
Table of Contents for All Volumes

VOLUME I Foundations and Vanilla Models

Part I Foundations

1	Introduction to Arbitrage Pricing Theory	3
1.1	The Setup	3
1.2	Trading Gains and Arbitrage	7
1.3	Equivalent Martingale Measures and Arbitrage	8
1.4	Derivative Security Pricing and Complete Markets	10
1.5	Girsanov's Theorem	12
1.6	Stochastic Differential Equations	14
1.7	Explicit Trading Strategies and PDEs	16
1.8	Kolmogorov's Equations and the Feynman-Kac Theorem	18
1.9	Black-Scholes and Extensions	21
1.9.1	Basics	21
1.9.2	Alternative Derivation	25
1.9.3	Extensions	27
1.9.3.1	Deterministic Parameters and Dividends	27
1.9.3.2	Stochastic Interest Rates	28
1.10	Options with Early Exercise Rights	30
1.10.1	The Markovian Case	32

1.10.2	Some General Bounds	34
1.10.3	Early Exercise Premia	36
2	Finite Difference Methods	43
2.1	1-Dimensional PDEs: Problem Formulation	43
2.2	Finite Difference Discretization	45
2.2.1	Discretization in x -Direction, Dirichlet Boundary Conditions	45
2.2.2	Other Boundary Conditions	47
2.2.3	Time-Discretization	49
2.2.4	Finite Difference Scheme	50
2.3	Stability	52
2.3.1	Matrix Methods	52
2.3.2	Von Neumann Analysis	53
2.4	Non-Equidistant Discretization	56
2.5	Smoothing and Continuity Correction	58
2.5.1	Crank-Nicolson Oscillation Remedies	58
2.5.2	Continuity Correction	58
2.5.3	Grid Shifting	59
2.6	Convection-Dominated PDEs	60
2.6.1	Upwinding	61
2.6.2	Other Techniques	62
2.7	Option Examples	63
2.7.1	Continuous Barrier Options	63
2.7.2	Discrete Barrier Options	65
2.7.3	Coupon-Paying Securities and Dividends	67
2.7.4	Securities with Early Exercise	68
2.7.5	Path-Dependent Options	69
2.7.6	Multiple Exercise Rights	70
2.8	Special Issues	72
2.8.1	Mesh Refinements for Multiple Events	72
2.8.2	Analytics at the Last Time Step	75
2.8.3	Analytics at the First Time Step	76
2.9	Multi-Dimensional PDEs: Problem Formulation	78
2.10	Two-Dimensional PDE with No Mixed Derivatives	79
2.10.1	Theta Method	80
2.10.2	The Alternating Direction Implicit (ADI) Method	81
2.10.3	Boundary Conditions and Other Issues	84
2.11	Two-Dimensional PDE with Mixed Derivatives	85
2.11.1	Orthogonalization of the PDE	85
2.11.2	Predictor-Corrector Scheme	88
2.12	PDEs of Arbitrary Order	91

3	Monte Carlo Methods	93
3.1	Fundamentals	93
3.1.1	Generation of Random Samples	95
3.1.1.1	Inverse Transform Method	96
3.1.1.2	Acceptance-Rejection Method	97
3.1.1.3	Composition	99
3.1.2	Correlated Gaussian Samples	100
3.1.2.1	Cholesky Decomposition	101
3.1.2.2	Eigenvalue Decomposition	102
3.1.3	Principal Components Analysis (PCA)	103
3.2	Generation of Sample Paths	104
3.2.1	Example: Asian Basket Options in Black-Scholes Economy	104
3.2.2	Discretization Schemes, Convergence, and Stability	106
3.2.3	The Euler Scheme	108
3.2.3.1	Linear-Drift SDEs	110
3.2.3.2	Log-Euler Scheme	110
3.2.4	The Implicit Euler Scheme	111
3.2.4.1	Implicit Diffusion Term	112
3.2.5	Predictor-Corrector Schemes	113
3.2.6	Ito-Taylor Expansions and Higher-Order Schemes	114
3.2.6.1	Ordinary Taylor Expansion of ODEs ...	115
3.2.6.2	Ito-Taylor Expansions	116
3.2.6.3	Milstein Second-Order Discretization Scheme	117
3.2.7	Other Second-Order Schemes	119
3.2.8	Bias vs. Monte Carlo Error	120
3.2.9	Sampling of Continuous Process Extremes	122
3.2.10	PCA and Bridge Construction of Brownian Motion Paths	126
3.2.10.1	Brownian Bridge and Quasi-Random Sequences	126
3.2.10.2	PC Construction	128
3.3	Sensitivity Computations	129
3.3.1	Finite Difference Estimates	129
3.3.1.1	Black-Scholes Delta	129
3.3.1.2	General Case	131
3.3.2	Pathwise Estimate	133
3.3.2.1	Black-Scholes Delta	133
3.3.2.2	General Case	134
3.3.2.3	Sensitivity Path Generation	136
3.3.3	Likelihood Ratio Method	136
3.3.3.1	Black-Scholes Delta	137
3.3.3.2	General Case	138
3.3.3.3	Euler Schemes	138

