

# A Guide to the CDS Package

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# Contents

<b>1</b>	<b>Introduction</b>	<b>3</b>
<b>2</b>	<b>Fixed Income Securities and Credit Risk</b>	<b>4</b>
2.1	Bond Basics . . . . .	4
2.2	Risk-free Bonds . . . . .	5
2.3	Bond Pricing . . . . .	6
2.4	Credit Risk Associated with Bonds . . . . .	7
<b>3</b>	<b>CDS Basics</b>	<b>8</b>
3.1	Why CDSs? . . . . .	8
3.2	CDS Mechanics . . . . .	9
<b>4</b>	<b>CDS Terminology and Cash Flows</b>	<b>10</b>
4.1	Entity-Specific Variables . . . . .	10
4.2	Premium Leg . . . . .	11
4.3	Protection Leg . . . . .	13
4.4	CDS Indices . . . . .	15
<b>5</b>	<b>CDS Pricing</b>	<b>15</b>
5.1	Mark-to-Market Calculations . . . . .	16
5.2	Present Value of CDSs . . . . .	16
5.3	Risk Measures of a Standard CDS Contract . . . . .	20
5.4	Risk-Neutral Pricing . . . . .	21
<b>6</b>	<b>Pricing Sources</b>	<b>21</b>
<b>7</b>	<b>Using the CDS package</b>	<b>24</b>
7.1	CDS Class . . . . .	24
7.2	Generic Methods . . . . .	25
7.3	CDS Pricing Related Functions . . . . .	27
7.4	Risk-related Functions . . . . .	29
<b>8</b>	<b>Conclusion</b>	<b>29</b>
	<b>Bibliography</b>	<b>30</b>

# 1 Introduction

Over the past three decades, **credit derivatives** have become increasingly common tools for financial institutions that wish to pass on **credit risk** to investors who accept that risk for a premium, or fee. To put it simply, credit risk is the possibility that a borrower will default on his or her loan. In the modern financial world, there are many types of credit derivatives, including collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs). In this vignette, we will focus on **credit default swaps** (CDSs), a type of credit derivative that has become quite popular among pension funds, hedge funds, and investment banks, among other financial institutions (see Figure 1). We will explain the mechanics of this financial product and show how the **CDS** package can be used to manipulate and calculate relevant CDS information.

*Credit Default Swap Market Size*

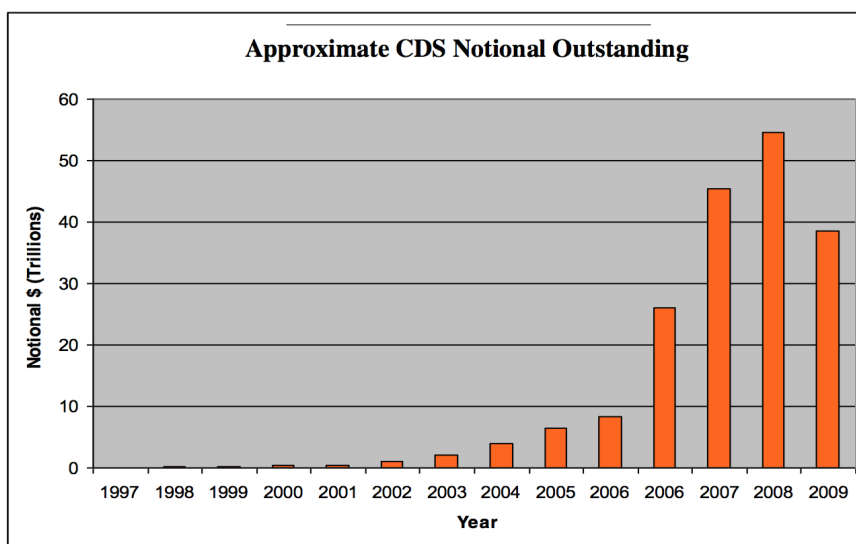


Figure 1: CDS notional outstanding from 1997-2009.

CDSs originated in the late 1980s and were popularized by a team at J.P. Morgan that included Blythe Masters (Lenzner, 2009; Lanchester, 2009). The CDS markets have grown exponentially over the past decade when financial institutions used CDSs to hedge against credit risk exposure. Many different types of CDSs have since emerged including basket default swaps (BDSs), index CDSs, credit-linked notes, etc. (Kallianiotis, 2013). In the **CDS** package, we focus on calculations related to single-name, or corporate, credit default swaps.

## 2 Fixed Income Securities and Credit Risk

CDSs are used for the purpose of hedging against the **credit risk** associated with **bonds** or **fixed income**. Before we approach understanding how CDSs work, we must understand the mechanics of a standard coupon bond and its associated risks.

### 2.1 Bond Basics

Consider the following example: let's say that there exists a pension fund manager who has to allocate her clients' money (a total sum of \$10 million dollars). Pension funds are usually risk-averse investors who seek to minimize their losses, even if that ultimately creates lower returns on investments. Pension funds also have to constantly return money to their clients, so they strive to hold assets that pay regular interests to the owner. Pension funds also want to invest in assets that are **liquid** i.e. whose sales do not affect their prices. In such a scenario, coupon bonds seem like an attractive investment.

A **coupon bond** is an agreement in which one party lends money to another party in exchange for that same sum of money, plus period **coupon payments**, at a future date. Since the bond pays a regular interest to the bondholder, it can also be termed as **fixed income**. A major advantage of holding bonds over shares (also known as equity) is that bondholders are compensated before shareholders in the case of liquidation. Furthermore, bonds can be categorized as "senior" or "junior"; there exist many other classifications, but we'll stick to these two for now. As the terms suggest, senior bonds usually have the greatest seniority in the issuer's capital structure and are repaid before junior bonds in the case of default.

To understand the different variables used to determine cash flows and bond pricing, let's look at actual data for an Alcoa Inc. bond that will mature, or be paid out, five years from now—in other words, the bond has a **maturity date** of five years. This data has been retrieved from Bloomberg, one of the most widely used sources of financial data.

DES			
ALCOA INC AA 5.72 02/23/19 112.063/112.063 (2.928/2.928) TRAC			
AA 5.72 02/23/19 Corp		Page 1/11	Description: Bond
94 Notes		95 Buy	96 Sell
97 Settings			
21 Bond Description		22 Issuer Description	
Pages		Identifiers	
1) Bond Info		ID Number EG3379369	
2) Addtl. Info		CUSIP 013817AP6	
3) Covenants		ISIN US013817AP64	
4) Guarantors		Bond Ratings	
5) Bond Ratings		Moody's Ba1	
6) Identifiers		S&P BBB-	
7) Exchanges		Fitch BB+	
8) Inv Parties		DBRS BBB	
9) Fees, Restrict		Issuance & Trading	
10) Schedules		Amt Issued/Outstanding	
11) Coupons		USD 749,500.00 (M) /	
Quick Links		USD 749,500.00 (M)	
32) ALLQ Pricing		Min Piece/Increment	
33) QRD Quote Reca		100,000.00 / 1,000.00	
34) TDH Trade Hist		Par Amount 1,000.00	
35) CAC Corp Action		Book Runner	
36) CF Prospectus		Reporting	
37) CN Sec News		TRACE	
38) HDS Holders			
39) VPR Underly Info			
66) Send Bond			
Issuer Information			
Name ALCOA INC			
Industry Metals & Mining			
Security Information			
Mkt Iss Global			
Country US			
Rank Sr Unsecured			
Coupon 5.72			
Cpn Freq S/A			
Day Cnt 30/360			
Maturity 02/23/2019			
MAKE WHOLE @15 until 02/23/19/BULLET			
Iss Sprd			
Calc Type (1)STREET CONVENTION			
Announcement Date 04/02/2007			
Interest Accrual Date 02/23/2007			
1st Settle Date 05/02/2007			
1st Coupon Date 08/23/2007			
ISSUED IN EXCH 1440/REGS: 013817AM3/USU01347AA84. CALL @ MAKE WHOLE +15BP. POISON PUT @ 101% SUBJ TO			
RATINGS TRIGGER.			

