Pricing constant maturity credit default swaps under jumo dynamics

Citation for published version (APA):

Document status and date:
Published: 01/01/2009

Document Version:
Publisher’s PDF, also known as Version of Record (includes final page, issue and volume numbers)

Please check the document version of this publication:
• A submitted manuscript is the version of the article upon submission and before peer-review. There can be important differences between the submitted version and the official published version of record. People interested in the research are advised to contact the author for the final version of the publication, or visit the DOI to the publisher’s website.
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Pricing Constant Maturity Credit Default Swaps
Under Jump Dynamics

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February 10, 2009

First version: December 15, 2007

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Abstract

In this paper we discuss the pricing of Constant Maturity Credit Default Swaps (CMCDS) under single sided jump models. The CMCDS offers default protection in exchange for a floating premium which is periodically reset and indexed to the market spread on a CDS with constant maturity tenor written on the same reference name. By setting up a firm value model based on single sided Lévy models we can generate dynamic spreads for the reference CDS. The valuation of the CMCDS can then easily be done by Monte Carlo simulation.

Keywords: Single sided Levy processes; Structural models; Credit risk; Default probability; Constant Maturity Credit Default Swaps; Monte Carlo methods

JEL subject category: C02, C15, C63, G12
1 Introduction

Constant Maturity Credit Default Swaps (CMCDS) are similar to the common Credit Default Swaps (CDS), offering the investor protection in exchange of a periodically paid spread. In contrast to the CDS spread, which is fixed throughout the maturity of the CDS, the spread of a CMCDS is floating and is indexed to a reference CDS with a fixed time to maturity at reset dates. The floating spread is proportional to the constant maturity CDS market spread. The maturity of the CMCDS and of the reference CDS does not have to be the same.

The aim of this paper is to present a Monte Carlo method for estimating the participation rate based on single sided Lévy models. We set up a firm's value model where the value is driven by the exponential of a Lévy process with positive drift and only negative jumps. These single sided firm’s value models allow us to calculate the default probabilities fast by a double Laplace inversion technique presented in Rogers (2000) and Madan and Schoutens (2008). The fast calculation of the default probabilities implies a fast calculation of CDS values which is important for calibration. The models' ability to calibrate on a CDS term structure has already been proven in Madan and Schoutens (2008). Based on the single sided firm’s value models Jönsson and Schoutens (2009) present how a dynamic spread generator can be set up that allows pricing of exotic options on single name CDS by Monte Carlo simulations.

The paper is organized as follows. In the following section we present the mechanics and valuation of Constant Maturity Credit Default Swaps. In Section 3 the single sided firm’s value model is introduced. The Monte Carlo algorithm and numerical results are given in Section 4. The paper ends with conclusions.

2 Constant Maturity Credit Default Swaps

2.1 The Mechanics of CMCDS

A single name Constant Maturity Credit Default Swap (CMCDS) has the same features as a standard single name CDS. It offers the protection buyer protection against loss at the event of a default of the reference credit in exchange for a periodically paid spread. The difference is that the spread paid is reset at pre-specified reset dates. At each reset date the CMCDS spread is set to a reference CDS market spread times a multiplier, the so called participation rate. The reference CDS has a constant maturity which is not necessarily the same as the
maturity of the CMCDS.

2.2 Valuation

We want to value a CMCDS with maturity $\hat{T}$ and $M$ reset dates $0 = t_0 < t_1 < t_2 < ... < t_{M-1} < \hat{T}$ with a reference CDS with constant maturity tenor $T$. To value the CMCDS is to find the participation rate, i.e. the factor we should multiply the reference spread of the CDS by. Just as for the CDS we equate the present value of the loss leg and the payment leg. However, the loss leg of the CMCDS and the loss leg of a CDS written on the same reference name and with the same maturity $\hat{T}$ are identical. This implies that the premium legs of the two contracts must be the same.

Denote by $\tau$ the default time of the reference credit.

We will assume that the spot rate $r = \{r_t, t \geq 0\}$ is deterministic. The riskless discount factor will be denoted $d(t_0, t) = \exp\left(-\int_{t_0}^{t} r_s ds\right)$. We will denote by $\mathbb{Q}$ the risk-neutral measure corresponding to the riskless discount factor.

Let $D(t_0, t_m)$ denote the time $t_0$ (pre-default) value of a defaultable zero-coupon bond with maturity $t_m$ and zero recovery in default, that is,

$$D(t_0, t_m) = \mathbb{E}_{\mathbb{Q}}[d(t_0, t_m)1(\tau > t_m)] = d(t_0, t_m)P_{\mathbb{Q}}(\tau > t_m)$$

under the risk-neutral measure $\mathbb{Q}$.

Assuming a constant recovery rate $R$ the fair (continuously paid) spread of the reference CDS with constant maturity tenor $T$ at time $t$ is

$$S(t, t + T) = \frac{(1 - R) \left(-\int_{t}^{t+T} d(t_0, t + s)dP_{\mathbb{Q}}(\tau > t + s|\tau > t)\right)}{\int_{t}^{t+T} d(t, t + s)P_{\mathbb{Q}}(\tau > t + s|\tau > t)ds}, \quad (1)$$

where $d(t, t + s) = \exp\left(-\int_{t}^{t+s} r_s du\right)$ and the probability of no default before time $t + s$, $s \geq 0$, given that there was no default before time $t$, that is, the probability that the firm survives at least to time $t + s$ given that it survived until $t$, is denoted by $P_{\mathbb{Q}}(\tau > t + s|\tau > t)$.

