Quantitative Finance > Pricing of Securities

Consistent Valuation of Bespoke CDO Tranches

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This paper describes a consistent and arbitrage-free pricing methodology for bespoke CDO tranches. The proposed method is a multi-factor extension to the (Li 2009) model, and it is free of the known flaws in the current standard pricing method of base correlation mapping. This method assigns a distinct market factor to each liquid credit index and models the correlation between these market factors explicitly. A low-dimensional semi-analytical Monte Carlo is shown to be very efficient in computing the PVs and risks of bespoke tranches. Numerical examples show that resulting bespoke tranche prices are generally in line with the current standard method of base correlation with TLP mapping. Practical issues such as model deltas and quanto adjustment are also discussed as numerical examples.

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