Figure 2: Bloomberg data for Senior Bonds of Alcoa Inc., maturing on February 23, 2019. This figure displays some essential information that a potential investor would need to consider such as the company (name), industry, seniority (rank), coupon, maturity, coupon payment dates and credit ratings.

## 2.2 Risk-free Bonds

Bonds issues by the U.S. Government (known as treasury bonds) are generally considered to be **risk-free** since the probability of the U.S. Government failing to meet its debt obligations is almost negligible. Bonds issued by Japan (Japanese Government Bonds or JGBs) and Britain (Gilts) are also considered to be risk-free. Therefore, the interest paid by sovereign bonds is an important benchmark for the pricing of corporate bonds or even the bonds of other governments.

Bonds from Alcoa Inc., or any corporation, are generally riskier than bonds issued by the U.S. Government. A rational investor would want a riskier bond to pay a higher interest rate than a U.S. reasury bond, since otherwise she could get the same interest payment at no risk at all. She would want the expected return of a corporate bond to be the same as the expected return of a risk-free bond. For this to be the case, the riskier bond would have to pay more than the risk-free asset, and the amount to which the riskier bond's expected profit exceeds that of a risk-free bond is known as the **risk premium**. So, the interest premium that an investor would want from a bond would change as the risk-free rate changes. It is important to understand the intuition behind this before we explain how bonds are priced.

## Swap Curve or Risk-free curve

Bond yields are directly proportional to the maturity of the bond. This is because the risk of default for a government, or any other entity, is higher over a long period than over a short one. The risk that a government may default on its debt over 30 years is higher than the risk that it defaults in six months. In rare cases, the short-term yields are higher than long term yields; this can often be a sign of a recession. If, for a given date, we plot the maturities of different bonds on the x-axis and their corresponding yields on the y-axis, we get the **Swap Curve**.

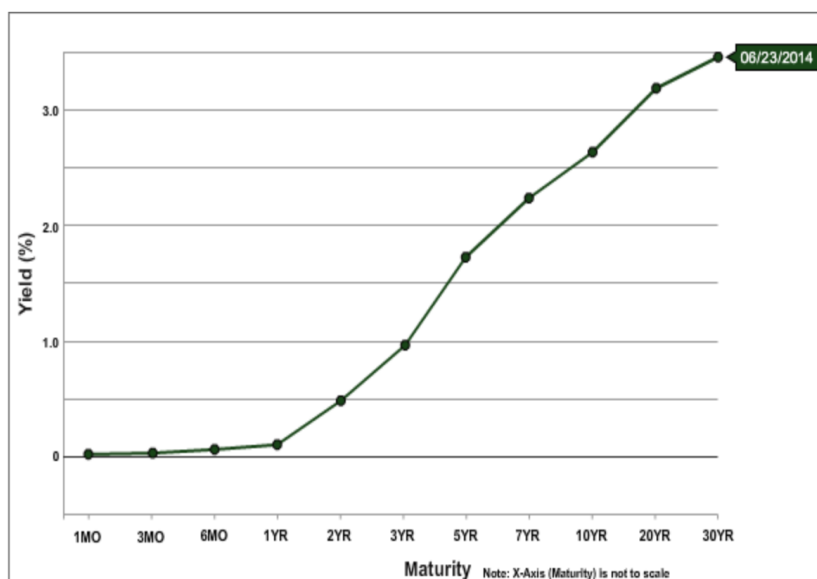


Figure 3: Treasury Yield Curve for June 23, 2014. We can see the yields are higher for debt obligations with a longer maturity

## 2.3 Bond Pricing

### Present Value (PV)

**Present value** refers to the current value of a future payment. For example, if an investor has \$1 million dollars, that asset (if invested) it is worth more today than \$1 million dollars ten years from now. If this person invests his \$1 million dollars in, say, a risk-free asset earning 5% a year (compounded semi-annually), that initial amount will become \$1.63 million in ten years. So, the present value of that \$1.63 million (that will accumulate over ten years) is \$1 million. The 5% interest rate that we are using to discount the future value is known as the **discount rate**.

### Present Value of Bonds

A bond's price is essentially the sum of the present values of its cash flows i.e. the sum of the present values of coupon payments and principal. Basically, we have to pretend as though we are investing the coupon payments and principal at different time periods. So for our \$1 million bond with a discount rate of 5% paid semi-annually (2.5% every six months), the present value of the first coupon of \$25,000

is \$25,000/1.025, that of the second coupon is \$25,000/1.025 and so on. The present value (and price) of a bond can be calculated using the equation below:

$$\text{Price} = C * \frac{1 - \frac{1}{(1+i)^n}}{i} + \frac{M}{(1+i)^n} \quad (1)$$

"M" represents the principal payment and "C" refers to the coupon payment of \$25,000. "i" is the discount rate and is also called the **yield to maturity (YTM)** or just **yield**. It is the required interest or discount rate for the present value of a future payment to be equal to the bond price.

If we look at the top of Figure 2.1, we see that bonds for Alcoa Inc. on June 24, 2014 have a coupon of 5.72%, a price of \$112.063 and a yield of 2.928%. The **Cpn Freq** (Coupon Frequency) is quoted as "S/A" which stands for "semi-annually." So, if our pension fund manager were to purchase Alcoa Inc. bonds that have a principal of \$10 million dollars and that pay a coupon of \$286,000 semi-annually, it would cost her \$11,206,300. If we substitute "i" in the above equation with 0.014514, "C" with \$2.86, "M" with \$100 and "n" with 10, we would get the bond price quoted in the Bloomberg screenshot in Figure 2.1: \$112.063.

When our portfolio manager has to purchase a bond, she has to determine what a fair yield, or discount rate, for that specific bond would look like. The factors affecting the yield include the risk-free rate, as explained earlier, and the credit health of the company, represented partly by the credit rating. If we look at the equation above or even think of these concepts intuitively, we can see that the bond yield has an inverse relationship with its price. Moreover, the difference between the yield of a bond and the yield of a risk-free bond of the same maturity is a common measurement of the company's credit risk.

## 2.4 Credit Risk Associated with Bonds

If we look to the right of Figure 2.1, under "Bond Ratings," we can see certain symbols representing **credit ratings** that are provided by rating agencies such as Moody's, S&P and Fitch. These symbols are indicators of a company's **creditworthiness** and its **credit risk**. When a company like Alcoa Inc. issues bonds, there is always a possibility that it may not be able to meet its debt obligations. That possibility, or risk, is known as the credit risk. Naturally, if a company's credit risk goes up, investors would demand a higher yield and consequently, a lower price.