The value of the payment at time $t_{m+1}$ is based on the floating spread reset at $t_m$, that is, for $m = 0, 1, \ldots, M - 1$,

$$Z_{m+1}(t_{m+1}) = \Delta(t_m, t_{m+1})S(t_m, t_m + T)1(\tau > t_{m+1}),$$
with $t_M = \hat{T}$ and where $Z_{m+1}(t_{m+1})$ is the time $t_{m+1}$ value of the payment scheduled for $t_{m+1}$, $\Delta(t_m, t_{m+1})$ is the length of the period over which the spread is payed, expressed in the appropriate day-count convention, $S(t_m, t_m + T)$ the market spread of the reference CDS at time $t_m$, $\tau$ is the default time and $1(\tau > t_{m+1})$ is the survival indicator until time $t_{m+1}$. We have omitted any premium accrued for ease of presentation throughout the text.

The $t_0$-value of the premium payment scheduled for $t_{m+1}$ is under the risk-neutral measure $Q$

$$Z_{m+1}(t_0) = d(t_0, t_{m+1})\Delta(t_m, t_{m+1})\mathbb{E}_Q[S(t_m, t_m + T)1(\tau > t_{m+1})],$$

for $m = 0, 1, \ldots, M - 1$.

A second choice as numeraire is the defaultable zero-coupon bond with maturity $t_{m+1}$. Using $D(t_0, t_{m+1})$ as the numeraire we can express the $t_0$-value of the payment scheduled for $t_{m+1}$ as

$$Z_{m+1}(t_0) = D(t_0, t_{m+1})\Delta(t_m, t_{m+1})\mathbb{E}_{Q_{m+1}}[S(t_m, t_m + T)],$$

for $m = 0, 1, \ldots, M - 1$, where the expectation is taken with respect to the risk-neutral probability measure $Q_{m+1}$ corresponding to the chosen numeraire. The measure $Q_{m+1}$ is called the $t_{m+1}$-survival measure (see, e.g., Schönbucher (2000)). We present a more detailed discussion on this in the Appendix.

What is of interest to us is that the following equality holds in our setting

$$\mathbb{E}_{Q_{m+1}}[S(t_m, t_m + T)] = \frac{\mathbb{E}_Q[S(t_m, t_m + T)1(\tau > t_{m+1})]}{P_Q(\tau > t_{m+1})},$$

which we will use in the Monte Carlo simulation.

The $t_0$-value of the floating premium leg is thus

$$\text{FL}(t_0, \hat{T}, T) = \sum_{m=0}^{M-1} D(t_0, t_{m+1})\Delta(t_m, t_{m+1})\mathbb{E}_{Q_{m+1}}[S(t_m, t_m + T)], \quad (2)$$

with $t_M = \hat{T}$.

As mentioned before, the values at the valuation date $t_0$ of the fee leg of the CMCDS and the fee leg of a CDS written on the same reference name and with the same maturity $\hat{T}$ must be equal. Hence we should find a participation rate $p(t_0, \hat{T}, T)$ such that the fee leg of the CMCDS equals the fee leg of a CDS.
written on the same reference name with maturity $\hat{T}$ at time $t_0$, that is

$$p(t_0, \hat{T}, T)FL(t_0, \hat{T}, T) = S(t_0, \hat{T})PV01(t_0, \hat{T}),$$

(3)

where PV01$(t_0, \hat{T})$ is the time $t_0$ risky annuity of a CDS with the same maturity and written on the same reference credit as the CMCDS, that is, the $t_0$-value of the premium leg assuming a premium of 1 basis point

$$PV01(t_0, \hat{T}) = \int_{t_0}^{\hat{T}} \exp \left( -\int_{t_0}^{s} r_u du \right) P_Q(\tau > s) ds.$$

Thus, from (3) we have that the participation rate is

$$p(t_0, \hat{T}, T) = \frac{S(t_0, \hat{T})PV01(t_0, \hat{T})}{\sum_{m=0}^{M-1} D(t_0, t_{m+1})\Delta(t_m, t_{m+1})E_{Q_{m+1}}[S(t_m, t_m + T)]}. \quad (4)$$

2.3 Caps and Floors

A natural extension of the floating premium CMCDS is to incorporate a cap. Following Pedersen and Sen (2004) we will assume that the cap acts directly on the reset spread. The cap is a portfolio of caplets. A caplet is a European call option and is used to limit the spread paid.

Denote by $K_C$ the spread cap. The $t_0$-value of the caplet applicable at time $t_{m+1}$, ignoring premium accrual on default, is

$$C_{m+1}(t_0) = D(t_0, t_{m+1})\Delta(t_m, t_{m+1})E_{Q_{m+1}}[(S(t_m, t_m + T) - K_C)^+]$$

where $x^+ := \max\{x, 0\}$.

The $t_0$-value of the cap is the sum of the $t_0$-values of the caplets

$$C(t_0) = \sum_{m=0}^{M-1} C_{m+1}(t_0).$$

Similarly, with $K_F$ denoting the spread floor, the $t_0$-value of the floorlet at the reset date $t_{m+1}$ is

$$F_{m+1}(t_0) = D(t_0, t_{m+1})\Delta(t_m, t_{m+1})E_{Q_{m+1}}[(K_F - S(t_m, t_m + T))^+]$$

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and $t_0$-value of the floor, that is, the portfolio of floorlets,

$$F(t_0) = \sum_{m=0}^{M-1} F_{m+1}(t_0).$$

### 2.4 Mark-to-Market

The mark-to-market of a CMCDS is done by comparing the present value of the contract floating fee leg with the market value of the protection leg. The value of the protection leg at a time $t$, $t_0 \leq t \leq \hat{T}$, is $S(t, \hat{T})PV01(t, \hat{T})$. The value of the floating fee leg is $p(t_0, \hat{T}, T)FL(t, \hat{T}, T)$. The mark-to-market for the protection seller is thus

$$\text{MTM}_{\text{CMCDS}}(t) = \left( \frac{p(t_0, \hat{T}, T)}{p(t, \hat{T}, T)} - 1 \right) S(t, \hat{T})PV01(t, \hat{T}),$$

since the floating fee leg at time $t$ is equal to the protection leg at time $t$ divided by the participation rate at $t$, i.e., $FL(t, \hat{T}, T) = S(t, \hat{T})PV01(t, \hat{T})/p(t, \hat{T}, T)$.

