

# Fixed Income Analytics in DRIP

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**v1.05**, 11 February 2015

### Terminology Background

### Framework Glossary

1. Self-Jacobian: Self-Jacobian refers to the Jacobian of the Objective Function at any point in the variate to the Objective Function at the segment nodes, i.e., .
2. Point-Measure State-Transform: Point-Measure transform refers to the one-to-one transform between a state measure at a predictor ordinate and its corresponding observation (e.g., discount factor from zero-coupon bond price observations).
3. Convolved-Measure State-Transform: Convolved-Measure transform refers to the many-to-one transform between a state metric/predictor ordinate combination to a given observation, i.e., a set of state metric/predictor ordinate pairs together imply an observation (e.g., zero rates from swap fair premium).
4. Discount-Curve Native Forward Curve: For discount curves built out of instruments dependent on forward rates, those rates and their discount curve usage ranges together constitute the discount curve’s native forward curve range.

### Document Layout

**Associations**

1. ISDA: Many rules and standards are proposed or collected by financial associations. Chief among the, the ISDA, was founded in 1985. In particular ISDA publishes the ISDA definitions. Reference => <http://www2.isda.org/>
2. British Bankers’ Association: The British Banker’s Association (BBA) is the trade association for the UK banking and the financial services sector. Reference => <http://www.bba.org.uk/>
3. EURIBOR-EBF: The EURIBOR-EBF is a international non-profit association founded in 1999 with the launch of the Euro. Its members are the national banking associations of the member nations of the European Union which are involved in the Euro-zone and the Euro system. Reference => <http://www.euribor-ebf.eu/>
4. Australian Financial Markets Association: AFMA was formed in 1986. Reference => <http://www.afma.com.au>
5. Danish Bankers’ Association: The Danish Bankers’ Association is an organization representing the banks in Denmark. It has the overall responsibility for the CIBOR indices. Reference => <http://www.finansraadet.dk>
6. Wholesale Markets’ Brokers’ Association: The WMBA is an association of the London brokers. Reference => <http://www.wmba.org.uk>
7. Japanese Bankers’ Association: The Japanese Bankers’ Association is a financial organization whose members consist of banks, bank holding companies, and bankers’ associations in Japan. Reference => <http://www.zenginko.or.jp/en/>

**Exchanges**

1. Introduction: There are many exchanges where financial instruments are traded throughout the world. This section includes the main ones where the interest rate derivatives are listed. Over the years a lot of mergers and acquisitions have taken place between the exchanges. The names and the organization structures have changed, and will certainly change again.
2. Australian Securities Exchange: In the interest rate landscape, the main products are the AUD bank bill futures and their options, and AUD bond futures. Reference => <http://www.asx.com.au/>
3. BM&FBovespa - Brazil: BM&FBovespa was created in 2008 through the integration between Sao Paolo Stock Exchange (Bolsa de Valores de Sao Paolo) and the Brazilian Mercantile and Futures Exchange (Bolsa de Mercadorias e Futuros). Reference => <http://www.bmfbovespa.com.br>
4. CME Group: The CME group is a result of mergers between the Chicago Mercantile Exchange (CME), the Chicago Board of Trade (CBOT), the New York Mercantile Exchange (NYMEX), and COMEX. In the interest rate landscape, the main products are the interest rate futures (on LIBOR) and their options listed on CME, the federal funds futures listed in CBOT, and the bond futures and their options listed in CBOT. CME also runs a swap clearing business. Reference => <http://www.cmegroup.com>
5. EUREX: Eurex is a derivatives exchange jointly operated by the Deutsche Borse AG and the SIX Swiss Exchange. It started its derivatives trading in 1998. In the interest rate landscape, the main products are the interest rate futures (on EURIBOR) and their options, and EUR bond futures. Reference => <http://www.eurexchange.com/index.html>
6. Intercontinental Exchange - ICE: ICE is a relatively recent exchange active mainly in commodity, energy, and credit. It is involved in interest rate derivatives mainly through its (as of November 2013) acquisition of NYSE EuroNext. Reference => <http:///www.theice.com>
7. LCH.ClearNet: LCH.ClearNet group is a clearing house serving major exchanges and platforms, as well as a range of OTC markets. ClearNet is owned 77.5% by its clients and 22.5% by the exchanges. Reference => <http://www.lchclearnet.com>
8. MEFF - Spain: MEFF is an official secondary market regulated by the Spanish laws and under the supervision of the Spanish National Securities Market Commission. Reference => <http://www.meff.com>
9. Montreal Exchange: The Montreal Exchange is an electronic exchange dedicated to the development of the Canadian derivative markets. Reference => <http://www.m-x.ca/>
10. NASDAQ OMX: In the interest rate landscape the main products are the Nordic futures; CIBOR futures, STIBOR futures, and Swedish Bond Futures. They are also known for publishing the CIBOR and the SIOR rates. NASDAQ OMX also runs an exchange in London – the NLX (New London eXchange). References => <http://www.nasdaqomx.com>; <http://www.nasdaqomx.com/transactions/markets/nlx>
11. NYSE EuroNext: NYSE EuroNext resulted from the mergers/acquisitions between EuroNext, NYSE< LIFFE, and AMEX. The exchange was acquired by InterContinental Exchange in November 2013. In the interest rate landscape the main products are the interest rate future (on LIBOR and EURIBOR), and their listed options on LIFFE. Reference => <http://www.euronext.com>
12. Singapore Exchange - SGX: In the interest rate landscape, the products are Japanese and Singaporean Government Bond Futures, JPY (LIBOR and TIBOR), the Eurodollar STIR futures/options, and SGD futures. SGX also runs a swap clearing business. Reference => <http://www.sgx.com>
13. Tokyo Stock Exchange: In the interest rate landscape, the main products are JPY bond futures. Reference => <http://www.tse.or.jp/english>
14. South African Futures Exchange (SAFE): The Johannesburg Stock Exchange’s Interest Rate Market offers bond futures and JIBAR 3M STIR futures. Reference => <http://www.safex.co.za>.

**Day Count Conventions**

1. 1/1: The day count fraction is always 1.0; Definition 4.16 (a) in 2006 ISDA definitions (Open Gamma (2012)).
2. 30/360 Methods: Here the DCF is computed as. The main differences are on how , , and are calculated.
3. Generic 30/360: The generic 30.360 rules are: a) If , set ; b) If and , set . This day count is also called 30/360 US, 30U/360, Bond Basis, 30/360, or 360/360. The last 3 are the ones used in the 2006 ISDA conventions. A variation of this uses an EOM Convention, which applies the following addition rule: If the EOM flag is turned on, and are the last days of February, the set . ISDA (as set out in 4.16(f)) does not use the EOM flag.
4. 30E/360: This is definition 4.16(g) in the 2006 ISDA definitions. The date adjustment rules are the following: If , change it to . Do the same for as well. This is also referred to as EUROBOND basis.
5. 30E/360 (ISDA): This is definition 4.16 (h) in ISDA 2006 definitions. The date adjustment rules are the following: a) If is the last day of the month, becomes 30. b) If is the last day of February, but not the termination date, or if , then .
6. 30E+/360 (ISDA): The date adjustment rules are the following: a) If , the set . b) If , then change and . This convention is also called 30E+/360.
7. Act/360: This is definition 4.16 € in the 2006 ISDA definitions. The accrual factor is where is the number of days between the 2 dates. This is the most widely used convention for the money market instruments (maturity below one year). This day count is also called the MONEY MARKET BASIS, Actual 360, or French Money Market Basis.
8. Act/365 Fixed: This is definition 4.16 (d) in the 2006 ISDA definitions. The accrual factor is where is the number of days between the 2 dates. The number 365 is used even in a leap year. This convention is also called the ENGLISG MONEY MARKET BASIS.
9. Act/365L: This convention, described in ICMA Rule 251.1 (i), is seldom used. It was originally designed for the Euro-Sterling FRNs. It is used to only compute the accrual factor of a coupon. The computation of the factor requires 3 dates – the accrual start date (), the accrual factor date (), and the accrual end date ().
10. Application of 365L: For semi-annual coupons (the type of coupons for which it was originally designed for), the accrual factor is , where is the number of days in the year contained by . This convention is extended to annual coupons by , where is 366 if 29 February is between (exclusive) and (inclusive), or 365 otherwise. The convention is also called Act/365 Leap Year.
11. Act/365A: The accrual factor here is , where is 366 if 29 February is between (exclusive) and (inclusive), or 365 otherwise. The convention is also called Act/365 Actual.
12. NL/365: The accrual factor is where if 29 February is between (exclusive) and (inclusive), or otherwise. The convention is also called Act/365 No Leap Year.
13. Act/Act ISDA: This is definition 4.16(a) in 2006 ISDA definitions. The accrual factor is , where the period first day is include and the period last day is excluded.
14. Act/Act ICMA – No Adjustment: This is taken from 4.16 (c) of the 2006 ISDA definitions. This convention is defined in Rule 251 of the ICMA Rule book. The accrual factor is where is the number of coupons per year and depends on the type of stub period. Where NO\_ADJUSTMENT is set, , so the accrual factor becomes simply .
15. Act/Act ICMA – Short at Start: Here the adjustment is computed as a ratio. The numerator is the number of days in the period, and the denominator is the number of days between the standardized start date computed as the coupon end date minus the number of month corresponding to the frequency (e.g., ) and the end date.
16. Act/Act ICMA – Long at Start: Two standardized start dates are computed as the coupon end date minus once and twice the number of months corresponding to the frequency. The numerator is the number of days between the start date and the denominator is the number of days between the first and the second standardized start date. The adjustment is the ratio of the numerator by the denominator plus 1.
17. Act/Act ICMA – Short at End: The adjustment is computed as a ratio. The numerator is the number of days between the start date and the standardized end date computed as the coupon start date plus the number of months corresponding to the frequency (i.e., ).
18. Act/Act ICMA – Long at End: Two standardized dates are computed as the coupon start dates plus once and twice the number of months corresponding to the frequency. The numerator is the number of months between the end date and the first standardized end date, and the denominator is the number of days between the second and the first standardized end date. The adjustment is the ratio of the numerator to the denominator plus 1.
19. Business/252: This day count is also called BUS/252. This day count is based on the business, not the calendar days. The accrual factor is where the numerator is the number of business days in a calendar year from and including the start date up to and excluding the end date. This day count convention is used in particular in the Brazilian market.

### References

* Open Gamma (2012): Interest Rate Instruments and Market Conventions Guide *Quantitative Research* **Open Gamma**.

**Business Day Conventions**

1. Following: Business day convention is the convention for the adjustment of the dates when the specified date is not a good business day. The adjustment is applied with respect to a specified calendar. In the *following* convention, the adjusted day is the following business day.
2. Preceding: Here the adjusted day is the preceding good business day. This convention is often linked to loans and is a translation of the amount that should be paid on or before a specific date.
3. Modified Following: Here the adjusted date is the following good business day unless that date falls on the next calendar month, in which case it is taken to be the preceding good business day. This is the most used convention for interest rate derivatives.
4. Modified Following Bi-monthly: The adjusted date is the following good business day unless that adjusted date crosses mid-month (15th) or the end of month, in which case the adjusted date is the preceding good business day.
5. End-of-Month: Where the tart of a period is on the final business day of a calendar month, the end date is also on the final business day of the end month (not necessarily the corresponding calendar date in the month).

**IBOR-like Indexes**

**Introduction**

1. The Indexes: IBOR-like indexes are related to interbank lending for maturities ranging from 1D to 1Y. They are usually computed as a trimmed average between rates contributed by the participating banks. The rates are the banks’ estimates, but usually do not refer to the actual transactions. The most common usage of these indexes in IRD is in IRS and caps/floors.
2. IBOR Indices for the main Currencies:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Currency** | **Name** | **Maturities** | **Convention** | **Spot Lag** |
| CHF | LIBOR | ON-12M | Act/360 | 2 |
| EUR | EURIBOR | 1W-12M | Act/360 | 2 |
| EUR | EURIBOR | 1W-12M | Act/365 | 2 |
| EUR | LIBOR | ON-12M | Act/360 | 2 |
| EUR | LIBOR | ON-12M | Act/360 | 0 |
| GBP | LIBOR | ON-12M | Act/365 | 0 |
| JPY | LIBOR | ON-12M | Act/360 | 2 |
| JPY | Japan TIBOR | 1W-12M | Act/365 | 2 |
| JPY | EuroYen TIBOR | 1W-12M | Act/360 | 2 |
| USD | LIBOR | ON-12M | Act/360 | 2 |

1. IBOR Indices for the Other Currencies:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Currency** | **Name** | **Maturities** | **Convention** | **Spot Lag** |
| AUD | BBSW | 1M-6M | Act/365 F | 0 |
| CAD | CDOR | 1M-12M | Act/365 F | 0 |
| CZK | PRIBOR |  | Act/360 | 2 |
| DKK | CIBOR | 1W-12M | Act/360 | 0 |
| HKD | HIBOR | 1M-12M | Act/365 F | 0 |
| HUF | BUBOR |  | Act/360 | 2 |
| IDR | IDRFIX |  | Act/360 | 2 |
| INR | MIFOR |  | Act/365 F | 2 |
| NOK | NIBOR |  | Act/360 | 2 |
| NZD | BBR |  | Act/365 | 0 |
| PLN | WIBOR |  | Act/365 | 2 |
| RMB | SHIBOR | ON-12M | Act/360 | 0 |
| SEK | STIBOR |  | Act/360 | 2 |
| SKK | BRIBOR |  | Act/360 | 2 |
| SGD | SIBOR |  | Act/365 F | 2 |
| SGD | SOR |  | Act/365 F | 2 |
| ZAR | JIBAR | 1M-12M | Act/365 F | 0 |

1. LIBOR: LIBOR is an acronym for London Interbank Offered Rate. It is calculated by Thomson Reuters on behalf of the British Bankers’ Association. Major banks submit their cost of borrowing unsecured funds for several tenors and currencies.
2. LIBOR Administration: Up until 2012 there were 15 tenors in 10 currencies (AUD, CAD, DKK, EUR, JPY, NZD, GBP, SEK, CHF, and USD). Some have been phased out in the first half of 2013 – to 42 rates. Rates are now published for 6 currencies (EUR, EUR same day, JPY, GBP, CHF, USD) and seven tenors (ON/SN, !W, 1M, 2M, 3M, 6M, and 12M). NYSE Euronext will be in charge of administration through its subsidiary NYSE Euronext Rates Administration Limited, starting from 2014.
3. LIBOR Conventions: For all the currencies apart from EUR and GBP, the period between the fixing date and the value date will be 2 London business days after the Fixing date. However, if the day is not a business day at the corresponding financial center, it will be adjusted to the following day at both London and the location – this date will be the new value date. The business day convention is modified following, and the EOM rule applies. For all currencies except GBP, the day count convention is Act/360. References => <http://www.bbalibor.com/technical-aspects/fixing-value-and-maturity>; <http://www.nyx.com/libor>

**Main IBOR-Indices**

1. GBP LIBOR: The fixing date and the value date are the same (0 day spot lag). The day count convention is Act/365.
2. EUR LIBOR: The value date is 2 TARGET business days after the fixing date.
3. EURIBOR: The day count convention is Act/360 and the spot lag is 2 business days. The business day convention is *modified following* and the EOM rule applies. The related calendar is TARGET. There are 43 contributor banks, and the rates are published at 11:00 AM CET. Reference => <http://www.euribor-ebf.eu/euribor-org/about-euribor.html>
4. JPY TIBOR: TIBOR is the acronym for Tokyo InterBank Offered Rate. It is published by the Japanese Bankers Association. There are 2 types of TIBOR. The *Japanese Yen TIBOR* rates reflect the prevailing rates on the unsecured call market. The *EuroYen TIBOR* rates are the rates from offshore Japan market. The JBA TIBOR is calculated by the JBA as a prevailing market rate based on quotes for 13 different maturities (1W, 1M-12M) provided by banks as of 11:00 AM each business day. The day count convention is Act/365 for the domestic market and Act/360 for the EuroYen market. Reference => <http://www.zenginkyo.or.jp/en/tibor/the-jba-tibor/>

**Other IBOR-Indices**

1. AUD BBSW: The rate is Bank Bill Rates (BBSW) and is published by the Australian Financial Markets Association, and the maturities are 1M-6M. The day count convention is Act/365, and the spot lag is zero days. The business day convention is *modified following bi-monthly*. The rates are published at 10:00 AM. Reference => <http://www.afma.com.au/data/bbsw.html>
2. CAD CDOR: CDOR is the acronym for Canadian Dealer Offered Rate. CDOR is determined daily from a survey of 9 market makers’ in bank acceptances (BA). The survey is conducted at 10:00 AM each business day, with the results being quoted by 10:15 AM on the same day. The day count convention is Act/365. The fixing date and the value date are the same (0 spot lag). Reference => <http://www.m-x.ca/marc_terme_bax_cdor_en.php>
3. DKK CIBOR: CIBOR is the acronym for Copenhagen InterBank Offered Rate. It is the reference interest rate for liquidity offered in the inter-bank market (in Denmark) on an uncollateralized basis for maturities from 1W-12M. NASDAQ OMX publishes CIBOR on a daily basis at 11:00 AM. The Danish Bankers’ Association has the overall responsibility for CIBOR. The day count convention is Act/360. References => <http://www.finansraadet.dk>; <http://nasdaqomxnordic.com/obligationer/danmark.cibor>
4. HKD HIBOR: Hungarian InterBank Offered Rate. Act/365 and *Modified Following*.
5. INR MIFOR: MIFOR is the acronym for Mumbai Interbank Forward Offered Rate. The day count convention is Act/365 and the spot lag is 2 days. It is published for 1M, 2M, 3M, 6M, and 12M tenors.
6. NOK NIBOR: NIBOR is the acronym for Norwegian InterBank Offered Rate. The day count convention is Act/360 and the business day convention is *modified following*.
7. RMB SHIBOR: SHIBOR is the acronym for SHanghai InterBank Offered Rate. The day count convention is Act/360 and the spot lag is zero days. It is published for ON, 1W, 2W, 1M, 2M, 3M, 6M, 9M, and 12M tenors. Reference => <http://www.shibor.org/shibor/web/html/index_e.html>
8. SEK STIBOR: STIBOR is the acronym for STockholm InterBank Offered Rate. The day count convention is Act/360. The business day convention is *modified following*.
9. SGD SIBOR: SIBOR is the acronym for Singapore InterBank Offered Rate. The day count convention is Act/365. An individual ABS SIBOR contributor bank contributes the rate at which it can borrow funds were it to do so by asking for and accepting inter-bank offers in a reasonable market size, just prior to 11:00 AM. The indexes are computed by the Association of Banks in Singapore. Reference => <http://www.abs.org.sg>
10. SGD SOR: SOR in the acronym for Swap Offered Rate. It is implied from the USD LIBOR and the forex forwards. The indexes are computed by the Association of Banks in Singapore.
11. ZAR JIBAR: JIBAR is the acronym for Johannesburg InterBank Agreed Rate. The rate is calculated daily by SAFEX as the average prime lending rate quoted independently by a number of different banks. The rate is available in 1M, 3M, 6M, and 12M tenors.

**Overnight Indexes**

**Index Definitions**

1. Setup: Overnight indexes are related to inter-bank lending on a one-day horizon. Most indexes are for overnight loans, and some are for tomorrow/next loans. The rates are computed as a weighted average of the actual transactions.
2. Main Currencies: To note: The publication lag is the number of days between the period start and the rate publication. A lag of 0 indicates that the rate is published on the start date, 1 indicates that the rate is published on the end date, and -1 indicates that the rate is published one day earlier.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Currency** | **Index Name** | **Reference** | **Convention** | **Lag** |
| CHF | TOIS | TN | Act/360 | -1 |
| EUR | EONIA | ON | Act/360 | 0 |
| GBP | SONIA | ON | Act/365 | 0 |
| JPY | TONAR | ON | Act/365 | 1 |
| USD | Fed Fund | ON | Act/360 | 1 |

1. Other Common Currencies:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Currency** | **Index Name** | **Reference** | **Convention** | **Lag** |
| AUD | RBA ON/AONIA | ON | Act/365 | 0 |
| CAD | CORRA | ON | Act/365 | 1 |
| DKK | DNB TN | TN | Act/360 | -1 |
| CZK | CZEONIA |  | Act/360 |  |
| HKD | HONIX | ON | Act/365 | 0 |
| HUF | HUFONIA | ON | Act/360 |  |
| INR | MIBOR ON | ON | Act/365 | 0 |
| INR | MITOR | TN | Act/365 | 0 |
| NZD | NZIONA | ON | Act/365 | 0 |
| PLN | POLONIA | ON | Act/365 |  |
| SEK | TN SIBOR/STIBOR | TN | Act/360 | -1 |
| SGD | SONAR | ON | Act/365 | 0 |
| ZAR | SAFEX ON Deposit Rate | ON | Act/365 |  |
| ZAR | SAONIA | ON | Act/365 |  |

**Committees and Meeting Dates**

1. Meetings: Overnight rates are strongly influenced by central banks monetary policy decisions. The meeting dates of the main central banks can be found on the following sites:
   1. <http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>
   2. <http://www.ecb.int/events/calendar/mgcgc/html/index.en.html>
   3. <http://www.bankofengland.co.uk/monetarypolicy/Pages/decisions.aspx>
2. TN vs. Reference Lag: TN essentially refers to an overnight lending contract between and , i.e., the TN contract. Therefore, these published rates correspond to a -1 publication lag; in fact, this is indeed the case for all the TN OIS contracts (CHF, DKK, SEK, etc.)
3. CHF TOIS: The reference rate used is the TOIS rate with TN inter-bank fixing. The index is calculated by Cosmorex AG, a division of Tullet Prebon.
4. EUR EONIA: EONIA is the acronym for Euro OverNight Index Average. It is computed as a weighted average of all the overnight unsecured lending transactions undertaken in the inter-bank market, initiated within the Euro area by the contributing banks (rounded to 3 decimal places). It is calculated by the European Central Bank. The rate is published in the evening (CET 19:00) of the period start date. Day Count convention is Act/360. Reference => <http://www.euribor-ebf.eu/euribor-eonia-org/about-eonia.html>.
5. EUR EURONIA: This is the weighted average of all the unsecured Euro overnight cash transactions brokered in London by WMBA member firms between midnight and 16:15 CET with all the counterparts with a minimum deal size. Reference => <http://www.wmba.org.uk/pages/index.cfm?page_id=32>.
6. GBP SONIA: SONIA is an acronym for Sterling OverNight Index Average. It is the weighted average of all unsecured overnight sterling cash transactions brokered in London by WMBA member firms between midnight and 16:15 CET with all the counterparts with a minimum deal size of GBP 25 million (rounded to 4 decimal places). The rate is published in the evening (around 17:00 CET) of the period start date. The day count convention is Act/365. Reference => <http://www.bba.org.uk/policy/article/sterling-overnight-index-average-sonia-a-guide/benchmarks>
7. JPY TONAR Uncollateralized Overnight Call Rate: TONAR is an acronym for Tokyo OverNight Average Rate. It is the weighted average of all unsecured overnight cash transactions between financial institutions. The rate is published by Bank of Japan (BOJ), and the day count is Act/365. A provisional result is published on the evening (17:15 JST, except on the last business day of the month, when it is at 18:15 JST) of the period start. The final result is published on the morning (10:00 JST) of the end date. Reference => <http://www.boj.or.jp/en/statistics/market/short/mutan>
8. USD Effective Federal Funds Rate: The daily effective federal funds rate is a volume weighted average of the rates on trades arranged by the major brokers. The effective rate is calculated by the Federal Reserve Bank of New York using the data provided by the brokers and is subject to revision. The rate is published in the morning (between 7:00 AM and 8:30 AM EST) of the period end date. The day count is Act/365. Reference => <http://www.newyorkfed.org/markets/omo/dmm/fedfundsdata.cfm>
9. AUD RBA Interbank Overnight Cash Rate Survey AONIA: The rate is computed by the Reserve Bank of Australia (RBA). It is the weighted average of the rates at which a sample of banks transact in the domestic interbank market for overnight funds. The interbank overnight cash rate calculated from the survey is published on electronic media services at the conclusion of each trading day. The rate is published on the evening of the period start date, and the day-count is Act/365. Reference => <http://www.rba.gov.au/mkt-operations/tech-notes/interbank-survey.html>
10. CAD CORRA: CORRA is the average for the Canadian Overnight Repo Rate Average. It is the weighted average of overnight general (non-specific) collateral repo trades that occur through designated inter-dealer brokers between 6:00 and 16:00 EDT on the specified date as reported by the Bank of Canada. The rate is published on the morning (9:00) of the end date, and the day count convention is Act/365. Reference => <http://www.bankofcanada.ca/rates/interest_rates/money-market-yields>
11. DKK Danmarks Nationalbank Tomorrow/Next: The TN money market rate is calculated and published by the Danmarks Nationalbank. The TN interest rate is an uncollateralized day-to-day interest rate for money market lending. Calculation of the TN interest rate is based on the daily reports from 11 banks. Each bank reports the day-to-day uncollateralized inter-bank lending and the average rates on these loans. The report is made with a time lag of one, e.g., Monday’s lending is reported on Tuesday. The day-count convention is Act/360. Reference => <http://www.nationalbanken.dk/dnuk/rates.nsf/side/reference_rates!opendocument>
12. NZD NZIONA: The rate used is a reference rate equal to the official cash rate for that date set by RBNZ. It is publishes as of 10:00 AM Wellington time, and the day count is Act/365.
13. SEK SIOR/TN STIBOR: STIBOR (Stockholm Interbank Offered Rate) is a reference rate that shows an average of interest rates at which a number of banks active in the Swedish money market are willing to lend to one another without collateral at different maturities. The reference rate is SIOR or TN STIBOR. The rate is published by the OMX exchange. SIOR is a reference rate equal to the daily fixing for the Swedish krona tomorrow next deposits as published at 11:00 AM Stockholm time, on the day that is one Stockholm banking day prior to the start of the payment period. Reference => <http://www.swedishbankers.se>
14. SGD SONAR: The SONAR rate is published by the association of banks in Singapore. The rate is published at 11:00 AM Singapore time on the period start date, and the day count convention is Act/365.
15. ZAR - SFX ZAR OND: The rate SFX ZAR OND rate is published by SAFEX JIBAR. SAFEX publishes the rate which is the average rate that is receives on its deposits with the banks, weighted by the size of the investments placed at each bank.
16. ZAR - SAONIA: The SAONIA rate is the weighted average rate paid on unsecured, interbank, overnight funding. For more details see *South African Financial Markets (G West, Financial Modeling Agency, 2009)*.

