

# Stochastic-alpha-beta-rho (SABR) Model

## Applied Stochastic Processes (FIN 514)

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# The project overview

## SABR Model

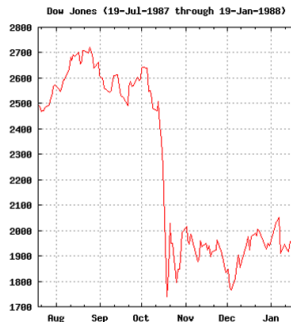
- One of the most popular **stochastic volatility (SV)** model.
- Heavily used for pricing and risk-managing options in interest rate and FX.
- Explains volatility skew/smile with minimal and intuitive parameters.

## Project Goal

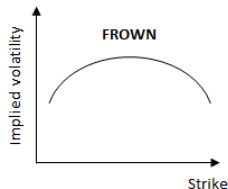
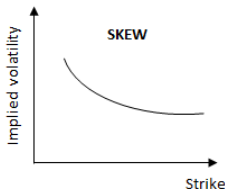
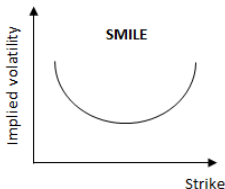
- Implement option pricing with Euler/Milstein scheme
- Implement conditional MC method (and check the variance reduction)
- Compare to the approximation formula by Hagan (code provided)
- Implement a smile calibration routine

# Background: volatility skew/smile

- Black Monday crash in 1987:  
DJIA  $-22.6\%$  in one day!
- Overall 'short gamma' due to the *portfolio insurance* (put on equity index)
- Market values (down-side) tail event higher than before.
- Market sees volatility skew/smile



(From Wikipedia)



# Why need model for smile? challenges in risk management

- Option trading desk (market-making/sell-side) usually accumulates option positions with different strikes.
- Under BSM model,
  - Vol  $\sigma$  fixed under spot change  $S_0 \rightarrow S_0 + \Delta$ .
  - Risk-management is easy: delta and vega clearly defined
  - One can hedge delta (with underlying stock) and vega (with ATM option)
  - However, **the OTM option prices/risks are not correct!**
- BSM model with different  $\sigma$  to each option  $K$ ?
  - How do we fix the volatilities?
  - Sticky strike rule  $\sigma = \sigma(K)$  vs sticky delta rule  $\sigma = \sigma(S_0 - K)$ .
  - Need to characterize the smile with a few minimal parameters.
- For better risk management, we need models which can capture the volatility smile.

# How to model smile? Local volatility (LV)

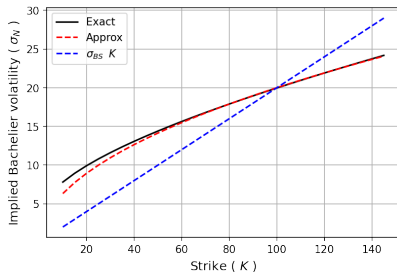
- Volatility depending on the 'current location' of  $S_t$ :

$$\text{BSM: } \frac{dS_t}{S_t} = \sigma_{\text{BS}} f_{\text{BS}}(S_t) dW_t \quad \text{Normal: } dS_t = \sigma_{\text{N}} f_{\text{N}}(S_t) dW_t$$

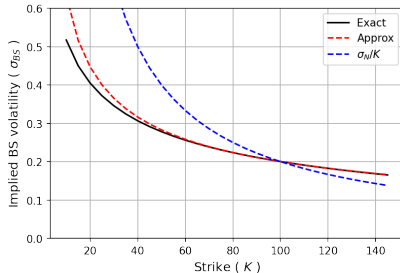
- BSM model:** a trivial case with  $f_{\text{BS}}(x) = 1$ . However, it is a local vol model under normal volatility ( $f_{\text{N}}(x) = x$ ).
- Normal model:** a trivial case with  $f_{\text{N}}(x) = 1$ . However, it is a local vol model under BSM volatility ( $f_{\text{BS}}(x) = 1/x$ ).
- What is the implied normal volatility of the Black-Scholes price on varying  $K$ ? What is the relation between the implied volatility and the local vol?
- The implied volatility is the volatility average of the in-the-money paths
- Exercise 1:** Chart the normal implied vol of the prices under BSM model for typical parameter sets. Measure the slope,  $\partial\sigma(K)/\partial K$ , at the money.

