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# Risk Finance AND Asset Pricing

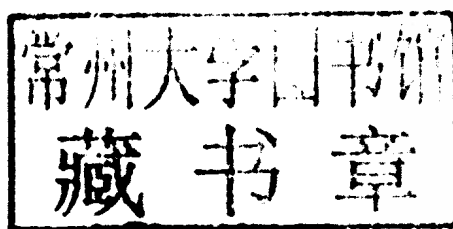
VALUE,  
MEASUREMENT  
AND MARKETS

Charles S. Tapiero

# Risk Finance and Asset Pricing

*Value, Measurements, and Markets*

CHARLES S. TAPIERO



WILEY

John Wiley & Sons, Inc.

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.  
Published simultaneously in Canada.

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***Library of Congress Cataloging-in-Publication Data:***

Tapiero, Charles S.

Risk finance and asset pricing : value, measurements, and markets / Charles S. Tapiero.  
p. cm. — (Wiley finance ; 563)

Includes index.

ISBN 978-0-470-54946-9 (cloth); 978-0-470-89237-4 (ebk); 978-0-470-89238-1 (ebk)

1. Financial engineering. 2. Financial risk management. 3. Finance—Mathematical models. 4. Investments—Mathematical models. I. Title.

HG176.7.T37 2010

658.15'5—dc22

2010015106

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

# **Risk Finance and Asset Pricing**

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*To Carole, Oscar, Bettina, Scarlett, Laura-Julia,  
Talya, and not least, Arielle*

# Introduction

**A**t both theoretical and practical levels, finance theory has made extraordinary intellectual strides while contributing immensely to economic development. At the same time it has enriched the many financial engineers able to innovate and trade in financial products that create greater liquidity, predict and price assets, manage financial risks, and contribute to the growth of financial markets.

Today, risk finance and engineering is confronted with immense challenges and opportunities. They include:

- Bridging theory and practice following the important contributions made these past decades by Kenneth Arrow and Gerard Debreu's fundamental theory of asset pricing and its many uses to better comprehend the working of financial markets and price assets and their derivatives.
- Reconciling the doubts raised by assumptions of fundamental finance and opportunities to profit by the initiated who can appreciate the pro and cons of these theories.

The motivation for this book arose in the course of my lectures in the Department of Finance and Risk Engineering at the New York University (NYU) Polytechnic Institute following the financial meltdown of 2008–2009. This was a year when risks and all their financial manifestations struck at the heart of financial citadels and world economies. No firm was too big to fail, and risks hitherto conceived of theoretically, ignored, or only dreamed of have revealed their potency. This was also a year when extreme events have come into their own: *ex ante* ignored, but factual and painful *ex post* for all those who ignored the unlikely. The whole world was hurting: Unemployment, deflation of assets, and times of reckoning with greed, regulation, constraints, and finiteness of resources have become the underlying tune of financial discourse. Both persons and institutions have questioned the validity of financial models and their practical implications. On the academic front, challenging questions have been raised against the fundamental and complete markets dogma of finance, claiming that models can default and that incomplete markets are far more prevalent than theoretical finance would have us believe.

The financial meltdown of 2008–2009 has also ignited a far greater concern for the underlying purposes of finance, not only as a means to get rich but to confront the risks that beset us—whether predictable or not. These include population growth, environmental challenges, globalization of finance, infrastructure, wellness, and so on. These are real problems of common and personal importance. Financial transparency is called for to be part of the answer. The intent of this book is to provide an accessible formulation of theoretical financial constructs embedded in a broad variety of real and useful problems.

The crisis of 2008–2009 has revealed that risks borne by those uninitiated in the complexity of financial products and markets can be very costly. It has also become apparent that corporations and financial firms, traditionally managing real resources, have gradually shifted their economic activity by turning to financial manipulations, acting as intermediaries, with losses assumed by uninformed investors. These firms have capitalized on leverage and short-term returns while strapping healthy corporations with a debt they may not be able to bear. Governmental institutions have not been spared either. They, too, have turned to financial markets to seek the funds needed for investments in infrastructure or to meet their financing needs. Pandora's financial box has been opened, and finance—for all the good and the risks it deals with and manages—has at the same time the potential to cause great damage if not understood.