A risk-averse investor, like our pension fund portfolio manager, would naturally want to purchase senior bonds from a company that has a low credit risk—a company like Alcoa Inc., which has a rating of BBB- from S&P and Ba1 from Moody's. We will not go into the details of how these ratings are determined, since those details are beyond the scope of this vignette. What we should note is that companies that have credit ratings of BBB- or higher from S&P or Baa3 or higher from Moody's can be classified as **Investment Grade** bonds. Such companies, at least from the viewpoint of the rating agencies, have a low credit risk. Bonds that have a rating below this are termed as **speculative grade** bonds or **junk** bonds, and have a higher yield than IG bonds. We can see a complete list of classifications from Moody's and S&P in Figure 2.4:

Investment Grade					Speculative Grade				
S&P	Fitch	Moody's	Interpretation	Numeric Scale	S&P	Fitch	Moody's	Interpretation	Numeric Scale
AAA	AAA	Aaa	Very high credit quality	1	BB+	BB+	Ba1	It has speculative elements and it is subject to substantial credit risk	11
					BB	BB	Ba2		12
					BB-	BB-	Ba3		13
AA+	AA+	Aa1	High credit quality	2	B+	B+	B1	It is considered speculative and it has high credit risk	14
AA	AA	Aa2		3	B	B	B2		15
AA-	AA-	Aa3		4	B-	B-	B3		16
A+	A+	A1	Medium-high grade, with low credit risk	5	CCC+	CCC+	Caa1	Bad credit conditions and it is subject to high credit risk	17
A	A	A2		6	CCC	CCC	Caa2		18
A-	A-	A3		7	CCC-	CCC-	Caa3		19
					CC	CC	Ca		20
BBB+	BBB+	Baa1	Moderate Credit Risk	8					
BBB	BBB	Baa2		9	C	C	C		22
BBB-	BBB-	Baa3		10	SD	DDD	-	Very close to default or in default	22
					D	DD			22
					-	D			22

Figure 4: Credit rating classifications from Moody's and S&P for long-term debt obligations.

Another important term associated with credit risk is a **credit event**. A credit event can signify the risk of a company's bankruptcy and resulting default, but the term can also expand to include failure to pay out debt within a certain amount of time, a credit downgrade and the confiscation of assets, among other events. In a later section, we will see the exact events that constitute a credit event.

### 3 CDS Basics

#### 3.1 Why CDSs?

Let's assume that our portfolio manager buys bonds of Alcoa Inc. with a face value of \$10 million and with a maturity of five years. Six months after the she makes this trade, her confidence in the creditworthiness of Alcoa Inc. begins to waiver. Of course, she could simply sell the bonds. However, that may be premature or even unprofitable. Instead, she could **hedge** her position by purchasing a financial product whose value rises with a drop in the bonds' value. In other words, she could take a position that allows her to *profit* from increased credit risk. This is known as **Hedging**, a process that allows you to profit from both a rise and a drop in an asset's value. When an investors hedges, she takes two opposite positions on an asset such that in the case of a rise or drop, her downside is limited and one position offsets the losses from the other.

When the asset in question is a bond, one option is to be **long**, a position in which you simply own the bond and profit when its price increases (or yield drops). The opposite position is to be **short**. Shorting is the process of borrowing and selling a security with the obligation to repurchase it in the future and return it to the lender. Clearly, this is profitable if the value of the security drops by the time it is repurchased in the future. It is a conventional technique of hedging against credit risk. However, there are several issues associated with this method. It is difficult to short bonds that are not



**liquid.** The portfolio manager may not be able to find enough bonds that will mature at the same time. Moreover, she would have to spend \$10 million to hedge her entire portfolio of \$10 million, which is a substantial opportunity cost.

### 3.2 CDS Mechanics

CDSs were invented in order to resolve these issues associated with hedging against credit risk (as described in Section 3.1).

As shown in Figure 3.2, a CDS is an agreement between two **counterparties**, or opposing groups, in which the buyer (in this case, the portfolio manager) pays a **fixed periodic coupon** to the seller in exchange for protection against a credit event associated with the buyer's bond.

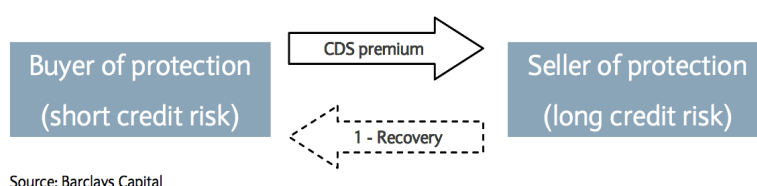


Figure 5: Cash flows in a single name CDS contract.

In our example, the portfolio manager is the **protection buyer**. Let's say that the **protection seller** is a hedge fund. The hedge fund sells protection to the portfolio manager for \$10 million of senior debt. This amount is known as the **notional amount**. In return, she has to pay the hedge fund an annual coupon rate of over 1%, or 100 basis points, for a period of five years. These \$100,000 payments are made quarterly, so she would have to pay 0.25% every quarter until the maturity date.

In the case of default, the hedge fund would have to pay a compensation equal to the notional amount minus the company's **recovery rate**. The recovery rate is defined as the amount that the company is able to give back to its debt holders after default. When a company goes into bankruptcy and is forced to default on its debt, whatever remains in the company's assets is paid out according to the firm's capital structure. This transaction protects the portfolio from the bonds' associated credit risk without forcing the owner to sell the bonds. The hedge fund, on the other hand, receives a fee and walks away without any losses if there is no credit event.

Our example above can be described as a single-name CDS contract, in which the transfer of credit risk takes place between two parties. The protection buyer of a CDS contract transfers the credit risk to the CDS protection seller by paying a series of coupons until the contract terminates. In other words, the protection buyer is **short credit** by selling the credit risk of an underlying bond to the protection seller, who is **long credit** since she believes that the bond will meet its debt obligations. Note that there is no direct involvement of the Alcoa Inc. in the transaction; this exchange only takes place between the two counterparties.

## 4 CDS Terminology and Cash Flows

Although the cash flows involved in a CDS seem pretty simple in Figure 3.2, the underlying mechanics of a CDS are a bit more complex. To understand this, let's look at actual CDS data from Bloomberg for Alcoa Inc. Bloomberg and Markit are the two most commonly used sources for CDS related data; we will discuss these sources extensively in a later section. Figure 4 below displays many different variables such as RED Pair Code, REF Entity, Trade Date, Debt Type etc. for the CDS of Alcoa Inc. for June 02, 2014. These are standard terms of CDS contracts that were set by the **International Swaps and Derivatives Association (ISDA)**, the organization that regulates over-the-counter derivatives such as CDSs. Let's understand what these variables are and how they are important for understanding the cash flow<sup>1</sup>.



Figure 6: CDS figures from Bloomberg for Alcoa Inc. Note that this **REF Obligation** (Reference Obligation) matches the ISIN in Figure 2.1.

### 4.1 Entity-Specific Variables

Some of these variables seem self-explanatory. **REF Entity** (Reference Entity) refers to the name of the company (Alcoa Inc., in this case) that the buyer wants protection against. The **ticker** is an abbreviated reference symbol for the Reference Entity, which is "AA" for Alcoa Inc. Moreover, the **Trade Date** is the date on which we are making the trade—June 02, 2014.

<sup>1</sup>Some of the definitions come from *Credit Derivatives Glossary* (Markit, 2009), *Standard Corporate CDS Handbook* (Leeming et al., 2010), *Credit Derivatives* (Green and Witschen, 2012), and *The Pricing and Risk Management of Credit Default Swaps, with a Focus on the ISDA Model* (White, 2013).

The **RED Pair Code** is a Markit product that stands for Reference Entity Database. Each entity/seniority pair has a unique six-digit RED Pair Code that matches the first six digits of the nine-digit RED Pair Code. Each entity also has a "preferred reference obligation," which is the default reference obligation for CDS trades. A user can input either the six-digit RED Pair Code or the nine-digit RED Pair Code. The input "014B98" is the six-digit RED Pair Code for "Alcoa Inc."

