CREDIT DERIVATIVES
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A PRIMER ON CREDIT RISK, MODELING, AND INSTRUMENTS

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INTRODUCTION

A Disease Known as Credit Risk

The following situation may sound familiar: A while ago, you lent money to a friend and the time has come for the friend to pay you back. You already worry, though, that your friend won’t be able to pay back the loan. The idea that you might have to remind him is unpleasant; it makes you uneasy, queasy, almost to the point of nausea. Well, we are here to inform you that you have just been infected with the Credit Risk virus. And you won’t be cured until the money is safely returned.

In the modern world, this is a virus as ordinary as the common cold. It does not limit itself to you or your friends. Credit risk touches anyone that extends a loan or has money due. It affects banks that offer loans to individuals, companies that give credit lines to their customers, and investors that buy corporate bonds from companies. In each of these examples, the credit taker—the individual, the clients, or the company—may not return the money or pay back the loan.

Put simply, credit risk is the risk that a borrower won’t pay back the lender.

Of course, this should be expected when lending money—and it should be just as expected that the lender wants to evaluate how “safe” or credit worthy the borrower is. Banks run background checks on borrowers to avoid ending up with—in industry terms—a non-performing or bad loan. For instance, if an individual applies for a house purchase loan, the bank will automatically verify the applicant’s history of bank
loans. This check of a person’s credit worthiness answers several questions: Has he taken loans earlier, how big were they, and did he pay them back on time? Furthermore, are there assets that the bank can use as substitutes for payment—also known as guarantees or collateral—if the person does not pay back the loan? How valuable is the collateral, or rather, how much of the bank loan can the collateral pay back (sometimes referred to as the recovery rate)?

The same type of evaluation takes place if the borrower is a company. Picture a corporation that wants to build a new steel factory and applies for a loan to finance the factory. The bank will want to learn the history of the company. Is it knowledgeable about the steel industry? Has it built steel factories before? Does it have a credit rating from an external agency, such as Standard & Poor’s or Moody’s? What guarantees can it provide? A good bank will discuss all these issues before deciding whether to grant the steel factory a loan.

Credit risk is not limited to banks and their borrowers. Companies themselves are exposed to credit risk when they trade with customers and suppliers. In business, almost all companies are exposed to credit risk, simply because they do not ask for direct payments for products or services. Think of the standard payment program for a new car: The car dealership carries a credit risk, which slowly diminishes until the car is paid in full. Or, think of the typical company that ships its products with a bill specifying 30 days net payment: During those 30 days, and until payment has been made, the company is exposed to credit risk. As a result, companies often have to rely on its clients and trust their credit worthiness.

Companies also have to pay attention to their own credit risk. If the actors in the financial markets—such as banks and bond investors—believe that a company’s credit worthiness has dropped, they will charge more for lending money to that firm, because they now have to factor in a higher perceived uncertainty and risk. For the firm, this means that its borrowing cost rises, as lenders demand a higher interest on loans than before. In other words, credit risk is a “disease” that can hit a company both as a lender and as a borrower.
Curing Credit Risk: Credit Derivatives

Several methods and instruments for handling credit risk have been developed over the years. Of course, the easiest way to avoid credit risk is to refuse making a loan. Although this may be a pretty infallible method of credit enhancement, it eliminates the possibility of making any kind of a profit. Other methods are less drastic. Some of them involve changing a company’s business practices—for instance, asking for payment before the service or product is delivered. This is more natural for some businesses than others; popular examples include magazine subscriptions, health club memberships, or travel. If the company cannot manage this change in cash flow, it can still improve its credit exposure. For instance, the company mentioned earlier with a 30-days net payment practice can simply tighten the payment terms to, for example, 15 days. It can apply this practice across the board for all customers, or just for troubled clients with a history of paying late or not at all. Companies can also sign up for insurance products or ask for guarantees or letters of credit from their counterparts.

