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#### Definition 1.0.1 Types of Banks

1. **Commercial Banks** are those that take deposits and make loans
  - a) retail banks-individuals and small firms
  - b) wholesale banks-corporate
2. **Investment Banks** are those that assist in raising capital for their customers and advising them on corporate finance matters such as M&A.

#### Definition 1.0.2 Major Risks Faced by Banks

1. **Credit Risk** refers to the risk that borrowers may default on loans or other counterparties contracts
2. **Market Risk** refers to the risk of losses from a bank's trading activities
3. **Operational Risk** refers to the possibility of losses arising from external events or failures of a bank's internal control

#### Definition 1.0.3 Types of Capitals

1. **Regulatory Capital** refers to the amount determined by bank regulators (must maintain this level!)
2. **Economic Capital** refers to the amount of capital that a bank believes is adequate based on its own risk models

#### Definition 1.0.4 IB Financing Arrangements

1. **Private Placement:** securities are sold directly to qualified investors with substantial wealth and investment knowledge
2. **Public Offering:** the securities are sold to the investing public at large
  - a) Firm Commitment: the IB agrees to purchase the entire issue and sell
  - b) Best Effort: sell as much as possible with commission
3. **Dutch Auction:** reduce price until all bidders have accepted all the shares.



To avoid conflict of interest, large integrated banks must implement **Chinese walls** internal

control.

**Definition 1.0.5** 1. **Banking Book** refers to loans made, which are the primary assets of a commercial bank.

$$\text{BV Value of a loan} = \text{Principal} + \text{Accrued Interest}$$

nonperforming: payments overdue for more than 90 days

2. **Trading Book** refers to assets and liabilities related to a bank's trading activities

### Types of Books

**Definition 1.0.6 The Originate-To-Distribute Model**

The model involves making loans and selling them to other parties. Government agencies using this model:

1. Ginnie Mae (GNMA)
2. Fannie Mae (FNMA)
3. Freddie Mac (FHLMC)

The benefit is increased liquidity but the drawback is the loose lending standards

### Definition 2.0.1 Categories of Insurance Companies

1. **Life Insurance**
2. **P&C Insurance**
  - a) Property insurance covers property losses such as fire and theft
  - b) Casualty (liability) insurance covers third-party liability
3. **Health insurance**
4. **Risks:**
  - a) Insufficient funds to satisfy policyholders' claims
  - b) Poor return on investments
  - c) Liquidity risk of investments
  - d) Credit risk
  - e) Operational risk

### Exercise 2.1 Breakeven Premium Payments Using Mortality Table

The relevant interest rate for insurance contracts is 3% per annum (semiannual compounding applies), and all premiums are paid annually at the beginning of the year. A \$500,000 term insurance contract is being proposed for a 60-year-old male in average health. Assuming that payouts occur halfway throughout the year, calculate the insurance company's breakeven premium for a one-year term and a two-year term.

#### Solution:

1. One-year term:

$$P_{death,60,1} \times 500,000 = (1 - P_{survival,60,1}) \times 500,000 = 5,598,50$$

$$Premium_{breakeven,1} = \frac{5598,50}{1,015} = 5515,76$$

2. Two-year term:

$$P_{death,60,2} = (1 - P_{death,60,1})P_{death,60,1} = 0,011874$$

$$P_{death,60,2} \times 500,000 = 5937,27$$

the payout is 18 months after

$$Premium_{breakeven,2} = \frac{5937,27}{1,015} = 5677,91$$

3. Take total:

$$Y + \frac{P_{survival,60,1}Y}{1,015^2} = Premium_{breakeven,1} + Premium_{breakeven,2} = 11193,67$$

Solve for  $Y = 5711,66$ .

### Definition 2.0.2 P&C Insurance Ratios

1. **Loss ratio** for a given year is the percentage of payouts versus premiums generated, usually between 60-80 % and increasing over time
2. **Expense ratio** for a given year is the percentage of expense versus premiums generated, usually between 25-30 % and decreasing over time
3. **Combined ratio** sum of loss and expense ratio
4. **Operating Ratio** for a given year is the combined ratio after dividends less investment income

**Definition 2.0.3 Adverse Selection** is where an insurer is unable to differentiate between a good risk and a bad risk

**Definition 2.0.4** 1. **Mortality Risk** refers to the risk of policyholder dying earlier than expected

2. **Longevity Risk** refers to the risk of policyholder living longer than expected

**R** If an insurance company has both life annuities and life insurance, then there is a natural hedge of these two risks. Otherwise, can consider reinsurance contracts.

