Contents

Preface xv

I An Introduction to Quantitative Risk Management **1**

1 Risk in Perspective **3**
- 1.1 Risk 3
  - 1.1.1 Risk and Randomness 3
  - 1.1.2 Financial Risk 5
  - 1.1.3 Measurement and Management 6
- 1.2 A Brief History of Risk Management 8
  - 1.2.1 From Babylon to Wall Street 8
  - 1.2.2 The Road to Regulation 15
- 1.3 The Regulatory Framework 20
  - 1.3.1 The Basel Framework 20
  - 1.3.2 The Solvency II Framework 25
  - 1.3.3 Criticism of Regulatory Frameworks 28
- 1.4 Why Manage Financial Risk? 30
  - 1.4.1 A Societal View 30
  - 1.4.2 The Shareholder's View 32
- 1.5 Quantitative Risk Management 34
  - 1.5.1 The Q in QRM 34
  - 1.5.2 The Nature of the Challenge 35
  - 1.5.3 QRM Beyond Finance 38

2 Basic Concepts in Risk Management **42**
- 2.1 Risk Management for a Financial Firm 42
  - 2.1.1 Assets, Liabilities and the Balance Sheet 42
  - 2.1.2 Risks Faced by a Financial Firm 44
  - 2.1.3 Capital 45
- 2.2 Modelling Value and Value Change 47
  - 2.2.1 Mapping Risks 47
  - 2.2.2 Valuation Methods 54
  - 2.2.3 Loss Distributions 58
- 2.3 Risk Measurement 61
  - 2.3.1 Approaches to Risk Measurement 61
  - 2.3.2 Value-at-Risk 64
  - 2.3.3 VaR in Risk Capital Calculations 67

2.3.4 Other Risk Measures Based on Loss Distributions 69
2.3.5 Coherent and Convex Risk Measures 72

3 Empirical Properties of Financial Data 79
3.1 Stylized Facts of Financial Return Series 79
3.1.1 Volatility Clustering 80
3.1.2 Non-normality and Heavy Tails 85
3.1.3 Longer-Interval Return Series 87
3.2 Multivariate Stylized Facts 88
3.2.1 Correlation between Series 88
3.2.2 Tail Dependence 90

II Methodology 95

4 Financial Time Series 97
4.1 Fundamentals of Time Series Analysis 98
4.1.1 Basic Definitions 98
4.1.2 ARMA Processes 100
4.1.3 Analysis in the Time Domain 105
4.1.4 Statistical Analysis of Time Series 107
4.1.5 Prediction 109
4.2 GARCH Models for Changing Volatility 112
4.2.1 ARCH Processes 112
4.2.2 GARCH Processes 118
4.2.3 Simple Extensions of the GARCH Model 121
4.2.4 Fitting GARCH Models to Data 123
4.2.5 Volatility Forecasting and Risk Measure Estimation 129

5 Extreme Value Theory 135
5.1 Maxima 135
5.1.1 Generalized Extreme Value Distribution 136
5.1.2 Maximum Domains of Attraction 139
5.1.3 Maxima of Strictly Stationary Time Series 141
5.1.4 The Block Maxima Method 142
5.2 Threshold Exceedances 146
5.2.1 Generalized Pareto Distribution 147
5.2.2 Modelling Excess Losses 149
5.2.3 Modelling Tails and Measures of Tail Risk 154
5.2.4 The Hill Method 157
5.2.5 Simulation Study of EVT Quantile Estimators 161
5.2.6 Conditional EVT for Financial Time Series 162
5.3 Point Process Models 164
5.3.1 Threshold Exceedances for Strict White Noise 164
5.3.2 The POT Model 166

6 Multivariate Models 173
6.1 Basics of Multivariate Modelling 174
6.1.1 Random Vectors and Their Distributions 174
6.1.2 Standard Estimators of Covariance and Correlation 176
6.1.3 The Multivariate Normal Distribution 178
6.1.4 Testing Multivariate Normality 180

