

Contents

Preface	VII
1. Introduction	1
1.1 Motivation	1
1.1.1 Counterparty Default Risk	1
1.1.2 Derivatives on Defaultable Assets	6
1.1.3 Credit Derivatives	7
1.2 Objectives	8
1.3 Structure	9
2. Contingent Claim Valuation	13
2.1 Valuation in Discrete Time	14
2.1.1 Definitions	14
2.1.2 The Finite Setting	15
2.1.3 Extensions	18
2.2 Valuation in Continuous Time	19
2.2.1 Definitions	19
2.2.2 Arbitrage Pricing	20
2.2.3 Fundamental Asset Pricing Theorem	25
2.3 Applications in Continuous Time	25
2.3.1 Black-Scholes Model	26
2.3.2 Margrabe's Model	30
2.3.3 Heath-Jarrow-Morton Framework	33
2.3.4 Forward Measure	38
2.4 Applications in Discrete Time	41
2.4.1 Geometric Brownian Motion	41
2.4.2 Heath-Jarrow-Morton Forward Rates	42
2.5 Summary	45
3. Review of Credit Risk Models	47
3.1 Pricing Credit-Risky Bonds	47
3.1.1 Traditional Methods	48
3.1.2 Firm Value Models	48
3.1.2.1 Merton's Model	48

3.1.2.2	Extensions and Applications of Merton's Model	51
3.1.2.3	Bankruptcy Costs and Endogenous Default	52
3.1.3	First Passage Time Models	53
3.1.4	Intensity Models	58
3.1.4.1	Jarrow-Turnbull Model	58
3.1.4.2	Jarrow-Lando-Turnbull Model	62
3.1.4.3	Other Intensity Models	64
3.2	Pricing Derivatives with Counterparty Risk	65
3.2.1	Firm Value Models	66
3.2.2	Intensity Models	67
3.2.3	Swaps	68
3.3	Pricing Credit Derivatives	70
3.3.1	Debt Insurance	70
3.3.2	Spread Derivatives	71
3.4	Empirical Evidence	72
3.5	Summary	73
4.	Firm Value Model	75
4.1	The Credit Risk Model	75
4.2	Deterministic Liabilities	77
4.2.1	Prices for Vulnerable Options	78
4.2.2	Special Cases	80
4.2.2.1	Fixed Recovery Rate	81
4.2.2.2	Deterministic Claims	82
4.3	Stochastic Liabilities	83
4.3.1	Prices of Vulnerable Options	85
4.3.2	Special Cases	86
4.3.2.1	Asset Claims	87
4.3.2.2	Debt Claims	87
4.4	Gaussian Interest Rates	88
4.4.1	Forward Measure	89
4.4.2	Prices of Vulnerable Stock Options	91
4.4.3	Prices of Vulnerable Bond Options	93
4.4.4	Special Cases	93
4.5	Stochastic Liabilities	94
4.5.1	Prices of Vulnerable Stock Options	95
4.5.2	Prices of Vulnerable Bond Options	97
4.5.3	Special Cases	97
4.6	Vulnerable Forward Contracts	97
4.7	Numerical Examples	98
4.7.1	Deterministic Interest Rates	98
4.7.2	Stochastic Interest Rates	102
4.7.3	Forward Contracts	109
4.8	Summary	111

5. Hybrid Model	113
5.1 The General Credit Risk Framework	113
5.1.1 Independence and Constant Parameters	115
5.1.2 Price Reduction and Bond Prices	117
5.1.3 Model Specifications	118
5.1.3.1 Arrival Rate of Default	118
5.1.3.2 Recovery Rate	119
5.1.3.3 Bankruptcy Costs	120
5.2 Implementations	121
5.2.1 Lattice with Deterministic Interest Rates	121
5.2.2 The Bankruptcy Process	125
5.2.3 An Extended Lattice Model	127
5.2.3.1 Stochastic Interest Rates	129
5.2.3.2 Recombining Lattice versus Binary Tree	130
5.3 Prices of Vulnerable Options	131
5.4 Recovering Observed Term Structures	132
5.4.1 Recovering the Risk-Free Term Structure	132
5.4.2 Recovering the Defaultable Term Structure	133
5.5 Default-Free Options on Risky Bonds	134
5.5.1 Put-Call Parity	135
5.6 Numerical Examples	136
5.6.1 Deterministic Interest Rates	136
5.6.2 Stochastic Interest Rates	140
5.7 Computational Cost	143
5.8 Summary	145
6. Credit Derivatives	147
6.1 Credit Derivative Instruments	148
6.1.1 Credit Derivatives of the First Type	148
6.1.2 Credit Derivatives of the Second Type	150
6.1.3 Other Credit Derivatives	150
6.2 Valuation of Credit Derivatives	150
6.2.1 Payoff Functions	152
6.2.1.1 Credit Forward Contracts	152
6.2.1.2 Credit Spread Options	154
6.3 The Compound Pricing Approach	155
6.3.1 Firm Value Model	155
6.3.2 Stochastic Interest Rates	157
6.3.3 Intensity and Hybrid Credit Risk Models	158
6.4 Numerical Examples	158
6.4.1 Deterministic Interest Rates	158
6.4.2 Stochastic Interest Rates	162
6.5 Summary	164

7. Conclusion	165
7.1 Summary	165
7.2 Practical Implications	167
7.3 Future Research	168
A. Proofs	169
A.1 Proof of Proposition 4.2.1	169
A.2 Proof of Proposition 4.3.1	174
A.3 Proof of Proposition 4.4.1	179
A.4 Proof of Proposition 4.5.1	185
A.5 Proof of Proposition 6.3.1	193
B. Stochastic Utilities	197
B.1 Probabilistic Foundations	197
B.2 Process Classes	199
B.3 Martingales	199
B.4 Brownian Motion	201
B.5 Stochastic Integration	203
B.6 Change of Measure	207
References	211
List of Figures	221
List of Tables	223
Index	225