**Over-The-Counter Instruments**

**Forward Rate Agreement**

1. Description: FRA’s are OTC contracts linked to an IBOR-like index. At the trade date, a *Reference Rate* (), a start period, and a *Reference Index* are all agreed to. The end period is equal to the start period plus the index tenor (i.e., a 6M start period and a 3M tenor result in a nominal 9M end period).
2. FRA Reference Period: The start of the reference period is computed from the spot date by adding the index spot lag, and then the spot tenor (using the business day convention and the calendar of the index). The reference period’s end date is computed by adding the index spot lag and then the end period. The *Fixing Date* (or the exercise date) is the spot lag before the start date.
3. FRA Accrual DCF: The accrual factor between the start date and the end date (in the index day count) is denoted by . Occasionally the dates (and sometimes the accrual) described above are not calculated, but simply agreed upon arbitrarily by the counter-parties (usually changing the dates by 1-2 days for convenience and/or operational reasons).
4. FRA Settlement: The *FRA Settlement Date* is the start date (and NOT the end date). For the FRA buyer, the settlement day pay amount is where is the value of the reference index on the fixing date, and is the strike. The payoff for the FRA seller is obviously the same amount with the opposite sign.
5. FRA Accounting Treatment: In some accounting schemes, since the payment is always regarded as accruing between the start and the end dates, the FRA instrument is regarded as “being alive” even if it has already fully settled.
6. FRA Period Mismatch: The FRA’s end date can be slightly different from the end date of the theoretical deposit underlying the IBOR rate. This potential mismatch comes from a mismatch comes from a difference in adjustment of the non-good business days between the different ways to compute the period.
7. IMM FRA’s: FRAs can also be traded as IMM FRAs, i.e., FRAs with accrual dates equal to consecutive IMM dates (just as in STIR futures). The underlying IBOR rate has a tenor the one relevant to the IMM dates’ frequency (3M IBOR for the quarterly dates and 1M IBOR for monthly dates).

**Interest Rate Swaps**

1. Interest Rate Swaps (Fixed for IBOR): Exchange of fixed payments for a floating stream of payments linked to an IBOR-like index. Typical payment/accrual periods and their generation rules are outlined below, and, since these are OTC, any variant is possible if agreed by the counterparts.
2. Forward Date Generation: The dates are computed from the start (or the settlement) date. The last date of the stream will be the start date plus the total length (maturity tenor) of the leg. The intermediate dates are regularly spaced, and the first one is the non-standard period. For example, a 15-month leg with a 6-month period can pay after 3 (), 9, and 15 months.
3. IRS - Date Adjustment: Dates adjustment is done by the business day convention and the EOM rule. All the dates are first computed without adjustment, and then all the dates are adjusted.
4. IRS Stubs: The non-standard period is referred to as the stub. It can be short (shorter than one period) or long (between one and two periods in length). The reason that the non-standard period is the first one is that once that period is finished, the instrument then has regular periods (similar to a standard one). If the stub was the last period, the swap could never become a standard one.
5. Start Date: The start (or the settlement) date of the swap is usually a certain lag called the spot lag after the trade date. The most common lag is 2 business days. The start date can also be a forward date. In that case, the start date is the forward period tenor plus the spot lag. The forward period tenor is specified W/M/Y.
6. Payer (Buyer) and Receiver (Seller) Swaps: The terms *Payer* and *Receiver* refer to the fixed leg of an IRS. The swap is a payer for one party if the swap pays the fixed leg and receives the floating leg. The payer swap for one party is the receiver swap for the other. Like FRA, the swap buyer buys the floating leg by paying the fixed.

**Vanilla IRS**

1. Notional and Coupon: In a vanilla IRS, all the coupons have the same notional, and the coupons on the fixed leg have the same rate.
2. Payments: The payments on the fixed leg are regularly placed, most with a 6M/12M gap. The payments on the floating leg are also regularly spaced, most with the 3M/6M gap. The fixing date for the floating payment is the index spot lag before the period start date. This lag is usually part of the index, and usually the same as the swap start spot lag.
3. Floater/index mismatch: The dates of the period corresponding to the deposit underlying the IBOR index can be slightly different from that of the coupon period. The difference is created by the adjustments due to non-good business days.
4. Main Currencies:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Currency** | **Spot Lag** | **Fixed** | | **Floating** | | |
| **Period** | **Convention** | **Index** | **Period** | **Convention** |
| USD (NY) | 2 | 6M | 30/360 | LIBOR | 3M | Act/360 |
| USD (London) | 2 | 1Y | Act/360 | LIBOR | 3M | Act/360 |
| EUR: 1Y | 2 | 1Y | 30/360 | EURIBOR | 3M | Act/360 |
| EUR: > 1Y | 2 | 1Y | 30/360 | EURIBOR | 6M | Act/360 |
| GBP: 1Y | 0 | 1Y | Act/365 | LIBOR | 3M | Act/365 |
| GBP: > 1Y | 0 | 6M | Act/365 | LIBOR | 6M | Act/365 |
| JPY | 2 | 6M | Act/365 | TIBOR | 3M | Act/365 |
| JPY | 2 | 6M | Act/365 | LIBOR | 6M | Act/360 |
| CHF: 1Y | 2 | 1Y | 30/360 | LIBOR | 3M | Act/360 |
| CHF: > 1Y | 2 | 1Y | 30/360 | LIBOR | 6M | Act/360 |

1. Other Currencies:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Currency** | **Spot Lag** | **Fixed** | | **Floating** | | |
| **Period** | **Convention** | **Index** | **Period** | **Convention** |
| AUD: 1Y – 3Y | 1 | 3M | Act/365 | BBSW | 3M | Act/365 |
| AUD: >= 4Y | 1 | 6M | Act/365 | BBSW | 6M | Act/365 |
| DKK | 2 | 1Y | 30/360 | CIBOR | 6M | Act/360 |
| INR: <= 1Y | 2 | 1Y | Act/365 | MIFOR | 3M | Act/365 |
| INR: > 1Y | 2 | 6M | Act/365 | MIFOR | 6M | Act/365 |
| HKD | 0 | 3M | Act/365 | HIBOR | 3M | Act/365 |
| NOK | 2 | 1Y | 30/360 | NIBOR | 6M | Act/360 |
| HZD | 0 | 6M | Act/365 | BKBM | 3M | Act/365 |
| PLN | 2 | 1Y | Act/Act ISDA | WIBOR | 6M | Act/365 |
| SEK | 2 | 1Y | 30/360 | STIBOR | 6M | Act/360 |
| SGD | 2 | 6M | Act/365 | SIBOR | 6M | Act/365 |
| SGD | 2 | 6M | Act/365 | SOR | 6M | Act/365 |
| ZAR | 0 | 3M | Act/365 | JIBAR | 3M | Act/365 |

1. Composition - Multi-reset Swaps: In some cases, the period between the payments is equal to the IBOR index, but a multiple thereof. The fixing rates are compounded over the sub-periods up to the payment at the end. The main currency for which this is a standard for vanilla swaps is CAD.
2. Reset Periods - Compounding: The description of the compounded coupon is as follows: The associated times are denoted . The fixing for the period is denoted by , and the corresponding accrual fraction in the index convention is . The fixing takes place at a date typically prior to the start of the accrual period, with the difference between the fixing date and the start date being referred to as the spot lag.
   1. Geometric Compounding => The coupon pays at the amount (to be multiplied by the notional) .
   2. Compounded Spread => In case a spread is agreed to on the compounding leg, there are 3 standard ways to deal with the compounded spread: *COMPOUNDING*, *FLAT COMPOUNDING*, and *COMPOUNDING WITH SPREAD AS A SIMPLE INTEREST*. These methods are described in the ISDA document [*Alternate compounding methods for the OTC derivative transaction (2009)*](http://www.isda.org/c_and_a/pdf/ISDA-Compounding-memo.pdf).
   3. CAD Swap => Multi-reset Composition:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Currency** | **Spot Lag** | **Fixed** | | **Floating** | | |
| **Period** | **Convention** | **Index** | **Period** | **Convention** |
| CAD: 1Y | 0 | 1Y | Act/365 | CDOR | 1Y | Act/365 |
| CAD: >= 1Y | 0 | 6M | Act/365 | CDOR | 6M | Act/365 |
| CNY | 2 | 3M | Act/365 | CNY-Repo | 3M | Act/365 |

1. IMM Dated Swap: Like for FRA, there exists the IMM dates IRS. These swaps pay the fixed and the floating legs at the IMM dates. The most common are the quarterly IMM dates on the floating legs based on the IBOR 3M rates. It is also common that the fixed leg payment is every 2nd (semi-annual) to 4th (quarterly).
2. In-arrears Swap: Another type of IBOR swaps is a swap with fixing in-arrears. Here the reference period for the IBOR index and the accrual period for the coupon are disjoint, i.e., the accrual period precedes the IBOR period. Thus, the start date of the IBOR period is the payment date. The fixing date for the floating payment is the index spot lag before the accrual period end date.
3. Short and Long Tenors: For some swaps, the period between the payments is not equal to the index tenor. The payment period can be shorter than the index period (the short tenor swap), or longer (long tenor swap). Typically this type of swap has a 3M pay accrual period on 6M-12M IBOR index (short) or an annual pay accrual period on a 3M-6M IBOR index (long). The long/short tenor swap can also be of the (fixing) in-advance or the in-arrears type.
4. Step-up and step-down: The rate paid on the fixed leg coupons does not need to be the same for each coupon. The swap is then referred to as a step-up when the coupons increase and step-down when they decrease.
5. Amortized, Accruing, and Roller Coaster Swaps: The coupon notional does not need to be the same for all the coupons. In most cases, the coupons are the same for both the legs of the period. If the notional is decreasing over time, the swap is called *Amortizing Swap*, and if is increases it is called *Accruing*. If the notional first increases and then decreases up to maturity, it is called a *Roller Coaster*.

**Interest Rate Swaps (Basis Swaps: IBOR for IBOR)**

1. Description: In a basis swap, both legs are floating legs and depend on an IBOR index in the same currency. In most cases, the indexes have different tenors. A spread above the IBOR index is paid in one of the legs. The quote convention used quotes the spread the spread over IBOR on the shorter tenor leg, in such a way that the spread is positive.
2. EUR Basis Swap: In EUR alone, the basis swap is quoted as 2 different swaps. For e.g., the quote of EURIBOR 3M vs. EURIBOR 6M at 12 bp has the following meaning: In the first swap you receive a fixed rate and pay 3M EURIBOR. In the second swap you pay the same fixed rate plus a spread of 12 bp and receive 6m EURIBOR. Note that with this convention the spread is paid on an annual basis, like the standard fixed leg of a fixed-float IBOR swap. Even if the quote refers to the spread of a 3M vs. 6M swap, the actual spread is paid annually with a fixed leg convention.
3. Compounded Basis Swap: The multi-reset composition functionality described above is not restricted to fix-float IBOR swaps alone. Some basis swaps are also traded on a compounded basis to align the payments on both the legs. For example, a basis 1M LIBOR vs. 3M LIBOR swap can be quoted with the 1M LIBOR compounded over 3 periods and paid quarterly in line with the 3M period. Note that the exact convention for the spread convention needs to be indicated for the trade. The multi-reset composition of the shorter leg is currently the standard in USD.

**Cross-Currency Swap, IBOR for IBOR**

1. Description: Here the notional is not the same in both legs as they are in different currencies. The notional in one leg is usually the notional on the other translated to the other currency through an exchange rate. The rate is often an exchange rate at the moment of trade as agreed between the parties. The notional is paid out on both the legs, at the start and at the end of the swap.
2. Non-MTM FX Cross-Currency Swap: In some cases, the FX rates used are not in line with the market rates. Often this can be abused to disguise some debts from the accounting rules. These types of cross-currency swaps at non-market exchange rates were famously used by Greece to hide some of its debts when it entered the Euro. The swaps used for construction are at-the-money exchange rates (although initially set, therefore non-MTM).
3. MTM Cross-Currency Swap: There also exist cross-currency swaps with the FX rate reset, and this is called the *Cross-Currency Mark-to-Market Swap*. They are specified in article 10 of the 2006 ISDA definitions. For each period, the FX rate that is observed at the beginning of the period is used for the following period. The notional of one of the legs is unchanged, and the other is adapted according to the new exchange rate. At each payment date and MTM amount is paid. The amount is calculated as the new notional in the adapted leg minus the previous notional. This is equivalent, up to netting, to exchanging notionals at the start and at the end of each period. This feature was introduced to reduce the credit risk induced by the movement of the FX rates.
4. Cross-Currency Swap Stream Construction: Bothe legs of a cross-currency swap are linked to an IBOR like index. In the standard cross-currency swaps, the IBOR tenor on both the legs is the same. The payments are done on the same day for both the legs to reduce the credit risk. This means that the payment calendar is the joint calendar of both the swaps involved in the swap.
5. Typical Cross Currency Swaps: The most liquid cross-currency swaps exchange 3 month payments. Even if the index of one of the currency is 6M as its most commonly used one, the cross-currency swaps may still use 3M payments. This is in particular the case with USD/JPY and USD/EUR swaps, and these use 3M payments, even if 6M EUR EURIBOR and 6M JPY LIBOR are the standard floating references for these currencies.
6. Spreaded Cross-Currency Swaps: The cross-currency swaps also pay a spread on one of the legs. On which currency leg the spread is paid out depends on the currency pairs. When one of the currencies is USD, the convention is usually USD LIBOR flat vs. the other currency plus a spread. The 2 exceptions to this rule are – USD/MXN Peso Swaps and USD/CLP Chilean Peso Swaps.

**Constant Maturity Swaps**

* 1. Description: Constant Maturity Swaps are in some sense similar to the standard IRS, in that the swap is composed of 2 legs, and each leg has its own payment type. One leg is typically a fixed leg or an IBOR leg. The other is a floating leg, the rate of which is based on a swap index.
  2. Key Features: The difference to that of a standard IBOR leg is that rate of the index period can be very different from the period on which it is paid. The CMS floating leg usually pays on a quarterly or on a semi-annual basis a swap rate. The most popular swap indexes are indices based on the 2Y, the 5Y, the 10Y, the 20Y, and the 30Y swaps.
  3. CMS Fixing: The details of the fixing and the payment are similar to that of the IBOR coupons. The coupon fixing can be in-advance or in-arrears. For the fixing in advance, the fixing takes place at the start of the accrual period. For the fixing in-arrears, the fixing takes place at the end of the accrual period. The lag between the reference rate and the fixing is that spot lag of the swap index.
  4. EUR CMS: In EUR, the most common CMS have quarterly payments on both legs. The non-CMS leg is 3M EURIBOR.
  5. Swap Rate Fixings for the Main Currencies:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Currency** | **Spot Lag** | **Fixed** | | **Floating** | | | |
| **Period** | **Convention** | **Index** | **Period** | **Convention** | **Fixing Time** |
| EUR: 1Y | 2 | 1Y | 30/360 | EURIBOR | 3M | Act/360 | 11:00 CET |
| EUR: > 1Y | 2 | 1Y | 30/360 | EURIBOR | 6M | Act/360 | 11:00 CET |
| EUR: 1Y | 2 | 1Y | 30/360 | EURIBOR | 3M | Act/360 | 12:00 CET |
| EUR: > 1Y | 2 | 1Y | 30/360 | EURIBOR | 6M | Act/360 | 12:00 CET |
| EUR: 1Y | 2 | 1Y | 30/360 | LIBOR | 3M | Act/360 | 10:00 GMT |
| EUR: > 1Y | 2 | 1Y | 30/360 | LIBOR | 6M | Act/360 | 10:00 GMT |
| EUR: 1Y | 2 | 1Y | 30/360 | LIBOR | 3M | Act/360 | 11:00 GMT |
| EUR: > 1Y | 2 | 1Y | 30/360 | LIBOR | 6M | Act/360 | 11:00 GMT |
| USD | 2 | 6M | 30/360 | LIBOR | 3M | Act/360 | 11:00 EST |
| USD | 2 | 6M | 30/360 | LIBOR | 3M | Act/360 | 15:00 EST |
| GBP: 1Y | 2 | 1Y | Act/365 | EURIBOR | 3M | Act/365 | 12:00 CET |
| GBP: > 1Y | 2 | 6M | Act/365 | EURIBOR | 6M | Act/365 | 12:00 CET |
| CHF: 1Y | 2 | 1Y | 30/360 | LIBOR | 3M | Act/360 | 10:00 GMT |
| CHF: > 1Y | 2 | 1Y | 30/360 | LIBOR | 6M | Act/360 | 10:00 GMT |

**Swap Indexes**

1. Introduction: The most common usage of these indexes is in CMS and CMS caps/floors. Swap rates for CHF, EUR, GBP, JPY, and USD are established by ISDA in co-operation with Reuters (now Thomson Reuters) and InterCapital Brokers (ICAP). The main fixing details are shown in the table above.
2. ISDA EUR: There are 4 daily fixings – 2 for swaps vs. LIBOR, and 2 for EURIBOR. The LIBOR fixings are at 10:00 GMT and 11:00 GMT. The EURIBOR fixings are at 11:00 CET and 12:00 CET. The maturities are 1Y-10Y, 12Y, 15Y, 20Y, 25Y, and 30Y. All are 6M tenor swaps, except for the 1Y maturity which is 3M.
3. ISDA USD: There are 2 fixings – at 11:00 EST and 15:00 EST. The maturities are 1Y-10Y, 15Y, 20Y, and 30Y. All swaps are vs. 3M LIBOR.
4. ISDA GBP: There is one fixing, at 11:00 GMT. The maturities are 1Y-10Y, 12Y, 15Y, 20Y, 25Y, and 30Y. All the swap fixings are quoted for 3M , except for the 1Y which is for 6M.
5. ISDA CHF: There is one fixing at 11:00 GMT. The maturities are 1Y-10Y. All swaps are vs. 6M except for the 1Y which is vs. 3M.
6. ISDA JPY: There are 2 fixings – at 10:00 and at 15:00 Tokyo time. The maturities are 1Y-10Y, 12Y, 15Y, 20Y, 25Y, 30Y, 35Y, and 40Y. All the swaps are vs. 6M. Note that for the JPY there is also an 18M fixing.

**Overnight Indexed Swaps**

1. Description: The overnight indexed swaps (OIS) exchange a leg of fixed payments for a leg of floating payments. The start (or the settlement) date of the swap is a certain lag (the spot lag) after the trade date. The most common lag is 2 business days.
2. Payments: The payments on the fixed leg are regularly spaced by the given period. Most of the OIS have a single payment if the maturity is shorter than 1Y, and a 12M period for longer swaps. The payments on the floating legs are also regularly spaced, usually on the same dates as the fixed leg. The amount paid on the floating leg is computed by compounding the rates.
3. Conventions for the Main Currencies:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Currency** | **Spot Lag** | **Fixed** | | **Floating** | | |
| **Period** | **Convention** | **Index** | **Pay Lag** | **Convention** |
| USD <= 1Y | 2 | tenor | Act/360 | Fed Fund | 2 | Act/360 |
| USD > 1Y | 2 | 1Y | Act/360 | Fed Fund | 2 | Act/360 |
| EUR: <= 1Y | 2 | tenor | Act/360 | EONIA | 2 | Act/360 |
| EUR: > 1Y | 2 | 1Y | Act/360 | EONIA | 2 | Act/360 |
| GBP: <= 1Y | 0 | tenor | Act/365 | SONIA | 1 | Act/365 |
| GBP: > 1Y | 0 | 1Y | Act/365 | SONIA | 1 | Act/365 |
| JPY: <= 1Y | 2 | tenor | Act/365 | TONAR |  | Act/365 |
| JPY: > 1Y | 2 | 1Y | Act/365 | TONAR |  | Act/365 |

1. Conventions for the Other Currencies: Pay Lag => The lag in days between the last fixing publication and the payment.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Currency** | **Spot Lag** | **Fixed** | | **Floating** | | |
| **Period** | **Convention** | **Index** | **Pay Lag** | **Convention** |
| AUD <= 1Y | 1 | tenor | Act/365 | RBA ON | 1 | Act/365 |
| AUD > 1Y | 1 | 1Y | Act/365 | RBA ON | 1 | Act/365 |
| CAD: <= 1Y | 0 | tenor | Act/365 | CORRA | 0 | Act/365 |
| CAD: > 1Y | 0 | 1Y | Act/365 | CORRA | 0 | Act/365 |
| INR: <= 1Y | 1 | tenor | Act/365 | ON MIBOR | 1 | Act/365 |
| INR: > 1Y | 1 | 6M | Act/365 | ON MIBOR | 1 | Act/365 |
| SGD: <= 1Y | 2 | tenor | Act/365 | SONAR | 1 | Act/365 |

1. Payment Calculation: Let be the relevant dates (all good business days) in the composite floating leg period. Let be the accrual factor between and and the accrual factor for the period . The overnight rates paid between and are given at by . The paid amount is multiplied by the notional. The payment is usually not done at the end of the period , but at a certain lag after the last fixing publication date. The reason for the lag is that the actual amount is known only at the very end of the period; the payment lag allows for a smooth settlement.
2. USD OIS: In USD the payment is 2D after the end of the fixing period. These two days are computed from the final publication date, which is at the end of the last period, plus 2 lag days.
3. EUR OIS: In EUR, the payment is 1D after the end of the fixing period. This one day is computed as the final publication date, which is the start of the previous period and 1D before the end of the previous period, plus 2 lag days.
4. OIS Committee Meetings: A somehow popular choice of start or end dates for the OIS Swaps are the dates of the relevant committee meetings, as shown earlier in the table.
5. Federal Funds Swaps: Federal Fund Swaps are a USD peculiarity. These are swaps exchanging quarterly USD LIBOR payments for the quarterly average of the effective USD Federal Funds Rate. They are often called as the Feds or the FED Swaps.
   1. Arithmetic Compounding => The particularity is that the rates paid is an arithmetic average of the Fed Funds Rates; the rates are not compounded as in the traditional OIS. The quarterly coupon payment is not equal to a 3M OIS.
   2. Fed Fund Coupon Calculation => Let be the relevant dates (all good business days) in the composite floating leg period. Let be the accrual factor between and and the accrual factor for the period . The overnight rates paid between and are given at by . The paid amount is multiplied by the notional.
   3. Fed Funds Final Fixing => The final Fed Funds effective fixing is applied to the last 2 fixing days. In terms of the above formula, it needs to be re-cast as . It is possible to trade absent the rate cut-off, but this requires the counterparty to make payment on the same day the last fixing information is published.
   4. Fed Funds vs. LIBOR Swaps => Here, the swaps are quoted with a spread over the Fed Funds ON leg. A quote of often in bp means that the swap exchanges LIBOR for ON average plus a spread of . The spread is usually positive. The computation of the interest on the ON floating leg is additive with simple compounding, and the spread is also additive with simple compounding. The multiple compounding alternatives as in IBOR compounding are not present here. The payment is (excluding the final day repeated fixing) . In some cases, the fed fund swaps are traded against 1M LIBOR. This type of swaps is less liquid.
6. OIS Indexes: The OIS Index Rates are reference rates to the standard OIS. As an example, the EONIA index is the average rate of rates provided by the prime banks to 3 decimal places that each panel bank believes is the mid-market rate of EONIA swap quotations between prime banks. It is quoted for spot value () and on an Act/360 basis with annual payments. The fixing time is 11:00 CET. The index covers swaps from 1W to 24M. The indexes are computed by the EURIBOR-EBF association, and were launched in 2005. Reference => <http://www.euribor-ebf.eu/eoniaswap-org/about-eoniaswap.html>

**Swaption**

1. Description: A swaption is an option on a swap. It is characterized by an exercise date and an underlying swap. The exercise date is on or before the swap start date. The option gives its holder the right (but not the obligation) to enter in the underlying swap. In theory an option can be written on any underlying swap. In practice, a large majority of swaptions are written on the vanilla interest rate swap.
2. Strike: The strike of an option is the common fixed rate across all the fixed leg coupons. If the underlying swap has a different rate for each coupon (in a step-up or step-down swap, for example), the strike is ill-defined (at least as in the “common strike”).
3. Payer/Receiver Swaptions: The term payer/receiver swaption refers to the payer/receiver of the underlying swap. A swaption is a payer/receiver swaption if the party long the option has the right to enter into a payer/receiver swap. Note that the payer/receiver indicator refers to the long party. Thus, if one is short a receiver option and the swaption is exercised, he enters into a payer swap (a receiver swap for the other party which is long the option). A payer swaption for one party is the receiver swaption for the other.
4. Swaption Dates: A swaption exercise date and its underlying swap start date are computed as follows for the standard swaptions. The swaption is described by an exercise tenor and an underlying swap tenor (like, as in, 6M by 10Y). The exercise date is computed as the spot date plus an exercise tenor, using the relevant calendar and the business day convention of the underlying swap. The swap settlement date is computed as the exercise date plus the underlying swap (or the underlying swap index) spot lag.
5. Swaption Settlement Conventions:

|  |  |  |  |
| --- | --- | --- | --- |
| **Currency** | **Method** | **Sub-method** | **Expiry** |
| EUR | Cash Settled | IRR | 11:00 CET |
| GBP | Cash Settled | IRR | 11:00 GMT |
| CHF | Cash Settled | IRR | 11:00 CET |
| DKK | Cash Settled | IRR | 11:00 CET |
| NOK | Cash Settled | IRR | 11:00 CET |
| SEK | Cash Settled | IRR | 11:00 CET |
| USD | Cash Settled | Exact Curve | 11:00 EST |
| JPY | Physical Delivery |  | 17:00 Tokyo |
| AUD | Physical Delivery |  |  |

1. Physical Delivery Swaptions: When the swaption is settled with physical delivery, at the exercise date the parties enter into an actual swap (the underlying swap).
2. Cash Settled Swaptions: When the swaption is cash-settled, a cash amount is paid (by the short party to the long party) at the exercise date (or, more precisely, spot lag after the exercise), and the actual swap is not entered into.
3. Yield Settled Swaptions: The cash amount to be paid to the long party is computed from a swap fixing rate using a conventional valuation formula of the theoretical underlying swap. The valuation is done using the swap fixing rate as the IRR for the swap. The cash-settled swaption can only be written on a vanilla swap with the standard convention. This is the standard convention for EUR and GBP.
   1. Yield Settlement – Computation => For a swaption with strike and maturity , the amount paid for a fixing is where is the cash-annuity , where is the number of payments per year.
4. Cash Settle Swaption – Exact Curve: The term cash-settled can also refer to another way to compute the cash amount. This approach is usually used for the USD cash-settled swaptions. The cash amount to be exchanged is explicitly calculated as the value of the underlying swap. To value the swap, a full yield curve (not just the fixing swap rate) has to be agreed to by the parties.
5. Upfront and Forward Premium: The standard for the options has been for a long time *Spot* payment. The premium relative to the option paid by the buyer to the seller was done at the spot date from the trade date. With the crisis that started in 2007, the credit risk awareness increased, and most of the dealers decided to change the standard to a forward premium. Since September 2010, in the main currencies, the premium is paid at the same date the swaption itself is settled. This is in general from the spot date from the exercise date.