Further, there is an increased awareness that financial systems are changing. For example, the traditional role of banks to provide liquidity to borrowers and business firms may have been jeopardized in their pursuit of (short-term) profits. These financial institutions have become marketers of financial products and intermediaries to ever-growing financial markets, rather than filling the role of providers of liquidity which underlies their charter granted by society and its governments. In the pursuit of profits, new financial institutions and previously nonfinancial firms have emerged and converged in new enterprises that both offer financial services and manage their own economic interests. These firms, such as insurance companies, provide liquidity and are transforming the financial system. In these processes, financial engineers remain the means to provide financial products and help decide how and where to invest and how to manage risks. The insurance-finance convergence has also afforded a means to assure buyers and sellers and thus contribute to the liquidity needed. The creation of a global insurance exchange in New York to cover complex risks, modeled after Lloyd's of London, is just such an example. Finally, the recent financial crisis has revealed that liquidity matters very much and the future may be unpredictable. Non-transparency, complexity and ambiguity have combined with greed to induce "Management's Risks" as being able to derail financial sustainability and produce financial models that are not efficient. These revelations have increased our awareness that financial expectations can and do falter. This renewed awareness may alter the financial regulatory environment, financial markets, financial attitudes and by extension the future challenges of financial risk engineering. In such an environment, we may be confronted with new problems and new opportunities to provide the solutions needed by financial, corporate firms and individuals.

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## **WHO THIS BOOK IS FOR**

This book is intended for both beginning and practicing financial engineers and seeks to engender an appreciation for and understanding of pricing of real financial problems. Throughout my classes I have become aware that many concepts transparent to mathematically savvy students are not understood by others. Inversely, many students with an extensive mathematics background fail to understand that financial engineering is not about mathematics but about complex relationships between buyers and sellers acting in financial markets, imputing values and prices to just about everything that can be traded. To better appreciate what financial engineering

is, can do, and its limitations, it is necessary to have a strong footing in principles of economics and finance, data and statistical analysis, personal utility, and their behavioral manifestations in financial markets and financial modeling. In particular, financial modeling provides a means to interpret implied values and prices such as options, credit derivatives, and so on.

In this sense, financial engineering is both real and virtual. Its usefulness is fueled by the needs of financial parties and by its potential contributions to investors, speculators, and society at large. The perspectives of this book, unlike many important books in financial engineering and mathematics, are thus: to bridge theory and practice; to study financial engineering as a means and not only as an end to make money; and to emphasize a real finance that can provide the support needed to meet both individual and collective needs. At the same time, the book emphasizes an intuitive and comprehensive approach to the foundations of risk finance and its many applications to asset pricing, real financial problems, and financial risk management. In such a frame of mind, the book's theoretical frameworks for expected utility, the Arrow-Debreu foundations of fundamental finance, and basic statistical manipulations of data and financial modeling, are shown to be useful, relevant, and complementary.

## **HOW THIS BOOK IS STRUCTURED**

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Theoretical concepts and theories applied mindlessly can have dire consequences. Thus, understanding the underlying rationales that financial engineers use in financial modeling, optimization, and decision making is important. By the same token, financial engineers cannot be the canary in the coal mine and ought to recognize that there is an inherent social and ethical responsibility that need not contradict the pursuit of wealth and money. There are as many opportunities to profit by contributing to economic sustainability—via investment in needed infrastructures, preventing booms and busts, reducing social inequities, pointing to market potential defaults and failures, and so on—as there are opportunities to profit from the design of complex and marketable financial products that provide greater and needed financial liquidity, and from seeking arbitrage opportunities and better forecasting financial market prices.

