

Course Outline

Credit Risk

Winter Intensive: 2016S – FINC.GB.3305.W1

MEETING ROOM – KMEC 5-80 (TO BE CONFIRMED)

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Aims and Objectives

Fuelled in part by burgeoning growth in the credit derivatives market in late 90's, the market in credit expanded dramatically for 10 years till 2Q 2007. These increased activity levels led to a much greater research focus on credit and one of the features of this work has been the high degree of complementarity between the research carried out by academics and by practitioners, for example, the investment banks and rating agencies.

The credit derivatives market was at the heart of the ongoing global financial and economic crisis, having contributed substantially to it by affecting lender incentives once loans were securitized, allowing banks to “game” regulatory capital requirements, and creating opacity due to their over-the-counter (rather than centralized or exchange-based) trading infrastructure. While the market for credit derivatives suffers at the current moment, a part of its underlying rationale in terms of risk transfer from banking sector to the rest of the economy remains robust. Securitization markets are nevertheless somewhat moribund. This market will perhaps never be as large as it was in 2Q 2007, but it will certainly continue to play a major role in the financial intermediation sector going forward, once the crisis abates. In the meanwhile, however, we have had a sovereign debt crisis in the Western Europe to deal with and a possible Chinese recession on the horizon... And the securitization markets appear to be coming back in some fashion, and regulators are in fact looking to “soften” the rules to hasten this comeback!

The objective of the course is to provide an introduction as well as an in-depth understanding of issues in credit risk, its modelling and analysis of credit related instruments such as default-prone debt of credit derivatives. The objective is also to provide an understanding of how and why these products played such a critical role in the ongoing crisis. As with any derivatives model, the idea is to learn it well so that one knows when *not to use it!* Hence, the objective is to provide a balance between developing, on one hand, a sound conceptual framework and, on the other, market understanding and insight, especially with respect to liquidity effects that are often so important in markets from a practitioner's standpoint. We regard both as essential to the informed practitioner and academic.

Given the important role played by credit derivatives in the crisis, the course will also devote substantial amount of time understanding this role. We will also understand the new financial sector reforms – most notably the Dodd-Frank Act – and their direct or indirect impact on credit derivatives, and credit markets in general, going forward. Along the way, we will look at methods to quantify the systemic risk of the financial sector and regulatory as well as market-based stress-testing of financial firms. Further, given the current risks in sovereign credit risk area, especially in the Eurozone, we will cover sovereign credit risk and derivatives as well. We will also study the intricate plumbing of credit markets such as through sale and repurchase agreements (“repo”) and their central role in preventing or enabling relative-value strategies. Finally, we will also touch upon new developments in shadow banking, especially in China, and the credit risks they create for banks and the financial system as a whole.

It should be fun and I welcome you the journey!

Topics Covered

The topics covered in the course will include:

- Credit Crisis 2007-09 and the role played by credit derivatives in the crisis
- Historical default experience
- Structural models of credit risk
- Applications of structural models of credit risk to default prediction and hedging; the KMV model
- The success of structural models in explaining credit spreads and corporate bond returns
- Historical recovery experience
- Introduction to single-name credit derivatives (corporate, sovereign, ...)
- Default-intensity or reduced-form models
- Application of default intensity models to Credit default swaps (single-name corporate and sovereign)
- Implications of the proposed financial sector reforms for the credit derivatives market
- Sovereign Credit Crisis in the Eurozone
- Basket default products: index tranches and CDOs
- Correlation modelling and applications
- Measuring and Managing Systemic Risk, and Stress tests of the Financial Sector
- Shadow banking: Repo Markets, Government-Sponsored Enterprises, Insurance Sector

Format and Teaching Methods

The classes will include discussions around empirical facts about credit, one or two guest speakers on market developments and financial plumbing, and lectures on models and their applications. Primary reading material will be my slides and handouts. Anything else that is relevant will be circulated over email to the class mailing list.

Reading Materials

In addition, the *required* books for the course are as follows: The first book (ACRW) has content on the proposed reforms of the financial sector and (ANRW) on the housing finance debacle in the United States and its possible reform. The latter is not a central focus of the course but the issue of housing finance is important enough to credit risk and financial crises in the United States (and elsewhere) that I am requiring you read it.

Acharya, Viral V., Thomas Cooley, Matthew Richardson and Ingo Walter, editors *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*, New York University Stern School of Business and John Wiley & Sons, November 2010 [ACRW].

Acharya, Viral, Stijn van Nieuwerburgh, Matthew Richardson and Larry White (2011): *Guaranteed to Fail: Fannie Mae, Freddie Mac and the Debacle of Mortgage Finance*, Princeton University Press. [ANRW]

Additional recommended materials (especially, Prologue of AR, and early chapters of Chacko et al. for a primer on credit derivatives – I will distribute relevant material in hard copies):

Acharya, Viral V., and Matthew Richardson, editors, *Restoring Financial Stability: How to Repair a Failed System*, NYU-Stern and John Wiley & Sons, March 2009. [AR]

Chacko, Sjomon, Motohashi and Dessain (2006): *Credit Derivatives – A Primer on Credit Risk, Modeling, and Instruments*. [Chacko et. Al]

There are two good books that deal with the technical analysis of credit risk. However, neither of them covers all the material we plan to discuss in the class and are a bit technical in my view:

Lando, David, *Credit Risk Modelling: Theory and Applications*, Princeton: Princeton University Press, 2004. [Lando]

Duffie, Darrell and Kenneth Singleton, *Credit Risk*, Princeton: Princeton University Press, 2003. [DS]

Assessment

The grade for the course will be based on a take-home mid-term and final exam. The mid-term will require you to conduct credit analysis of an individual corporation based on methods learnt in the course. The final will require you to conduct credit analysis of an individual sovereign based on methods learnt in the course. Both the mid-term and the final exams must be done in groups of four each. The groups do not have to be the same between mid-term and final (Again, I will leave that to you). These will determine 40% of your grade each. There will also be 20% credit for class participation and bringing to the classroom discussion relevant themes from on-going credit risk issues at time of the course. Please take class attendance seriously and enrich the classroom experience for yourself and others. No auditing is allowed as per restrictions and guidelines imposed by the Registrar's office.

PLEASE REVIEW THE RULES GOVERNING ACADEMIC INTEGRITY AND THE STERN CODE OF CONDUCT:

http://www.stern.nyu.edu/sites/default/files/assets/documents/con_039512.pdf

Week	Topic
1 (17 January)	The role played by credit derivatives in the crisis of 2007-09 The Dodd-Frank Act and proposed reforms to the financial sector Overview of credit market and trends: Historical default experience Statistical models of default probability
2 (19 January)	Structural models: Merton's model and Moody's KMV Approach
3 (21 January)	Empirical performance of structural models Historical recovery or loss-given default experience
4 (24 January)	Introduction to single-name credit derivatives Intensity modelling : Litterman and Iben's reduced-form model
5 (26 January)	Mid-term exam: Project assessing the credit risk of a <u>corporation</u> due Intensity modelling : Continued The changing nature and regulation of credit derivatives
6 (28 January)	Sovereign Credit Risk and Crises Correlation: Products
7 (31 January)	Correlation: Modelling Government-sponsored enterprises and housing finance (Fannie Mae, Freddie Mac)
8 (2 February)	Measuring and managing systemic risk Stress-testing the financial sector
9 (4 February)	Shadow Banking: Repo Markets, Money-market Funds, Insurance Sector Shadow Banking in China: The Wealth-Management Products
(11 January)	Final exam: Project assessing the credit risk of a <u>sovereign</u> due