3.3.3.4	Some Remarks	139
3.4	Variance Reduction Techniques	140
3.4.1	Variance Reduction and Efficiency	141
3.4.2	Antithetic Variates	141
3.4.2.1	The Gaussian Case	141
3.4.2.2	General Case	143
3.4.3	Control Variates	143
3.4.3.1	Basic Idea	143
3.4.3.2	Non-Linear Controls	145
3.4.4	Importance Sampling	146
3.4.4.1	Basic Idea	146
3.4.4.2	Density Formulation	147
3.4.4.3	Importance Sampling and SDEs	149
3.4.4.4	More on SDE Path Simulation	150
3.4.4.5	Rare Event Simulation and Linearization	152
3.5	Some Notes on Bermudan Security Pricing	156
3.5.1	Basic Idea	156
3.5.2	Parametric Lower Bound Methods	157
3.5.3	Parametric Lower Bound: An Example	158
3.5.4	Regression-Based Lower Bound	159
3.5.5	Upper Bound Methods	160
3.5.6	Confidence Intervals	161
3.5.7	Other Methods	162
3.A	Appendix: Constants for Φ^{-1} Algorithm	163
4	Fundamentals of Interest Rate Modeling	165
4.1	Fixed Income Notations	165
4.1.1	Bonds and Forward Rates	165
4.1.2	Futures Rates	167
4.1.3	Annuity Factors and Par Rates	168
4.2	Fixed Income Probability Measures	169
4.2.1	Risk Neutral Measure	170
4.2.2	T -Forward Measure	172
4.2.3	Spot Measure	173
4.2.4	Terminal and Hybrid Measures	174
4.2.5	Swap Measures	175
4.3	Multi-Currency Markets	176
4.3.1	Notations and FX Forwards	176
4.3.2	Risk Neutral Measures	177
4.3.3	Other Measures	178
4.4	The HJM Analysis	179
4.4.1	Bond Price Dynamics	179
4.4.2	Forward Rate Dynamics	180
4.4.3	Short Rate Process	181
4.5	Examples of HJM Models	182

4.5.1	The Gaussian Model	182
4.5.2	Gaussian HJM Models with Markovian Short Rate	185
4.5.3	Log-Normal HJM Models	187
5	Fixed Income Instruments	189
5.1	Fixed Income Markets and Participants	189
5.2	Certificates of Deposit and Libor Rates	192
5.3	Forward Rate Agreements (FRA)	193
5.4	Eurodollar Futures	194
5.5	Fixed-for-Floating Swaps	195
5.6	Libor-in-Arrears Swaps	198
5.7	Averaging Swaps	199
5.8	Caps and Floors	199
5.9	Digital Caps and Floors	201
5.10	European Swaptions	201
5.10.1	Cash-Settled Swaptions	203
5.11	CMS Swaps, Caps and Floors	204
5.12	Bermudan Swaptions	205
5.13	Exotic Swaps and Structured Notes	206
5.13.1	Libor-Based Exotic Swaps	207
5.13.2	CMS-Based Exotic Swaps	208
5.13.3	Multi-Rate Exotic Swaps	208
5.13.4	Range Accruals	209
5.13.5	Path-Dependent Swaps	210
5.14	Callable Libor Exotics	211
5.14.1	Definitions	211
5.14.2	Pricing Callable Libor Exotics	213
5.14.3	Types of Callable Libor Exotics	214
5.14.4	Callable Snowballs	214
5.14.5	CLEs Accreting at Coupon Rate	214
5.14.6	Multi-Tranches	215
5.15	TARNs and Other Trade-Level Features	215
5.15.1	Knock-out Swaps	216
5.15.2	TARNs	216
5.15.3	Global Cap	217
5.15.4	Global Floor	217
5.15.5	Pricing and Trade Representation Challenges	217
5.16	Volatility Derivatives	218
5.16.1	Volatility Swaps	218
5.16.2	Volatility Swaps with a Shout	219
5.16.3	Min-Max Volatility Swaps	220
5.16.4	Forward Starting Options and Other Forward Volatility Contracts	220
5.A	Appendix: Day Counting Rules and Other Trivia	221
5.A.1	Libor Rate Definitions	222
5.A.2	Swap Payments	223

Part II Vanilla Models

6	Yield Curve Construction and Risk Management	227
6.1	Notations and Problem Definition	228
6.1.1	Discount Curves	228
6.1.2	Matrix Formulation	230
6.1.3	Construction Principles and Yield Curves	230
6.2	Yield Curve Fitting with N -Knot Splines	232
6.2.1	C^0 Yield Curves: Bootstrapping	232
6.2.1.1	Piecewise Linear Yields	233
6.2.1.2	Piecewise Flat Forward Rates	234
6.2.2	C^1 Yield Curves: Hermite Splines	236
6.2.3	C^2 Yield Curves: Twice Differentiable Cubic Splines	238
6.2.4	C^2 Yield Curves: Twice Differentiable Tension Splines	241
6.3	Non-Parametric Optimal Yield Curve Fitting	243
6.3.1	Norm Specification and Optimization	243
6.3.2	Choice of λ	246
6.3.3	Example	247
6.4	Managing Yield Curve Risk	248
6.4.1	Par-Point Approach	249
6.4.2	Forward Rate Approach	250
6.4.3	From Risks to Hedging: The Jacobian Approach	252
6.4.4	Cumulative Shifts and other Common Tricks	254
6.5	Various Topics in Discount Curve Construction	256
6.5.1	Curve Overlays and Turn-of-Year Effects	256
6.5.2	Cross-Currency Curve Construction	257
6.5.2.1	Basic Problem	257
6.5.2.2	Separation of Discount and Forward Rate Curves	258
6.5.2.3	Cross-Currency Basis Swaps	260
6.5.2.4	Modified Curve Construction Algorithm	261
6.5.3	Tenor Basis and Multi-Index Curve Group Construction	263
6.A	Appendix: Spline Theory	268
6.A.1	Hermite Spline Theory	268
6.A.2	C^2 Cubic Splines	271
6.A.3	C^2 Exponential Tension Splines	272
7	Vanilla Models with Local Volatility	275
7.1	General Framework	276
7.1.1	Model Dynamics	276
7.1.2	Volatility Smile and Implied Density	276