The many applications treated in this book, drawn from a variety of financial, engineering, and business professions, include insurance, pricing corporate loans and managing their risks, pricing safety and reliability, pricing franchises, operations risks, environmental quality and its control, infrastructure pricing, pricing water, pricing the insurance of rare events and uncommon risks, and more. These applications are used to establish a motivation and a background for a greater appreciation of finance and its risk engineering. Throughout the book, simplifications are made to focus greater attention on the problem-solving rationality financial engineers use. The required quantitative level needed for the book is kept at a consistent and introductory level. Some sections, however, require a slightly more advanced mathematical background; these are marked with an asterisk (\*) in the table of contents and offer an added motivation to ambitious students. Additional extensions to each of the book chapters and problems solved are relegated to a web site companion, [www.charlestapiero.com](http://www.charlestapiero.com). This web site introduces as well in far greater detail

facets of continuous-time finance that this book has sought to avoid as a price for simplicity.

The book is structured as follows. Chapters 1 and 2 provide an introduction to the business of finance, risk, and their many applications. Issues such as ethics and finance are discussed.

Chapters 3 and 4 are an introduction to risk measurement and to various statistical approaches to doing it. These chapters use data to measure risk and to estimate financial trends, financial volatility, and the many terms that make up the essential content of basic financial applications. These two chapters introduce the student to the need to confront the measurement, the *quantification* of finance, and to perform basic analyses using financial data. Chapter 4 is of a more advanced nature, however, and emphasizes the problems of dependence including statistical dependence, complexity, contagious risks, latent risks, and black swan risks. The rationale for introducing these complex issues prior to a thorough study of financial and economic constructs used by financial engineers is to point out the true complexity of quant finance, which cannot always be explained by available theories. Allowing students to grapple with complicated issues sooner rather than later offers a challenge that is similar to the concerns and the manner in which we proceed to financial risk management.

Chapters 5 and 6 introduce the concept of utility and financial risk management. Many theories applied in financial economics are applications of or interpreted in terms of utility concepts. These include risk aversion, portfolio selection, certain equivalents in financial valuation, the capital asset pricing model (CAPM), kernel pricing, insurance, and utility-based risk management. These applications are still profusely used (explicitly or implicitly) in many practical problems. The presumption that financial engineering is essentially concerned with options pricing is, I believe, misguided. These chapters will show through applications that underlying financial theory there are almost always three issues to reckon with: the rationality of the parties to a financial transaction, their private and common information, and the market price. In many cases, any two would imply the other. In other words, any model in fundamental finance implies in fact an underlying rationality—which when violated leads to model defaults.

Chapter 7 outlines the Arrow-Debreu framework in discrete states and time for assets and derivatives (options) pricing. An intuitive introduction to martingales and their importance for asset pricing is included in the appendix to Chapter 7. Chapter 8 provides a review of financial markets and optional portfolios used to manage and trade risks. These two chapters present the basic concept of fundamental finance. The theory is discussed, criticized, and applied to many examples. To keep this introduction tractable (without losing its essential implications and applications) simple binomial, multinomial, and discrete state models are used. Extensions to continuous-time finance are considered briefly, and specific problems are posted on the book web site, [www.charlestapiero.com](http://www.charlestapiero.com). Applications to a variety of problems including derivatives pricing, default bonds, pricing insurance contracts, stochastic volatility models, multiple sources of risks models, and a plethora of problems commonly treated in practice and in advanced texts are also presented simply to explain the rationale that the Arrow-Debreu financial framework uses to solve such problems. Throughout these chapters, issues and instruments of current interest, such as the financial meltdown of 2008, volatility and chaos, globalization, outsourcing, and

so on, are used to explain these important facets of financial practice and the limits of the current theoretical models of finance.

Chapters 9, 10, and 11 can be seen as a whole that can be delivered as one course on credit risk. Chapters 9 and 10 deal with credit risk and scoring, multi-name credit risk, and credit derivatives. Several approaches to pricing credit risk are outlined. Following the credit crisis, a greater awareness has developed that these risks ought to be better regulated. Chapter 10 focuses on multi-name credit risk portfolios and structured financial products such as collateralized debt obligation (CDO), collateralized mortgage obligation (CMO), and collateralized loan obligation (CLO). Finally, Chapter 11 addresses the important and practical problems in calculating an implied volatility and an implied risk-neutral distribution. Three approaches are emphasized: parametric, a-parametric, and a utility-rationality-based approach.