We can also note the label **Debt type**, marked as "Senior." Clearly, this refers to the seniority of the debt. The **notional amount** is printed as "10" or \$10 million USD (US Dollars). The "MM" between the amount and the currency refers to the type of restructuring of the contract—in this case, "Modified Modified" Restructuring (explained further in Section 4.3). The **REF Obligation** (Reference Obligation) refers to the bond involved in the CDS. Since our portfolio manager is purchasing protection on the bonds she previously purchased, this **REF Obligation** (Reference Obligation) matches the ISIN in Figure 2.1.

**Maturity** refers to the **tenor**, or length, of the contract. The most commonly traded contracts have maturities of five years. The Bloomberg screenshot displays the length of the contract, as well as the implied maturity date. Interestingly, the maturity date for the CDS of Alcoa Inc. on June 02, 2014 is June 20, 2019. This seems odd since we would expect it to be on June 02, 2019, exactly five years from the Trade Date. However, the maturity date always falls on one of the four **roll dates**: March 20, June 20, September 20 and December 20. Therefore, the maturity date for this contract will be on the roll date after June 02, 2019, which is June 20, 2019. Also note that this contract is of the type **SNAC** or Standard North American Contract, which is a convention that specifies how North American single-name CDSs are supposed to trade. In European markets, CDSs belong to the **STEC** category, or Standard European Contract.

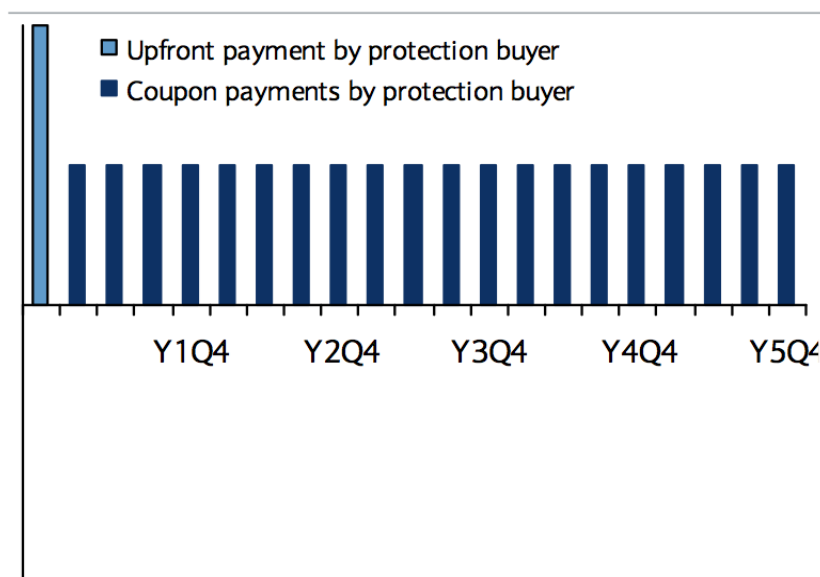
## 4.2 Premium Leg

The stream of cash flows from the protection buyer to the seller, when there is no default, is known as the **premium leg**. To understand the premium leg, we must look at the **Trade Spread** (marked as **Trd Sprd** in Figure 4) and **Coupon** in Figure 4. In section 3.2, we stated that the protection buyer pays the protection seller a fixed coupon for purchasing protection. Until 2009, the two counterparties in a CDS contract would agree on the coupon level before the trade. Then, as the market moved, this tradable coupon would vary. So if our portfolio manager was purchasing a CDS before 2009, she would have had to negotiate a fixed coupon—which would then vary as the company's credit risk varied—with the hedge fund.

In April 2009 in North America, the ISDA introduced a series of mandatory modifications to the CDS contract known as the "Big Bang Protocol". Under the new rules, coupon rates were standardized in North America in Europe from June 2009 on. Dealers now had to quote **standard coupons** of 100bps or 500bps in North America, or 25bps, 100bps, 500bps or 1000bps in Europe, and all coupons were paid quarterly on one of the four roll dates. The coupon printed in the figure above is the fixed coupon for Alcoa Inc., which is 100bps, or 1% of the notional amount. However, the dealers may not feel that this is the fair premium for protection. For instance, the hedge fund selling protection to the portfolio

manager may feel that the fair premium should be 160bps, and not 100bps. This fair premium rate is known as **trade spread** (or **par spread**, or just **spread**), labeled as 160 in the figure above.

Naturally, if the hedge fund believes that the fair premium should be 160bps, it would like to be compensated for receiving just 100bps. As a result, the portfolio manager would have to make what is known as an **Upfront Payment** at the trade inception. Therefore, in the absence of a credit event, the cash flow between the two parties, over the life of the contract, would look like Figure 4.2.



Source: Barclays Capital

Figure 7: CDS cash flows when there is no credit event.

The ISDA protocol, since April 2009, specifies that all premium payments, by default, start on the roll date before the Trade Date. So if the Trade Date is June 02, 2014, the **Accrual Begin Date** is, by default, March 20, 2014. Now if the Accrual Begin Date is 75 days before the Trade Date, the portfolio manager would not want to pay interest for the 75 days she has not received protection for.

$$\text{Accrued} = \frac{75}{360} * \frac{1}{100} * \$10000000 = \$20,833 \quad (2)$$

We must note that we are dividing 75 by 360 instead of 365 in the above calculation. This has to do with the **Day Count Convention (Day Cnt in Figure 4)** of the contract, which specifies that the accrual factor between two dates is ACT/360, or Actual/360.

If we subtract the **Accrued Interest** over the past 75 days from the upfront payment, we get the **Dirty Upfront** or **Cash Settlement Amount**. With the information for Alcoa Inc. given in the Figure 4, the dirty upfront value for this contract is \$258,478. **Clean Upfront**, on the other hand, is the dirty upfront minus any accrued interest payment, and is also called the **Principal**. In this case, it is \$27,931. Moreover, we can also note a variable called **Pts Upf** in Figure 4. This is the **Points Upfront**, or simply **points**, which is the clean upfront expressed as a percentage of the notional amount.

As we can see, the upfront and points upfront values are positive, since the spread of the CDS is

higher than the fixed coupon rate. If instead, the portfolio manager and hedge fund agree that the fair premium should be 60bps, the upfront value would be negative i.e. the hedge fund would pay the portfolio manager a compensation for receiving a coupon higher than the fair premium or spread. The cash flows would then look like the values in Figure 4.2. The clean and dirty values are now both negative.

Calculation Results		
Market Value	-117,057	
Cash Settlement	-117,061	
Accrued Days	75	
Accrued Amt	20,833.33	
Currency	USD	
Details		<a href="#">Show Cash Flows</a>
	Transformed	User
Market Value	-117,057	-117,059
Clean Price	100.96 %	100.96 %
Cash Settlement	-117,058	-117,061
Accrued Days	75	75
Accrued Amt	20,833.33	20,833.33
Credit DV01	4,849	4,849
IR DV01	25	25

Figure 8: CDS cash flows for Alcoa Inc. when spread is equal to 60bps and the coupon is equal to 100bps. These have been calculated using the calculator provided by Markit.

### 4.3 Protection Leg

So far we have only discussed the stream of payments for a contract in which a credit event does not occur. The stream of payments that would have to be made in the case of a credit event is known as the **protection leg** or **contingent leg**. If, however, there is a credit event, the cash flow would look like Figure 4.3.