7.1.3	Choice of φ	277
7.2	CEV Model	278
7.2.1	Basic Properties	278
7.2.2	Call Option Pricing	280
7.2.3	Regularization	282
7.2.4	Displaced Diffusion Models	283
7.3	Quadratic Volatility Model	285
7.3.1	Case 1: Two Real Roots to the Left of $S(0)$	285
7.3.2	Case 2: One Real Root to the Left of $S(0)$	289
7.3.3	Extensions and Other Root Configurations	289
7.4	Finite Difference Solutions for General φ	290
7.4.1	Multiple λ and T	291
7.4.2	Forward Equation for Call Options	291
7.5	Asymptotic Expansions for General φ	293
7.5.1	Expansion around Displaced Log-Normal Process ..	293
7.5.2	Expansion around Gaussian Process	296
7.6	Extensions to Time-Dependent φ	297
7.6.1	Separable Case	297
7.6.2	Skew Averaging	298
	7.6.2.1 Examples	302
	7.6.2.2 A Caveat About the Process Domain ..	304
7.6.3	Skew and Convexity Averaging by Small-Noise Expansion	305
7.6.4	Numerical Example	309
8	Vanilla Models with Stochastic Volatility I	313
8.1	Model Definition	313
8.2	Model Parameters	315
8.3	Basic Properties	316
8.4	Fourier Integration	322
8.4.1	General Theory	322
8.4.2	Applications to SV Model	325
8.4.3	Numerical Implementation	328
8.4.4	Refinements of Numerical Implementation	330
8.4.5	Fourier Integration for Arbitrary European Payoffs	334
8.5	Integration in Variance Domain	337
8.6	CEV-Type Stochastic Volatility Models and SABR	341
8.7	Numerical Examples: Volatility Smile Statics	343
8.8	Numerical Examples: Volatility Smile Dynamics	345
8.9	Hedging in Stochastic Volatility Models	350
8.9.1	Hedge Construction, Delta and Vega	350
8.9.2	Minimum Variance Delta Hedging	353
8.9.3	Minimum Variance Hedging: an Example	354
8.A	Appendix: General Volatility Processes	356

9	Vanilla Models with Stochastic Volatility II	359
9.1	Fourier Integration with Time-Dependent Parameters	359
9.2	Asymptotic Expansion with Time-Dependent Volatility . .	362
9.3	Averaging Methods	366
9.3.1	Volatility Averaging	367
9.3.2	Skew Averaging	369
9.3.3	Volatility of Variance Averaging	370
9.3.4	Calibration by Parameter Averaging	372
9.4	PDE Method	377
9.4.1	PDE Formulation	377
9.4.2	Range for Stochastic Variance	378
9.4.3	Discretizing Stochastic Variance	379
9.4.4	Boundary Conditions for Stochastic Variance	381
9.4.5	Range for Underlying	382
9.4.6	Discretizing the Underlying	383
9.5	Monte Carlo Method	383
9.5.1	Exact Simulation of Variance Process	384
9.5.2	Biased Taylor-Type Schemes for Variance Process	385
9.5.2.1	Euler Schemes	385
9.5.2.2	Higher-Order Schemes	385
9.5.3	Moment Matching Schemes for Variance Process . .	386
9.5.3.1	Log-normal Approximation	386
9.5.3.2	Truncated Gaussian	387
9.5.3.3	Quadratic-Exponential	388
9.5.3.4	Summary of QE Algorithm	390
9.5.4	Broadie-Kaya Scheme for the Underlying	390
9.5.5	Other Schemes for the Underlying	392
9.5.5.1	Taylor-Type Schemes	392
9.5.5.2	Simplified Broadie-Kaya	392
9.5.5.3	Martingale Correction	392
9.A	Appendix: Proof of Proposition 9.3.4	393
9.B	Appendix: Coefficients for Asymptotic Expansion	397

VOLUME II Term Structure Models

Part III Term Structure Models

10	One-Factor Short Rate Models I	401
10.1	The One-Factor Gaussian Short Rate Model	402
10.1.1	The Ho-Lee Model	402
10.1.1.1	Notations and First Steps	402
10.1.1.2	Fitting the Term Structure of Discount Bonds	403
10.1.1.3	Analysis and Comparison with HJM Approach	405
10.1.2	The Mean-Reverting GSR Model	407
10.1.2.1	The Vasicek Model	407
10.1.2.2	The General One-Factor GSR Model	409
10.1.2.3	Time-Stationarity and Caplet Hump	412
10.1.3	European Option Pricing	414
10.1.3.1	The Jamshidian Decomposition	414
10.1.3.2	Gaussian Swap Rate Approximation	416
10.1.4	Swaption Calibration	417
10.1.5	Finite Difference Methods	418
10.1.5.1	PDE and Spatial Boundary Conditions	419
10.1.5.2	Determining Spatial Boundary Conditions from PDE	420
10.1.5.3	Upwinding	421
10.1.6	Monte Carlo Simulation	421
10.1.6.1	Exact Discretization	421
10.1.6.2	Approximate Discretization	423
10.1.6.3	Using other Measures for Simulation	424
10.2	The Affine One-Factor Model	425
10.2.1	Basic Definitions	425
10.2.1.1	SDE	425
10.2.1.2	Regularity Issues	426
10.2.1.3	Volatility Skew	426
10.2.1.4	Time-Dependent Parameters	427
10.2.2	Discount Bond Pricing and Extended Transform	427
10.2.2.1	Constant Parameters	428
10.2.2.2	Piecewise Constant Parameters	430
10.2.3	Discount Bond Calibration	431
10.2.3.1	Change of Variables	431
10.2.3.2	Algorithm for $\omega(t)$	432
10.2.4	European Option Pricing	433