Chapters also include:

- *Examples and problems.* These highlight both some of the techniques used in asset pricing and their very broad applications.
- *“Test Yourself.”* Most chapters end with a series of questions to test your newfound knowledge.

## **WHAT'S ON THE COMPANION WEB SITE**

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At [www.wiley.com/go/tapiero](http://www.wiley.com/go/tapiero) (password: risk) you will find a number of additional resources for this book, including:

- Additional examples, errata, and updates to the book.
- Links to the author's other publications.
- Recommended reading.
- Information about the author's classes at the New York University Polytechnic Institute.

The Instructor's site includes answers to the problems and “Test Yourself” material found in the book, as well as PowerPoint slides and other materials for classroom use.

# Contents

<b>Introduction</b>	<b>xv</b>
Who This Book Is For	xvi
How This Book Is Structured	xvii
What's on the Companion Web Site	xix
<b>CHAPTER 1</b>	
<b>Risk, Finance, Corporate Management, and Society</b>	<b>1</b>
Overview	1
Risks Everywhere—A Consequence of Uncertainty	1
Risk and Finance: Basic Concepts	4
Finance and Risks	6
Financial Instruments	7
Securities or Stocks	7
Example: An IBM Day-Trades Record	7
Bonds	9
Portfolios	10
Example: Constructing a Portfolio	11
Derivatives and Options	12
Real and Financial Assets	15
Financial Markets	16
Option Contracts	16
Problem 1.1: Options and Their Prices	17
Options and Specific Needs	18
Example: Options and The Price of Equity	19
Example: Management Stock Options	19
Options and Trading in Specialized Markets	20
Trading the CO <sub>2</sub> Index	20
Trading on Commodities (Metal, Gold, Silver, Corn, Oil)	20
Trading the Weather and Insurance	21
Securitization, Mortgage-Backed Securities, and Credit Derivatives	21
Real-Life Crises and Finance	22
The ARS Crisis	22
The Banking–Money System Crisis	23
The 2008 Meltdown and Financial Theory	24
Finance and Ethics	27
Crime and Punishment	29
Summary	30

**CHAPTER 2****Applied Finance****35****Overview****35**

## Finance and Practice

35

## Risk Finance and Insurance

35

## Infrastructure Finance

36

## Finance, the Environment, and Exchange-Traded Funds Indexes

37

## Finance and Your Pension

38

## Contract Pricing and Franchises

39

## Catastrophic Risks, Insurance and Finance

40

## The Price of Safety

41

## The Price of Inventories

42

## Pricing Reliability and Warranties

42

## The Price of Quality Claims

43

## Financial Risk Pricing: A Historical Perspective

44

## Essentials of Financial Risk Management

47

## Comprehensive Financial Risk Management

49

## Technology and Complexity

49

## Retailing and Finance

51

## Finance, Cyber Risks, and Terrorism

52

## IT and Madoff

52

## Virtual Markets

52

## Virtual Products

52

## Virtual Markets Participants

53

## Virtual Economic Universes

53

## Market Making and Pricing Practice

53

## Market Makers, Market Liquidity, and Bid-Ask Spreads

55

## Alternative Market Structures

56

## Summary

57

**CHAPTER 3****Risk Measurement and Volatility****63****Overview****63**

## Risk, Volatility, and Measurement

63

## Moments and Measures of Volatility

66

## Expectations, Volatility, Skewness, Kurtosis, and the Range

67

**Example: IBM Returns Statistics****69****Example: Moments and the CAPM****70****Problem 3.1: Calculating the Beta of a Security****72**