**Forex and Forward Swaps**

1. Description: A forex swap is essentially a contract on the interest-rate differences, and therefore similar to a cross-currency swap. The conventions on these transactions are similar to the conventions on interest-rate swaps.
2. Currency Pair Order: FX rates are usually quoted for the currency pairs in the conventional order. For the main currencies, the orders are: EUR/USD, GBP/USD, JPY/USD, and GBP/EUR. The first currency in these pairs is called the *Base Currency*, and the second one is called the *Quote Currency*.
3. Conventional Currency Strength Table:
   1. Strength #1 => EUR
   2. Strength #2 => GBP
   3. Strength #3 => AUD
   4. Strength #4 => NZD
   5. Strength #5 => USD
   6. Strength #6 => CAD
   7. Strength #7 => CHF
   8. Strength #8 => JPY
   9. Strength #9 => Other
4. FX Forward: An FX/Forex forward is simply another FX transaction taking place at a forward date. The payments are in one amount in one currency vs. another amount in another currency. The amount in the other currency is the base currency multiplied by the exchange rate agreed. The rate is often quoted in 2 parts – the spot rate and the *Forward Rate*.
5. FX Swap: The FX/Forex Swap is the exchange of an FX spot and an FX forward. An FX spot rate and an FX forward rate are first agreed to. The signs of the spot and the forward amount in the same currency are opposite. For e.g., in the following EUR/USD trade, the jargon used for FX swap trade would be something like: *I buy spot and sell forward 3M EUR vs. USD for 10m with 10 (forward) points and a spot of 1.25*. This means that on the spot date I receive € 10m and pay $ 12.5m, and at I pay € 10m and receive . The Spot part is called the *Near Leg* and the Forward part is called the *Far Leg*.
6. FX Building Blocks: An FX spot is a pure currency trade. The FX swap is mainly an interest rate trade, it is a trade on the differences between interest rates in the 2 currencies. As the amounts in each currency are paid and received, there is almost no currency exposure, similar to the cross-currency swap with initial and final exchange of notional. In the Forex market, the trader sees an FX forward as a net between the FX spot and the FX swap, as opposed visualizing the FX Swap as a combination of the FX spot and the FX forward. The FX forward mixes up the currency exposure and the rate exposure, and is therefore not looked at as a building block.
7. Forward Point Quotation Factors: For most of the currencies, the forward point code is the same as the currency code. This is not the case, however, for non-deliverable currencies. The Bloomberg code is built from the prefix in the table below, the maturity (1W, 1M, 2M etc), and the postfix \_CRNCY.

|  |  |  |  |
| --- | --- | --- | --- |
| **Base Currency** | **Other Currency** | **Factor** | **BBG Code Prefix** |
| AUD | EUR | 10,000 | AUDEUR |
| AUD | EUR | 10,000 | AUD |
| EUR | GBP | 10,000 | EURGBP |
| EUR | JPY | 100 | EURJPY |
| EUR | USD | 10,000 | EUR |
| GBP | JPY | 100 | GBPJPY |
| GBP | USD | 10,000 | GBP |
| USD | BRL | 10,000 | BCN |
| USD | CAD | 10,000 | CAD |
| USD | CHF | 10,000 | CHF |
| USD | CNY | 1 | CCN |
| USD | EGP | 10,000 | EPN |
| USD | HUF | 100 | HUF |
| USD | INR | 100 | INR |
| USD | JPY | 100 | JPY |
| USD | KRW | 1 | KRW |
| USD | MXN | 10,000 | MXN |
| USD | PLN | 100 | PLN |
| USD | TRY | 100 | TRY |
| USD | TWD | 1 | TWD |
| USD | ZAR | 10,000 | ZAR |

1. Forward Points: The *Forward Points* are quoted for the currency pairs in the conventional order. The mechanism of forward points is the same as that for FX forward and FX swap. The points are added to the FX spot rate to obtain the FX forward rate. For a spot rate and points , the forward rate is . The points are usually quoted with a conventional factor (just as the interest rates, which are quoted in percentage). The factor is dependent upon the currency pair, as can be seen in the table above.

**Exchange Traded Instruments**

**Introduction**

1. Exchange Month Codes: The exchange traded instruments with a regular schedule (like futures) use the following code to refer to the corresponding months:
   1. January – F
   2. February – G
   3. March – H
   4. April – J
   5. May – K
   6. June – M
   7. July – N
   8. August – Q
   9. September – U
   10. October – V
   11. November – X
   12. December – Z
2. Contract Event Dates:
   1. Expiry Date.
   2. Last Trading Date.
   3. Final Settlement Date.

In addition, for contracts with *Physical Deliverables*, the following additional dates apply:

* 1. First Delivery Date.
  2. Final Delivery Date.
  3. Delivery Notice Date.

Typically all the dates are computed from a single date pivot (often the expiry date pivot).

**Overnight Futures**

1. Overnight Index Linked Futures: The overnight index futures are linked to an average of overnight rates over a certain period (usually a calendar month). Here we look at in detail at the Fed Fund Futures, 1M EONIA Indexed Futures, and 1D Interbank Deposit Futures Contract – Brazil. All these are exchange traded.
2. Federal Funds Futures: The 30D Federal Funds Futures (called Fed Funds Futures) are based on the monthly average of the overnight Fed Funds rate for the contract month. The notional is $5m. The contract months are the first 36 calendar months. They are quoted on CBOT for USD.
   1. Pricing => Let be the relevant dates for the Fed Funds Futures, with being the first business day of the month, the business day following , and the first business day of the following month. Let be the accrual factor between and () and the day count fraction for the full period . The day count convention for USD ON rate is Act/360. If the overnight rate between and is given at as , the future price on the final setment date is . The margining is done on the price multipled by the notional, and described by the monthly accrual fraction (i.e. ).
3. 1M EONIA Indexed Futures: The contract was introduced in 2008, and is traded on LIFFE. The notional is €3m and the underlying overnight rate is EONIA. The delivery month covers a single ECB Reserve Maintenance Period. The number of available delivery months will be limited to the number of Reserve Maintenance Periods for which dates have been published by the ECB.
   1. Pricing => The Exchange Delivery Settlement Price (EDSP) is one minus the EDSP Rate. The EDSP Rate is calculated as . Reference => <https://globalderivatives.nyx.com/contract/content/29179/contract-specification>
4. 1D InterBank Deposit Futures Contract – Brazil: They are also called 1D Futures, and are traded in BM&FBovespa. The underlying is the daily interest rate compounded until the contracts’ expiration date. The rate is the Average 1D InterBank Deposit Rate (1D) as calculated by CETIP.
   1. Contract Details => The *Expiration Date* is the first business day of the contract. The *Last Trading Day* is the business day preceding the expiration date. The quotations ar4 expressed as a rate per annum compounded daily based on a 252-day year to 3 decimal places. This the *Trading Price* is related to the *Quoted Rate* as where is the number reserves between the trade date and the day preceeding the expiration date.
   2. Margining => On the trade date , the margin is computed as (to be multipled by the real value and the number of contracts) where is the contract settlement price on , and is the initial price paid for the contract. The 1D margining increment can be computed as where is the indexation factor estimates as where is the 1D rate corresponding to the period .

**STIR Futures**

**Introduction**

1. IBOR Based STIR Futures: IBOR-based STIR Futures are also called Interest Rate Futures. The settlement mechanisms are common across all currencies, but the STIR contract details differ on the notional, the underlying rate index, and the exchange on which they are quoted. He dates relevant to the futures are based on the 3rd Wednesday of the month (and adjusted to the following day if the Wednesday is not a good business day) – this date is the *Start Date* of the IBOR rate underlying the future.
2. STIR Future Contract Dates: The rate is fixed at a *Spot Lag* prior to the *Start Date* (using the currency spot lag seen earlier). The fixing, thus, usually takes place on the Monday or on the Wednesday itself. The fixing date is also the *Last Trading Date* for the future.The *End Date* of the IBOR period is usually 1-3 months after the *Start Date* depending on the type of the future (using the conventions associated with the relevant IBOR index).
3. STIR Futures – Margining: The margining process works in the following way. For a given closing price (as published by the exchange), the daily margin paid is that price minus the *Reference Price* multiplied by the notional and the accrual factor of the future. Equivalently, it is the price difference multiplied by 100 *and* by the *Point Value* (*Point Value* being the margin that results from a 1% change in the price). The reference price is the trade price on the trade date and the previous closing price on subsequent dates.
4. STIR Futures - Prices/Ticks: The futures price at is denoted by . On the fixing date, at the moment of publication of the underlying IBOR rate , the future price is . Before that moment, the price evolves according to the market dynamics including bid/offer. The *Tick Value* is the value of the smallest increment in price. The price usually changes in or 1 bp increments.
5. STIR Futures - Designation Codes: The futures are designated by character codes. The first part is dependent upon the data provider, and is usually 2-4 characters. The second part describes the month (from the month code table), and the year, with its last digit. As interest rate futures are quoted 10 years only, there is no ambiguity in using only one digit for the year. Note also that this means that when a future reaches its last trading date, a new one is created a couple of days later with the same name, but for a 10Y maturity in the future.

**Currency Specific Futures**

1. Main Currencies:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Currency** | **Tenor** | **Exchange** | **Underlying** | **Notional** |
| CHF | 3M | LIFFE | LIBOR | CHF 1m |
| EUR | 3M | EUREX | EURIBOR | € 1m |
| EUR | 3M | LIFFE | EURIBOR | € 1m |
| EUR | 3M | NLX | EURIBOR | € 1m |
| GBP | 3M | LIFFE | LIBOR | £ ½ m |
| GBP | 3M | NLX | LIBOR | £ ½ m |
| JPY | 3M | SGX/CME | TIBOR | JPY 100 m |
| JPY | 3M | SGX | LIBOR | JPY 100 m |
| USD | 3M | CME | LIBOR | $ 1m |
| USD | 1M | CME | LIBOR | $ 3m |
| USD | 3M | SGX | LIBOR | $ 1m |

1. Other Currencies:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Currency** | **Tenor** | **Exchange** | **Underlying** | **Notional** |
| CAD | 3M | MX | CDOR | CAD 1m |
| DKK | 3M | OMX | CIBOR | CAD 1m |
| ZAR | 3M | SAFEX | JIBAR | ZAR 0.1m |

1. USD: USD interest rate futures are traded on CME and on LIFFE. For the 3M futures, the notional is $ 1m and the accrual fraction is ¼. The fixing index is LIBOR 3M. For 1M Futures, then notional is $ 3m and the accrual factor is . In both cases, the notional to multiply the accrual factor is 250,000.
2. EUR: The EUR 3M interest rate futures are traded on LIFFE, EUREX, and NLX. The notional is € 1m and the accrual factor is ¼. The fixing index is LIBOR.
3. GBP: The GBP 3M interest rate futures are traded on LIFFE and NLX. The notional is £ 1m and the accrual factor is ¼. The fixing index is LIBOR.
4. JPY: The JPY 3M interest rate futures are traded on CME and on SGX for TIBOR-based futures and on SGX for LIBOR-based futures. The notional is JPY 100m and the accrual factor is ¼.
5. CHF: CHF interest rate futures are traded on LIFFE. The fixing is LIBOR 3M.The notional is CHF 1m and the accrual factor is ¼.
6. AUD: Underlying Index: AUD BBSW 3M. Margin Based on .
7. CAD: The CAD 3M interest rate futures (3M Canadian Banker’s Acceptance Futures) are traded on MX. The notional is CAD 1m and the accrual factor is ¼. The fixing index is CDOR. The contract months are the quarterly March, June, September, and December months for up to 3 years, plus the 2 nearest non-quarterly months (serials). Reference => <http://www.m-x.ca/produits_taux_int_bax_en.php>
8. ZAR: The 3M ZAR interest rate futures are traded on SAFEX. The notional is ZAR 0.1 m and the accrual factor is ¼. The fixing index is JIBAR 3M, and the futures are traded 8 quarters ahead. Reference => <http://www.jse.co.za/Libraries/Interest_Rate_Market_-_Products_Documentation/Jibar_FuturesContract_specifications.sf/b.ashx>

**Interest Rate Futures Option – Premium**

1. Definition: An option on futures is described by the underlying future, an option expiration date , a strike , and an option type (call/put). The expiration is before or on the futures trading date: . The premium type options referred to here are the American type and pay premium upfront at the transaction date. The premium type is traded on CME and SGX, and there is no margining process for the option. On the CME, the options are Eurodollar futures (1M and 3M), on SGX the options are Eurodollar futures (1M), on JPY LIBOT futures, and JPY TIBOR futures.
2. Upfront Option Types: There are 3 types of options - the quarterly options, the mid-curve options, and the serial options. The quarterly options expire at the last trading day of the underlying future, i.e., . The serial and the mid-curve options expire before the futures’ last trading date. For the serial, the delay is 1-2 months (plus one weekend). For the mid-curve options, the delay is 1, 2, or 4 years. The quoted price for the option follows the same rule as the futures. For a quoted price, the amount paid is multiplied by the notional and the accrual factor of the underlying future.

**Interest Rate Futures Option – Margin**

1. Definition: An option on futures is described by the underlying future, the *Option Expiration Date* , a strike , and an option type (call/put). The expiration is before or on the futures trading date: . The option on futures referred to here are the American type and have a futures-like margining process. This type of option is traded on LIFFE for the EUR, GBP, CHF, and the USD futures (3M), and on EURX for EUR 3M.
2. Options Margining and Quoted Price: Note that there are 2 margining processes involved in the instrument – the margining process on the underlying futures, and one on the quoted option itself. The quoted price for the option follows the same rule as that for the future. For a quoted price, the daily margin is paid on the current closing price minus the reference price multiplied by the notional and the accrual factor of the underlying future. The reference price is the trade price on the trade date, and the previous closing price on the subsequent dates.
3. The Standard Contracts List:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Currency** | **Tenor** | **Exchange** | **Underlying** | **Type** |
| USD | 3M | LIFFE | LIBOR | Option on Future |
| USD | 3M | LIFFE | LIBOR | Mid-Curve Options |
| EUR | 3M | LIFFE | EURIBOR | Option on Future |
| EUR | 3M | LIFFE | EURIBOR | Mid-Curve Options |
| EUR | 3M | LIFFE | EURIBOR | 2Y Mid-Curve Options |
| EUR | 3M | EUREX | EURIBOR | Option on Future |
| EUR | 3M | EUREX | EURIBOR | 1Y Mid-Curve Options |
| GBP | 3M | LIFFE | LIBOR | Option on Future |
| GBP | 3M | LIFFE | LIBOR | Mid-Curve Options |
| GBP | 3M | LIFFE | LIBOR | 2Y Mid-Curve Options |
| GBP | 3M | LIFFE | LIBOR | Option on Future |

1. Margined IRF Options: Trading Dates: For standard options (not mid-curve options), the last trading date is the same as the last trading date for the underlying future. For mid-curve options, the last trading date is 1BD before the last trading date of the future in the same month. For example, the EUR mid-curve options with expiry in March 2014 (OR14) on the March 2015 Future (ER15) have a last trading date on Friday 10 March 2014, while the March 2014 Futures (ER14) and their associated standard options (ER14) trade upto 13 March 2014.

**Bank Bill Futures – AUD Style**

1. Definition: The AUD Bill Futures are traded on ASX. At expiry different bills can be delivered. The bills eligible for delivery are the bills having between 85 and 95 days to maturity on the settlement date. The bills issuers can be any banks in the approved banks’ list (currently there are 4 banks – ANZ Banking Group, National Australia Bank Limited, Commonwealth Bank of Australia, and Westpac Banking Corporation).

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Currency** | **Tenor** | **Exchange** | **Underlying** | **Notional** |
| AUD | 3M | ASX | Bank Bill | AUD 1m |

1. Delivery: The party short on the futures chooses the bill it wants to deliver – for each contract, the short party can choose up to 10 different bills of AUD 0.1 m each. Thus, the short party has a delivery option – a situation very similar to bond futures in the main currencies.
2. Expiry: The expiry date (also called the announcement date) is the second Friday of the future month and the *Delivery Date* is the next business day (usually Monday). The futures are quoted with fixing upto 5 years.
3. Settlement: Let denote the possible maturity dates of the bills. At settlement, the price received for the bill will depend on the last quoted Future Index that we denote by . The yield associated with this index is The paid price is where is the accrual factor between and . For the AUD bill futures is Act/365. In exchange of the price the short party delivers the bills with the notional equivalent to that of the futures (remember, in practice, there can be at most 9 possible dates taking into account weekends).

**Deliverable Swap (IRS) Futures (PV Quoted)**

1. Definition: These futures are traded in CBOT/CME, and the notional is $ 0.1m per contract. The margining feature is the future-daily margin on the quoted price (note that the price is quoted in percentage points and nd of a point, like the bond futures contract). The underlying swap has the standard convention for a USD swap – semi-annual bond-basis vs. 3M LIBOR. The futures are quoted swaps with tenors 2Y, 5Y, 10Y, and 30Y. The underlying swap has a fixed rate as decided by the exchange on the first trading date of the contract. The rate of change is in increments of 25 bp. The rate is NOT fixed at a pre-defined value, unlike the reference coupon of bond futures.
2. CBE/CBOT Deliverable Swap Futures in USD:

|  |  |  |
| --- | --- | --- |
| **Contract** | **Notional** | **Coupon** |
| 2Y | $ 0.1m | 0.50% as of March 2014 |
| 5Y | $ 0.1m | 1.00% as of March 2014 |
| 10Y | $ 0.1m | 2.50% as of March 2014 |
| 30Y | $ 0.1m | 2.75% as of March 2014 |

1. CME/CBOT Deliverable Swap: Delivery/Trading Dates: The *Delivery Dates* follow the quarterly cycle standard to the interest rate futures. The *Delivery Date* is the 3rd Wednesday of the quarterly month (March, June, September, and December). The *Last Trading Date* or the *Expiry Date* is 2 trading days prior to that date, usually on the Monday.
2. Deliverable Swap – Delivery and Settlement: On the expiry date, the parties agree to enter into a swap where the party long the futures receives fixed on the swap and the party short the futures pays the fixed. The delivered swap is cleared on a CME clearing. The *Effective Date* of the Swap is also the *Delivery Date*. The swap has an upfront payment on the delivery date. The upfront payment is obtained from the futures settlement price on the last trading date, denoted by . The amount received by the long party is (if the amount is negative, it is interpreted as the absolute value paid by the long party).

**Bond Futures (non AUD/NZD)**

1. Definition: These bond futures are exchange traded instruments. One of their peculiarities is that the underlying is not a single instrument, but a basket. For most of the instruments the short party has an option to deliver any of the instruments in the basket.
2. Basket: The basket is composed of government bonds from a unique issuer (country) with rules on initial maturity, remaining maturity, and size to be eligible. The bond futures are traded on different exchanges for different countries. In general, there are several maturity buckets for each underlying country.
3. Conversion Factor: The bonds in the basket are transformed to be comparable through a conversion factor mechanism. The factor is such that in a certain yield environment all the bonds have the same price. The reference yield acts in a way as the strike for a delivery process.
4. Main Contracts:

|  |  |  |  |
| --- | --- | --- | --- |
| **Country** | **Currency** | **Exchange** | **Number of Contracts** |
| Canada | CAD | MSE | 3 |
| Germany | EUR | EUREX | 4 |
| Germany | EUR | NLX | 3 |
| Italy | EUR | EUREX | 2 |
| Japan | JPY | TSE | 3 |
| Japan | JPY | LIFFE | 1 |
| Japan | JPY | SGX | 1 |
| Spain | EUR | MEFF | 1 |
| United Kingdom | GBP | LIFFE | 3 |
| United Kingdom | GBP | NLX | 1 |
| United States | USD | CBOT | 5 |
| Switzerland | CHF | EUREX | 1 |

1. Embedded Options: Some of the other embedded options for certain currencies include:
   1. Timing Option => The delivery notice can be made inside of a period and not just on a single date. This provides some American Option flavor to the futures.
   2. Wild Card Option => The underlying bonds can be selected after the price of the future has been fixed. During the delivery period, there is a daily option between the end of the future trading at 14:00 and the end of the bond trading at 18:00. After the last trading date, there can be a period of up to 7 days where the future price is fixed, but the delivery notice has not been given yet.
2. Settlement: Suppose there are bonds in the basket. Let denote the accrued interest of bond at the delivery date . The conversion factor associated with bond is . The bond future delivery notice takes place at some date before the actual delivery, with this lag usually being around 1-2 days. If the *Futures Price* is denoted by , at the delivery time the short party can choose the bond he wishes to deliver and receives at the delivery date the amount .
   1. Settle Price Clarification => The term *Price* used above is the standard in the jargon for futures, however, it should be viewed as a *Number* or as a *Traded Reference Index.* The *Future Price* is never paid in itself. It only serves as an input for the eventual computation.

**Country-specific Bond Futures - USD**

1. Treasury Bond Futures: The futures on United States debt are traded on CBOT. The price is quoted in percentage points and 32nd of a point. Note that the last trading day and the last delivery date are not the same for all the basket underlyings.
2. Conversion Factor: The description of the price used in the delivery (using an explicit quote from the exchange) is: *The invoice price equals a future settlement price times a conversion factor, plus accrued interest. The conversion factor is the price of the delivered bond (USD 1 par value) to yield 6%*. The conversion factor is provided by the exchange and does not need to be computed by the users. Nevertheless, there are clear rules to compute them. The values do not change through the life of the future.
3. Long Futures: The Ultra T-Bond futures, the US Treasury Bond Futures, and the 10Y US Treasury Note Futures all have the same last trading day and the last delivery date. The last trading day is *the 7th business day preceding the last business day of the delivery month. Trading in expiring contracts closes at 12:01 PM on the last trading day*. Previously the US Treasury Long Bond Futures referred to all bonds with maturities greater than 15 years. That range has recently (since March 2011) been divided into 2 futures – the Ultra T-Bond Futures, and the US Treasury Bond Futures.
   1. Ultra T-Bond Futures => The underliers of the Ultra T-Bond Futures are the *US Treasury Bonds with remaining term to maturity of not less than 25 years from the first day of the futures contract delivery month*.
   2. US Treasury Bond Futures => Formerly called the 30 years futures, the deliverable grade for the Treasury Bond Futures are *bonds with remaining maturity of at least 15 years, but less than 25 years, from the first date of the delivery month*. These are also known as *Classic Bond Futures*. The Treasury Bond Futures are less liquid than the 5Y and the 10Y futures. To match the US Treasury Naming Convention, the futures would be better called *Note Futures*.
   3. Catalog => Volume refers to the Monthly volume, as on October 2013.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Contract** | **Maturity** | **Notional** | **Yield** | **Code** | **Volume** |
| Ultra T-Bond | > 25Y | $ 0.1m | 6.00 % | UB/UL/LBE | 1,387,996 |
| 30Y Bond | 15Y - 25Y | $ 0.1m | 6.00 % | ZB/US | 6,193,997 |
| 10Y Bond | 6½Y – 10Y | $ 0.1m | 6.00 % | ZN/TY | 21,265,689 |
| 5Y Note | 4Y2M – 5Y3M | $ 0.1m | 6.00 % | ZF/FV | 10,198,247 |
| 3Y Note | 2Y9M - 3Y | $ 0.2m | 6.00 % | Z3N/3YR | 0 |
| 2Y Note | 1Y9M – 2Y | $ 0.2m | 6.00 % | ZT/TU | 3,132,990 |

1. 10Y Treasure Note Futures: *US Treasury Notes with a remaining term to maturity of at least 6½Y, but no more than 10Y, from the first date of the delivery month*.
2. 5Y Treasury Note Futures: The last trading day is *the last business day of the calendar month*. The last delivery day is *the 3rd business day following the delivery day*. The eligible bonds are *US Treasury notes with the original term to maturity if note more than 5Y3M, and a remaining term to maturity of not less than 4Y2M as of the first day of the delivery month*.
3. 3Y Treasury Note Futures: The last trading day is *the last business day of the transaction month*. The notional is $ 0.2m. The eligible bonds are *US Treasury Notes that have an original maturity of 5Y3M and a remaining maturity of not less than 2Y9M from the first day of the delivery month, but not more than 3Y from the last day of the delivery month*.
4. 2Y Treasury Note Futures: The notional is $ 0.2m. The eligible bonds are *US Treasury Notes that have an original maturity of 5Y3M and a remaining maturity of not less than 1Y9M from the first day of the delivery month, but not more than23Y from the last day of the delivery month*.