6.2 Normal Mixture Distributions 183
  6.2.1 Normal Variance Mixtures 183
  6.2.2 Normal Mean–Variance Mixtures 187
  6.2.3 Generalized Hyperbolic Distributions 188
  6.2.4 Empirical Examples 191
6.3 Spherical and Elliptical Distributions 196
  6.3.1 Spherical Distributions 196
  6.3.2 Elliptical Distributions 200
  6.3.3 Properties of Elliptical Distributions 202
  6.3.4 Estimating Dispersion and Correlation 203
6.4 Dimension-Reduction Techniques 206
  6.4.1 Factor Models 206
  6.4.2 Statistical Estimation Strategies 208
  6.4.3 Estimating Macroeconomic Factor Models 210
  6.4.4 Estimating Fundamental Factor Models 213
  6.4.5 Principal Component Analysis 214

7 Copulas and Dependence 220
7.1 Copulas 220
  7.1.1 Basic Properties 221
  7.1.2 Examples of Copulas 225
  7.1.3 Meta Distributions 229
  7.1.4 Simulation of Copulas and Meta Distributions 229
  7.1.5 Further Properties of Copulas 232
7.2 Dependence Concepts and Measures 235
  7.2.1 Perfect Dependence 236
  7.2.2 Linear Correlation 238
  7.2.3 Rank Correlation 243
  7.2.4 Coefficients of Tail Dependence 247
7.3 Normal Mixture Copulas 249
  7.3.1 Tail Dependence 249
  7.3.2 Rank Correlations 253
  7.3.3 Skewed Normal Mixture Copulas 256
  7.3.4 Grouped Normal Mixture Copulas 257
7.4 Archimedean Copulas 259
  7.4.1 Bivariate Archimedean Copulas 259
  7.4.2 Multivariate Archimedean Copulas 261
7.5 Fitting Copulas to Data 265
  7.5.1 Method-of-Moments Using Rank Correlation 266
  7.5.2 Forming a Pseudo-sample from the Copula 269
  7.5.3 Maximum Likelihood Estimation 270

8 Aggregate Risk 275
8.1 Coherent and Convex Risk Measures 275
  8.1.1 Risk Measures and Acceptance Sets 276
  8.1.2 Dual Representation of Convex Measures of Risk 280
  8.1.3 Examples of Dual Representations 283
8.2 Law-Invariant Coherent Risk Measures 286
  8.2.1 Distortion Risk Measures 286
  8.2.2 The Expectile Risk Measure 290

8.3 Risk Measures for Linear Portfolios 293
  8.3.1 Coherent Risk Measures as Stress Tests 293
  8.3.2 Elliptically Distributed Risk Factors 295
  8.3.3 Other Risk Factor Distributions 297
8.4 Risk Aggregation 299
  8.4.1 Aggregation Based on Loss Distributions 300
  8.4.2 Aggregation Based on Stressing Risk Factors 302
  8.4.3 Modular versus Fully Integrated Aggregation Approaches 303
  8.4.4 Risk Aggregation and Fréchet Problems 305
8.5 Capital Allocation 315
  8.5.1 The Allocation Problem 315
  8.5.2 The Euler Principle and Examples 316
  8.5.3 Economic Properties of the Euler Principle 320

III Applications 323

9 Market Risk 325
9.1 Risk Factors and Mapping 325
  9.1.1 The Loss Operator 326
  9.1.2 Delta and Delta–Gamma Approximations 327
  9.1.3 Mapping Bond Portfolios 329
  9.1.4 Factor Models for Bond Portfolios 332
9.2 Market Risk Measurement 338
  9.2.1 Conditional and Unconditional Loss Distributions 339
  9.2.2 Variance–Covariance Method 340
  9.2.3 Historical Simulation 342
  9.2.4 Dynamic Historical Simulation 343
  9.2.5 Monte Carlo 346
  9.2.6 Estimating Risk Measures 347
  9.2.7 Losses over Several Periods and Scaling 349
9.3 Backtesting 351
  9.3.1 Violation-Based Tests for VaR 352
  9.3.2 Violation-Based Tests for Expected Shortfall 354
  9.3.3 Elicitability and Comparison of Risk Measure Estimates 355
  9.3.4 Empirical Comparison of Methods Using Backtesting Concepts 358
  9.3.5 Backtesting the Predictive Distribution 363