The mark-to-market of a standard CDS with maturity $\hat{T}$ is for the protection seller

$$\text{MTM}_{\text{CDS}}(t) = \left( S(t_0, \hat{T}) - S(t, \hat{T}) \right) PV01(t, \hat{T}).$$

### 2.5 Valuation Using Forward Spreads and Convexity Adjustment

A first approximation to the value of the floating fee leg is to approximate the expected market spread at the reset dates with the forward spread at time $t_0$. The forward spread is the fair spread for a forward starting CDS. Denote by $S(t_0, t, t + T)$ the forward spread at time $t_0$ of a CDS starting at time $t$ with maturity $t + T$. Its value is given by

$$S(t_0, t, t + T) = \frac{S(t_0, t + T)PV01(t_0, t + T) - S(t_0, t)PV01(t_0, t)}{PV01(t_0, t + T) - PV01(t_0, t)}.$$

Substituting the expected spreads in (2) with the forward spreads the $t_0$-value of the fee leg is approximated by

$$FL(t_0, \hat{T}, T) \approx \sum_{m=0}^{M-1} D(t_0, t_{m+1}) \Delta(t_m, t_{m+1}) S(t_0, t_m, t_m + T),$$

(5)
where \( S(t_0, t_0, t_0 + T) = S(t_0, t_0 + T) \).

We need however to adjust this approximation since the realized spread at the reset dates are not equal to the forward spreads calculated at the valuation date \( t_0 \). The adjustment that has to be added to the fee leg is called the *convexity adjustment* and is given by

\[
A(t_0, \hat{T}, T) = \sum_{m=1}^{M-1} D(t_0, t_{m+1}) \Delta(t_m, t_{m+1}) A(t_m, t_m + T),
\]

where for \( m = 1, \ldots, M - 1 \)

\[
A(t_m, t_m + T) = \mathbb{E}_{Q_m+1}[S(t_m, t_m + T)] - S(t_0, t_m, t_m + T).
\]

### 3 Single Sided Firm’s Value Model

Lévy models have proven their usefulness in financial modelling, such as in equity and fixed income settings, over the last decade, see e.g. Schoutens (2003), and has recently gained growing interest in credit risk modelling, see e.g. Cariboni (2007) and Cariboni and Schoutens (2007).

We will in this section set up the single sided firm’s value model presented in Madan and Schoutens (2008). We thus model the value of the reference entity of a CDS by exponential Lévy driven models with positive drift and only negative jumps. Following the same methodology as Black and Cox (1976) default is triggered the first time the firm’s value is crossing a low barrier. The models were used to construct spread dynamics to price exotic credit default swaptions in Jönsson and Schoutens (2009).

#### 3.1 Single Sided Lévy Processes

We first introduce some notation. Let \( Y = \{Y_t, t \geq 0\} \) be a pure jump Lévy process that has only negative jumps, that is, \( Y \) is spectrally negative, and let \( X = \{X_t, t \geq 0\} \) be given by

\[
X_t = \mu t + Y_t, \quad t \geq 0,
\]

where \( \mu \) is a positive real number.
The Laplace transform of $X_t$

$$E[\exp(zX_t)] = \exp(t\psi_X(z)),$$

where $\psi_X(z)$ is the Lévy exponent, which by the Lévy-Khintchin representation has the form

$$\psi_X(z) = \mu z + \int_{-\infty}^{0} (e^{zx} - 1 + z(|x| \wedge 1))\nu(dx).$$

The Lévy measure $\nu(dx)$ satisfies the integrability condition

$$\int_{-\infty}^{0} (|x| \wedge 1)\nu(dx) < \infty.$$

For the processes we consider in this paper the Lévy measure has a density and we can write $\nu(dx) = m(x)dx$, where $m(x)$ is the density function. For the general theory of Lévy processes see, for example, Bertoin (1996) and Sato (2000).

### 3.2 Firm’s Value Model

Let $X = \{X_t, t \geq 0\}$ be a pure jump Lévy process. The risk neutral value of the firm at time $t$ is then

$$V_t = V_0 \exp(X_t), \quad t \geq 0,$$

and we work under an admissible pricing measure $Q$.

For a given recovery rate $R$ default occurs the first time the firm’s value is below the value $RV_0$. That is, the time of default is defined as

$$\tau := \inf\{t \geq 0 : V_t \leq RV_0\}.$$

Let us denote by $P(t) := P_Q(\tau > t)$ the risk-neutral *survival probability*
between 0 and $t$:

$$P(t) = P_Q \left( \min_{0 \leq s \leq t} X_s > \log R, \text{for all } 0 \leq s \leq t \right)$$

$$= P_Q \left( \min_{0 \leq s \leq t} X_s > \log R \right)$$

$$= \mathbb{E}_Q \left[ 1 \left( \min_{0 \leq s \leq t} X_s > \log R \right) \right]$$

$$= \mathbb{E}_Q \left[ 1 \left( \min_{0 \leq s \leq t} V_s > RV_0 \right) \right]$$

where we used the indicator function $1(A)$, which is equal to 1 if the event $A$ is true and zero otherwise; the subindex $Q$ refers to the fact that we are working in a risk-neutral setting.

As can be seen in (1) and (4) the price of the CDS and the participation rate of the CMCDS, respectively, depends on the survival probability, or non-default probability, of the firm. In our case, where we work under single sided Lévy models with positive drift and only negative jumps, the default probabilities can be calculated by a double Laplace inversion based on the Wiener-Hopf factorization as presented in Madan and Schoutens (2008).

### 3.3 Example - The Shifted Gamma-Model

Three well known examples of single sided jump models with positive drift were presented in Madan and Schoutens (2008), namely: the Shifted Gamma, the Shifted Inverse Gaussian and the Shifted CMY model. We present here in detail only the Shifted Gamma model.