More advanced methods involve financial instruments known as credit derivatives. Initially created by actors in the financial sector, such as banks and insurance companies, these tools are now also commonly used by regular commercial businesses. Credit derivatives include instruments such as total return swaps, credit spread options, and credit linked notes. They all serve the same primary purpose: to help companies and institutions reduce credit risk by separating out the credit risk part of an investment or asset and sell it onward. As an example, let’s return to the bank that was considering making a loan to a steel factory. The bank believes in the project, and wants to grant the loan. However, it already has a number of loans outstanding to other steel factories, and worries about its overall exposure to the steel industry. If the steel sector were to experience economic difficulties, the bank would have a number of borrowers that might be unable to pay their interests or repay their loans. Therefore, to be able to grant the loan to the new steel factory, the bank (let’s call it Bank A) turns to another bank (Bank B) and enters into an agreement using a credit derivative mechanism.
The agreement says that if the steel company stops its loan payments (or defaults on them, to use the industry jargon), Bank B will pay Bank A the amount in the place of the steel company. For this service, Bank A will pay a monthly fee to Bank B. Hopefully, the steel company will never default on its loan payments, but if it does, Bank A is now insured against the effects of that eventuality. On the one hand, Bank A’s credit exposure improves. On the other, Bank B earns a monthly fee and wagers that the steel factory will probably not default on its loan.

This basic agreement is an example of a credit derivative (in this case, a credit default swap). Credit derivatives are financial instruments or contracts that allow a participant to decrease (Bank A in the preceding steel example) or increase (Bank B) its exposure to a particular type of credit risk for a specified length of time.

Who Suffers from Credit Risk?

This book is for anyone who suffers from credit risk, wants to understand the disease better, and wants to learn what there is to do about it. It is an introductory book—hence the word Primer in its title—and thus is not meant for the seasoned credit risk manager with years of credit experience. However, it is still a practitioner’s book, written for the working professional and not for the academic researcher.

The book is a guide for industry, service, or finance professionals with an interest in credit risk and credit instruments. It is meant for investing institutions on the buy-side of the financial markets, such as mutual funds, pension funds, and insurance firms, as well as sell-side retail brokers and research departments. Our reader can be, for example, the chief financial officer (CFO) who wants to assess a proposal for a new credit derivative—or the investment banker who sits down to prepare the proposal.
How to Read This Book

Investors face all sorts of risk and not just credit risk. Grouping risks into different “baskets” helps investors choose which type(s) of risk to accept and which to leave for other investors. They might try to minimize company-specific risk through diversification, or use long-short strategies to cancel out market risk as they speculate on converging prices for individual securities. Interest rate risk is a common concern for anyone else looking to finance a large project. Investors who consume in one currency but invest in another are exposed to currency risk.

This book, however, addresses none of these risks. Instead, it focuses on another important risk that is often borne by investors, namely the risk that a company or individual cannot meet its obligations or liabilities on schedule: credit risk.

Part I, “What Is Credit Risk?,” covers the basics of credit risk. It defines what credit is, what facing credit risk might entail, and also gives a short overview of some common credit derivative tools that transfer credit risk from those investors who do not want to bear it to those investors who are willing to accept it. The two chapters also discuss concepts such as default probabilities, recovery rates, and credit spreads.

After the introduction, Part II, “Credit Risk Modeling,” then goes into detail on how credit risk models can be used to describe and predict credit risk events. It covers three different approaches to modeling credit risk: the structural, empirical, and reduced-form approaches. Chapter 3 focuses on structural models. It features the Merton model as an example of the approach, and also discusses the Black and Cox, and Longstaff and Schwartz models. Chapter 4 looks at empirical models, especially the Z-model, and reduced-form models, such as the Jarrow-Turnbull model.

Part III, “Typical Credit Derivatives,” concludes the book by discussing in detail two specific credit derivative instruments used to transfer credit risk. Chapter 5 looks at credit default swaps (CDSs) and Chapter 6 at collateralized debt obligations (CDOs).
Endnotes

1 In financial jargon, a derivative is a financial instrument whose value is based on, or derived from, another security such as stocks, bonds, and currencies. For instance, a typical derivative is a stock option, which gives the holder the right but not the obligation to buy a company's stock at a future date. Derivatives can also be seen as contracts between two parties; its value then normally depends on a risk factor such as a credit event, an interest rate level, bond prices, currency changes, or even weather data. A credit derivative thus derives its value from a credit note, such as a corporate bond, just as a currency forward contract derives its value from currency exchange rates.
INDEX

