CONTENTS

FOREWORD vii
INTRODUCTION ix
ACKNOWLEDGMENTS xi

Chapter 1
Credit, Financial Markets, and Microeconomics 1
The Role of Debt in the Theory of the Firm 4
Banking Intermediation Theory 12
Conclusion 19

Chapter 2
External and Internal Ratings 23
Ratings and External Agencies 24
Comments and Criticisms about External Ratings 28
Approaching Credit Risk through Internal Ratings or Score-Based Ratings 39
Conclusion 48

Chapter 3
Default Risk: Quantitative Methodologies 63
Assessing Default Risk Through Structural Models 64
Credit Scoring 73
Conclusion 108

Chapter 4
Loss Given Default 117
Some Definitions 118
What Measure of Recovery Should One Use? 123
History and Determinants of Recovery Rates 124
Recovery on Nontraded Debt 136
The Importance of Stochastic Recovery Rates 138
Fitting Recovery Functions 139
Extracting Recoveries from Security Prices 151
Conclusion 153

Chapter 5
Default Dependencies 167
Sources of Dependencies 168
Correlations and Other Dependency Measures 170
Default Dependencies—Empirical Findings 184
Conclusion 208

Chapter 6
Credit Risk Portfolio Models 213
Credit Risk Portfolio Models: What For? 213
Classes of Models 215
Review of Commercial Models 216
Alternative Approaches 234
Calculating Risk-Adjusted Performance Measures (RAPM) 236
Stress-Testing Portfolio Loss Calculations 248
Conclusion 251

Chapter 7
Credit Risk Management and Strategic Capital Allocation 271
Do Rating Agencies Have a Point of View on Strategic Capital Allocation? 272
What Is Bank Capital Meant For? 273
The Various Static Methodologies to Allocate Equity Capital among Business Units 283
Performance Measurement, the Cost of Capital, and Dynamic Equity Capital Allocation 298
Conclusion 305

Chapter 8
Yield Spreads 309
Corporate Spreads 310
Conclusion 328