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management; 1.1.1 Market risk; 1.1.2 Liquidity risk; 1.1.3 Operational risk; 1.1.4 Credit risk; 1.1.5 Value-at-risk; 1.1.6 Disadvantages of value-at-risk; 1.2 The failure of models; 1.2.1 Why models?; 1.2.2 Good model, bad model; 1.3 The derivatives market; 1.3.1 What is a derivative?; 1.3.2 Market structure; 1.4 Risks of derivatives; 1.4.1 Too big to fail; 1.4.2 Systemic risk; 1.4.3 Compensation culture; 1.4.4 Credit derivatives; 1.5 Counterparty risk in context; 1.5.1 What is counterparty risk?; 1.5.2 Mitigation of counterparty risk; 1.5.3 Counterparty risk and integration of risk types; 1.5.4 Counterparty risk and today's derivatives market; 2 Defining Counterparty Credit Risk; 2.1 Introducing counterparty risk; 2.1.1 Origins of counterparty risk; 2.1.2 Repos; 2.1.3 Exchange-traded derivatives; 2.1.4 OTC derivatives; 2.1.5 Counterparty risk; 2.1.6 Counterparty risk versus lending risk; 2.1.7 Mitigating counterparty risk; 2.1.8 Counterparty risk players; 2.2 Components and terminology; 2.2.1 Credit exposure; 2.2.2 Default probability and credit migration; 2.2.3 Recovery; 2.2.4 Mark-to-market; 2.2.5 Replacement cost; 2.2.6 Exposure; 2.2.7 Exposure as a short option position; 2.2.8 Potential future exposure (PFE); 2.3 Controlling counterparty credit risk; 2.3.1 Trading with high-quality counterparties; 2.3.2 Cross-product netting; 2.3.3 Close-out; 2.3.4 Collateralisation; 2.3.5 Walkaway features; 2.3.6 Monolines; 2.3.7 Diversification of counterparty risk; 2.3.8 Exchanges and centralised clearing houses; 2.4 Quantifying counterparty risk; 2.4.1 Credit lines; 2.4.2 Pricing counterparty risk; 2.4.3 Hedging counterparty risk; 2.4.4 Capital requirements and counterparty risk; 2.5 Metrics for credit exposure; 2.5.1 Expected MtM; 2.5.2 Expected exposure; 2.5.3 Potential future exposure; 2.5.4 EE and PFE for a normal distribution; 2.5.5 Overview of exposure metrics; 2.5.6 Expected positive exposure; 2.5.7 Effective EPE; 2.5.8 Maximum PFE; 2.6 Summary; Appendix 2.A Characterising exposure for a normal distribution; 3 Mitigating Counterparty Credit Risk; 3.1 Introduction; 3.1.1 Two-way or one-way agreements; 3.1.2 Standardisation; 3.2 Default-remote entities; 3.2.1 High-quality counterparties; 3.2.2 Special purpose vehicles; 3.2.3 Central counterparties; 3.3 Termination and walkaway features; 3.3.1 Termination events; 3.3.2 Additional termination events; 3.3.3 Walkaway features; 3.4 Netting and close-out; 3.4.1 Close-out; 3.4.2 Payment and close-out netting; 3.4.3 The need for close-out netting; 3.4.4 The birth of netting; 3.4.5 Netting agreements; 3.4.6 The ISDA Master Agreement; 3.4.7 Product coverage; 3.4.8 Netting and exposure; 3.4.9 Advantages and disadvantages of netting; 3.4.10 Multilateral netting; 3.5 Netting and exposure

Sommario/riassunto

The first decade of the 21st Century has been disastrous for financial institutions, derivatives and risk management. Counterparty credit risk has become the key element of financial risk management, highlighted by the bankruptcy of the investment bank Lehman Brothers and failure of other high profile institutions such as Bear Sterns, AIG, Fannie Mae and Freddie Mac. The sudden realisation of extensive counterparty risks has severely compromised the health of global financial markets. Counterparty risk is now a key problem for all financial institutions. This book explains the emergence of c