A
ABSs (asset-backed securities), 192
Acme, Inc., balance sheets, 67
adjusted market value, 216
advance rates, market-value CDOs, 215-216
Altman’s initial Z-score paper, 124-125
Altman, Edward I., 121, 125
American option, 72
arbitrage CDOs versus balance-sheet CDOs, 222
arbitrage motivated CDOs, 198-199
arrival rate, 132
arrivals, 131
asset price volatility, 86
asset value
  comparing Black and Cox model and Merton model, 112
  sensitivity analysis of Merton model, 102
asset value models, 66
asset volatility
  comparing Black and Cox model and Merton model, 111
  sensitivity analysis of Merton model, 99-100
asset-backed securities (ABSs), 192
assets, 67
attachment point, 195

B
bad loans, 3
balance sheets
  balance sheet motivated CDOs, 197
  structural credit risk models, 66-69
balance-sheet CDOs versus arbitrage CDOs, 222
Bank for International Settlements (BIS), 58
bankruptcies, 18, 193
  by geography, 37
  U.S. companies, 17
bankruptcy filings, U.S., 14-15
banks, CDOs, 223
barrier function, Black and Cox model, 105-107
basis points, 59
basket CDSs, 156-157
basket credit default swaps, 49
basket default swaps
  loss distribution, 179
  pricing, 176-177, 181-182
    nondefault correlation portfolio, 178-181
    perfect default correlation portfolio, 177-178
BBA (British Bankers’ Association), 55, 187
being long, 73
binary CDSs, 154-155
BIS (Bank for International Settlements), 58
Black and Cox model, 70, 104
  barrier function, 105-107
  comparing to Merton model, 110-113
  example of applying extension to Merton model, 107-110
Black, Fischer, 104
Black-Scholes economy
  applying Merton model, 83-84
  assumptions underlying this approach, 86-87
  Black-Scholes formula for call options, 84-85
  Black-Scholes formula for put options, 86
Black-Scholes model, volatility value, 92
bonds, 12
commercial papers, 13
corporate bond market, 34
corporate bonds, 13
corporate bonds with risk premium, 24
corporate bonds without risk premium, 23
government bonds, 13
public and private bond market debt, U.S., 33
redemption features, 14
risk-free bonds, 13
U.S. Treasury Bonds, 13
zero-coupon bonds, 14
book value, 128
breaking points, 71
British Bankers’ Association (BBA), 55, 187

C
calculating
credit spread, 25-26
debt value, Merton model, 89-90
expected default payment, 226
risk-neutral default probability, 94-95
call options, 52, 71-72
Black-Scholes formula, 84-85
cash CDOs, 193, 199
cash flows
arbitrage motivated CDOs, 199
basket CDSs, 157
CDOs, 193
CDOs of EDS, 204
digital CDSs, 155
iTraxx, 163
plain vanilla CDSs, 153
portfolio CDSs, 159
synthetic CDOs, 200
cash settlement, 153
cash-flow CDOs, 205-208
O/C and I/C, 208-215
cash-flow period, life cycle of CDOs, 197
cash-flow waterfall, cash-flow CDOs, 207
CBOs (collateralized bond obligation), 52, 191
CDO market, 220-223
CDO squared, 202-203
CDO2, 202
CDOs (collateralized debt obligations), 52, 147, 189, 192-195
arbitrage motivated CDOs, 198-199
balance sheet motivated CDOs, 197
balance-sheet CDOs versus arbitrage CDOs, 222
cash CDOs, 199
cash flows, 193
CDO squared, 202-203
CDOs of EDS, 203-204
credit enhancement provisions, 205
cash-flow CDOs, 205-215
market-value CDO, 205-206
life cycle, 197
market-value CDOs. See market-value CDOs
pricing, 220, 225-227
Cholesky decomposition, 232-233
comparing protection leg and premium leg to arrive at a fee, 230
Copula model, 244-245
with correlation using a Monte Carlo simulation, 237-244
with no correlation using a Monte Carlo simulation, 234-237
premium leg, 230
protection leg, 227-229
simulating default outcomes to arrive at a price, 231-232
protection buyers, 223
protection sellers, 223
seniority, 194
synthetic CDOs, 199-201
tranches, 194-197
CDOs of EDS, 203-204
CDS market, 186-188
CDSs (credit default swap), 48-49, 56, 147-148, 151
  basket CDSs, 156-157
digital CDSs, 154-155
indices, 160-163
interest rate swaps, 148-150
leg, 165
multiname CDSs, 156
  pricing, 172-176
multiname CDSs. See multiname CDSs
plain vanilla CDSs, 152-154
portfolio CDSs, 158-159
premium leg, 165
pricing, 164-165
pricing swaps, 150-151
protection leg, 165
protection sellers, 188
single-name CDSs, 156
Cholesky decomposition, 226, 232-233
Cholesky, Andre-Louis, 232
CLNs (credit linked notes), 49-51
CLO (collateralized loan obligation), 52, 191
CMOs (collateralized mortgage obligations), 52, 191
collateral, 4, 59
collateralized bond obligation (CBO), 52, 191
collateralized debt, 53
collateralized debt obligations. See CDOs
collateralized loan obligation (CLO), 19, 52, 191
collateralized mortgage obligations (CMOs), 19, 52, 191
collateralized products, 52
Colombia Healthcare, 38
corporate bond market, 34
corporate bond with risk premium, 24
corporate bond without risk premium, 23
corporate bonds, sinking fund provision, 13