10.2.5	Swaption Calibration	435
10.2.5.1	Basic Problem	435
10.2.5.2	Calibration Algorithm	436
10.2.6	Quadratic One-Factor Model	437
10.2.7	Numerical Methods for the Affine Short Rate Model	437
11	One-Factor Short Rate Models II	439
11.1	Log-Normal Short Rate Models	439
11.1.1	The Black-Derman-Toy Model	439
11.1.2	Black-Karasinski Model	441
11.1.3	Issues in Log-Normal Models	441
11.1.4	Sandmann-Sondermann Transformation	442
11.2	Other Short Rate Models	445
11.2.1	Power-Type Models and Empirical Model Estimation	445
11.2.2	The Black Shadow Rate Model	446
11.2.3	Spanned and Unspanned Stochastic Volatility: the Fong and Vasicek Model	448
11.3	Numerical Methods for General One-Factor Short Rate Models	449
11.3.1	Finite Difference Methods	450
11.3.2	Calibration to Initial Yield Curve	451
11.3.2.1	Forward Induction	452
11.3.2.2	Forward-from-Backward Induction	453
11.3.2.3	Yield Curve and Volatility Calibration	455
11.3.2.4	The Dybvig Parameterization	457
11.3.2.5	Link to HJM Models	458
11.3.2.6	The Hagan and Woodward Parameterization	459
11.3.3	Monte Carlo Simulation	462
11.3.3.1	SDE Discretization	462
11.3.3.2	Practical Issues with Monte Carlo Methods	464
11.A	Appendix: Markov-Functional Models	466
11.A.1	State Process and Numeraire Mapping	466
11.A.2	Libor MF Parameterization	467
11.A.3	Swap MF Parameterization	469
11.A.4	Non-Parametric Calibration	470
11.A.5	Numerical Implementation	471
11.A.6	Comments and Comparisons	472

12 Multi-Factor Short Rate Models	473
12.1 The Gaussian Model	474
12.1.1 Development from Separability Condition	474
12.1.1.1 Mean-Reverting State Variables	475
12.1.1.2 Further Changes of Variables	479
12.1.2 Classical Development	481
12.1.2.1 Diagonalization of Mean Reversion Matrix	482
12.1.3 Correlation Structure	484
12.1.4 The Two-Factor Gaussian Model	485
12.1.4.1 Some Basics	485
12.1.4.2 Variance and Correlation Structure	486
12.1.4.3 Volatility Hump	487
12.1.4.4 Another Formulation of the Two-Factor Model	488
12.1.5 Multi-Factor Statistical Gaussian Model	491
12.1.6 Swaption Pricing	496
12.1.6.1 Jamshidian Decomposition	496
12.1.6.2 Gaussian Swap Rate Approximation ...	500
12.1.7 Calibration via Benchmark Rates	501
12.1.8 Monte Carlo Simulation	504
12.1.9 Finite Difference Methods	505
12.2 The Affine Model	506
12.2.1 Introduction	506
12.2.2 Basic Model	507
12.2.3 Regularity Issues	508
12.2.4 Discount Bond Prices	509
12.2.5 Some Concrete Models	511
12.2.5.1 Fong-Vasicek Model	511
12.2.5.2 Longstaff-Schwartz Model	512
12.2.5.3 Multi-Factor CIR Models	513
12.2.6 Brief Notes on Option Pricing	514
12.3 The Quadratic Gaussian Model	514
12.3.1 Quadratic Gaussian Models are Affine	515
12.3.2 The Basics	516
12.3.3 Parameterization	518
12.3.3.1 Smile Generation	518
12.3.3.2 Quadratic Term	519
12.3.3.3 Linear Term	521
12.3.4 Swaption Pricing	522
12.3.4.1 State Vector Distribution Under the Annuity Measure	522
12.3.4.2 Exact Pricing of European Swaptions ..	523
12.3.4.3 Approximations for European Swaptions	524
12.3.5 Calibration	527

12.3.6	Spanned Stochastic Volatility	528
12.3.7	Numerical Methods	528
12.A	Appendix: Quadratic Forms of Gaussian Vectors	528
13	The Quasi-Gaussian Model	533
13.1	One-Factor Quasi-Gaussian Model	533
13.1.1	Definition	533
13.1.2	Local Volatility	535
13.1.3	Swap Rate Dynamics	536
13.1.4	Approximate Local Volatility Dynamics for Swap Rate	537
13.1.4.1	Simple Approximation	538
13.1.4.2	Advanced Approximation	538
13.1.5	Linear Local Volatility	541
13.1.6	Linear Local Volatility for a Swaption Strip	543
13.1.7	Volatility Calibration	544
13.1.8	Mean Reversion Calibration	546
13.1.8.1	Effects of Mean Reversion	546
13.1.8.2	Calibrating Mean Reversion to Volatility Ratios	548
13.1.8.3	Calibrating Mean Reversion to Inter-Temporal Correlations	551
13.1.8.4	Final Comments on Mean Reversion Calibration	553
13.1.9	Numerical Methods	554
13.1.9.1	Direct Integration	554
13.1.9.2	Finite Difference Methods	556
13.1.9.3	Monte Carlo Simulation	559
13.1.9.4	Single-State Approximations	559
13.2	One-Factor Quasi-Gaussian Model with Stochastic Volatility	563
13.2.1	Definition	563
13.2.2	Swap Rate Dynamics	564
13.2.3	Volatility Calibration	566
13.2.4	Mean Reversion Calibration	567
13.2.5	Non-Zero Correlation	567
13.2.6	PDE and Monte Carlo Methods	568
13.3	Multi-Factor Quasi-Gaussian Model	568
13.3.1	General Multi-Factor Model	568
13.3.2	Local and Stochastic Volatility Parameterization	570
13.3.3	Swap Rate Dynamics and Approximations	572
13.3.4	Volatility Calibration	577
13.3.5	Mean Reversions, Correlations, and Numerical Schemes	578
13.A	Appendix: Density Approximation	579

