Credit Default Swap Valuation Study

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ABSTRACT

The standard credit default swap (CDS) pricing model in the market assumes that there is no counterparty risk. Although this oversimplified model may be accepted in normal market conditions, its reliability in times of distress has recently been questioned. In fact, counterparty risk has become one of the most dangerous threats to the CDS market. This article presents a model for valuing a credit default swap (CDS) contract by accounting for counterparty credit risk. There are three default resources from buyer, seller and reference entity. We show that default correlation and dependency have a significant impact on CDS price and risk.

Key Words: valuation model; credit risk modeling; collateralization; correlation, CDS.

1 Introduction

There are two primary types of models that attempt to describe default processes in the literature: structural models and reduced-form (or intensity) models. Many practitioners in the credit trading arena have tended to gravitate toward the reduced-form models given their mathematical tractability.

The main drawback of the conditionally independent assumption of the reduced-form models is that the range of default correlations that can be achieved is typically too low when compared with empirical default correlations (see Das et al. (2007)). The responses to correct this weakness can be generally classified into two categories: endogenous default relationship approaches and exogenous default relationship approaches.

The exogenous approaches (see Li (2000), Laurent and Gregory (2005), Hull and White (2004), Brigo et al. (2011), etc) attempt to link marginal default probability distributions to the joint default probability distribution through some external functions. Due to their simplicity in use, practitioners lean toward the exogenous ones.

Collateralization as one of the primary credit risk mitigation techniques becomes increasingly important and widespread in derivatives transactions. According to the ISDA (2013), 73.7% of all OTC derivatives trades (cleared and non-cleared) are subject to collateral agreements. For large firms, the figure is 80.7%. On an asset class basis, 83.0% of all CDS transactions and 79.2% of all fixed income transactions are collateralized. For large firms, the figures are 96.3% and 89.4%, respectively. Previous studies on collateralization include Johannes and Sundareshan (2007), Fujii and Takahashi (2012), Piterbarg (2010), Bielecki, et al (2013) and Hull and White (2014), etc.

In general, a CDS contract is used to transfer the credit risk of a reference entity from one party to another. The risk circularity that transfers one type of risk (reference credit risk) into another (counterparty credit risk) within the CDS market is a concern for financial stability. Some people claim that the CDS market has increased financial contagion or even propose an outright ban on these instruments.

The standard CDS pricing model in the market assumes that there is no counterparty risk. Although this oversimplified model may be accepted in normal market conditions, its reliability in times of distress has recently been questioned. In fact, counterparty risk has become one of the most dangerous threats to the CDS market. For some time now it has been realized that, in order to value a CDS properly, counterparty effects have to be taken into account (see ECB (2009)).

There is a significant increase in the use of collateral for CDS after the recent financial crises. Many people believe that, if a CDS is fully collateralized, there is no risk of failure to pay. Collateral posting regimes are originally designed and utilized for bilateral risk products, e.g., interest rate swap (IRS), but there are many reasons to be concerned about the success of collateral posting in offsetting the risk of CDS contracts. First, the value of CDS contracts tends to move very suddenly with big jumps, whereas the price movements of *IRS* contracts are far smoother and less volatile than *CDS* prices. Second, CDS spreads can widen very rapidly. Third, CDS contracts have many more risk factors than *IRS* contracts. In fact, our model shows that full collateralization *cannot* eliminate counterparty risk completely for a CDS contract.

2 Pricing Financial Contracts Subject to Multiple Credit Risks

We consider a filtered probability space $(\Omega, \mathcal{F}, \{\mathcal{F}_t\}_{t \geq 0}, \mathcal{P})$ satisfying the usual conditions, where Ω denotes a sample space, $\mathcal{F}$ denotes a σ -algebra, $\mathcal{P}$ denotes a probability measure, and $\{\mathcal{F}_t\}_{t \geq 0}$ denotes a filtration.

It is well-known that the survival probability from time t to s in this framework is defined by

$$p_i(t, s) := P_i(\tau > s \mid \tau > t, Z_t) = \exp\left(-\int_t^s h_i(u) du\right) \quad (2a)$$

The default probability for the period (t, s) in this framework is given by

$$q_i(t, s) := P_i(\tau \leq s \mid \tau > t, Z_t) = 1 - p_i(t, s) = 1 - \exp\left(-\int_t^s h_i(u) du\right) \quad (2b)$$

There is ample evidence that corporate defaults are correlated. The default of a firm's counterparty might affect its own default probability. Thus, default correlation/dependence occurs due to the counterparty relations.