The density function of the Gamma distribution $\text{Gamma}(a, b)$ with parameters $a > 0$ and $b > 0$ is given by

$$f_{\text{Gamma}}(x; a, b) = \frac{b^a}{\Gamma(a)} x^{a-1} \exp(-xb), \quad x > 0.$$  

The characteristic function is given by

$$\phi_{\text{Gamma}}(u; a, b) = (1 - iu/b)^{-a}, \quad u \in \mathbb{R}.$$  

Clearly, this characteristic function is infinitely divisible. The Gamma-process $G = \{G_t, t \geq 0\}$ with parameters $a,b > 0$ is defined as the stochastic process which starts at zero and has stationary, independent Gamma-distributed
increments. More precisely, the time enters in the first parameter: $G_t$ follows a Gamma$(a, b)$ distribution.

The Lévy density of the Gamma process is given by

$$m(x) = a \exp(-bx)x^{-1}, \quad x > 0.$$  

The properties of the Gamma$(a, b)$ distribution given in Table 1 can easily be derived from the characteristic function.

<table>
<thead>
<tr>
<th></th>
<th>Gamma$(a, b)$</th>
</tr>
</thead>
<tbody>
<tr>
<td>mean</td>
<td>$a/b$</td>
</tr>
<tr>
<td>variance</td>
<td>$a/b^2$</td>
</tr>
<tr>
<td>skewness</td>
<td>$2/\sqrt{a}$</td>
</tr>
<tr>
<td>kurtosis</td>
<td>$3(1 + 2/a)$</td>
</tr>
</tbody>
</table>

Table 1: Mean, variance, skewness and kurtosis of the Gamma distribution.

Note also that we have the following scaling property: if $X$ is Gamma$(a, b)$ then for $c > 0$, $cX$ is Gamma$(a, b/c)$.

Let us start with a unit variance Gamma-process $G = \{G_t, t \geq 0\}$ with parameters $a > 0$ and $b > 0$. As driving Lévy process (in a risk-neutral setting), we then take

$$X_t = \mu t - G_t, \quad t \geq 0,$$

where in this case $\mu = r - \log(\phi(i)) = r + a \log(1 + b^{-1})$, such that $\{\exp(X_t - rt), t \geq 0\}$ is a martingale, and $r$ is the default-free discount rate (assumed to be constant here). Thus, there is a deterministic up trend with random downward shocks coming from the Gamma process.

The characteristic exponent is in this case available in closed form

$$\psi(z) = \mu z - a \log(1 + zb^{-1}).$$

3.3.1 Calibration

We have calibrated the Shifted Gamma model to the term structure of ABN-AMRO CDSs minimizing the average absolute percentage error

$$\text{APE} = \frac{1}{\text{mean CDS spread}} \sum_{\text{CDS}} \frac{|\text{market CDS spread} - \text{model CDS spread}|}{\text{number of CDSs}}.$$

Calibrating the Shifted Gamma model to the term structure of ABN-AMRO
on the 5th of January 2005 gives the parameters $a = 0.74475$ and $b = 6.59491$. The fit of the Shifted Gamma model on the market CDSs is shown in Figure 1. The evolution of 1, 3, 5, 7 and 10 years par spreads of the ABN-AMRO CDSs from 5th January 2005 to 8th February 2006 is shown in Figure 2. The evolution over time of the parameters of the Shifted Gamma model calibrated on the term structure is shown in Figure 3.

For the calibration we applied the numerical double Laplace inversion technique presented in Madan and Schoutens (2008). An extensive calibration study was performed by Madan and Schoutens (2008) and the fitting error was typically around 1-2 basis points per quote.

4 A Monte Carlo Valuation Approach

As seen from (2) we need a model for the spread dynamics of the reference CDS with constant maturity. We will use Shifted-Gamma model throughout this section and the spread dynamics developed in Jönsson and Schoutens (2009).
Denote by \( \{v_1, \ldots, v_K\} \) a grid of initial firm values with \( v_k = R + (k+1)\Delta v \), \( k = 1, 2, \ldots, K \), where \( \Delta v > 0 \) is the step size. The maximum value \( v_K \) is chosen such that \( v_K = \exp(\mu \hat{T}) \), \( \hat{T} \) being the maturity of the CMCDS.

For each firm value \( v_k \) on the grid we will associate a corresponding CDS spread value denoted \( s_k(v_k, R, r, T, \theta) \) to stress the fact that the spread is a function of the initial firm value \( v_k \), the recovery rate \( R \), the interest rate \( r \), the maturity tenor of the CDS, \( T \) and the parameters of the underlying single sided Lévy model, which we denote by the vector \( \theta \) (for Shifted-Gamma \( \theta = (a, b) \)).

The method is based on four steps. The first step is to calibrate the model on a given term structure of market spreads. The calibration gives us the model parameters \( \theta \) that best match the current market situation as described above. Next we precalculate for the grid of firm values \( \{v_1, \ldots, v_K\} \) the corresponding spread values \( \{s_i(v_i, R, r, T, \theta), i = 1, \ldots, K\} \) by using the fast way of calculating the default probabilities presented by Madan and Schoutens (2008). The third step is to generate \( N \) independent realizations of firm’s value paths on a time grid \( \tau_j = (j + 1)\Delta \tau, j = 1, 2, \ldots, J \) and \( \Delta \tau > 0 \), with \( \tau_J = \hat{T} \), the maturity of the CMCDS, and the reset dates being a subset of the grid (if possible).
Figure 3: The parameters of Shifted Gamma model calibrated to the term structure of the CDSs on ABN-AMRO, weekly data from 5th January 2005 to 8th February 2006. The objective function to be minimized was the average absolute percentage error (APE).

Denote by \{v(n)(\tau_j), j = 1, \ldots, J\} the \(n\)th realization of the firm’s value path, where

\[ v(n)(\tau_j) = \exp(\mu \tau_j - \sum_{i=1}^{j} G_i^{(n)}), \quad j = 1, \ldots, J, \]

where \(G_i^{(n)}, i = 1, \ldots, J\) are independent random variables from a Gamma distribution with parameters \(\theta = (a, b)\) and with \(\mu\) given as described in Section 3.3. Note that we here use the mean-correcting martingale measure \(Q\).

