

Abstract

The aim of this thesis is to shed more light into practical challenges related to pricing of contingent convertibles by empirically evaluating validity of two most crucial modelling assumptions of contingent convertible pricing framework.

First assumption is that contractually specified capital ratio can be proxied by stock price level. Second modelling assumption is that volatility smile characteristic for stock market can be also incorporated into the contingent pricing model.

First assumption is tested by comparison of probability of conversion implied by balance sheet figures with probability implied by market spreads. Analysis of our dataset indicates that probability implied by figures reported on balance sheet of issuer is statistically higher than probability estimated by market participants, suggesting that there is a confidence that reported figures do not fully represent the capital position of issuer and its ability to raise additional capital and revert the potential conversion. New information available on balance sheet also does not tend to immediately and fully materialize in contingent convertibles market.

Secondly, incorporation of volatility smile characteristic for stock market leads to very low and unstable trigger level compared to level implied by balance sheet.

Finally, findings collected throughout the thesis are utilized to suggest possible calibration setup of Credit derivatives model, which is again tested empirically on our dataset and evaluated based on various criteria.

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