**Country-specific Bond Futures - Germany**

1. German € Bond Futures Catalog: Volume is as of December 2011.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Contract** | **Maturity** | **Notional** | **Yield** | **Volume** |
| EURO-BUXL | 24Y – 35Y | € 0.1m | 6.00 % | 222, 821 |
| EURO-BOND | 8½Y – 10½Y | € 0.1m | 6.00 % | 11,778,488 |
| EURO-BOBL | 4½Y – 5½Y | € 0.1m | 6.00 % | 7,252,498 |
| EURO-SCHATZ | 1¾Y – 2¼Y | € 0.1m | 6.00 % | 8.659,722 |

1. The Contracts: All the futures are traded on EURX and NLX, except for EURO-BUXL which is only traded on EUREX. *The delivery option arising out of a short position may only be fulfilled by the delivery of certain securities issued by the Federal Republic of Germany with a remaining term on the delivery day within the remaining term of the underlying*. To be eligible, the debt securities must have a minimum issue of € 5bn.
2. Trading/Delivery Dates: The Delivery Date is *the 10th calendar day of the respective quarterly month, if this day is an exchange day; otherwise it is the exchange day immediately succeeding that day*. The last trading day is *2 exchange days prior to the Delivery Day of the relevant maturity month*.
3. Reference Yields: Note that the reference yield for the EURO-BUXL, which the most recent among the others, is 4% (and not 6% as for the majority of the others).

**Country-specific Bond Futures - Spain**

1. € Bond Futures: The BONO10 Futures Contract on the Spanish 10Y Government Bond was launched on 29 May 2012 by MEFF. The volumes are currently very low (quoted below for October 2013).

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Contract** | **Maturity** | **Notional** | **Yield** | **Volume** |
| BONO 10 | > 8½Y | € 0.1m | 6.00 % | 253 |

1. Underliers: The underlying asset is a national government bond with a 6.00% annual coupon and a maturity of 10Y. The contract face value is € 0.1m. The expiration day is the 10th day of the month of maturity (if holiday, the next business day). The last trading and the registration days are 2 business days prior to the expiration date. The bonds in the basket are Spanish government bonds with a remaining life of no less than 8½Y.
2. Settlement: The settlement price at the expiration date is calculated by dividing the CTD bond market price (ex-coupon) at the end of the session by the conversion factor of the bond. The market price of the CTD bond will be the closing price determined by SENAF.

**Country-specific Bond Futures - £**

1. UK £ Bond Futures Catalog: Volume is monthly as of December 2010. Note – the change from 6.00 % coupon to a lower coupon took place with the December 2011 contract.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Contract** | **Maturity** | **Notional** | **Yield** | **Volume** |
| Long GILT Futures | 8Y9M – 13Y | £ 0.1m | 6.00 %/4.00 % | 476,025 |
| Medium GILT Futures | 4Y – 6Y3M | £ 0.1m | 6.00 %/4.00% | 183 |
| Short GILT Futures | 1Y6M – 3Y3M | £ 0.1m | 6.00 %/ 3.00% | 1,131 |

1. The Contracts: All the futures are traded on LIFFE, and the Long GILTs are also traded on NLX. The first notice day in 2BD prior to the first day of the delivery month. The *Last Notice Day* is the first business day after the *Last Trading Day*. The *Last Trading Day* is 2BD prior to the last business day of the delivery month. The *Delivery Day* is any business day in the delivery month (at the sellers’ choice). The deliverable bonds are subject to a coupon range of 3.00% around the reference yield.

**Country-specific Bond Futures - ¥**

1. Japan ¥ Bond Futures: These are traded on TSE. The notional is ¥ 100m. The *Final Settlement Day* is the 20th of each contract month. The *Last Trading Day* is the 7th business day prior to each delivery date. Trading for the new contract month begins on the business day following the last trading day. There also used to be a 20Y JGB futures, but its trading was halted in December 2002 due to lack of volume.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Contract** | **Maturity** | **Notional** | **Reference Yield** | **Volume** |
| 10Y JGB Futures | 7Y - 10Y | ¥ 100m | 6.00 % | 657,356 |
| 5Y JGB Futures | 4Y – 5¼Y | ¥ 100m | 3.00 % |  |

**Options On Bond Futures (non AUD/NZD) - Premium**

1. Description: An option on futures is described by the underlying future, and expiration date , the strike , and an option type (Call/Put). The option expiration is on or before the last trading date of the futures, i.e., . Premium-type options pay a premium upfront at the transaction date, and are of American type. As such, there is no margining process for them. This type is traded on CBOT for USD bond futures.
2. CBOT Options on USD Bond Futures: The contract months are the first 3 consecutive contract months (2 serial expirations and one quarterly expiration) plus the next 4 months in the March, June, September, and December quarterly cycle. The serials exercise into the first nearby quarterly futures contract. Quarterlies exercise into the futures contracts of the same delivery period. The *Last Trading Day* is the *Last Friday* which precedes by at least 2BD the last business day of the month preceding the option month. The options are quoted in th of a point.
3. USD Bond Futures Options Catalog: Volumes quoted here are monthly for October 2013. The codes are for CME Globex (Electronic Platform)/Open Outcry (Trading Floor) Call-Put.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Contract** | **Maturity** | **Notional** | **Codes** | **Volume** |
| Ultra-Bond | > 25Y | $ 0.1m | OUB/OUL | 3,786 |
| Classic Bond | 15Y – 25Y | $ 0.1m | OZB/CG-PG | 1,247,787 |
| 10Y Note | 6½Y – 10Y | $ 0.1m | OZN/TC-TP | 7,710,256 |
| 5Y Note | 4Y2M – 5¼Y | $ 0.1m | OZF/FL-FP | 1,752,940 |
| 2Y Note | 1¾Y – 2Y | $ 0.1m | OZT/TUP-TUC | 197,574 |

**Options On Bond Futures (non AUD/NZD) - Margin**

1. Description: An option on futures is described by the underlying future, and expiration date , the strike , and an option type (Call/Put). The option expiration is on or before the last trading date of the futures, i.e., . The margin type options are American type and have a future-style method of margining process for the option. This type is traded on EUREX for bond futures.
2. EUR - EUREX Margin Options: The contract months are the first 3 consecutive contract months (2 serial expirations and one quarterly expiration) plus the next month in the March, June, September, and December quarterly cycle. For calendar months, the maturity month of the futures contract is the quarterly month following the expiration month of the option. For quarterly months, the maturity month of the underlying futures contract and the expiration month of the option are identical.
3. Trading/Settlement Days: *Last Trading Day for the Option Series introduced from September 1, 2011 is the last Friday prior to the first calendar day of the option expiration month, followed by at least 2 exchange days prior to the first calendar day of the option expiration month. Exception => If this Friday is not an exchange day, or if this Friday is an exchange day but is followed by only one exchange day prior to the first calendar day of the option expiration month, the exchange day immediately preceding that Friday is the* ***Last Trading Day****. For the purposes of this exception, an exchange day is an exchange day at both the EUREX exchanges as well as being a Federal work day at the US*. Reference => <http://www.eurexchange.com/products/INT/FIX/OGBL_en.html>

**AUD-NZD Bond Futures**

1. Introduction: The Australian and New Zealand futures are settled in cash against a standardized bond. The standardized bond yield is computed as an average of actual bond yields for AUD, and as a linear interpolation of actual bond yields for NZD.
2. Basket Weightings: The average yield cash delivery implies that the futures behave roughly like a weighted average of the underlying. The weights are not exactly equal, but they do not change too much with level of the rates. One single bond will never represent the future exactly, but the mixture of bonds that best represent the future does not vary too much with time and rates.
3. Characteristics: Compared to the non AUD/USD bond futures, the AUD bond futures traded in SFE have very different characteristics. The main difference is that they settle in cash vs. the average yield of the underlying bonds. The exact mechanism of the settlement (which is non-trivial) is described below.
4. Maturity Types: There exist 2 maturity types for the SFE Australian Treasury Bond Futures – the 3Y and the 10Y futures. Beyond the maturity the other characteristics of these futures types are similar. Both have a notional of 0.1m AUD per contract. The 3Y futures are more liquid than the 10Y one.
5. Settlement Yield Rules: The general scheme for choosing the yields used in settlement is that a set of randomly chosen dealer quotes is selected (after discarding extreme quotes). The selection of the underlying bonds does not appear to be captured by a very precise rule. A certain number of bonds is chosen by the exchange, often around 3 underlying bonds. The maturities are between 2Y and 4Y for the 3Y futures, and 8Y – 12Y for the 10Y futures. Reference => <http://www.asx.com.au>
6. Settle Yield Calculation: Suppose there are bonds underlying the future. Since the contract settles in cash, the settlement is done against the average yield of the underlying bonds. Let be the yields on the fixing date for the underlying bonds. The reference yield for the settlement is . This yield is used to calculate the final future index yield and the equivalent bond price, as shown below.
7. Reference Price: The time *Futures Price* (all the caveats regarding the price being a jargon rather than an actual economic quantity applies here) is denoted by . All the margining payments related to SFE bond futures are done using a reference bond price is computed from the future index in the following way: Let be the number of payments ( for semi-annual 3Y futures and for semi-annual 10Y futures). Then ; ; . Finally, this reference price is multiplied by notional value, which is AUD 0.1m per contract.
8. Reference Price Calculation: The expression seen above for is simply a consequence of using semi-annual 3Y/10Y bond with coupon, and semi-annual yield . It is just a special case of the expression .

**Desired Curve Builder Features**

### Overview

1. Smoothness Criterion Evolution: Smoothness formulation is related to the minimization of strain energy (Schwarz (1989)), and the relation to Natural cubic spline (Burden and Faires (1997)), financial cubic spline (Adams (2001)) has been explored.
2. Empirical vs. Theoretical Curve Builder Frameworks: Zangari (1997) and Lin (2002) discuss this in detail.

* Theoretical Term Structure posit explicit term structure for a variable known as short rate of interest whose values are extracted, possibly, from a statistical analysis of market variables (Vasicek (1977), Cox, Ingersall, and Ross (1985), Rebonato (1998), Barzanti and Corradi (1998), Golub and Tilman (2000)).
* For bonds/treasuries see Nelson and Siegel (1987), Diament (1993), Svensson (1994), Soderlind and Svensson (1997), Tanggaard (1997). Effectiveness of such treatments is examined in Christensen, Diebold, and Rudebusch (2007), and Coroneo, Nyholm, and Vidova-Koleva (2008).
* Hybrid methods use empirically determined yield curve inside of a theoretical model (Hull and White (1990), Heath, Jarrow, and Morton (1990), Ron (2000)).
* A fairly comprehensive (although a bit dated) description of yield curve construction is given in Andersen and Piterbarg (2010).
* Notes on some of the standard implementations by vendors are available in Jurcaga (2010), Lipman and Mercurio (2010), White (2012a), White (2012b), Gibbs and Goyder (2012), Misys (2012).

### Discount Curves

1. Exact instrument quote match: Does the builder scheme successfully construct the curve if the quotes do not pose arbitrage? Conversely, for inexact matches, does the builder algorithm converge rapidly, and minimal error (Hagan and West (2006), Hagan and West (2008))?
2. Implied Forward Rates: Taken to be typically 1M or 3M forwards – how smooth/positive/continuous are they (McCulloch and Kochin (2000))?
3. Locality: How local is the interpolating builder? If an input is changed, does the interpolator change only nearby, or is there spillover to non-adjacent far-off segments?
4. Stability of the Forward Rates: How sensitive are the forward rates to change in the inputs? The Jacobian analysis below shows the results for several splining scenarios.
   1. Forward rates are chosen for the curve behavior examination because it is the most elemental entity whose continuous/smooth behavior is meaningful to the practitioner.
5. Hedge Locality: Does most of the delta risk for a given instrument get assigned to the hedging instruments that have maturities close to the given instrument?
6. Sequential vs. Tenor Delta: Does the cumulative tenor delta equal to the aggregate (i.e., parallel shifted) delta? Le Floc’h (2013) examines the importance of this.

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**Curve Construction Methodology**

**Base Methodology**

1. Instrument Setup: Construct the calibration instruments, and set up the instrument baseline. This includes initializing the span/segments, as well as the “tuning parameter” to achieve the desired “inner” and the “outer” calibrations.
2. Span/segment stretch set up: Calibrate the segments one by one using the calibration measures/inputs.
3. Tuning Adjustment: Adjust tuners to achieve the desired “boundary” condition.

**State Span Design Components**

1. Base Quantification Metric Retrieval: This refers to the functionality for retrieval of the State Quantification Metric Response Value at different predictor ordinates, the relative values, and canonical (possibly categorical) representations.
2. Targeted State Metric Computation: This functionality computes state/model specific targeted state metrics (e.g., LIBOR for a discount Curve, I Spread etc.) that may be absolute or relative.
3. Sensitivity Jacobian: This functionality provides for the ability to extract sensitivity Jacobian at the following levels:

* Cross Quantification Metric (Quantification Metric 1 to Quantification Metric 2) Sensitivity Jacobian
* External Manifest Metric to Quantification Metric Sensitivity Jacobian

1. Calibration Input Manifest Measure Retrieval: This functionality records and retrieves the calibration input manifest measure set and other relevant calibration details.

* It needs to be remembered that the calibration input manifest measure set need not just be instrument quotes, but also “event” rates such as user specified turns meant to account for items such as year-end yield adjustments, periods of high activity etc. (Ametrano and Bianchetti (2009a), Kinlay and Bai (2009)). In the case of turns, they may be modeled as discrete latent state jumps across specific pairs of dates, of a user-specified magnitude.
* Exogenously specified State Differentials => As just noted, certain state attributes maybe exogenously specified (e.g., turns, bases, etc.). These state shift differentials may be applied before or after the calibration step.

1. Scenario State Span Re-construction: This functionality re-constructs the state using adjusted, bumped, or otherwise scenario-tweaked quantification metrics and/or manifest measures.
2. Boot State Span: This functionality is used in boot state spans. Here, there needs to be the ability to set the boot values at the node knots, and the build the segment.
3. Non-linear State Span: This functionality sets up the non-linear fixed-point extraction process and the corresponding target match criterion evaluator.

## Curve Calibration From Instruments/Quotes

* 1. Instrument Conventions: Market Conventions for all the typical calibration instruments such as deposits, futures, FRA, IRS, float-float basis swaps, OIS, cross currency swaps etc. are available in a wide variety of publications (e.g., Open Gamma (2012)).
  2. Construction from Single Instrument/Quote Set: If there is only one type instrument/quote set to be calibrated from, you can simply “spline” through the constituent segments. In particular, if there are no value limitations/constraints, then spline construction may be achieved directly from the points (e.g., bond yield curve).
* Questionable if quote interpolation is necessary for even the single instrument set, since this results in double interpolation – the first on the quote space, and the second on the span/segment canonical space.
  1. Construction from Diverse/Multiple Instrument/Quote Set: Given a diverse set of instruments and/or quotes, we need canonical quote-independent/quote-transforming measure formulation that is valid across the full instrument stretch.
  2. Curve Span/Segment Latent State Quantification Metric:
* For discount curves, this can be the discount factor/zero rate/forward rate.
* For forward curves, this can be the absolute forward rate/forward rate basis.
* For credit curves, this can be survival factor/cumulative hazard rate/ forward hazard rate.
* For recovery curves, this can be the expected loss/recovery, of the forward loss/recovery.
  1. Cumulative vs. Forward Quantification Metric: The cumulative span quantification metric  and the forward segment quantification metric  are related as , where S is the span variate (specifically the tenor – in this case).
  2. Physics of Quantification Metric Constraints: More generally, , where  comes from the physics of the process. For the discount curve, the credit curve, and the recovery curve .
  3. Cumulative Quantification Metric from Forward Quantification Metric (or Span from Segment): Cumulative may be extracted from forwards using the quadrature formulation, as they are integrands over the segment dimension. For survival/discount/recovery curves .
  4. Structure of cumulative vs. Forward: Forward quantification metric is more sharp-edged/swinging than cumulative quantification metric, which, by virtue of the quadrature construct, is smoother.
* Therefore, single instrument/quote interpolation may be able to use the forward quantification metric, and imply the cumulative quantification metric.
* Multiple instrument/quote should use the cumulative manifest metric, and perhaps imply the forward quantification metric using the segment <-> span transformation relationship.
  1. Constraints on the forward Quantification Metric: Depends on the driver physics.
* For survival curve, , and this is a hard constraint.
* For discount curve, there are no such constraints.
* For recovery curve, the constraint is that .
  1. Constraints on the cumulative Quantification Metric: Again depends on the stochastic variate driver physics.
* For survival curve, if Z is the cumulative survival/hazard rate, , and it should be monotonically decreasing - this is a hard constraint.
* For discount curve, if Z is the discount factor, then . Beyond this there are no constraints.
  1. Challenges with interpolating in the forward Quantification Metric space: For survival/discount, due to the exponential nature of the formulation, splining on  can very often cause the prior two constraints to be violated – so relatively speaking, the choice is less stable.
  2. Span/Segment Quantification Metric Relationship:
* Discontinuity in the cumulative quantification metric automatically implies discontinuity in the forward quantification metric.
* Continuous, but non-differentiable cumulative quantification metric implies discontinuity in the forward quantification metric.
* Continuity in the first derivative of cumulative quantification metric implies continuous, non-differentiable forward quantification metric.
* Continuity in the first/second/third derivative of cumulative (using, e.g., quartic splines) quantification metric implies continuous, first/second differentiable forward quantification metric.
* Certain splines become problematic for highly uneven segment lengths, e.g., cubic splines will be unsatisfactory for the situation where you start with close set of nodes and move to a sparser set (Burden and Faires (1997)). This is because the curve is too convex and bulging for points far away from each other.
  1. Span Quantification Metric – “Effective” Rate/Hazard Rate: This can simply be defined as , where  is either the discount factor (for the discount curve) or the survival factor (for the survival curve). This needs to be matched for 4 powers (quartic) for polynomial spline, or for three derivatives for non-polynomial (e.g., tension) splines.

## Calibration Considerations

1. Exponential/Hyperbolic Tension Splines as a Natural Basis for DF representation: This is popular (Sankar (1997), Securities Industry and Financial Markets Association (2004), Andersen (2005)) because the discount factor simply goes as . Obviously this basis will not be suitable for forward/zero rates.

* The Trouble with the High-Tension Tension Splines is: This causes the segment responses to be almost linear with the predictor, therefore:
  + For big gaps in the predictor ordinates, “linear” can soon become a huge problem.
  + NASTY, NASTY low-tenor forward’s starting near the segment edges.
  + High Tension implies high local forward interest (using above).
  + While Renka (1987) shows an automatic way to extract to specify the tension, the resulting  presents fundamentally no more of an advantage than a  cubic (Le Floc’h (2013)).
  + Other issues with the impact of automatic selection (see Preuss (1978)) and the corresponding implications for sensitivities remain.

1. Sensitivity of the Forward Rate to the Spot Measure: The forward rate/DF sensitivity to the spot quote is not just low, but also ends up producing multiple matching results.

* In particular, the presence of root multiplicity within a single segment (as is the case for polynomial splines) reduces the calibration to a needle in a haystack search – with huge demands on intelligent heuristics placed on the searcher.

1. Pay Date DF Pre-computation: This method is outlined in Kinlay/Bai, and is NOT a robust method, for the following reasons:
2. It starts by estimating the DF’s parametrically (using constant forwards) between dates.
3. Fine pay date grids (owing to, say, diverse/overlapping instrument types, and diverse/overlapping quote types) means that the interpolation grid becomes highly clustered, and this produces challenges for many splining techniques.
4. Non-linear DV01: The DV01 term , or more generally, the DV01-type terms, is non-linear on both the discount factor and the forward rate – this is what makes the curve calibration using the Kinlay/Bai and the Andersen schemes difficult.

* Relating the discount factor the forward rate as shown may really help simplify the formulation. . Here  refers to the instrument maturity that precedes the time t.

1. No Arbitrage Conditions:

* No Arbitrage for Rates implies that  => , although this can easily seen to be violated in several instances.
* Options => Arbitrage free Implied Volatility Surface for Call Options (Homescu (2011)) =>  and .

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## Curve Construction Formulation

## Linearized Discount Curve Calibration from Instruments

1. Cash flow PV Linearity in Discount Factor and Survival: Simply put, , or more generally  where  is the cash flow, is the discount factor, and  is the survival probability. The challenge is to re-cast the measure computation in a manner that retains the formulation linearity in the latent state (it is already linear in and , so that simplifies things a bit).

* Re-casting all the product/measure calibration as a linear equation depends on the product/measure combination, but many typical formulations satisfy this criterion.

1. Different Linearized Discount Curve Formulations:

* Single Segment Giant Spline => Use all the market observations to construct all the linearization constraints to synthesize one giant multi-basis spline.
* One Spline Segment per adjacent cash flow pair => This gives maximal control, but ends up being way too computationally involved, as their will be as many spline segments as there are cash flow pairs.
* One Spline Segment per Instrument Maturity => Here a unique spline segment will be used between 2 adjacent calibration instrument maturities. This ordering is identical to typical instrument level bootstrapping.
* Transition Spline => This retains the spline cluster per each instrument group. This representation is valuable when you have instruments assembling in cluster (as cash/EDF/swaps etc., which is obviously a typical arrangement). Judicious choice of knots and instruments etc. reduce the chances of jumps/bumps, although can still be a challenge.

1. Nomenclature:

* Instrument Set => 
* Segment exclusive to instrument  spans the times .
* Instrument  has  cash flows indexed by : 
* Segment ’s spline coefficients  are determined by ’s cash flows and market quotes.
* Each Segment has , i.e.,  basis function set representing the discount factor.
* Instrument ’s cash flow  has a pay date of .

1. Importance of some of the Linear Algebra Operations: While most of what is used in spline systems for linearized curve building can be achieved using a robust linear system solver (e.g., Gauss Elimination, see Press, Teukolsky, Vetterling, and Flannery (1992)), robust matrix inversion algorithms are needed for Jacobian estimation.

## Segment Linear Discount Curve Calibration from Instruments

1. Step #1: Identify and sort instruments by their maturities.

* In between two maturities lies a segment, and the curve start date demarcates the start of the first (exclusive) segment.

1. Step #2: For each instrument, extract the coefficient of each discount factor (which corresponds to the net cash flow at that node).
2. Step #3: Say that the market PV quote of instrument  is . This indicates 
3. Step #4: Given that all segment  cash flows whose pay date is less than belong to the prior periods, their discount factors should be computable. Thus,  should be pre-computed.
4. Step #5: The segment specific constraint now becomes .
5. Step #6: In terms of the segment spline coefficients  and the segment basis functions , the constraint gets re-specified as follows:

* 
* 
* Again, notice that  can be pre-computed. Thus, the above becomes .

1. Step #7: Of course, in general  need not just be the P – it just needs to be any measure linearizable in the discount factor.
2. Cash  Coefficient:

* Given a rate calibration measure , .

1. EDF  Coefficient:

* Given a rate calibration measure , .
* Given a price based calibration measure , .

1. Fixed Stream  Coefficient: Given a price measure , , where  is the coupon.
2. Floating Stream  Coefficient: Given a price measure , , where  is the floater spread.
3. IRS  Coefficient:

* For a par swap IRS, => .
* Given a price measure , .

1. Bond  Coefficient:

* Given a dirty price measure , .
* Given a yield measure, the yield can be converted to the dirty price measure .
* Given a spread over TSY measure, it may also be converted to the dirty price measure  through the yield.

## Curve Jacobian

* 1. Representation Jacobian: Every Curve implementation needs to generate the Jacobian of the following latent state metric using its corresponding latent state quantification metric:
* Forward Rate Jacobian to Quote Manifest Measure
* Discount Factor Jacobian to Quote Manifest Measure
* Zero Rate Jacobian to Quote Manifest Measure
  1. Importance of the representation Self-Jacobian: Representation Self-Jacobian computation efficiency is critical, since Jacobian of any function  is going to be dependent on the self-Jacobian  because of the chain rule.
  2. Forward Rate->DF Jacobian:
* .
* .
*  => Forward rate between times  and .
*  => Discount Factor at time 
  1. Zero Rate to Forward Rate Equivalence: This equivalence may be used to construct the Zero Rate Jacobian From the Forward Rate Jacobian. Thus the above equation may be used to extract the Zero Rate micro-Jacobian.
  2. Zero Rate->DF Jacobian:
* 
*  => Zero rate at time t
  1. Analytical Sensitivity vs. Quote Bumped Sensitivity: In general, when dealing with the splined mechanisms for curve cooking, it may not be accurate to depend on the quote bumped sensitivity, because it may end up throwing it to a totally different curve builder scheme (Le Floc’h (2013)).
* Also, analytical sensitivities may be estimated right during the calibration itself. However, analytical-to-quote sensitivities implies two-stage Jacobian – the Jacobian of the quote to the state representations, then the Jacobian of the state representation to the sensitivity measure.
* In-situ Calibration Sensitivities => Measure to state sensitivities maybe generated quiet readily, depending on the calibration mode.
  + For linear calibrator, this is simply the state Jacobian inverse.
  + In some non-linear search techniques (esp. open ones like the Newton’s method, but with the closed schemes as well), sensitivity Jacobians are automatically (or using light adjustment) generated as part of the calibration itself.
* Spline coefficient sensitivity to segment/node inputs => High sensitivity of the spline coefficients to the node inputs across specific stretches indicates instability in curve (re-) construction and the corresponding deltas (i.e., spurious deltas and leakage). Le Floc’h (2013) examines this for several standard interpolating estimators in use.
  1. Derivative to Quote Jacobian via the Discount Factor Latent State:
*  Calibration Components
*  Corresponding Quotes
* Let’s say the Derivative PV is . Thus what is typically needed to estimate product-to-quote sensitivities via the Discount Factor latent state is .
  1. Quote->Zero Rate Jacobian:
* 
*  => Zero rate at time t
  1. PV->Quote Jacobian:
* 
  1. Cash Rate DF micro-Jacobian:
* 
*  => Cash Rate Quote for the jth Cash instrument.
*  => Discount Factor at time 
  1. Cash Instrument PV-DF micro-Jacobian:
* 
* There is practically no performance impact on construction of the PV-DF micro-Jacobian in the adjoint mode as opposed to the forward mode, due to the triviality of the adjoint.
  1. Euro-dollar Future DF micro-Jacobian:
* 
*  => Quote for the jth EDF with start date of  and maturity of .
  1. Euro-dollar Future PV-DF micro-Jacobian:
* 
* There is practically no performance impact on construction of the PV-DF micro-Jacobian in then adjoint mode as opposed for forward mode, due to the triviality of the adjoint.
  1. Interest Rate Swap DF micro-Jacobian:
* 
*  => Quote for the jth IRS maturing at .
*  => DV01 of the swap
*  => Floating PV of the swap
* 
* 
* 
* 
* 
  1. Interest Rate Swap PV-DF micro-Jacobian: See Hull (2002) for the preliminaries.
* 
* There is no performance impact on construction of the PV-DF micro-Jacobian in then adjoint mode as opposed for forward mode, due to the triviality of the adjoint. Either way the performance is , where n is the number of cash flows, and k is the number of curve factors.
  1. Credit Default Swap DF micro-Jacobian:
* 
* j => jth CDS Contract with a maturity 
*  => Coupon of the jth CDS
*  => PV of the full CDS contract
*  => PV of the Coupon leg of the CDS Contract
*  => PV of the Accrual paid on default
* 
* 
* 
* 
* 
* 
  1. Credit Default Swap DF micro-Jacobian:
* 
* There is no performance impact on construction of the PV-DF micro-Jacobian in then adjoint mode as opposed for forward mode, due to the triviality of the adjoint. Either way the performance is , where n is the number of cash flows, and k is the number of curve factors.