correlation
  Cholesky decomposition, 232-233
defaults, 225
  pricing CDOs using a Monte Carlo simulation, 237-244
countries, defaulting on loans, 17
coupon payments, 14
coupons, 10
coverage tests, 206, 209-215
covered option, 118
Cox, J.C., 104

credit
  defined, 10
  types of, 11-14
credit default option, 189
credit default spread premium, 152
credit default swap spread, 152
credit default swaps. See CDSs
credit derivatives, 5-6, 44-46
credit derivatives market, 53-54
  market participants, 55-56
  product usage, 56-57
  regional markets, 54
  underlying reference assets, 57-58
credit enhancements provisions
cDOs, 205
  cash-flow CDOs, 205-215
  market-value CDOs, 205-206
market-value CDOs, 215
  advance rates and overcollateralization tests, 215-216
  example using advance rates to calculate overcollateralization ratios, 217-220
credit event after merger, 18
credit events, 18
credit exposure, 20
credit linked notes (CLNs), 49-51
credit rating, recovery rate, 42
credit rating agencies, 26-27
credit ratings
  evaluating default probability, 27, 30-31
  one-year ratings transition matrix, 31
credit risk, 3-4
  defined, 9, 20
  measuring through credit spread, 21-24
  reducing, 5-6
  who suffers from credit risk?, 6
credit risk instruments, 45
credit risk models
  empirical credit risk models, 65
  reduced form models, 65
  structural credit risk models, 65-66
    balance sheet, 66-69
    limitations, 69
    Merton model. See Merton model
  option pricing, 70
  types of, 70
  structure of, 64
credit risk statistics, 33-35
  default rates, 35-38
  recovery rates, 40-43
credit scoring models, 120-121
  Z-score model, 121-123
    Altman's initial Z-score paper, 124-125
    example, 126-127
    Z'-score, 128-130
credit spread, 21-22
  calculating, 25-26
  corporate bond with risk premium, 24
  corporate bond without risk premium, 23
  determining with Merton model, 90-91
  irregularities, 97
  risk-free government bond, 23
credit spread options (CSOs), 51-52
credit spread sensitivity
  against maturity time by default intensity, Jarrow-Turnbull model, 141-142
  against maturity time by recovery rate, Jarrow-Turnbull model, 143
credit structures, CDOs, 205
creditors, 10
cross-default provisions, 105
CSOs (credit spread options), 51-52
currency, 11
currency risk, 7
D
debt
  investment grade debt, 26
  junior debt, 19
  junk bonds, 26
  Merton model, 79-81
  mortgage related debt, 34
  non-investment grade, 26
  public and private bond market debt, U.S., 33
  risky debt, Merton model, 76
  senior debt, 19
  speculative grade, 26
debt obligations, 12-14
debt value
  calculating with Merton model, 89-90
  sensitivity analysis of Merton model, 103-104
debt waterfalls, 19
debtors, 10
default, 6
default correlation, 173, 225
  basket default swaps, 177-178
  multiname CDSs, 173-174
default data, evaluating default probability, 27, 30-31
default intensity, 131-133
  credit spread sensitivity against maturity time by default intensity, Jarrow-Turnbull model, 141-142
  Jarrow-Turnbull model, 138-139
  over time, 133-136
default intensity modeling, 131
default probability, 21, 225
evaluating, 26-27
credit ratings and default data, 27, 30-31
example of difficulty in rating, 31-33
default probability, 21
default process, 19
default rates, 35-36
by geography, 36-38
by industry sector, 38
for 1994, 30
default remoteness, 193
default risk. See credit risk
default timing, Merton model, 104
default-free bonds, 13
default-free rate, 23
defaulting on loans, 14
companies, 15-17
countries, 17
individuals, 14
defaults
correlation, 225
credit events, 18
derivatives, 8
diffusion process, 116
digital CDSs, 154-155
distribution, loss distribution, 173
distribution model, 144
Dow Jones CDS indices, 160
Dow Jones iTraxx, 160-161
cash flows, 163
equity value, finding debt value by calculating equity value (Merton model), 89
Euro LIBOR, 162
European options, 72
evaluating default probability, 26-27
credit ratings and default data, 27, 30-31
example of difficulty in rating, 31-33
exercise date, 72
expected default payment, protection leg (CDOs), 227-229
expected loss, 22
expiration date, 12
exponential function, 144
exposure at default (EAD), 20
extending Merton model, 104-105
barrier function, 105-107
example of applying Black and Cox’s extension, 107-110
Longstaff and Schwartz, 113-114