Let us discuss a three-party case first. A CDS is a good example of a trilateral defaultable instrument where the three parties are counterparties A , B and reference entity C . In a standard CDS contract one party purchases credit protection from another party, to cover the loss of the face value of a reference entity following a credit event. The protection buyer makes periodic payments to the seller until the maturity date or until a credit event occurs. A credit event usually requires a final accrual payment by the buyer and a loss protection payment by the protection seller. The protection payment is equal to the difference between par and the price of the cheapest to deliver (CTD) asset of the reference entity on the face value of the protection.

For years, a widespread practice in the market has been to mark CDS to market without taking the counterparty risk into account. The realization that even the most prestigious investment banks could go bankrupt has shattered the foundation of the practice. It is wiser to face frankly the real complexities of pricing a CDS than to indulge in simplifications that have proved treacherous. For some time now it has been realized that, in order to value a CDS properly, counterparty effects have to be taken into account.

The joint probability representations of a trivariate Bernoulli distribution (see Teugels (1990)) are given by

$$p_{000} := P(Y_A = 0, Y_B = 0, Y_C = 0) = p_A p_B p_C + p_C \sigma_{AB} + p_B \sigma_{AC} + p_A \sigma_{BC} - \theta_{ABC} \quad (3a)$$

$$p_{100} := P(Y_A = 1, Y_B = 0, Y_C = 0) = q_A p_B p_C - p_C \sigma_{AB} - p_B \sigma_{AC} + q_A \sigma_{BC} + \theta_{ABC} \quad (3b)$$

$$p_{010} := P(Y_A = 0, Y_B = 1, Y_C = 0) = p_A q_B p_C - p_C \sigma_{AB} + q_B \sigma_{AC} - p_A \sigma_{BC} + \theta_{ABC} \quad (3c)$$

$$p_{001} := P(Y_A = 0, Y_B = 0, Y_C = 1) = p_A p_B q_C + q_C \sigma_{AB} - p_B \sigma_{AC} - p_A \sigma_{BC} + \theta_{ABC} \quad (3d)$$

$$p_{110} := P(Y_A = 1, Y_B = 1, Y_C = 0) = q_A q_B p_C + p_C \sigma_{AB} - q_B \sigma_{AC} - q_A \sigma_{BC} - \theta_{ABC} \quad (3e)$$

$$p_{101} := P(Y_A = 1, Y_B = 0, Y_C = 1) = q_A p_B q_C - q_C \sigma_{AB} + p_B \sigma_{AC} - q_A \sigma_{BC} - \theta_{ABC} \quad (3f)$$

$$p_{011} := P(Y_A = 0, Y_B = 1, Y_C = 1) = p_A q_B q_C - q_C \sigma_{AB} - q_B \sigma_{AC} + p_A \sigma_{BC} - \theta_{ABC} \quad (3g)$$

$$p_{111} := P(Y_A = 1, Y_B = 1, Y_C = 1) = q_A q_B q_C + q_C \sigma_{AB} + q_B \sigma_{AC} + q_A \sigma_{BC} + \theta_{ABC} \quad (3h)$$

where

$$\theta_{ABC} := E((Y_A - q_A)(Y_B - q_B)(Y_C - q_C)) \quad (3i)$$

Equation (3) tells us that the joint probability distribution of three defaultable parties depends not only on the bivariate statistical relationships of all pair-wise combinations (e.g., σ_{ij}) but also on the trivariate statistical relationship (e.g., θ_{ABC}). θ_{ABC} was first defined by Deardorff (1982) as *comvariance*, who use it to correlate three random variables that are the value of commodity net imports/exports, factor intensity, and factor abundance in international trading.

Definition 1: For three random variables X_A , X_B , and X_C , let μ_A , μ_B , and μ_C denote the means of X_A , X_B , and X_C . The comrelation of X_A , X_B , and X_C is defined by

$$\zeta_{ABC} = \frac{E[(X_A - \mu_A)(X_B - \mu_B)(X_C - \mu_C)]}{\sqrt[3]{E|X_A - \mu_A|^3 \times E|X_B - \mu_B|^3 \times E|X_C - \mu_C|^3}} \quad (4)$$

