Hedging Default and Credit Spread Risks within CDOs

Global Derivatives Trading & Risk Management
Paris
23 May 2007

Jean-Paul LAURENT
Professor, ISFA Actuarial School, University of Lyon,
Scientific consultant, BNP PARIBAS
http://laurent.jeanpaul.free.fr

Presentation related to papers
A note on the risk management of CDOs (2006)
Hedging default risks of CDOs in Markovian contagion models (2007)
Available on www.defaultrisk.com

Hedging Default and Credit Spread Risks within CDOs

- Bullet points
  - Hedging default and credit spread risks in contagion models
  - Dealing with simultaneous defaults
  - Hedging default and credit spread risks within intensity models
  - Parallel and idiosyncratic Gammas
- Purpose of the presentation
  - Not trying to embrace all risk management issues
  - Focus on very specific aspects of default and credit spread risk
- Overlook of the presentation
  - Economic background
  - Tree approach to hedging defaults
  - Hedging credit spread risks for large portfolios

I - Economic Background

- Hedging CDOs context
- About 1 000 papers on defaultrisk.com
- About 10 papers dedicated to hedging issues
  - **In interest rate or equity markets, pricing is related to the cost of the hedge**
  - **In credit markets, pricing is disconnect from hedging**
- Need to relate pricing and hedging
- What is the business model for CDOs?
- Risk management paradigms
  - Static hedging, risk-return arbitrage, complete markets

I - Economic Background

- Static hedging
- Buy a portfolio of credits, split it into tranches and sell the tranches to investors
    - No correlation or model risk for market makers
    - No need to dynamically hedge with CDS
- Only « budget constraint »:
    - Sum of the tranche prices greater than portfolio of credits price
    - Similar to stripping ideas for Treasury bonds
- <u>No clear idea of relative value of tranches</u>
    - Depends of demand from investors
    - Markets for tranches might be segmented

I - Economic Background

- Risk – return arbitrage
- Historical returns are related to ratings, factor exposure
  - CAPM, equilibrium models
  - **In search of high alphas**
  - **Relative value deals, cross-selling along the capital structure**
- Depends on the presence of « arbitrageurs »
  - Investors with small risk aversion
    - Trading floors, hedge funds
  - Investors without too much accounting, regulatory, rating constraints

I - Economic Background

- The ultimate step : complete markets
  - As many risks as hedging instruments
  - News products are only designed to save transactions costs and are used for risk management purposes
  - Assumes a high liquidity of the market
- Perfect replication of payoffs by dynamically trading a small number of « underlying assets »
  - Black-Scholes type framework
  - Possibly some model risk
- This is further investigated in the presentation
  - Dynamic trading of CDS to replicate CDO tranche payoffs

I - Economic Background

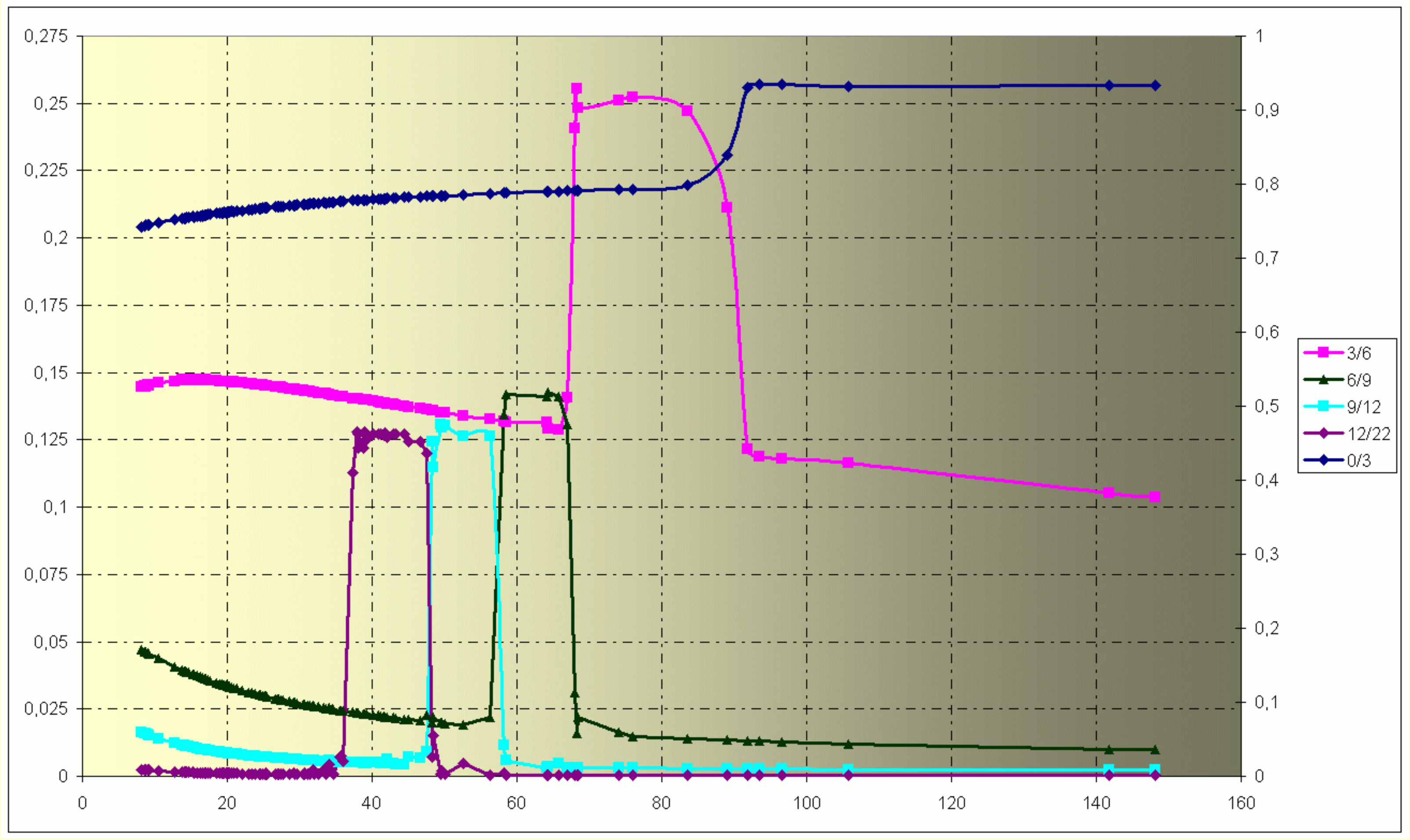
- Default risk
  - Default bond price jumps to recovery value at default time.
  - Drives the CDO cash-flows
- Credit spread risk
  - Changes in defaultable bond prices prior to default
    - ➢ Due to shifts in credit quality or in risk premiums
  - Changes in the marked to market of tranches
- Interactions between credit spread and default risks
  - Increase of credit spreads increase the probability of future defaults
  - Arrival of defaults may lead to jump in credit spreads
    - ➢ Contagion effects (Jarrow & Yu)

I - Economic Background

- Credit deltas in copula models
- CDS hedge ratios are computed by bumping the marginal credit curves
  - Local sensitivity analysis
  - Focus on credit spread risk
  - Deltas are copula dependent
  - Hedge over short term horizons
    - Poor understanding of gamma, theta, vega effects
    - Does not lead to a replication of CDO tranche payoffs
- Last but not least: not a hedge against defaults…

I - Economic Background

- Credit deltas in copula models
  - Stochastic correlation model (Burstchell, Gregory & Laurent, 2007)



II - Tree approach to hedging defaults

- Main assumptions and results
  - Credit spreads are driven by defaults
    - ➢Contagion model
    - ➢Credit spreads are deterministic between two defaults
  - Homogeneous portfolio
    - ➢Only need of the CDS index
    - ➢No individual name effect
  - Markovian dynamics
    - ➢Pricing and hedging CDOs within a binomial tree
    - ➢Easy computation of dynamic hedging strategies
    - ➢Perfect replication of CDO tranches

II - Tree approach to hedging defaults

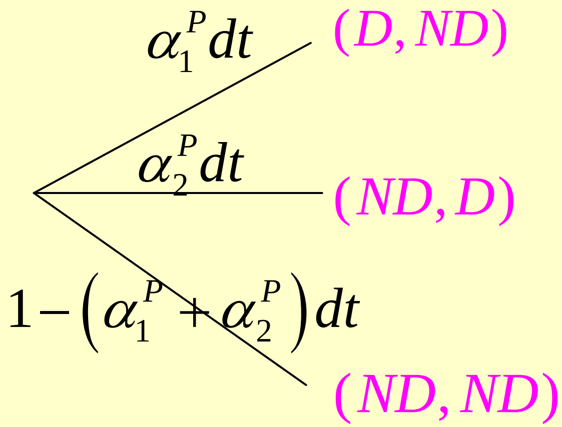
- We will start with two names only
- Firstly in a static framework
  - Look for a First to Default Swap
  - Discuss historical and risk-neutral probabilities
- Further extending the model to a dynamic framework
  - Computation of prices and hedging strategies along the tree
  - Pricing and hedging of tranchelets
- Multiname case: homogeneous Markovian model
  - Computation of risk-neutral tree for the loss
  - Computation of dynamic deltas
- Technical details can be found in the paper:
  - "hedging default risks of CDOs in Markovian contagion models"

