Contents

Busine	ss Snapshots	XXi
Prefac	Preface	
1.1	Distriction Risk vs. Return for Investors	1 2
1.3 1.4 1.5	The Efficient Frontier The Capital Asset Pricing Model Arbitrage Pricing Theory Risk vs. Return for Companies	5 8 13 13
	Risk Management by Financial Institutions Credit Ratings Summary Further Reading Practice Questions and Problems (Answers at End of Book) Further Questions	17 18 19 19 19 20
	NE. Ancial institutions and their trading	
CHAPTI		25
2.2 2.3 2.4 2.5 2.6	Commercial Banking The Capital Requirements of a Small Commercial Bank Deposit Insurance Investment Banking Securities Trading Potential Conflicts of Interest in Banking Today's Large Banks	26 28 30 31 36 37 38 41 42 43 43

CHAPTER	13	
Insur	ance Companies and Pension Plans	45
3.1	Life Insurance	45
3.2	Annuity Contracts	49
3.3	Mortality Tables	50
3.4	Longevity and Mortality Risk	53
3.5	Property-Casualty Insurance	54
3.6	Health Insurance	56
3.7	Moral Hazard and Adverse Selection	58
3.8	Reinsurance	59
3.9	Capital Requirements	60
3.10	The Risks Facing Insurance Companies	61
3.11	Regulation	61
3.12	Pension Plans	63
	Summary	66
	Further Reading	67
	Practice Questions and Problems (Answers at End of Book)	68
	Further Questions	69
CHAPTER	4	
Mutua	ol Funds and Hedge Funds	71
4.1	Mutual Funds	71
4.2	Hedge Funds	79
4.3	Hedge Fund Strategies	84
4.4	Hedge Fund Performance	88
	Summary	89
	Further Reading	90
	Practice Questions and Problems (Answers at End of Book)	90
	Further Questions	91
CHAPTER	5	
Tradic	ng in Financial Markets	93
5.1	The Markets	93
5.2	Clearing Houses	94
5.3	OTC Market Changes	95
5.4	Long and Short Positions in Assets	96
5.5	Derivatives Markets	97
5.6	Plain Vanilla Derivatives	98
5.7	Non-Traditional Derivatives	108
5.8	Exotic Options and Structured Products	112
5.9	Risk Management Challenges	114
	Summary	116
	Further Reading	116
	Practice Questions and Problems (Answers at End of Book)	117
	Further Questions	119

_	
- 1	7
	ч

Contents

CHAPTER (101
	edit Crisis of 2007	121
6.1	The U.S. Housing Market	121
6.2	Securitization	124
	The Crisis	130
	What Went Wrong?	131
6.5	Lessons from the Crisis	133
	Summary	134
	Further Reading	135
	Practice Questions and Problems (Answers at End of Book) Further Questions	135 136
CHAPTER :	7	
	on and Scenario Analysis: The Risk-Neutral and Real Worlds	137
7.1	Volatility and Asset Prices	138
7.2	Risk-Neutral Valuation	139
7.3	Scenario Analysis	144
	When Both Worlds Have to be Used	144
	The Calculations in Practice	145
7.6	Estimating Real-World Processes	146
	Summary	147
	Further Reading	148
	Practice Questions and Problems (Answers at End of Book)	148
	Further Questions	148
PART TWO) FT RISK	
CHAPTER How T	8 raders Manage Their Risks	153
8.1	Delta	153
8.2	Gamma	160
8.3	Vega	162
8.4		
8.5	Theta	164
8.6	•	164 165
	Theta	
8.7	Theta Rho Calculating Greek Letters	165
8.7 8.8	Theta Rho	165 166
	Theta Rho Calculating Greek Letters Taylor Series Expansions	165 166 167 168
8.8	Theta Rho Calculating Greek Letters Taylor Series Expansions The Realities of Hedging	165 166 167 168 169 170
8.8 8.9	Theta Rho Calculating Greek Letters Taylor Series Expansions The Realities of Hedging Hedging Exotic Options	165 166 167 168 169
8.8 8.9	Theta Rho Calculating Greek Letters Taylor Series Expansions The Realities of Hedging Hedging Exotic Options Scenario Analysis Summary Further Reading	165 166 167 168 169 170
8.8 8.9	Theta Rho Calculating Greek Letters Taylor Series Expansions The Realities of Hedging Hedging Exotic Options Scenario Analysis Summary	165 166 167 168 169 170