According to the Holder inequality, we have

$$\begin{aligned} |E((X_A - \mu_A)(X_B - \mu_B)(X_C - \mu_C))| &\leq E|(X_A - \mu_A)(X_B - \mu_B)(X_C - \mu_C)| \\ &\leq \sqrt[3]{E|X_A - \mu_A|^3 \times E|X_B - \mu_B|^3 \times E|X_C - \mu_C|^3} \end{aligned} \quad (5)$$

Obviously, the comrelation is in the range of $[-1, 1]$. Given the comrelation, Equation (3i) can be rewritten as

$$\begin{aligned} \theta_{ABC} &:= E((Y_A - q_A)(Y_B - q_B)(Y_C - q_C)) = \zeta_{ABC} \sqrt[3]{E|Y_A - q_A|^3 \times E|Y_B - q_B|^3 \times E|Y_C - q_C|^3} \\ &= \zeta_{ABC} \sqrt[3]{p_A q_A (p_A^2 + q_A^2) p_B q_B (p_B^2 + q_B^2) p_C q_C (p_C^2 + q_C^2)} \end{aligned} \quad (6)$$

where $E(Y_j) = q_j$ and $E|Y_j - q_j|^3 = p_j q_j (p_j^2 + q_j^2)$, $j=A, B$, or C .

If we have a series of n measurements of X_A , X_B , and X_C written as x_{Ai} , x_{Bi} and x_{Ci} where $i = 1, 2, \dots, n$, the sample *comrelation coefficient* can be obtained as:

$$\zeta_{ABC} = \frac{\sum_{i=1}^n (x_{Ai} - \mu_A)(x_{Bi} - \mu_B)(x_{Ci} - \mu_C)}{\sqrt[3]{\sum_{i=1}^n |x_{Ai} - \mu_A|^3 \times \sum_{i=1}^n |x_{Bi} - \mu_B|^3 \times \sum_{i=1}^n |x_{Ci} - \mu_C|^3}} \quad (7)$$

More generally, we define the *comrelation* in the context of n random variables as

Definition 2: For n random variables $X_1, X_2, \dots, X_n$, let μ_i denote the mean of X_i where $i=1, \dots, n$.

The *comrelation* of $X_1, X_2, \dots, X_n$ is defined as

$$\zeta_{12\dots n} = \frac{E[(X_1 - \mu_1)(X_2 - \mu_2) \cdots (X_n - \mu_n)]}{\sqrt[n]{E|X_1 - \mu_1|^n \times E|X_2 - \mu_2|^n \cdots E|X_n - \mu_n|^n}} \quad (8)$$

Correlation is just a specific case of *comrelation* where $n = 2$. Again, the *comrelation* $\zeta_{12\dots n}$ is in the range of $[-1, 1]$ according to the Holder inequality.

2.1 Risky valuation without collateralization

Recovery assumptions are important for pricing credit derivatives. If the reference entity under a CDS contract defaults, the best assumption, as pointed out by J. P. Morgan (1999), is that the recovered value equals the recovery rate times the face value plus accrued interest¹. In other words, the recovery of par value assumption is a better fit upon the default of the reference entity, whereas the recovery of market value assumption is a more suitable choice in the event of a counterparty default².

Proposition 1: The value of the CDS is given by

$$V(t) = \sum_{i=1}^m E \left[\left(\prod_{j=0}^{i-1} O(T_j, T_{j+1}) \right) X_i | \mathcal{F}_t \right] + \sum_{i=1}^m E \left[\left(\prod_{j=0}^{i-2} O(T_j, T_{j+1}) \right) \Omega(T_{i-1}, T_i) R(T_{i-1}, T_i) | \mathcal{F}_t \right] \quad (9a)$$

where $t = T_0$ and

$$O(T_j, T_{j+1}) = 1_{(V(T_{j+1}) + X_{j+1}) \geq 0} \phi_B(T_j, T_{j+1}) + 1_{(V(T_{j+1}) + X_{j+1}) < 0} \phi_A(T_j, T_{j+1}) \quad (9b)$$

¹ In the market, there is an average accrual premium assumption, i.e., the average accrued premium is half the full premium due to be paid at the end of the premium.

