

MPRA

Munich Personal RePEc Archive

Levy Subordinator Model of Default Dependency

Balakrishna, B S

14 March 2010

Online at <https://mpra.ub.uni-muenchen.de/22090/>
MPRA Paper No. 22090, posted 16 Apr 2010 14:37 UTC

Lévy Subordinator Model of Default Dependency

B. S. BALAKRISHNA*

March 14, 2010; Revised: April 14, 2010

Abstract

This article presents a model of default dependency based on Lévy subordinator. It is a tractable dynamical model, computationally structured similar to the one-factor Gaussian copula model, providing easy calibration to individual hazard rate curves and efficient pricing with Fast Fourier Transform techniques. The subordinator is an $\alpha=1/2$ stable Lévy process, maximally skewed to the right, with its distribution function known in closed form as the Lévy distribution. The model provides a reasonable fit to market data with just two parameters to assess dependency risk, a measure of correlation and that of the likelihood of a catastrophe.

Correlation products are derivatives sensitive to default correlation among a collection of credit names. Pricing of these involves either directly or indirectly modeling default dependency among the credit names. Market standard among such models is still the Gaussian copula model, a one-factor model that enables easy quotation of market prices. But, it is well-known that the model is inadequate to price nonstandard products.

Major attraction of the Gaussian copula model is its simplicity and tractability. It can easily be calibrated to individual hazard rate curves. It can be formulated in closed form providing a semi-analytical framework for pricing. It can be priced efficiently by employing Fast Fourier Transform techniques. As it turns out, there exists another model similar in architecture that also enjoys these properties. Unlike the Gaussian copula model, it is a two-parameter model, but is able to offer a reasonable explanation of the correlation smile. The two parameters provide the two measures necessary to assess dependency risk, a measure of correlation and that of the likelihood of a catastrophe. It is a dynamical model based on the Lévy subordinator, an $\alpha=1/2$ stable Lévy process maximally skewed to the right, whose distribution function is expressible in closed form and is known as the Lévy distribution. Though it is inevitable that, with a model of such few parameters, there is bound to exist a residual correlation smile, the ability to capture the correlation smile will be helpful in sensitivity analysis and stress testing.

Issues with the Gaussian copula model have been addressed before. Many authors have presented models going beyond the Gaussian copula, and the following is obviously a limited review of the literature. Brigo, Pallavicini and Torresetti [2010] provide an account of the developments in this field. Hull and White [2006] introduce an implied copula model that can

*Email: balak_bs@yahoo.co.in

calibrate consistently across all CDO tranches for a given maturity. Brigo, Pallavicini and Torresetti [2006] provide a fit across tranches as well as maturities in a generalized Poisson cluster loss model. Balakrishna [2009] models the jump distribution in an intensity based model. A doubly stochastic framework for intensity modeling is introduced in Duffie and Garleanu [2001]. Joshi and Stacey [2005] consider an intensity based modeling of business time as a gamma process. Chapovsky, Rennie and Tavares [2007] model default intensity as a jump-diffusion process. Errais, Giesecke and Goldberg [2006] present a model based on affine point processes.

An approach using Markov chains is presented in Di Graziano and Rogers [2005]. Putyatin, Prioul and Maslova [2005] use a Markovian approach with a Poissonian mixing distribution. Bennani [2005] presents a Markov functional approach to instantaneous loss rate. Sidenius, Piterbarg and Andersen [2005] consider a no-arbitrage approach to modeling future loss distribution. Overbeck and Schmidt [2005] propose a threshold model based on time-changed Wiener processes. Albanese, Chen, Dalessandro and Vidler [2006] present a structural model based on spectral analysis. Baxter [2007] presents a structural framework using Lévy processes. Albrecher, Ladoucette and Schoutens [2007] present a unified approach to generic one-factor Lévy models. For an introduction to Lévy processes and their financial applications, see, for instance, Applebaum [2005].

The article is organized as follows. Section 1 formulates one-factor models independent of the factor dynamics. Section 2 realizes this framework with Lévy processes called subordinators, and presents a specific model based on the Lévy subordinator. Section 3 discusses large homogeneous pool approximation. Section 4 presents a semi-analytical framework to compute expected loss for a finite number of names with Fast Fourier Transform techniques. Section 5 discusses CDO pricing semi-analytically and via a Monte Carlo algorithm. Section 6 concludes with a brief summary. Table 1 presents the results of calibrating the model to CDX.NA.IG and iTraxx Europe CDOs.