## Modeling Rates of Return

72

## Models of Rate of Returns

73

## Statistical Estimations

77

## Least Squares Estimation

77

## Maximum Likelihood

79

## ARCH and GARCH Estimators

80

**Example: The AR(1)-ARCH(1) Model****81**

<b>Example: A GARCH (1,1) Model</b>	<b>83</b>
High-Low Estimators of Volatility	83
Extreme Measures, Volume, and Intraday Prices	84
Statistical Orders, Volume, and Prices	85
<b>Problem 3.2: The Probability of the Range</b>	<b>87</b>
Intraday Prices and Extreme Distributions	87
Data Transformation	88
<b>Example: Taylor Series</b>	<b>89</b>
Value at Risk and Risk Exposure	90
VaR and Its Application	92
<b>Example: VaR and Shortfall</b>	<b>94</b>
<b>Example: VaR, Normal ROR, and Portfolio Design</b>	<b>95</b>
The Estimation of Gains and Losses	97
Summary	99

## **CHAPTER 4**

<b>Risk Finance Modeling and Dependence</b>	<b>109</b>
<b>Overview</b>	<b>109</b>
Introduction	109
Dependence and Probability Models	111
Statistical Dependence	111
Dependence and Quantitative Statistical Probability Models	113
Many Sources of Normal Risk: Aggregation and Risk Factors	
Reduction	114
<b>Example: Risk Factors Aggregation</b>	<b>115</b>
<b>Example: Principal Component Analysis (PCA)</b>	<b>116</b>
<b>Example: A Bivariate Data Matrix and PCA</b>	<b>117</b>
<b>Example: A Market Index and PCA</b>	<b>119</b>
Dependence and Copulas	120
<b>Example: The Gumbel Copula, the Highs and the Lows</b>	<b>123</b>
<b>Example: Copulas and Conditional Dependence</b>	<b>124</b>
<b>Example: Copulas and the Conditional Distribution</b>	<b>125</b>
Financial Modeling and Intertemporal Models	126
Time, Memory, and Causal Dependence	127
Quantitative Time and Change	129
Persistence and Short-term Memory	130
The R/S Index	133
Summary	135

## **CHAPTER 5**

<b>Risk, Value, and Financial Prices</b>	<b>141</b>
<b>Overview</b>	<b>141</b>
Value and Price	141
Utility, Risk, and Money	143
Utility's Normative Principles: A Historical Perspective	144
Prelude to Utility and Expected Utility	145
Lotteries and Utility Functions	147

Example: The Utility of a Lottery	148
Quadratic Utility and Portfolio Pricing	149
Utility and an Insurance Exchange	150
Example: The Power Utility Function	151
Example: Valuation and the Pricing of Cash Flows	152
Example: Risk and the Financial Meltdown	153
Utility Rational Foundations	155
The Risk Premium	155
Utility and Its Behavioral Derivatives	156
Examples: Specific Utility Functions	159
The Price and the Utility of Consumption	161
Example: Kernel Pricing and the Exponential Utility Function	164
Example: The Pricing Kernel and the CAPM	165
Example: Kernel Pricing and the HARA Utility Function	166
The Price and Demand for Insurance	167
Summary	170

## CHAPTER 6

<b>Applied Utility Finance</b>	<b>177</b>
Overview	177
Risk and the Utility of Time	177
Expected Utility and the Time Utility Price of Money	177
Risk, Safety, and Reliability	178
Asset Allocation and Investments	180
Example: A Two-Securities Problem	182
Example: A Two-Stocks Portfolio	184
Problem 6.1: The Efficiency Frontier	185
Problem 6.2: A Two-Securities Portfolio	187
Conditional Kernel Pricing and the Price of Infrastructure Investments	188
Conditional Kernel Pricing and the Pricing of Inventories	191
Agency and Utility	193
Example: A Linear Risk-Sharing Rule	194
Information Asymmetry: Moral Hazard and Adverse Selection	195
Adverse Selection	196
The Moral Hazard Problem	197
Signaling and Screening	199
Summary	200