Parameters:  $S_0 = 100, \sigma_{BS} = 20\% (\sigma_N = 20), r = q = 0$ :

- Implied normal vol for constant BSM vol ( $\sigma_{BS} = 20\%$ )
- Approx:  $\sigma_N \approx \sigma_{BS} \sqrt{S_0 K}$
- Local vol:  $\sigma_N \approx \sigma_{BS} K$



- Implied BSM vol for constant normal vol ( $\sigma_N = 20$ ):
- Approx:  $\sigma_{BS} \approx \sigma_N / \sqrt{S_0 K}$
- Local vol:  $\sigma_{BS} \approx \sigma_N / K$



# Displaced BM (DBS) model

- A simple local vol model with analytic solution (i.e., Black-Scholes formula)
- *Displaced* asset price  $D(S_t) = \beta S_t + (1 - \beta)S_0$  follows a GBM:

$$\frac{dS_t}{D(S_t)} = \sigma_D dW_t \quad \text{where} \quad D(S_t) = \beta S_t + (1 - \beta)S_0.$$

- Calibration of  $\sigma_D$  (ATM option price on target):

$$\sigma_N \approx \sigma_D D(S_0) \approx \sigma_{BS} S_0 \quad \Rightarrow \quad \sigma_D = \sigma_{BS}$$

- Bridges the Bachelier ( $\beta = 0$ ) and BS ( $\beta = 1$ ) models.

# Displaced BM (DBS) model

- Final asset price  $S_T$ :

$$S_T = \left( S_0 + \frac{1 - \beta}{\beta} S_0 \right) \exp \left( \beta \sigma_D W_T - \frac{\beta^2 \sigma_D^2 T}{2} \right) - \frac{1 - \beta}{\beta} S_0,$$

- Option price:

$$C_D(K) = \frac{D(S_0)N(d_{1D}) - D(K)N(d_{2D})}{\beta},$$

$$\text{where } d_{1D,2D} = \frac{\log(D(S_0)/D(K))}{\beta \sigma_D \sqrt{T}} \pm \frac{\beta \sigma_D \sqrt{T}}{2}.$$

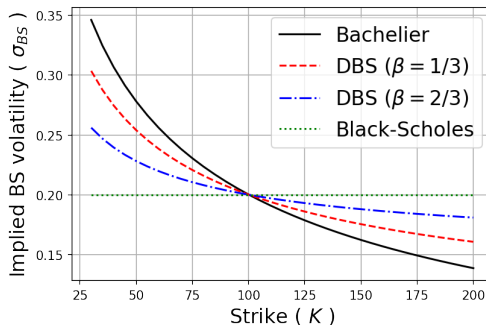
- We can reuse BS formula with the following substitutions:

$$S_0 \Rightarrow D(S_0), \quad K \Rightarrow D(K), \quad \sigma_{BS} \Rightarrow \beta \sigma_D, \quad C_{BS} \Rightarrow \beta C_D$$



# BS vol skew of the DBS model

**Exercise 2:** Chart the BS implied volatility of the prices under the DBS model.



# How to model smile? Stochastic volatility (SV)

- Volatility changing over time:

$$\text{BSM: } \frac{dS_t}{S_t} = \sigma_t dW_t \quad \text{Normal: } dS_t = \sigma_t dW_t$$

- Many models proposed (mostly for BSM). For  $dW_t dZ_t = \rho dt$ ,
  - Hull-White and SABR:

$$\frac{d\sigma_t}{\sigma_t} = \nu dZ_t$$

- Heston:  $V_t = \sigma_t^2$  follows Cox-Ingersoll-Ross (CIR) process,

$$dV_t = \kappa(V_\infty - V_t)dt + \nu\sqrt{V_t}dZ_t$$

- SV model correctly captures the smile,  $\nu$  for curvature and  $\rho$  for skewness.

