A Simple Model of Credit Contagion

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Abstract

We propose a simple and implementable model of credit contagion where we include macro- and microstructural dependencies among the debtors within a credit portfolio. We show that, even for diversified portfolios, moderate microstructural dependencies have already a significant impact on the tails of the loss distribution. This impact increases dramatically for less diversified microstructures. Since the inclusion of microstructural dependencies acts on the tails, the choice of an appropriate risk measure for credit risk management is a delicate task.