² Three different recovery models exist in the literature. The default payoff is either i) a fraction of par (Madan and Unal (1998)), ii) a fraction of an equivalent default-free bond (Jarrow and Turnbull (1995)), or iii) a fraction of market value (Duffie and Singleton (1999)).

$$\begin{aligned}
\phi_A(T_j, T_{j+1}) = & \{p_A(T_j, T_{j+1})p_B(T_j, T_{j+1})p_C(T_j, T_{j+1}) + q_A(T_j, T_{j+1})p_B(T_j, T_{j+1})p_C(T_j, T_{j+1})\varphi_A(T_{j+1}) \\
& + p_A(T_j, T_{j+1})q_B(T_j, T_{j+1})p_C(T_j, T_{j+1})\bar{\varphi}_A(T_{j+1}) + q_A(T_j, T_{j+1})q_B(T_j, T_{j+1})p_C(T_j, T_{j+1})\varphi_{AB}(T_{j+1}) \\
& + p_C(T_j, T_{j+1})\sigma_{AB}(T_j, T_{j+1})(1 - \varphi_A(T_{j+1}) - \bar{\varphi}_A(T_{j+1}) + \varphi_{AB}(T_{j+1})) \\
& + \sigma_{AC}(T_j, T_{j+1})[p_B(T_j, T_{j+1})(1 - \varphi_A(T_{j+1})) + q_B(T_j, T_{j+1})(\bar{\varphi}_A(T_{j+1}) - \varphi_{AB}(T_{j+1}))] \\
& + \sigma_{BC}(T_j, T_{j+1})[p_A(T_j, T_{j+1})(1 - \bar{\varphi}_A(T_{j+1})) + q_A(T_j, T_{j+1})(\varphi_A(T_{j+1}) - \varphi_{AB}(T_{j+1}))] \\
& + \theta_{ABC}(T_j, T_{j+1})(-1 + \bar{\varphi}_A(T_{j+1}) - \varphi_{AB}(T_{j+1}) + \varphi_A(T_{j+1}))\}D(T_j, T_{j+1})
\end{aligned} \tag{9c}$$

$$\begin{aligned}
\phi_B(T_j, T_{j+1}) = & \{p_A(T_j, T_{j+1})p_B(T_j, T_{j+1})p_C(T_j, T_{j+1}) + q_A(T_j, T_{j+1})p_B(T_j, T_{j+1})p_C(T_j, T_{j+1})\bar{\varphi}_B(T_{j+1}) \\
& + p_A(T_j, T_{j+1})q_B(T_j, T_{j+1})p_C(T_j, T_{j+1})\varphi_B(T_{j+1}) + q_A(T_j, T_{j+1})q_B(T_j, T_{j+1})p_C(T_j, T_{j+1})\varphi_{AB}(T_{j+1}) \\
& + p_C(T_j, T_{j+1})\sigma_{AB}(T_j, T_{j+1})(1 - \varphi_B(T_{j+1}) - \bar{\varphi}_B(T_{j+1}) + \varphi_{AB}(T_{j+1})) \\
& + \sigma_{AC}(T_j, T_{j+1})[p_B(T_j, T_{j+1})(1 - \bar{\varphi}_B(T_{j+1})) + q_B(T_j, T_{j+1})(\varphi_B(T_{j+1}) - \varphi_{AB}(T_{j+1}))] \\
& + \sigma_{BC}(T_j, T_{j+1})[p_A(T_j, T_{j+1})(1 - \varphi_B(T_j)) + q_A(T_j, T_{j+1})(\bar{\varphi}_B(T_{j+1}) - \varphi_{AB}(T_{j+1}))] \\
& + \theta_{ABC}(T_j, T_{j+1})(-1 + \bar{\varphi}_B(T_{j+1}) - \varphi_{AB}(T_{j+1}) + \varphi_B(T_{j+1}))\}D(T_j, T_{j+1})
\end{aligned} \tag{9d}$$