F
failure to pay, 18
finding
debt value by calculating equity value, 89
default intensity, Jarrow-Turnbull model, 138-139
First Passage model. See Black and Cox model
first-to-default (FTD), 49
first-to-default (FTD) basket CDSs, 156
fixed-recovery CDSs. See digital CDSs
FLP (First-to-Loss Protection), 49
FTD (first-to-default), 49

going long, 74
going long the credit, 153
going short the credit, 153
government action, credit events, 18
government bonds, 13
grey zone, 125
guarantees, 4

Index 251
H-I

haircut asset value, 216
I/C (interest coverage), 207
I/C (overcollateralization), 208-215
IMF (International Monetary Fund), 17
implied volatility, 92
in-the-money, 78
indenture, 118
indices, CDSs, 160-161
example, 161-163
individuals, defaulting on loans, 14
industries

default rates, 38
recovery rate, 42-43
inflation, interest, 11
insurance, 152
insurance companies, CDOs, 223
interest, 10-11
interest cash-flow waterfall, 211
interest coverage (I/C), 207-208
interest coverage test, 208
interest rate risk, 7
interest rates, 44
comparing Black and Cox model and Merton model, 112
sensitivity analysis of Merton model, 100-101
International Monetary Fund (IMF), 17
investment grade, 26
iTraxx, 160-161
cash flows, 163
iTraxx Europe, 162

J-K

Jarrow-Turnbull model, 130, 137
credit spread sensitivity against maturity time by default intensity, 141-142
credit spread sensitivity against maturity time by recovery rate, 143
default intensity, finding, 138-139
example, 139-140
sensitivity analysis, 140-141

joint default probability, 225
junior debt, 19
junk bonds, 26

L

leg, 150
CDSs, 165
liabilities, 67
LIBOR (London Inter Bank Offered Rate), 58, 148
life cycle of CDOs, 197
limitations, structural credit risk models, 69
loans, 11
bad loans, 3
defaulting on loans. See defaulting on loans
mortgages, 12
non-performing loans, 3
lognormal distribution, 87
London Inter Bank Offered Rate (LIBOR), 58
Longstaff and Schwartz model, 113-116
example of applying, 116-117
sensitivity analysis, 117
loss distribution, 173
basket default swaps, 179
multiname CDSs, 174-176
portfolio default swap, 184-185