10 Credit Risk 366
10.1 Credit-Risky Instruments 367
  10.1.1 Loans 367
  10.1.2 Bonds 368
  10.1.3 Derivative Contracts Subject to Counterparty Risk 369
  10.1.4 Credit Default Swaps and Related Credit Derivatives 370
  10.1.5 PD, LGD and EAD 372
10.2 Measuring Credit Quality 374
  10.2.1 Credit Rating Migration 374
  10.2.2 Rating Transitions as a Markov Chain 376
10.3 Structural Models of Default 380
  10.3.1 The Merton Model 380
  10.3.2 Pricing in Merton's Model 381
  10.3.3 Structural Models in Practice: EDF and DD 386
  10.3.4 Credit-Migration Models Revisited 389

10.4 Bond and CDS Pricing in Hazard Rate Models 391
  10.4.1 Hazard Rate Models 391
  10.4.2 Risk-Neutral Pricing Revisited 394
  10.4.3 Bond Pricing 399
  10.4.4 CDS Pricing 401
  10.4.5 P versus Q: Empirical Results 404
10.5 Pricing with Stochastic Hazard Rates 406
  10.5.1 Doubly Stochastic Random Times 406
  10.5.2 Pricing Formulas 411
  10.5.3 Applications 413
10.6 Affine Models 416
  10.6.1 Basic Results 417
  10.6.2 The CIR Square-Root Diffusion 418
  10.6.3 Extensions 420

11 Portfolio Credit Risk Management 425
11.1 Threshold Models 426
  11.1.1 Notation for One-Period Portfolio Models 426
  11.1.2 Threshold Models and Copulas 428
  11.1.3 Gaussian Threshold Models 430
  11.1.4 Models Based on Alternative Copulas 431
  11.1.5 Model Risk Issues 433
11.2 Mixture Models 436
  11.2.1 Bernoulli Mixture Models 436
  11.2.2 One-Factor Bernoulli Mixture Models 437
  11.2.3 Recovery Risk in Mixture Models 440
  11.2.4 Threshold Models as Mixture Models 441
  11.2.5 Poisson Mixture Models and CreditRisk$^+$ 444
11.3 Asymptotics for Large Portfolios 449
  11.3.1 Exchangeable Models 450
  11.3.2 General Results 452
  11.3.3 The Basel IRB Formula 455
11.4 Monte Carlo Methods 457
  11.4.1 Basics of Importance Sampling 457
  11.4.2 Application to Bernoulli Mixture Models 460
11.5 Statistical Inference in Portfolio Credit Models 464
  11.5.1 Factor Modelling in Industry Threshold Models 465
  11.5.2 Estimation of Bernoulli Mixture Models 466
  11.5.3 Mixture Models as GLMMs 470
  11.5.4 A One-Factor Model with Rating Effect 472

12 Portfolio Credit Derivatives 476
12.1 Credit Portfolio Products 476
  12.1.1 Collateralized Debt Obligations 477
  12.1.2 Credit Indices and Index Derivatives 481
  12.1.3 Basic Pricing Relationships for Index Swaps and CDOs 484
12.2 Copula Models 487
  12.2.1 Definition and Properties 487
  12.2.2 Examples 489
12.3 Pricing of Index Derivatives in Factor Copula Models 491
  12.3.1 Analytics 491
  12.3.2 Correlation Skews 494
  12.3.3 The Implied Copula Approach 497

13 Operational Risk and Insurance Analytics **503**
- 13.1 Operational Risk in Perspective 503
  - 13.1.1 An Important Risk Class 503
  - 13.1.2 The Elementary Approaches 505
  - 13.1.3 Advanced Measurement Approaches 506
  - 13.1.4 Operational Loss Data 509
- 13.2 Elements of Insurance Analytics 512
  - 13.2.1 The Case for Actuarial Methodology 512
  - 13.2.2 The Total Loss Amount 513
  - 13.2.3 Approximations and Panjer Recursion 518
  - 13.2.4 Poisson Mixtures 524
  - 13.2.5 Tails of Aggregate Loss Distributions 525
  - 13.2.6 The Homogeneous Poisson Process 526
  - 13.2.7 Processes Related to the Poisson Process 529