The fourth step is to translate these firm’s value paths into spread paths. Recall that we are only interested in the spreads on the reset dates \(t_0, t_1, \ldots, t_{M-1}\), so we do not have to do this for each point on the time grid. Assuming that the reset \(t_m\) is on the time grid, take the firm value of the \(n\)th path at time \(t_m, v(n)(t_m)\), and interpolate in the precalculated firm value grid \(\{v_1, \ldots, v_K\}\) and the corresponding spread values \(\{s_i(v_i, R, r, T, \theta), i = 1, \ldots, K\}\) to find the spread value, which we denote by \(s^{(n)}(t_m, t_m + T)\). Do this for each path and every reset date. If a reset date \(t_m\) is not on the time grid, one first has to
interpolate the firm values of the two nearest neighbors of \( t_m \), say \( v(n)(\tau_i) \) and \( v(n)(\tau_{i+1}) \), with \( \tau_i < t_m < \tau_{i+1} \), to get \( v(n)(t_m) \).

For each reset date \( t_m \), \( m = 0, 1, \ldots, M - 1 \), estimate the expected value in (2) by simulating \( N \) spread paths of the reference CDS with constant maturity

\[
\mathbb{E}_{Q,m+1}[S(t_m, t_m+T)] \approx \hat{s}_m = \frac{1}{NP_Q(\tau > t_{m+1})} \sum_{n=1}^{N} s^{(n)}(t_m, t_m+T) 1^{(n)}(\tau > t_{m+1}),
\]

where \( s^{(n)}(t_m, t_m+T) \) is the spread at reset time \( t_m \) of the \( n \)th path and \( 1^{(n)}(\tau > t_m) \) is the survival indicator function until \( t_m \) of the \( n \)th path.

The participation rate is then

\[
\hat{p}(t_0, \hat{T}, T) = \frac{s(t_0, \hat{T})PV01(t_0, \hat{T})}{\sum_{m=0}^{M-1} D(t_0, t_{m+1}) \Delta(t_m, t_{m+1}) \hat{s}_m}.
\]

To be more precise, we estimate \( q = 1/p \) by

\[
\hat{q} = \frac{\sum_{m=0}^{M-1} D(t_0, t_{m+1}) \Delta(t_m, t_{m+1}) \hat{s}_m}{s(t_0, \hat{T})PV01(t_0, \hat{T})}.
\]

The variance of this estimate is

\[
Var(\hat{q}) = \frac{\sum_{m=0}^{M-1} (D(t_0, t_{m+1}) \Delta(t_m, t_{m+1}))^2 Var(\hat{s}_m)}{\left(s(t_0, \hat{T})PV01(t_0, \hat{T})\right)^2},
\]

since we use independent paths to estimate each expected reset spread \( \hat{s}_m \).

The variance of the estimate \( \hat{p} \) is given by noticing that

\[
\mathbb{E}[(\hat{q} - q)^2] = \mathbb{E}[(\frac{1}{\hat{p}} - \frac{1}{p})^2] \approx \frac{\mathbb{E}[(\hat{p} - p)^2]}{p^4},
\]

if \( \hat{p} \) is close to its true value \( p \). Thus,

\[
Var(\hat{p}) = \mathbb{E}[(\hat{p} - p)^2] \approx p^4 Var(\hat{q}) \approx \hat{p}^4 Var(\hat{q}^4).
\]

The standard deviation of our estimate is therefore

\[
\sigma_p \approx \hat{p}^2 \sqrt{Var(\hat{q})}.
\]

The convexity adjustment for the premium leg between dates \( t_m \) and \( t_{m+1} \),
that is, the difference between the expected spread realized at $t_m$ and the forward spread for the same period, is approximated by

$$\hat{A}(t_m, t_m + T) = \hat{s}_m - S(t_0, t_m, t_m + T),$$

where $S(t_0; t_m, t_m + T)$ is the $t_0$ forward spread on a CDS starting at time $t_m$ and maturing at $t_m + T$. The convexity adjustment (6) is approximated by

$$\hat{A}(t_0, \hat{T}, T) = \sum_{m=1}^{M-1} D(t_0, t_m) \Delta(t_m, t_{m+1}) \hat{A}(t_m, t_m + T).$$

### 4.1 Numerical Results

We calculated the participation rate of a 3 year CMCDS with a reference CDS written on ABN-AMRO using the proposed Monte Carlo approach with 100,000 paths for each reset date. Total time for calculating one participation rate is approximately 30 minutes. In Table 2 we present the participation rate with standard errors estimated using the single sided firm’s value Monte Carlo approach, the participation rate calculated using the forward spreads without convexity adjustments, and the convexity adjustment for different constant maturities of the reference CDS. The participation rate calculated using the Monte Carlo approach and the forward rate approach (without convexity adjustment) are shown for different constant maturities in Figure 4.

From Table 2 and Figure 4 we can see that the Monte Carlo participation rate is always lower than the forward spread participation rate, which implies that the forward rates underestimate the expected future reset spreads in this case. The decrease of the participation rates is due to the fact that we have an upward sloping term structure of the reference CDS.

The size of the convexity adjustment versus constant maturity is given in Figure 5.

Valuation of a cap is done by valuating each individual caplet. A caplet is an option to buy protection for the strike spread $K_C$ and is therefore similar to a payer on the reference constant maturity tenor CDS. Payers and receivers were valued in Jönsson and Schoutens (2009) using the same spread dynamics we use here.