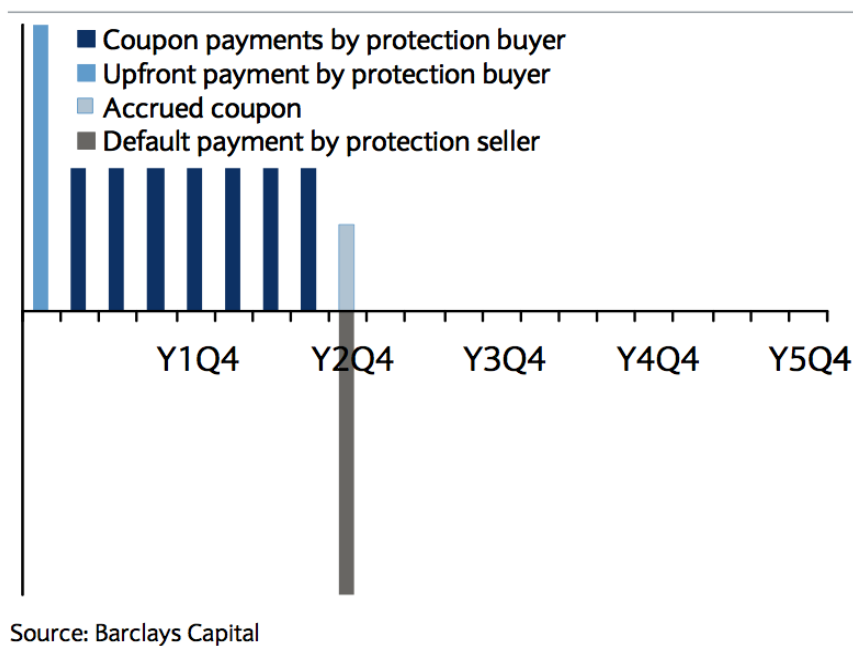


Figure 9: CDS cash flows when there is a credit event.

When a default does occur, the protection seller would owe the protection buyer the notional amount minus any money recovered from the company. It must be noted that the protection is effective for the credit events that have taken place since 60 days *before* the trade date; this date is known as **backstop date**. Before the “Big Bang” Protocol, this date used to be one day *after* the trade date. The advantage of the new system is that if there is a delay in the credit event becoming known, the two dealers have sufficient time to process the information.

### Types of Settlements in the Case of a Default

In the event of a default, there are two ways this transaction could take place. The first is a **physical settlement** where the buyer will actually deliver the defaulted bonds to seller and the seller will then pay the face value of those bonds. The disadvantage of this is that in the case of a default the buyers of protection who do not own those bonds will have to find the bonds to deliver to the seller and this may artificially drive up the price of the bonds. This is especially the case when there are a large number of outstanding CDS contract.

The alternative to physical settlements is a **cash settlement**, in which the seller simply pays the buyer the notional amount\*(1-recovery rate). Clearly, determining a recovery rate is a problem. One approach the ISDA has been using lately is an **auction** style process in which major dealers submit their bids for the value they place on a company’s debt. CDS contracts for corporate bonds generally assume a 40% recovery rate for valuation purposes.

### What Constitutes a Default?

Another problem that we face is determining what constitutes a default. A default does not have to be outright bankruptcy. Often companies **restructure** their debt instead of declaring for bankruptcy. In debt restructuring, companies basically renegotiate the terms of their debt. In some CDS contracts, restructuring does not constitute a default. In Figure fig:CDSalcoa, if we look between the notional amount and the currency, we will see a text box printed as 'MM'. This stands for 'Modified Modified' restructuring and implies that debt restructuring does constitute a default for this contract. So if Alcoa Inc. decides to restructure this specific debt, the portfolio manager will have to be paid by the hedge fund.

### Counterparty Risk

When a counterparty like the hedge fund sells protection on a bond, there is always the possibility that, in case of a default, the counterparty may not be able to pay the notional amount to the protection buyer. Or it could so happen that our portfolio manager is unable to make her periodic payments. The risk of either of these eventualities taking place is known as **counterparty risk**.

## 4.4 CDS Indices

Holding a portfolio of a disproportionate number of Alcoa Inc. bonds is naturally a risky idea. It is akin to putting all your eggs in one basket, as the saying goes. In the real world, most successful portfolio managers prefer to distribute their risk by holding a portfolio with hundreds, if not thousands, of different positions. Instead of holding a 10 million USD of Alcoa Inc. bonds, let's say our portfolio manager decides to take less risk by holding bonds of 100 different Investment Grade companies. This is known as **diversification**. Although this strategy reduces her exposure to the credit risk of any particular company, she hasn't reduced her exposure to factors that might affect a wide variety of assets simultaneously, such as interest rate risk or political risk. Fortunately, in the modern financial world, she has the option of purchasing multi-name CDSs, or CDS indices, which contain a basket of CDSs.

Moreover, if our portfolio manager has a high-risk appetite and wants to earn a higher return for her investors, she may invest a portion of her portfolio in bonds that have a lower credit rating but provide a higher yield. She may consider investing in a tranche of CDS indices known as CDX.NA.HY. These index products trade in high volumes and are very liquid.

## 5 CDS Pricing

The ISDA has created the "Standard Model," which allows market participants to calculate cash settlement from conventional spread quotations, convert between conventional spread and upfront payments, and build the spread curve of a CDS. In this section we will lay out the assumptions made

by the standard model, and explain the methods and formulas used to calculate certain information related to CDSs.

## 5.1 Mark-to-Market Calculations

Let's say our portfolio manager wants to sell her CDS contract, for whatever reasons. Finding the market value of a CDS contract, for the protection buyer, is known as **Marking-to-market (MTM)** and the value is known as the **mark-to-market** value. Theoretically, the value of this Alcoa CDS for the portfolio manager is:

$$\text{Money she is expected to receive} - \text{Money she is expected to pay.}$$

Clearly if she is expected to receive more than she expects to pay, the value of the contract will be positive. So if the fair spreads for this CDS contract rise, the market value of her CDS will increase. If Alcoa's credit risk increases and the fair spreads actually rise, she will be in a **mark-to-market profit**. If on the other hand, the credit risk and fair spreads drop, she would be in a **mark-to-market loss**.

The Standard Model assumes that the mark-to-market value is computed by discounting the expected protection leg and premium leg cashflows to the trade date. What this basically means is that the price of a CDS is the difference in the present value of the premium leg and protection leg.

## 5.2 Present Value of CDSs

In Section 2.3 we explained the concept of **present value** and how a bond's price is the present value of its future cash flows. This concept applies in the pricing of CDSs as well. If we are looking at the value of a CDS from the protection buyer's perspective, the premium leg has a negative value and the protection leg has a positive value. So it is equivalent to saying that,

$$\text{PV(CDS)} = \text{PV(Protection)} - \text{PV(Premium)}$$

Using the above equation, we can intuitively understand how the upfront value is calculated. We know that one of the central components in determining the price of a CDS is the spread. When the spread is different from the standard coupon of the contract, an upfront payment has to be made as a compensation.

This upfront value is the present value of the extra cash flows that will be made hypothetically, on top of the standard coupon payments. So if we have a five-year contract for the CDS of Alcoa Inc., in which the standard coupon is 100bps and the fair spread is 160bps, the upfront value paid by the portfolio manager to the hedge fund is the *net expected* present value of the extra 60bps payments made quarterly (15 bps per quarter) over a period of five years. When we say expected present value what we imply is that there is a chance is hypothetical payment will never have to be made, since the company might default then and the protection seller may have to make the contingent payment. We have to account for that probability in calculating the present value of those payments.