### References

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**Stream-based Calibration**

**Latent State Formulation Metric (LSFM)**

1. Case for LSFM: In addition to the quantification metric employed as described above for quantifying the latent state, we also need a “Latent State Formulation Metric”. The LSFM is the metric that dictates the formulation specification for the predictor/response constraint relation for the latent state at hand. For e.g., commonly price/PV based formulation (i.e., predictor/response relation determination) is used in the discount curve construction using swap calibration instruments, whereas direct manifest measure observations (e.g., the observed FRA rate or the par forward deposit rate etc.) are used for forward curve construction (if zero coupon bond prices are available, they are form direct manifest measure maps of the discount factor quantification metric). While the quantification metric representation is chosen the same across all the constituent segments/stretches to facilitate ancillary objectives (e.g., smoothness/ requirements), the LSFM chosen need not be subject to such limitations. The only demand is that, using the manifest measure, the formulation metric result in a linear relation involving the LSQM’s corresponding to a given segment/stretch/span.
2. Latent State QM as the Formulation Metric: In this case the relation becomes trivial, as , and the Jacbian reduces to unity (thus producing a unit loading).

**Stream Inference Setup**

1. The Calibration Entities: The principle quantities involved in the latent state calibration are the latent state response variables, the manifest quote measure, and the formulation metric. Typical latent state calibration relations are set up so that the linearity between the latent state quantification metric and the formulation metric are maintained (there are notable exceptions, however - e.g., . However, the relationship between the manifest measure quote and the latent state quantification/formulation metrics WILL NOT be linear, generally speaking.
2. Latent State Quantification Metric Ordinate Affixation or Predictor Tagging: Typical quantification metrics for latent states (such as collateral, funding, FX etc.) affix/tag their responses to the pay date predictor ordinate node. The forward latent state (quantified using, say, the forward rate) is an exception, as seen below.
3. Forward Rate Quantification Metric “Affixation Ordinate” Choice: While the “affixation ordinate” for the discount factor is point-wise unique (i.e., it corresponds to the pay date), similar affixation for the forward rate is unique only to within the segment range (i.e., either the start/end of the period). This would allow the choice of any of reset/start/end as a viable nominal affixation ordinate. However, the specific choice of the inference routines (e.g., a boot calibrator) may render some choices of the affixation ordinate more convenient than the others. For instance, the boot calibrator utilizes the notion of sequential segment build-out, thus a particular choice of the affixation ordinate (namely the start/end date against the reset date) may fit in very well with the marking scheme applied to attach the quote to its corresponding exclusive manifest segment.

**Coupon Period-Based Calibration Specification**

1. Period Latent State Loading: The period formulation metric may require the latent state response values at one/more time predictor ordinates. Recalling that the latent state loading at the appropriate predictor ordinate represents the linear calibration coefficient for the latent states, single point formulation metric requires single point state loading, and multi-point formulation metric requires multi-point state loading.
2. Single Point State Formulation Metric: Whenever the formulation metric is dependent only on a single latent state response value realization, we require just a single corresponding loading. Examples include single period single reset forward rate, period terminal discount factor, period survival probability, period pay FX rate, etc.
3. Single Point State Loading: In the case of PV formulation metric, the PV for period is .
   1. Credit Loading =>
   2. Funding Loading =>
   3. Forward Loading =>
   4. FX Loading =>
   5. Predictor Ordinate Anchoring => As will be seen later, it is common to anchor the credit loading and the forward loading to period end date predictor ordinate, while funding and FX loading are anchored to period pay date predictor ordinate.
4. Multi-Point Loading - Multi-Reset: This corresponds to the joint cases of a) multi-reset periods per coupon period, and b) the reset periods get compounded arithmetically. In this situation a compounding adjustment identical to the typical non-merged state forward/funding convexity adjustment is applied to each reset period as
5. Multi-Point Loading - Quadrature: Quadrature-based multi-point loading results from the state response realizations being evaluated using a quadrature routine, e.g., loss quadrature grid – and therefore is continuous. While this is the primary distinction between multi-point reset and multi-point quadrature loadings, in practice the quadrature loadings also tend to be discretized – although a finer granularities.

**Stream-Based Calibration Specification**

1. Calibration State Loadings and Stream Sensitivities Sought: We consider the case of curve construction for the discount rates and the forward rate latent state as a concrete example. In this case we seek:
   1. Distinct Discount State Segment-local Quantification Metric Loading
   2. Distinct Discount State Segment-local Quantification Metric Jacobian Loading
   3. Distinct Forward State Segment-local Quantification Metric Loading
   4. Distinct Forward State Segment-local Quantification Metric Jacobian Loading
   5. Merged Discount/Forward State Segment-local Quantification Metric Loading
   6. Merged Discount/Forward State Segment-local Quantification Metric Jacobian Loading
2. Boot Stretch Calibration: In addition to the above, given that we are going to be focused on a boot stretch with manifest measure exclusivity , we also seek to determine the leading formulation metric contribution from the leading segments/regimes of the stretch . Given the boot framework, we presume no contributions arising out of the trailing segments.
3. Fixed and Floating Streams: We treat each stream as the calibration unit, since the potential state merging and telescoping occur at this level. The fixed and the floating streams are:
   1. is the floating stream basis, and we’ve partitioned the manifest measure exclusive segment into the floater and the basis parts.
4. Leading Stream Contribution:
   1. Merged/non-merged Fix:
   2. Merged/non-merged Floater:
   3. The Merged Floater reduces to
5. Fixed Stream Loading:
6. Floating Stream Loading:
7. Distinct Forward Rate: Given that the fixed stream relies on no floating stream payments, the forward latent quantification metric loadings will be NULL. However, for the floating stream:
8. Loadings vs. Constraint for the Stream: While a given stream may not have explicit dependence on the specified latent state, it may still participate in the constraint generation process. For instance, in the case of the fix-float swap seen above, the fixed stream does not have dependence on the floating rate, but will still contribute to the net PV (in this case through the PV formulation metric).

**Calibration of Multi-Stream Component**

1. Loadings Consolidation as Linear Overlays: In the case of linear formulation metric, the loadings and the constraints of the individual streams are simply overlaid across onto the component level. Thus, for the component index , the consolidated constraint becomes where corresponds to the loading for node and component , and is the corresponding constraint wo within the containing segment . Clearly this generalizes well to the case of more than 2 components, with the only limitation being that there can only be one outstanding quantification metric to be inferred (of course, in the case of merged latent states, as single quantification metric suffices to uniquely quantify multiple latent states).
2. Formulation Metric Consistency across the Streams and the Component: As is obvious, the inference within a single segment (for all streams contained within the component’s manifest measure exclusive segment) NEED to share the same formulation metric. While the unitary loadings generation entity is still the stream, the latent state sequence builder interacts (via the specified manifest measure quotes) only with the component. Thus implies that the component needs to maintain an intimate awareness of the layout/metric of the corresponding constituent streams, and may “create/translate/introduce” stream-specific manifest measures during the calibration run.
3. Fixed Income Product Aggregations: Just as cash flows get aggregated into streams, streams get aggregated onto components, and components onto products. Also cash flows inside a stream get telescoped out to simplify valuation/loadings generation. Likewise, entire streams may get telescoped off inside constituent product components – in particular this feature is utilized in “package calibrations” – as in CCBS discount/forward, and USD OIS using LIBOR-OIS and LIBOR-fixed swaps.

## Spanning Spline

## Formulation and Set up

1. Spline vs. Boot Span: For the purposes of this discussion, the main difference between spline and boot span is that, in boot span, the segment boundaries HAVE to line up with the instrument maturity edges. In spline spans, however, additional criterion-based knots may be used to determine the boundaries (e.g., parametric knot insertion in line with regression spline approaches).
2. Basic Setup: All instruments and quotes fall into one set of constraints as , where .

* In general, , so you have  degrees of freedom.

1. Local Ordinate Re-formulation: The spline extends from . Setting , . Further, .
2. Basis Formulation: Setting , . Thus, if , there now are  equations and  unknowns.
3. Monotonicity Preservation in Spanning Splines: The heterogeneity of the calibration instruments demands special techniques for monotonicity maintenance (Hagan West (2006) described in detail earlier was a sample).

* Stringent monotonic constraints introduced by Hyman (1983) was relaxed by Dougherty, Edelman, and Hyman (1989), and this was works well in practice in its ability to maintain monotonicity (Ametrano and Bianchetti (2009a), Le Floc’h (2013), also implemented in Quantlib (2009)).
* Intermediate filter constraints introduced by Steffen (1990) and their variants treated in some detail by Huynh (1993) – all suffer from the same unnatural dips or cook bumps.

1. Pros: As always, the degrees of freedom may be expanded beyond  to allow for optimizing spline construction (covered in the spline builder section).
2. Cons: With many basis functions (esp. for polynomials), the inevitable Runge’s phenomenon takes over.

## Challenges with the Spanning Spline Approach

1. Problems with Cubic Polynomial Spline: Too well known to documented – spurious inflection, too much concavity/convexity at widely separated predictor nodes (esp. in long end), and no guarantee of positivity where desired.

* As noted in Le Floc’h (2013), monotone variants (including Hagan and West (2006), Wolberg and Alfy (1999), Hyman (1983)) of the standard cubic spline have differing degrees of problems since they are attempt to model the entire span with a single representation.

1. Problems with Quartic Spline: While this makes the interpolation very smooth (Adams and van Deventer (1994), van Deventer and Inai (1997), Adams (2001), Lim and Xiao (2002), Quant Financial Research (2003)), the stiffness needed for shape-preservation is completely lost. Other troubles as with cubic splines (spurious inflection, too much concavity/convexity at widely separated predictor nodes (esp. in long end), and no guarantee of positivity where desired) as well Runge’s swings are also present.

### References

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## Monotone Decreasing Splines

### Motivation

1. These are spline basis functions that monotonically decrease over the given interval. Valuable for representing discount factors.
2. Why represent discount factors? Because the pay-offs are linearizable in them, so working with them implies working with the linear rates space representation, and all the advantages that come with that.

## Exponential Rational Basis Spline

1. Basis Function Set: 
2. Monotone Decreasing Nature: Each of the above basis functions is decreasing. For the functional form to be monotonically decreasing, conservatively speaking, this imposes the demand that  for every .

* Alternatively, we may also require that no infection exist within the given segment, but that is hard to enforce.

## Exponential Mixture Basis Set

1. Motivation: Since the discounting function goes as , an exponential mixture basis such as  may be a good choice, as they are both intuitively monotone, and linear combinations of them produce convexity/concavity.
2. Basis Function Set:  for .

* Choosing : Since for  continuity we require 4 basis functions, we choose , , , and .  accounts for adjusting jumps.
* Typical values can be: , , , and .
* Parallel with Tension Splines =>  are comparable to tension splines.
* With this choice,  may be maintained for , thereby making the forwards continuous, preserving locality, imparting segment convexity/concavity. Thus all the smoothing schemes may be maintained.

1. Similarity with exponential/hyperbolic tension splines: Very similar in formulation. However, given that with exponential/hyperbolic basis set spline at one of basis functions has a non-negative exponential argument, that basis function becomes monotonically increasing.

* Further, while estimation of the exponential tension needs to be done extraneously (Renka (1987)), here we appeal to the intuitive physics, as shown.

### References

* Renka, R. (1987): Interpolator tension splines with automatic selection of tension factors *SIAM* *J. ScL. Stat. Comput.* **8 (3)** 393-415.

**Hagan West (2006) Smoothness Preserving Spanning Spline**

## Monotone/Convexity Preserving Estimator

1. Premise: This is primarily focused on a quadratic interpolant, but it also contains heterogeneously inserted sub-segment knots in effect to achieve the desired monotonicity, convexity, and positivity effect.
2. Philosophy:

* This is mainly meant for forward rates inside finance, although bit more general outside of it.
* The observation set  is simply a quantity conserved on a per-segment basis, e.g., the segment mean of the state variate response, i.e., .
*  is positive and piece-wise quadratic inside of .
* The node response value  at the predicate ordinate  is linearly interpolated from the observations at and  (obviously edges will be treated slightly differently).
* Based on the specified monotonicity maintenance and convexity preservation criteria, the algorithm identifies and inserts knots. Zero or more knots may need to be inserted.
* The quadratic interpolant is essentially a Bessel  Hermite interpolant.
* Finally, similarity response value may be applied for positivity, and range-bounded-ness.

1. Steps:

* Infer the response node value  at the predicate ordinate  is linearly interpolated from the observations at and  as:
  +  for 
  + 
  + 
* Work out the “Z-score” metric within :
  + 
  + 
  + Further, we work in the local predictor ordinate space , where .
* Apply the appropriate adjustments for the monotonicity/convexity enforcement at the appropriate zones:
  + Case ,  [OR] , : Here, the function  can be used unchanged, as the original construct is already monotone and convex.
  + Case ,  [OR] , : Here, insert a knot at . The segment univariate now becomes:  for , and  for .
  + Case ,  [OR] , : Here, insert a knot at . The segment univariate now becomes:  for , and  for .
  + Case ,  [OR] , : Here, insert a knot at . Setting , the segment univariate now becomes:  for , and  for .

## Positivity Preserving Estimator

1. Positivity of the interpolant: Hagan and West (2006) guarantee this by setting he following bounds:

* 
* 
*  for 

## Ameliorating Estimator

1. Amelioration (i.e., Smoothing) of the Interpolant - Steps:

* #1: Expand the Range at the edges => Add an interval at the beginning and at the end.
  +  and 
  +  and 
  + Complete the linear interpolation of the response variate across all the intervals as before.
* #2: Set the Extraneous Bounds Parametrically/Empirically => Assume that the left and the right mini-max bounds are set extraneously for each segment, i.e., , , , and  are extraneously set. They may be set either point-by-point, or using another parametrization. This ensures locality, at expense of , however.
  + Check if the given response value is inside of the specified range, i.e., , set as follows:
    - If , .
    - If , .
  + Otherwise:
    - If , .
    - If , .
* #3: Re-work the edges =>
  + If , then .
  + If , then .
  + If  is already explicitly specified (as the zero-day rate in some markets) use that instead.
  + Finally, if needed re-apply the positivity enforcement across all the segments as before.

## Harmonic Spline Extension to the Framework above

1. Harmonic Splines and Continuous Limiters extension: Le Floc’h (2013) applies the harmonic splines originally introduced by Fritsch and Butland (1984), and extends the monotonicity preserving limiters of Van Leer (1974) and Huynh (1993) by using rational functions.
2. Harmonic Forwards in Hagan-West: Couple of interesting items to note: Given , on substituting , you get , and .
3. Estimation of the node forwards using Harmonic mean: Apply the above now to get  if , and  otherwise. After this, the regular Hagan-West may be applied without the need to enforce monotonic or convexity constraints, as it now is monotonic/convex by construction.

## Minimal Quadratic Estimator

1. Design Philosophy: The algorithm extracts the spline coefficients keeping in mind the following:

* Formulate using a 2nd degree quadratic polynomial for each segment
* Maintain the Conserved Quantities
* Maintain the Segment Edge Continuities
* Optimize for the linear combination of two penalties:
  + Jump of the inter-segment discontinuities on the first derivatives
  + Curvature of the second derivative

1. Step #1: Preservation of the Conserved Quantity Set: This results in the following equation: 
2. Step #2: Edge Continuity Constraint: .
3. Step #3: Minimize the Penalty:

* Jump of the inter-segment discontinuities on the first derivatives 
* Curvature of the second derivative 
* Complete Penalty Formulation => 
* , so minimum exists.

1. Equation Set and Unknowns Analysis:

*  => One per segment =>  Equations
*  => One per common edge =>  Equations
*  => One each for all  up to  =>  Equations
* Total number of linear equations => 
* Total number of unknowns => 
* As always, the final 2 conditions from natural, financial, or the not-a-knot clamped boundary conditions.

### References

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**Extrapolation in Curve Construction**

1. Latent State Choice for the Extrapolator: The quantification metric used to extrapolate the latent state may be completely different from that used to infer within the span.

* This clearly indicates that the span spans the extrapolated range as well. Further, the extrapolator should be a property of the Span, not any stretch.

1. Extrapolator Construction: At the span edges, the  continuity constraints may be passed onto the extrapolator as well. These may take the form of the stretch boundary conditions (natural/financial etc.).
2. State Space Extrapolation using Synthetic Observations: This is really what it is. In particular, to get the desired left/right boundary behavior, you may insert synthetic observations at either end to produce the desired custom behavior (this may also be used in lieu of the explicit boundary condition specification).

**Multi-Pass Curve Construction**

## Motivation

1. Introduction: This is composed of one shape preserving pass on the inferable state quantification metric, followed by one or more “smoothing passes”.
2. Shape Preserving Pass: The shape preservation pass occurs on the “native designate” measure, preferably one that is linearly inferred from the manifest measure. The primary objective of the shape preservation pass is to maintain the monotonicity, the convexity, the locality, and possibly the positivity of the quantification metric.

* The output of the shape-preserving pass is a span on the quantification metric that is “well-behaved”, and one that contains a new set of “truthness” nodes on which the eventual smoothing can be done.

1. Shape Preservation Variants:

* Linear in the discount Factor Quantification Metric => They are obviously the best shape preserver (owing to the perfection in the match and zero curvature penalty), but they no inherent convexity/concavity in them, so it gets harder fort the smoothing stage.
* Constant forward rate bootstrapping may also be used.

1. Smoothing Pass: Here you smooth on the appropriate quantification metric that is deemed to be a better hidden-state characterizer.
2. Advantages of the Shape-Preserving Pass:

* Separation between Shape-preservation and smoothing.
* Choice of convenient, yet potentially different metrics across shape-preserving and smoothing.
* The final state representation quantification metric need not be linear on the manifest measure.
* The granularity/precision of fit of the curve automatically adjusts with information (i.e., cash flow event dates such as pay dates), thereby making it inherently more precise.
* PCHIP techniques may be applied more conveniently on the smoothing pass.
* Other closeness of fit techniques (such as least squares methodologies etc.) become much more relevant on the smoothing pass.

1. Disadvantages of the Shape-Preserving Pass:

* Calculation overhead penalty associated with the dual pass (although, by choosing linearity between manifest measure/quantification metric and the quantification metric/ quantification metric combinations this adverse impact maybe reduced).
* Artifacts produced during shape-preservation (again, there will be artifacts associated with just about any basis representation).

## Bear Sterns Multi-Pass Curve Building Techniques

1. DENSE Methodology: This method is outlined in Nahum (2004).

* Cash/Forwards => Piece-wise constant forwards. Turn Spreads imposed as needed.
* Swaps => Shape Preserving uniform tension splines.
* RAW Swaps Inputs => Quarterly swap rates are now re-implied from the curve constructed in the earlier stage.
* From these new swap quotes, a new curve is constructed using quarterly constant forward rates (constant forward rates methodology is called RAW).

1. DUAL DENSE Methodology: Again, this method is outlined in Nahum (2004).

* Short end (Cash/Futures) => Daily forwards (i.e., constant daily forwards or cdf) latent state implied.
* Long End => Same methodology as DENSE, except for the non-uniform tension that is applied across quarterly swap contracts.

### References

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**Transition Spline (Or Stitching Spline)**

### Motivation

1. Spline per Instrument Grouping: Another possibility is to use transition spline to bridge across different instrument groups – this simply needs to adjust to the smoothness/truthness constraints of each of the instrument groups.

* Essentially, transition splines connect spline families across instrument group (each instrument essentially belongs to its own spline cluster).

1. Design:

* May use discontinuous Hermite splines in the transition area, or higher order basis (say, with an appropriate  constraint), or even an optimizing transition spline.
* Instrument choice is critical if we are to avoid steep transition slopes (esp. tight group gaps, and steep measure drops). These are challenges in any mechanism, but possibly a lot more here.
* Construct single instrument spanning spline curves, then demarcate/spec out the instrument range, finally bridge in the transition splines.
* Transition splines may also be used to stitch in arbitrary instruments together, each belonging to its own separate group, although it is hard to find a practical need for such a construct.
* In general, instrument group boundaries need not strictly coincide with the instrument termination nodes (esp. in case of stitch-in splines). Boundaries may be inserted using any of the appropriate knot insertion techniques.

1. Advantages:

* These preserve the curve character embedded in each instrument grouping, which can be a sub-set of a vaster instrument set.
* By retaining the localization to the corresponding instrument grouping, the hedges produces by the transition spline may, in principle, be better than those produced by the typical ones.

1. Disadvantages:

* Of course, by construction, they do not allow for overlapping instrument groups (which, however, may not be a problem in the practical world). This forces a decision on the instrument set choices and boundaries.
* Technically, the single “natural spline boundary condition” is not applicable across all the unprocessed instrument groups – this is really what is compromised.
  + How much the effectiveness is compromised due to the above may be estimated using targeted metrics, say the span DPE.

1. Transition Segment in the Transition Spline: This needs at least  basis functions for representation, as it needs to “mate out” the left stretch and the right stretch ( for each of the  continuity spec - plus 2 more, one at each end to match up the point node).
2. Using Transition Splines for Calibration Instrument Selection: As shown in Figures 2 and 3 below, the transition stretch represented in figure 2 is narrower, and therefore more abrupt/jumpy (with corresponding implications for the forward rates) than that in Figure 3. A criteria based approach is necessary to develop this.

### Stretch Modeling Using Transition Splines

1. Information Propagation across Stretches: All the truthness/smoothness information of the predecessor stretch is captured by the stretch’s calibrated span parameters. Any state inference for predictors in a given domain needs to be deferred to the domain’s span stretch.

* The corollary to the above is that trailing stretches will typically need information from the leading stretches for state inference/estimation (leading/trailing here are set in regards to the inference flow (or information flow)). Applied to discount curve cooking, the leading stretch that uses cash instruments is essentially self-calibrating, whereas the trailing stretch of swap instruments is going to rely on information that comes out of the cash calibration. Going into swap segments, the information will propagated in the form of RVC’s, so they will need to be handled right from the left-most segment of each stretch.
* Regular Stretches vs. Finance Curve Stretches => For typical stretch construction, all you need is the transmission of the segment-to-segment continuity constraints through . For segment curve builders, however, , i.e., more construction information in addition to just the  is required (mostly via explicit evaluation of arbitrary points in earlier segments’ stretches).

1. Response Stretches: Markov response state variables may follow distinct behavior in different predictor stretches. For example, the discount factor/zero rate/swap rate may be characterized using one set of representations for the cash stretch, whereas the swap stretch may use a different set.
2. Why Response Stretches exist: Is it simply because of the instrument choice (cash for the front end, swap for the back end, etc.), or is there a more fundamental driver? Can’t say one way or the other, but the fact is we empirically attempt to match point-by-point in a left to right manner (we do this today) without compromising the empirical characteristics of each instrument group. We call each of these groups manifest groups, since they could be result of specific product manifest measures).
3. Manifest Group Contribution to the Response Signal Strength: Say that a signal strength contribution to a specific response signal is proportional to its liquidity (to improve accuracy, you may make it sided liquidity). As you move from left to right in the predictor space, by working it in terms of the liquidity-fade of the left stretch to the liquidity-explode of the right stretch, you may be able to characterize the response space more naturally (with less dependence on explicit stitching splines, or on artificially inserted knots).
4. Liquidity-Fade and Liquidity-Explosion in practice: In practice the actual predictor ordinates across the manifest stretches will be too discrete for tracking the liquidity-fade and liquidity-explosion. Thus, it may be more appropriate to operate on predictor windows. If convenient and admissible, the predictor window boundaries may also coincide with the segment boundaries.

### Stretch Partition/Isolation in Transition Splines

1. Definition: A given calibratable predictor ordinate/response realization space is called a span. The span is partitioned into stretches. Stretches can be either core stretches or transition stretches. Both the core stretches and the transition stretches are built from segments (within which the response values may be represented using basis splines). Core stretch are inferred to truthness and the smoothness signals, and the transition stretches provide the explicit bridge between the core stretches that may not be possible using the plain core stretch representations.
2. Information Patterns: With a higher unit, information propagation is associated with each sub-unit entities below. Across peer units, information exchange is materially similar in nature. Across higher units, information exchange may be more parsimonious (although it may still happen between lower entities belonging to the higher units).
3. Information Localization and Transmission: Intra-segment information propagation occurs through smoothness constraints such as .
4. Stretch-Level Information Localization: In the spline case, this happens though boundary-condition delimitation/isolation (i.e., natural/financial/clamped boundary conditions based isolation is applicable to within a single stretch).
5. Stretch-Stretch Transmission: These are not bound by the equivalent isolation constraints, therefore the connecting/transition splines need to have a qualitatively different nature.
6. Transition/Connecting Splines: By definition, since they are the bridge between the stretches, they need to have greater degrees of freedom for a complete bridge.

### Knot Insertion vs. Transition Splines

1. Equivalence: In some sense, they are equivalent in that inserting knots also attempts to complete the bridge. However, transition splines are more customizable, since the splines that flank the knots are assumed in the literature to be variants of the others.
2. Advantages on Knot Insertion: Remember that transition splines need  basis function. Thus, for high , you are stuck with higher-order polynomials (for e.g.), along with all the Runge’s oscillations/instabilities that it brings. Suitable choice of knots may minimize this.
3. Advantage of Transition Spline: Knots are stretch response altering (via their  criteria), whereas transition splines enable each stretch to retain their character.

