Contents

Preface xiii

1 What is risk management? 1
   1.1 Introduction 2
   1.2 Identifying and documenting risk 5
   1.3 Fallacies and traps in risk management 7
   1.4 Why safety is different 9
   1.5 The Basel framework 11
   1.6 Hold or hedge? 12
   1.7 Learning from a disaster 13
      1.7.1 What went wrong? 15
   Notes 17
   References 18
   Exercises 19

2 The structure of risk 22
   2.1 Introduction to probability and risk 23
   2.2 The structure of risk 25
      2.2.1 Intersection and union risk 25
      2.2.2 Maximum of random variables 28
   2.3 Portfolios and diversification 30
      2.3.1 Adding random variables 30
      2.3.2 Portfolios with minimum variance 33
      2.3.3 Optimal portfolio theory 37
      2.3.4 When risk follows a normal distribution 38
   2.4 The impact of correlation 40
      2.4.1 Using covariance in combining random variables 41
      2.4.2 Minimum variance portfolio with covariance 43
      2.4.3 The maximum of variables that are positively correlated 44
      2.4.4 Multivariate normal 46

*Sections marked by an asterisk may be skipped by readers requiring a less detailed discussion of the subject.
CONTENTS

2.5 Using copulas to model multivariate distributions 49
  2.5.1 *Details on copula modeling 52
  Notes 58
  References 59
  Exercises 60

3 Measuring risk 63
  3.1 How can we measure risk? 64
  3.2 Value at risk 67
  3.3 Combining and comparing risks 73
  3.4 VaR in practice 76
  3.5 Criticisms of VaR 79
  3.6 Beyond value at risk 82
    3.6.1 *More details on expected shortfall 86
    Notes 88
    References 88
    Exercises 89

4 Understanding the tails 92
  4.1 Heavy-tailed distributions 93
    4.1.1 Defining the tail index 93
    4.1.2 Estimating the tail index 95
    4.1.3 *More details on the tail index 98
  4.2 Limiting distributions for the maximum 100
    4.2.1 *More details on maximum distributions and Fisher–Tippett 106
  4.3 Excess distributions 109
    4.3.1 *More details on threshold exceedances 114
  4.4 Estimation using extreme value theory 115
    4.4.1 Step 1. Choose a threshold u 116
    4.4.2 Step 2. Estimate the parameters \( \xi \) and \( \beta \) 118
    4.4.3 Step 3. Estimate the risk measures of interest 119
    Notes 121
    References 122
    Exercises 123

5 Making decisions under uncertainty 125
  5.1 Decisions, states and outcomes 126
    5.1.1 Decisions 126
    5.1.2 States 127
    5.1.3 Outcomes 127
    5.1.4 Probabilities 128
    5.1.5 Values 129
5.2 Expected Utility Theory 130
  5.2.1 Maximizing expected profit 130
  5.2.2 Expected utility 132
  5.2.3 No alternative to Expected Utility Theory 135
  5.2.4 *A sketch proof of the theorem 139
  5.2.5 What shape is the utility function? 142
  5.2.6 *Expected utility when probabilities are subjective 145
5.3 Stochastic dominance and risk profiles 148
  5.3.1 *More details on stochastic dominance 152
5.4 Risk decisions for managers 156
  5.4.1 Managers and shareholders 156
  5.4.2 A single company-wide view of risk 158
  5.4.3 Risk of insolvency 158
Notes 160
References 161
Exercises 162

6 Understanding risk behavior 164
  6.1 Why decision theory fails 165
    6.1.1 The meaning of utility 165
    6.1.2 Bounded rationality 167
    6.1.3 Inconsistent choices under uncertainty 168
    6.1.4 Problems from scaling utility functions 171
  6.2 Prospect Theory 172
    6.2.1 Foundations for behavioral decision theory 173
    6.2.2 Decision weights and subjective values 175
  6.3 Cumulative Prospect Theory 180
    6.3.1 *More details on Prospect Theory 183
    6.3.2 Applying Prospect Theory 185
    6.3.3 Why Prospect Theory does not always predict well 187
  6.4 Decisions with ambiguity 189
  6.5 How managers treat risk 191
Notes 194
References 194
Exercises 195