## Present Value 01 (PV01) and its determinants

In order to go into the details of how each of how we calculate the PV of the different pricing legs and arrive at the simplified equation for the present value of a CDS above, we must first understand the present value of a stream of 1 basis points, also known as **PV01**. The PV01 is used to calculate the cash flows and risk measures of a CDS. PV01 is the present value of a stream of 1 basis point payments at each CDS coupon date. It is sometimes referred to as the **CDS duration** or **risky duration**. Analytically, PV01 can be calculated by

$$PV01 = \sum_t Df(t_i)S(t_i)B(t_i),$$

- $i$  = coupon index,
- $t_i$  = coupon date,
- $B(t_i)$  = day count fraction at  $t_i$ .
- $Df(t_i)$  = discount factor until  $t_i$ ,
- $S(t_i)$  = survival probability until  $t_i$ ,

As we can see in the equation above, we need the coupon index, coupon dates, the day count fraction, discount factor for each date, and survival probability until the date of the respective coupon payment. Before go into the details of how PV01 is used in determining the market price or the risk measures, it is essential to understand the different components used to calculate it. Coupon dates refer to the dates on which coupon payments are made. Day count fraction is the fraction of the day on which the coupon payment is made upon 360 or 365, depending on the day count convention of that CDS. While the first three components of the above equation seem straightforward, the other two - survival probability and discount factor require more explanation.

**Discount factor: Using the Swap Curve or Risk-Free Curve.** The risk free rates are the discount factor used in the calculation of PV01. In calculating the price of a CDS we use the swap curve of the *previous day*, and use the rates for the corresponding currency. So for CDSs denominated in USD, we will use the US treasury rates, for those in GBP we will use UK Government bond yields and so on. If we look at Figure 2.2, we can see the yields for different treasury bonds, at 8pm UTC, June 23 2014, which will be used for pricing the CDS of Alcoa Inc.

Yield Curve		
Date 23-Jun-2014		
Snap 1600 TimeZone: New York		
Recalculate		
Period	Type	Rate
1M	Deposit	0.1520 %
2M	Deposit	0.1963 %
3M	Deposit	0.2326 %
6M	Deposit	0.3253 %
1Y	Deposit	0.5471 %
2Y	Swap	0.6190 %
3Y	Swap	1.0630 %
4Y	Swap	1.4665 %
5Y	Swap	1.7930 %
6Y	Swap	2.0570 %
7Y	Swap	2.2725 %
8Y	Swap	2.4450 %
9Y	Swap	2.5880 %
10Y	Swap	2.7110 %
12Y	Swap	2.9085 %
15Y	Swap	3.1110 %
20Y	Swap	3.2915 %
25Y	Swap	3.3710 %
30Y	Swap	3.4100 %
Interest Rate Conventions		
Spot Date: 26-Jun-2014		Swap DCC: 30/360
MM DCC: A/360		Swap Interval: 6M
Floating DCC: A/360		Holidays: none
Floating Interval: 3M		Bad Day Conv: MF

Figure 10: Risk-free rates with their day count conventions on June 23 2014, at 4pm EST. These are the rates that will be used to price the CDS of Alcoa Inc. on June 24, 2014.

The ISDA also standardizes the interest rates used by the Standard Model in valuing a CDS contract. There are two types of rates used in valuing a USD-denominated CDS contract: cash rates and swap rates. Cash rates are of the following maturities: one, two, three, and six month(s), and one year. They are provided by the British Bankers' Association (BBA). Swap rates are of maturity 2, 3, 4, 5, 6, 7, 8, 9, 10, 12, 15, 20, 25, and 30 years, and are provided by ICAP (Markit, 2013). The Standard Model follows the conventions below for interpolation of the entire USD yield curve:

- The day count convention (DCC) for money market instruments and the floating legs of the swaps is **ACT/360**.
- DCC for floating legs of the swaps is **30/360**.
- Payment frequency for fixed legs of the swaps is 6 months.
- Payment frequency for floating legs of the swaps is 3 months.<sup>2</sup>

<sup>2</sup>See <http://www.fincad.com/derivatives-resources/wiki/swap-pricing.aspx> for details on floating and fixed legs calculation.

- A business day calendar of weekdays (Monday to Friday) is assumed. Saturdays and Sundays will be the only non-business days.
- If a date falls on a non-business day, the convention used for adjusting coupon payment dates is **M** (Modified Following).
- Recovery Rate is the estimated percentage of par value that bondholders will receive after a credit event. It is commonly reported in percentage of notional value. CDS contracts for corporate bonds assume a 40% recovery rate for valuation purposes.

$$\text{CDS mark-to-market} = T - 60 \text{ Calendar Days.}$$

**Survival Probability.** The probability that the firm will default between two time periods.

### Present Value of the Net Expected Cash Flows

Now that we understand PV01 and the different components that are used to calculate it, we can understand how the present value of the protection and premium legs, and the upfront value, are calculated. The present value of the premium leg is the present value of future coupon payments. It is simply the coupon payment multiplied by the PV01

$$PV(Premium) = C * \sum_t Df(t_i)S(t_i)B(t_i),$$

The present value of the protection leg is the present value of an expected contingent payment.

$$PV(Protection) = (1 - R) * \int_0^T Df(t)dQ(t)$$

So when an upfront payment is made it implies that the present value of the protection and premium legs are not equal. In the all-running contracts before the “Big Bang Protocol”, where the coupon could be set at any level the two parties agreed to, the premium leg would naturally equal the protection leg and the present value of the contract would be zero. But when the coupon is fixed and if the fair spread is not equal to the coupon, the present values of the two legs would not be the same and an upfront payment would have to be made as compensation. We can then use the formula above for PV01 to calculate the principal amount (clean upfront payment) paid from the protection buyer to the seller using the following formula:

$$\text{Principal Amount} = PV(Protection) - PV(Premium) = (\text{Par Spread} - \text{Coupon}) \times PV01$$

The Standard Model allows market participants to convert between the par spread and the upfront payment, and compute the cash settlement amount for a standard contract.

### Price

**Price** refers to the clean dollar price of the contract. The price of this Alcoa CDS is 97.13, less than 100. A CDS will have a price less than 100 if the points upfront are positive; that is, the CDS buyer needs

to pay money to obtain protection because he promises to pay a coupon of, say, 100 even if the spread is 160. This is analogous to a bond investor paying less than the face value of a bond because current interest rates are higher than the coupon rate on the bond. It can be calculated by

$$\text{Price} = (1 - \text{Principal/Notional}) * 100$$

$$\& = 100 - \text{Points Upfront.}$$

### 5.3 Risk Measures of a Standard CDS Contract

The PV01 can be used to compute certain risk measures related to interest rates, spread and the default probability.

#### Spread DV01

Using the concept of PV01, we show the calculation of the main risks (exposures) of a CDS position, **Spread DV01**. Spread DV01 reflects the risk duration of a CDS trade, also known as **Sprd DV01**, **Credit DV01**, **Spread Delta**, and just **DV01**.

It measures the sensitivity of a CDS contract mark-to-market to a parallel shift in the term structure of the par spread. DV01 should always be positive for a protection buyer since he or she is short credit, and a rising spread is a sign of credit deterioration. Starting with PV01 and taking the derivative with respect to the spread gives us:

$$\begin{aligned} PV &= (S - C) * PV01 \\ DV01 &= \frac{\partial PV}{\partial S} \\ &= PV01 + (S - C) \frac{\partial PV01}{\partial S}, \end{aligned}$$

where  $S$  is the spread of the contract and  $C$  is the coupon. Both DV01 and PV01 are measured in dollars and are equal if the spread equals the coupon.