13.A.1	Simplified Forward Measure Dynamics	579
13.A.2	Effective Volatility	580
13.A.3	The Forward Equation for Call Options	581
13.A.4	Asymptotic Expansion	582
13.A.5	Proof of Theorem 13.1.14	583
14	The Libor Market Model I	585
14.1	Introduction and Setup	586
14.1.1	Motivation and Historical Notes	586
14.1.2	Tenor Structure	587
14.2	LM Dynamics and Measures	587
14.2.1	Setting	587
14.2.2	Probability Measures	588
14.2.3	Link to HJM Analysis	591
14.2.4	Separable Deterministic Volatility Function	592
14.2.5	Stochastic Volatility	594
14.2.6	Time-Dependence in Model Parameters	597
14.3	Correlation	597
14.3.1	Empirical Principal Components Analysis	598
14.3.1.1	Example: USD Forward Rates	599
14.3.2	Correlation Estimation and Smoothing	600
14.3.2.1	Example: Fit to USD Data	603
14.3.3	Negative Eigenvalues	604
14.3.4	Correlation PCA	605
14.3.4.1	Example: USD Data	607
14.3.4.2	Poor Man's Correlation PCA	608
14.4	Pricing of European Options	608
14.4.1	Caplets	609
14.4.2	Swaptions	610
14.4.3	Spread Options	613
14.4.3.1	Term Correlation	614
14.4.3.2	Spread Option Pricing	615
14.5	Calibration	615
14.5.1	Basic Principles	615
14.5.2	Parameterization of $\ \lambda_k(t)\ $	616
14.5.3	Interpolation on the Whole Grid	617
14.5.4	Construction of $\lambda_k(t)$ from $\ \lambda_k(t)\ $	619
14.5.4.1	Covariance PCA	620
14.5.4.2	Correlation PCA	620
14.5.4.3	Discussion and Recommendation	621
14.5.5	Choice of Calibration Instruments	621
14.5.6	Calibration Objective Function	624
14.5.7	Sample Calibration Algorithm	626
14.5.8	Speed-Up Through Sub-Problem Splitting	627
14.5.9	Correlation Calibration to Spread Options	629

14.5.10	Volatility Skew Calibration	631
14.6	Monte Carlo Simulation	631
14.6.1	Euler-Type Schemes	632
14.6.1.1	Analysis of Computational Effort	633
14.6.1.2	Long Time Steps	634
14.6.1.3	Notes on the Choice of Numeraire	636
14.6.2	Other Simulation Schemes	636
14.6.2.1	Special-Purpose Schemes with Drift Predictor-Corrector	637
14.6.2.2	Euler Scheme with Predictor-Corrector	638
14.6.2.3	Lagging Predictor-Corrector Scheme ...	638
14.6.2.4	Further Refinements of Drift Estimation	640
14.6.2.5	Brownian-Bridge Schemes and Other Ideas	641
14.6.2.6	High-Order Schemes	643
14.6.3	Martingale Discretization	644
14.6.3.1	Deflated Bond Price Discretization ...	645
14.6.3.2	Comments and Alternatives	646
14.6.4	Variance Reduction	647
14.6.4.1	Antithetic Sampling	647
14.6.4.2	Control Variates	648
14.6.4.3	Importance Sampling	648
15	The Libor Market Model II	651
15.1	Interpolation	651
15.1.1	Back Stub, Simple Interpolation	652
15.1.2	Back Stub, Arbitrage-Free Interpolation	653
15.1.3	Back Stub, Gaussian Model	655
15.1.4	Front Stub, Zero Volatility	656
15.1.5	Front Stub, Exogenous Volatility	657
15.1.6	Front Stub, Simple Interpolation	660
15.1.7	Front Stub, Gaussian Model	661
15.2	Advanced Swaption Pricing via Markovian Projection ...	662
15.2.1	Advanced Formula for Swap Rate Volatility	664
15.2.2	Advanced Formula for Swap Rate Skew	666
15.2.3	Skew and Smile Calibration in LM Models	668
15.3	Near-Markov LM Models	670
15.4	Swap Market Models	670
15.5	Evolving Separate Discount and Forward Rate Curves ...	672
15.5.1	Basic Ideas	673
15.5.2	HJM Extension	674
15.5.3	Applications to LM Models	677
15.5.4	Deterministic Spread	681
15.6	SV Models with Non-Zero Correlation	681
15.7	Multi-Stochastic Volatility Extensions	683

15.7.1	Introduction	683
15.7.2	Setup	684
15.7.3	Pricing Caplets and Swaptions	685
15.7.4	Spread Options.....	686
15.7.5	Another Use of Multi-Dimensional Stochastic Volatility	687

