Credit Derivatives: Techniques to Manage Credit Risk for Financial Professionals (McGraw-Hill Financial Education Series)

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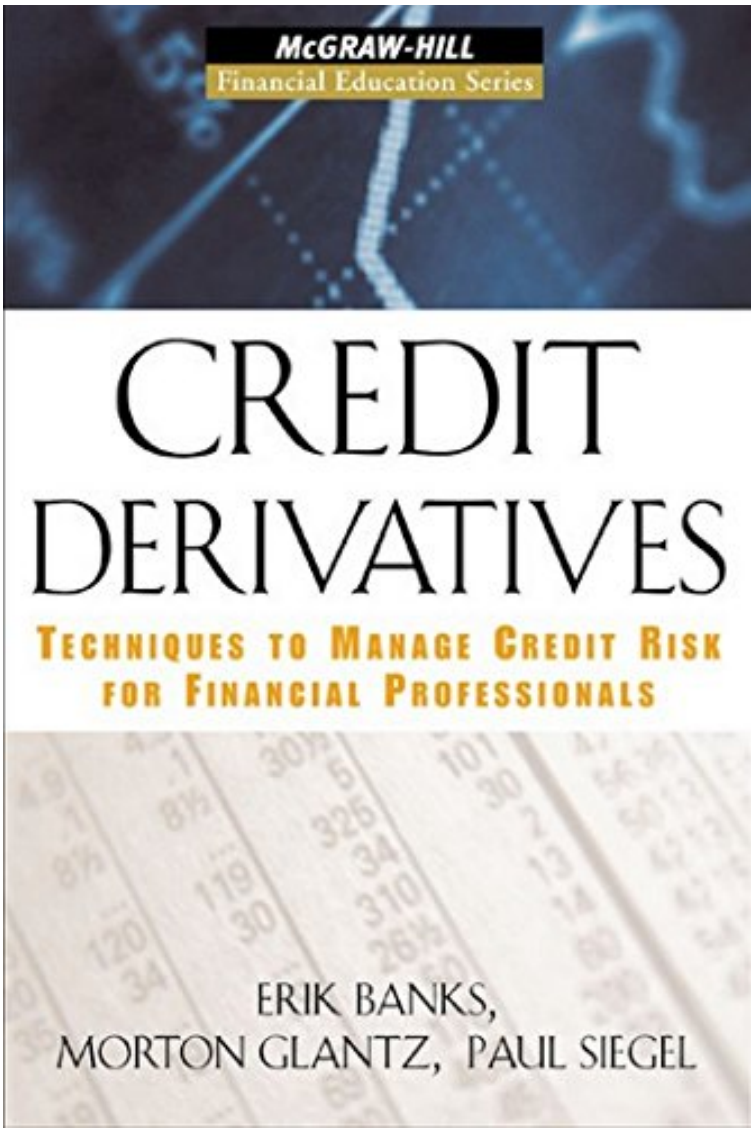

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Erik Banks, Morton Glantz, Paul Siegel : Credit Derivatives: Techniques to Manage Credit Risk for Financial Professionals (McGraw-Hill Financial Education Series) before purchasing it in order to gage whether or not it would be worth my time, and all praised Credit Derivatives: Techniques to Manage Credit Risk for Financial Professionals (McGraw-Hill Financial Education Series):

3 of 5 people found the following review helpful. A fine introductionBy Dr. Lee D. CarlsonA credit derivative is a

contract that transfers the risk and return of an asset from one counterparty to another. This is done without transferring ownership of the underlying asset. In comparison to other types of derivatives, credit derivatives are relatively new, and like any new financial instrument their use and analysis has proven to be challenging, both from a technical and regulatory standpoint. This book gives an overview of credit derivatives that can be read by anyone who has an interest in learning about them. Those new to credit derivatives, such as this reviewer, will find the reading straightforward, with appropriate mathematical background in linear algebra, probability and statistics, and time series analysis assumed. The use of credit derivatives is accelerating in many of the major institutions all over the world. A familiarity with them is thus required for all who are responsible for the management of risk or financial analysts who need to understand the pricing mechanisms involved.The book is divided into three parts, with the first giving a detailed outline of the most important types of credit derivatives. These include asset swaps, credit default swaps, credit spread forwards, total return swaps, basket swaps, and credit spread options. In an asset swap a synthetic asset is created in order to satisfy the need of an investor for a cash flow profile that does not exist in the marketplace. As an example, one can change an instrument paying only fixed rates to one that has floating rates and vice versa. In a credit default swap, as the name implies, one is interested in hedging against default events, and this is done by transferring credit risk of a third party from one party to another. The lender is one of the parties, who is confronted with credit risk from the third party. The other is the counterparty, who agrees to an insurance premium with regular periodic payments. The default of the third party will require the counterparty to purchase from the insured party the asset that has defaulted. In a credit spread forward a single cash flow at a future time is exchanged based on the difference between the credit spread on the date of trading and the market spread at maturity, or alternatively on the difference between two risky spreads. In a total return swap, an agreement is reached between two parties wherein they agree to swap a periodic payment for the duration of the agreement. One of the parties makes payments based upon the total return of a specified reference asset. The other party agrees to make fixed or floating payments to the other. For a basket swap, one pools a number of reference credits into a single structure. There will be a payment to the buyer if a credit defaults, but will not receive a payment if the reference credit merely deteriorates. In a credit spread option, as the name implies, the buyer has the option to receive a payment from the seller if the spread of a particular reference credit increases beyond the strike level for a put option, or decreases within the strike level for a call option. They buyer pays the seller a premium for this option.The authors discuss other variations of credit derivatives and how certain financial instruments not really classified as credit derivatives can be constructed from them. They also remark on the value of technology in fine-tuning the marketing of credit derivatives, particularly in the over the counter (OTC) trading of these financial instruments. Short commentary is also made on the regulatory environment faced by financial institutions, particularly banks, that desire to use credit derivatives to mitigate risk. The authors are aware that a careless use of credit derivatives can compound the risk, rather than mitigate it.It is the mathematical formalism behind the pricing and analysis of credit derivatives that is of main interest to those who work in financial engineering. The second part of this book discusses some of this formalism, with emphasis of course on risk modeling. The authors define credit risk as the potential loss that may occur if an obligor is unable to make contractual payments, and consists of three components, namely the probability of default, the recovery rate, and credit risk exposure. After an elementary discussion of risk modeling, wherein some of the standard mathematical tools are discussed, along with the data requirements needed for successful modeling (some of these being quite formidable). For analysts and modelers, this part of the book will of course be the most useful. The mathematical tools used are very well known and there are not beyond the reach of the typical analyst, as compared to more academic approaches to the subject. Because of the background of the authors, the Moody KMV software is emphasized throughout the analysis. In their discussions of the modeling of credit default risk, the reader can clearly see the importance of comparing the market value of assets with the book value of liabilities, and the lack of empirical support for the idea that firms will default when the value of their assets reaches the book value of their total liabilities. Also interesting is the discussion of the Vasicek-Kealhofer model, and its use in calculating the expected default frequency.

After reading this book, readers will be able to: Identify product consideration and borrower characteristics Understand expected vs. unexpected losses Evaluate the probability of default Determine the probability of a spread increase

About the AuthorPaul Siegel (New York, NY) is chairman and CEO of The Globecon Group, a leading provider of consulting, education, training, and other professional development services to clients including ABN AMRO, J. P. Morgan, Deutsche Bank, and Moodyrsquo;s. Siegel previously held executive positions at Olympia York, Cushman Wakefield, and Daiwa Securities American.