Contents

List of Figures List of Tables Foreword			x xviii xxii		
1	Int	roducti	ion	1	
2	Pri	Pricing in Liquid Markets		7	
	2.1	Intro	duction	7	
	2.2	The N	Merton structural default model*	7	
		2.2.1	The Mathematical Model	13	
	2.3	Nelsc	on–Siegel: a parametric approach	15	
		2.3.1	The credit default swap	15	
		2.3.2	Liquid curves	17	
		2.3.3	Non-liquid curves	18	
3	Pricing in Non-liquid Markets			21	
	3.1	Introc	luction	21	
	3.2	Intern	al rating and pricing models	22	
	3.3	Incor	prporating market view in pricing models		
	3.4	Probability of default			
		3.4.1	The corporate rating model	30	
		3.4.2	The validation and improvement approach	31	
		3.4.3	Term structure of probability of default	39	
	3.5	Transi	ition matrix state – dependent pricing model	43	
		3.5.1	Large corporate transition matrices	44	
		3.5.2	Corporate transition matrices	46	
		3.5.3	SME corporate transition matrices	47	
		3.5.4	SME retail transition matrices	48	
	3.6	Usage	given default (Exposure at Default)	49	
		3.6.1	Defining and calculating the components of EaD	51	
		3.6.2	Data gathering and assessment of data	58	
		3.6.3	Calculating EaD	58	

3.7	Loss g	iven default	60
	3.7.1	Structure of the basic calculation	61
	3.7.2	LGD model	69
	3.7.3	LGD estimates used in the pricing model	69
	3.7.4	Cure rate	70
3.8	Analyt	ics of pricing models	75
	3.8.1	Credit risk capital – the global correlation factor	
		structure	75
	3.8.2	Operational risk capital	85
	3.8.3	Assembly of cash flows	86
	3.8.4	Fee revenue	86
	3.8.5	Net interest revenue	86
	3.8.6	Operating costs	88
	3.8.7	Expected loss	88
	3.8.8	Capital benefit	89
	3.8.9	Cost of capital	89
	3.8.10	Profitability measurement	89
3.9	Pricing	g of a pre-payment option	93
Ann	ex A1 –	- RiskCalc [™] for private companies	96
	A1.1	Introduction	96
	A1.2	What we will cover	98
	A1.3	Section I: The current credit risk toolbox	99
	A1.4	Section II: Past studies and current theory of	
		private firm default	104
	A1.5	Appendix 2	116
	A1.6	Section III: Data	118
	A1.7	Section IV: Univariate ratios as predictors of	
		default: the variable selection process	125
	A1.8	Appendix 4A	146
	A1.9	Section V: Similarities and differences between	
		public and private companies	152
	A1.10	Section VI: Transformations and functional form	162
	A1.11	Appendix 6A: Transformations of input ratios	169
	A1.12	Appendix 6B: RiskCalc schema	171
	A1.13	Section VII: Mapping to default rates and	
		Moody's ratings	176
	A1.14	Appendix 7A: Perceived risk of private vs. public	
		firm debt	185
	A1.15	Section VIII: Model validation	187
	A1.16	Appendix 8A: Accuracy ratios and conditional	
		entropy ratios	202

		A1.1′	7 Appendix 8B: Information entropy ratios	206
		A1.18	8 Section IX: Conclusion	206
	Annex A2 – Proxying the non-liquid market using equities			208
4	CDS Valuation and Trading Strategies			212
	4.1	Comp	paring bonds to credit default swaps	212
		4.1.1	Decomposing risk in a bond	212
		4.1.2	Par-equivalent credit default swap spread	214
		4.1.3	Methodology for isolating credit risk in bonds	
			with embedded options	222
	4.2	Basis	trading	227
		4.2.1	Understanding the difference between bonds and	
			credit default swap spreads	227
		4.2.2	Trading the basis	230
	4.3	Tradi	ng credit curves	236
		4.3.1	Drivers of P+L in curve trades	237
		4.3.2	Curve trading strategies	247
		4.3.3	Equal-notional strategies: forwards	248
		4.3.4	Duration-weighted strategies	254
		4.3.5	Carry-neutral strategies	260
		4.3.6	Different ways of calculating slide	262
		4.3.7	Calculating breakevens	265
		4.3.8	The Horizon Effect	267
		4.3.9	Changing risky annuities over the trade	
			horizon	268
		4.3.10) A worked example	269
		4.3.11	Horizon Effect conclusion	273
	4.4 Recovery rate and curve shape impact on CDS valuation		274	
		4.4.1	Intuition	274
		4.4.2	CDS curve shape impact	275
		4.4.3	Recovery rate impact	276
		4.4.4	Assumptions at contract inception	277
	4.5	Tradir	ng CDS against equity puts	278
		4.5.1	Structuring a CDS/put trade	279
		4.5.2	Risks to the strategy	283
		4.5.3	Analyzing fixed recovery CDS/put trades	285
		4.5.4	Implications for put skew in the equity market	285
5	Index Products			286
	5.1	Credit	default swap index products	286
		5.1.1	Introduction	286
		5.1.2	Mechanics of the CDX and iTraxx indices	287

		5.1.3	Basis to theoretical	287
		5.1.4	Comparing on-the-run and off-the-run basis	289
		5.1.5	Credit events	290
		5.1.6	CDX and iTraxx indices	292
		5.1.7	History of US CDS indices	297
	5.2	CDX a	and iTraxx options	297
		5.2.1	Product description	297
		5.2.2	Basic option strategy payoff diagrams	300
		5.2.3	Using options to express a spread view	301
		5.2.4	Using options to express a volatility view	302
		5.2.5	Combining spread and volatility views	302
		5.2.6	Option trading strategies	303
		5.2.7	The practical side to trading options	306
	5.3	Trading credit volatility		311
		5.3.1	Defining volatility	311
		5.3.2	Delta-hedging	312
		5.3.3	The returns from delta-hedging in credit	313
		5.3.4	Historical analysis	315
	5.4	Tranche products		
		5.4.1	What is a tranche?	316
		5.4.2	Why are synthetic tranches traded?	321
		5.4.3	The mechanics of trading tranche protection	323
		5.4.4	The role of correlation	325
		5.4.5	Pricing tranches	326
		5.4.6	Other products	328
6	Consistency Analysis between EVA Metrics and Credit Pricing 33			
	6.1	Marke	t-based pricing vs. EVA IRB pricing approach: a	
		consis	tent framework	332
		6.1.1	Introduction to different approaches to transition	
			matrices	332
		6.1.2	Present EVA backward-looking methodology	335
		6.1.3	Present EVA Nelson–Siegel methodology	337
		6.1.4	Comparison between present EVA	
			backward-looking methodology and present EVA	
			Nelson–Siegel methodology	338
	6.2	Credit	treasury profit & loss: the accounting framework	341
	Annex A3 – case studies			346
		A.3.1	Company officially rated and with	
			liquid CDS: Enel SpA	346
		A.3.2	Company officially rated and with liquid CDS:	
			Fiat SpA	348

Index			365
Bibliography			359
Notes	Notes		354
4	A.3.5	Lending to small business	353
	A.3.4	Asset finance – pricing of implied option: ACS	351
		SpA	349
د	A.3.3 Large corporate without an official rating: Ferrett		