Stochastic-alpha-beta-rho model SDE:

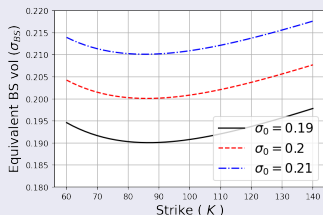
$$\frac{dS_t}{S_t^\beta} = \sigma_t dW_t \quad \text{and} \quad \frac{d\sigma_t}{\sigma_t} = \nu dZ_t \quad (dW_t dZ_t = \rho dt)$$

- Parameters:  $\sigma_0, \nu, \beta, \rho$ .
- $\sigma_0$ : overall volatility, calibrated to ATM implied vol
- $\beta$ : elasticity or 'backbone'. (Normal:  $\beta = 0$ , BSM:  $\beta = 1$ )
- $\nu$ : volatility of volatility,  $\sigma$  following a GBM
- $\rho$ : correlation between asset price and volatility

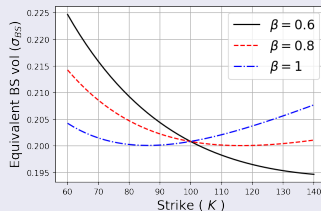
# The impact of parameters

Base parameters:  $\sigma_0 = 0.2$ ,  $\nu = 0.2$ ,  $\rho = 0.1$ ,  $\beta = 1$ .

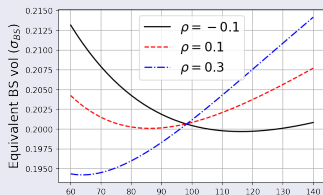
## Initial vol $\sigma_0$



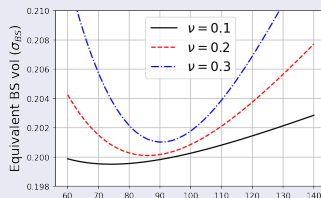
## Backbone $\beta$



## Correlation $\rho$



## Vol-of-vol $\nu$



# Equivalent BSM-volatility formula (Hagan et al., 2002)

The leading-order and first-order terms of Taylor's expansion around  $\nu\sqrt{T} \approx 0$ .

$$\sigma_{\text{BS}}(K) = H(z) \frac{\alpha}{k^{\beta_*/2}} \frac{1 + \left( \frac{\beta_*^2}{24 k^{\beta_*}} \alpha^2 + \frac{\rho\beta}{4 k^{\beta_*/2}} \alpha \nu + \frac{2-3\rho^2}{24} \nu^2 \right) T}{1 + \frac{\beta_*^2}{24} \log^2 k + \frac{\beta_*^4}{1920} \log^4 k},$$

where,

$$\beta_* = 1 - \beta, \quad \alpha = \frac{\sigma_0}{S_0^{\beta_*}}, \quad k = \frac{K}{S_0}, \quad z = \frac{\nu}{\alpha} k^{\beta_*/2} \log k,$$
$$H(z) = \frac{z}{x(z)}, \quad x(z) = \log \left( \frac{V(z) + z + \rho}{1 + \rho} \right), \quad \text{and } V(z) = \sqrt{1 + 2\rho z + z^2}.$$

The option price can be obtained by plugging  $\sigma_{\text{BS}}(K)$  in to the Black-Scholes formula.

$$C_{\text{SABR}} = C_{\text{BS}}(K, S_0, \sigma_{\text{BS}}(K), T)$$

# Success of the SABR model

- Volatility smile information encoded into three parameters  $\sigma_0, \nu, \rho$ .
- These three parameters are parsimonious (minimal) and intuitive.
- Equivalent BSM volatility is available although not accurate for wide parameter range.
- Vega (volatility) risk managed by the three parameters rather than each individual vol.
- Three implied vols (or option prices) on the smile can calibrate the parameters. → An effective interpolation method for implied volatility (or option price)

# Limitation of Hagan's formula

- Arbitrage is equivalent to some event happening with negative probability. The price of a derivative paying \$1 on that event is negative (should be free at most)!
- Probability (digital call option price) from the call spread:

$$\begin{aligned}\mathbb{P}(S_T > K) &= D(K, \sigma(K)) \\ &= \frac{C_{BS}(K, \sigma(K)) - C_{BS}(K + \Delta K, \sigma(K + \Delta K))}{\Delta K} = -\frac{\partial C_{BS}(K, \sigma(K))}{\partial K}\end{aligned}$$