## CHAPTER 7

<b>Derivative Finance and Complete Markets</b>	<b>205</b>
Overview	205
The Arrow-Debreu Fundamental Approach to Asset Pricing	206
Example: Generalization to $n$ States	210
Example: Binomial Option Pricing	212
Problem 7.1: The Implied Risk-Neutral Probability	213
Example: The Price of a Call Option	213

Example: A Generalization to Multiple Periods	215
Problem 7.2: Options and Their Prices	218
Put-Call Parity	218
Problem 7.3: Proving the Put-Call Parity	219
Example: Put-Call Parity and Dividend Payments	219
Problem 7.4: Options Put-Call Parity	220
The Price Deflator and the Pricing Martingale	220
Pricing and Complete Markets	222
Risk-Neutral Pricing and Market Completeness	224
Options Galore	226
Packaged and Binary Options	227
Example: Look-Back Options	227
Example: Asian Options	227
Example: Exchange Options	228
Example: Chooser Options	228
Example: Barrier and Other Options	228
Example: Passport Options	229
Options and Their Real Uses	229
Fixed-Income Problems	231
Example: Pricing a Forward	231
Example: Pricing a Fixed-Rate Bond	232
Pricing a Term Structure of Interest Rates	232
Example: The Term Structure of Interest Rates	234
Problem 7.5: Annuities and Obligations	235
Options Trading, Speculation, and Risk Management	235
Option Trading Strategies	237
Problem 7.6: Portfolio Strategies	240
Summary	245
Appendix A: Martingales	246
Essentials of Martingales	246
The Change of Measures and Martingales	248
Example: Change of Measure in a Binomial Model	249
Example: A Two-Stage Random Walk and the Radon Nikodym Derivative	251
Appendix B: Formal Notations, Key Terms, and Definitions	253

## CHAPTER 8

<b>Options Applied</b>	<b>258</b>
Overview	259
Option Applications	259
Risk-Free Portfolios and Immunization	260
Selling Short	261
Future Prices	262
Problem 8.1: Pricing a Multiperiod Forward	264
Pricing and New Insurance Business	264

<b>Example: Options Implied Insurance Pricing</b>	<b>266</b>
Option Pricing in a Trinomial Random Walk	267
Pricing and Spread Options	269
Self-Financing Strategy	270
Random Volatility and Options Pricing	271
Real Assets and Real Options	273
The Option to Acquire the License for a New Technology	275
The Black-Scholes Vanilla Option	276
The Binomial Process as a Discrete Time Approximation	277
The Black-Scholes Model Option Price and Portfolio Replication	278
Risk-Neutral Pricing and the Pricing Martingale	281
The Greeks and Their Applications	284
Summary	287

## **CHAPTER 9**

<b>Credit Scoring and the Price of Credit Risk</b>	<b>291</b>
Overview	291
Credit and Money	291
Credit and Credit Risk	294
Pricing Credit Risk: Principles	296
Credit Scoring and Granting	299
What Is an Individual Credit Score?	299
Bonds Rating or Scoring Business Enterprises	300
Scoring/Rating Financial Enterprises and Financial Products	301
Credit Scoring: Real Approaches	304
The Statistical Estimation of Default	305
Example: A Separatrix	310
Example: The Separatrix and Bayesian Probabilities	311
Probability Default Models	312
Example: A Bivariate Dependent Default Distribution	314
Example: A Portfolio of Default Loans	315
Example: A Portfolio of Dependent Default Loans	316
Problem 9.1: The Joint Bernoulli Default Distribution	317
Credit Granting	317
Example: Credit Granting and Creditor's Risks	319
Example: A Bayesian Default Model	322
Example: A Financial Approach	323
Example: An Approximate Solution	326
Problem 9.2: The Rate of Return of Loans	327
The Reduced Form (Financial) Model	327
Example: Calculating the Spread of a Default Bond	328
Example: The Loan Model Again	329
Example: Pricing Default Bonds	330
Example: Pricing Default Bonds and the Hazard Rate	331
Examples	332
Example: The Bank Interest Rate on a House Loan	333