Types of Risk Count Most?	13
2.2. Economics of Market Risk	15
2.3. Economic Principles of Credit Risk	26
2.4. Risk Measurement	29
2.5. Measuring Credit Risk	38
3 Default Arrival: Historical Patterns and Statistical Models	43
3.1. Introduction	43
3.2. Structural Models of Default Probability	53
3.3. From Theory to Practice: Using Distance to Default to Predict Default	57
3.4. Default Intensity	59
3.5. Examples of Intensity Models	64
3.6. Default-Time Simulation	72
3.7. Statistical Prediction of Bankruptcy	74
4 Ratings Transitions: Historical Patterns and Statistical Models	85
4.1. Average Transition Frequencies	85
4.2. Ratings Risk and the Business Cycle	87

4.3.	Ratings Transitions and Aging	91
4.4.	Ordered Probits of Ratings	92
4.5.	Ratings as Markov Chains	94
5	Conceptual Approaches to Valuation of Default Risk	100
5.1.	Introduction	100
5.2.	Risk-Neutral versus Actual Probabilities	102
5.3.	Reduced-Form Pricing	106
5.4.	Structural Models	112
5.5.	Comparisons of Model-Implied Spreads	114
5.6.	From Actual to Risk-Neutral Intensities	118
6	Pricing Corporate and Sovereign Bonds	122
6.1.	Uncertain Recovery	122
6.2.	Reduced-Form Pricing with Recovery	125
6.3.	Ratings-Based Models of Credit Spreads	137
6.4.	Pricing Sovereign Bonds	146
7	Empirical Models of Defaultable Bond Spreads	156
7.1.	Credit Spreads and Economic Activity	156
7.2.	Reference Curves for Spreads	162
7.3.	Parametric Reduced-Form Models	166
7.4.	Estimating Structural Models	169
7.5.	Parametric Models of Sovereign Spreads	171
8	Credit Swaps	173
8.1.	Other Credit Derivatives	173
8.2.	The Basic Credit Swap	175
8.3.	Simple Credit-Swap Spreads	178
8.4.	Model-Based CDS Rates	185
8.5.	The Role of Asset Swaps	190
9	Optional Credit Pricing	194
9.1.	Spread Options	194
9.2.	Callable and Convertible Corporate Debt	201
9.3.	A Simple Convertible Bond Pricing Model	215

10	Correlated Defaults	229
10.1.	Alternative Approaches to Correlation	229
10.2.	CreditMetrics Correlated Defaults	230
10.3.	Correlated Default Intensities	233
10.4.	Copula-Based Correlation Modeling	237
10.5.	Empirical Methods	242
10.6.	Default-Time Simulation Algorithms	243
10.7.	Joint Default Events	247
11	Collateralized Debt Obligations	250
11.1.	Introduction	250
11.2.	Some Economics of CDOs	252
11.3.	Default-Risk Model	255
11.4.	Pricing Examples	260
11.5.	Default Loss Analytics	271
11.6.	Computation of Diversity Scores	280
12	Over-the-Counter Default Risk and Valuation	285
12.1.	Exposure	285
12.2.	OTC Credit Risk Value Adjustments	295
12.3.	Additional Swap Credit Adjustments	304
12.4.	Credit Spreads on Currency Swaps	311
13	Integrated Market and Credit Risk Measurement	314
13.1.	Market Risk Factors	315
13.2.	Delta-Gamma for Derivatives with Jumps	326
13.3.	Integration of Market and Credit Risk	332
13.4.	Examples of VaR with Credit Risk	334
	Appendix A Introduction to Affine Processes	346
	Appendix B Econometrics of Affine Term-Structure Models	362
	Appendix C HJM Spread Curve Models	367
	References	371
	Index	385