$$\begin{aligned}
\Omega(T_j, T_{j+1}) = & \{p_A(T_j, T_{j+1})p_B(T_j, T_{j+1})q_C(T_j, T_{j+1}) + q_A(T_j, T_{j+1})p_B(T_j, T_{j+1})q_C(T_j, T_{j+1})\bar{\varphi}_B(T_{j+1}) \\
& + p_A(T_j, T_{j+1})q_B(T_j, T_{j+1})q_C(T_j, T_{j+1})\varphi_B(T_{j+1}) + q_A(T_j, T_{j+1})q_B(T_j, T_{j+1})q_C(T_j, T_{j+1})\varphi_{AB}(T_{j+1}) \\
& + q_C(T_j, T_{j+1})\sigma_{AB}(T_j, T_{j+1})(1 - \varphi_B(T_{j+1}) - \bar{\varphi}_B(T_{j+1}) + \varphi_{AB}(T_{j+1})) \\
& - \sigma_{AC}(T_j, T_{j+1})[p_B(T_j, T_{j+1})(1 - \bar{\varphi}_B(T_{j+1})) + q_B(T_j, T_{j+1})(\varphi_B(T_{j+1}) - \varphi_{AB}(T_{j+1}))] \\
& - \sigma_{BC}(T_j, T_{j+1})[p_A(T_j, T_{j+1})(1 - \varphi_B(T_{j+1})) + q_A(T_j, T_{j+1})(\bar{\varphi}_B(T_{j+1}) - \varphi_{AB}(T_{j+1}))] \\
& + \theta_{ABC}(T_j, T_{j+1})(1 - \bar{\varphi}_B(T_{j+1}) + \varphi_{AB}(T_{j+1}) - \varphi_B(T_{j+1}))\}D(T_j, T_{j+1})
\end{aligned} \tag{9e}$$

where $R(T_j, T_{j+1}) = (N(1 - \varphi_C(T_{j+1})) - \alpha(T_j, T_{j+1}))$, $\alpha(T_j, T_{j+1}) = sN\delta(T_S, T)/2$, and $X_i = -sN\delta(T_j, T_{j+1})$.

Proof: See the Appendix.

We may think of $O(t, T)$ as the risk-adjusted discount factor for the premium and $\Omega(t, T)$ as the risk-adjusted discount factor for the default payment. Proposition 1 says that the pricing process of a multiple-payment instrument has a backward nature since there is no way of knowing which risk-adjusted discounting rate should be used without knowledge of the future value. Only on the maturity date, the value of an instrument and the decision strategy are clear. Therefore, the evaluation must be done in a backward fashion, working from the final payment date towards the present. This type of valuation process is referred to as backward induction.

Corollary 1: *If counterparties A and B are default-free, the value of the CDS is given by*

$$\begin{aligned}
V(t) = & \sum_{i=1}^m E\left[\left(\prod_{j=0}^{i-1} O(T_j, T_{j+1})\right)X_i | \mathcal{F}_t\right] + \sum_{i=1}^m E\left[\left(\prod_{j=0}^{i-2} O(T_j, T_{j+1})\right)\Omega(T_{i-1}, T_i)R(T_{i-1}, T_i) | \mathcal{F}_t\right] \\
= & \sum_{i=1}^m E[D(t, T_i)p_C(t, T_i)X_i | \mathcal{F}_t] + \sum_{i=1}^m E[D(t, T_i)p_C(t, T_{i-1})q_C(T_{i-1}, T_i)R(T_{i-1}, T_i) | \mathcal{F}_t]
\end{aligned} \tag{10}$$

where $O(T_{i-1}, T_i) = D(T_{i-1}, T_i)p_C(T_{i-1}, T_i)$; $\Omega(T_{i-1}, T_i) = D(T_{i-1}, T_i)q_C(T_{i-1}, T_i)$.

The proof of this corollary becomes straightforward according to Proposition 1 by setting $\rho_{kl}=0$,

$$\varphi_{AB} = 0, \zeta_{ABC} = 0, p_j = 1, q_j = 0, p_C(t, T_i) = \prod_{g=0}^{i-1} p(T_g, T_{g+1}), \text{ and } D(t, T_i) = \prod_{g=0}^{i-1} D(T_g, T_{g+1}).$$

If we further assume that the discount factor and the default probability of the reference entity are uncorrelated and the recovery rate φ_C is constant, we have

Corollary 2: Assume that i) counterparties A and B are default-free, ii) the discount factor and the default probability of the reference entity are uncorrelated; iii) the recovery rate φ_C is constant; the value of the CDS is given by

$$V(t) = \sum_{i=1}^m P(t, T_i) \bar{p}_C(t, T_{i-1}) \bar{q}_C(T_{i-1}, T_i) (N(1 - \varphi_C) - \alpha(T_{i-1}, T_i)) - \sum_{i=1}^m P(t, T_i) \bar{p}_C(t, T_i) sN\delta(T_{i-1}, T_i) \quad (11)$$

where $P(t, T_i) = E[D(t, T_i) | \mathcal{F}_t]$ denotes the bond price, $\bar{p}_C(t, T_i) = E[p_C(t, T_i) | \mathcal{F}_t]$, $\bar{q}_C(t, T_i) = 1 - \bar{p}_C(t, T_i)$, $\bar{p}(t, T_{i-1}) \bar{q}(T_{i-1}, T_i) = \bar{p}(t, T_{i-1}) - \bar{p}(t, T_i)$.