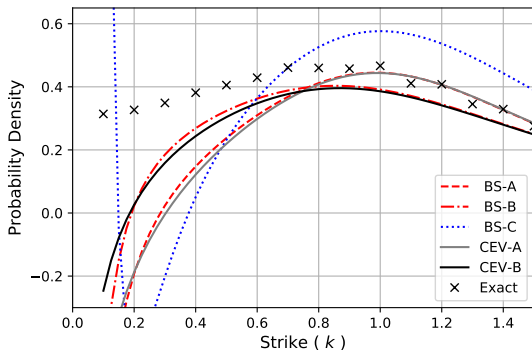
- Probability density from the second derivative:

$$f_{SABR}(K) = \frac{\partial^2 C_{BS}(K, \sigma(K))}{\partial K^2} \geq 0.$$

- The PDF from the exact SABR solution should be positive. When  $\nu\sqrt{T} \gg 1$ , however, Hagan's approximation formula often implies negative PDF.

$$D(K, \sigma(K)) < D(K + \Delta K, \sigma(K + \Delta K)).$$

The volatility effect  $\sigma(K + \Delta K)$  dominates (should NOT!) the moneyness effect  $K + \Delta K$ .



- Parameters:  $\sigma_0 = 0.25$ ,  $\nu = 0.3$ ,  $\rho = -0.2$ ,  $\beta = 0.6$ ,  $T = 20$
- Many volatility approximation methods imply negative PDF at low  $K$ .
- Reference: [Choi and Wu \(2021\)](#)



# Euler method (MC with time-discretization)

- Unlike normal or BSM model (as in spread/basket option project), we can not jump the simulation directly from  $t = 0$  to  $T$ .
- Divide the interval  $[0, T]$  into  $N$  small steps,  $t_k = (k/N)T$  and  $\Delta t_k = T/N$  and simulate each time step with

$$S_t : \begin{cases} \beta = 0 : S_{t_{k+1}} = S_{t_k} + \sigma_{t_k} W_1 \sqrt{\Delta t_k} \\ \beta = 1 : \log S_{t_{k+1}} = \log S_{t_k} + \sigma_{t_k} \sqrt{\Delta t_k} W_1 - \frac{1}{2} \sigma_{t_k}^2 \Delta t_k, \end{cases}$$
$$\sigma_t : \sigma_{t_{k+1}} = \sigma_{t_k} \exp \left( \nu \sqrt{\Delta t_k} Z_1 - \frac{1}{2} \nu^2 \Delta t_k \right),$$

where  $W_1, Z_1 \sim N(0, 1)$  with correlation  $\rho$ .

- Typically,  $\Delta t_k \approx 0.25$ . For  $T = 30$ ,  $N = 120$ , quite time-consuming.
- Any good control variate?

$$C(K) = \frac{1}{N} \sum_{i=1}^N (S_T^{(i)} - K)^+$$

# Euler method vs Milstein method

For a stochastic process,

$$dX_t = \mu(X_t)dt + \sigma(X_t)dW_t,$$

the Euler scheme is given as:

$$X_{t+\Delta t} = X_t + \mu(X_t)\Delta t + \sigma(X_t)W_1\sqrt{\Delta t} \quad \text{for } W_1 \sim N(0, 1).$$

In Milstein scheme, an higher-order correction is added:

$$\begin{aligned} X_{t+\Delta t} &= X_t + \mu(X_t)\Delta t + \sigma(X_t)\Delta W_t + \frac{\sigma(X_t)\sigma'(X_t)}{2}((\Delta W_t)^2 - \Delta t), \\ &= X_t + \mu(X_t)\Delta t + \sigma(X_t)W_1\sqrt{\Delta t} + \frac{\sigma(X_t)\sigma'(X_t)}{2}\Delta t(W_1^2 - 1). \end{aligned}$$

The idea is from the well-known stochastic integral

$$\int_0^{\Delta t} W_t dW_t = \frac{1}{2}((\Delta W_t)^2 - \Delta t) = \frac{\Delta t}{2}(W_1^2 - 1).$$

