

# Contents

<b>1. Introduction . . . . .</b>	<b>1</b>
1.1 Motivation . . . . .	1
1.2 Objectives, Structure, and Summary . . . . .	5
<b>2. Modeling Credit Risk Factors . . . . .</b>	<b>13</b>
2.1 Introduction . . . . .	13
2.2 Definition and Elements of Credit Risk . . . . .	13
2.3 Modeling Transition and Default Probabilities . . . . .	14
2.3.1 The Historical Method . . . . .	15
2.3.2 Excursus: Some Fundamental Mathematics . . . . .	48
2.3.3 The Asset Based Method . . . . .	50
2.3.4 The Intensity Based Method . . . . .	58
2.3.5 Adjusted Default Probabilities . . . . .	86
2.4 Modeling Recovery Rates . . . . .	87
2.4.1 Definition of Recovery Rates . . . . .	87
2.4.2 The Impact of Seniority . . . . .	89
2.4.3 The Impact of the Industry . . . . .	90
2.4.4 The Impact of the Business Cycle . . . . .	92
2.4.5 LossCalc <sup>TM</sup> : Moody's Model for Predicting Recovery Rates . . . . .	95
<b>3. Pricing Corporate and Sovereign Bonds . . . . .</b>	<b>99</b>
3.1 Introduction . . . . .	99
3.1.1 Defaultable Bond Markets . . . . .	99
3.1.2 Pricing Defaultable Bonds . . . . .	106
3.2 Asset Based Models . . . . .	110
3.2.1 Merton's Approach and Extensions . . . . .	110
3.2.2 First Passage Time Models . . . . .	114
3.3 Intensity Based Models . . . . .	121
3.3.1 Short Rate Type Model . . . . .	121
<b>4. Correlated Defaults . . . . .</b>	<b>125</b>
4.1 Introduction . . . . .	125
4.2 Correlated Asset Values . . . . .	125

4.3	Correlated Default Intensities . . . . .	129
4.4	Correlation and Copula Functions . . . . .	133
<b>5.</b>	<b>Credit Derivatives . . . . .</b>	<b>137</b>
5.1	Introduction to Credit Derivatives . . . . .	137
5.2	Technical Definitions . . . . .	145
5.3	Single Counterparty Credit Derivatives . . . . .	146
5.3.1	Credit Options . . . . .	146
5.3.2	Credit Spread Products . . . . .	148
5.3.3	Credit Default Products . . . . .	151
5.3.4	Par and Market Asset Swaps . . . . .	153
5.3.5	Other Credit Derivatives . . . . .	156
5.4	Multi Counterparty Credit Derivatives . . . . .	159
5.4.1	Index Swaps . . . . .	159
5.4.2	Basket Default Swaps . . . . .	160
5.4.3	Collateralized Debt Obligations (CDOs) . . . . .	161
<b>6.</b>	<b>A Three-Factor Defaultable Term Structure Model . . . . .</b>	<b>179</b>
6.1	Introduction . . . . .	179
6.1.1	A New Model For Pricing Defaultable Bonds . . . . .	179
6.2	The Three-Factor Model . . . . .	184
6.2.1	The Basic Setup . . . . .	184
6.2.2	Valuation Formulas For Contingent Claims . . . . .	189
6.3	The Pricing of Defaultable Fixed and Floating Rate Debt . . . . .	197
6.3.1	Introduction . . . . .	197
6.3.2	Defaultable Discount Bonds . . . . .	197
6.3.3	Defaultable (Non-Callable) Fixed Rate Debt . . . . .	209
6.3.4	Defaultable Callable Fixed Rate Debt . . . . .	212
6.3.5	Building a Theoretical Framework for Pricing One-Party Defaultable Interest Rate Derivatives . . . . .	213
6.3.6	Defaultable Floating Rate Debt . . . . .	218
6.3.7	Defaultable Interest Rate Swaps . . . . .	221
6.4	The Pricing of Credit Derivatives . . . . .	228
6.4.1	Some Pricing Issues . . . . .	228
6.4.2	Credit Options . . . . .	232
6.4.3	Credit Spread Options . . . . .	239
6.4.4	Default Swaps and Default Options . . . . .	242
6.5	A Discrete-Time Version of the Three-Factor Model . . . . .	250
6.5.1	Introduction . . . . .	250
6.5.2	Constructing the Lattice . . . . .	250
6.5.3	General Interest Rate Dynamics . . . . .	255
6.6	Fitting the Model to Market Data . . . . .	255
6.6.1	Introduction . . . . .	255
6.6.2	Method of Least Squared Minimization . . . . .	256
6.6.3	The Kalman Filtering Methodology . . . . .	259

<b>6.7 Portfolio Optimization under Credit Risk . . . . .</b>	<b>306</b>
6.7.1 Introduction . . . . .	306
6.7.2 Optimization . . . . .	309
6.7.3 Case Study: Optimizing a Sovereign Bond Portfolio . . . . .	315
<b>A. Some Definitions of S&amp;P . . . . .</b>	<b>327</b>
A.1 Definition of Credit Ratings . . . . .	327
A.1.1 Issue Credit Ratings . . . . .	327
A.1.2 Issuer Credit Ratings . . . . .	327
A.2 Definition of Default . . . . .	331
A.2.1 S&P's definition of corporate default . . . . .	331
A.2.2 S&P's definition of sovereign default . . . . .	331
<b>B. Technical Proofs . . . . .</b>	<b>333</b>
B.1 Proof of Lemma 6.2.1 . . . . .	333
B.2 Proof of Theorem 6.3.1 for $\beta = \frac{1}{2}$ . . . . .	338
B.3 Proofs of Lemma 6.3.1 and Lemma 6.4.2 . . . . .	338
B.4 Proof of Lemma 6.4.3 . . . . .	343
B.5 Tools for Pricing Non-Defaultable Contingent Claims . . . . .	344
<b>C. Pricing of Credit Derivatives: Extensions . . . . .</b>	<b>349</b>
<b>List of Figures . . . . .</b>	<b>351</b>
<b>List of Tables . . . . .</b>	<b>357</b>
<b>References . . . . .</b>	<b>363</b>
<b>Index . . . . .</b>	<b>379</b>