This corollary is easily proved according to Corollary 1 by setting $E[XY | \mathcal{F}_t] = E[X | \mathcal{F}_t]E[Y | \mathcal{F}_t]$ when X and Y are uncorrelated. Corollary 2 is the formula for pricing CDS in the market.

Our methodology can be extended to the cases where the number of parties $n \geq 4$. A generating function for the (probability) joint distribution (see details in Teugels (1990)) of n -variate Bernoulli can be expressed as

$$p^{(n)} = \begin{bmatrix} p_n & -1 \\ q_n & 1 \end{bmatrix} \otimes \begin{bmatrix} p_{n-1} & -1 \\ q_{n-1} & 1 \end{bmatrix} \otimes \dots \otimes \begin{bmatrix} p_1 & -1 \\ q_1 & 1 \end{bmatrix} \sigma^{(n)} \quad (12)$$

where $\otimes$ denotes the Kronecker product; $p^{(n)} = \{p_k^{(n)}\}$ and $\sigma^{(n)} = \{\sigma_k^{(n)}\}$ are vectors containing 2^n components: $p_k^{(n)} = p_{k_1, k_2, \dots, k_n}$, $k = 1 + \sum_{i=1}^n k_i 2^{i-1}$, $k_i \in \{0, 1\}$; $\sigma_k^{(n)} = \sigma_{k_1, k_2, \dots, k_n} = E\left(\prod_{i=1}^n (Y_i - q_i)^{k_i}\right)$.

2.2 Risky valuation with collateralization

Collateralization is the most important and widely used technique in practice to mitigate credit risk. The posting of collateral is regulated by the Credit Support Annex (CSA) that specifies a variety of terms

including the threshold, the independent amount, and the minimum transfer amount (MTA), etc. The threshold is the unsecured credit exposure that a party is willing to bear. The minimum transfer amount is the smallest amount of collateral that can be transferred. The independent amount plays the same role as the initial margin (or haircuts).

The main role of collateral should be viewed as an improved recovery in the event of a counterparty default. According to Bankruptcy law, if there has been no default, the collateral is returned to the collateral giver by the collateral taker. If a default occurs, the collateral taker possesses the collateral. In other words, collateral does not affect the survival payment; instead, it takes effect on the default payment only.

Collateral posting regimes are originally designed and utilized for bilateral risk products, e.g., IRS, but there are many reasons to be concerned about the success of collateral posting in offsetting the risks of CDS contracts. First, the values of CDS contracts tend to move very suddenly with big jumps, whereas the price movements of IRS contracts are far smoother and less volatile than CDS prices. Second, CDS spreads can widen very rapidly. The amount of collateral that one party is required to provide at short notice may, in some cases, be close to the notional amount of the CDS and may therefore exceed that party's short-term liquidity capacity, thereby triggering a liquidity crisis. Third, CDS contracts have many more risk factors than IRS contracts.

The value of the collateralized instrument at time t is the discounted expectation of all the payoffs and is given by

$$\begin{aligned} V(t) &= E\{D(t, u)[p_{000}(t, u)V(u) + p_{001}(t, u)R(u) \\ &\quad + (p_{100}(t, u) + p_{010}(t, u) + p_{110}(t, u) + p_{101}(t, u) + p_{011}(t, u) + p_{111}(t, u))V(t)/D(t, u)]|\mathcal{F}_t\} \quad (14a) \\ &= E\{[D(t, u)(p_{000}(t, u)V(s) + p_{001}(t, u)R(u)) + (1 - p_{000}(t, u) - p_{001}(t, u))V(t)]|\mathcal{F}_t\} \end{aligned}$$

or

$$\begin{aligned} &E[(p_A(t, u)p_B(t, u) + \sigma_{AB}(t, u))|\mathcal{F}_t]V(t) \\ &= E\{[D(t, u)(p_C(t, u)V(u) + q_C(t, u)R(u))(p_A(t, u)p_B(t, u) + \sigma_{AB}(t, u)) \\ &\quad + D(t, u)(V(u) - R(u))(p_B(t, u)\sigma_{AC}(t, u) + p_A(t, u)\sigma_{BC}(t, u) - \theta_{ABC}(t, u))]\mathcal{F}_t\} \quad (14b) \end{aligned}$$