VOLUME III Products and Risk Management

Part IV Products

16	Single-Rate Vanilla Derivatives	691
16.1	European Swaptions	691
16.1.1	Smile Dynamics	692
16.1.2	Adjustable Backbone	693
16.1.3	Stochastic Volatility Swaption Grid	696
16.1.4	Calibrating Stochastic Volatility Model to Swaptions	697
16.1.5	Some Other Interpolation Rules	699
16.2	Caps and Floors	700
16.2.1	Basic Problem	700
16.2.2	Setup and Norms	701
16.2.3	Calibration Procedure	702
16.3	Terminal Swap Rate Models	703
16.3.1	TSR Basics	703
16.3.2	Linear TSR Model	705
16.3.3	Exponential TSR Model	708
16.3.4	Swap-Yield TSR Model	709
16.4	Libor-in-Arrears	710
16.5	Libor-with-Delay	713
16.5.1	Swap-Yield TSR Model	714
16.5.2	Other Terminal Swap Rate Models	715
16.5.3	Approximations Inspired by Term Structure Models	715
16.5.4	Applications to Averaging Swaps	716
16.6	CMS and CMS-Linked Cash Flows	717
16.6.1	The Replication Method for CMS	718
16.6.2	Annuity Mapping Function as a Conditional Expected Value	720
16.6.3	Swap-Yield TSR Model	722
16.6.4	Linear and Other TSR Models	722
16.6.5	The Quasi-Gaussian Model	724
16.6.6	The Libor Market Model	725
16.6.7	Correcting Non-Arbitrage-Free Methods	728
16.6.8	Impact of Annuity Mapping Function and Mean Reversion	729
16.6.9	CDF and PDF of CMS Rate in Forward Measure	730
16.6.10	SV Model for CMS Rate	734

16.6.11	Dynamics of CMS Rate in Forward Measure	735
16.6.12	Cash-Settled Swaptions	738
16.7	Quanto CMS	740
16.7.1	Overview	740
16.7.2	Modeling the Joint Distribution of Swap Rate and Forward Exchange Rate	742
16.7.3	Normalizing Constant and Final Formula	743
16.8	Eurodollar Futures	744
16.8.1	Fundamental Results on Futures	745
16.8.2	Motivations and Plan	747
16.8.3	Preliminaries	748
16.8.4	Expansion Around the Futures Value	748
16.8.5	Forward Rate Variances	751
16.8.6	Forward Rate Correlations	753
16.8.7	The Formula	754
16.9	Convexity and Moment Explosions	755
17	Multi-Rate Vanilla Derivatives	759
17.1	Introduction to Multi-Rate Vanilla Derivatives	759
17.2	Marginal Distributions and Reference Measure	761
17.3	Dependence Structure via Copulas	762
17.3.1	Introduction to Gaussian Copula Method	762
17.3.2	General Copulas	764
17.3.3	Archimedean Copulas	766
17.3.4	Making Copulas from Other Copulas	767
17.4	Copula Methods for CMS Spread Options	770
17.4.1	Normal Model for the Spread	770
17.4.2	Gaussian Copula for Spread Options	771
17.4.3	Spread Volatility Smile Modeling with the Power Gaussian Copula	774
17.4.4	Copula Implied From Spread Options	775
17.5	Rates Observed at Different Times	778
17.6	Numerical Methods for Copulas	779
17.6.1	Numerical Integration Methods	780
17.6.2	Dimensionality Reduction for CMS Spread Options	783
17.6.3	Dimensionality Reduction for Other Multi-Rate Derivatives	785
17.6.4	Dimensionality Reduction by Conditioning	787
17.6.5	Dimensionality Reduction by Measure Change	791
17.6.6	Monte Carlo Methods	793
17.7	Limitations of the Copula Method	795
17.8	Stochastic Volatility Modeling for Multi-Rate Options	796
17.8.1	Measure Change by Drift Adjustment	797
17.8.2	Measure Change by CMS Caplet Calibration	798
17.8.3	Impact of Correlations on the Spread Smile	799

17.8.4	Connection to Term Structure Models	800
17.9	CMS Spread Options in Term Structure Models	802
17.9.1	Libor Market Model	802
17.9.2	Quadratic Gaussian Model	804
17.A	Appendix: Implied Correlation in Displaced Log-Normal Models	805
17.A.1	Preliminaries	805
17.A.2	Implied Log-Normal Correlation	806
17.A.3	A Few Numerical Results	807
18	Callable Libor Exotics	809
18.1	Model Calibration for Callable Libor Exotics	809
18.1.1	Risk Factors for CLEs	810
18.1.2	Model Choice and Calibration	813
18.2	Valuation Theory	814
18.2.1	Preliminaries	814
18.2.2	Recursion for Callable Libor Exotics	815
18.2.3	Marginal Exercise Value Decomposition	816
18.3	Monte Carlo Valuation	817
18.3.1	Regression-Based Valuation of CLEs, Basic Scheme	817
18.3.2	Regression for Underlying	819
18.3.3	Valuing CLE as a Cancelable Note	821
18.3.4	Using Regressed Variables for Decision Only	822
18.3.5	Regression Valuation with Boundary Optimization	824
18.3.6	Lower Bound via Regression Scheme	825
18.3.7	Iterative Improvement of Lower Bound	827
18.3.8	Upper Bound	830
18.3.8.1	Basic Ideas	830
18.3.8.2	Nested Simulation (NS) Algorithm	831
18.3.8.3	Bias and Computational Cost of NS Algorithm	834
18.3.8.4	Confidence Intervals and Practical Usage	836
18.3.8.5	Non-Analytic Exercise Values	837
18.3.8.6	Improvements to NS Algorithm	839
18.3.8.7	Other Upper Bound Algorithms	841
18.3.9	Regression Variable Choice	842
18.3.9.1	State Variables Approach	842
18.3.9.2	Explanatory Variables	843
18.3.9.3	Explanatory Variables with Convexity	846
18.3.10	Regression Implementation	848
18.3.10.1	Automated Explanatory Variable Selection	848
18.3.10.2	Suboptimal Point Exclusion	850
18.3.10.3	Two Step Regression	851