CHAPTE	8	
Inter	est Rate Risk	
9.1	The Management of Net Interest Income	175
9.2	Types of Rates	175
9.3	Duration	178
9.4	Convexity	182
9.5	Generalization	185
9.6	Nonparallel Yield Curve Shifts	187
9.7	Interest Rate Deltas in Practice	189
9.8	Principal Components Analysis	191 193
9.9	Gamma and Vega	193
	Summary	196
	Further Reading	197
	Practice Questions and Problems (Answers at End of Book)	198
	Further Questions	199
CHAPTER	10	
Volatil		
10.1		201
10.2	Definition of Volatility Implied Volatilities	201
10.3	Are Daily Personness Classics By	204
10.4	Are Daily Percentage Changes in Financial Variables Normal? The Power Law	205
10.5	Monitoring Daily Volatility	207
10.6	The Exponentially Weight 1 M.	209
10.7	The Exponentially Weighted Moving Average Model The GARCH(1,1) Model	212
10.8	Choosing Between the Models	214
10.9	Maximum Likelihood Methods	216
10.10	Using GARCH(1,1) to Forecast Future Volatility	216
	Summary	222
	Further Reading	225
	Practice Questions and Problems (Answers at End of Book)	226
	Further Questions (Answers at End of Book)	227 228
OHADTED 4		
CHAPTER 1		
111	tions and Copulas	231
11.1	Definition of Correlation	231
11.2	Monitoring Correlation	233
11.3 11.4	Multivariate Normal Distributions	236
11. 4 11.5	Copulas	238
11.3	Application to Loan Portfolios: Vasicek's Model	244
	Summary	250
	Further Reading	250
	Practice Questions and Problems (Answers at End of Book)	250
	Further Questions	252

Xiii

CHAPTER 1	2	
Value at	Risk and Expected Shortfall	255
12.1	Definition of VaR	255
12.2	Examples of the Calculation of VaR	257
12.3	A Drawback of VaR	258
12.4	Expected Shortfall	259
12.5	Coherent Risk Measures	260
12.6	Choice of Parameters for VaR and ES	263
12.7	Marginal, Incremental, and Component Measures	268
12.8	Euler's Theorem	269
12.9	Aggregating VaRs and ESs	270
12.10	Back-Testing	270
	Summary	273
	Further Reading	274
	Practice Questions and Problems (Answers at End of Book) Further Questions	274275
CHAPTER 1		0.77
	al Simulation and Extreme Value Theory	277
13.1	The Methodology	277
13.2		282
13.3		284
13.4	Computational Issues	289
13.5	Extreme Value Theory	289
13.6	Applications of EVT	292
	Summary	295
	Further Reading	295
	Practice Questions and Problems (Answers at End of Book)	296
	Further Questions	297
CHAPTER 1		299
14.1	Ruilding Approach The Basic Methodology	299
14.1	Generalization	302
14.2	Correlation and Covariance Matrices	303
14.3 14.4	Handling Interest Rates	307
14.4		310
14.5	Applications of the Linear Model	311
	Linear Model and Options Quadratic Model	314
14.7	Monte Carlo Simulation	316
14.8		317
14.9	Non-Normal Assumptions Model Building vs. Historical Simulation	318
14.10	Model-Building vs. Historical Simulation	319
	Summary Europhor Reading	319
	Further Reading Practice Questions and Problems (Answers at End of Book)	319
		321
	Further Questions	J41

PARI THE	E.	
	LATION	
CHAPTER	15	
Basel	i, Basel II, and Solvency II	325
15.1	The Reasons for Regulating Banks	325
15.2	Bank Regulation Pre-1988	326
15.3		327
15.4	The G-30 Policy Recommendations	330
15.5	Netting	331
15.6	1996 Amendment	333
15.7	Basel II	336
15.8	Credit Risk Capital Under Basel II	337
15.9	Operational Risk Capital Under Basel II	346
15.10	Pillar 2: Supervisory Review	346
15.11		347
15.12		347
	Summary	349
	Further Reading	349
	Practice Questions and Problems (Answers at End of Book)	350
	Further Questions	351
CHAPTER	16 I.5, Basel III, and Other Post-Crisis Changes	
16.1	Basel II.5	353
16.2	Basel III	353
16.3		357
16.4	Bone Convertible Bollds	365
16.5	Legislation in other Countries	366
	Summary	368
	Further Reading	370
	Practice Questions and Problems (Answers at End of Book)	371
	Further Questions	371 372
MIADTED		
CHAPTER 1		
	nental Review of the Trading Book	373
17.1	New Market Risk Measures	373
17.2	Trading Book vs. Banking Book	377
17.3	Credit Trades	378
	Summary	379
	Further Reading	379
	Practice Questions and Problems (Answers at End of Book)	379
	Further Questions	380

CREDIT	RISK	
CHAPTER 1	18	
Managi	ing Credit Risk: Margin, OTC Markets, and CCPs	383
18.1	Margin and Exchanges	383
18.2	OTC Markets	388
18.3	Consequences of New OTC Regulations	392
18.4	The Risk of a CCP Failure	396
	Summary	396
	Further Reading	397
	Practice Questions and Problems (Answers at End of Book)	397
	Further Questions	398
CHAPTER	19	
Estima	ting Default Probabilities	399
19.1	Credit Ratings	399
19.2	Historical Default Probabilities	401
19.3	Recovery Rates	403
19.4	Credit Default Swaps	404
19.5	Credit Spreads	409
19.6	Estimating Default Probabilities from Credit Spreads	412
19.7	Comparison of Default Probability Estimates	414
19.8	Using Equity Prices to Estimate Default Probabilities	419
	Summary	422
	Further Reading	422
	Practice Questions and Problems (Answers at End of Book)	423 424
	Further Questions	424
CHAPTER CVA as		427
20.1	Credit Exposure on Derivatives	427
20.1	CVA	429
20.2	The Impact of a New Transaction	432
20.4	CVA Risk	434
20.5	Wrong-Way Risk	435
20.6	DVA	436
20.7	Some Simple Examples	437
	Summary	441
	Further Reading	442
	Practice Questions and Problems (Answers at End of Book)	442
	Further Questions	443