If we assume that $(p_A(t,u)p_B(t,u) + \sigma_{AB}(t,u))$ and $D(t,u)(p_C(t,u)V(u) + q_C(t,u)R(u))$ are uncorrelated, we have

$$V(t) = V^F(t) + \xi_{ABC}(t,u) / \psi_{AB}(t,u) \quad (15a)$$

where

$$V^F(t) = E\{D(t,u)[p_C(t,u)V(u) + q_C(t,u)R(u)] | \mathcal{F}_t\} \quad (15b)$$

$$\psi_{AB}(t,u) = E\{[p_A(t,u)p_B(t,u) + \sigma_{AB}(t,u)] | \mathcal{F}_t\} \quad (15c)$$

$$\xi_{ABC}(t,u) = E\{[D(t,u)(p_B(t,u)\sigma_{AC}(t,u) + p_A(t,u)\sigma_{BC}(t,u) - \theta_{ABC}(t,u))(V(u) - R(u))] | \mathcal{F}_t\} \quad (15d)$$

The first term $V^F(t)$ in equation (15) is the counterparty-risk-free value of the CDS and the second term is the exposure left over under full collateralization, which can be substantial.

Proposition 2: *If a CDS is fully collateralized, the risky value of the CDS is NOT equal to the counterparty-risk-free value, as shown in equation (15).*

Proposition 2 or equation (15) provides a theoretical explanation for the failure of full collateralization in the CDS market. It tells us that under full collateralization the risky value is in general not equal to the counterparty-risk-free value except in one of the following situations: i) the market value is equal to the default payment, i.e., $V(u) = R(u)$; ii) firms A , B , and C have independent credit risks, i.e., $\rho_{ij} = 0$ and $\zeta_{ABC} = 0$; or iii) the following relationship holds $p_B\sigma_{AC} + p_A\sigma_{BC} = \theta_{ABC}$.

3 Numerical Results

Our goal in this section is to study the quantitative relationship between CDS premia and the credit quality of counterparties and reference entities, including the default correlations and comrelations.

The current (spot) market data are shown in Table 1 provide by FinPricing (2018). Assume that the reference entity C has an “A+200bps” credit quality throughout this subsection. The 5-year counterparty-risk-free CDS premium is 0.027 (equals the 5-year ‘A’ rated CDS spread in Table 1 plus 200 basis points).

The CIR process has been widely used in the literature of credit risk and is given by

$$dh_t = a(b - h_t)dt + \sigma\sqrt{h_t}dW_t \quad (16)$$

where a denotes the mean reversion speed, b denotes the long-term mean, and σ denotes the volatility.

Table 1: Current/spot market data

This table displays the current (spot) market data used for all calculations in this paper, including the term structure of continuously compounded interest rates, the term structure of A-rated breakeven CDS spreads, and the curve of at-the-money caplet volatilities.

Term (days)	31	91	182	365	548	730	1095	1825	2555	3650	5475
Interest Rate	0.002	0.002	0.002	0.004	0.007	0.010	0.016	0.024	0.030	0.035	0.040
	8	7	9	3	1	2		9	6	5	5
Credit Spread	0.004	0.004	0.004	0.004	0.004	0.005	0.005	0.007	0.007	0.009	0.010
	2	2	2	5	9	2	8		9	1	6
Caplet	0.326	0.331	0.337	0.350	0.364	0.377	0.308	0.247	0.214	0.167	0.163
Volatility	7		6	9	1	3		3	1	8	4

Table 2: Risk-neutral parameters for CIR model

This table presents the risk-neutral parameters that are calibrated to the current market shown in Table 1.

‘A+100bps’ represents a ‘100 basis points’ parallel shift in the A-rated CDS spreads.

Credit Quality	A	A+100bps	A+200bps	A+300bps
Long-Term Mean a	0.035	0.056	0.077	0.099
Mean Reverting Speed b	0.14	0.18	0.25	0.36
Volatility σ	0.022	0.028	0.039	0.056

The calibrated parameters are shown in table 2. We assume that interest rates are deterministic and select the regression-based Monte-Carlo simulation (see Longstaff and Schwartz (2001)) to perform risky valuation.

We first assume that counterparties A , B , and reference entity C have independent default risks, i.e., $\rho_{AB} = \rho_{AC} = \rho_{BC} = \varphi_{AB} = \zeta_{ABC} = 0$, and examine the following cases: i) B is risk-free and A is risky; and ii) A is risk-free and B is risky. We simulate the hazard rates using the CIR model and then determine the appropriate discount factors according to Proposition 1. Finally we calculate the prices via the regression-based Monte-Carlo method. The results are shown in Table 3 and 4.