1 One-Factor Formulation

Consider a model wherein common economic variables determine default dependency. Factors governing default dependency can be considered to be functions of the sample paths followed by the common variables. In a simplified version of the model, only one such path-function would be relevant. Let $F_t()$ be the cumulative distribution function of this path-function at time t . Given a value for $F_t()$, defaults are considered to be independent of each other such that, for the joint default probability $P_{ij\dots}(t)$ that names labeled $\{i, j, \dots\}$ are in the defaulted state at time t , we may write

$$P_{ij\dots}(t) = \int_0^1 dF [p_i(F, t)p_j(F, t)\dots], \quad (1)$$

where $p_i(F, t)$ is the default probability that i^{th} name is in the defaulted state at time t given that $F_t()$ has value F . This expression does not depend on the past history of the common factor. To see that such a formulation is possible, at least in principle, note that, in a large homogeneous collection of credit names (to be discussed in section 3), $p_i(F, t)$ itself can be viewed upon as a path-function, and identified with the fraction of names in the defaulted

state at time t . Just as this suggests that a homogeneous collection should be describable by a one-factor model, a heterogeneous collection is expected to be describable by not more than the number of heterogeneous name types in the collection.

The above formulation of one-factor models, though appears rather simple and straightforward, has the attractive feature that the time-dependence of the common factor has disappeared into the integration variable F . As we will see, this helps us define a model independent of the dynamics governing the common factor. In fact, it lets us define a model independent of the common factor itself since the F -variable, being uniformly distributed, hides all the intricacies of the common factor. Though this still leads to a dynamical model at the effective level, that is after the F -integration, a full specification of the model dynamics, such as joint distribution of default times, would require specifying the common factor and its dynamics, but for our purpose the above formulation is sufficient.

Consider F as an indicator of the state of the economy, say with increasing F corresponding to less favorable economic conditions. This suggests that the conditional survival probability $q_i(F, t) \equiv 1 - p_i(F, t)$ decreases as a function of F for all $t > 0$. Let $F = 1$ correspond to the worst case scenario, that of total collapse with all the names defaulting, so that $q_i(1, t) = 0$. At the $F = 0$ end, the common variables could be considered to be ineffective in causing defaults so that $q_i(0, t)$ would be firm-specific, say $e^{-\kappa_i(t)}$, where $\kappa_i(t)$ is a deterministic increasing function of t with $\kappa_i(0) = 0$. Further $q_i(F, t)$, in particular contribution from the common factor, is expected to be a non-increasing function of t , starting at one and ending up at zero as t runs from zero to infinity. These properties of $q_i(F, t)$ suggest that we look for a stochastic process $\Phi_i(t)$ such that

$$q_i(F, t) = e^{-\kappa_i(t)} \mathbb{E} \left\{ 1_{\Phi_i(t) \geq F} \right\}, \quad (2)$$

where $1_{\{\dots\}}$ denotes the indicator function. $\Phi_i(t), i = 1, \dots, n$ are independent stochastic processes taking values in $[0, 1]$ with $\Phi_i(0) = 1$ and $\Phi_i(\infty) = 0$, having only non-increasing sample paths. For the individual credit name, its default probability $P_i(t)$, or equivalently its survival probability $Q_i(t) \equiv 1 - P_i(t)$, can now be expressed as

$$Q_i(t) = \int_0^1 dF q_i(F, t) = e^{-\kappa_i(t)} \mathbb{E} \left\{ \int_0^1 dF 1_{\Phi_i(t) \geq F} \right\} = e^{-\kappa_i(t)} \mathbb{E} \{ \Phi_i(t) \}. \quad (3)$$

Satisfying this ensures that the model gets calibrated to individual hazard rate curves.

The above one-factor formulation covers some of the well-known one-factor models. For instance, the standard one-factor Gaussian copula model is recovered with $\kappa_i(t) = 0$ and

$$\Phi_i(t) = N \left(\frac{1}{\sqrt{\rho}} \left(\sqrt{1 - \rho} Z_i - K_i(t) \right) \right), \quad (4)$$

where $N()$ is the cumulative normal distribution function, Z_i is a standard normal random variable associated with the i^{th} credit name, ρ is the correlation parameter and $K_i(t) = N^{-1}(P_i(t))$. This follows after writing $F = N(-Y)$ where Y is a normally distributed. The copula results from a straightforward extension of expression (1) to joint distribution of default times. However, the model lacks dynamics as is evident from above and has no support for firm-specific risk. It is not the natural choice from the point of view of the present formulation of one-factor models.

