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A Markov Model for the Term Structure of Credit Risk Spreads

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Abstract

This article provides a Markov model for the term structure of credit risk spreads. The model is based on Jarrow and Turnbull (1995), with the bankruptcy process following a discrete state space Markov chain in credit ratings. The parameters of this process are easily estimated using observable data. This model is useful for pricing and hedging corporate debt with imbedded options, for pricing and hedging OTC derivatives with counterparty risk, for pricing and hedging (foreign) government bonds subject to default risk (e.g., municipal bonds), for pricing and hedging credit derivatives, and for risk management.

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