The impact of using a cap on the reset spread is clearly visible in Table 3 and Figure 6. If we have a cap on the reset spread the participation rate will, as expected, increase to compensate for the fact that the seller (buyer) of protection
<table>
<thead>
<tr>
<th>$T_{CDS}$</th>
<th>Part. rate MC (s.e.)</th>
<th>Part. rate F</th>
<th>Conv. adj. (s.e.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.0</td>
<td>0.834099 (0.004879)</td>
<td>0.840152</td>
<td>0.000018 (0.000015)</td>
</tr>
<tr>
<td>2.0</td>
<td>0.700115 (0.002919)</td>
<td>0.715743</td>
<td>0.000066 (0.000013)</td>
</tr>
<tr>
<td>3.0</td>
<td>0.617491 (0.002000)</td>
<td>0.634810</td>
<td>0.000093 (0.000011)</td>
</tr>
<tr>
<td>4.0</td>
<td>0.563900 (0.001520)</td>
<td>0.579728</td>
<td>0.000102 (0.000010)</td>
</tr>
<tr>
<td>5.0</td>
<td>0.524616 (0.001230)</td>
<td>0.541190</td>
<td>0.000123 (0.000009)</td>
</tr>
<tr>
<td>6.0</td>
<td>0.498530 (0.001034)</td>
<td>0.513811</td>
<td>0.000126 (0.000009)</td>
</tr>
<tr>
<td>7.0</td>
<td>0.478470 (0.000899)</td>
<td>0.493920</td>
<td>0.000138 (0.000008)</td>
</tr>
<tr>
<td>8.0</td>
<td>0.462596 (0.000804)</td>
<td>0.479082</td>
<td>0.000157 (0.000008)</td>
</tr>
<tr>
<td>9.0</td>
<td>0.452172 (0.000728)</td>
<td>0.467648</td>
<td>0.000155 (0.000008)</td>
</tr>
<tr>
<td>10.0</td>
<td>0.444485 (0.000667)</td>
<td>0.458462</td>
<td>0.000145 (0.000007)</td>
</tr>
</tbody>
</table>

Table 2: The constant maturity of the reference CDS ($T_{CDS}$), participation rates using the Monte Carlo approach, standard errors, participation rate using forward spreads (without convexity adjustment), and convexity adjustment. The CMCDS has a 3 year maturity and resets quarterly, the term structure of interest rate is assumed to be flat at 3%, the underlying model is the Shifted Gamma with parameters $a = 0.74475$ and $b = 6.59491$. Valuation date is 5th January 2005.

<table>
<thead>
<tr>
<th>$T_{CDS}$</th>
<th>Part. rate Cap (s.e.)</th>
<th>Cap (s.e.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.0</td>
<td>2.129509 (0.002020)</td>
<td>0.001423 (0.000015)</td>
</tr>
<tr>
<td>2.0</td>
<td>1.448004 (0.001181)</td>
<td>0.001411 (0.000012)</td>
</tr>
<tr>
<td>3.0</td>
<td>1.112441 (0.000843)</td>
<td>0.001340 (0.000011)</td>
</tr>
<tr>
<td>4.0</td>
<td>0.921242 (0.000671)</td>
<td>0.001236 (0.000009)</td>
</tr>
<tr>
<td>5.0</td>
<td>0.802036 (0.000568)</td>
<td>0.001144 (0.000009)</td>
</tr>
<tr>
<td>6.0</td>
<td>0.724393 (0.000500)</td>
<td>0.001046 (0.000008)</td>
</tr>
<tr>
<td>7.0</td>
<td>0.670125 (0.000452)</td>
<td>0.000964 (0.000007)</td>
</tr>
<tr>
<td>8.0</td>
<td>0.629794 (0.000419)</td>
<td>0.000892 (0.000007)</td>
</tr>
<tr>
<td>9.0</td>
<td>0.599598 (0.000398)</td>
<td>0.000804 (0.000006)</td>
</tr>
<tr>
<td>10.0</td>
<td>0.576215 (0.000384)</td>
<td>0.000714 (0.000006)</td>
</tr>
</tbody>
</table>

Table 3: Participation rate with cap estimated using the Monte Carlo approach for different constant maturity tenors of the reference CDS ($T_{CDS}$). The CM-CDS has a 3 year maturity and resets quarterly, the term structure of interest rate is assumed to be flat at 3%, the underlying model is the Shifted Gamma with parameters $a = 0.74475$ and $b = 6.59491$. The cap strike was set to three times the market CDS spread. Valuation date is 5th January 2005.

will not receive (pay) a higher spread than the cap strike. The cap strike was set to three times the market spread of the reference CDS, see Figure 1 for the 1, 3, 5, 7 and 10 years market spreads. It is more likely for the reset spread to be higher than the cap for the shorter maturities since the cap is a multiple
Figure 4: Participation rate of a 3 years CMCDS on ABN-AMRO for different constant maturities calculated using the Monte Carlo approach and forward spreads, respectively. The underlying model is the Shifted Gamma with parameters $a = 0.74475$ and $b = 6.59491$. Valuation date 5th January 2005.

of the initial market spread and the market spread is increasing with maturity. It is therefore not surprising that the cap plays a more significant role for the shorter maturities than for the longer. Comparing the “uncapped” participation rates given in Table 2 with the participation rates in Table 3 we see that the participation rate is significantly higher when a cap is present, especially for the shorter constant maturities. The increase is ranging from 30% for the longest maturity to 155% for the shortest maturity. The smaller standard error on the cap participation rate is a natural effect of the cap since we cut off high values of the reset spreads.

The participation rate with and without cap for different maturities of the CMCDS are shown in Table 4 together with the price of the corresponding caps. The cap strike (30 bp) was chosen to be three times the initial reset spread (10 bp). The increase is ranging from 48% for the shortest maturity up to 70% for the longest maturity which is expected since it is more likely that the cap strike will be reached for longer CMCDS maturities. The smaller standard error on
Figure 5: Convexity adjustment of a 3 years CMCDS on ABN-AMRO for different constant maturity tenors. The underlying model is the Shifted Gamma with parameters $a = 0.74475$ and $b = 6.59491$. Valuation date 5th January 2005.

the cap participation rate is a natural effect of the cap since we cut off high values of the reset spreads. The prices of the cap is increasing since the number of reset dates, and hence the number of caplets, increases with the CMCDS maturity.