### Overlapping Stretches

1. Premise: By definition, stretch fade-out and stretch explode axiomatizations imply predictor ordinate overlapping stretches.
2. Stretch Boundaries: Each stretch constituting an overlapping stretch needs to have its boundaries identified. What ***do*** not necessarily overlap are the smoothness constraints.
3. Overlapping Stretch – Problem Statement:

* Predictor Ordinate Stretches overlap.
* Stretches (and by implication, their predicate ranges) are contained/telescoped.
* Smoothness constraints may not overlap, in which case they are posited to be distinct in each of the constituent stretches.
* Truthness should be strictly telescopically contained/localized, i.e., there is a ***manifest measurement exclusivity*** to each stretch.
* A consequence of this is that the inferred state response variable will be propagated, but not (necessarily) the smoothness criterion.

## Index/Tenor Basis Swaps

## Component Layout and Motivation

1. Basis Swap Market: Although Basis Swaps did exist even earlier (Tuckman and Porfirio (2003), Morini (2008)), post-crisis segmentation (attributable, among other things, to the preference towards receiving higher frequency payments) intensified these differentials (Mercurio (2009)).
2. Origins of Basis Swap Existence: In principle, these are expected to represent embedded duration counter-party credit risk. The “good” model should couple embedded credit risk with the sided flow dynamics (i.e., the credit quality of the counter-party that enters into the long/short side of the greater frequency leg, etc.)
3. Float-Float Swap as a Combination of Two Fix-Float Swaps: The proxy of the float-float as two fix-floats would be perfect if both the fixed legs had the same frequency and day count conventions. In terms of the tenor basis swap conventions, pre-2008 the convention was to quote the float-float basis directly – post-2008, however, it was quoted as a combination listed above.
4. The Discounting Curve: Challenges regarding the uniqueness in relation to the instrument choice for building the discount curve have been identified by Henrard (2007). The issues stem primarily from the uncollateralized nature of deposits and forwards, therefore, these are typically replaced by OIS/EONIA and Futures (Madigan (2008)).

* Interest Rate Swap continues to be used for the discount curve calibration, as it possesses the following characteristics:
  + Par IRS’es are collateralized at inception.
  + Collateral margining may be applied over time.
  + IRS is the only liquidly available fix-float swap, and as such effectively implies just a single forward curve.
* Convexity adjustment for extracting the rate from future/forward price => Since futures/forwards act effectively as a zero coupon bond, the transformation of price to the latent zero/forward rate requires a dynamical volatility based curve evolution model. Sophisticated, comprehensive approaches are available in literature (see for e.g., Kirikos and Novak (1997), Jackel and Kawai (2005), Brigo and Mercurio (2006), Piterbarg and Renedo (2006)); common practitioner approaches, however, employ simpler approaches such as the Hull-White one-factor short-rate model (Hull and White (1990)).

1. Multi Curve vs. Forward Smoothness: Given that the discount curve and the forward curve are essentially distinct in the multi-curve latent state, the stringent demands that all forwards stay smooth (as in the single discount curve that covers all the basis curve scenarios) may be relaxed.

* Forwards Implied in the Discount Curve => Since the forwards are used only for the “core” tenor pillars in the discount curve, only those forwards need to be smooth (e.g., 6M forwards). By discount curve construction this will typically be the case, as the forwards period will always straddle/span fully a single reset pillar.

1. Point- vs. Convolved-Measure State Transform:

* Point-Measure transform refers to the one-to-one transform between a state measure at a predictor ordinate and its corresponding observation (e.g., discount factor from zero-coupon bond price observations). Since these may be expressed as straightforward transformations, the observation-state non-linearity may be easily accommodated.
* Convolved measure-state transforms introduce what are effectively observation constraints across predictor ordinate/state response combinations. Non-linearity introduces complications, therefore usage of spline-based linearization constraints are highly effective.

1. Reset-Date Forward-Rate Pair Constraint in Discount Curve Building: The  tenor (e.g., ) may be extracted only at the reset start/end date (depending on the reset rate-rime axis label) from the discount curve, i.e., only the pair  makes sense. In other words, this is the only set of dates for which the information on forward rates is available. Splining may be an option at the other dates.

*  Tenor/DF Relationship => . For  to be telescoped away into , the requirements are: Period Accrual End Date == Period Reset End Date == Period Pay Date. This is the main reason why the period dates are adjusted before the cash flows are rolled out.

1. Alternative View: Discount Curve IS the  Forward Curve: To automatically ensure uniqueness and consistency of the latent state space, it may also be more restrictively imposed that the native Forward Curve be implied entirely off of the discount curve. Thus, the native Forward Curve may now be implied at all nodes, not just at the reset nodes as postulated earlier. This automatically eliminates the state basis between these measures; further, this is still not too restrictive in terms of the native Forward Curve smoothness for same reasons as before.
2. Basis between the  Forward Curve and the Discount Curve: Given that basis constraints are of paramount consideration in other markets, why not look at the basis between discount curve and its native forward curve? This is because neither the latent state underpinning the forward curve or that underpinning the discount curve is entirely observable (unlike, say basis between a bond and the issuer’s underlying CDS). Thus an extraneous observation model is necessary. By convention, the current practice achieves this by construction – the formulation mandates that the discount curve and the “discounting-native” forward curve be alternate quantification metrics of the same latent state.

## Formulation

1. Float-Float Swap Setup: The phenomenology and flow details laid out in Figure 5 are based off of descriptions and details provided by ISDA (2006), Ametrano and Bianchetti (2009a), Bianchetti (2012)). The two swap legs are:

* The “known” or the “Reference” leg. Forwards of this leg come from the discount curve’s IRS contracts, and 6M LIBOR/EURIBOR is the most common such tenor. We generalize this with a basis spread, i.e., the “effective” forward is , where and  stand for the corresponding forward and the spread.
* The “unknown” or the “Derived” leg with a tenor of . Forwards of this leg are computed from the corresponding basis market quotes. We generalize this with a basis spread, i.e., the “effective” forward is , where and  stand for the corresponding forward and the spread.

1. Basic Formulation Setup:

* 
* 
* Equivalence of  and  => Since both  and  are additive, we work in a space that is essentially an adjusted forward rate space, with  and . While this is straightforward to accommodate in the case of , from a calibration point-of-view, we work off of a biased  space, and re-adjust back after splining.

1. Basis Swap Calibration Formulation:  implies that . For all but the left most basis swap, .
2. Basis Swap Calibration Constraint Specification:
3. Set . Notice that  maybe fully computed from before.
4. Recognize that .
5. Combine above to get the calibration constraint .
6. Reference/Derived Par Spread Relations: For parity, . Setting , . Likewise, . Remember that both and can be negative.

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## Penalizing Exact/Closeness of Fit and Curvature Penalty

1. Least Squares Exact Fit vs. Best Fit: Unlike in functional analysis/financial curve construction, in machine learning “exact fit” is treated as a rarity in machine learning, as there is presumed to be an irreducible manifest measure generation error. Here we assume that there are processes the result in “zero manifest measure uncertainties” – in other words, these are “quotes” that are explicitly honored.
2. Basic Setup: As described in the companion Spline Library Documentation,

* Gross Penalizer = Fitness Match Penalizer + Curvature Penalizer
* 
* 
* 

1. Estimation of : While the segment spline coefficients are computed by minimizing ,  is often extraneously supplied as a tuner that trades the prefect high degree of fit to the curvature. Tanggaard (1997) suggests using a few methods to estimate :

* Using the GCV criterion as demonstrated by Craven and Wahba (1979) and Wahba (1990).
* From the smoothing spline viewpoint, set the number of basis functions, then search for the corresponding  using the technique listed in Tanggaard (1997).

1. Measurement Filtering vs. Best Fit Weighted Response: These approaches are very similar, in that the Best Fit Weighted Response “steers” the calibrated spline basis and their coefficients to accommodate the measurements in the uncertain sense (potentially by incorporating measurement uncertainty).
   1. If the measurement uncertainty/variance is explicitly known, the Andersen (2005), the Tanggaard (1997), and/or the GCV techniques may be used to extract better estimate for  - through Andersen RMS  estimator, Craven/Wahba’s GCV, or Tanggaard’s trace-based  estimator.
   2. Differences => However, it needs to be remembered that, for current curve construction methodologies, a key requirement is the  matches (i.e., exactly reproducing state estimations) – which is not the typical case for the filtered state estimations.
2. Effectiveness of State Representation Quantification Metric: The combination of curvature penalty, the length penalty, and the closeness of fit penalty must be taken together to gauge the effectiveness of the chosen Quantification Metric/Smoothing spline scheme set. Alternatively, full simulations of the manifest metric (with induced noise terms as explained in for e.g., Fisher, Nychka, and Zervos (1994)) and their corresponding evaluations are also appropriate, although they tend to be time consuming (and possibly overkill).

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## Multi-Stretch Merged Curve Construction

### Motivation

1. Discount Curve composed of Forward Rate Stretches: The discount curve span may be viewed as being composed of overlapping/non-overlapping forward rate stretches, i.e., adjacent or otherwise 3M Tenor forward stretch, 6M Tenor forward stretch, etc. This visualization is a consequence of the representation of the “single discount curve latent state”, whose alternate/parallel quantification metrics are composed off of these stretches of forward rates that share the latent state space with the global discount curve.
2. Out-of-Native Stretch Arbitrage: If one seeks a forward rate outside these stretches for the given tenor/index combination, there can be no expectations of no-arbitrage, i.e., there will be a basis between the forward implied by this latent space quantification metric and the forward rate under consideration.

* Likewise, if inside the stretch, there should be no implied basis, since the diver latent state is identical/fully correlated.

1. Merging/de-merging of the Latent State along the Predictor Ordinates: If you imagine the rates state space being characterized by a set of latent states (which may be highly correlated), each state may ideally be characterized by a quantification metric that is native to the state physical view. Thus, the unification of the sub-states in a stretch may be viewed as state-merging (i.e., one quantification metric may be inferred from another within a merged space via a trivial transformation).
2. Probit-based Latent State Merger Analysis: Given that the discount/forward latent states merge/de-merge, it might it particularly amenable to a common-factor probit (or even a logistic) analysis of the merger driver dynamics. The challenge would then be to link the driver dynamics to the maturity based predictor ordinate.

### Merge Stretch Calibration

1. Cross-Stretch Calibration: Clearly the latent state span characterized by multiple stretches will in turn be composed of latent state merge sub-stretches. The merged stretch may be followed by de-merged stretch, etc.
2. Calibration Challenges:
   1. What would be most optimal cross-representation inside the merge sub-stretch (i.e., the state representation needs to be smooth for both the discount factor latent state as well as the forward curve latent state)?
   2. On the other hand in the solitary segment sub-stretch, you may have more representation freedom, but may still need to carry over the smoothness constraints from the merged sub-stretch. How can this be done? Can the transition spline treatment above be effectively employed here? In other words, what would be appropriate transition zone applicable to the sub-stretch?

## Latent State Manifest Measure Sensitivity

### Introduction

1. : Remember that the floater leg PV goes as . Thus, these terms tend to dominate both the PV and the manifest measure sensitivity calculations. The fixed annuity per-coupon-date cash-flow is smaller comparatively, and that is reflected in the Jacobians.
2. Latent State Sensitivities to the Product Segments:

* Cash/Deposit => Here the sensitivities are to within a single segment, since it is spot starting.
* Future/FRA => Here the manifest sensitivities are to the two straddling segments, since it is forward starting.
* IRS => Sensitivities through multiple segment/preceding segments, but concentrated a more on the edges for the reasons seen above.

1. Latent State Sensitivities Signs: The far end is always negative, since the PV decreases with the increase in the manifest measure sensitivity – this is valid across all products. The near end is positive for Future/FRA as well as IRS, as that corresponds to the shorted side. There is no shorted side for cash.
2. Latent State Segment Manifest Measure Sensitivity: It may be appropriate to imagine that, for a given segment, the latent state sensitivity is contributed to only from the current and the prior segment manifest quotes.

* Justification for the above => As may be observed from Figure 6, sensitivity has to be zero at the start of the current and at the end of the next. “Current” is completely determined through the constraints and the matches corresponding to intra-segment observations, but the “next” dependence propagation is exclusively via  transmission constraints, and devoid of targeted segment-specific contributions.

1. Design of Manifest Measure Sensitivity Segment Tail: Since the tail is, technically, a strict fade, any monotonically decreasing-to-zero function will work – the smoother the better.
2. Preceding Manifest Measure Sensitivity Basis Function: Given the shape in figure 6, a choice of sinusoidal function would serve as appropriate set of basis. Alternately, the same basis as manifest measure sensitivity (which should, strictly speaking, be the same basis used for quantifying the latent state response) may also be used – the head/tail  may provide additional customization.
3. Preceding Manifest Measure Sensitivity Fade off/Retain: The two possibilities of the transmission of the preceding manifest measure stem from the differing nature of the current manifest metric. If the current manifest measure is of the “retain” type, the preceding manifest measure sensitivity is retained as is (i.e., uses a flat through transmission of the right edge value). If the current manifest measure demands that the preceding manifest measure sensitivity fade, then the preceding manifest measure sensitivity is faded off/decayed, as seen above.
4. Fade off/retention sequence: Further, if the current is “retain”, all the segment manifest measure sensitivities of the earlier segments since the last fade-off are transmitted, and replicated.
5. Preceding Manifest Measure Sensitivity Customization: The fade-off/retain preceding manifest measure sensitivity customization should be applied on a stretch-by-stretch basis:

* Cash/Deposit Stretch => Use Fade-off
* Futures/FRA Stretch => Use Retain
* IRS Stretch => Use Fade-off

### Float-Float Manifest Measure Sensitivities

1. Float-Float Reference Leg Sensitivity to the Derived Leg Basis: 
2. Float-Float Derived Leg Sensitivity to the Derived Leg Basis:   where the  cash flow instances belong to the manifest measure exclusive segment .

* Closed Form => The non-exclusive (i.e., the earlier segments and stretches) do NOT contribute to the current manifest measure sensitivity. Thus, the sensitivity becomes  where the right hand side is the manifest measure exclusive segment incremental derived floating leg annuity.

1. Float-Float Derived Basis Sensitivity Transmission Rule: Given that the floating leg sensitivity could potentially be OVERLAPPING, the preceding manifest measure sensitivity choice will be FADE ON, not RETAIN.
2. Tenor Basis Swap Sensitivity:

* 
* 

Their magnitudes must be similar, save for the annuity flow differences.

1. Multi Leg Basis Sensitivity Points: For each of the constituent legs and their corresponding manifest measure, the symbolic sensitivities need to be computed/splined in. The sensitivity nodes will be the payment dates, along with an additional cross-leg “final upfront’. The current manifest measures are the derived leg basis, the reference leg basis, and the interest rate sensitivity.
2. Multi-Metric Latent State Calibration: As long as the latent state is linearizable among the multiple metrics, such a calibration is possible. Further, a chain sweep multi-metric sensitivity Jacobian is estimable on the calibration pass. Of course, the preceding quote sensitivity control must be customizable on a per-manifest measure basis.

**Multi-Reset Floating Period**

1. The Setup: This small sections concerns itself with the case where the reset tenor that is different from the floating period tenor. In this situation, there are 2 specific impacts to be considered:
   1. The compounding rule to accumulate the reset periods onto the floating period, and
   2. The associated convexity correction mismatch since the terminal measure numeraire for the floater period pay is different from that of the reset period terminal measure.
2. Convexity Correction vs. Quanto Adjustment: Remember that the forward and the discount latent states form part of the same shared latent state in the case of convexity correction, and the convexity adjustment stems purely from the terminal measure mismatch, as just observed. Quanto adjustment, however, is applied across multiple distinct latent states that are non-merged, e.g., funding vs. collateral vs. forward vs. FX latent states.
3. Origin of the Convexity Correction: In practical settings, the convexity correction occurs only when a) the floater periods encapsulates the multiple reset periods, AND b) these reset periods DO NOT compound geometrically (e.g., the compounding is arithmetic). As examples, these reset periods include overnight fixings applied via a corresponding index, 3M reset vs. 6M floater etc. The latter is the case for certain standard sovereign IRS’es (CAD).
4. Merged/non-merged Latent State Convexity/Quanto Estimation: Each constituent segment/stretch/regime is still expressed using distinct stochastic (e.g., Brownian) component partitions, in practice the merged state convexity adjustment ends up looking very similar to that of quanto adjustment. Thus, generalizing from the above, the of the forward rate between and paid at time in a differency looks identical (save for the specific volatilities involved) in both cases (please note the integration time limit differences):

**OIS Valuation and Curve Construction**

### Base Framework and Environment Setup

* The OIS Model: Given the compounded overnight rate , the par OIS Rate  is given as . As expected, given that this corresponds to the par OIS, this telescopes to . The compounded rate  is computed from the daily overnight fixes as (Lipman and Mercurio (2010), Mercurio (2011)) .
* Stringency on the OIS Spline Construction: Since the OIS has shown itself to dip into the negative territory (Whitall (2010), Cameron (2011), Atkins and Jones (2012), Carver (2012), Lipman (2012)), the corresponding demands on the shape preserving splines need to be accommodative.

### OIS Valuation Extensions and Approximations

1. OIS Extensions Using Fed Fund Basis Quotes: For some jurisdictions (say, USD), the OIS quotes are not widely available beyond the 10Y tenor. Therefore the OIS discount curve is constructed using the USD LIBOR – Fed Fund Basis Swap Quotes that trade till the 30Y tenor. Since both the OIS and the Fed Funds Basis Swap Quotes are projected from the forwards of the Fed Funds Effective Rate FEDL01, no arbitrage arguments may be used to extract the OIS Curve (Bloomberg (2011a), Bloomberg (2012), Bloomberg (2013)).
2. USD OIS Curve Construction: As discussed partly in White (2012a), the USD OIS curve construction can occur in the same manner as that done for building discount curves from CCBS and IRS quotes – i.e., the OIS long end OIS curve can be constructed from fed funds-LIBOR basis swap (a float-float swap) and IRS.
3. Fed Fund OIS Basis Swap:
4. Basis Free LIBOR Leg PV:
   1. Setting , we get
   2. Working from an IRS point-of-view, by matching the fixed and the floating legs we get
   3. Here stands for the notional sign (typical convention is to assume -1 for the floater side), and stands for the swap rate.
5. Consolidated Discount Curve Builder Relation:
6. Curve/Quote Dependence for the Cross DC Builder: Remember . This clearly shows that there is no explicit market curve dependence for building the OIS curve – the only quote dependences are on / (one of them, typically , is zero) and . What the equation provides is to create a sequence of linear constraints over , , and .
7. Bloomberg (2013) Approximation for the OIS Curve Rate, given LIBOR Level: If, say, the 10Y LIBOR is known, and so is the FF-LIBOR basis, Bloomberg (2013) approximates the OIS rate as , where is the Fed Funds OIS Basis,  is the corresponding 10Y LIBOR, and .
8. Bloomberg (2013) Enhanced Approximation: The approximation above is in place because the daily discrete compounding applied over specific holidays, weekends etc. becomes very expensive to compute. Therefore Bloomberg (2013) introduces an additional accuracy enhancement to compensate for the daily compounding of the FF using a flat curve to get  as: .

### OIS FX-Basis Swap Valuation and Approximations

1. OIS-FX-Basis Swap Definition: Consider 2 OIS floating streams of the corresponding currencies CCY1 and CCY2 respectively. This package of both the legs together is called the OIS FX-Basis Cross-Currency Swap. Further, assume that this is collateralized in currency #1.
2. OIS-FX-Basis Swap Valuation: This valuation is straightforward.  and  where  is the appropriate starting FX Rate.
3. LIBOR FX-Basis Swap: This is identical to the OIS-FX-Basis Swap, except that the floating leg now pays LIBOR floating plus a basis. The valuation is done precisely as in the case of the OIS-FX-Basis Swap, with the OIS part replaced by the LIBOR part.
4. Approximating the OIS FX Basis using the LIBOR FX Basis: Since LIBOR FX-Basis is more widely traded than OIS-FX Basis, Bloomberg (2011b) claim to have developed an approximation for the OIS-FX-Basis Spread in terms of the LIBOR-FX-Basis Spread that is intuitive, simple, easy to use, and very accurate (they demonstrate this using comparative reconciliations): .

**Arithmetic Accrual Convexity Correction**

1. One Floater Unit Paid out at the non-terminal Time: As shown in Figure 7, this corresponds to the classic change of measure paradigm. The payout time is , and the forward period is . The PV of the accrual unit becomes .
2. Equivalent Martingale Forward Valuation: where is simply the de-drifted martingale devoid of the drift , and where we assume (by the fundamental theorem) that is a martingale itself. Setting up the dynamics for and as and alongwith their joint moves we get where and stand for today’s expectations of and respectively.
3. Convexity Adjusted Accrual PV: The model above for and is pretty generic – but deterministic (i.e., non-local). This may now be applied to assess the convexity adjustment to be used for each of the daily payments on the overnight fund index for the period as .

**Composed Period Latent State Loadings**

* + - 1. Composed Period Compounding – Arithmetic: In literature, the notional of arithmetic/geometric accruals is often spelt out in terms of rates averaging, i.e., arithmetic vs. geometric averaging over the composable rates periods. The arithmetic accrual over the composable periods (with the index running over the composable periods) is given as , thereby clearly inducing the convexity adjustment across each composable period.
      2. Composed Period Compounding - Geometric: Here the period PV becomes . Using the fact that where refers to the discount factor quantification metric of the corresponding forward rate , we reduce the above to . Thus, this induces a single convexity correction, at the end of the period.
      3. Composite Period - Accruals: The difference between the above analysis and the one for accruals is that, in the case of accruals, all the unit periods’ rates preceding the accrual valuation date have been realized. This makes the analysis more straightforward. Given that the fixings have been realized, we have ONLY ONE convexity adjustment across all the realized periods for both arithmetic and geometric compounding – the one at the period terminal anchor.
      4. Merged Forward/Funding State Loading Under Arithmetic Compounding: Using the discount factor quantification metric above for the case of arithmetic compounding above, we get . This demonstrates that, since there will be a mismatch between the terminal measures at and , the telescoping will not occur in this case. Thus the merged forward/funding calibration trial becomes a non-linear exercise, thereby not making itself amenable to much of the linear scenarios seen above.
      5. Separated Forward and Funding State Loadings under Arithmetic Compounding: Since the expression is linear separately in both and (as well as and ), linear state loadings should absolutely be generatable for those states, the basis spline representations described above are applicable.

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**Correlated Multi-Curve Build-out**

### Introduction

1. Regime Segmentation: Indicators of regime changes in the interest rate markets, e.g., divergence between XIBOR-based deposits vs. OIS/EONIA, FRA’s vs. forwards implied by consecutive deposits etc. are discussed in Ametrano and Bianchetti (2009b), Goldman Sachs (2009), and Bianchetti (2012) among others.
2. Pre-Crisis Segmentation: Segmentation was already present and well-understood pre-2008, but ignore since the effects were small (Fruchard, Zammouri, and Willems (1995), Tuckman and Porfirio (2003)).

* Prior Multi-Curve Frameworks: The cross-currency swap multi-curve framework was proposed by Boenkost and Schmidt (2005), and was extended to the 3-curve case (i.e., the discount curve, the LIBOR curve, and the bond rates instance) by Kijima, Tanaka, and Wong (2008).
  + Other Two-Curve Extensions =>
    - Morini (2008) and Morini (2009) approach this from the point-of-view of counter-party risk
    - Mercurio (2009) approaches this in terms of an extended LMM
    - Henrard (2009) approaches this using a more foundational axiomatization framework setup

### Standard FRA Setup

* + - 1. Standard FRA Setup Basis:  for tenor .  is the discount factor for tenor . From Brigo and Mercurio (2006),  where , i.e.,  is the -spot LIBOR maturing at .
      2. LIBOR-Standard FRA Specification:   where  is the corresponding Standard FRA rate,  denotes the expectation taken at time  with respect to the measure  (within the filtration  that encodes the market information available at ) over the -forward measure corresponding to the numeraire .
      3. Multiplicative Standard FRA Basis:  which simply results in 
      4. Additive Standard FRA Basis:   
      5. Forward Basis Bootstrapping Relations: These come from Bianchetti (2012).
* , AND
* 
  + - 1. Quanto-Adjusted Standard FRA Evolution Dynamics: The forward Rates are martingales in their own measure : , . Likewise, we employ an analogy with the quanto-based approaches used in the FX world to derive the dynamics of a multiplicative quanto-adjustment  as ,  with .
* FX Quanto Analogy Application => The Standard FRA Payoff at  is . The payoff over the “local/domestic” currency using the domestic numeraire is . This quantity, by using the FX quanto analogy, is a martingale in the domestic/discounting measure.
* Quanto Drift Adjustment => This sets us up for the application of the change of numeraire that produces an additional drift, i.e., , i.e.,  where  is the multiplicative quanto adjustment (Jamshidian (1989), Geman, El Karoui, and Rochet (1995), Brigo and Mercurio (2006)).
* Additive Quanto Adjustment => Define this as Bianchetti (2012) does: 
* Additive/Multiplicative Basis Adjustment =>
  + Multiplicative Basis Adjustment  is given as: 
  + Additive Basis Adjustment  is given as: 
* Mean-reverting Deterministic Volatility Form => This is outlined in Andersen and Piterbarg (2010), and it possesses distinctive properties that enable it to capture certain kinds of physics: . In his collateral choice option calculation, Piterbarg (2012) uses  and .
  + - 1. Standard FRA Price:
* 
* 
  + - 1. Standard FRA Quanto-Adjusted Par Swap Rate: .
      2. Applicability of the Quanto Adjustment Formulas: It is important to remember that these quanto adjustments above are primarily for textbook/standard FRAs. Further, for these FRA’s, the observed prices/rates can be worked out explicitly in the discounting measure in itself anyway, thus rendering the quanto correlation effects irrelevant. Obviously, both the discounting and the native FRA measure converge at the FRA exercise date due to the fixing.

### Standard FRA Options

* + - 1. Caplet/Floorlet Options: Caplet/Floorlet Options on a -spot rate exercised date with the payoff maturity at  is given by (Bianchetti (2012), Bianchetti and Carlicchi (2012)) . Thus, .
  + Closed Form Expression =>  where  with , , , and .
  + Cap/Floor Option Prices => . Plug in the earlier developed relation for the cap/floor prices.
    - SABR/LIBOR Cap Volatility Functional Form => The claim is that the industry uses the following humped function for capturing the cap volatility: . Rebonato, McKay, and White (2009) assign physical meanings to , , , and , as well as how to calibrate this model using caplet volatilities.