7 Stochastic optimization 198
  7.1 Introduction to stochastic optimization 199
    7.1.1 A review of optimization 199
    7.1.2 Two-stage recourse problems 203
    7.1.3 Ordering with stochastic demand 208
  7.2 Choosing scenarios 212
    7.2.1 How to carry out Monte Carlo simulation 213
    7.2.2 Alternatives to Monte Carlo 217
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.3</td>
<td>Multistage stochastic optimization</td>
<td>218</td>
</tr>
<tr>
<td>7.3.1</td>
<td>Non-anticipatory constraints</td>
<td>220</td>
</tr>
<tr>
<td>7.4</td>
<td>Value at risk constraints</td>
<td>224</td>
</tr>
<tr>
<td>Notes</td>
<td></td>
<td>228</td>
</tr>
<tr>
<td>References</td>
<td></td>
<td>228</td>
</tr>
<tr>
<td>Exercises</td>
<td></td>
<td>229</td>
</tr>
<tr>
<td>8</td>
<td>Robust optimization</td>
<td>232</td>
</tr>
<tr>
<td>8.1</td>
<td>True uncertainty: Beyond probabilities</td>
<td>233</td>
</tr>
<tr>
<td>8.2</td>
<td>Avoiding disaster when there is uncertainty</td>
<td>234</td>
</tr>
<tr>
<td>8.2.1</td>
<td>More details on constraint reformulation</td>
<td>240</td>
</tr>
<tr>
<td>8.2.2</td>
<td>Budget of uncertainty</td>
<td>243</td>
</tr>
<tr>
<td>8.2.3</td>
<td>More details on budgets of uncertainty</td>
<td>247</td>
</tr>
<tr>
<td>8.3</td>
<td>Robust optimization and the minimax approach</td>
<td>250</td>
</tr>
<tr>
<td>8.3.1</td>
<td>Distributionally robust optimization</td>
<td>254</td>
</tr>
<tr>
<td>Notes</td>
<td></td>
<td>261</td>
</tr>
<tr>
<td>References</td>
<td></td>
<td>262</td>
</tr>
<tr>
<td>Exercises</td>
<td></td>
<td>263</td>
</tr>
<tr>
<td>9</td>
<td>Real options</td>
<td>265</td>
</tr>
<tr>
<td>9.1</td>
<td>Introduction to real options</td>
<td>266</td>
</tr>
<tr>
<td>9.2</td>
<td>Calculating values with real options</td>
<td>267</td>
</tr>
<tr>
<td>9.2.1</td>
<td>Deriving the formula for the surplus with a normal distribution</td>
<td>272</td>
</tr>
<tr>
<td>9.3</td>
<td>Combining real options and net present value</td>
<td>273</td>
</tr>
<tr>
<td>9.4</td>
<td>The connection with financial options</td>
<td>278</td>
</tr>
<tr>
<td>9.5</td>
<td>Using Monte Carlo simulation to value real options</td>
<td>282</td>
</tr>
<tr>
<td>9.6</td>
<td>Some potential problems with the use of real options</td>
<td>285</td>
</tr>
<tr>
<td>Notes</td>
<td></td>
<td>287</td>
</tr>
<tr>
<td>References</td>
<td></td>
<td>287</td>
</tr>
<tr>
<td>Exercises</td>
<td></td>
<td>288</td>
</tr>
<tr>
<td>10</td>
<td>Credit risk</td>
<td>291</td>
</tr>
<tr>
<td>10.1</td>
<td>Introduction to credit risk</td>
<td>292</td>
</tr>
<tr>
<td>10.2</td>
<td>Using credit scores for credit risk</td>
<td>294</td>
</tr>
<tr>
<td>10.2.1</td>
<td>A Markov chain analysis of defaults</td>
<td>296</td>
</tr>
<tr>
<td>10.3</td>
<td>Consumer credit</td>
<td>301</td>
</tr>
<tr>
<td>10.3.1</td>
<td>Probability, odds and log odds</td>
<td>302</td>
</tr>
<tr>
<td>10.4</td>
<td>Logistic regression</td>
<td>308</td>
</tr>
<tr>
<td>10.4.1</td>
<td>More details on logistic regression</td>
<td>313</td>
</tr>
<tr>
<td>10.4.2</td>
<td>Building a scorecard</td>
<td>315</td>
</tr>
<tr>
<td>10.4.3</td>
<td>Other scoring applications</td>
<td>317</td>
</tr>
<tr>
<td>Notes</td>
<td></td>
<td>317</td>
</tr>
<tr>
<td>References</td>
<td></td>
<td>318</td>
</tr>
<tr>
<td>Exercises</td>
<td></td>
<td>319</td>
</tr>
</tbody>
</table>
Appendix A  Tutorial on probability theory 323
  A.1 Random events 323
  A.2 Bayes’ rule and independence 326
  A.3 Random variables 327
  A.4 Means and variances 329
  A.5 Combinations of random variables 332
  A.6 The normal distribution and the Central Limit Theorem 336

Appendix B  Answers to even-numbered exercises 340

Index 361