



# Advanced Financial Risk Management: Tools and Techniques for Integrated Credit Risk and Interest Rate Risk Managements (Wiley Finance)

By Donald R. Van Deventer, Mark Mesler, Kenji Imai

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An in-depth look at financial risk management Advanced Financial Risk Management integrates interest rate risk, credit risk, foreign exchange risk, and capital allocation using a consistent risk management approach. It explains, in detailed, yet understandable terms, the analytics of these issues from A to Z. Written by experienced risk managers, this book bridges the gap between the idealized assumptions used for valuation and the realities that must be reflected in management actions. It covers everything from the basics of present value, forward rates, and interest rate compounding to the wide variety of alternative term structure models.

Donald R. Van Deventer (Hawaii) founded the Kamakura Corporation in April 1990 and is currently President. In 2003, he was voted into the Risk Hall of Fame for having made a profound contribution to the field of risk management. Kenji Imai (Hawaii) heads Software Development for Kamakura and participates in selected Japan-related financial advisory assignments. Mark Mesler (Hawaii) heads the information production for Kamakura Risk Information Services.

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### **Bibliography**

- Rank: #3781841 in Books
- Brand: Brand: Wiley
- Published on: 2004-11-10
- Original language: English
- Number of items: 1
- Dimensions: 9.00" h x 1.69" w x 6.32" l, 2.37 pounds
- Binding: Hardcover
- 650 pages



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## **Editorial Review**

### **From the Inside Flap**

Advanced Financial Risk Management outlines an integrated framework for fully integrated risk management. Credit risk, market risk, asset and liability management, and performance measurement have historically been thought of as separate disciplines, but recent developments in financial theory and computer science now allow these views of risk to be analyzed on a fully integrated basis.

In Advanced Financial Risk Management Donald R. van Deventer and Kenji Imai, joined by Mark Mesler, extend the concepts outlined in their previous book Credit Risk Models and the Basel Accords and update their 1996 work Financial Risk Analytics. The authors lay out a comprehensive strategy of risk management measures, objectives, and hedging techniques that apply to all types of institutions. They describe a performance measurement approach that goes far beyond traditional capital allocation techniques in measuring risk-adjusted shareholder value creation. Most important, the authors supplement this strategic view of integrated risk with step-by-step tools and techniques for constructing a risk management system that achieves these objectives.

The authors start with an updated review of techniques for constructing the building blocks of risk management, continuous yield curves that are used in everything from equity options to mortgage-backed securities analysis. They show how the creation of smooth credit spreads from bond price data is an extension of traditional yield curve smoothing technology. The authors review the primary credit risk models and discuss the implementation of the most modern form of credit models, the reduced form models of Jarrow, Duffy and Singleton, at great length. They present results from a 1.2 million observation data base on default probabilities in demonstrating how to meet Basel II requirements for credit model testing. They also show how to estimate default probabilities from bond prices and credit derivatives prices even when there is a liquidity ?premium? reflected in those prices above and beyond the risk of expected loss due to default or bankruptcy.

The authors then go on to show how three important topics in finance are special cases of the credit risk analysis they introduce: prepayment modeling, valuation of life insurance policies, and the valuation of property and casualty insurance contracts. Van Deventer, Imai and Mesler also revisit the critical issue of the valuation of savings deposits and demand deposits, which have no explicit maturity and a random principal balance.

Finally, the authors present a comprehensive framework for performance measurement at both the transaction level and the portfolio level that is consistent with best practice valuation techniques. Performance measurement has a history of many decades but it is rapidly evolving beyond simple concepts of ?plus alpha? or interest rate margin to true measures of value generation.

Advanced Financial Risk Management also contains a rich array of formulas for basic and advanced risk management calculations which will be of enormous use to practitioners in fund management, pension fund management, banking, insurance and the securities industry.

### **From the Back Cover**

"This invaluable book combines a rigorous primer on risk management and fixed income analytics with

sophisticated treatment of modern financial instruments and markets. I am particularly impressed with the authors' treatment of modern credit risk management models and techniques. Any serious student of the fields of risk management and investment strategies will find this volume extremely useful." - Edward I. Altman, Director, Credit & Debt Markets Research Program, Max L. Heine Professor of Finance New York University, Stern School of Business

"Derivatives traders in credit default swaps and collateralized debt obligations are using state of the art technology that integrates both interest rate and credit risk. In this groundbreaking book, Don van Deventer, formerly treasurer of one of the largest banks in the United States and a member of the RISK hall of fame, Kenji Imai, and Mark Mesler show why it's desirable and practical to apply these same concepts to the total balance sheet of a financial institution. This book should be on every risk manager's essential reading list." - Robert Jarrow, Ronald and Susan Lynch Professor of Investment Management, Johnson School of Business, Cornell University

"Van Deventer, Imai, and Mesler utilize their incomparable academic and professional experience and their technical expertise to comprehensively express their perspectives on how integrated interest rate and credit risk management creates shareholder value. I recommend this book to banking and hedge fund professionals seeking a complete education in current interest rate and credit risk management practices." - David P. Belmont, Author of Value Added Risk Management in Financial Institutions

"Successful risk management demands up-to-date knowledge of asset-liabilities management, market, credit and operational risk; and the ability to implement sound quantitative tools and techniques. This book provides an insightful overview of credit and interest rate risk, and discusses a broad treatment of the related modeling theory and methods. In particular, it discusses the pros and cons of both structural and reduced form models of credit risk. The presentation is accessible, foregoing unnecessary technical details. Written by experienced professionals, it offers both technical information and advice that can help practitioners involved in managing credit and interest rate risk." - J.R. Sobehart, VP - Senior Analyst, Credit and Operational Risk Analytics, Citigroup Risk Architecture

"In clear prose, the authors show why market-based tools such as put option theory, interest rate analytics, mark-to-market thinking, and bond prices are so important to modern credit risk management. Helpful examples pepper each chapter, illustrating and developing important concepts. This reader-friendly book is both a reference manual and a teaching companion for developing risk management skills." - Drake Pike, Head of Credit Risk Management, Asia ex-Japan Lehman Brothers

#### About the Author

Donald R. Van Deventer founded the Kamakura Corporation in April 1990 and is currently President. In 2003, he was voted into the Risk Hall of Fame for having made a profound contribution to the field of risk management. He has been involved in financial advisory assignments involving both risk management and mergers and acquisitions, for the municipalities affected in the Orange County bankruptcy, in a major derivatives dispute between JPMorgan and a Korean securities firm, Bank Negara Malaysia, ITT Financial Corporation and many other leading institutions. Prior to founding Kamakura Corporation, he was Senior Vice President of in the investment banking department of Lehman Brothers (then Shearson Lehman Hutton). From 1982 to 1987, he was the treasurer for First Interstate Bancorp in LA, USA. He holds a Ph.D. in Business Economics, a joint degree of the Harvard University Department of Economics and the Harvard Graduate School of Business Administration.

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