IV Special Topics 537

14 Multivariate Time Series **539**
- 14.1 Fundamentals of Multivariate Time Series 539
  - 14.1.1 Basic Definitions 539
  - 14.1.2 Analysis in the Time Domain 541
  - 14.1.3 Multivariate ARMA Processes 542
- 14.2 Multivariate GARCH Processes 545
  - 14.2.1 General Structure of Models 545
  - 14.2.2 Models for Conditional Correlation 547
  - 14.2.3 Models for Conditional Covariance 550
  - 14.2.4 Fitting Multivariate GARCH Models 553
  - 14.2.5 Dimension Reduction in MGARCH 554
  - 14.2.6 MGARCH and Conditional Risk Measurement 557

15 Advanced Topics in Multivariate Modelling **559**
- 15.1 Normal Mixture and Elliptical Distributions 559
  - 15.1.1 Estimation of Generalized Hyperbolic Distributions 559
  - 15.1.2 Testing for Elliptical Symmetry 562
- 15.2 Advanced Archimedean Copula Models 566
  - 15.2.1 Characterization of Archimedean Copulas 566
  - 15.2.2 Non-exchangeable Archimedean Copulas 568

16 Advanced Topics in Extreme Value Theory **572**
- 16.1 Tails of Specific Models 572
  - 16.1.1 Domain of Attraction of the Fréchet Distribution 572
  - 16.1.2 Domain of Attraction of the Gumbel Distribution 573
  - 16.1.3 Mixture Models 574
- 16.2 Self-exciting Models for Extremes 577
  - 16.2.1 Self-exciting Processes 578
  - 16.2.2 A Self-exciting POT Model 580
- 16.3 Multivariate Maxima 583
  - 16.3.1 Multivariate Extreme Value Copulas 583
  - 16.3.2 Copulas for Multivariate Minima 586
  - 16.3.3 Copula Domains of Attraction 586
  - 16.3.4 Modelling Multivariate Block Maxima 589

16.4 Multivariate Threshold Exceedances 591
  16.4.1 Threshold Models Using EV Copulas 591
  16.4.2 Fitting a Multivariate Tail Model 592
  16.4.3 Threshold Copulas and Their Limits 594

17 Dynamic Portfolio Credit Risk Models and Counterparty Risk 599
17.1 Dynamic Portfolio Credit Risk Models 599
  17.1.1 Why Dynamic Models of Portfolio Credit Risk? 599
  17.1.2 Classes of Reduced-Form Models of Portfolio Credit Risk 600
17.2 Counterparty Credit Risk Management 603
  17.2.1 Uncollateralized Value Adjustments for a CDS 604
  17.2.2 Collateralized Value Adjustments for a CDS 609
17.3 Conditionally Independent Default Times 612
  17.3.1 Definition and Mathematical Properties 612
  17.3.2 Examples and Applications 618
  17.3.3 Credit Value Adjustments 622
17.4 Credit Risk Models with Incomplete Information 625
  17.4.1 Credit Risk and Incomplete Information 625
  17.4.2 Pure Default Information 628
  17.4.3 Additional Information 633
  17.4.4 Collateralized Credit Value Adjustments and Contagion Effects 637

Appendix 641
A.1 Miscellaneous Definitions and Results 641
  A.1.1 Type of Distribution 641
  A.1.2 Generalized Inverses and Quantiles 641
  A.1.3 Distributional Transform 643
  A.1.4 Karamata's Theorem 644
  A.1.5 Supporting and Separating Hyperplane Theorems 644
A.2 Probability Distributions 644
  A.2.1 Beta 645
  A.2.2 Exponential 645
  A.2.3 *F* 645
  A.2.4 Gamma 645
  A.2.5 Generalized Inverse Gaussian 646
  A.2.6 Inverse Gamma 646
  A.2.7 Negative Binomial 646
  A.2.8 Pareto 647
  A.2.9 Stable 647
A.3 Likelihood Inference 647
  A.3.1 Maximum Likelihood Estimators 648
  A.3.2 Asymptotic Results: Scalar Parameter 648
  A.3.3 Asymptotic Results: Vector of Parameters 649
  A.3.4 Wald Test and Confidence Intervals 649
  A.3.5 Likelihood Ratio Test and Confidence Intervals 650
  A.3.6 Akaike Information Criterion 650

References 652

Index 687