In our case, it is more convenient to work with $\Lambda_i(t) \equiv -\ln \Phi_i(t)$, a non-decreasing stochastic process taking values in $[0, \infty]$ with $\Lambda_i(0) = 0$ and $\Lambda_i(\infty) = \infty$. The conditional survival probability $q_i(F, t)$ then reads

$$q_i(F, t) = e^{-\kappa_i(t)} \mathbf{E} \left\{ 1_{\Lambda_i(t) \leq -\ln F} \right\}. \quad (5)$$

For the individual survival probability $Q_i(t)$, this gives

$$Q_i(t) = e^{-\kappa_i(t)} \mathbf{E} \left\{ e^{-\Lambda_i(t)} \right\}. \quad (6)$$

We may also express the joint survival probability $Q_\Omega(t)$ for a list of names in Ω as

$$Q_\Omega(t) = e^{-\sum_{i \in \Omega} \kappa_i(t)} \mathbf{E} \left\{ e^{-\text{Max}_{i \in \Omega} \Lambda_i(t)} \right\}, \quad (7)$$

where $\text{Max}_{i \in \Omega}$ picks up the largest $\Lambda_i(t)$ in the list Ω . This follows from the fact that $\Lambda_i(t)$ s are independent stochastic processes. This result is not needed for our discussion to follow, but it is interesting to note that it defines the model with no reference to the common factor that has been integrated away.

Though a specification of factor dynamics is not needed for our purpose, we may note here that if “barrier” F or its underlying variable evolves as some stochastic process with non-decreasing sample paths, the model could be formulated as a first passage model with the barrier crossing of the non-increasing $\Phi_i(t)$ triggering default of the i^{th} credit name, conditional on surviving firm-specific risk factors. The stochastic process for the underlying variable would provide a specification of the model dynamics, allowing extension of expression (1) to joint distribution of default times. This is reminiscent of a barrier diffusion model, but the relationship, if any, is not clear yet, though the first passage time distribution of a Brownian motion is known to follow the Lévy distribution and, as we will see next, the same distribution turns out to be relevant here as well.

2 Lévy Subordinator Model

The above formulation of one-factor models left us with individual stochastic processes that are a priori expected to be quite complicated. Fortunately, as we will see below, they can be realized neatly with a class of Lévy processes with non-decreasing sample paths known as subordinators. Of these, a stable process called the Lévy subordinator¹ turns out to be the appropriate one to choose.

Let $X_i(t), i = 1, \dots, n$ be n independent subordinators for a collection of n credit names. For a parsimonious model, let us assume that they are identically distributed. Let $\eta(u)$ be their Laplace exponent given by

$$\mathbf{E} \left\{ e^{-uX_i(t)} \right\} = e^{-t\eta(u)}. \quad (8)$$

Given such subordinators, let us set

$$\kappa_i(t) = (1 - \sigma\eta(1))\theta_i(t), \quad \Lambda_i(t) = X_i(\sigma\theta_i(t)). \quad (9)$$

¹In the literature, one sometimes finds the term “Lévy subordinator” used for all subordinators. As in Applebaum [2005], it is used here just for the $\alpha = 1/2, \beta = 1$ stable process. Similarly, the term “Lévy distribution” is used here just for the distribution of that process.

This introduces σ , a measure of correlation, as one of the parameters of the model. $\theta_i(t)$ is derived from the individual survival probability $Q_i(t)$ as

$$\theta_i(t) \equiv -\ln Q_i(t). \quad (10)$$

Now, individual hazard rate curves are automatically calibrated to, since

$$Q_i(t) = e^{-\kappa_i(t)} \mathbb{E} \{e^{-\Lambda_i(t)}\} = e^{-(1-\sigma\eta(1))\theta_i(t)} \mathbb{E} \{e^{-X_i(\sigma\theta_i(t))}\} = e^{-\theta_i(t)}. \quad (11)$$