### Definition 2.0.5 Types of Pension Plans

1. **Defined Benefits Plans**
2. **Defined Contribution Plans**

- R**
1. Liability insurance is subject to long-tail risk, the risk of legitimate claims being submitted years after the insurance coverage has ended
  2. Property and Casualty insurance companies typically have a greater amount of equity than a life insurance company

### Definition 3.0.1 Types of Mutual Funds

$$\text{NAV} = \frac{\text{fund assets} - \text{fund liabilities}}{\text{total shares outstanding}}$$

1. **Open-ended Mutual Funds:** most common, trades at the fund's **net asset value**, which is essentially the sum of all assets owned minus any liabilities of the fund then divided by shares outstanding.
  - a) Poor price visibility, market order only
  - b) Taxes passed onto investors
  - c) Fees required
    - 1) Management fee: as high as 2.5-3.0 %
    - 2) Advertising fee: 0.0-1.0 %
    - 3) Sales charge:
      - a' Front-end load: charge when the asset is sold
      - b' Back-end load: charge when the investor leaves a fund
2. **Closed-End Mutual Funds**
  - a) Niche investment
  - b) Number of funds remains static and can be purchased from other investors
  - c) Cannot sell the fund back to the company but need to find next investor
  - d) Transact at a price other than NAV with discount or premium
3. **Exchange-Traded Funds**
  - a) Like a daily traded closed-end funds with options available
  - b) Tremendous visibility
  - c) Low management fee

### Definition 3.0.2 Hedge Funds

More complex compensation structure centered around incentive fees, **2 plus 20 %**, 2% of all assets plus an additional 20 % of all profits above a specified benchmark. Safeguards for



investors:

1. Hurdle Rate: benchmark that must be beaten
2. High-water mark clause: previous losses must first be recouped and hurdle rates surpassed before incentive fees once again apply
3. Clawback clause: enables investors to remain a portion of previously paid incentive fees to offset investment losses

### Exercise 3.1 Calculate a Hedge Fund Manager's Expected Return

What is the expected return to a hedge fund if the fund uses a standard 2 and 20 incentive fee structure with an investment that has a 35 % probability of making 55 % and a 65 % probability of losing 45 %?

**Solution**

$$P(W)(2\% + 0,2 \times (W - 2\%)) + P(L) \times 2\% \\ = 0,35(2\% + 0,2(55\% - 2\%)) + 0,65 \times 2\% = 5,71\%$$

### Definition 3.0.3 Hedge Fund Strategies

1. **Long/Short Equity**
2. **Dedicated Short**
3. **Distressed Securities**: high return if they can turn things around
4. **Merger Arbitrage**: cash deals and stock deals
5. **Convertible Arbitrage**: utilize convertible bond
6. **Fixed Income Arbitrage**
7. **Emerging Market**: developing country securities or American Depository Receipts (ADRs)
8. **Global Macro**: global macro trend that is in disequilibrium
9. **Managed Futures**: future of commodity prices

### Definition 3.0.4 Hedge Fund Performance and Measurement Bias

1. **Measurement Bias**: report good, avoid bad
2. **Backfill Bias**: use previous return to boost return rate
3. **Protection during period of stock market volatility**



1. Mutual funds must offer immediate access to withdrawals from their fund as an SEC requirement. Whereas, the hedge funds have advance notification and lock-up periods.

