

CQF 2009
Module 5.2
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Reduced Form Models

In this lecture:

- Modeling default by Poisson Process
- Derivation of pricing PDE for a risky bond
- Fundamental pricing formula for general contingent claims subject to default risk
- Affine intensity models

By the end of this lecture, you will be able to:

- Understand what are reduced form (intensity based) models
- Its pros and cons relative to structural model
- Derive risky bond pricing equation when both interest rate and hazard rate (intensity) are stochastic
- Solve simple affine intensity models

Introduction	4
A simple model for default event	5
Definition of Poisson Process	6
Distribution of function $N(sub) t$	8
Construction of Poisson Process	9
Poisson Plot	10
Distribution of Tau	11
Definition of Intensity	12
Finding distribution of Tau	13
Simulating Poisson Process	14
Inhomogeneous Poisson Process	15
Cox Process	16
(Chart)	17
Plan for risky bond pricing model	18
Risky bond with constant hazard rate	19
Hedging interest rate risk	20
No default occurs	21
Default occurs	22
Bond pricing PDE	23
Feynman-Kac: 1 st call	24
Yield Spread	25
Forward Spread	26
Implied default probability: no recovery	27
PD chart	28
To find the risky bond value	29
Stochastic risk of default	30
Hedging default intensity	31
Hedged portfolio	32
No default	33
If defaults	36
Feynman-Kac: 2 nd call	37

Positive recovery	38
Feynman-Kac: 3 rd call	40
Affine intensity model	41
Example: Vasicek intensity model	44
Modified Vasicek	45
Solution for risky bond price	46
Compare to structural approach	47

Summary:

- Poisson process can be used to model default if intensity is constant
- Stochastic default intensity leads us to higher dimension bond pricing PDE
- Risky bond pricing PDE is consistent with fundamental pricing formula by Feynman-Kac
- Reduced form models can be tractable in affine term structure model