M

marked-to-market, 206
market disruptions, credit events, 18
market participants, credit derivatives market, 55-56
market risk, 7
market value, 128
market value of equity/book value of total liabilities (MVE/TL), 123
market-value CDOs, 205-206
credit enhancements, 215
advance tests and overcollateralization tests, 215-216
example using advance rates to calculate overcollateralization ratios, 217-220
markets
  CDO market, 220-223
  CDS market, 186-188
maturity date, 12, 72
measuring credit risk through credit spread, 21-24
Merton model, 66, 70, 75-76, 78
  applying in Black-Scholes economy, 83-84
  assumptions underlying this approach, 86-87
  Black-Scholes formula for call options, 84-85
  Black-Scholes formula for put options, 86
comparing to Black and Cox model, 110-113
debt interpretation, 79-81
default timing, 104
equity interpretation, 78, 81-82
equity payoff as a function of asset value, 77
example, 87-88, 91-94
  arriving at the credit spread, 90-91
  balance sheet, 91
  calculating debt value directly, 89-90
  finding debt value by calculating equity value, 89
extending, 104-105
  barrier function, 105-107
  example of applying Black and Cox’s extension, 107-110
  Longstaff and Schwartz, 113-114
option pricing, 82-83
payoff of a zero-coupon Treasury Bond, 79
risk-neutral default probability, 94-95
risky debt, 76
sensitivity analysis, 95-98
  asset value, 102
  asset volatility, 99-100
  debt value, 103-104
  interest rates, 100-101
Merton, Robert C., 66, 75
mezzanine tranches, 243
models
  asset value models, 66
  Black and Cox model. See Black and Cox model
  Copula model, 244-245
credit risk models. See credit risk models
credit scoring models. See credit scoring models
default intensity modeling, 131
empirical models. See credit scoring models
Longstaff and Schwartz. See Longstaff and Schwartz model
Merton model. See Merton model
reduced form models. See reduced form models
Money Market, 34
Monte Carlo simulation, 227
  pricing with correlation, 237-244
  pricing with no correlation, 234-237
Moody, credit rating system, 27
moral hazard dilemma, 197
mortgage related debt, 34
mortgages, 12
multiname CDSs, 156
  pricing, 172-173
    basket default swaps, 176-182
    default correlation, 173-174
    loss distribution, 174-176
    portfolio default swap, 182-184, 186
MVE/TL (market value of equity/book value of total liabilities), 123
N
  naked option, 118
non-investment grade, 26
non-performing loans, 3
nondefault correlation portfolio, basket default swaps, 178-181
notional amount, 150
nth-to-default basket CDSs, 156
O

O/C (overcollateralization), 207-215
obligor, 10
option pricing, 66
  Merton model, 82-83
  structural credit risk models, 70
options
  American options, 72
  being long, 73
  call options, 71-72
  covered option, 118
  defined, 71
  equity, 71
  European options, 72
  going long, 74
  naked option, 118
  payoffs for holding options, 73
  payoffs for selling options, 74-75
  put options, 71, 73
  shorting the option, 74
OTC (over-the-counter) market, 53
out-of-the-money, 78
over-the-counter (OTC) market, 53
overcollateralization (O/C), 207
overcollateralization tests, 208
  market-value CDOs, 215-216

P

payoffs
  for holding options, 73
  for selling options, 74-75
physical settlement, 153
plain vanilla credit default swaps, 152-154
Poisson distribution, 132
Poisson event, 131
portfolio CDSs, 158-159
portfolio default swap
  loss distribution, 184-185
  pricing multiname CDSs, 182-184, 186
portfolio products, 52
premium leg
  CDOs, 230
  CDSs, 165
  pricing, 165-167

pricing
  CDOs, 220, 225-227
  Cholesky decomposition, 232-233
  comparing protection leg and premium leg to arrive at a fee, 230
  Copula model, 244-245
  premium leg, 230
  protection leg, 227-229
  simulating default outcomes to arrive at a price, 231-232
  with correlation using a Monte Carlo simulation, 237-244
  with no correlation using a Monte Carlo simulation, 234-237
CDSs, 164-165
  pricing single-name CDSs using the reduced form approach, 171-172
  pricing single-name CDSs using the structural approach, 165-170
multiname CDSs, 172-173
  basket default swaps, 176-182
  default correlation, 173-174
  loss distribution, 174-176
  portfolio default swap, 182-184, 186
  premium leg, 165-167
  protection leg, 167-168
  swaps, 150-151
principal, 10
principal value of debt, comparing
  Black and Cox model and Merton model, 113
probability, calculating risk-neutral default probability, 94-95
products, credit derivatives market, 56-57
protection buyers, 153
  CDOs, 223
protection leg
  CDOs, expected total default payment, 227-229
  CDSs, 165
  pricing, 167-168
protection sellers, 46, 153
CDOs, 223
CDSs, 188
put options, 71, 73
Black-Scholes formula, 86