II - Tree approach to hedging defaults

- Some notations :
  - τ_1, τ_2 default times of counterparties 1 and 2,
  - $\mathcal{H}_t$ available information at time t,
  - P historical probability,
  - α_1^P, α_2^P : (historical) default intensities:
    - $P\left[\tau_i \in \left[t, t+dt\right[\middle| H_t\right] = \alpha_i^P dt,\ i = 1,2$
- Assumption of « local » independence between default events
  - Probability of 1 and 2 defaulting altogether:
    - $P\left[\tau_1 \in \left[t, t+dt\right[, \tau_2 \in \left[t, t+dt\right[\middle| H_t\right] = \alpha_1^P dt \times \alpha_2^P dt \text{ in } (dt)^2$
  - Local independence: simultaneous joint defaults can be neglected

II - Tree approach to hedging defaults

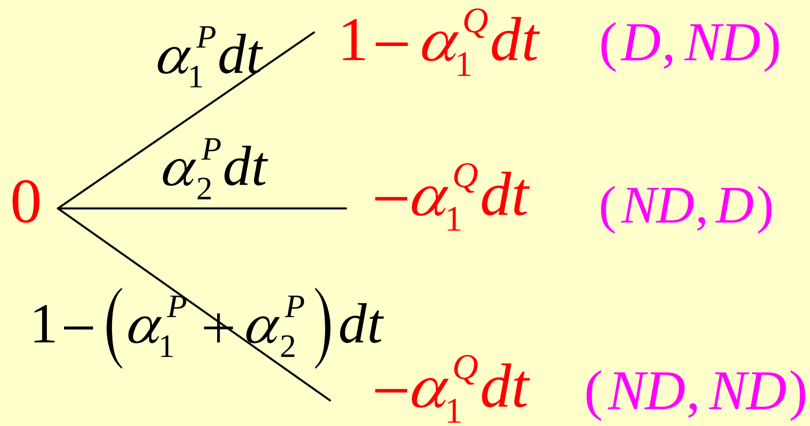
- Building up a tree:
  - Four possible states: (D,D), (D,ND), (ND,D), (ND,ND)
  - Under no simultaneous defaults assumption $p_{(D,D)}=0$
  - Only three possible states: (D,ND), (ND,D), (ND,ND)
  - Identifying (historical) tree probabilities:



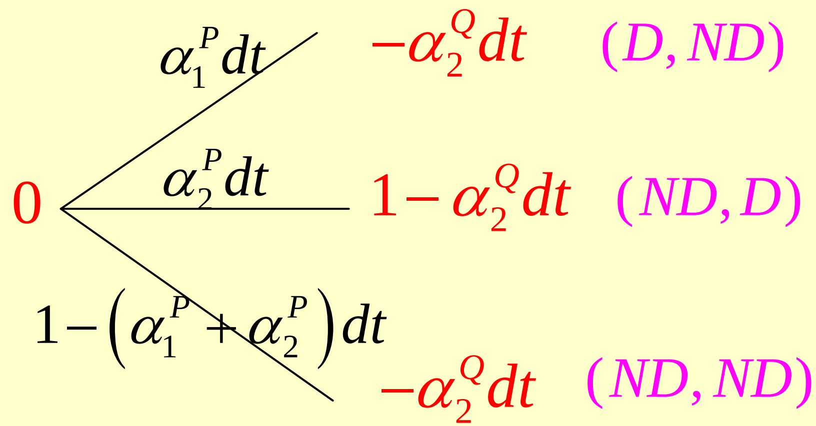
$$\begin{cases} p_{(D,D)} = 0 \Rightarrow p_{(D,ND)} = p_{(D,D)} + p_{(D,ND)} = p_{(D,.)} = \alpha_1^P dt \\ p_{(D,D)} = 0 \Rightarrow p_{(ND,D)} = p_{(D,D)} + p_{(ND,D)} = p_{(.,D)} = \alpha_2^P dt \\ p_{(ND,ND)} = 1 - p_{(D,.)} - p_{(.,D)} \end{cases}$$

II - Tree approach to hedging defaults

- Stylized cash flows of short term digital CDS on counterparty 1:
  - $\alpha_1^Q dt$ CDS 1 premium



- Stylized cash flows of short term digital CDS on counterparty 2:



II - Tree approach to hedging defaults

- Cash flows of short term digital first to default swap with premium $\alpha_F^Q dt$:

  0:
  - $\alpha_1^P dt$ → $1-\alpha_F^Q dt$ (D, ND)
  - $\alpha_2^P dt$ → $1-\alpha_F^Q dt$ (ND, D)
  - $1-\left(\alpha_1^P+\alpha_2^P\right)dt$ → $-\alpha_F^Q dt$ (ND, ND)

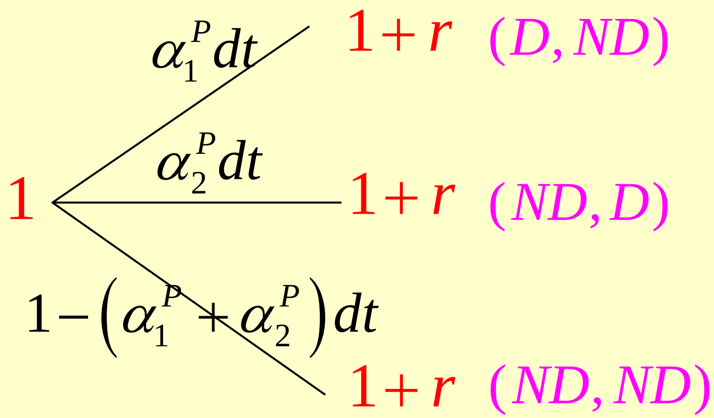
- Cash flows of holding CDS 1 + CDS 2:

  0:
  - $\alpha_1^P dt$ → $1-\left(\alpha_1^Q+\alpha_2^Q\right)dt$ (D, ND)
  - $\alpha_2^P dt$ → $1-\left(\alpha_1^Q+\alpha_2^Q\right)dt$ (ND, D)
  - $1-\left(\alpha_1^P+\alpha_2^P\right)dt$ → $-\left(\alpha_1^Q+\alpha_2^Q\right)dt$ (ND, ND)

- Perfect hedge of first to default swap by holding 1 CDS 1 + 1 CDS 2
  - Delta with respect to CDS 1 = 1, delta with respect to CDS 2 = 1

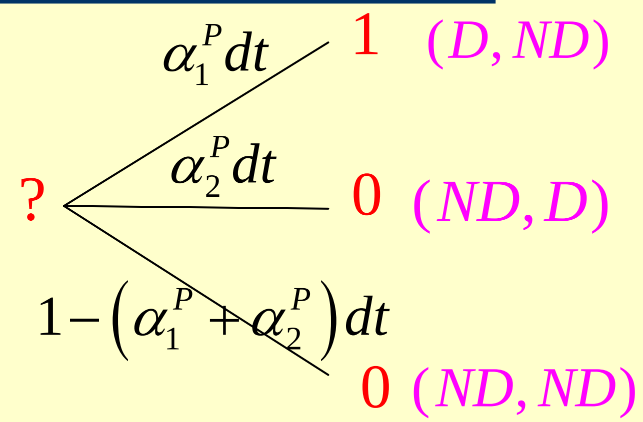
II - Tree approach to hedging defaults

- Absence of arbitrage opportunities imply:
  - $\alpha_F^Q = \alpha_1^Q + \alpha_2^Q$
- Arbitrage free first to default swap premium
  - Does not depend on historical probabilities α_1^P, α_2^P
- Three possible states: (D,ND), (ND,D), (ND,ND)
- Three tradable assets: CDS1, CDS2, risk-free asset

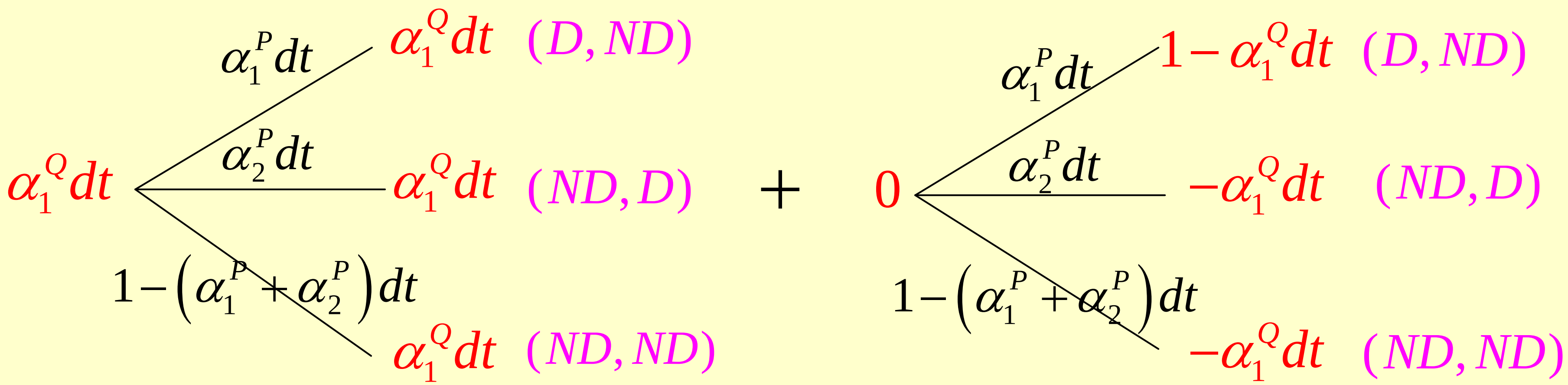


- For simplicity, let us assume $r = 0$

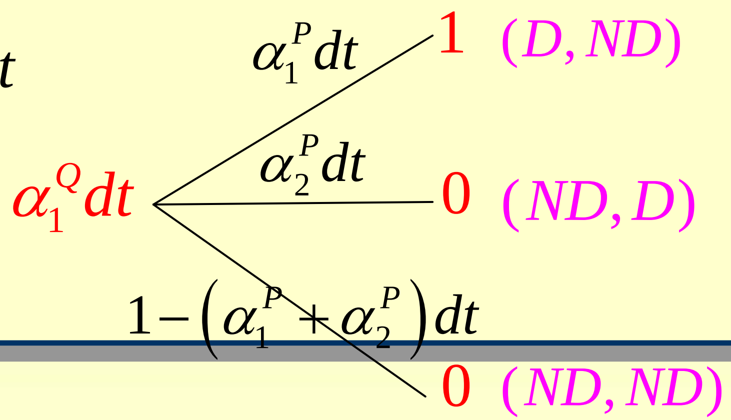
II - Tree approach to hedging defaults



- Three state contingent claims
  - Example: claim contingent on state (D, ND)
  - Can be replicated by holding
  - 1 CDS 1 + $\alpha_1^Q dt$ risk-free asset