### No Arbitrage and Counter-party Risk Based Standard FRA Formulation

1. Setup: Following Mercurio (2009) we set  where  given  is the recovery rate, and  is the counter-party default probability associated with the default time .
2. Counter-party risk based Risky XIBOR and Standard Forward:
   * 
   * 
   * The corresponding Standard FRA price is 
3. Counter-party risk Quanto Adjustment:
   * 
   * 
   * Morini (2009) expresses the counter party risk spot exchange rate in terms of the credit variables.
4. Counter-party risk Basis Adjustment:
   * 
   * 

### Market FRA Setup

1. Standard FRA vs. Market FRA: Using the time  payoff, the standard FRA value is . The payoff at time  for the market FRA is .
2. Pricing of the Market FRA: We employ the formulation presented in Mercurio (2010), simplifying the notation a little. Setting  and , we get .
   * Reduced discounting measure representation for Market FRA => Unfortunately, given the above payoff definition for the market FRA’s, further discounting measure representations are not possible.
3. The Par FRA: Since FRA’s are fully collateralized, we work assuming that overnight rate is the collateral rate. The par FRA rate at time  is the  above that results in the net value of zero, i.e., , or . Thus .
4. Measure Change from  to : If the terminal payoff only depended on , the above evaluation can be made in the terminal measure . However, since  also depends on the collateral account’s numeraire evolution from  to , we need to apply the appropriate risk neutral measure  and change the measure to .
   * -Forward Measure Numeraire Changes => Every cash flow needs to be discounted at its terminal/payout date, a consequence of the basic Arrow replication principle. Thus, the “inner” contingent claims need to be evaluated using their own terminal measure. This necessitates a measure change, which, using the corresponding forward numeraire change, results in the deterministic discount factor being pulled out (this numeraire corresponds to the discount factor spanning the inner start and the end dates).
5. Expectation Under :  where .
6. FRA Par Rate Expression: Thus, the par FRA Rate becomes .
7. FRA Par Rate in Terms of the Collateral Forward Rate: Remembering that  we get . It is easy to see that under the single curve case .
8. Modeling the Dynamics of  and : We choose the convenient shifted log normal evolution form for  and :  and   and  are the constant instantaneous volatilities, and  and  are the -adapted  Brownians with instantaneous correlations .
9. Evaluating the Closed-Form for the Dynamics:  and . The evolution stops to , since both  and  cease their evolutions beyond their fixing time, i.e.,.
10. Connection to Fixings: Remember that  and are linked to their corresponding market FRA via  and . Also, since this caters only to the evolution of the forward rates, they are still in their stochastic forms, with the expectations taken to within the  measure only at the final stage.
11. Evaluation of the Expectation:  . Evaluation of this stochastic integral leads to  .
12. Closed Form Par FRA and Convexity Correction:  Thus the convexity correction is computed as .
13. Constant FRA-Collateral Forwards Basis: Mercurio (2010) shows that the dual log-normal formulation above results in corrections of the order of one bp in most cases. Thus, a case is made for analyzing the impact of using a small/constant FRA-forward collateral basis.
14. Constant FRA-Collateral Forwards Basis Formulation: , a small positive constant. The  then becomes  .
15. Shifted Log Normal Dynamics for : Assuming shifted log normal dynamics for , and assuming  (an equivalent simplifying basis assumption would correspond to ) we get .
16. Convexity Correction: The corresponding convexity correction is   to the leading order in . Since the convexity adjustment goes as , it may appear that the straightforward dependence on linear, unadjusted  may cause the correction to blow up at sufficient maturities. However, the shifted log-normal volatility is at least one order of magnitude smaller than the corresponding log normal volatility, i.e.,  where  is the log normal volatility.

### Futures

1. Futures Terminal Price/Payoff: Futures Payoff is , thus . Here the measure  will be treated as the collateralized discounting measure, as the futures are collateralized transactions (the collateralized discounting measure can be a discretely re-balanced bank account numeraire – called the spot- measure).
2. Treatments of Convexity Adjustment: Several treatments of the convexity adjustment exist in the literature:

* Both Kirikos and Novak (1997) and Henrard (2005) use the 1-factor Hull and White (1990) model
* Piterbarg and Renedo (2006) use the stochastic volatility model
* Mercurio (2009) and Mercurio (2010) use the multi-curve extended Market Model – that is what we consider here.

1. Terminology for the Extended Multi-Curve Market Model: Borrowing from Mercurio (2009) and Mercurio (2010) we get:

*  The M-dimensional discretely balanced bank-account numeraire measure , and its Brownian components
*  is the discounting curve forward rate, and  is the time interval.
*  and  are respective deterministic volatilities of  and  (instantaneous)
*  is the instantaneous correlation between  and 

1. Change of Numeraire to get to : Applying the change of measure on successive segments to get to , the extended market model predicts that  where  given ; ; ; such that .
2. Full Drift Freeze: For computational convenience, we freeze the drift evolution at its time 0 value as . Now we can evolve  as .

* Future Price => The Futures Price Valuation now becomes straightforward, as .  then is the convexity adjustment, and given that  is a market observable,  may be computed from .

1. Drift Freeze Adjustment #2: Here, only the values of the forward rates at frozen at time 0, not : . Thus .
2. Price/Convexity Adjustment:  . Thus .

### Multi-Curve Swap Valuation

1. Interest Rate Futures: Just like the standard FRA, interest rate futures are key for the discovery of the forward swap rates and volatilities, and therefore for their calibration. These do trade, and appear to referred to literature under different names – STIR (short-term interest rate) future (Henrard (2013)), or FSIRS (forward starting IRS) (Bianchetti (2012)).
2. Swap Annuities in the Discount/Forward Measure:  and . The swap rate in the forward measure would be , and similar expressions may be computed for .
3. Dynamics of : In its own measure,  is a martingale, i.e., , with ,  being the starting/effective date of the swap contract.
4. Swap Annuity Exchange Rate: Given that the swap annuity is the numeraire, we may introduce the swap annuity exchange rate quanto adjustment by resorting to FX-type quanto adjustment we have seen before, i.e., . Further, we consider the dynamics of   along with , .
5. Swap Annuity Quanto Adjustment: . Given that, by construction,  is a martingale in the  measure, this produces the drift adjustment .
6. Quanto Adjusted Par Swap Rate: Setting  we get , and  where  is the multiplicative swap quanto adjustment, and  is the additive swap quanto adjustment.
7. Swaption Pricing: The -Spot swap rate with an exercise date at  is given by . The corresponding price at  is  where  is the drift seen before.
8. Multiple Underlying Interest Rates: When two or more underlying interest rate are present, the pricing expressions can become considerably more complicated (e.g., spread options – see Brigo and Mercurio (2006)).
9. Generalization for Joint Multi Factor Numeraire: Say that the Brownian dynamics of evolution of latent states are for . The evolution for is guided by . From this it is easy to derive the joint numeraire .

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## Cross Currency Basis Swap

### Product Details and Valuation

1. Background: From Fujii, Shimada, and Takahashi (2010a, 2010b, 2010c, 2010d), for a USDJPY CCS that uses a USD discounting, the set of constitutive equations are , i.e., the USD Leg in itself is a full basis swap. Likewise, the JPY leg is also a full basis swap. Thus, .

* The CCS basis swap is quoted typically on the non-funding leg. In the above case that would be the JPY leg.

1. Valuation: Generalizing from the approach of Fujii, Shimada, and Takahashi (2010), we use the following nomenclature:

*  are the corresponding LIBOR legs.
*  for leg , and  for leg , where  and  are the cash flow indices.
*  is the PV of the USD segment of the CCS, i.e., . This need not be zero.

1. CCS Valuation Base Setup: From the USDJPY CCS market information we get for the JPY basis swap . From the JPY tenor basis swap market information we get . Here we’ve removed all expectation operators  etc.  are the basis quotes in the cross currency markets, and  are the tenor basis market quotes.
2. Basis Quotes Inputs: Notice that both swaps need to refer to the same tenor/maturity set  and  - that is the only restriction. If the quote for the tenor swap is not available, they will need to be implied off of others – this provides a very strong motivation to mark the forward curve off of the forwards basis space. This may also require extrapolation – we’ll get to that messy challenge later.

### Building the CCS Discount Curve

* 1. Setup: Subtracting the basis quote legs from the CCS legs, we get . Actually, , , , and  to explicitly spell out the bootstrapping dependence. In particular, if  and , then we have the really simple following bootstrapping relationship: .
  2. Symmetry in the Discount Curve Calibration from CCS: Notice that , when taken to the other side, becomes . Thus from the same market quotes we may calibrate the USD discount curve using the JPY discount curve as well.
  3. Parallel between Forward and Discount Curve Construction:
* Relevant leg for the Forward Curve Extraction => Derived Component Derived Leg (which corresponds to a Floating stream, as the derived component is a float-float swap).
* Relevant leg for the Discount Curve Construction => Again derived component Derived Leg, this now corresponds to a Fixed Stream, as the derived component is a fix-float (IRS) component.
* Remember that the basis is always placed on the reference component – either the reference leg or the derived leg.

4. CCBS Cross Bases Computation: Say is the cross-currency basis. where indicates the component side (i.e., reference or derived), and indicates the component stream under consideration (i.e., the reference stream or the derived stream). corresponds to the DV01 of stream inside of component . is the FX of the derived/reference cross, i.e., units of the derived currency in terms of the reference currency.

### Custom CCBS Based Curve Construction SKU

1. Curve Construction from CCBS: For each currency leg, there are 3 potential latent states – the forward latent states 1 & 2, and the discounting latent state. Thus there are 6 of them in all. This contributes to the cognitive confusion – the number of latent states.
2. Latent State Determination using CCBS: Typically we are given a one set of currency parameters, and made to determine the other. The practical use case would be for:
   1. Computing the funding curve parts – this includes the merge-stretched discount curve and its corresponding forward curve
   2. Computing the non-funding forward curve – in this case we need to have either the merge-stretch discount and forward, or the distinct discount/forward curves.
3. Separated “Derived Product” Latent States: Since we infer the latent states of the derived sides from the inputs, in we general we are required to extract:
   1. The derived forward state
   2. The reference forward latent state
   3. The discounting latent state

Thus the state composites are built strictly on the availability of the additional contingent inputs (beyond the CCBS quotes).

1. CCBS Derived Forward vs. Discount Curve Construction: If the derived product discount curve and the derived product reference leg forward curves are available, the derived product derived leg products then become spline constructible using the CCBS quotes alone. Otherwise, additional external inputs and/or simplifying assumptions are needed (these assumptions help set the merge states).
2. Joint Latent State Estimations: If there are non-linear couplings between 2/more latent states above, the linear splined state extractions become infeasible without some kind of kernel transformation. This is among the 2 troubles with Fujii, Takahashi, and Shimada (2010 a, 2010b, 2010c, 2010d):
   1. The instrument set pair of CCBS/IRS used for calibration purposes needs to be completely paired up
   2. Linear reductions (either directly or by using kernel transformations) need to be possible by the elimination of the correspondingly paired CCBS/IRS streams
3. CCBS Deep-Drill Cognitive Challenge: CCBS is possibly the biggest challenge so far in terms of back-and-forth cognitive switch-in/switch-out, owing to the following:
   1. The variety of the latent states
   2. The manner in which these latent states interleave
   3. Estimation of each of them at each segment level using the corresponding “deep-drill” instrument quotes
   4. Cross influence via the transmission criterion across the latent states
   5. Interleaving of the sensitivities as well

### Mark-To-Market Cross-Currency Swap Valuation

1. The “MTM” in MTM Cross Currency Swap: In this context the term “MTM” is a misnomer in that it is simply an MTM in the FX dimension, i.e., it is an FX-MTM cross-currency swap. The floating nature ensures “MTM” in the floater dimension, however, it does not address MTM in the FX/floating and the forward cross-currency dimensions.
2. MTM is not Collateralization: For the reasons above, the MTM cross-currency may not be viewed as a collateralized transaction – not even in the non-continuous collateralization limit. Collateralization impact is essentially undetermined in account of the reasons above – even in the absence of a stochastic cross-currency basis, under-collateralization/over-collateralization is determined entirely by the sign of the FX/floater correlation.
3. MTM for Dual Stream Instruments: Instruments in this category include the fix-float and the float-float swaps. As noted above, while explicit MTM’ing using the forward construction is not necessary in this case, the instruments are still exposed to collateral/forward, collateral/funding, and forward/funding volatilities/correlations, which are not easy to hedge for – thereby making a case for “MTM” type agreements (esp. for the basis).

### Mark-To-Market Cross-Currency Swap – Valuation Formulation

1. Setup:
   * The last term simply indicates that the basis can be either on the reference leg or on the derived leg.
   * We will assume that is indepdendent of the FX process or the discount factor process.
2. Reference Component PV in Derived Currency: Consider a forward starting CCBS, maturing at time . The PV of the reference component in the derived currency at tome t can be expressed as:
3. -Forward MTM CCBS PV: From we get =>
4. Joint Evolution:
5. MTM Reference Component Adjustment:
   * Here
   * The MTM Adjuster is given from
6. Aggregated MTM CCBS PV:
7. MTM Adjustment to MTM CCBS PV: From above where . The correction term vanishes as as one would expect. Further owing to the presence of the exponentials, when the correction term dominates as tend higher. If negatively correlated (i.e. ) the correction essentially reduces towards , and the contribution to from diminishes.
8. Absence of the explicit Cross Currency Basis in the MTM Correction: Since the basis is confined exclusively to the reference component, it is automatically incorporated into and its derivative terms above. Throughout the only assumption made about the cross currency basis is that it evolve independently of the discount factor and the FX rate.

**Absolute/Relative MTM Application**

1. Component Pair Relative MTM Generalization:
   1. The “MTM”able component pair consists of 2 components – the reference and the derived.
   2. “MTM”ing occurs at discrete MTM dates – which is most typically set to the coupon dates of either of the streams.
   3. The MTM process can be absolute or relative, i.e., in the relative MTM’ing the reference is MTM’ed w.r.t. the derived.
   4. The Reference Component is decomposed into forward components – each forward being built out from the forward MTM dates.
   5. Valuation of each of the stripped forward component may be customized to correspond to employ its own model/assumptions/market data/evolution dynamics.
2. Component Pair Absolute MTM Generalization: Situation here is identical to the “Relative” Case, except for items c) (the reference and the derived are MTM’ed independent of each other, not relative to one another) and e) (of course, the forward evolution/valuation is still going to be based off of one set market parameters and their realization).
3. Generalized Absolute/Relative Valuation Adjustment Market Data: Models that drive the valuation in this case would rely on the following external market data:
   1. Funding/FX Volatility/Correlation
   2. Funding/Forward Volatility/Correlation
   3. Collateral/Funding Volatility/Correlation
   4. Collateral/FX Volatility/Correlation
   5. Collateral/Forward Volatility/Correlation
   6. Joint modes implied from the combinations above
4. No Convexity Adjustment for non-MTM Contracts: Given that the convexity adjustment is applicable only to dynamic (i.e., MTM) jointly-evolved state-specification in the contract, no joint state convexity corrections with respect to the given state will be applied to non-MTM counterparts of a specific numeraire.

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## Collateralized Valuation

### Background

1. Background: While economies without risk-free rates have been considered in the past (Black (1972)), typical derivatives pricing treatments have assumed the existence of such rates as a matter of course (e.g., Duffie (2001)).
2. Holy Grail of Curve Construction: Combining multiple curves, partial collateralization involving multiple currencies, with liquidity, counter party risk, funding, and credit risk factored in into a dynamic approach is treated in a variety of papers (Pallavicini and Tarenghi (2010), Fujii, Shimada, and Takahashi (2010a), Fujii, Shimada, and Takahashi (2010b), Fujii, Shimada, and Takahashi (2010c), Fujii and Takahashi (2011a, 2011b), Castagna (2012), Henrard (2013)).
3. Treatments of CVA/DVA: Partial collateralization results in non-zero counter-party risk, and these cases are covered in Burgard and Kjaer (2011a, 2011b), Brigo, Pallavicini, Buescu, and Liu (2012), Crpey (2012a), Crpey (2012b). Considerations regarding the risk of an “average” counter-party are treated in Morini (2009).

### Introduction and Motivation

1. Counter party Credit Risk Free Asset: Closest to a credit-risk free asset is an asset that is fully collateralized on a continuous basis (ISDA (2009), ISDA (2011), Sawyer (2011), Piterbarg (2012)), i.e., the collateralized asset produces cash flows that are continuous with changes in both the derivative MTM and the collateral coupon. Macey (2011) and Piterbarg (2012) illustrate how to retain the traditional risk-neutral valuation in a collateralized context.
2. Collateralized Asset Process: At the inception of a fully collateralized trade, there is no cash exchange, i.e., the upfront payment amount is returned back as collateral. Further, in exchange for the continuous pay streams above, the trade can be cancelled at any time with zero net value for either side.
3. Price of a Collateralized Asset: The price of a collateralized asset is effectively the outstanding level of the collateral account, i.e., a collateralized transaction is an asset with a zero-drift price process and with the given cumulative dividend flows (Duffie (2001)).
4. Collateral Cash Flows:  is the asset price paid by to , and  posts this amount back as collateral.  now pays the contractual collateral coupon flow  back to . In time unit , the cash flow that is exchanged (i.e., paid to ) is , i.e., . Once this is exchanged, the transaction can terminate, and  can keep the collateral.

### Two Collateralized Assets

1. Setup: Assume that each of the assets follows its corresponding real-world measures, but are exposed to the same risk factor , i.e., , .
2. Hedge Portfolio: Say that the corresponding collateralized account for each of these assets has the dynamics . Construct a hedge portfolio using  of asset 2 and  of asset 1. The net change in the real world collateralized portfolio of these two assets is:

* 
* 

1. Application of the Collateral Rules: The above amount is known at time , and maybe exchanged at , at zero additional cost to either party. Thus, the only way both can enter into this transaction is if the net cash flow is zero (this is the collateralized version of no arbitrage). This produces .
2. Differences with Traditional Risk Neutral Pricing: The main difference is: in the traditional risk-neutral pricing, the hedged portfolio grows at the “risk-free” rate. In collateralized pricing, the COLLATERALIZED + HEDGED portfolio grows at ZERO rate (i.e., does not grow at all) after incremental netting! Therefore the “risk-free” rate does not enter into this setting at all.
3. Measure Change: Create a new measure  where . In this new measure, the individual assets grow as , using which we estimate  as . As may be observed, measure looks like the traditional risk neutral measure.
4. Different Collateral Rates: The collateral rates  can be asset-specific within changing any of out principal conclusions, except that  now becomes . Examples would be, say, a stock collateralized at its repo rate (or other funding rate), while the derivative would be collateralized at it collateral rate (e.g., Piterbarg (2010)).
5. Other Variants: Other collateralization variants include varying collateral processes, different counter-parties etc. Typically all these only end up varying the drift, thus you get . Of course, the collateralization drift can also be stochastic. This measure change from collateralization scheme #1 to collateralization scheme #2 induces a drift to the scheme #2 as .
6. Many Collateralized Assets: Will quickly flip through this, as Piterbarg (2012) spells out he details. -dimensional asset  possesses the real-world dynamics . A linearly combined weight set  of the hedge portfolio satisfies the constraint . Using the collateral cash flow matching arguments presented above, we get .

* Measure Change => As before, there exists a measure  with the drift vector , one for each asset, such that an adjustment  can be made to the real world measure making it  such that  can become drift-less. Once again, in this new measure, the individual assets follow .

### Collateral PDE Formulation

1. PDE Collateralization Treatments: Bjork (2009), Piterbarg (2010), Castagna (2011), Fujii and Takahashi (2011a, 2011b), Henrard (2012), Piterbarg (2012), Ametrano and Bianchetti (2013), and Han, He, and Zhang (2013) extend the no-arbitrage to the collateralization case.
2. Derivative PDE Using Replication: The derivative that is replicated using  assets and a bond via  undergoes the evolution through the self-financing formulation . This is matched to the derivative change . Equating the two, setting  to eliminate stochasticity, and noticing that , we get . Using , this may be re-composed as the Black-Scholes PDE from  (Harrison and Kreps (1979), Harrison and Pliska (1981), Harrison and Pliska (1983)).
3. Derivative Replication with Collateral Account: The replication strategy now involves the assets, the bank funding account, and the collateral account.  where  and  are the number of assets and the bank funding notional account, respectively, and  is the collateral account. Under perfect collateralization . Further , , and .
4. Derivative Value Change: Applying the self-financing condition . Using the perfect collateral condition we get   . Thus   . The quantity  is referred to as the cash account.
5. The Collateralization PDE: . Setting , we get . Re-casting using the appropriate measure terminology, we get  where .

### Cross Currency Model

1. LCH.ClearNet Collateral Rules: Single currency trades (currently mostly swaps) are collateralized in their own currencies, but multi-currency trades (e.g., cross currency swaps) are typically collateralized in USD.
2. Building Blocks: The building blocks typically are a) Domestic-Currency Collateralized Domestic Zero Coupon Bonds, b) Foreign-Currency Collateralized Foreign Zero Coupon Bonds, c) Collateralized FX Contracts. In practice, the former (the collateralized zeros) may not trade, whereas collateralized FX contracts typically do.
3. Foreign Bonds Collateralized in Domestic Currency: Consider a foreign zero-coupon bond collateralized with domestic collateral. The price of this zero coupon bond in foreign currency is . If  is the forex rate (i.e., the number of domestic units per foreign unit), the collateral account cash flow growth is  where  is the domestic collateral rate.
4. Collateralization of the FX: If  is the rate agreed on a domestic loan collateralized by foreign collateral, then the FX collateral account cash flow growth is: . The contention by Piterbarg (2012) is that there is no relation between the collateralization rates , , and .
5. Collateralization Using Domestic Collateral:

* . Thus, under the domestic collateralization risk-neutral measure  we have the following:
* 
* 
* 

1. Collateralization Using Foreign Collateral:

* . Thus, under the foreign collateralization risk-neutral measure  we have the following:
* 
* 
* 

1.  and  Numeraires: These are effectively the cross-currency, oppositely collateralized numeraires, i.e., one unit of domestic/foreign currency collateralized using the corresponding foreign/domestic collateral. Thus these numeraires, as such, can form the basis for cross-currency discount curves employed in cross-currency swaps. Further, the building blocks are primarily only discounting oriented – securities with forward/floater leg may also require a quanto adjustment to be applied.
2. Cross Currency Model Parameters: All the model parameters and the process dynamical parameters in the set of equations above can be independently observed.
3. “Implied” Cross Currency Risk Free Rate: The measure change from to  under the  measure is captured by the  martingale . Thus, the corresponding growth rate  also helps clarify the references to the “cross-currency risk-free Rates” (e.g., Fujii and Takahashi (2011a, 2011b)) – viz., they are instantaneous FX collateralization rate using the foreign collateral.
4. Forward Forex Contract Collateralized with Domestic Collateral: This contract pays  in the domestic currency, and is collateralized using the domestic collateral. Thus . Therefore, the par strike for this contract is .
5. Forward Forex Contract Collateralized with Foreign Collateral: This contract pays  in the foreign currency, and is collateralized using the foreign collateral. Thus . Therefore, the par strike for this contract is .
6. Same Currency Collateralization: , and . No rocket science, really, with simple forwards. Question, however, is that whether  would ever be domestically collateralized, and that whether  would ever be collateralized in foreign currency. Same currency collateralization is uncommon presumably for these reasons.
7. Market Quotes for Collateralized Forex Forwards: Strictly speaking, all Forex Forwards should always be collateralized using either foreign or domestic collateral. Thus, the Forward Prices should be different depending on the collateralization currency. However, this DOES NOT appear to be the market practice, as the quotes are independent of collateral.

### Collateral Choice Model

1. Setup: Here, an American style path-dependent collateral is chosen at every incremental step by opting for the collateral among the choices available that maximizes the incremental collateral cash flow.
2. Motivation: Collateralization at the domestic collateral accrual rate is . On switching over to the foreign collateral, the rate becomes . Thus at each time step we want to maximize the incremental collateral cash flow . We begin by setting .
3. Dynamics of : Consider the dynamics of  - this entity has a drift . First of all, the dynamics of , , and  may be worked out using one of several typically accepted practices – e.g., the HJM-type dynamics, or an even more simplified Hull-White type dynamics.

* Using , it is fairly straightforward to show that  where .

1. Piterbarg (2012) Expression for : Piterbarg (2012) employs a combination of HJM machinery as listed above and additional techniques outlined in Andersen and Piterbarg (2010) to obtain .
2. Collateral Choice - Deterministic : If  is deterministic, there will be no optionality involved; however, depending upon the sign of , there will be a collateral switch at each time increment. Piterbarg (2012) demonstrates this in his framework by turning the volatility explicitly down to zero.
3. Deterministic and Incremental Curve Decay Collateral: If the collateral discounting path choice can be proxied using a “curve roll up” phenomenon, the collateral choice discount factor becomes , where  are the  possible collateral choices,  is the domestic collateral curve,  is the discount factor between and  for one unit of domestic currency collateralized using the foreign collateral , and  is the collateral choice discount factor between and  for one unit of domestic currency collateralized using the most appropriate incremental collateral. Note that this discount curve is artificial and deterministic.

* Advantages of using deterministic collateral choices => All the advantages stem from the computational simplicity. They are:
  + More than one collateral currency may be used, thus optimizing over the multiple collateral choices (USD, GBP, EUR, JPY, etc.)
  + Empirical Curve Representations using splining techniques may be usable

1. Valuing the Collateral Choice Option: The value we seek is of the form  where  is the terminal payoff at the time instant . It may be a fixed amount (i.e., the fixed swap rate) or a variable amount (the floating swap coupon).

* Closed Form => Typically  has to be computed using Monte-Carlo or a PDE, therefore we seek an alternative fast analytic approximation. By Jensen’s inequality, Piterbarg (2012) noticed that . This approximation may be used to compute the fixed leg value for the swap above. For the floater leg, the term  may be pushed outside to a separated expectation to get . Piterbarg (2012) performs a full set of comparison to demonstrate that these approximations behave favorably with the Monte-Carlo under several situations.