Table 3: Impact of the credit quality of the protection buyer on CDS premia

This table shows how the CDS premium increases as the credit quality of party A decreases. The 1st data column represents the counterparty-risk-free results. For the remaining columns, we assume that party B is risk-free and party A is risky. ‘A+100bps’ represents a ‘100 basis points’ parallel shift in the A-rated CDS spreads. The results in the row ‘Difference from Risk-Free’ = current CDS premium – counterparty-risk-free CDS premium.

Credit Quality	Party A Party B	-	A	A+100bps	A+200bps	A+300bps
		-	-	-	-	-
CDS premium		0.027	0.02703	0.02708	0.02713	0.02717
Difference from Risk-Free		0	0.003%	0.008%	0.013%	0.017%

Table 4: Impact of the credit quality of the protection seller on CDS premia

This table shows the decrease in the CDS premium with the credit quality of party B . The 1st data column represents the counterparty-risk-free results. For the remaining columns, we assume that party A is risk-free and party B is risky. ‘A+100bps’ represents a ‘100 basis points’ parallel shift in the A-rated CDS spreads. The results in the row ‘Difference from Risk-Free’ = current CDS premium – counterparty-risk-free CDS premium.

Credit Quality	Party A Party B	-	-	-	-	-
		-	A	A+100bps	A+200bps	A+300bps
CDS premium		0.027	0.02695	0.02687	0.0268	0.02672
Difference from Risk-Free		0.00%	-0.005%	-0.013%	-0.020%	-0.028%

From table 3 and 4, we find that a credit spread of about 100 basis points maps into a CDS premium of about 0.4 basis points for counterparty *A* and about -0.7 basis points for counterparty *B*. The credit impact on the CDS premia is approximately linear. As would be expected, i) the dealer's credit quality has a larger impact on CDS premia than the investor's credit quality; ii) the higher the investor's credit risk, the higher the premium that the dealer charges; iii) the higher the dealer's credit risk, the lower the premium that the dealer asks. Without considering default correlations and comrelations, we find that, in general, the impact of counterparty risk on CDS premia is relatively small. This is in line with the empirical findings of Arora, Gandhi, and Longstaff (2009).

Figure 1: Impact of default correlations and comrelation on CDS premia

Each curve in this figure illustrates how CDS premium changes as default correlations and comrelation move from -1 to 1. For instance, the curve 'cor_BC' represents the sensitivity of the CDS premium to changes in the correlation ρ_{BC} when $\rho_{AB} = \rho_{AC} = \zeta_{ABC} = 0$.

Next, we study the sensitivity of CDS premia to changes in the joint credit quality of associated parties. Sensitivity analysis is a very popular way in finance to find out how the value and risk of an instrument/portfolio changes if risk factors change. One of the simplest and most common approaches involves changing one factor at a time to see what effect this produces on the output. We are going to examine the impacts of the default correlations ρ_{AB} , ρ_{AC} , ρ_{BC} , and the comrelation ζ_{ABC} separately. Assume that party A has an ‘A+100bps’ credit quality and party B has an ‘A’ credit quality. The 5-year risky CDS premium is calculated as 0.02703.

As the absolute value of the slope increases, so does the sensitivity. The results illustrate that ρ_{BC} has the largest effect on CDS premia. The second biggest one is ζ_{ABC} . The impacts of ρ_{AB} and ρ_{AC} are very small. In particular, the effect of the comrelation is substantial and has never been studied before. A natural intuition to have on CDS is that the party buying default protection should worry about the default correlations and comrelation.

4 Conclusion

This article presents a new valuation framework for pricing financial instruments subject to credit risk. In particular, we focus on modeling default relationships.

We study the sensitivity of the price of a defaultable instrument to changes in the joint credit quality of the parties. For instance, our analysis shows that the effect of default dependence on CDS premia from large to small is the correlation between the protection seller and the reference entity, the comrelation, the correlation between the protection buyer and the reference entity, and the correlation between the protection buyer and the protection seller.

The model shows that a fully collateralized CDS is not equivalent to a risk-free one. Therefore, we conclude that collateralization designed to mitigate counterparty risk works well for financial instruments subject to bilateral credit risk, but fails for ones subject to multilateral credit risk.

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