As for the conditional survival probability, we get

$$q_i(F, t) = e^{-(1-\sigma\eta(1))\theta_i(t)} \mathbb{E} \{1_{X_i(\sigma\theta_i(t)) \leq -\ln F}\} = e^{-(1-\sigma\eta(1))\theta_i(t)} g(-\ln F, \sigma\theta_i(t)), \quad (12)$$

where $g(x, t) = \mathbb{E} \{1_{X_i(t) \leq x}\}$ is the cumulative distribution function of $X_i(t)$. Note that, due to the introduction of σ , an overall scale for $\eta(1)$ can be conveniently chosen. Allowing $F \rightarrow 0$ in the above result and ensuring $q_i(F, t) \leq 1$ requires $\sigma\eta(1) \leq 1$ so that $\kappa_i(t)$ remains non-negative as is expected of the firm-specific contribution.

A subclass of subordinators are stable processes having index of stability $\alpha \in (0, 1)$ and skew parameter $\beta = 1$. Their distributions are not known in closed form except for the $\alpha = 1/2$ stable process known as the Lévy subordinator. The cumulative distribution function of the Lévy subordinator is the Lévy distribution ($\eta(u) = \sqrt{u} + \mu u$)

$$g(x, t) = 2N \left(-t / \sqrt{2(x - \mu t)} \right), \quad (13)$$

where $N()$ is the cumulative normal distribution function. This includes a non-negative drift component μt introducing μ as the second of our model parameters, so that the distribution has support only to the right of μt . With the Lévy subordinator chosen for $X_i(t)$, the above distribution gives us for the conditional survival probability

$$q_i(F, t) = 2e^{-(1-\sigma(1+\mu))\theta_i(t)} N \left(-\sigma\theta_i(t) / \sqrt{-2(\ln F + \mu\sigma\theta_i(t))} \right). \quad (14)$$

Consistency requirement $\sigma\eta(1) \leq 1$ here reads $\sigma(1 + \mu) \leq 1$.

Result (14) defines our two-parameter Lévy subordinator model. Though, in general, the two parameters could be different for different names, and time-dependent as well, they are considered uniform and constant for ease of calibration. Positive drift forces $q_i(F, t)$ to zero above $F = e^{-\mu\sigma\theta_i(t)}$. This F -threshold is name-dependent, but, in the large homogeneous pool approximation discussed below, it implies a finite probability of all the names in the pool defaulting, μ measuring the likelihood of such a catastrophe.

3 Large Homogeneous Pool

Large homogeneous pool approximation can be a useful tool since it admits an explicit expression for the loss distribution. For a homogeneous collection of n credit names, the joint default probability of k or less number of names in the defaulted state at time t is

$$P_{\{k\}}(t) = \sum_{j=0}^k \binom{n}{j} \int_0^1 dF [p_t(F)]^j [1 - p_t(F)]^{n-j}, \quad (15)$$

where $p_i(F, t)$ has been written as $p_t(F)$. For a large homogeneous pool of names, that is as $n \rightarrow \infty$, it is well-known that the above simplifies to

$$G_t(\nu) \equiv P_{\{\nu n\}}(t) = \int_0^1 dF 1_{p_t(F) \leq \nu}, \quad (16)$$

where $\nu = k/n$ is the fraction of names in the defaulted state at time t . This indicates that $G_t(\nu)$ can be obtained by summing up the region of F over which $p_t(F) \leq \nu$.

We have considered $p_t(F)$ to be an increasing function of F . Hence, $G_t(\nu)$ can be obtained by solving $p_t(F) = \nu$ for $F = G_t(\nu)$. When $\sigma(1 + \mu) \leq 1$ as is required for consistency, there is a $\nu_{\min}(t)$ below which $G_t(\nu) = 0$,

$$\nu_{\min}(t) = 1 - e^{-(1-\sigma(1+\mu))\theta(t)}. \quad (17)$$

This increases with t starting from zero at $t = 0$. For ν above $\nu_{\min}(t)$, $G_t(\nu)$ is

$$G_t(\nu) = \exp \left\{ -\mu\sigma\theta(t) - \frac{1}{2}(\sigma\theta(t))^2 \left[N^{-1} \left(\frac{1}{2}(1-\nu)e^{(1-\sigma(1+\mu))\theta(t)} \right) \right]^{-2} \right\}, \quad \nu \geq \nu_{\min}(t). \quad (18)$$

Note that $G_t(\nu) \rightarrow e^{-\mu\sigma\theta(t)}$ as $\nu \rightarrow 1$ so that there is a probability mass at $\nu = 1$ as observed earlier, suggesting a finite probability $1 - e^{-\mu\sigma\theta(t)}$ of a total collapse.

