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Credit gap risk in a first passage time model with jumps

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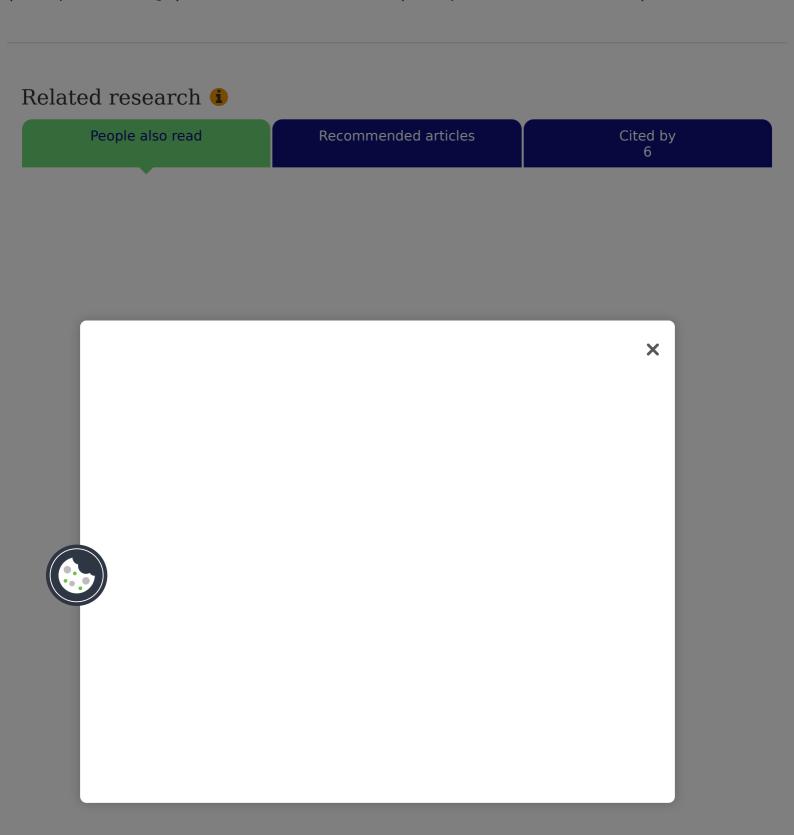
Notes

¹Since 2009, following an initiative of the International Swaps and Derivatives
Association to facilitate netting, credit default swaps are nowadays entered into with
standardised premiums of 25, 100, 500 or 1000 basis points. As a consequence,
entering into a CDS normally requires an upfront premium to be paid. In the analysis of
our model, we neglect the changes in market quoting conventions, since the qualitative
results on the spread dynamics are not affected.

²The term credit spread also refers to the yield spread, which is the yield difference of defaultable and default-free zero-coupon bonds of the same maturity. There are some subtle d actors such X as liquid er, we ated to the assume credit ris ure as well. ³A credit an investor 2002, for bear section ⁵For not ner setups of time poi ⁶Actually , hence for efficienc

⁷If the initial hazard rate is not constant, then a calibration where the variance moves purely by jumps cannot be attained. This is due to the fact that the jump intensity of the variance's compound Poisson process is constant, whereas a non-constant, deterministic hazard rate requires the jump intensity to be non-constant and deterministic. The former can be incorporated by specifying the jump process as an additive process.

⁸Under a suitable metric on C, resp. D, the σ -algebra(C), resp. (D), corresponds to the σ -algebra generated by the open sets (with respect to the metric) of C, resp. D, see e.g. (1996, section II.§2) or Karatzas and Shreve (1998, sections 2.4 and 6.2).



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