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Credit Default Swap Valuation with Counterparty Risk

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Abstract: Using the reduced form framework with inter-dependent default correlation, we perform valuation of credit default swap with counterparty risk. The inter-dependent default risk structure between the protection buyer, protection seller and the reference entity in a credit default swap are characterized by their correlated default intensities, where the default intensity of one party increases when the default of another party occurs. We explore how settlement risk and replacement cost affect the swap rate in credit default swaps.

Keywords: Counterparty risk; contagious defaults; intensity model; credit default swap

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To cite this article:

Seng Yuen Leung and Yue Kuen Kwok; "Credit Default Swap Valuation with Counterparty Risk", *The Kyoto Economic Review*, Vol. **74**, pp.25-45 (2005) .