

Factor distributions and correlations implied by market quotes for synthetic CDO tranches

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Traditionally, default dependence has been the most difficult calibration issue in credit risk modelling. This is because there were no liquidly traded instruments from which a “market implied” correlation could be inferred. However, the rapid pace of innovation in the market for credit risk has recently given rise to new financial products, synthetic collateralised debt obligation (CDO) tranches, the prices of which will increasingly serve to aggregate the market views on default dependence between different obligors. Already, practitioners are talking about implied correlation “smiles” and “skews” in a manner reminiscent of the volatility smiles found in liquid option markets. On the one hand, “implied correlation” is a far more complicated concept than implied volatility, imposing limits as to how far this analogy can be taken when making relative value assessments about derivative financial instruments. However, there remain useful applications in robustly pricing bespoke tranches on standardised portfolios. In particular, one may represent the information about default correlation embedded in market quotes for synthetic CDO tranches by extracting implied factor distributions.