#### Definition 4.0.1 Derivative Markets

1. **Open outcry system/electronic trading system:** like NASDAQ
2. **OTC:** customized
3. **Traditional Exchange**

#### Definition 4.0.2 Basics of Derivative Securities

1. **Option Contract** is a contract that, in exchange for the option price, gives the option buyer the right, but not obligation, to buy/sell an asset at the exercise price from/to the option seller within a specified time period
2. **Forward Contract** is a contract that specifies the price and quantity of an asset to be delivered sometime in the future—foreign currency risk hedge
3. **Futures contract** is a more formalized, legally binding agreement to buy/sell a commodity/financial instrument in a pre-designated month in the future, at a price agreed upon today—exchange traded

#### Theorem 4.0.1 Call Option Payoff/Profit

For call option buyer

$$C_T = \max(0, S_T - X)$$

$$\text{Profit} = C_T - C_0$$

where  $S_T$  is the stock price at maturity and  $X$  is the strike price and  $C_0$  is the call premium. **The put version is analogous**

#### Theorem 4.0.2 Forward Contract Payoff

For a forward contract long position

$$\text{Payoff} = S_T - K$$

where  $S_T$  is the spot price at maturity and  $K$  is the delivery price. **The case for a future is similar**

**Exercise 4.1 How to use forward contracts to hedge?**

Suppose that a company based in the United States will receive a payment of 10M in three months. The company is worried that the euro will depreciate and is contemplating using a forward contract to hedge this risk. Compute the following:

1. The value of the 10M in U.S. dollars at maturity given that the company hedges the exchange rate risk with a forward contract at 1.25 \$/€
2. The value of the 10M in U.S. dollars at maturity given that the company did not hedge the exchange rate risk and the spot rate at maturity is 1.2 \$/€



**Speculative Strategies** Derivatives create significant leverage for the speculators.

$$\text{Open Interest} = \text{Total \# Long Position} = \text{Total \# Short Position}$$

#### Definition 5.0.1 Futures Contract Characteristics

1. Quality of the underlying asset
2. Contract size
3. Delivery location
4. Delivery time
5. Price quotation and tick size: tick size is the minimum price fluctuation for the contract
6. Daily price limits: limit down (cannot go down further), limit up (cannot go up further)
7. Position limits: maximum number of contracts that a speculator may hold

#### Theorem 5.0.1 Future/Spot Convergence

$$\text{Basis} = \text{Spot Price} - \text{Futures Price}$$

when  $T$  approaches maturity, basis will converge to 0. Otherwise, arbitrage exists.

#### Definition 5.0.2 Operation of Margins

1. **Margin** is cash or highly liquid collateral placed in an account to ensure that any trading losses will be met.
2. **Marking to market** is the daily procedure of adjusting the margin account balance for daily movements in the future price.
3. **Initial Margin**
4. **Maintenance Margin:** lower than this, there will be a margin call
5. **Variation Margin:** the amount necessary to bring the margin account back to the initial margin amount

**Exercise 5.1 Margin Trading**

Let's return to our investor with the long gold contract. The investor entered the position at \$993.60. Each contract controls 100 troy ounces for a current market value of \$99,360. Assume that the initial margin is \$2,500, the maintenance margin is \$2,000, and the futures price drops to \$991.00 at the end of the first day and \$985.00 on the end of the second day. Compute the amount in the margin account at the end of each day for the long position and any variation margin needed.

**Solution**

1. First day: amount of loss

$$2,6 \times 100 = 260 < 2500 - 2000 = 500$$

No margin call, the margin balance is 2240.

2. Second day: amount of loss

$$6 \times 100 = 600 > 2240 - 2000 = 240$$

There is a margin call and the current balance is 1640, the variation margin is  $2500 - 1640 = 860$ .

**Definition 5.0.3 OTC Markets**

1. **Collateralization** is basically a marked to market feature for the OTC market where any loss is settled in cash at the end of the trading day.
2. In practice, the current OTC market is a mix of both bilateral agreements and transactions dealing with one or more clearinghouses. **Why clearinghouse?**
  - a) Automatic posting of collateral
  - b) Reduction of financial system credit risk
  - c) Increase transparency of OTC trades

- Definition 5.0.4**
1. **Settlement price** is the average of the prices of the trades during the last period of trading
  2. **Normal Market:** increasing settlement prices
  3. **Inverted Market:** decreasing settlement prices

**Definition 5.0.5 The Delivery Process of A Future Contract**

1. Delivering the goods to the clearing house
2. Cash-settlement contract
3. Reverse/offsetting
4. Exchange for physicals: between traders, not the clearinghouse

**Definition 5.0.6 Types of Orders**

1. **Market order**
2. **Discretionary order:** delayed market order by the broker
3. **Limit order**
4. **Stop orders**
5. **Time-of-day order**
6. **Good-till-canceled order**
7. **Fill-or-kill order:** must execute immediately or the trade will not take place.




