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Abstract

This paper proposes a method for quantifying the variance risk premium in the credit market. We derive theoretically and we show numerically that the risk-neutral expected value of the return variance can be inferred from the market prices of the credit index options. The variance risk premium is defined as the difference between the realized variance and the synthetic simple variance swap rate. Using a novel data set, we synthesize the risk neutral variance, and we empirically test the historical variance risk premia magnitude on three European Credit Default Swap Indices.