The expected loss per tranche size for a tranche with attachment point a and detachment point b can be computed as

$$\bar{L}(t)_{[a,b]} = 1 - \frac{1}{\nu_b - \nu_a} \int_{\nu_a}^{\nu_b} d\nu G_t(\nu), \quad (19)$$

where $\nu_a = a/(1 - R)$, $\nu_b = b/(1 - R)$ and R is the recovery rate (this known result follows from the usual expressions). Note that $\int_0^1 d\nu G_t(\nu) = e^{-\theta(t)}$ as expected. The above shows that the expected loss becomes 100% of the tranche size once $\nu_{\min}(t)$ crosses ν_b , if b is small enough for this to occur within the life-time of the trade. This leads to overpricing of the equity tranches. Finite n and heterogeneity is expected to offer better pricing by smoothening out the small ν behavior.

4 Finite n with FFT

Large homogeneous pool approximation yields fast results, but at the expense of accuracy. As is well-known, many of the factor models can be efficiently computed for finite n by employing Fast Fourier Transform (FFT) techniques. This is true with the present model as well. To obtain the loss distribution for finite n , consider the loss variable at time t conditional on F ,

$$\mathcal{L}(F, t) = \sum_{i=1}^n L_i \tau_i(F, t), \quad (20)$$

where $\tau_i(F, t)$ is the conditional default indicator at time t and $L_i = (1 - R_i)w_i$, R_i being the recovery rate and w_i the fraction of the total pool notional associated with the i^{th} name. L_i

is assumed to be deterministic and time-independent. Default indicators being independent conditional on F , the above has the characteristic

$$\mathbb{E} \left\{ e^{iu\mathcal{L}(F,t)} \right\} = \prod_{m=1}^n [q_m(F,t) + p_m(F,t)e^{iuL_m}], \quad (21)$$

where $i = \sqrt{-1}$. This characteristic is the Fourier transform of the density function of the loss distribution (conditional on F unless mentioned otherwise). Hence, the loss distribution can be obtained by inverting it using FFT techniques. The result can be used to compute the expected loss per tranche size for a tranche with attachment point a and detachment point b according to

$$\bar{L}(F,t)_{[a,b]} = 1 - \frac{1}{b-a} \int_a^b dx H_t(F,x), \quad (22)$$

where $H_t(F, \cdot)$ is the cumulative loss distribution function.

FFT requires discretization of u . Discretization is straightforward if L_i 's are uniform at L across the collection ($L = (1 - R)/n$ if R_i s are uniform). Inversion then yields the loss distribution at loss-points $j = 0, \dots, n$ in units of L . This gives the default probability density $P_{[j]}(F,t)$, the sum of products of various combinations of j of the $p_i(F,t)$ s and $n - j$ of the $q_i(F,t)$ s. Consider it extended up to $j = N - 1 \geq n$ by padding with zeros where N is a power of 2, as is usually done for an efficient FFT. In this case, (21) reads

$$\sum_{j=0}^{N-1} P_{[j]}(F,t) e^{i\omega jk} = \prod_{m=1}^n [q_m(F,t) + p_m(F,t) e^{i\omega k}], \quad k = 0, \dots, N-1, \quad (23)$$

where $\omega = 2\pi/N$. This can easily be computed and inverted using FFT techniques to obtain $P_{[j]}(F,t)$, $j = 0, \dots, n$, and hence its cumulative counterpart $G_t(F, \nu)$ (that corresponds to $H_t(F, jL)$) where $\nu = j/n$ is the fraction of names in the defaulted state. Expected loss per tranche size is then

$$\bar{L}(F,t)_{[a,b]} = 1 - \frac{1}{\nu_b - \nu_a} \int_{\nu_a}^{\nu_b} d\nu G_t(F, \nu), \quad (24)$$

where $\nu_a = a/(nL)$, $\nu_b = b/(nL)$, and $G_t(F, \nu)$ is flat in-between successive ν -points. Integration of $\bar{L}(F,t)_{[a,b]}$ over F gives $\bar{L}(t)_{[a,b]}$, the unconditional expected loss per tranche size. This integration is deferred to the end of computations for efficiency reasons.