1. Commodity Futures Trading Commission (CFTC) is responsible for regulating futures markets
2. Hedging accounting specifies that gains/losses from a hedging instrument be recognized in the same period as gains/losses from the asset being hedged

#### Definition 6.0.1 Hedging With Futures

1. **Short Hedge** short a future contract to hedge against a price decrease in the existing long position
2. **Long Hedge** long a future contract to hedge against an increase in price in the existing short position

#### Definition 6.0.2 Basic Risk exists if one of the following is true

1. the asset in the existing position is often not the same as that underlying the futures
2. the hedging horizon may not match perfectly with the maturity of the futures contract

 To minimize basis risk, hedgers should select asset that is highly correlated to the spot position and contract maturity that is closest to the hedging horizon. Liquidity must be considered as well.

#### Definition 6.0.3 Sources of Basis Risks

1. Interruption in the convergence of the futures and spot prices
2. Changes in the cost of carry
3. Imperfect matching between the cash asset and the hedge asset: maturity/duration mismatch, liquidity mismatch, credit risk mismatch

#### Theorem 6.0.1 Optimal Hedge Ratio

A hedge ratio is the ratio of the size of the futures position relative to the spot position. The **optimal hedge ratio**, which minimizes the variance of the combined hedge position, is defined as follows:

$$HR = \rho_{S,F} \frac{\sigma_S}{\sigma_F} = \beta_{S,F} = \frac{\text{Cov}_{S,F}}{\sigma_F^2} = \frac{\text{Cov}_{S,F}}{\sigma_S \sigma_F} \frac{\sigma_S}{\sigma_F}$$

where  $S$  is the spot position and the  $F$  is the future position.

- R** This is optimal since it can minimize the variance. The **effectiveness of the hedge** measures the variance that is reduced by implementing the optimal hedge. We can measure it by  $\rho_{S,F}^2$

### Theorem 6.0.2 Hedging With Stock Index Futures

$$\# \text{ of Contracts} = \beta_{port} \times \frac{\text{portfolio value}}{\text{value of future contract}} = \beta_{port} \times \frac{\text{portfolio value}}{\text{future price} \times \text{contract multiplier}}$$

### Exercise 6.1 Tailing the Hedge

Suppose that you would like to make a tailing the hedge adjustment to the number of contracts needed in the previous example. Assume that when evaluating the next daily settlement period you find that the S&P 300 spot price is 1,095 and the futures price is now 1,160. Determine the number of S&P 500 contracts needed after making a tailing the hedge adjustment.

#### Solution

We need to adjust the formula to spot-to-future ratio

$$\begin{aligned} \# \text{ of Contracts} &= \beta_{port} \times \frac{\text{portfolio value}}{\text{future price} \times \text{contract multiplier}} \times \frac{\text{spot price}}{\text{future price}} \\ &= 1,4 \times \frac{20000000}{1150 \times 250} \times \frac{1095}{1160} = 92 \end{aligned}$$

### Theorem 6.0.3 Adjusting Portfolio Beta

$$\# \text{ of Contracts} = (\beta^* - \beta) \frac{P}{A}$$

where  $P$  is the portfolio value,  $A$  is the value of the underlying asset,  $\beta^*$  is the target beta and  $\beta$  is current portfolio beta

- R** Due to different maturities of the spot and future, the hedger needs to introduce a new future to roll the hedge forward and this will get rid of the old basis risk but introduce a new basis risk



### Definition 7.0.1 Types of Rates

1. Treasury rates: risk-free rates
2. LIBOR
3. Repo rates: implied rate on a repurchase agreement

**R** We are ignoring a bunch of ACTSC231 stuff here. BORING.

### Theorem 7.0.1 Bootstrap Spot Rate Curves

Given a set of treasury price  $P_1, \dots, P_n$  and related periods  $t_1, \dots, t_n$ , then we calculate  $z_{t_1}, \dots, z_{t_n}$  one-by-one.