# Milstein Scheme (continued)

For the time  $s$ ,  $t \leq s \leq t + \Delta t$ , the dynamics of  $\sigma(X_s)$  is

$$d\sigma(X_s) = \sigma'(X_s)dX_s + O(\Delta t) = \sigma'(X_s)\sigma(X_s)dW_s + O(\Delta t).$$

Applying the Euler scheme, we get

$$\sigma(X_s) = \sigma(X_t) + \sigma'(X_t)\sigma(X_t)(W_s - W_t) + O(\Delta t).$$

The Milstein scheme is derived as

$$\begin{aligned} X_{t+\Delta t} - X_t &= \mu(X_t) \int_{s=t}^{t+\Delta t} ds + \int_{s=t}^{t+\Delta t} \sigma(X_s) dW_s \\ &= \mu(X_t)\Delta t + \int_{s=t}^{t+\Delta t} (\sigma(X_t) + \sigma'(X_t)\sigma(X_t)(W_s - W_t)) dW_s \\ &= \mu(X_t)\Delta t + \sigma(X_t)\Delta W_t + \sigma'(X_t)\sigma(X_t) \int_{s=t}^{t+\Delta t} (W_s - W_t) dW_s \\ &= \mu(X_t)\Delta t + \sigma(X_t)\Delta W_t + \frac{\sigma'(X_t)\sigma(X_t)}{2} ((\Delta W_t)^2 - \Delta t) \\ &= \mu(X_t)\Delta t + \sigma(X_t)W_1\sqrt{\Delta t} + \frac{\sigma(X_t)\sigma'(X_t)}{2} \Delta t (W_1^2 - 1). \end{aligned}$$

# Stochastic integral of $\sigma_t$

From Itô's lemma,

$$\frac{d\sigma_t}{\sigma_t} = \nu dZ_t \quad \Rightarrow \quad d \log \sigma_t = -\frac{1}{2}\nu^2 dt + \nu dZ_t$$

we can solve the volatility process:

$$\sigma_t = \sigma_0 \exp \left( \nu Z_t - \frac{1}{2}\nu^2 t \right).$$

We also know

$$\nu \int_0^T \sigma_t dZ_t = \sigma_T - \sigma_0 = \sigma_0 \exp \left( -\frac{1}{2}\nu^2 T + \nu Z_T \right) - \sigma_0,$$

which will be useful for the integration of  $S_t$ .

# Stochastic integral of $S_t$ (normal: $\beta = 0$ )

Writing the SDE in a de-correlated form using  $X_t$  and  $Z_t$  ( $dX_t dZ_t = 0$ ),

$$dS_t = \sigma_t (\rho dZ_t + \rho_* dX_t) \quad \text{with} \quad \rho_* = \sqrt{1 - \rho^2}.$$

Integrating  $S_t$ , we get so far as

$$\begin{aligned} S_T - S_0 &= \rho \int_0^T \sigma_t dZ_t + \rho_* \int_0^T \sigma_t dX_t \\ &= \frac{\rho}{\nu} (\sigma_T - \sigma_0) + \rho_* \int_0^T \sigma_t dX_t \end{aligned}$$

From Itô's Isometry, the integration in blue is equivalent to

$$\int_0^T \sigma_t dX_t = X_1 \sqrt{V_T} \quad \text{where} \quad X_1 \sim N(0, 1), \quad V_T := \int_0^T \sigma_t^2 dt.$$

Here, the random variable  $X_1$  is independent from  $V_T$  and  $\sigma_T$ .

# Normalization of $V_T$

- Note that  $V_T = \sigma_0^2 T$  if  $\nu = 0$  (i.e., constant volatility).
- We normalize by  $I_T = V_T/(\sigma_0^2 T)$ :

$$\begin{aligned} I_T &= \frac{V_T}{\sigma_0^2 T} = \frac{1}{\sigma_0^2 T} \int_0^T \sigma_t^2 dt \\ &= \frac{1}{\sigma_0^2 T} \int_0^T \sigma^2 \exp(2\nu Z_t - \nu^2 t) dt \\ &= \frac{1}{T} \int_0^T \exp(2\nu Z_t - \nu^2 t) dt \\ &= \int_0^1 \exp(2\hat{\nu} Z_s - \hat{\nu}^2 s) ds, \quad (\hat{\nu} = \nu\sqrt{T}) \end{aligned}$$

- We don't need to simulate  $\sigma_t$  again when  $\sigma_0$  changes.