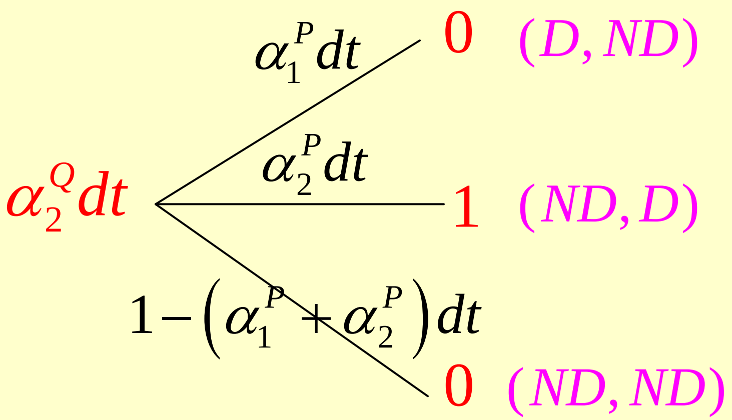


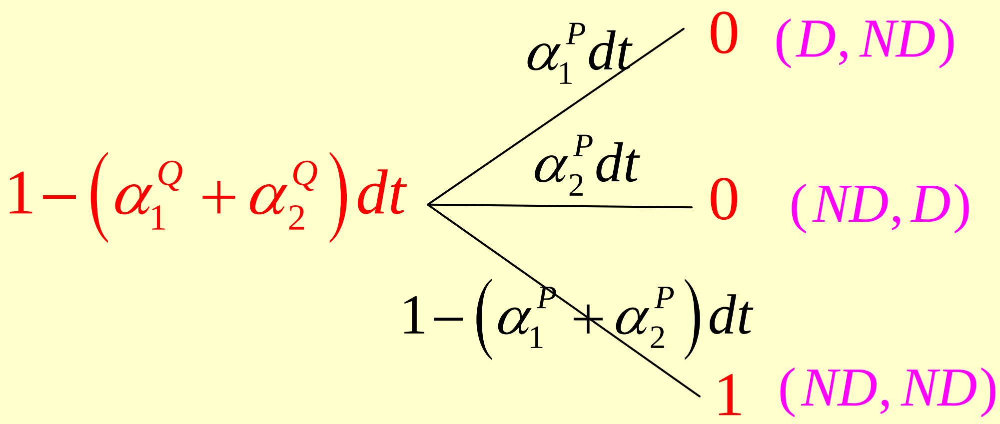
  - Replication price = $\alpha_1^Q dt$



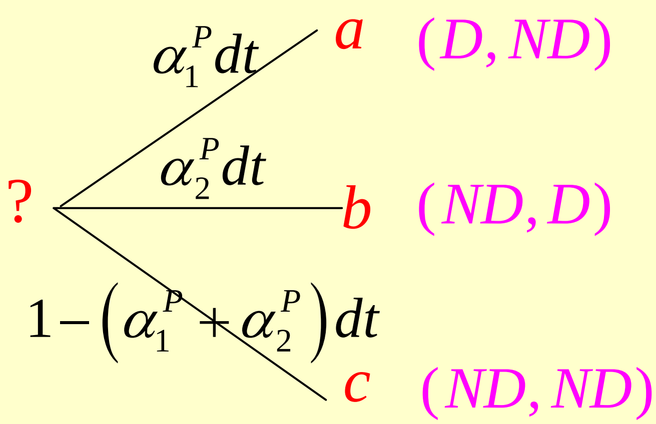
II - Tree approach to hedging defaults

- Similarly, the replication prices of the (ND, D) and (ND, ND) claims





- Replication price of:

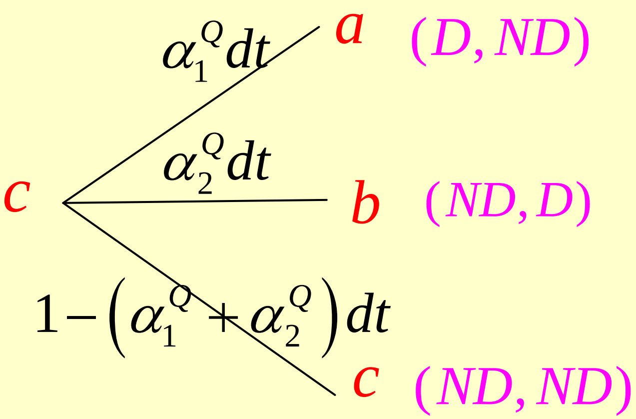


- Replication price = $\alpha_1^Q dt \times a + \alpha_2^Q dt \times b + \left(1-(\alpha_1^Q+\alpha_2^Q)dt\right)c$

II - Tree approach to hedging defaults

- Replication price obtained by computing the expected payoff
  - Along a risk-neutral tree

$$\alpha_1^Q dt \times a + \alpha_2^Q dt \times b + \left(1 - (\alpha_1^Q + \alpha_2^Q) dt\right) c$$



- Risk-neutral probabilities
  - Used for computing replication prices
  - Uniquely determined from short term CDS premiums
  - No need of historical default probabilities

II - Tree approach to hedging defaults

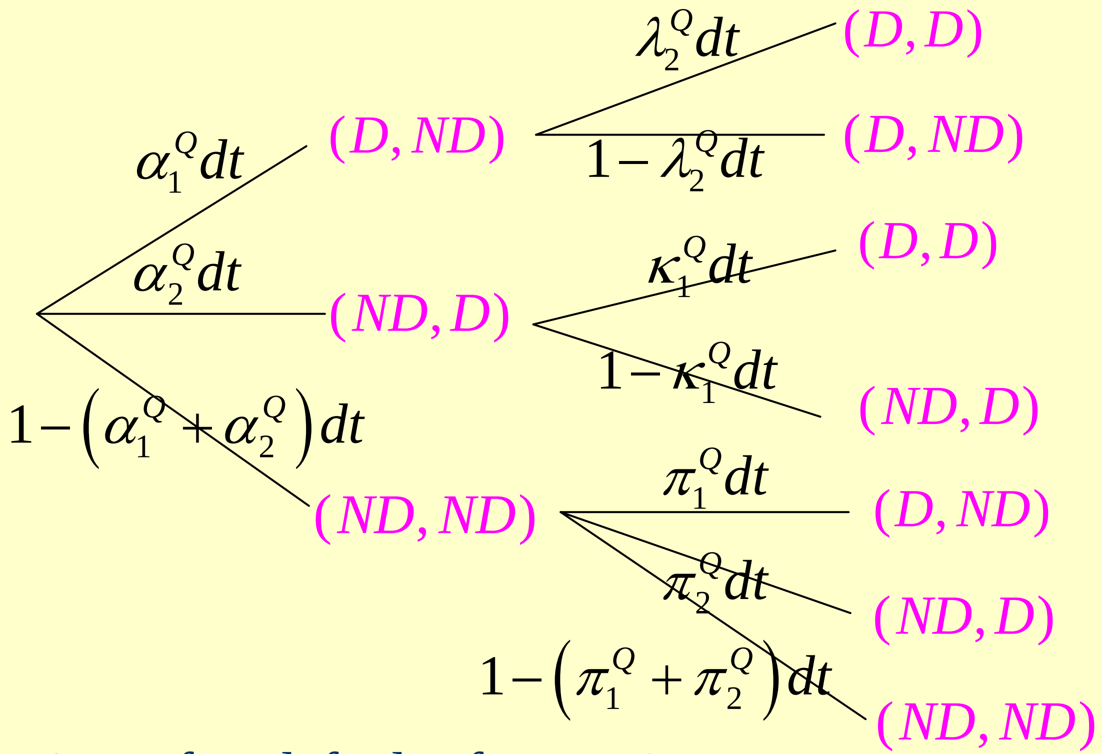
- Computation of deltas
  - Delta with respect to CDS 1: δ_1
  - Delta with respect to CDS 2: δ_2
  - Delta with respect to risk-free asset: p
    - ➢ p also equal to up-front premium

$$
\begin{cases}
a = p + \delta_1 \times \overbrace{\left(1 - \alpha_1^Q dt\right)}^{\text{payoff CDS 1}} + \delta_2 \times \overbrace{\left(-\alpha_2^Q dt\right)}^{\text{payoff CDS 2}} \\
b = p + \delta_1 \times \left(-\alpha_1^Q dt\right) + \delta_2 \times \left(1 - \alpha_2^Q dt\right) \\
c = p + \delta_1 \times \underbrace{\left(-\alpha_1^Q dt\right)}_{\text{payoff CDS 1}} + \delta_2 \times \underbrace{\left(-\alpha_2^Q dt\right)}_{\text{payoff CDS 2}}
\end{cases}
$$