5 CDO Pricing

The analytical results for the expected loss can be used to price the CDO tranches. The default leg of a tranche per tranche size can be priced as

$$\text{DL}_{[a,b]} = \int_0^1 dF \left\{ \int_0^T D(t) d\bar{L}(F,t)_{[a,b]} \right\}, \quad (25)$$

where T is the maturity and $D(t)$ is the discount factor for the time period $(0, t)$. Similarly the premium leg per tranche size per unit spread can be priced as

$$\text{PL}_{[a,b]} = \int_0^1 dF \left\{ \sum_{i=1}^{N_\delta} \delta_i(t_i) D(t_i) [1 - \bar{L}(F, t_i)_{[a,b]}] \right\}, \quad (26)$$

where $\delta_i(t_i)$ is the accrual factor for the period (t_{i-1}, t_i) , $t_{N_\delta} = T$ and N_δ is the number of periods. To this premium leg, we need to add a contribution from accrued interest payments made upon default,

$$\text{PL}'_{[a,b]} = \int_0^1 dF \left\{ \sum_{i=1}^{N_\delta} \int_{t_{i-1}}^{t_i} \delta_i(t) D(t) d\bar{L}(F, t)_{[a,b]} \right\}, \quad (27)$$

where $\delta_i(t)$ is the accrual factor for the partial period covering (t_{i-1}, t) . Given the leg values, fair spread can be obtained by dividing the default leg by the premium leg, after taking care of any upfront payments.

It is found to be efficient to perform the numerical integration over F after the expressions within the curly brackets are computed over a sufficiently fine time-grid. The super senior tranche can be priced like an ordinary tranche along with an additional premium leg of notional that is a fraction R of the total notional of the underlying credit default swaps outstanding, or, if recovery rates are nonuniform, sum of fractions R_i of the individual notionals of the underlying credit default swaps outstanding.

Though the model can be handled semi-analytically as detailed above, a Monte Carlo algorithm could be a useful tool to price more exotic products. It can also be useful for pricing standard tranches as it is found to be efficient, accurate, easily implementable and does not involve discretization of time. Note that the following is not to be viewed as simulating model dynamics, rather just as a method of computing the above integrals. If desired, but at the expense of efficiency, it can be generalized to simulate model dynamics by simulating the stochastic process with non-decreasing sample paths chosen for the variable underlying F . The algorithm reads as follows.

1. Draw a uniformly distributed random number F and n independent uniformly distributed random numbers $u_i, i = 1, \dots, n$.
2. For each credit name i , first determine whether it defaults before the time horizon T by checking if $q_i(F, T) < u_i$ where $q_i(F, \cdot)$ is given in equation (14). If so, solve the equation $q_i(F, t_i) = u_i$ for $\theta_i(t_i)$. Determine default time t_i of credit name i by a table look up into its hazard rate curve.
3. Given the default times before the time horizon, price the instrument. For the next scenario, go to step 1.
4. Average all the prices thus obtained to get a price for the instrument.

To improve efficiency, quasi random sequences such as Sobol sequences can be used to generate each of the independent uniform random numbers.

Given a scenario of default times, it is straightforward to price the CDOs. One proceeds processing the defaults one by one, starting from the first up to maturity, picking up payments by the default leg, switching to the next tranche whenever a tranche gets wiped out, at the same time computing the premium legs per unit spread for all the surviving tranches. Whenever a default leg pays out the loss amount, the notional of that tranche gets reduced by the same amount, and the notional of the super senior tranche gets reduced by the recovery amount (when the super senior is the only survivor, it gets treated like a default swap). The leg values can be added across tranches to obtain those for the index default swap. Fair spreads can be computed given the leg values at the end of the simulation.

