Rating Based Modeling of Credit Risk

Theory and Application of Migration Matrices
## Contents

**Preface** xi

1 **Introduction: Credit Risk Modeling, Ratings, and Migration Matrices** 1
   1.1 Motivation ........................................ 1
   1.2 Structural and Reduced Form Models ............... 2
   1.3 Basel II, Scoring Techniques, and Internal Rating Systems ... 3
   1.4 Rating Based Modeling and the Pricing of Bonds ....... 4
   1.5 Stability of Transition Matrices, Conditional Migrations and Dependence .................. 5
   1.6 Credit Derivative Pricing .......................... 6
   1.7 Chapter Outline ................................... 7

2 **Rating and Scoring Techniques** 11
   2.1 Rating Agencies, Rating Processes, and Factors .... 11
      2.1.1 The Rating Process ............................ 14
      2.1.2 Credit Rating Factors ......................... 16
      2.1.3 Types of Rating Systems ....................... 17
   2.2 Scoring Systems .................................... 17
   2.3 Discriminant Analysis ............................... 19
   2.4 Logit and Probit Models ............................ 21
      2.4.1 Logit Models .................................. 22
      2.4.2 Probit Models .................................. 23
   2.5 Model Evaluation: Methods and Difficulties ........ 25
      2.5.1 Model Performance and Benchmarking ........... 25
      2.5.2 Model Accuracy, Type I and II Errors .......... 29

3 **The New Basel Capital Accord** 31
   3.1 Overview ........................................... 31
      3.1.1 The First Pillar—Minimum Capital Requirement .... 33
      3.1.2 The Second Pillar—Supervisory Review Process .... 35
      3.1.3 The Third Pillar—Market Discipline ............... 35
   3.2 The Standardized Approach .......................... 36
      3.2.1 Risk Weights for Sovereigns and for Banks ...... 36
      3.2.2 Risk Weights for Corporates .................... 39
      3.2.3 Maturity ....................................... 39
      3.2.4 Credit Risk Mitigation .......................... 40
   3.3 The Internal Ratings Based Approach ................. 41
      3.3.1 Key Elements and Risk Components ................ 41
      3.3.2 Derivation of the Benchmark Risk Weight Function ... 42
      3.3.3 Asset Correlation ................................ 46
      3.3.4 The Maturity Adjustment ......................... 48
      3.3.5 Expected, Unexpected Losses and the Required Capital .... 50
   3.4 Summary ............................................ 50
Contents

7.3.4 Migration Distance (MD) ........................................... 136
7.3.5 Devising a Distance Measure ................................. 136
7.3.6 Difference Indices for the Exemplary Matrices .......... 140
7.4 Summary ............................................................... 142

8 Real-World and Risk-Neutral Transition Matrices 145
8.1 The JLT Model ....................................................... 145
8.2 Adjustments Based on the Discrete-Time Transition Matrix .... 148
8.3 Adjustments Based on the Generator Matrix ............... 151
8.3.1 Modifying Default Intensities .................................. 152
8.3.2 Modifying the Rows of the Generator Matrix ............ 153
8.3.3 Modifying Eigenvalues of the Transition Probability Matrix .... 154
8.4 An Adjustment Technique Based on Economic Theory ...... 156
8.5 Risk-Neutral Migration Matrices and Pricing .............. 157

9 Conditional Credit Migrations: Adjustments and Forecasts 159
9.1 Overview ............................................................... 159
9.2 The CreditPortfolioView Approach ............................. 160
9.3 Adjustment Based on Factor Model Representations ....... 165
9.3.1 Deriving an Index for the Credit Cycle .................. 166
9.3.2 Conditioning of the Migration Matrix ....................... 167
9.3.3 A Multifactor Model Extension .............................. 171
9.4 Other Methods ...................................................... 173
9.5 An Empirical Study on Different Forecasting Methods .... 175
9.5.1 Forecasts Using the Factor Model Approach ............... 176
9.5.2 Forecasts Using Numerical Adjustment Methods ...... 178
9.5.3 Regression Models .............................................. 179
9.5.4 In-Sample Results ............................................. 180
9.5.5 Out-of-Sample Forecasts ..................................... 184

10 Dependence Modeling and Credit Migrations 187
10.1 Introduction ......................................................... 187
10.1.1 Independence .................................................... 188
10.1.2 Dependence ...................................................... 189
10.2 Capturing the Structure of Dependence ..................... 191
10.2.1 Under General Multivariate Distributions ............... 195
10.3 Copulas ............................................................... 196
10.3.1 Examples of Copulas ......................................... 198
10.3.2 Properties of Copulas ....................................... 199
10.3.3 Constructing Multivariate Distributions with Copulas .... 200
10.4 Modeling Dependent Defaults ................................... 201
10.5 Modeling Dependent Migrations ................................ 204
10.5.1 Dependence Based on a Credit Cycle Index ............... 205
10.5.2 Dependence Based on Individual Transitions .......... 206
10.5.3 Approaches Using Copulas .................................. 207
10.6 An Empirical Study on Dependent Migrations ............... 209
10.6.1 Distribution of Defaults ..................................... 209
10.6.2 The Distribution of Rating Changes ....................... 212

11 Credit Derivatives .................................................. 217
11.1 Introduction ......................................................... 217
11.1.1 Types of Credit Derivatives ................................ 219
11.1.2 Collateralized Debt Obligations (CDO) .................... 222
Contents

11.2 Pricing Single-Named Credit Derivatives ........................................ 224
11.3 Modeling and Pricing of Collateralized Debt Obligations and Basket Credit Derivatives ................................................................. 231
  11.3.1 Estimation of Macroeconomic Risk Factors .................................. 235
  11.3.2 Modeling of Conditional Migrations and Recovery Rates .............. 237
  11.3.3 Some Empirical Results ............................................................... 238
11.4 Pricing Step-Up Bonds ....................................................................... 243
  11.4.1 Step-Up Bonds ............................................................................ 244
  11.4.2 Pricing of Step-Up Bonds ............................................................. 244

Bibliography .......................................................... 249

Index ................................................................. 259