**Definition 7.0.2 Forward Rate Agreements** is a forward contract obligating two parties to agree that a certain interest rate will apply to the principal amount during a specified future time.

### Theorem 7.0.2 FRA Valuation

$$PV_{rec, R_K} = L(R_K - R_F)(T_2 - T_1)e^{-R_2 T_2}$$

$$PV_{pay, R_K} = L(R_F - R_K)(T_2 - T_1)e^{-R_2 T_2}$$

where  $L$  is the principal,  $R_K$  is the annualized rate on  $L$ ,  $R_F$  is the forward rate between  $T_1$  and  $T_2$  continuous compounding period.

### Exercise 7.1 Computing the Value of an FRA

Suppose the 3-month and 6-month LIBOR spot rates are 4% and 5%, respectively (continuously compounded rates). An investor enters into an FRA in which she will receive 8% (assuming quarterly compounding) on a principal of \$5,000,000 between months 3 and 6. Calculate the

value of the FRA.

**Solution**

$$e^{0,25R_{F,c}} = \frac{e^{0,5 \cdot 0,05}}{e^{0,25 \cdot 0,04}} \rightarrow R_{F,c} = 0,06 = 6\%$$

$$R_{F,quarter} = 4 \left( e^{\frac{0,06}{4}} - 1 \right) = 0,060452 = 6,05\%$$

$$PV_{rec,R_K} = 5000000(8\% - 6,05\%)(0,5 - 0,25)e^{-0,05 \times 0,5} = 23773$$

### Definition 7.0.3 Duration

The duration of a bond is the cash flow weighted average time until the cash flows on the bond are received. Under continuous compounding:

$$D = \sum_{i=1}^n t_i \left( \frac{c_i e^{-y t_i}}{P_{Bond}} \right)$$

where  $t_i$  is the time until cash flow  $c_i$  is to be received and  $y$  is the continuously compound yield.

### Theorem 7.0.3 Approximation of Bond Price Change

Under a parallel shift in the yield curve of  $\Delta y$ , we have

$$\frac{\Delta P_{Bond}}{P_{Bond}} = -D \times \Delta y$$

### Definition 7.0.4 1. Modified Duration:

$$D^* = \frac{D}{1 + \frac{y}{m}}$$

where  $m$  is the number of compounding periods per year

### 2. Dollar Duration:

$$\$D = D^* \times P_{Bond}$$

### Theorem 7.0.4 Improved Approximation Using Convexity

$$\Delta P_{Bond} = P_{Bond} \left( -D\Delta y + \frac{1}{2}C(\Delta y)^2 \right)$$

### Proposition 7.0.5 Theories of The Term Structure

1. **Expectations Theory:**  $R_F = \mathbb{E}(Z_t)$
2. **Market Segmentation Theory:** different maturity sectors yield different supply and demand
3. **Liquidity Preference Theory:** most depositors prefer short-term liquid deposits

- Definition 8.0.1**
1. **Investment Asset** is an asset that is held for the purpose of investing
  2. **Consumption Asset** is an asset that is held for the purpose of consumption

**Definition 8.0.2 Rules of Short Selling**

1. The short seller must pay all dividends due to the lender of the security
2. The short seller must deposit collateral to guarantee the eventual repurchase of the security

**Exercise 8.1 Net profit of a short sale**

Assume that trader Alex Rodgers sold short XYZ stock in March by borrowing 200 shares and selling them for \$50/share. In April, XYZ stock paid a dividend of \$2/share. Calculate the net profit from the short sale assuming Rodgers bought back the shares in June for \$40/share in order to replace the borrowed shares and close out his short position.

**Solution**

Initial revenue =  $200 \times 50 = 10000$

Get rid of dividend =  $2 \times 200 = 400$

Return the stock =  $40 \times 200 = 8000$

Total Profit =  $10000 - 400 - 8000 = 1600$

**Definition 8.0.3 Future vs. Forwards**

1. Similarities:
  - a) Deliverable or cash-settlement
  - b) Priced to have zero value at entrance
2. Differences:
  - a) Future:
    - 1) Trade on organized exchanges
    - 2) highly standardized
    - 3) A single clearinghouse is the counterparty to all futures contracts
    - 4) Government regulated market

b) Forward:

- 1) Private contracts not on an exchange
- 2) customized contracts
- 3) Forwards are contracts with the originating counterparty
- 4) Forward contracts are usually not regulated

### Theorem 8.0.1 Forward Pricing

Under the following assumptions:

1. No transaction costs or short-sale restrictions
2. Same tax rates on all net profits
3. Borrowing and lending at the risk-free rate
4. Arbitrage opportunities are exploited as they arise

No interim cash flows or carrying costs

$$F_0 = S_0 e^{rT}$$

If  $I$  is the PV of all cash flows over the  $T$  years, we have

$$F_0 = (S_0 - I) e^{rT}$$

If there is a dividend on the stock with  $\delta$  continuous return

$$F_0 = S_0 e^{(r-\delta)T}$$

### Theorem 8.0.2 Value of A Forward Contract

For the buyer of the contract

$$S_0 e^{-\delta T} - I - K e^{rT}$$

where  $K$  is the obligated delivery price after inception

### Theorem 8.0.3 Currency Futures

$$F_0 = S_0 e^{(r-r_f)T}$$

### Theorem 8.0.4 Commodity Futures

$$F_0 = S_0 e^{(r+u-y)T}$$

where  $u$  is the storage cost and  $y$  is the convenience yield.

- Definition 8.0.4**
1. **Backwardation** refers to a situation where the futures price is below the spot price. There must be a significant benefit to holding the asset
  2. **Contango** refers to a situation where the futures price is above the spot price. If there are no benefits to holding the asset

#### Definition 9.0.1 Day Count Convention

$$\text{Accrued Interest} = \text{Coupon} \times \frac{\text{\# of days from last coupon to the settlement date}}{\text{\# of days in coupon period}}$$

1. US Treasury bonds use actual/actual
2. US corporate and municipal bonds use 30/360
3. US money market (T-Bill) use actual/360

#### Definition 9.0.2 Quotation of T-Bonds

Quoted relative to \$100 par amount in dollars and 32nds.

$$95 - 05 \qquad 95\frac{5}{32} \qquad 95,15625$$

$$\text{Cash Price} = \text{Quoted Price} + \text{Accrued Interest}$$

The cash price is also known as the dirty price while the quoted price is the clean price.

#### Definition 9.0.3 Quotation for T-Bills

We use actual/360 and  $Y$  as the cash price and  $n$  days to maturity, then

$$\text{T-Bill discount rate} = \frac{360}{n}(100 - Y)$$

**Definition 9.0.4 Treasury Bond Futures** For the short position to deliver, the cash received is

$$\text{cash received} = (QFP \times CF) + AI$$

where QFP is the quoted futures price, CF is the conversion factor, and AI is the accrued interest

$$CF = \frac{\text{discounted price of a bond} - AI}{\text{face value}}$$

**Theorem 9.0.1 Cheapest-to-Deliver Bond**

$$\text{CTD Bond} = \text{Quoted Bond Price} - (QFP \times CF)$$

we take the minimum!



CTD Bonds Behaviours:

1. When yield  $> 6\%$ , CTD bonds tend to be low-coupon, long-maturity bonds
2. When yield  $< 6\%$ , CTD bonds tend to be high-coupon, short-maturity bonds
3. When the yield curve is upward sloping, CTD bonds tend to have longer maturities
4. When the yield curve is downward sloping, CTD bonds tend to have shorter maturities

**Exercise 9.1 Theoretical Futures Price**

Suppose that the CTD bond for a Treasury bond futures contract pays 10% semiannual coupons. This CTD bond has a conversion factor of 1.1 and a quoted bond price of 100. Assume that there are 180 days between coupons and the last coupon was paid 90 days ago. Also assume that Treasury bond futures contract is to be delivered 180 days from today, and the risk-free rate of interest is 3%. Calculate the theoretical price for this T-bond futures contract.