6 Conclusions

The article has presented a one-factor model of default dependency to capture the correlation smile. It is driven by the Lévy subordinator, an $\alpha=1/2$ stable process maximally skewed to the right whose distribution function is known in closed form as the Lévy distribution. The attractive feature of the model is its tractability, at par with that of the Gaussian copula model. It gets automatically calibrated to individual hazard rate curves. It can be used for pricing both semi-analytically by employing Fast Fourier Transform techniques and via a Monte Carlo algorithm. As can be seen from Table 1, despite having only two parameters at its disposal, it is able to capture the correlation smile reasonably well. Market quotes are as on October 2, 2006 (source: Brigo, Pallavicini and Torresetti [2006]), and it remains to see how the model performs during distressed market conditions (when parameter μ is expected to play a significant role). Calibration is done for a homogeneous collection, with constant interest rates and recovery rates, and with hazard rates flat in-between maturities. Relaxing these assumptions could improve the fit.

We modeled the individual process $\Lambda_i(t)$ as a time-changed Lévy subordinator. A natural extension of the Lévy subordinator is the inverse Gaussian subordinator, but it does not appear to improve the fit. Other model variations are possible, for instance, $\Lambda_i(t)$ could be the time-integral of a nonnegative stochastic process, perhaps mean-reverting, that in some sense could be interpreted as stochastic default intensity. Such variations result in individual survival probabilities that are not as easily calibrated to. Though it is simpler and to some extent equivalent when the intensity process is a stable process, the model presented here is the simplest and still results in a reasonable fit to market data. An issue with the model is its inability to sufficiently account for the super senior tranche spread, resulting in some price discrepancies for the lower tranches. There is some improvement upon using a lower recovery rate, and recovery rate modeling such as random recovery considered within the context of the Gaussian copula model could be helpful.

Though the model has been developed with an application to CDOs in mind, it could be useful in other disciplines that involve modeling a dependent set of events. The model provides two measures to assess dependency risk, that of correlation and that of the likelihood of a catastrophe. Simplicity and tractability with its large homogeneous pool approximation, an efficient semi-analytical framework and a Monte Carlo algorithm makes the model an attractive choice.

References

- [1] Albanese, C., O. Chen, A. Dalessandro, and A. Vidler (2006), “Dynamic Credit Correlation Modeling”, Available at http://www.defaultrisk.com/pp_corr_75.htm.
- [2] Albrecher, H., S. Ladoucette, W. Schoutens (2007), “A Generic One-factor Lévy model for Pricing Synthetic CDOs”, in “Advances in Mathematical Finance”, Birkhauser, 259-277.
- [3] Applebaum, D. (2005), “Lectures on Lévy Processes, Stochastic Calculus and Financial Applications”, Ovronnaz, September 2005.

- [4] Balakrishna, B. S. (2009), “Lévy Density Based Intensity Modeling of the Correlation Smile”, Available at http://www.defaultrisk.com/pp_cdo_63.htm.
- [5] Baxter, M. (2007). “Lévy Simple Structural Models”, in “Credit Correlation - Life after Copulas”, Lipton and Rennie (Editors), World Scientific.
- [6] Bennani, N. (2005), “The Forward Loss Model: A Dynamic Term Structure Approach for the Pricing of Portfolio Credit Derivatives”, http://www.defaultrisk.com/pp_crdrv_95.htm.
- [7] Brigo, D., A. Pallavicini and R. Torresetti (2006), “Default Correlation, Cluster Dynamics and Single Names: The GPCL dynamical loss model”, <http://ssrn.com/abstract=956827>.
- [8] Brigo, D., A. Pallavicini and R. Torresetti. (2010) “Credit Models and the Crisis, or: How I learned to stop worrying and love the CDOs”, <http://ssrn.com/abstract=1529498>.
- [9] Chapovsky, A., A. Rennie and P. A. C. Tavares (2007), “Stochastic Intensity Modeling for Structured Credit Exotics”, *Int. Jnl. of Theoretical and Applied Finance*, 10(4), pp. 633-652.
- [10] Di Graziano, G. and C. Rogers (2009), “A Dynamic Approach to the Modeling of Correlation Credit Derivatives Using Markov Chains”, *Int. Jnl. of Th. and App. Finance*, 12(1), pp. 45-62.
- [11] Duffie, D. and N. Garleanu (2001), “Risk and the Valuation of Collateralized Debt Obligations”, *Financial Analysts Journal*, 57, pp. 41-59.
- [12] Errais, E., K. Giesecke and L. Goldberg (2006), “Affine Point Processes and Portfolio Credit Risk”, Available at <http://ssrn.com/abstract=908045>.
- [13] Hull, J. and A. White (2006), “Valuing Credit Derivatives Using an Implied Copula Approach”, *Journal of Derivatives*, 14(2), pp. 8-28.
- [14] Joshi, M. and A. Stacey (2005), “Intensity Gamma: A New Approach to Pricing Credit Derivatives”, *Risk Magazine*, July 2006.
- [15] Overbeck, L. and W. Schmidt (2005), “Modeling Default Dependence with Threshold Models”, *Journal of Derivatives*, 12(4), pp. 1019.
- [16] Putyatin, V., D. Prieul and S. Maslova (2005), “A Markovian approach to Modeling Correlated Defaults”, *Risk Magazine*, May 2005.
- [17] Sidenius, J., V. Piterbarg and L. Andersen (2005), “A New Framework for Dynamic Credit Portfolio Loss Modeling”, http://www.defaultrisk.com/pp_model_83.htm.