<table>
<thead>
<tr>
<th>$T_{cmcds}$</th>
<th>Part.rate</th>
<th>(s.e.)</th>
<th>Part.rate Cap</th>
<th>(s.e.)</th>
<th>Cap</th>
<th>(s.e.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.313751</td>
<td>0.000829</td>
<td>0.465747</td>
<td>0.000440</td>
<td>0.000117</td>
<td>0.00003</td>
</tr>
<tr>
<td>2</td>
<td>0.430554</td>
<td>0.001116</td>
<td>0.626417</td>
<td>0.000493</td>
<td>0.000535</td>
<td>0.00006</td>
</tr>
<tr>
<td>3</td>
<td>0.523892</td>
<td>0.001232</td>
<td>0.801649</td>
<td>0.000567</td>
<td>0.001148</td>
<td>0.00009</td>
</tr>
<tr>
<td>4</td>
<td>0.592256</td>
<td>0.001287</td>
<td>0.963917</td>
<td>0.000633</td>
<td>0.001941</td>
<td>0.00011</td>
</tr>
<tr>
<td>5</td>
<td>0.647413</td>
<td>0.001299</td>
<td>1.106990</td>
<td>0.000684</td>
<td>0.002800</td>
<td>0.00014</td>
</tr>
</tbody>
</table>

Table 4: The participation rates with and without cap using the Monte Carlo approach. The CMCDS has a 1 to 5 years maturity and resets quarterly, the constant maturity of the reference CDS is 5 years, the term structure of interest rate is assumed to be flat at 3%, the initial reset spread is 10 bp and the cap strike is $K_C = 30$ bp. The underlying model is the Shifted Gamma with parameters $a = 0.74475$ and $b = 6.59491$. Valuation date is 5th January 2005.
If all contract parameters are kept constant except the cap strike the participation rate and cap price are decreasing with increasing cap strike, as can be seen in Table 5.

Figure 7 shows the participation rate and mark-to-market of a $\hat{T} = 3$ year CMCDS with quarterly reset indexed to a 5 year CDS on ABN-AMRO over one year from the valuation date 5th of January 2005. At each mark-to-market date $t$ the Shifted Gamma model is calibrated on the given term structure of the CDS on ABN-AMRO and the participation rate of a new CMCDS with the same characteristics and same maturity, that is, the time to maturity of the new CMCDS is $\hat{T} - t$, is calculated using these parameters. The notional is assumed to be 10 million. The mark-to-market is increasing because the participation rate is decreasing with decreasing time to maturity, which is as expected.

The behaviour of the participation rate and the mark-to-market depends of course on the CDS term structure and the model parameters estimated from it. There are three significant “jumps” in the participation rate in week 3, 14 and

Figure 6: Participation rate of a 3 years CMCDS on ABN-AMRO for different constant maturities calculated using the Monte Carlo approach with and without a cap on the reset spread. The underlying model is the Shifted Gamma with parameters $a = 0.74475$ and $b = 6.59491$. Valuation date 5th January 2005.
Table 5: The participation rates with cap using the Monte Carlo approach. The CMCDS has a 3 years maturity and resets quarterly, the constant maturity tenor of the reference CDS is 5 years, the term structure of interest rate is assumed to be flat at 3%, and the initial reset spread is 10 bp. The participation rate of the CMCDS without cap is 52.5% (standard error 0.124%). The underlying model is the Shifted Gamma with parameters $a = 0.74475$ and $b = 6.59491$. Valuation date is 5th January 2005.

49 that results in “jumps” in the mark-to-market. These jumps can be traced back to changes of the reference CDS’ spread curve’s slope and level, which forced the calibrated model parameters to “jump”, see Figure 2 and Figure 3. Further the changes of the spread curve’s level and slope influence the market spread of the CDS with the same maturity as the CMCDS, $\tilde{T}$, as can be seen in Figure 8. It is interesting to note that the change of the mark-to-market in week 19 and 36 is not found in the participation rate. Looking at the spread curve evolutions in Figure 2 we see a peak in week 19 and a downward movement in week 36 over all maturities, which of course influence the market spread of the CDS with maturity $\tilde{T}$.

5 Conclusions

We have presented a Monte Carlo approach to value Constant Maturity Credit Default Swaps (CMCDS) based on a single sided Lévy firm’s value model. A CMCDS is linked to a reference CDS with constant maturity tenor. At speci-
Figure 7: Participation rate and mark-to-market of a quarterly reseted CMCDS indexed to a 5 year CDS on ABN-AMRO calculated on weekly data from 5
January 2005 to 8
February 2006. The CMCDS has a 3 years maturity at week 0. The underlying model is Shifted Gamma.

fied dates the spread of the CMCDS is reset to the par spread of the reference CDS. The pricing of a CMCDS is equivalent to determining the participation rate, which is the proportion of the reference par spread to be paid at the next payment. The estimation of the participation rate is done by estimating the expected par spread of the reference CDS on each reset date. To achieve this we set up a spread generator where, after the model has been calibrated on an appropriate CDS term structure, the generated firm’s value paths are mapped into spread paths of the reference CDS. With the proposed Monte Carlo approach we have estimated the participation rate of a CMCDS for different constant maturity tenors and we have compared this with the participation rate based on the forward spreads without convexity adjustment. For both approaches the participation rate is decreasing with increasing constant maturity tenor. However, the Monte Carlo estimate is always smaller than the non-adjusted forward spread participation rate. The convexity adjustment, that is, the difference between the expected reset spread and the forward spread, is increasing with increasing
constant maturity tenor. Furthermore, we showed how to price caps and how the participation rate is affected if we introduce a cap on the reset spread. We finally showed the evolution of the participation rate and the mark-to-market of a CMCDS over time using weekly evolution of a 5 year CDS on ABN-AMRO as reference.

