

A Multi-Factor Approach for Systematic Default and Recovery Risk

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Abstract

The present paper develops a simultaneous multi-factor model for defaults and recoveries. Applying this model, risk parameters can be forecast using systematic and idiosyncratic risk factors and their implied correlations. The theoretical framework is accompanied by an empirical analysis in which a negative correlation between defaults and recoveries over the business cycle is observed. In the study, default and recovery rates are modeled by business cycle indicators and the properties of the economic and regulatory capital given these risk drivers are shown.

Key Words: Business Cycle, Correlation, Credit Risk, Basel II, Retail Portfolio Models

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