**Solution**

1. Step 1: calculate the dirty price of the bond

$$\text{Dirty Price} = 100 + 5 \times \frac{90}{180} = 102,5$$

2. Step 2: calculate the cash future price, since this is a treasury bond, we use actual/actual

$$F_0 = (102,5 - 5e^{-0,03 \times (90/365)})e^{0,03(180/365)} = 98,99$$

3. Step 3: calculate the quoted futures price at delivery

$$98,99 - 5 \times \frac{90}{180} = 96,49$$

4. Step 4: calculate theoretical price using conversion factor

$$QFP = \frac{96,49}{1,1} = 87,72$$

**Definition 9.0.5 Eurodollar Futures**

The 3-month eurodollar futures contract trades on Chicago Mercantile Exchange (CME). One tick is \$25 per \$1 million contract. if  $Z$  is the quoted price, the contract price is

$$\text{Eurodollar future price} = 10000[100 - (0,25)(100 - Z)]$$

**Theorem 9.0.2 Convexity Adjustment**

$$\text{Forward Rate Implied By Futures} = (100 - Z) \%$$

$$\text{Actual Forward Rate} = \text{Forward Rate Implied By Futures} - \frac{1}{2} \sigma^2 T_1 T_2$$

where  $\sigma$  is the annual sd of the 90-LIBOR,  $T_1$  is the maturity of the future contract and  $T_2$  is 90 days of the underlying contract.

**Theorem 9.0.3 Duration-Based Hedging**

To create a combined position that does not change in value when yields change by small amount.

$$N = -\frac{P \times D_P}{F \times D_F}$$

**Exercise 9.2** Assume there is a 6-month hedging horizon and a portfolio value of \$100 million. Further assume that the 6-month T-bond contract is quoted at 105—09, with a contract size of \$100,000. The duration of the portfolio is 10, and the duration of the futures contract is 12. Outline the appropriate hedge for small changes in yield.

**Solution**

$$N = -\frac{100000000 \times 10}{105\frac{9}{32} \times 0,01 \times 100000 \times 12} = -791,53$$

Thus, the manager should short 792 contracts. ■

#### Definition 10.0.1 Financial Intermediaries in Swap Markets

1. Swaps typically require no payment by either party at initiation
2. Swaps are custom instruments
3. Swaps are not traded in any organized secondary market
4. Swaps are largely unregulated
5. Default risk is an important aspect of the contract
6. Most participants in the swaps market are large institutions
7. Individuals are rarely swap markets participants

#### Theorem 10.0.1 Discount Rate for Swaps

Implied forward rate is used to produce LIBOR, so under continuous compounding

$$R_{forward} = R_2 + (R_2 - R_1) \frac{T_1}{T_2 - T_1}$$

#### Theorem 10.0.2 IRS Value

$$V_{fltrec} = PV_{flt} - PV_{fix}$$

$$V_{fixrec} = PV_{fix} - PV_{flt}$$



1. Bond methodology use the fixed rate to calculate floating rate payment right away
2. FRA methodology use Theorem 10.0.1 to calculate each floating rate payment and discount accordingly



**Theorem 10.0.3 Fixed-for-fixed Currency Swap**

$$V_{swap}(USD) = B_{USD} - (S_0 \times B_{GBP})$$

**Theorem 10.0.4 FRA Currency Swap** We first calculate the forward rates using

$$F_t = S_0 e^{(r - r_f)t}$$

then, discount cash flows like before and calculate difference.

**Definition 10.0.2 Other Types of Swaps**

1. **Equity Swap** the return on a stock, a portfolio, or a stock index is paid each period by one party in return for a fixed-rate or floating-rate payment
2. **Swaption** is an option which gives the holder the right to enter into an interest rate swap
3. **Volatility swap** involves the exchanging of volatility based on notional principal

#### Definition 11.0.1 Types of Options

1. **LEAP:** long-term equity anticipation securities, January expiration
2. **FLEX options** exchange-traded options on equity (indices) that allow alterations on specifications
3. **ETF options:** American-style options and utilize delivery rather than cash settlement
4. **Weekly options:** created on Thursday and matures next Friday
5. **Binary options:** pays \$ $x$  when the strike price is reached
6. **CEBOs:** specific form of credit default swap
7. **DOOM options:** put option that has really low strike price in case of large downward price movement in the underlying asset.



1. Option is not adjusted for dividends but for stock-split. A 25 % dividend is treated as a 5-for-4 stock split
2. Options with maturities nine months or fewer cannot be purchased on margin; otherwise, a maximum of 25 % of the option value can be borrowed
3. **Naked options** refers to options in which the writer does not also own a position in the underlying asset.
4. OCC is the clearinghouse for exchange-traded options
5. Other option-like instruments are **warrants**, **employee stock options**, and **convertible bonds**.