# Conditional MC method (normal $\beta = 0$ )

Conditional on  $(\sigma_T, I_T)$ ,  $S_T$  can be sampled from

$$S_T = S_0 + \frac{\rho}{\nu}(\sigma_T - \sigma_0) + \sigma_0 \sqrt{(1 - \rho^2)I_T T} X_1$$

and the option price is from the normal model:

$$C_N \left( K, S_0 := S_0 + \frac{\rho}{\nu}(\sigma_T - \sigma_0), \sigma_N := \sigma_0 \sqrt{(1 - \rho^2)I_T T} \right)$$

Then, the price is obtained as an expectation over  $(\sigma_T, I_T)$ :

$$C_{\beta=0} = E(C_N(\sigma_T, I_T)), \quad \text{where} \quad I_T = \frac{1}{N} \sum_k \sigma_{t_k}^2 \quad (\sigma_0 = 1)$$

For  $I_T$ , we can use higher-order numerical integration methods ([trapezoidal rule](#) or Simpson's rule)

$$I_T = \frac{1}{2N} \sum_{k=0}^{N-1} (\sigma_{t_k}^2 + \sigma_{t_{k+1}}^2) = \frac{1}{2N} (\sigma_{t_0}^2 + 2\sigma_{t_1}^2 + \cdots + 2\sigma_{t_{N-1}}^2 + \sigma_{t_N}^2)$$

# Conditional MC method (BSM $\beta = 1$ )

Conditional on  $(\sigma_T, I_T)$ ,  $S_T$  can be sampled from

$$\log \left( \frac{S_T}{S_0} \right) = \frac{\rho}{\nu} (\sigma_T - \sigma_0) - \frac{\sigma_0^2 T}{2} I_T + \sigma_0 \sqrt{(1 - \rho^2) I_T T} X_1$$

and the option price is from the BSM formula:

$$C_{\text{BS}} \left( K, S_0 := S_0 e^{\frac{\rho}{\nu} (\sigma_T - \sigma_0) - \frac{\sigma_0^2 T}{2} I_T}, \sigma_{\text{BS}} := \sigma_0 \sqrt{(1 - \rho^2) I_T} \right)$$

Then, the price is obtained as an expectation over  $(\sigma_T, I_T)$ :

$$C_{\beta=1} = E(C_{\text{BS}}(\sigma_T, I_T)), \quad \text{where} \quad I_T = \frac{1}{N} \sum_k \sigma_{t_k}^2 \quad (\sigma_0 = 1)$$

For  $I_T$ , we can use higher-order numerical integration methods (trapezoidal rule or [Simpson's rule](#))

$$I_T = \frac{1}{3N} \left( \sigma_{t_0}^2 + 4\sigma_{t_1}^2 + 2\sigma_{t_2}^2 + \cdots + 4\sigma_{t_{N-2}}^2 + 2\sigma_{t_{N-1}}^2 + \sigma_{t_N}^2 \right) \quad \text{for even } N$$



# Advantages of conditional MC method

- No need to simulate  $S_t$ : less computation, less memory use.
- Given  $(\sigma_T, I_T)$ , the option price is exact. Therefore, MC variance is much smaller than that of the MC simulating both  $\sigma_t$  and  $S_t$ .
- Can obtain correct option value for extreme strike values: If we have so simulate  $S_T$ , no simulation path arrives at  $S_T > K$  for very big or small  $K$ , option value from MC is zero. The conditional MC method result in very small (correct) option value because the price comes from (analytic) BSM formula.

- When  $\beta$  is given (0 or 1), three parameters,  $\sigma_0$ ,  $\rho$  and  $\nu$ , can be calibrated to three option prices (or implied volatilities), typically at  $K = S_0$  (ATM),  $S_0 - \Delta$  and  $S_0 + \Delta$ .

$$\text{SABR}(\sigma_0, \rho, \nu) \rightarrow \sigma(S_0), \sigma(S_0 - \Delta), \sigma(S_0 + \Delta)$$

- Write a calibration routine in R to solve  $\sigma_0$ ,  $\rho$  and  $\nu$  in homework.

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