Table 1: Best fits to the five tranches of CDX.NA.IG and iTraxx Europe CDOs for each maturity*, obtained for a homogeneous collection using semi-analytical pricing with FFT. Hazard rate is taken to be flat in-between maturities. Interest rate is constant at 5.0% and 3.5% respectively, and recovery rate at 40%. Equity tranche is quoted as an upfront fee in percent (plus 500bp per year running) and the other tranches are quoted as spreads per year in bp (with bid-ask spreads in brackets). The three rows under each maturity present respectively the quotes, results and delta hedge ratios.

CDX.NA.IG7								
	0-3%	3-7%	7-10%	10-15%	15-30%	30-100%	0-100%	σ, μ
3y	9.75(2.0)	7.9(1.6)	1.20(0.2)	0.50(0.1)	0.20(0.1)		24.0(0.5)	0.38,0.0
	10.15	7.45	1.51	0.54	0.28	0.12	24.1	
	34.28	0.80	0.14	0.06	0.00	0.00	1.0	
5y	30.50(1.0)	102.0(6.1)	22.50(1.4)	10.25(0.6)	5.00(0.3)		40.0(0.5)	0.62,0.06
	32.00	102.3	22.04	10.51	4.80	1.32	40.0	
	24.67	5.91	1.13	0.49	0.19	0.01	1.0	
7y	45.63(2.0)	240.0(48.0)	53.00(10.6)	23.00(4.6)	7.20(1.4)		49.0(0.5)	0.68,0.03
	47.05	257.6	55.42	22.99	7.74	1.19	49.0	
	16.23	10.62	2.51	0.97	0.25	0.04	1.0	
10y	55.00(1.0)	535.0(21.4)	123.00(7.4)	59.00(3.5)	15.50(0.9)		61.0(0.5)	0.63,0.06
	56.72	530.0	139.50	52.38	16.41	2.60	61.0	
	8.29	13.11	5.42	1.96	0.56	0.04	1.0	
iTraxx Europe 6								
	0-3%	3-6%	6-9%	9-12%	12-22%	22-100%	0-100%	σ, μ
3y	3.50(1.5)	5.5(4.0)	2.25(3.0)				18.0(0.5)	0.45,0.0
	4.08	6.1	1.54	0.61	0.28	0.13	18.1	
	34.53	0.81	0.19	0.10	0.01	0.00	1.0	
5y	19.75(0.25)	75.0(1.0)	22.25(1.0)	10.50(1.0)	4.00(0.5)	1.50(0.5)	30.0(0.5)	0.76,0.03
	20.55	77.4	21.19	10.31	4.60	0.85	30.0	
	27.00	5.53	1.46	0.68	0.27	0.02	1.0	
7y	37.12(0.25)	189.0(2.0)	54.25(1.5)	26.75(1.5)	9.00(1.0)	2.85(0.5)	40.0(0.5)	0.73,0.03
	38.70	204.7	53.12	24.11	9.73	1.32	40.0	
	19.67	10.48	2.88	1.25	0.47	0.05	1.0	
10y	49.75(0.25)	474.0(4.0)	125.50(3.0)	56.50(2.0)	19.50(1.0)	3.95(0.5)	51.0(0.5)	0.68,0.03
	53.95	470.1	136.48	56.10	20.18	2.15	51.0	
	10.36	14.88	6.15	2.48	0.82	0.07	1.0	

*Market quotes as on October 2, 2006. Source: Brigo, Pallavicini and Torresetti [2006].