  - As for the replication price, deltas only depend upon CDS premiums

II - Tree approach to hedging defaults

- Dynamic case:



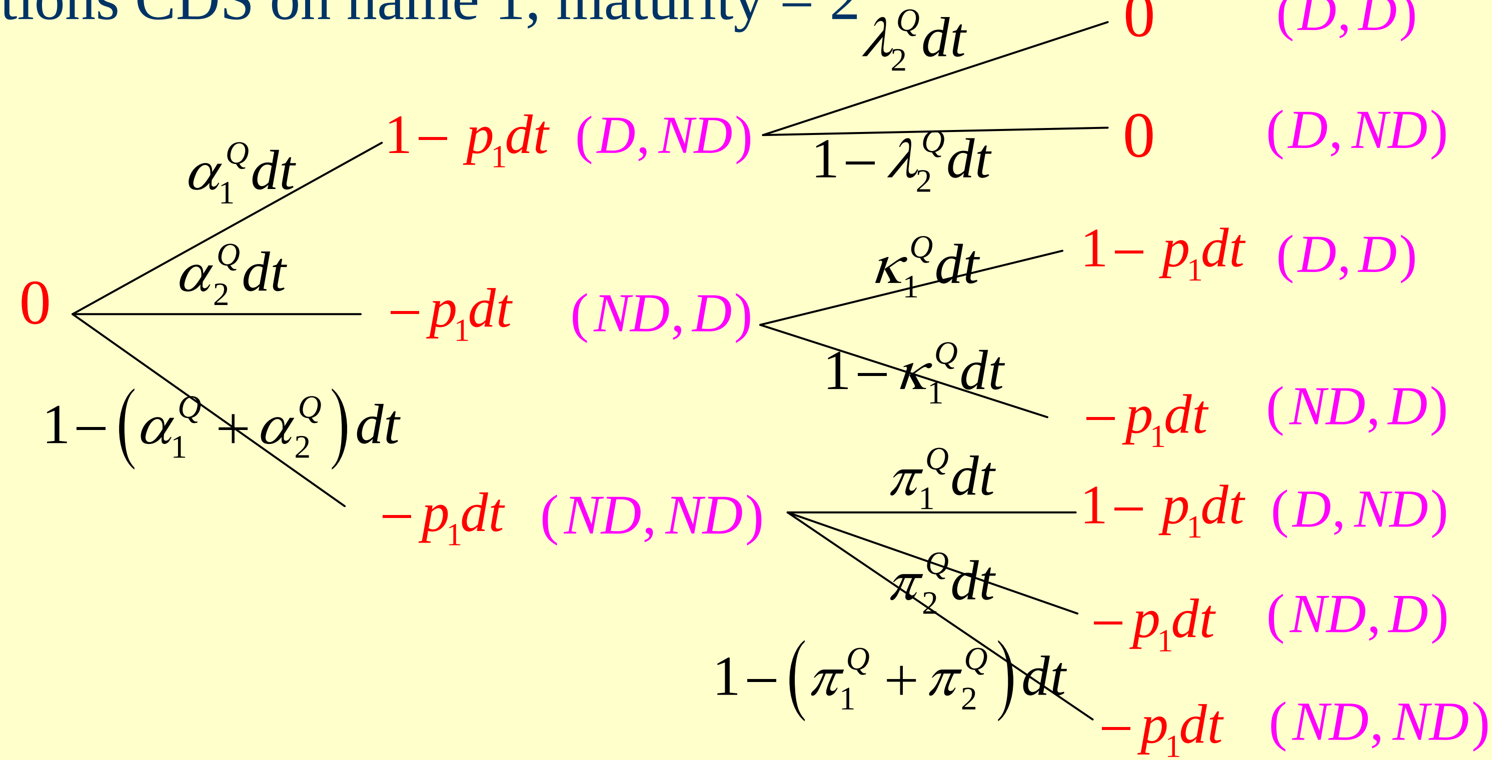
  - $\lambda_2^Q dt$ CDS 2 premium after default of name 1
  - $\kappa_1^Q dt$ CDS 1 premium after default of name 2
  - $\pi_1^Q dt$ CDS 1 premium if no name defaults at period 1
  - $\pi_2^Q dt$ CDS 2 premium if no name defaults at period 1
- Change in CDS premiums due to contagion effects
  - Usually, $\pi_1^Q < \alpha_1^Q < \lambda_1^Q$ and $\pi_2^Q < \alpha_2^Q < \lambda_2^Q$

II - Tree approach to hedging defaults

- Computation of prices and hedging strategies by backward induction
  - use of the dynamic risk-neutral tree
  - Start from period 2, compute price at period 1 for the three possible nodes
  - + hedge ratios in short term CDS 1,2 at period 1
  - Compute price and hedge ratio in short term CDS 1,2 at time 0
- Example to be detailed:
  - computation of CDS 1 premium, maturity = 2
  - $p_1 dt$ will denote the periodic premium
  - Cash-flow along the nodes of the tree

II - Tree approach to hedging defaults

- Computations CDS on name 1, maturity = 2

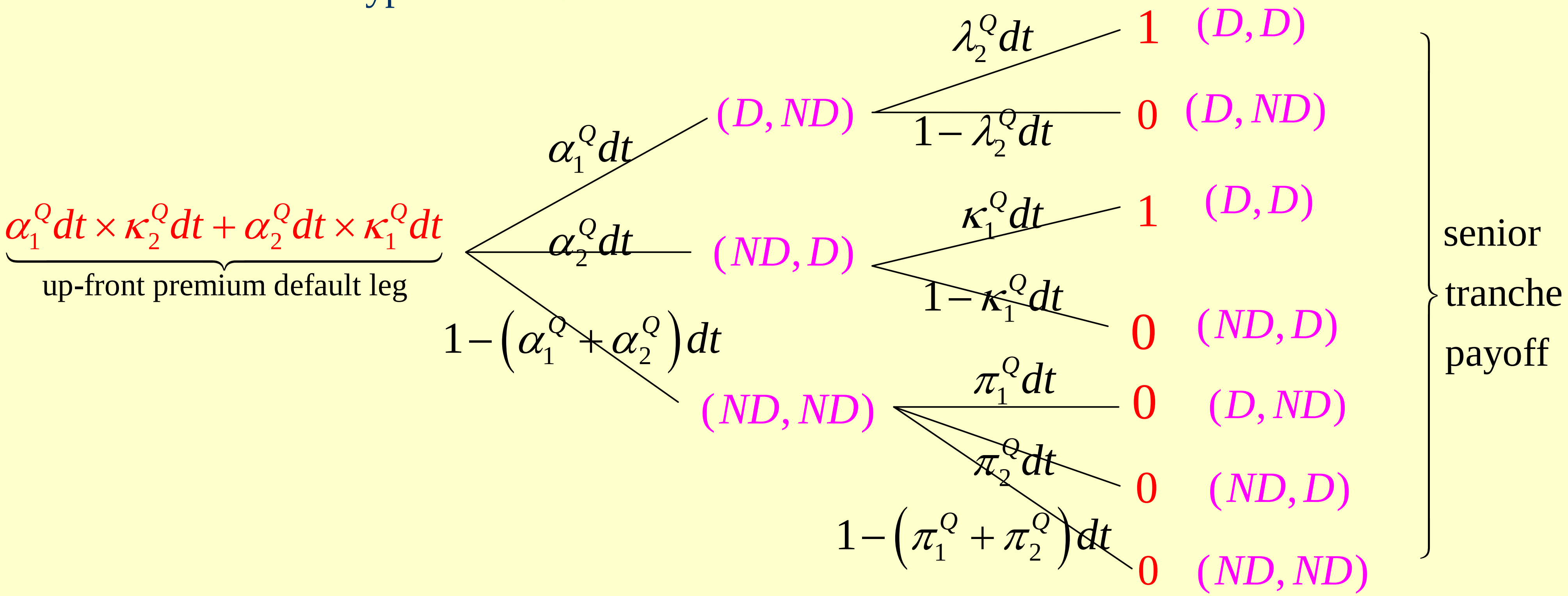


- Premium of CDS on name 1, maturity = 2, time = 0, p_1dt solves for:

$$0=\left(1-p_1\right)\alpha_1^Q+\left(-p_1+\left(1-p_1\right)\kappa_1^Q-p_1\left(1-\kappa_1^Q\right)\right)\alpha_2^Q$$
$$+\left(-p_1+\left(1-p_1\right)\pi_1^Q-p_1\pi_2^Q-p_1\left(1-\pi_1^Q-\pi_2^Q\right)\right)\left(1-\alpha_1^Q-\alpha_2^Q\right)$$