CHAPTER	21	
Credit	Value at Risk	445
21.1	Ratings Transition Matrices	446
21.2	Vasicek's Model	448
21.3	Credit Risk Plus	449
21.4	Creditmetrics	451
21.5	Credit-Sensitive Instruments in the Trading Book	454
	Summary	457
	Further Reading	458
	Practice Questions and Problems (Answers at End of Book)	458
	Further Questions	459
PART FIVE		
	TOPICS	
CHAPTER 2		
Scenar	rio Analysis and Stress Testing	463
22.1	Generating the Scenarios	463
22.2	Regulation	469
22.3	What to Do with the Results	473
	Summary	476
	Further Reading	476
	Practice Questions and Problems (Answers at End of Book)	477
	Further Questions	478
CHAPTER 2		
-	ional Risk	478
23.1	Defining Operational Risk	481
23.2	Determination of Regulatory Capital	481
23.3	Categorization of Operational Risks	483
23.4	Loss Severity and Loss Frequency	484
23.5	Implementation of AMA	485
23.6	Proactive Approaches	489
23.7	Allocation of Operational Risk Capital	492
23.8	Use of Power Law	492
23.9	Insurance	493
23.10	Sarbanes-Oxley	494
	Summary	495
	Further Reading	496
	Practice Questions and Problems (Answers at End of Book)	496
	Further Questions	497
CHAPTER 2		
Liquidity		499
24.1	Liquidity Trading Risk	499
24.2	Liquidity Funding Risk	507

Contents		xvii
242	T' 'I'. Di la II-la	515
24.3	Liquidity Black Holes	522
	Summary	522
	Further Reading Problems (Answers at End of Book)	523
	Practice Questions and Problems (Answers at End of Book) Further Questions	524
CHAPTER 2		525
Model I		525
25.1	Marking to Market	523 527
25.2	Models for Linear Products	529
25.3	Physics vs. Finance	530
25.4	How Models are Used for Pricing Standard Products	536
25.5	Hedging	537
25.6	Models for Nonstandard Products	540
25.7	Dangers in Model Building	541
25.8	Detecting Model Problems	542
	Summary	542
	Further Reading Practice Questions and Problems (Answers at End of Book)	543
	Further Questions	543
	nic Capital and RAROC	545
26.1	Definition of Economic Capital	545
26.2	Components of Economic Capital	547 549
26.3	Shapes of the Loss Distributions	
26.4	Relative Importance of Risks	551
26.5	Aggregating Economic Capital	552
26.6	Allocation of Economic Capital	555 557
26.7	Deutsche Bank's Economic Capital	557 557
26.8	RAROC	559
	Summary	559
	Further Reading	559
	Practice Questions and Problems (Answers at End of Book) Further Questions	560
CHAPTER	27	F00
Enter	prise Risk Management	563
27.1	Risk Appetite	564
27.2	Risk Culture	568
27.3	Identifying Major Risks	572
27.4	Strategic Risk Management	574 575
	Summary	575
	Further Reading	576 576
	Practice Questions and Problems (Answers at End of Book) Further Questions	576 576

-	KE E
W 100	

CHAPTER		
Risk N	Management Mistakes to Avoid	<u> </u>
28.1	Risk Limits	577
28.2		577
28.3	Liquidity Risk	580
28.4	Lessons for Nonfinancial Corporations	582
28.5	A Final Point	585
	Further Reading	586
		587
PART SIX		
APPEN	DICES	
Appendix /		
	unding Frequencies for Interest Rates	
	odgonotop tot. miral.est uging	591
Appendix B		
Zero Ra	ites, Forward Rates, and Zero-Coupon Yield Curves	F0F
		595
Appendix C		
valung	Forward and Futures Contracts	599
Annondi. D		000
Appendix D Valuing :		
samily (omaha	601
Appendix E		
The second secon	European Options	
		603
Appendix F		
Valuing A	Imerican Options	605
Appendix G		000
	eries Expansions	
	•	608
Appendix H		
ciyenyeci	tors and Eigenvalues	613
Appendix i		
Principal	Components Analysis	
	, , , , , , , , , , , , , , , , , , , ,	617
Appendix J		
Manipulat	ion of Credit Transition Matrices	619
Ippendi x K		3.0
The second secon	of Credit Default Swaps	
		621

Contents	xix
Appendix L Synthetic CDOs and Their Valuation	625
Answers to Questions and Problems	629
Glossary	669
DerivaGem Software	689
Table for $N(x)$ when $x \leq 0$	695
Table for $N(x)$ when $x \ge 0$	697
Index	698