18.3.10.4	Robust Implementation of Regression Algorithm	852
18.4	Valuation with Low-Dimensional Models	856
18.4.1	Single-Rate Callable Libor Exotics	856
18.4.2	Calibration Targets for the Local Projection Method	856
18.4.3	Review of Suitable Local Models	857
18.4.4	Defining a Suitable Analog for Core Swap Rates ..	859
18.4.5	PDE Methods for Path-Dependent CLEs	861
18.4.5.1	CLEs Accreting at Coupon Rate	862
18.4.5.2	Snowballs	864
19	Bermudan Swaptions	867
19.1	Definitions	867
19.2	Local Projection Method	868
19.3	Smile Calibration	870
19.4	Amortizing, Accreting, Other Non-Standard Swaptions ...	872
19.4.1	Relationship Between Non-Standard and Standard Swap Rates	874
19.4.2	Same-Tenor Approach	875
19.4.3	Representative Swaption Approach	876
19.4.4	Basket Approach	879
19.4.5	Super-Replication for Non-Standard Bermudan Swaptions	882
19.4.6	Zero-Coupon Bermudan Swaptions	886
19.4.7	American Swaptions	887
19.4.7.1	American Swaptions vs. High- Frequency Bermudan Swaptions	888
19.4.7.2	The Proxy Libor Rate Method	889
19.4.7.3	The Libor-as-Extra-State Method	890
19.4.8	Mid-Coupon Exercise	891
19.5	Flexi-Swaps	892
19.5.1	Purely Global Bounds	893
19.5.2	Purely Local Bounds	893
19.5.3	Marginal Exercise Value Decomposition	895
19.5.4	Narrow Band Limit	896
19.6	Monte Carlo Valuation	897
19.6.1	Regression Methods	897
19.6.2	Parametric Boundary Methods	898
19.6.2.1	Sample Exercise Strategies for Bermudan Swaptions	898
19.6.2.2	Some Numerical Tests	901
19.6.2.3	Additional Comments	904
19.7	Other Topics	904

- 19.7.1 Robust Bermudan Swaption Hedging with European Swaptions 904
- 19.7.2 Carry and Exercise 907
- 19.7.3 Fast Pricing via Exercise Premia Representation . 908
- 19.A Appendix: Forward Volatility and Correlation 912
- 19.B Appendix: A Primer on Moment Matching 913
 - 19.B.1 Basics 913
 - 19.B.2 Example 1: Asian Option in BSM Model 914
 - 19.B.3 Example 2: Basket Option in BSM Model 916
- 20 TARNs, Volatility Swaps, and Other Derivatives 919**
 - 20.1 TARNs 919
 - 20.1.1 Definitions and Examples 919
 - 20.1.2 Valuation and Risk with Globally Calibrated Models 921
 - 20.1.3 Local Projection Method 922
 - 20.1.4 Volatility Smile Effects 923
 - 20.1.5 PDE for TARNs 925
 - 20.2 Volatility Swaps 927
 - 20.2.1 Local Projection Method 928
 - 20.2.2 Shout Options 929
 - 20.2.3 Min-Max Volatility Swaps 932
 - 20.2.4 Impact of Volatility Dynamics on Volatility Swaps 934
 - 20.3 Forward Swaption Straddles 939
- 21 Out-of-Model Adjustments 945**
 - 21.1 Adjusting the Model 946
 - 21.1.1 Calibration to Coupons 946
 - 21.1.2 Adjusters 948
 - 21.1.3 Path Re-Weighting 950
 - 21.1.4 Proxy Model Method 955
 - 21.1.5 Asset-Based Adjustments 957
 - 21.1.6 Mapping Function Adjustments 959
 - 21.2 Adjusting the Market 959
 - 21.3 Adjusting the Trade 960
 - 21.3.1 Fee Adjustments 961
 - 21.3.2 Fee Adjustment Impact on Exotic Derivatives 962
 - 21.3.3 Strike Adjustment 963

