

INTRODUCTION

Recent growth of credit derivatives has been explosive. The global credit derivatives market grew in notional value from \$1 to \$20 trillion dollars from 2000 to 2006. However, understanding the true nature of these instruments still poses both theoretical and practical challenges. For a long time now, the framework of Gaussian copulas parameterised by correlation, and more recently base correlation, has provided an adequate, if unintuitive, description of the market. However, increased liquidity in credit indices and index tranches, as well as proliferation of exotic instruments, such as forward starting tranches, options on tranches, leveraged super senior tranches, and the like, have made it imperative to come up with models which describe market reality better.

In view of this fact, Merrill Lynch decided to organize a conference entitled “Credit Correlation: Life after Copulas” in order to discuss the current developments in modelling for credit derivatives and the practical implications. This conference took place in September, 2006 at the Merrill Lynch Financial Centre in the City of London and brought together both practitioners and prominent academics. Practitioners presented 6 talks, while 4 academics participated in a panel discussion. This book volume, reprinted from the *International Journal of Theoretical and Applied Finance* (Vol. 10, No. 4), brings together these talks and panel presentations. The book contains 8 papers (the presentation by Prof. L. C. G. Rogers of Cambridge will be published elsewhere).

All participants agreed that base correlation has outlived its usefulness; opinions of how to replace it, however, were divided. Both the top-down and bottom-up approaches to describing the dynamics of credit baskets were presented and pro and contra arguments were put forward. Proponents of the top-down approach presented several complementary methods for studying the evolution of the loss distribution for a credit basket. Advocates of the bottom-up approach used both reduced-form and structural models. It is fair to say that neither camp won over the other; we leave it to the reader to decide which direction is the most promising at the moment. However, there was a real sense of forward movement and genuine belief in the importance of modelling. We can hope that in the near future, models which transcend base correlation will be proposed and accepted by the market.

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