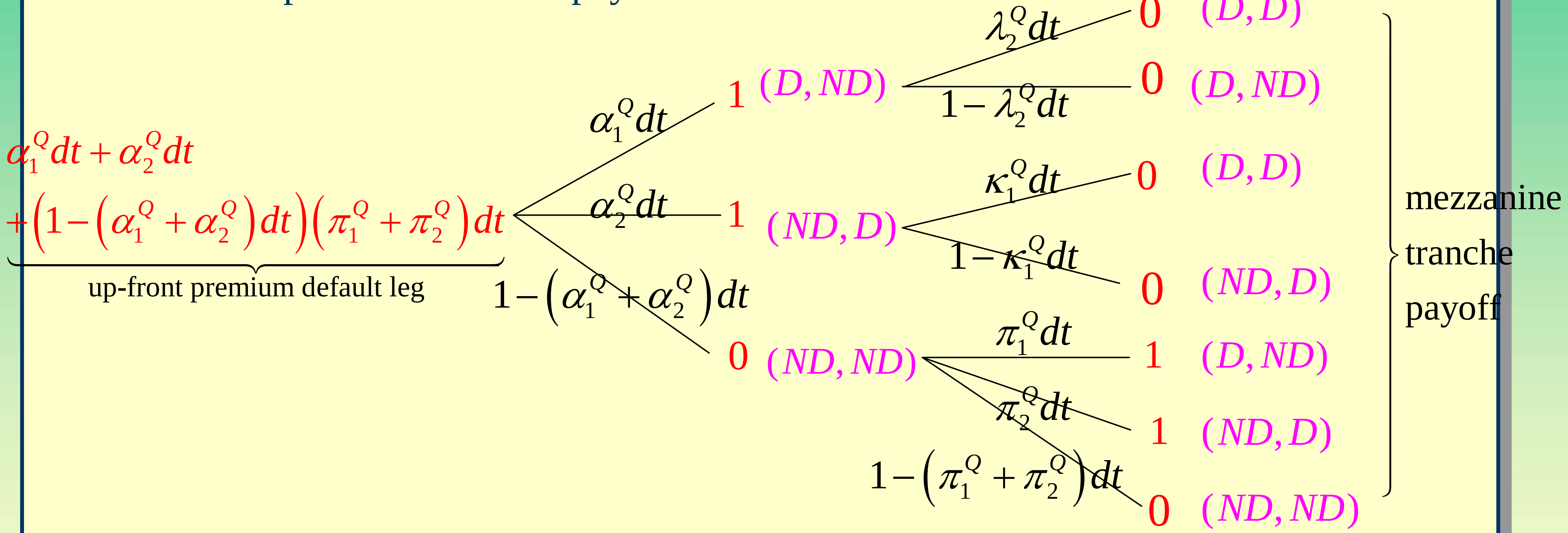
II - Tree approach to hedging defaults

- Example: stylized zero coupon CDO tranchelets
  - Zero-recovery, maturity 2
  - Aggregate loss at time 2 can be equal to 0,1,2
    - ➢ Equity type tranche contingent on no defaults
    - ➢ Mezzanine type tranche : one default
    - ➢ Senior type tranche : two defaults



II - Tree approach to hedging defaults

- mezzanine tranche
  - Time pattern of default payments



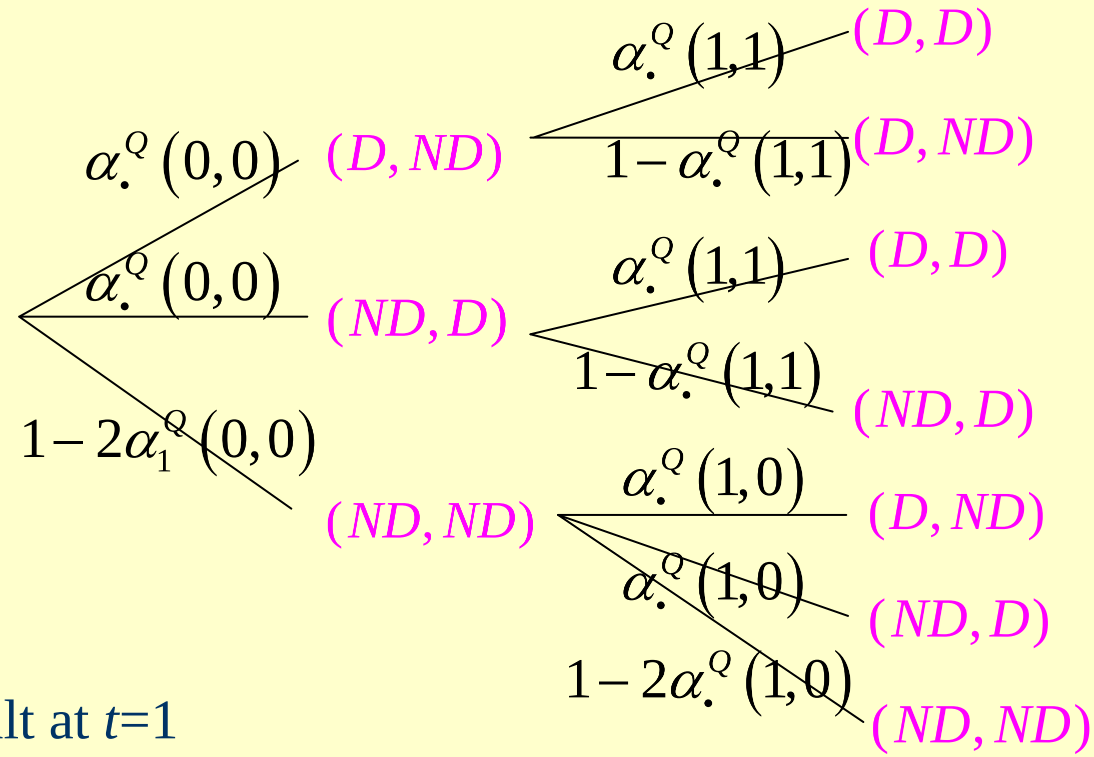
  - Possibility of taking into account discounting effects
  - The timing of premium payments
  - Computation of dynamic deltas with respect to short or actual CDS on names 1,2

II - Tree approach to hedging defaults

- In theory, one could also derive dynamic hedging strategies for index CDO tranches
  - Numerical issues: large dimensional, non recombining trees
  - Homogeneous Markovian assumption is very convenient
    - CDS premiums at a given time *t* only depend upon the current number of defaults $N(t)$
  - CDS premium at time 0 (no defaults) $\alpha_1^Q dt = \alpha_2^Q dt = \alpha_\bullet^Q \left(t = 0, N(0) = 0\right)$
  - CDS premium at time 1 (one default) $\lambda_2^Q dt = \kappa_1^Q dt = \alpha_\bullet^Q \left(t = 1, N(t) = 1\right)$
  - CDS premium at time 1 (no defaults) $\pi_1^Q dt = \pi_2^Q dt = \alpha_\bullet^Q \left(t = 1, N(t) = 0\right)$