#### IRDV01 or Interest Rate Dollar Value 01

The **IR DV01** is the change in value of a CDS contract for a 1 bp parallel increase in the interest rate curve. IR DV01 is, typically, a much smaller dollar value than Spread DV01 because moves in overall interest rates have a much smaller effect on the value of a CDS contract than does a move in the CDS spread itself.

#### Default Probability or Probability of Default (PD)

**Default Probability** refers to the default probability which is the estimated probability of default for each maturity by a given time. It can be approximated by

$$\text{Default Prob} \approx \left[ 1 - \exp\left(\frac{rt}{1-R}\right) \right],$$

where  $r$  is the spread,  $t$  is the time to maturity, and  $R$  is the recovery rate.

## Default Exposure

"Default Expo" refers to the exposure to the default of a CDS contract based on the formula below.

$$\text{Default Exposure} = (1 - \text{Recovery Rate}) * \text{Notional} - \text{Principal}.$$

## 5.4 Risk-Neutral Pricing

## 6 Pricing Sources

Bloomberg and Markit are the most widely used sources for data related to pricing of CDSs. We compared the results from our package with results from Bloomberg and Markit. Interestingly, the results from Markit and Bloomberg were not always identical.

**CDS Reference Entity And Contract Terms**

**Alcoa Inc.** (R) Required

Trade Details

Ticker/CompanyAA (R) Red Code

Trade Date02-Jun-2014 (R) Buyer/SellerBuyer (R)

Trade Level100,000 bp (R)

CDS Contract Terms

Maturity Date20-Jun-2019 (R) Running Cpn100 bps (R)

Notional (MM)10 (R) TierSNRFOR (R)

CurrencyUSD (R) Recovery Rate40 % (R)

Counterparty RestructuringXR

Advanced Terms

Cash Settlement3 Roll CodeF

Holiday Codenone Day Count ConvA/360

Payment Freq3M Step In Date03-Jun-2014

Calculate Clear All

E-mail Results Send

**Please note:**  
All cash flows and default probabilities correspond to the trade level and trade maturity.  
Maturities correspond to: IMM dates

**Credit Curve**

Transform MethodProportional

Maturity	Markit EOD	Transformed	Default Prob
6M		100,000 bps	1.4749 %
1Y		100,000 bps	2.7916 %
2Y		100,000 bps	5.3865 %
3Y		100,000 bps	7.9053 %
4Y		100,000 bps	10.3570 %
5Y		100,000 bps	12.7435 %
7Y		100,000 bps	17.3336 %
10Y		100,000 bps	23.7672 %
15Y		100,000 bps	33.3934 %
20Y		100,000 bps	41.8040 %
30Y		100,000 bps	55.5765 %

Recalculate

**Calculation Results**

Market Value	258,463
Cash Settlement	258,478
Accrued Days	75
Accrued Amt	20,833.33
Currency	USD

Details Show Cash Flows

	Transformed	User
Market Value	258,463	258,475
Clean Price	97.21 %	97.21 %
Cash Settlement	258,466	258,478
Accrued Days	75	75
Accrued Amt	20,833.33	20,833.33
Credit DV01	4,539	4,539
IR DV01	-71	-71

Figure 11: CDS figures from Markit.com



Figure 12: CDS figures from Bloomberg

The interest rate results were identical, at least until the fourth decimal place.

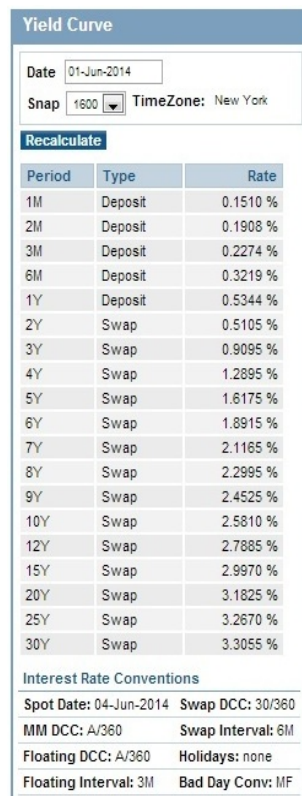


Figure 13: Interest Rate figures from Markit.com

Benchmark		S260 (USD ISDA Standard Curve - Mid)	
Date		06/02/2014	
Term	Rate	Term	Rate
1 Month	0.1510	12 Year	2.7885
2 Month	0.1908	15 Year	2.9970
3 Month	0.2274	20 Year	3.1825
6 Month	0.3219	25 Year	3.2670
12 Month	0.5344	30 Year	3.3055
2 Year	0.5105		
3 Year	0.9095		
4 Year	1.2895		
5 Year	1.6175		
6 Year	1.8915		
7 Year	2.1165		
8 Year	2.2995		
9 Year	2.4525		
10 Year	2.5810		

Figure 14: Interest Rate figures from Bloomberg

## 7 Using the CDS package

In this section, we will demonstrate the use of the **CDS** package in detail and provide a series of examples. The **CDS** package implements the Standard Model, allowing users to value credit default swaps and calculate various risk measures associated with these instruments. Currently, a market participant can conduct CDS-related calculations by using the **CDSW Calculator** on a Bloomberg Terminal or the Markit CDS Calculator<sup>3</sup>. The **CDS** package provides tools for valuing a single-name CDS contract. The default setting allows a user to value a USD-denominated CDS contract following the Standard Model as mentioned before. She can also specify her own set of parameters to customize the calculation.

### 7.1 CDS Class

In the **CDS** package, we call the function `CDS` to construct an object of a class `CDS`. Below we show an example of how to construct a CDS contract in the package.

```
> library(CDS)
> cds1 <- CDS(entityName = "Alcoa Inc.",
+             RED = "49EB20",
+             TDate = "2014-06-24",
+             tenor = "5Y",
+             notional = 1e7,
+             coupon = 100,
+             parSpread = 160)
```

Here the user enters the CDS contract with "Alcoa Inc." as the underlying entity and sets the spread at 160 bps and the coupon at 100 bps. However, the valuation of a CDS contract requires neither the Reference Entity or the RED Code. She does not have to know that information to use the **CDS** package. As shown below, as long as she inputs the same Trade Date, parSpread, and maturity information, the valuation of the contract will be the same.

Besides parSpread, a market participant can choose to specify either `ptsUpfront` or `upfront` to construct a CDS class object.<sup>4</sup> One of the three arguments has to be specified in order to construct the CDS class object.

#### Default Settings of the CDS Contract

The default settings of valuing a CDS contract in the **CDS** package follow the Standard North American Corporate (SNAC) CDS Contract specifications.<sup>5</sup> Below we list the ISDA specifications implemented in the **CDS** package. Additional default settings in the package which are not specified by the Standard Model, such as the default notional amount, are also listed.

- Currency: USD.

---

<sup>3</sup>The Markit CDS Calculator is available at <http://www.markit.com/markit.jsp?jspage=pv.jsp>.

<sup>4</sup>See Section 4.2 for definitions on both terms.

<sup>5</sup>See <http://www.cdsmodel.com/assets/cds-model/docs/Standard%20CDS%20Contract%20Specification.pdf> for details.