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**Convexity Corrections Associated with Margining**

1. Origin of Convexity Corrections in Margining: Certain exchanges (esp. CME, on the futures) expect posting of the collateral (full or the maintenance amount) or moving out of the money. However, when in the money, you get nothing. This results in a returns mismatch asymmetry between in-the-money/out-of-the-money snaps of the trade, i.e., this happens because you need to fund your margin gaps. This is also sometimes referred to as a one-way CSA.
2. Literature Confusion on Margin Convexity: The above asymmetry, of course, is a drag on the position value, and needs to be accounted for – and it is also called convexity correction for some reason, and requires a dynamic rates model to value.
3. Modern CSA’s and CCP’s: CSA’s essentially provide for symmetric collateral cash flow payments, therefore the situation listed above does not arise explicitly. Further some of the newer margining rules in CCP’s trat in/out symmetrically (through a concept referred to as PAI – price alignment interest rate – which essentially appears like a collateral rate), so again in these term contracts these issues vanish.

**Hedging Considerations**

* + - 1. Curve Construction vs. Product Hedging Instrument Manifest Measure Choices: It may be preferable to incorporate a vaster universe of input instruments and their manifest measures (the manifest measures maybe both exact matches as well as the imperfect best-fit matches) in the latent state calibration. Hedging, however, may use only the most liquid set of products and their manifest measures.
      2. Hedge Manifest Measure Moves: As a better approximation, of you can work out the ’s of the manifest measure moves for the “non-hedging” product observation set to the manifest measure moves of the “hedging” manifest measure set, you may achieve a better and more complete PnL explain.

## Spline-Based Credit Curve Calibration

1. Overview: Andersen (2003) has made an initial effort in this regard.

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#### Inference-Based Curve Construction

## Curve Smoothing in Finance

1. Unconstrained Curve Smoothing:

* Applicable primarily for rates/semi-liquid FX curves. Smoothing can be done here without constraints.
* Smoothing may also be applicable to the quotes for a given instrument across several days.
* Smoothing may also be applied over a single day curve – particularly to model the switch over from instrument to instrument (e.g., between EDF and Swaps).

1. Constrained Curve Smoothing: Applicable, for e.g., to the case of a hazard curve. The smoothing basis functions/weights combination must guarantee, from a formulation PoV, that the implied hazard rate is always greater than zero.
2. Latent State Inference as a Deep Learning Exercise: Multi-stretch, multi-pass latent state inference/representation (esp. in the financial curve construction context) can be essentially construed as a shallow version of the deep neural network.
3. Liquidity Based Weighted Signal Smoothing:

* Fidelity at the “liquid bonds” / benchmark bond nodes
* Lower fidelity penalty, but higher smoothness penalty for the less liquid bonds
* Penalty measure is calculated off of the relative liquidity ranking measure (for e.g., TRACE)

1. Non Bayesian Liquidity Based Smoothing:

* Liquidity indicator serves as a roughness/fidelity magnifier/dampener
* Also need to penalize for over-parameterized fits using AIC/BIC (also CV/GCV – given that this is essentially a frequentist case).
* These can be applied not just for bonds, but also CDS, rates, FX – even less liquid ones.

1. Bayesian Extension to the above: Any parametrically specified distribution needs to evolve using a hyper-prior, and the Wahba parametric Bayesian priors need evolving too.
2. Nodal Jacobian/Sensitivity Impact: As always study the impact on the locality of the perturbation, as well as the ease of Jacobian estimation – esp. if the calibration needs to occur through MCMC, non-linear optimization etc.
3. Mixtures of splines and smoothness penalties: As always estimate the impact on monotonicity, convexity, shape preservation etc. - the category item checks in Goodman’s paper.
4. Knot Selection Tips: Need some tips in both situations – frequentist and Bayesian.
5. Suggestion on the locally adaptive Parametric Form: Examine the knot-to-knot smoothness and penalty by using additional locally adaptive microstructure parameters and their implications.
6. Goodman and Eilers/Marx Talking Point Issues: Criterion check for these specific “goodness” checks.

## Bayesian Curve Calibration

1. Bayesian based past knowledge incorporation of survival probabilities: Given that the prior’s, the posterior’s and the likelihood’s are all probabilities, perhaps the best starting point is for applying it to the problem of updating the survival probabilities and recovery rates based on price observations.
2. Curve Updating techniques: Need grand new formulation techniques that are based on AD and Bayesian methodologies as part of the curve updating strategies based upon individual incoming observations and their strength signals.
3. Curve Construction off of hard/soft signals: Hard Signals are typically the truthness signals. Typically reduce to one calibration parameter per hard observation, and they include the following:

* Actual observations => Weight independent true truthness signals
* Weights => Potentially indicative of the truthness hard signal strength

Soft signals are essentially signals extracted from inference schemes. Again, typically reduce to one calibration parameter per soft inference unit, and they include the following:

* Smoothness signals => Continuity, first, second, and higher-order derivatives match – one parameter per match.
* Bayesian update metrics => Inferred using Bayesian methodologies such as maximum likelihood estimates, variance minimization, and error minimization techniques.

1. No-arbitrage hard signals: Simply indicates that ***the*** given hard observation is out of bounds and irreconcilable (i.e., no solution can be found) within the axiomatic inference space dictated by:
   * 1. The parameter sequence implied by the other set of hard signals.
     2. The model axiom schemes.
     3. The inference rules.

* Directionality “bias” is inherent in calibration (e.g., left to right, ordered sequence set, etc.) – this simplifies the problem space significantly. Therefore, the same directional bias also exists in the calibration nodal sequence.

1. Parameter Space Explosion: Generally not a problem as long as it is segment-localized (in matrix parlance, as long the transition matrix is tri-diagonal, or close to it), i.e., local information discovery does not affect far away nodes/segments.

* Also maybe able to use optimization techniques to trim them.

1. Live Calibrated Parameter Updating: Use automatic differentiation to:

* Estimate parametric Jacobians (or sub-coefficient micro-Jacobians) to the observed product measures.
* Re-adjust the shifts using the hard-signal strength.
* Update the parameters from the calculated shifts.
* Re-construct the curve ever so periodically (for a full re-build, as opposed to the incremental).
* Remember that AD based parametric updates break smoothness (including continuity as Bayesian MLE’s) – so use a tolerance in the shift if this is acceptable.

1. Causality Bayesian Network DAG For Credit Curve Building: See Figure 1.

* DAG searches are not really needed, since here they maybe formulated conceptually/axiomatically, as opposed to being established through a search mechanism.

1. Financial First Principles SKU: Following concepts are the core components that can be used to create the curve construction SKU:

* Time Value of Money.
* Latent Default Indicator.
* Recovery on Default.
* Imbalance premium/discount (for FX, Basis Swaps, etc.)

1. Financial Signal Analysis: Need special analysis techniques to pick out “event trends” from “concept jumps”, even for highly liquid instruments.

* Liquidity-based Signal Extraction =>
* Identify a liquidity metric
* Imply the “perfect liquidity” – the point at which there is no premium
* Compute the liquidity metric for each security
* Regress (or conceptually determine, or fit) the bid-ask spread to inverse liquidity (remember that even benchmarks only have finite liquidity, not infinite) for each security
* Try to slap in a secular “event premium” across all the instruments, over and above liquidity

1. Systemic Finance Variables Evolution: Given that every measurement is uncertain to within bounds, it stands to reason that every distribution is also a true distribution (to within the tolerance provided by the corresponding sufficient statistics, and over a finite observation window) of the technical state of the world (i.e., technical = fundamental + a bias).
2. Technical to Fundamental Bias Estimation: This should result from the flow of the information. Non-technical/Fundamental may possibly be estimated using a bias correction applied to the technical signal – Bayesian/frequentist techniques may be of value here.

* Proxy for non-technical behavior => Identify the non-market proxies for the fundamental drivers, and estimate market drivers as possibly lagging indices.

1. Bayesian Decomposition of Technical Signals: In general, the signal core drivers are limited (like systemic/idiosyncratic factors – alternatively, the latent state quantification metric), but the product specific manifest measures are more varied. Bayesian frameworks well suited for these.
2. Financial Stretch Identification: Bayesian classification techniques can be readily adapted for these purposes – in fact, with abundance of data, these techniques are very appropriate now.

## Sequential Curve Estimation

1. Calibration Framework Drivers: Calibration is considered to occur FOR a hidden state , which is quantified using the quantification metric .  is estimated from the manifest measure .
2. Product-Measure Point-of-View: From the Dempster-Shaefer/Kalman Filter/Linear Quadratic Estimator point-of-view, the Kalman  matrix probabilistically transforms the hidden state quantification metric to an observation measure, e.g., the latent forward rate manifests itself through the swap rate.
3. Segment/Span Nomenclature vs. Curve Calibrator Nomenclature: Call the Curve Calibrator the Dempster-Shaefer Calibrator. Under this:

* LSQM (Latent State Quantification Metric) => Elastic Variate
* State Dimensions (Tenor Axis, X/Y Axis of predictors) => Inelastic Variates
* Thus, the predictors are inelastic, and the responses are elastic.

1. Linearization of LSQM over the predictor axes: The Kalman  observation transformer should just linearize  onto the space of  over the predictor dimensions. Non-linearity of  over the predictors is handled through basis splines.
2. Hidden State Evolution vs. Hidden State Representation: The Kalman  matrix is more of a state modeling and state representation matrix (i.e., the update part that is fully local to the current time slice) that already brings in the manifest measure ⬄ LSQM transformation model.
3. The Curve Builder  matrix: Due to the above, the curve builder  matrix needs to accommodate the 2 possible uncertainties:

* Uncertainty in the manifest measure
* Uncertainty in the manifest measure ⬄ LSQM transformation model. If this transformation is non-parametric, then treat it as certain/deterministic. If it is parametric, then use MLE/MAP to the handle the parameter estimation.

1. UKF Techniques applied to evolve the Curve Builder  matrix: Potential non-linearity in the curve builder  may be handled using the Jacobian EKF and/or the sigma-point UKF schemes.
2. The Curve Builder  matrix: The Curve builder  Matrix dictates the evolution from  to  as . This should be explicitly posited/formulated. Again, use splining to linearize.
3. Financial Noise Covariance Estimation: May be able to extraneously determine these covariance independent of the state evolution model (if not, we may have to rely on techniques such as ALS (Rajamani (2007), Rajamani and Rawlings (2009)).

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**Per-trade Risk Isolation Components**

* 1. Underlier Security Price Market Risk
  2. Discount Factor Risk
  3. Forward Rate Risk
  4. Currency/FX Risk
  5. Basis Risk (on any Risk Factor)
  6. Funding Risk
  7. Collateral Risk
  8. Counter-party Risk

## Product Curve Effect Attribution

### Market Value Change Explain Components

1. Linear Daily Market Value Change Components: The 3 main linear principal components to the market value change are:
   * Coupon Accruals
   * Time Value Market Parameters Intrinsic
   * Market Parameters Extrinsic.

Time is an implicit factor entity across all the three components, simply because PnL explains are conducted across distinct time entity snapshots.

### Coupon Accrual Intrinsic

1. Motivation: This is applicable only to coupon/dividend bearing securities – here the coupon payout is part of the security value, and therefore causes a security value jump at the payout dates.
2. Modern Accrual Intrinsic: This should include funding flows, re-investment flows, as well as collateral flows. Collateral flows should include initial, maintenance, and valuation margins. Switches on the collateral choice numeraire generate their own flows, depending on the corresponding rolling numeraires (analogous to the traditional CTD’s). Accrual flows only relate to realized cash flows, and are therefore deterministic.

### Market Parameters Intrinsic

1. Motivation: This refers to the “riding the market” effects. The baseline level corresponds to the world where all the market levels stay frozen at the current instant levels. This is closes to what is referred to as θ (the intrinsic time value change).
2. Computation: Effectively this calculation addresses the question “How does the value of the derivative change as the market parameters stay frozen over the incremental period under consideration at the initial levels”. STAY FROZEN is NOT the same as riding the curve. Simple put, this principal component quantifies the incremental period market curve set effects, owing to the component’s maturity shrinkage by the corresponding time horizon.
3. Related Market Parameter Intrinsic Computation: The principal component measured precisely as above is referred to as the “maturity roll down” principal component. Related to this are the other ones:
   1. Maturity Roll Up => Here the derivative is valued by rolling/riding up the market curve
   2. Time Roll => Here the derivative values differences are estimated as the difference between the values at 2 distinct time snaps of the same latent state projected at the respective instants.
4. Modern Time Value Intrinsic: Roll up, roll down, and time roll are all computed on the instantaneous valuation market parameter set that determine the security value. Thus, there should be one time value intrinsic corresponding to each latent state.
5. Shape Sensitive Explain Component: The market parameter intrinsic component happens to be the most shape sensitive explain component (this includes roll down, roll up, and time roll). As a consequence, this component ends up being the most sensitive to the splined latent state representation scheme.

### Market Parameters Extrinsic

1. Motivation: This principal component aims to capture the first order market move impact on the security value. This leading linear order is referred to as the “curve shift” effect, i.e., impact of the change in quote that intuitively corresponds closest to the product’s extrinsic market move impact (it a single such manifest measure quote uniquely exists). Subsequent orders (such as twist/tilt, farther quote manifest measure re-calibration impact etc.) cause higher order change impacts (e.g., convexity, butterflies, etc.)
2. Modern Market Parameters Extrinsic: Since the extrinsic market parameters simply correspond in reality to the full variety of the calibrated latent states, each of these latent state metric changes triggers the corresponding linear principal component shift, and thereby a non-zero corresponding explain component. The additional “modern” latent states contributing to these factors are the collateral curves, collateral switch curves, funding curves, and re-investment curves.

### Market Value Change Effects Formulation

1. The Linear Explain Components:
   1. is the cumulative carry
   2. is the per-market parameter specific roll-down
   3. is the per-market parameter specific “curve shift”
   4. refers to the latent state designated by the market value, and may need to be computed as where corresponds to the quote set required for the calibration, and is the corresponding Jacobian.
2. The Linear Explain Using Value Quote Jacobian: In practice what we want is where .

# Credit Analytics Bond RV Calculation Methodology

**Introduction**

This document outlines the methodology used in Credit Analytics (release 1.4 and above) for the calculation of the bond curve-based relative value measures.

### The Bond RV Measure Set

Classification of a given bond measure as an “RV” measure is somewhat arbitrary. In general, it is used (here) to refer to any of the measure that is in use for spotting relative value across bonds for a given issuer (or any similar category), and which is usually determined straight from a bond market measure (price/yield/spread to treasury). Specifically, it excludes such bond measures as DV01, loss PV, principal PV etc.

Following is the list of the RV measures - refer to the section below for a precise definition of these terms.

* Bond Basis
* Convexity
* Credit Basis
* Discount Margin
* Duration
* DV01
* G Spread (Spread to the Government/Treasury Discount Curve)
* I Spread (Interpolated Spread to the Discount Curve)
* Option Adjusted Spread
* Macaulay Duration
* Modified Duration
* Par Asset Swap Spread
* Par Equivalent CDS Spread (PECS)
* Price
* Spread over Treasury (TSY) benchmark
* Yield
* Yield Basis
* Yield Spread
* Yield01
* Zero Discount Margin (ZDM)
* Zero (Z) Spread

#### Asset Swap Spread

Asset swap is an estimate of the spread over a matching swap maturing at the bond’s maturity. For a non-par swap, an additional spread is added by dividing the departure from par by the swap annuity.

**Bond Basis**

Bond Basis to Exercise () is a bond RV metric capturing the basis in the yield space. It is defined as the difference between the yield to exercise computed from the market price and the yield to exercise computed from the theoretical price off of the risk-free discount curve.

#### Convexity

Convexity to Exercise () measures the rate of change of duration with yield. It is defined as the change in market duration on 1 basis point increase in yield.

#### Credit Basis

Credit Basis to Exercise () captures the adjustment needed to the input credit curve to account for the bond market price. It is defined as the parallel shift needed to be applied across the input credit curves quotes to make create the credit curve that produces the market price.

Credit Basis can be negative; given that the credit curve does not typically calibrate for negative hazard rates, the credit basis may not be calculable for market prices above a certain range.

#### Discount Margin

Discount Margin to Exercise () measures that spread earned above the reference rate. For fixed coupon bonds, it is computed as the difference between market yield and the initial implied discount rate to the bond’s frequency. For floaters, it is computed as the difference between market yield and the initial reference index rate.

#### Duration

Duration to Exercise () captures the relative rate of change of bond price with yield. It is defined as the fractional change of price as the market yield increases by 1 basis point.

#### DV01

DV01 to exercise captures the cash flow present-value weighted pay date durations.

#### G Spread

G Spread to Exercise () accounts for the Spread over the Government/Treasury Discount Curve. It is defined as the difference between the market yield to exercise of the bond and the rate calculated to the exercise date, implied from the specified discount curve constructed from the government debt instruments.

#### I Spread

I-Spread to Exercise () measures the spread over the specified Discount Curve interpolated to the exercise date. It is defined as the difference between the market yield to exercise of the bond and the rate interpolated to the exercise date, implied from the specified discount curve.

#### Macaulay Duration

Macaulay duration to exercise captures the cash flow present-value weighted pay date durations.

#### Modified Duration

Modified duration to Exercise () captures the relative rate of change of bond price with yield. It is defined as the fractional change of price as the market yield increases by 1 basis point.

#### Option Adjusted Spread

Option adjusted to Exercise () spread captures the value of the option embedded in the bond. It is calculated identical to the Z-Spread (see Z-Spread for details), although it may be based off of a different discount curve.

#### Par Asset Swap Spread

Par asset swap spread to Exercise () estimates the spread implied by the price that a par floater would be expected to pay. It is defined as the difference between the market price and the theoretical price computed using the discount curve, computed in units of the bond PV01 (duration times price).

#### Par Spread

Par spread to Exercise () estimates the fair fixed coupon implied by the market price that an equivalent fixed coupon bond trading at par would pay. It is defined as the difference between the market price and par, computed in units of the bond PV01 (duration times price).

**Par Equivalent CDS Spread (PECS)**

The PECS to Exercise () measures the flat credit spread premium implied by the bond price. It is computed as the implied flat spread of the fictitious CDS needed to recover the market price of the bond.

#### Price

The theoretical exercise price of the bond can be computed from the bond cash flows, the discount curve and/or the credit curve and recovery using the methodology described below.

#### Spread Over Treasury Benchmark

Treasury Spread to Exercise () accounts for the returns over the given benchmark bond. It is defined as the difference between the market yield to exercise of the bond and the yield to maturity of the specified benchmark treasury bond.

#### Yield

The yield to exercise () implied from the bond market price is calculated according to the equations shown below.

#### Yield Basis

Yield basis to Exercise is defined identically as the bond basis. See Bond Basis for details.

#### Yield Spread

Yield spread is defined identically as the bond basis. See Bond Basis for details.

#### Yield01

Yield01 (also called YV01) to Exercise () captures the relative rate of change of bond price with yield. It is defined as the fractional change of price as the market yield increases by 1 basis point.

**Zero Discount Margin (ZDM)**

Zero Discount Margin to Exercise () estimates the excess spread over the reference index curve. It is a measure valid only floaters; it is defined as the extra coupon spread to be applied to the reference index rate curve so as to be able to recover the market price.

#### Zero (Z) Spread

Z Spread to Exercise () captures the excess spread over the discount curve. The details of implying the zero-curve and the corresponding calculation of the Z Spread are described below.

|  |  |
| --- | --- |
| **Symbol** | Description |
|  | Bond Basis to Exercise |
|  | Convexity to Exercise |
|  | Credit Basis to Exercise |
|  | Discount Margin to Exercise |
|  | Duration to Exercise |
|  | G-Spread to Exercise |
|  | I Spread to Exercise |
|  | Option Adjusted Spread to Exercise |
|  | Par Asset Swap Spread to Exercise |
|  | Par Spread to Exercise |
|  | Par Equivalent CDS Spread to Exercise |
|  | Zero Discount Margin to Exercise |
|  | The Full Period Coupon Rate between  and |
|  | Government Curve implied Rate to Exercise |
|  | Coupon Day Count Fraction between  and |
|  | Yield Quote Day Count Fraction between  and |
|  | Spread applied to the Interest Rate curve |
|  | Coupon Day Count Convention |
|  | Yield Quote Day Count Convention |
|  | Coupon Frequency |
|  | Frequency for Yield Quote |
|  | Time at coupon flow # i |
|  | Exercise Date Time |
|  | Yield To Exercise |
|  | Coupon Flow at Date Time |
|  | Discount Curve based Discount Factor at Date Time |
|  | Bumped Discount Curve based Discount Factor at Date Time |
| ) | Discount Factor at Date Time  given Yield To Exercise , Quote Frequency , Quote Day Count Convention |
|  | Discount Factor at date time  given the Z Spread , the quote frequency , Quote Day Count Convention |
|  | Notional at Exercise |
|  | Outstanding Notional at Date Time |
|  | Principal Notional Payout at Date Time |
|  | Theoretical Dirty Price calculated from the input IR Curve |
|  | Theoretical Dirty Price calculated from the input IR and Credit Curves |
|  | Theoretical Dirty Price calculated from the input IR Curve with a spread adjustment |
|  | Theoretical Dirty Price calculated from the input IR Curve and Credit Curve, where the Credit Curve is created off of a flat spread |
|  | Theoretical Dirty Price calculated from the input IR Curve and Credit Curve, with a spread adjustment applied to the Credit Curve |
|  | Discount Curve implied Rate to Exercise |
|  | Survival Probability at time t |
|  | Treasury Benchmark Spread to Exercise (done) |
|  | Yield of the Specified Treasury Benchmark |
|  | Yield to Exercise |
|  | Theoretical Yield to exercise |
| {} | Collection of the ordered nodes {, , …, } that constitute the Zero Curve |
|  | Zero Rate to the Date Time |
|  | Z Spread |

### Basic Measures

Equation (1): The Coupon Cash Flow of the bond at coupon date time  is given as



Equation (2): The Discount Factor at date time t given the yield to exercise , the quote frequency , and the annualized quote day count based time fraction  is given as



Equation (3): The Zero Rate  to a date time  is determined by the solution to  that computes the discount factor  given the quote frequency , and the annualized quote day count based time fraction  is given as



Equation (4): The Discount Factor at date time  given the zero rate , the Z Spread , the quote frequency , and the annualized quote day count based time fraction  is given as



Equation (5): The Principal redeemed, amortized, or capitalized at time  is given as



Equation (6): The Dirty Price of the bond at exercise given an exercise yield  is given as



Equation (7): The Dirty Price of the bond at exercise given a Z spread () is given as



Equation (8): The Theoretical IR implied Dirty Price  of the bond at exercise calculated using the discount factors from the input discount curve is given as



Equation (9): The IR implied Dirty Price  of the bond at exercise calculated using the discount factors from the input discount curve bumped by a rate  is given as



Equation (10): The Theoretical Credit implied Dirty Price  of the bond at exercise calculated using the discount factors and the survival probabilities from the input discount curve and the credit curve respectively is given as



Equation (11): The Theoretical Credit implied Dirty Price  of the bond at exercise calculated using the discount factors and the survival probabilities from the input discount curve and the credit curve respectively, where the credit curve is bumped by a rate , is given as



Equation (12): The Credit Basis to Exercise  of the bond given the market price () is given as the solution of  in Equation (11):



Equation (13): The Theoretical Credit implied Dirty Price of the bond at exercise  is calculated using the discount factors and the survival probabilities from the input discount curve and the credit curve respectively, where the credit curve is created off of a flat spread , is given as



Equation (14): The Par Equivalent CDS Spread to Exercise of the bond given the market price () is given as the solution of  in Equation (13):



Equation (15): The Bond Spread to Treasury Benchmark at exercise  is computed from the Bond Yield to Exercise  and the given Treasury Benchmark Yield  as



Equation (16): The Bond I Spread to exercise  is computed from the Bond Yield to Exercise  and the Discount rate to Exercise implied from the input Interest Rate Curve  as



Equation (17): The Bond G Spread to exercise  is computed from the Bond Yield to Exercise  and the Discount rate to Exercise implied from the input Government Rate Curve  as



Equation (18): The Theoretical Yield to exercise  of the bond at exercise calculated using the discount factors from the input discount curve is given as the solution of  in Equation (6), where the dirty price  is substituted by  of Equation (8).

Equation (19): The Bond Basis at exercise  (also referred to as yield basis or as yield spread) is computed from the Bond Yield to Exercise  and the Bond Yield to Exercise  as



Equation (20): The Bond Duration to exercise  is computed as the fractional change in bond market price () to the change in the market yield () as



Equation (21): The Bond Convexity to exercise  is computed as the change in bond market duration to exercise () to the change in the market yield () as



Equation (22): The Discount Margin to Exercise  of the bond given the market yield to exercise () is given as:



Equation (23): The Par Asset Swap Spread to Exercise () of the bond given the market price () is given as:



Equation (24): The Option Adjusted Spread to Exercise  is calculated identical to Z Spread, as a solution to  in Equation (7).

**Figure 1: Causality Bayesian Network DAG For Credit Curve Building**

**Transition**

**Stretch**

**Stretch 2**

**Stretch 1**

**Figure 2: Transition Splines – Low Width Transition Stretch**

**Transition Stretch**

**Stretch 2**

**Stretch 1**

**Figure 3: Transition Splines – High Width Transition Stretch**

**Transition Stretch**

**Stretch 2**

**Stretch 1**

**Figure 4: Transition Splines – Segment <-> Stretch Layout**

**Stretch 2**

**Segment 2**

**Stretch 2**

**Segment 1**

**Stretch 1**

**Segment 2**

**Stretch 1**

**Segment 1**

“Work-out” Leg, i.e., leg whose forwards are known (e.g., 3M LIBOR Leg)

“Visible” Leg, i.e., leg whose forwards are known (e.g., 6M LIBOR Leg)

Calibrated Cash Flow Set

ml+1

ml

m

j=1

b

a=1

**Figure 5: Float-Float Swap Set-up**

**Latent State Current**

**Quote Sensitivity**

**Latent State Left**

**Quote Sensitivity**

**Current**

**Left**

**Figure 6: Latent State Quote Sensitivity**

**Figure 7: Measure Change Setup**

t

T

t + τ