II - Tree approach to hedging defaults

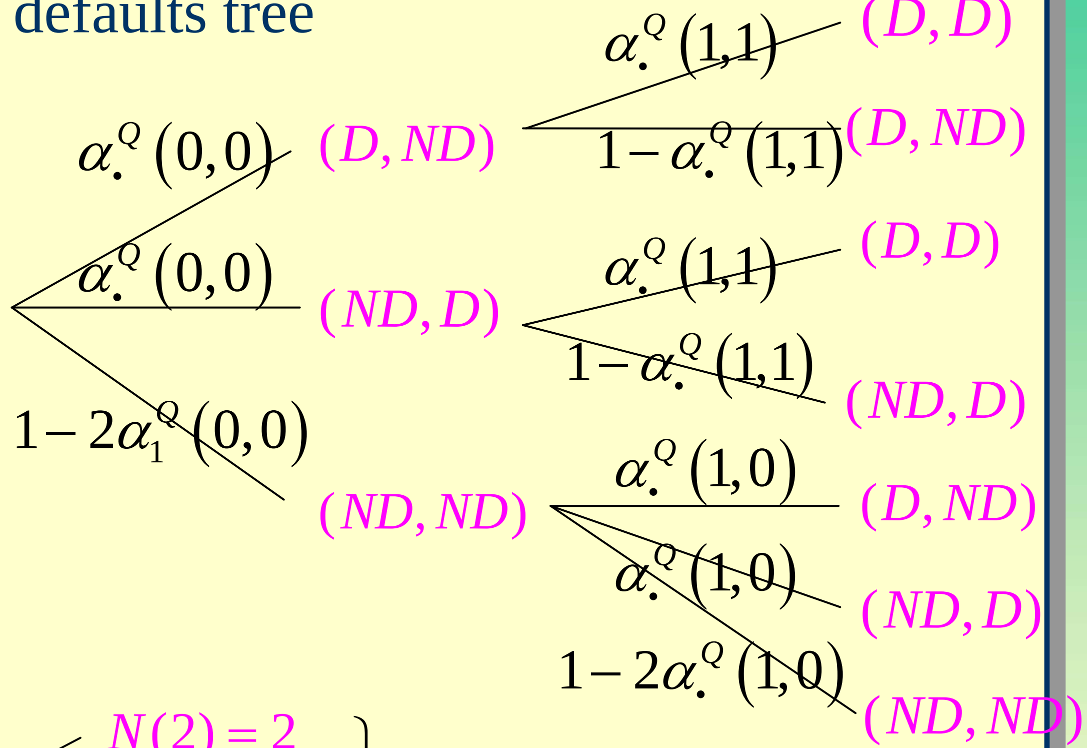
- Homogeneous Markovian tree

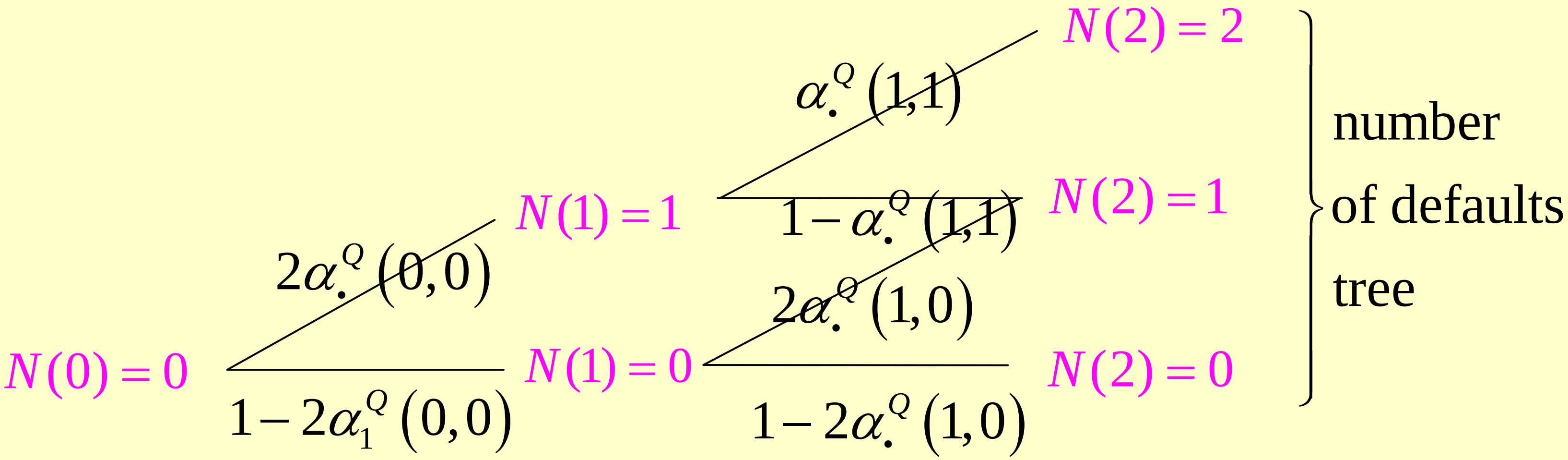


  - If we have $N(1)=1$, one default at t=1
  - The probability to have $N(2)=1$, one default at t=2…
  - Is $1-\alpha_{\cdot}^{Q}(1,1)$ and does not depend on the defaulted name at t=1
  - $N(t)$ is a Markov process
  - Dynamics of the number of defaults can be expressed through a binomial tree

II - Tree approach to hedging defaults

- From name per name to number of defaults tree

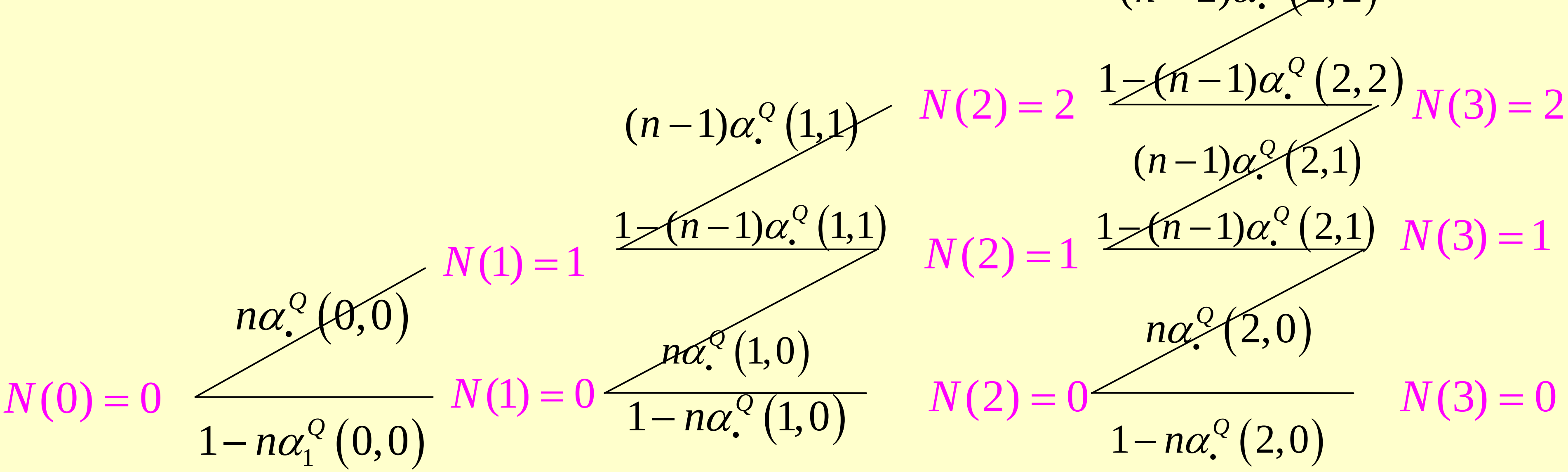




II - Tree approach to hedging defaults

- Easy extension to *n* names
  - Predefault name intensity at time *t* for $N(t)$ defaults: $\alpha_{\bullet}^{Q}\left(t, N(t)\right)$
  - Number of defaults intensity : sum of surviving name intensities:

$$\lambda\left(t, N(t)\right) = \left(n - N(t)\right)\alpha_{\bullet}^{Q}\left(t, N(t)\right)$$



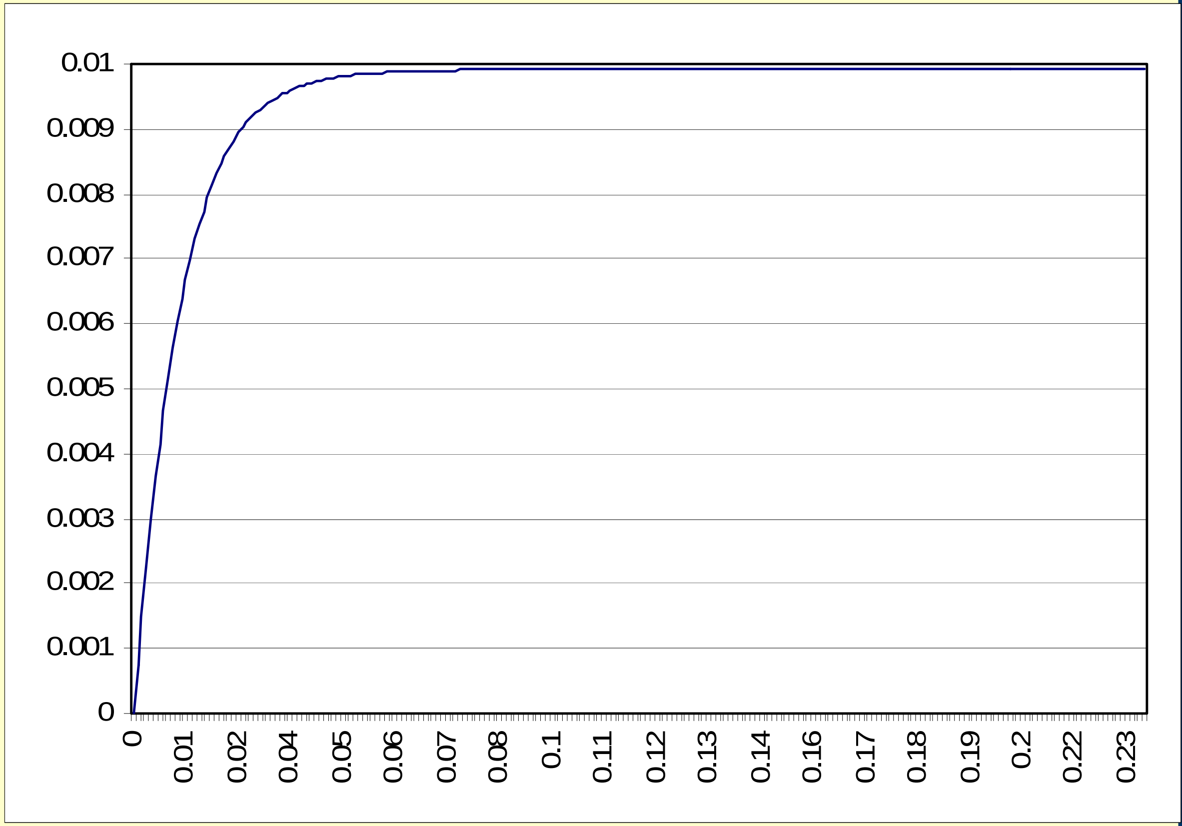
  - $\alpha_{\bullet}^{Q}(0,0), \alpha_{\bullet}^{Q}(1,0), \alpha_{\bullet}^{Q}(1,1), \alpha_{\bullet}^{Q}(2,0), \alpha_{\bullet}^{Q}(2,1), \ldots$ can be easily calibrated
  - on marginal distributions of $N(t)$ by forward induction.