Q
quantitative scores, 120

R
ramp-up period, life cycle of CDOs, 197
random walk, 118
ratings transition matrix, 31
RE/TA (related earnings/total assets), 122
recovery rate, 4, 19, 21-22
credit spread sensitivity against maturity time by recovery rate, Jarrow-Turnbull model, 143
recovery rates, 40
by credit rating, 42
by industry, 42-43
by seniority, 40
redemption features, bonds, 14
reduced form approach, pricing single-name CDSs, 171-172
reduced form models, 65, 130-131
default intensity, 131-133
over time, 133-136
reducing credit risk, 5-6
regional markets, credit derivatives market, 54
regression analysis, 144
reinvestment period, life cycle of CDOs, 197
related earnings, 122
related earnings/total assets (RE/TA), 122
replicated swaps, 151
resecuritization, 202
retiring the bond, 13
risk buyer, 153
risk hedger, 153
risk premium, 22
risk-free bonds, 13
risk-free government bond, 23
risk-neutral default probability, calculating, 94-95

S
S&P, credit rating system, 27
S/TA (sales/total assets), 123
safety covenants, 105
sales/total assets (S/TA), 123
second to default (STD), 156
securitization, 192
sellers, protection sellers. See protection sellers
senior debt, 19
seniority, 19
CDOs, 194
recovery rate, 40
sensitivity analysis
Jarrow-Turnbull Model, 140-141
Longstaff and Schwartz model, 117
Merton model. See Merton model
shortfall, 219
shorting the option, 74
significant downgrading of credit rating, 18
simulating default outcomes to arrive at a price, CDOs, 231-232
single-name CDSs, 156
pricing using the reduced form approach, 171-172
pricing using the structural approach, 165-170
sinking fund provision, 13
SPCs (special purpose companies), 50
speculative grade, 26
SPEs (special purpose entities), 50, 193
SPVs (special purpose vehicle), 193, 193
stale sources, 32
Standard & Poor’s 500 Index, 189
STD (second-to-default), 156
stress scenarios, 22
strike price, 72
structural approach, pricing single-name CDSs, 165, 168
example, 169-170
premium leg, 165-167
protection leg, 167-168
structural credit risk models, 65-66
balance sheet, 66-69
limitations, 69
Merton model. See Merton model
option pricing, 70
types of, 70
swaps, CDSs. See CDSs
synthetic CDOs, 199-201

T
T-Bills (Treasury Bills), 13
term-to-maturity, 13
the diffusion, 116
the drift, 116
third-to-default, 156
time value, 11
total return swap, 47-48
tranches, 52, 191
CDOs, 194-198
mezzanine tranches, 243
Treasury Bills (T-Bills), 13
types of
credit, 11-14
structural credit risk models, 70

U
U.S.
bankruptcies, companies, 17
bankruptcy filings, 14-15
public and private bond market
debt, 33
U.S. Treasury Bonds, 13
Ulam, Stanislaw, 246
underlying reference assets, credit
derivatives market, 57-58
unwind period, life cycle of CDOs, 197

V
volatility
asset price volatility, 86
asset volatility, sensitivity analysis of
Merton model, 99-100

W
Wal-Mart, 2004 financials, 126
WC/TA (working capital/total asset), 122
working capital, 122
WorldCom, 32
element of the difficulty in rat-
ing, 31-33

Y
yield, 59

Z
Z''-score, 128-130
Z'-score, 128
Z-score model, 121-123
Altman's initial Z-score paper,
124-125
example, 126-127
revised Z-score model, 128-130
zero-coupon bond, 14