Part V Risk Management

22	Introduction to Risk Management	969
22.1	Risk Management and Sensitivity Computations	970
22.1.1	Basic Information Flow	970
22.1.2	Risk: Theory and Practice	972
22.1.3	Example: the Black-Scholes Model	974
22.1.4	Example: Black-Scholes Model with Time-Dependent Parameters	977
22.1.5	Actual Risk Computations	979
22.1.6	What about Θ_{prm} and Θ_{num} ?	980
22.1.7	A Note on Trading P&L and the Computation of Implied Volatility	981
22.2	P&L Analysis	984
22.2.1	P&L Predict	985
22.2.2	P&L Explain	987
22.2.2.1	Waterfall Explain	987
22.2.2.2	Bump-and-Reset Explain	988
22.3	Value-at-Risk	989
22.A	Appendix: Alternative Proof of Lemma 22.1.1	992
23	Payoff Smoothing and Related Methods	995
23.1	Issues with Discretization Schemes	995
23.1.1	Problems with Grid Dimensioning	996
23.1.2	Grid Shifts Relative to Payout	996
23.1.3	Additional Comments	999
23.2	Basic Techniques	1000
23.2.1	Adaptive Integration	1000
23.2.2	Adding Singularities to the Grid	1001
23.2.3	Singularity Removal	1003
23.2.4	Partial Analytical Integration	1004
23.3	Payoff Smoothing For Numerical Integration and PDEs ..	1006
23.3.1	Introduction to Payoff Smoothing	1006
23.3.2	Payoff Smoothing in One Dimension	1008
23.3.2.1	Box Smoothing	1009
23.3.2.2	Other Smoothing Methods	1012
23.3.3	Payoff Smoothing in Multiple Dimensions	1013
23.4	Payoff Smoothing for Monte Carlo	1016
23.4.1	Tube Monte Carlo for Digital Options	1016
23.4.2	Tube Monte Carlo for Barrier Options	1018
23.4.3	Tube Monte Carlo for Callable Libor Exotics	1023
23.4.4	Tube Monte Carlo for TARNs	1023
23.A	Appendix: Delta Continuity of Singularity-Enlarged Grid Method	1024
23.B	Appendix: Conditional Independence for Tube Monte Carlo	1026

24	Pathwise Differentiation	1029
24.1	Pathwise Differentiation: Foundations	1029
24.1.1	Callable Libor Exotics	1029
24.1.1.1	CLE Greeks	1030
24.1.1.2	Keeping the Exercise Time Constant ...	1032
24.1.1.3	Noise in CLE Greeks	1033
24.1.2	Barrier Options	1034
24.2	Pathwise Differentiation for PDE Based Models	1038
24.2.1	Model and Setup	1038
24.2.2	Bucketed Deltas	1039
24.2.3	Survival Density	1042
24.3	Pathwise Differentiation for Monte Carlo Based Models ..	1045
24.3.1	Pathwise Derivatives of Forward Libor Rates	1045
24.3.2	Pathwise Deltas of European Options	1048
24.3.2.1	Pathwise Deltas of the Numeraire	1048
24.3.2.2	Pathwise Deltas of the Payoff	1049
24.3.3	Adjoint Method For Greeks Calculation	1050
24.3.4	Pathwise Delta Approximation for Callable Libor Exotics	1052
24.4	Notes on Likelihood Ratio and Hybrid Methods	1054
25	Importance Sampling and Control Variates	1057
25.1	Importance Sampling In Short Rate Models	1057
25.2	Payoff Smoothing by Importance Sampling	1059
25.2.1	Binary Options	1059
25.2.2	TARNs	1062
25.2.3	Removing the First Digital	1062
25.2.4	Smoothing All Digitals by One-Step Survival Conditioning	1063
25.2.5	Simulating Under the Survival Measure Using Conditional Gaussian Draws	1066
25.2.6	Generalized Trigger Products in Multi-Factor LM Models	1068
25.3	Model-Based Control Variates	1071
25.3.1	Low-Dimensional Markov Approximation for LM models	1072
25.3.2	Two-Dimensional Extension	1075
25.3.3	Approximating Volatility Structure	1076
25.3.4	Markov Approximation as a Control Variate	1078
25.4	Instrument-Based Control Variates	1080
25.5	Dynamic Control Variates	1084
25.6	Control Variates and Risk Stability	1087

26	Vegas in Libor Market Models	1089
26.1	Basic Problem of Vega Computations	1089
26.2	Review of Calibration	1091
26.3	Vega Calculation Methods	1092
26.3.1	Direct Vega Calculations	1092
26.3.1.1	Definition and Analysis	1092
26.3.1.2	Numerical Example	1095
26.3.2	What is a Good Vega?	1096
26.3.3	Indirect Vega Calculations	1099
26.3.3.1	Definition and Analysis	1099
26.3.3.2	Numerical Example and Performance Analysis	1102
26.3.4	Hybrid Vega Calculations	1105
26.3.4.1	Definition and Analysis	1105
26.3.4.2	Numerical Example	1107
26.4	Skew and Smile Vegas	1107
26.5	Vegas and Correlations	1109
26.5.1	Term Correlation Effects	1109
26.5.2	What Correlations should be Kept Constant?	1110
26.5.3	Vegas with Fixed Term Correlations	1112
26.5.4	Numerical Example	1113
26.6	Deltas with Backbone	1114
26.7	Vega Projections	1116
26.8	Some Notes on Computing Model Vegas	1118

Appendix

A	Markovian Projection	1123
A.1	Marginal Distributions of Ito Processes	1123
A.2	Approximations for Conditional Expected Values	1128
A.2.1	Gaussian Approximation	1128
A.2.2	Least-Squares Projection	1130
A.3	Applications to Local Stochastic Volatility Models	1131
A.3.1	Markovian Projection onto an SV Model	1131
A.3.2	Fitting the Market with an LSV Model	1133
A.3.3	On Calculating Proxy Local Volatility	1137
A.4	Basket Options in Local Volatility Models	1139
A.5	Basket Options in Stochastic Volatility Models	1143
A.A	Appendix: $E(\sqrt{z_n(t)z_m(t)})$ and $E(\sqrt{z_n(t)})$	1146
A.A.1	Proof of Proposition A.A.1	1147
A.A.1.1	Step 1. Reduction to Covariance	1147
A.A.1.2	Step 2. Linear Approximation	1148
A.A.1.3	Step 3. Coefficients	1148
A.A.1.4	Step 4. Order of Approximation	1149
A.A.2	Proof of Lemma A.A.2	1149