II - Tree approach to hedging defaults

- Previous recombining binomial risk-neutral tree provides a framework for the valuation of payoffs depending upon the number of defaults
  - Applies to CDO tranches (homogeneous portfolio)
  - Applies to credit default swap index
- What about the credit deltas?
  - In a homogeneous framework, deltas with respect to CDS are all the same
  - Possibility of perfect dynamic replication of a CDO tranche with a credit default swap index and the default-free asset
  - Credit delta with respect to the credit default swap index
  - = change in PV of the tranche / change in PV of the CDS index

II - Tree approach to hedging defaults

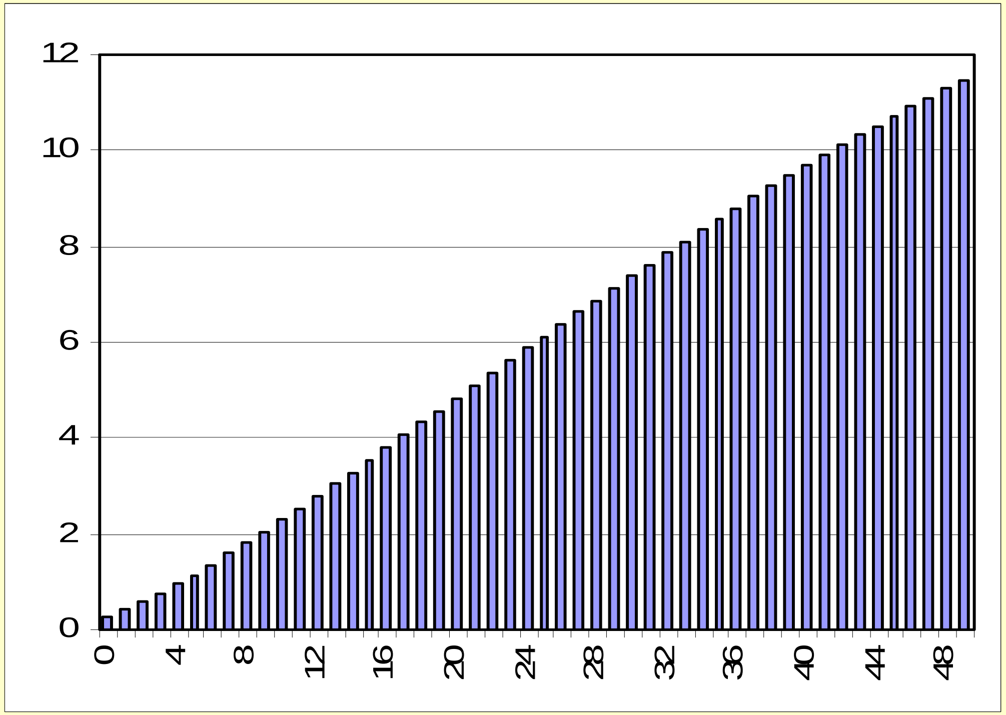
- Example: number of defaults distribution at 5Y generated from a Gaussian copula
  - Correlation parameter: 30%
  - Number of names: 125
  - Default-free rate: 3%
  - 5Y credit spreads: 20 bps
  - Recovery rate: 40%



- Figure shows the corresponding expected losses for a 5Y horizon

II - Tree approach to hedging defaults

- Calibration of loss intensities
  - For simplicity, assumption of time homogeneous intensities
  - Figure below represents loss intensities, with respect to the number of defaults
  - Increase in intensities: contagion effects



II - Tree approach to hedging defaults

- Dynamics of the 5Y CDS index spread
  - In bp pa

		Weeks						
		0	**14**	**28**	**42**	**56**	**70**	**84**
Nb Defaults	**0**	20	19	19	18	18	17	17
	1	0	31	30	29	28	27	26
	2	0	46	44	43	41	40	38
	3	0	63	61	58	56	54	52
	4	0	83	79	76	73	70	67
	5	0	104	99	95	91	87	83
	6	0	127	121	116	111	106	101
	7	0	151	144	138	132	126	120
	8	0	176	169	161	154	146	140
	9	0	203	194	185	176	168	160
	10	0	230	219	209	200	190	181
	11	0	257	246	235	224	213	203
	12	0	284	272	260	248	237	225
	13	0	310	298	286	273	260	248
	14	0	336	324	311	298	284	271
	15	0	0	348	336	323	308	294

II - Tree approach to hedging defaults

- Dynamics of credit deltas ([0,3%] equity tranche)
  - With respect to the 5Y CDS index
  - For selected time steps

Nb Defaults		OutStanding Nominal	Weeks						
			0	14	28	42	56	70	84
	0	3.00%	0.967	0.993	1.016	1.035	1.052	1.065	1.075
	1	2.52%	0	0.742	0.786	0.828	0.869	0.908	0.943
	2	2.04%	0	0.439	0.484	0.532	0.583	0.637	0.691
	3	1.56%	0	0.206	0.233	0.265	0.301	0.343	0.391
	4	1.08%	0	0.082	0.093	0.106	0.121	0.141	0.164
	5	0.60%	0	0.029	0.032	0.035	0.039	0.045	0.051
	6	0.12%	0	0.004	0.005	0.005	0.006	0.006	0.007
	7	0.00%	0	0	0	0	0	0	0

  - Hedging strategy leads to a perfect replication of equity tranche payoff
  - Deltas > 1

II - Tree approach to hedging defaults

- Credit deltas default leg and premium leg (equity tranche)

		OutStanding Nominal	Weeks						
			0	14	28	42	56	70	84
Nb Defaults	0	3.00%	0.814	0.843	0.869	0.893	0.915	0.933	0.949
	1	2.52%	0	0.614	0.658	0.702	0.746	0.787	0.827
	2	2.04%	0	0.341	0.384	0.431	0.482	0.535	0.591
	3	1.56%	0	0.140	0.165	0.194	0.229	0.269	0.315
	4	1.08%	0	0.045	0.054	0.064	0.078	0.095	0.117
	5	0.60%	0	0.013	0.015	0.017	0.020	0.024	0.030
	6	0.12%	0	0.002	0.002	0.002	0.003	0.003	0.003
	7	0.00%	0	0	0	0	0	0	0

		OutStanding Nominal	Weeks						
			0	14	28	42	56	70	84
Nb Defaults	0	3.00%	-0.153	-0.150	-0.146	-0.142	-0.137	-0.132	-0.126
	1	2.52%	0	-0.128	-0.127	-0.126	-0.124	-0.120	-0.116
	2	2.04%	0	-0.098	-0.100	-0.101	-0.102	-0.101	-0.100
	3	1.56%	0	-0.066	-0.068	-0.071	-0.073	-0.074	-0.076
	4	1.08%	0	-0.037	-0.039	-0.041	-0.043	-0.045	-0.047
	5	0.60%	0	-0.016	-0.017	-0.018	-0.019	-0.020	-0.021
	6	0.12%	0	-0.003	-0.003	-0.003	-0.003	-0.003	-0.003
	7	0.00%	0	0	0	0	0	0	0

II - Tree approach to hedging defaults

- Dynamics of credit deltas ([3,6%] tranche)

Nb Defaults	OutStanding Nominal	Weeks						
		0	14	28	42	56	70	84
0	3.00%	0.162	0.139	0.117	0.096	0.077	0.059	0.045
1	3.00%	0	0.327	0.298	0.266	0.232	0.197	0.162
2	3.00%	0	0.497	0.489	0.473	0.448	0.415	0.376
3	3.00%	0	0.521	0.552	0.576	0.591	0.595	0.586
4	3.00%	0	0.400	0.454	0.508	0.562	0.611	0.652
5	3.00%	0	0.239	0.288	0.343	0.405	0.473	0.544
6	3.00%	0	0.123	0.153	0.190	0.236	0.291	0.358
7	2.64%	0	0.059	0.073	0.090	0.115	0.147	0.189
8	2.16%	0	0.031	0.036	0.043	0.052	0.066	0.086
9	1.68%	0	0.019	0.020	0.023	0.026	0.030	0.037
10	1.20%	0	0.012	0.012	0.013	0.014	0.016	0.018
11	0.72%	0	0.007	0.007	0.007	0.007	0.008	0.009
12	0.24%	0	0.002	0.002	0.002	0.002	0.002	0.003
13	0.00%	0	0	0	0	0	0	0

II - Tree approach to hedging defaults

- Dynamics of credit deltas ([6,9%] tranche)

		OutStanding Nominal	Weeks						
			0	14	28	42	56	70	84
Nb Defaults	0	3.00%	0.017	0.012	0.008	0.005	0.003	0.002	0.001
	1	3.00%	0	0.048	0.036	0.025	0.017	0.011	0.006
	2	3.00%	0	0.133	0.107	0.083	0.061	0.043	0.029
	3	3.00%	0	0.259	0.227	0.193	0.157	0.122	0.090
	4	3.00%	0	0.371	0.356	0.330	0.295	0.253	0.206
	5	3.00%	0	0.405	0.423	0.428	0.420	0.396	0.358
	6	3.00%	0	0.346	0.392	0.433	0.465	0.482	0.481
	7	3.00%	0	0.239	0.292	0.350	0.409	0.465	0.510
	8	3.00%	0	0.139	0.181	0.232	0.293	0.363	0.436
	9	3.00%	0	0.074	0.098	0.132	0.177	0.235	0.307
	10	3.00%	0	0.042	0.053	0.070	0.095	0.132	0.183
	11	3.00%	0	0.029	0.033	0.040	0.051	0.070	0.098
	12	3.00%	0	0.025	0.026	0.028	0.033	0.040	0.053
	13	2.76%	0	0.022	0.022	0.022	0.024	0.026	0.031
	14	2.28%	0	0.020	0.018	0.018	0.018	0.019	0.020
	15	1.80%	0	0	0.015	0.014	0.014	0.014	0.014
	16	1.32%	0	0	0.013	0.011	0.010	0.010	0.010
	17	0.84%	0	0	0.009	0.008	0.007	0.006	0.006
	18	0.36%	0	0	0.005	0.004	0.003	0.003	0.003
	19	0.00%	0	0	0	0	0	0	0

II - Tree approach to hedging defaults

- Small dependence of credit deltas with respect to recovery rate
  - Equity tranche, R=30%

		OutStanding Nominal	Weeks						
			0	14	28	42	56	70	84
Nb Defaults	0	3.00%	0.975	0.997	1.018	1.035	1.050	1.062	1.072
	1	2.44%	0.000	0.735	0.775	0.814	0.852	0.888	0.922
	2	1.88%	0.000	0.417	0.456	0.499	0.544	0.591	0.641
	3	1.32%	0.000	0.178	0.200	0.225	0.253	0.286	0.324
	4	0.76%	0.000	0.060	0.066	0.074	0.084	0.095	0.109
	5	0.20%	0.000	0.011	0.011	0.013	0.014	0.015	0.017
	6	0.00%	0.000	0.000	0.000	0.000	0.000	0.000	0.000