Acknowledgements

The authors thank the referee for valuable comments improving the paper. The research presented in the paper was done while H. Jönsson was a EU-Marie Curie Intra-European Fellow with funding from the European Community’s Sixth Framework Programme (MEIF-CT-2006-041115).

References


**Appendix**

We have a filtered probability space \((\Omega, (\mathcal{F}_t)_{t \geq 0}, Q)\).

We will follow Schönbucher (2000) and separate (the pre-default) price of the bond \(D(t, t_m)\) and the default indicator \(1(\tau > t)\), such that, for \(t > 0\) we will write \(D(t, t_m)1(\tau > t)\). In such a way the pre-default price need not jump to zero at default because \(1(\tau > t)\) already does. Denoted by \(B(t, t_m)\) will
be the time $t$ price of a riskless zero-coupon bond with maturity $t_m$, that is, $B(t, t_m) = \exp \left(-\int_t^{t_m} r_s ds \right)$.

The value of the payment at time $t_{m+1}$ is based on the floating spread reset at $t_m$, that is, for $m = 0, 1, \ldots, M - 1$,

$$Z_{m+1}(t_{m+1}) = \Delta(t_m, t_{m+1}) S(t_m, t_m + T) 1(\tau > t_{m+1}),$$

with $t_M = \hat{T}$ and where $Z_{m+1}(t_{m+1})$ is the time $t_{m+1}$ value of the payment scheduled for $t_{m+1}$, $\Delta(t_m, t_{m+1})$ is the length of the period over which the spread is payed, expressed in the appropriate day-count convention, $S(t_m, t_m + T)$ the market spread of the reference CDS at time $t_m$, $\tau$ is the default time and $1(\tau > t_{m+1})$ is the survival indicator until time $t_{m+1}$.

The $t_0$-value of the premium payment scheduled for $t_{m+1}$ is under the risk-neutral measure $\mathbb{Q}$

$$Z_{m+1}(t_0) = d(t_0, t_{m+1}) \Delta(t_m, t_{m+1}) \mathbb{E}^{\mathbb{Q}}[S(t_m, t_m + T) 1(\tau > t_{m+1})],$$

for $m = 0, 1, \ldots, M - 1$.

As an alternative the value of the premium payment at $t_{m+1}$ could be calculated using the riskless zero-coupon bond $B(t, t_{m+1})$ as numeraire, that is,

$$Z_{m+1}^B(t_0) = \frac{Z_{m+1}(t_0)}{B(t_0, t_{m+1})},$$

$$= \Delta(t_m, t_{m+1}) \mathbb{E}^{\mathbb{Q}}_B \left[ \frac{d(t_0, t_{m+1})}{B(t_0, t_{m+1})} S(t_m, t_m + T) 1(\tau > t_{m+1}) \right],$$

$$= \Delta(t_m, t_{m+1}) \mathbb{E}^{\mathbb{Q}}_{m+1} \left[ S(t_m, t_m + T) 1(\tau > t_{m+1}) \right],$$

where we used the fact that $B(t_{m+1}, t_{m+1}) = 1$ and where $\mathbb{Q}^B_{m+1}$ is called the $t_{m+1}$-forward measure and is related to $\mathbb{Q}$ through the Radon-Nikodym density process

$$\frac{d\mathbb{Q}^B_{m+1}}{d\mathbb{Q}} \bigg|_{\mathcal{F}_t} := \frac{d(t_0, t)B(t, t_{m+1})}{B(t_0, t_{m+1})},$$

with $\mathcal{F}_t$ being the appropriate sigma-field.

A third choice as numeraire is the defaultable zero-coupon bond with maturity $t_{m+1}$. Using $D(t_0, t_{m+1})$ as the numeraire we can express the $t_0$-value of
the payment scheduled for \( t_{m+1} \) as

\[
Z^D_{m+1}(t_0) = \frac{Z_{m+1}(t_0)}{D(t_0, t_{m+1})}
\]

\[
= \Delta(t_m, t_{m+1}) \mathbb{E}_Q \left[ \frac{d(t_0, t_{m+1})}{D(t_0, t_{m+1})} S(t_m, t_m + T) 1(\tau > t_{m+1}) \right]
\]

\[
= \Delta(t_m, t_{m+1}) \mathbb{E}_{Q_{m+1}} [S(t_m, t_m + T)],
\]

for \( m = 0, 1, \ldots, M - 1 \), where the expectation is taken with respect to the risk-neutral probability measure \( Q_{m+1} \) corresponding to the chosen numeraire. The measure \( Q_{m+1} \) is called the \( t_{m+1} \)-survival measure (see, e.g., Schönbucher (2000)) and is related to \( Q \) through the Radon-Nikodym density process

\[
\frac{dQ_{m+1}}{dQ} \bigg|_{\mathcal{F}_t} := \frac{d(t_0, t) 1(\tau > t) D(t, t_{m+1})}{D(t_0, t_{m+1})},
\]

where \( D(t, t_{m+1}) \) is the pre-default price of the defaultable zero-coupon bond (with zero recovery).

What is important for us is that it is possible to express the \( Q_{m+1} \)-expectation as the \( Q_{m+1}^P \)-expectation conditioned on no default at time \( t_{m+1} \) (see Schönbucher (2000))

\[
\mathbb{E}_{Q_{m+1}}^P [S(t_m, t_m + T) | \tau > t_{m+1}] = \frac{\mathbb{E}_{Q_{m+1}} [S(t_m, t_m + T) 1(\tau > t_{m+1})]}{\mathbb{E}_{Q_{m+1}}^P [1(\tau > t_{m+1})]}
\]

\[
= \frac{\mathbb{E}_Q [S(t_m, t_m + T) 1(\tau > t_{m+1})]}{\mathbb{P}_Q (\tau > t_{m+1})}
\]

\[
= \mathbb{E}_{Q_{m+1}} [S(t_m, t_m + T)].
\]