- Trade Date (T): the current business day.
- CDS Date: Mar/Jun/Sep/Dec 20th of a year.
- Maturity: five years.
- Maturity Date (End Date): It falls on a CDS date without adjustment.
- Coupon Rate: 100 bps.
- Notional Amount (MM): 10MM.
- Recovery Rate (%): 40% for senior debts.
- Premium Leg:
  - Payment Frequency: quarterly
  - DCC: ACT/360
  - Pay Accrued On Default: It determines whether accrued interest is paid on a default. If a company defaults between payment dates, there is a certain amount of accrued payment that is owed to the protection seller. "True" means that this accrued will need to be paid by the protection buyer, "False" otherwise. The default is "True,"
  - Adjusted CDS Dates: "F." It means that it assumes the next available business day when a CDS date falls on a non-business day except the maturity date.
  - First Coupon Payment: It is the earliest Adjusted CDS Date after T + 1.
  - Accrual Begin Date (Start Date): It is the latest Adjusted CDS Date on or before T + 1.
  - Accrual Period: It is from previous accrual date (inclusive) to the next accrual date (exclusive), except for the last accrual period where the accrual end date (Maturity Date) is included.
- Protection Leg:
  - Protection Effective Date (Backdrop Date): T - 60 calendar days for credit events.
  - Protection Maturity Date: Maturity Date.
  - Protection Payoff: Par minus Recovery.

## 7.2 Generic Methods

### summary Method

A user can call `summary` on a `cds1` to view essential information on the contract.

```
> summary(cds1)
```

Contract Type:	SNAC	TDate:	2014-06-24
Entity Name:	Alcoa Inc.	RED:	49EB20
Currency:	USD	End Date:	2019-09-20
Spread:	160	Coupon:	100
Upfront:	286,048	Spread DV01:	4,667
IR DV01:	-75.63	Rec Risk (1 pct):	-330.15

In the summary output, it shows that the type of the CDS contract is "SNAC". Trade Date refers to the trade date and is April 15, 2014. Reference Entity (called `entityName` in the package) refers to the entity name of the CDS contract and is "Alcoa Inc.". The RED code is "48EB20" as specified by the user. spread shows that the quoted spread for the contract is 50 bps and the coupon is 100 bps as shown in the coupon field. upfront indicates the dirty upfront payment in dollars or the cash settlement amount.

The remaining three items from the summary output are Spread DV01, IR DV01, and Rec Risk (1 pct). In `cds1`, the IR DV01 is \$66.14. **Recovery Risk 01** or Rec Risk (1 pct) as shown in the summary output, is the dollar value change in market value if the recovery rate used in the CDS valuation were increased by 1%. It is \$90.03 in `cds1`.

Besides calling the `summary` method, one can type in the name of the CDS class object in the current R Session and obtain a full description of the CDS contract.

### update method

A market participant can also update the CDS class objects she has constructed by calling the `update` method. It updates a CDS class object with a new spread and points upfront by specifying the relevant input.

```
> cds3 <- update(cds1, spread = 55)
```

`cds3` is a new CDS class object with a spread of 55 bps; all other specifications of the contract are the same as those in `cds1` since it is updated from `cds1`. One can also specify upfront (in dollar amount) or `ptsUpfront` (in bps) in the `update` method.

There are three parts of the output. The first part "CDS Contract" provides basic information on the contract including "Contract Type", "Currency", "Reference Name" (called Entity Name in the package), "RED", "Trade Date", various dates related to the contract, and the day count conventions for `cds3`. The last part of the output reports the interest rates used in the calculation. The second part of the output contains relevant risks measures of `cds3`. Calling the function `getRates` also produces the rates used in building a curve for CDS valuation.

### show method

```
> cds1
```

CDS Contract

Contract Type:	SNAC	Currency:	USD
----------------	------	-----------	-----

Entity Name:	Alcoa Inc.	RED:	49EB20
TDate:	2014-06-24	End Date:	2019-09-20
Start Date:	2014-06-20	Backstop Date:	2014-04-25
1st Coupon:	2014-09-20	Pen Coupon:	2019-06-20
Day Cnt:	ACT/360	Freq:	Q

#### Calculation

Value Date:	2014-06-27	Price:	97.13
Spread:	160	Pts Upfront:	0.0287
Principal:	287,436	Spread DV01:	4,667
Accrual:	-1,389	IR DV01:	-75.63
Upfront:	286,048	Rec Risk (1 pct):	-330.15
Default Prob:	0.1322	Default Expo:	5,712,564

Credit curve effective of 2014-06-24

Term	Rate	Term	Rate
1M	0.001520	7Y	0.022725
2M	0.001963	8Y	0.024450
3M	0.002326	9Y	0.025880
6M	0.003253	10Y	0.027110
1Y	0.005471	12Y	0.029085
2Y	0.006190	15Y	0.031110
3Y	0.010630	20Y	0.032915
4Y	0.014665	25Y	0.033710
5Y	0.017930	30Y	0.034100
6Y	0.020570		

## 7.3 CDS Pricing Related Functions

### CS 10

CS10 is a method which calculates the change in value of the CDS contract when the spread of the contract increases by 10%. CS10 takes in a CDS class object formed by calling the CDS function. The CS10 of cds1 is \$25385.2.

```
> cds1.CS10 <- CS10(cds1)
> cds1.CS10
[1] 74191.79
```

### getRates function

```
> cds3Rates <- getRates(date = "2014-06-24")
```

The output from the `getRates` function below consists of two list objects. The first list contains rates of various maturities. They are directly obtained from the Markit website based on the specifications (Markit, 2013).

	expiry	matureDate	rate	type
1	1M	2014-07-28	0.00152	M
2	2M	2014-08-26	0.001963	M
3	3M	2014-09-26	0.002326	M
4	6M	2014-12-26	0.003253	M
5	1Y	2015-06-26	0.005471	M
6	2Y	2016-06-26	0.00619	S
7	3Y	2017-06-26	0.01063	S
8	4Y	2018-06-26	0.014665	S
9	5Y	2019-06-26	0.01793	S
10	6Y	2020-06-26	0.02057	S
11	7Y	2021-06-26	0.022725	S
12	8Y	2022-06-26	0.02445	S
13	9Y	2023-06-26	0.02588	S
14	10Y	2024-06-26	0.02711	S
15	12Y	2026-06-26	0.029085	S
16	15Y	2029-06-26	0.03111	S
17	20Y	2034-06-26	0.032915	S
18	25Y	2039-06-26	0.03371	S
19	30Y	2044-06-26	0.0341	S

The second list reports the specific day count conventions and payment frequencies regarding the interest rate curve used.

	text
effectiveDate	"2014-06-24"
badDayConvention	"M"
mmDCC	"ACT/360"
mmCalendars	"none"
fixedDCC	"30/360"
floatDCC	"ACT/360"
fixedFreq	"6M"
floatFreq	"3M"
swapCalendars	"none"

## 7.4 Risk-related Functions

`recRisk01`

`IRDV01`

`spreadDV01`

`defaultExpo`

`defaultProb`

`impliedRecoveryRate`

## 8 Conclusion

In this paper, we describe the basics of a CDS contract and the ISDA Standard Model. We also provide a simple collection of tools to implement the Standard Model in **R** with the CDS package. Moreover, the flexibility of **R** itself allows users to extend and modify this package to suit their own needs and/or create their preferred models for valuing CDS contracts. An **R** package, `backtest` Campbell et al. (2007), provides facilities to explore portfolio-based conjectures about credit default swaps. It is possible to use the `backtest` package based on the output from the CDS package. Before reaching that level of complexity, however, CDS provides a good starting point for valuing credit default swaps.

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