  - Equity tranche, R=40%

		OutStanding Nominal	Weeks						
			0	14	28	42	56	70	84
Nb Defaults	0	3.00%	0.967	0.993	1.016	1.035	1.052	1.065	1.075
	1	2.52%	0	0.742	0.786	0.828	0.869	0.908	0.943
	2	2.04%	0	0.439	0.484	0.532	0.583	0.637	0.691
	3	1.56%	0	0.206	0.233	0.265	0.301	0.343	0.391
	4	1.08%	0	0.082	0.093	0.106	0.121	0.141	0.164
	5	0.60%	0	0.029	0.032	0.035	0.039	0.045	0.051
	6	0.12%	0	0.004	0.005	0.005	0.006	0.006	0.007
	7	0.00%	0	0	0	0	0	0	0

II - Tree approach to hedging defaults

- Small dependence of credit deltas with respect to recovery rate
  - Initial delta with respect to the credit default swap index

	Recovery Rates					
Tranches	**10%**	**20%**	**30%**	**40%**	**50%**	**60%**
[0-3%]	0.9960	0.9824	0.9746	0.9670	0.9527	0.9456
[3-6%]	0.1541	0.1602	0.1604	0.1616	0.1659	0.1604
[6-9%]	0.0164	0.0165	0.0168	0.0168	0.0168	0.0169

  - Only a small dependence of credit deltas with respect to recovery rates
- First conclusion:
  - Thanks to stringent assumptions
    - ➢ credit spreads driven by defaults + homogeneity + Markovian
  - It is possible to compute a dynamic hedging strategy
    - ➢ Based on the CDS index
  - That fully replicates the CDO tranche payoffs

III - Hedging credit spread risks for large portfolios

- When dealing with the risk management of CDOs, traders
  - concentrate upon credit spread and correlation risk
  - Neglect default risk
- What about default risk ?
  - For large indices, default of one name has only a small direct effect on the aggregate loss
- Is it possible to build a framework where hedging default risk can be neglected?
- And where one could only consider the hedging of credit spread risk?
  - See paper “A Note on the risk management of CDOs”

III - Hedging credit spread risks for large portfolios

- Main and critical assumption
  - Default times follow a multivariate Cox process
    - For instance, affine intensities
    - Duffie & Garleanu, Mortensen, Feldhütter, Merrill Lynch

2. *the default times follow a multivariate Cox process:*

$$\tau_i = \inf\left\{t \in \mathbb{R}^+, U_i \geq \exp\left(-\int_0^t \lambda_{i,u} du\right)\right\}, \quad i = 1, \ldots, n \qquad (2.2)$$

where $\lambda_1, \ldots, \lambda_n$ *are strictly positive,* $\mathcal{F}$ *- progressively measurable processes,* $U_1, \ldots, U_n$ *are independent random variables uniformly distributed on* $[0, 1]$ *under* Q *and* $\mathcal{F}$ *and* $\sigma(U_1, \ldots, U_n)$ *are independent under* Q.

- No contagion effects

III - Hedging credit spread risks for large portfolios

- No contagion effects
  - credit spreads drive defaults but defaults do not drive credit spreads
  - For a large portfolio, default risk is perfectly diversified
  - Only remains credit spread risks: parallel & idiosyncratic
- Main result
  - With respect to dynamic hedging, default risk can be neglected
  - Only need to focus on dynamic hedging of credit spread risks
    - With CDS
  - Similar to interest rate derivatives markets

III - Hedging credit spread risks for large portfolios

- Formal setup
  - $\tau_1, \ldots, \tau_n$ default times
  - $N_i(t) = 1_{\{\tau_i \leq t\}}, i = 1, \ldots, n$ default indicators
  - $H_t = \bigvee_{i=1,\ldots,n} \sigma\left(N_i(s), s \leq t\right)$ natural filtration of default times
  - F_t background (credit spread filtration)
  - $G_t = H_t \vee F_t$ enlarged filtration, P historical measure
  - $l_i(t,T), i = 1, \ldots, n$ time t price of an asset paying $N_i(T)$ at time T

III - Hedging credit spread risks for large portfolios

- Sketch of the proof
- Step 1: consider some smooth shadow risky bonds
  - Only subject to credit spread risk
  - Do not jump at default times
- Projection of the risky bond prices on the credit spread filtration

Definition 3.2 *The* **default free** T **forward loss process** *associated with name* $i \in \{0, \ldots, n\}$, *denoted by* $p^i(., T)$ *is such that for* $0 \le t \le T$:

$$p^i(t,T) \triangleq E^Q\left[p^i(T) \mid \mathcal{F}_t\right] = E^Q\left[N_i(T) \mid \mathcal{F}_t\right] = Q(\tau_i \le T \mid \mathcal{F}_t). \qquad (3.2)$$

Lemma 3.1 $p^i(t,T)$, $i = 1, \ldots, n$ *are projections of the forward price processes* $l^i(t,T)$ *on* $\mathcal{F}_t$:

$$p^i(t,T) = E^Q\left[l^i(t,T) \mid \mathcal{F}_t\right], \qquad (3.3)$$

for $i = 1, \ldots, n$ *and* $0 \le t \le T$.

III - Hedging credit spread risks for large portfolios

- Step 2: Smooth the aggregate loss process
- … and thus the tranche payoffs
  - Remove default risk and only consider credit spread risk
  - Projection of aggregate loss on credit spread filtration

Definition 3.1 *We denote by $p^i(.)$, the* **default-free running loss process** *associated with name $i \in \{0, \ldots, n\}$, which is such that for $0 \le t \le T$:*

$$p^i(t) \triangleq E^Q[N_i(t) \mid \mathcal{F}_t] = Q(\tau_i \le t \mid \mathcal{F}_t) = 1 - \exp\left(-\Lambda_{i,t}\right). \qquad (3.1)$$

Definition 3.5 default-free aggregate running loss process *The default free aggregate running loss at time t is such that for $0 \le t \le T$:*

$$p_n(t) \triangleq \frac{1}{n} \sum_{i=1}^{n} p^i(t). \qquad (3.7)$$

III - Hedging credit spread risks for large portfolios

- Step 3: compute perfect hedge ratios of the smoothed payoff
  - ➢With respect to the smoothed risky bonds
  - – Smoothed payoff and risky bonds only depend upon credit spread dynamics
  - – Both idiosyncratic and parallel credit spread risks
  - – Similar to a multivariate interest rate framework
  - – Perfect hedging in the smooth market

Assumption 2 *There exists some bounded $\mathcal{F}$ - predictable processes $\theta_1(.), \ldots, \theta_n(.)$ such that:*

$$(p_n(T) - K)^+ = E^Q\left[(p_n(T) - K)^+\right] + \frac{1}{n}\sum_{i=1}^{n}\int_0^T \theta_i(t)dp^i(t,T) + z_n, \qquad (4.2)$$

where z_n is $\mathcal{F}_T$-measurable, of Q-mean zero and Q-strongly orthogonal to $p^1(.,T), \ldots, p^n(.,T)$.

III - Hedging credit spread risks for large portfolios

- Step 4: apply the hedging strategy to the true defaultable bonds
- **Main result**
  - Bound on the hedging error following the previous hedging strategy
  - When hedging an actual CDO tranche with actual defaultable bonds
  - Hedging error decreases with the number of names
    - ➢ Default risk diversification

Proposition 1 *Under Assumptions (1) and (2), the hedging error* ε_n *defined as:*

$$\varepsilon_n = (l_n(T) - K)^+ - E^Q\left[(l_n(T) - K)^+\right] - \frac{1}{n}\sum_{i=1}^{n}\int_0^T \theta_i(t)dl^i(t,T), \tag{4.4}$$

is such that $E^P[\| \varepsilon_n \|]$ *is bounded by:*

$$\frac{1}{\sqrt{2n}}\left(1 + \left(E^Q\left[\left(\frac{dP}{dQ}\right)^2\right]\right)^{1/2}\right) + \frac{1}{n}\left(E^Q\left[\left(\frac{dP}{dQ}\right)^2\right]\right)^{1/2}\left(\sum_{i=1}^{n}\left(Q(\tau_i \leq T) + E^Q\left[B_i\right]_T\right)\right)^{1/2}$$
$$+E^P[\| z_n \|]. \tag{4.5}$$

III - Hedging credit spread risks for large portfolios

- Provides a hedging technique for CDO tranches
  - Known theoretical properties
  - Takes into account idiosyncratic and parallel gamma risks
  - Good theoretical properties rely on no simultaneous defaults, no contagion effects assumptions
  - Empirical work remains to be done
- Thought provocative
  - To construct a practical hedging strategy, do not forget default risk
  - Equity tranche [0,3%]
  - iTraxx or CDX first losses cannot be considered as smooth

Hedging credit spread risk for large portfolios

- Linking pricing and hedging ?
- The black hole in CDO modeling ?
- Standard valuation approach in derivatives markets
    - Complete markets
    - Price = cost of the hedging/replicating portfolio
- Mixing of dynamic hedging strategies
    - for credit spread risk
- And diversification/insurance techniques
    - For default risk

Conclusion

- Two different models have been investigated
- Contagion homogeneous Markovian models
  - Perfect hedge of default risks
  - Easy implementation
  - Poor dynamics of credit spreads
  - No individual name effects
- Multivariate Cox processes
  - Rich dynamics of credit spreads
  - But no contagion effects
  - Thus, default risk can be diversified at the index level
  - Replication of CDO tranches is feasible by hedging only credit spread risks.