Figure 1: Summary of Effects of Increasing a Factor on the Price of an Option

Factor	European Call	European Put	American Call	American Put
S	+	−	+	−
X	−	+	−	+
T	?	?	+	+
σ	+	+	+	+
r	+	−	+	−
D	−	+	−	+

Figura 12.0.1: Stock Option Properties

**Theorem 12.0.1** Upper Bounds for European and American Option Prices

$$c_{Ame} \leq S_0 \qquad c_{Eur} \leq S_0$$
$$p_{Ame} \leq X \qquad p_{Eur} \leq Ke^{-rT}$$

**Theorem 12.0.2** Upper Bounds for European and American Option Prices If the stock does not have dividend payments

$$\max(S_0 - Ke^{-rT}, 0) \leq c_{Eur} \qquad \max(Ke^{-rT} - S_0, 0) \leq p_{Eur}$$

$$\max(S_0 - Ke^{-rT}, 0) \leq c_{Ame}$$

$$\max(K - S_0, 0) \leq p_{Ame}$$

Note that  $S_0 - Ke^{-rT} \geq S_0 - K$ , thus, if there is no dividend, American call option should never be exercised early.

**Figure 2: Lower and Upper Bounds for Options**

<i>Option</i>	<i>Minimum Value</i>	<i>Maximum Value</i>
European call	$c \geq \max(0, S_0 - Xe^{-rT})$	$S_0$
American call	$C \geq \max(0, S_0 - Xe^{-rT})$	$S_0$
European put	$p \geq \max(0, Xe^{-rT} - S_0)$	$Xe^{-rT}$
American put	$P \geq \max(0, X - S_0)$	$X$

**Figura 12.0.2:** Stock Option Lower and Upper Bounds

**Theorem 12.0.3 Put-Call Parity Theorem Only holds for European Options!**

$$c_{Eur} + Ke^{-rT} = p_{Eur} + Se^{-\delta T}$$

**Theorem 12.0.4 American Option: Call and Put Relationship**

$$S_0 - K \leq c_{Ame} - p_{Ame} \leq S_0 - Ke^{rT}$$

**Theorem 12.0.5 Impact of Large Dividend on European Options** Let  $D$  be the PV of the large dividend, then the put-call parity becomes

$$p_{Eur} + S_0 - D = c_{Eur} + Ke^{-rT}$$

**Theorem 12.0.6 Impact of Large Dividend on American Options** Let  $D$  be the PV of the large dividend, then the impact on American option is

$$S_0 - K - D \leq c_{Ame} - p_{Ame} \leq S_0 - Ke^{rT}$$

#### Definition 13.0.1 Types of Strategies

1. **Protective Put:** long stock, long put
2. **Covered Call:** long stock, short call
3. **Bull Call Spread:** long lower call, short higher call  
The profit =  $\max(0, S_T - K_L) - \max(0, S_T - K_H) - c_L + c_H$
4. **Bear Call Spread:** short lower call, long higher call  
The profit =  $\max(0, S_T - K_H) - \max(0, S_T - K_L) + c_L - c_H$
5. **Butterfly Spreads:** if the strike prices of three call options are  $K_L, K_M, K_H$ , then to construct a butterfly spread
  - a) buy  $K_H - K_M$  call with  $C_L$
  - b) sell  $K_H - K_L$  call with  $C_M$
  - c) buy  $K_M - K_L$  call with  $C_H$
6. **Calendar Spread:** created by transacting in two options that have the same strike price but different expiration dates. This is not symmetric and not linear.
7. **Diagonal Spread:** based on calendar spread with different strike price
8. **Box Spread:** a bull call spread and a bear put spread, this provides a constant payoff and profit. Such arbitrage only exists for European options.
9. **Straddle:** long a put and a call at the same strike price to capture volatility
10. **Strangle:** long a put at  $K_L$  and a call at  $K_H$  to capture volatility with cheaper cost than Straddle
11. **Strips:** long more call than put at the same strike price
12. **Straps:** long more put than call at the same strike price

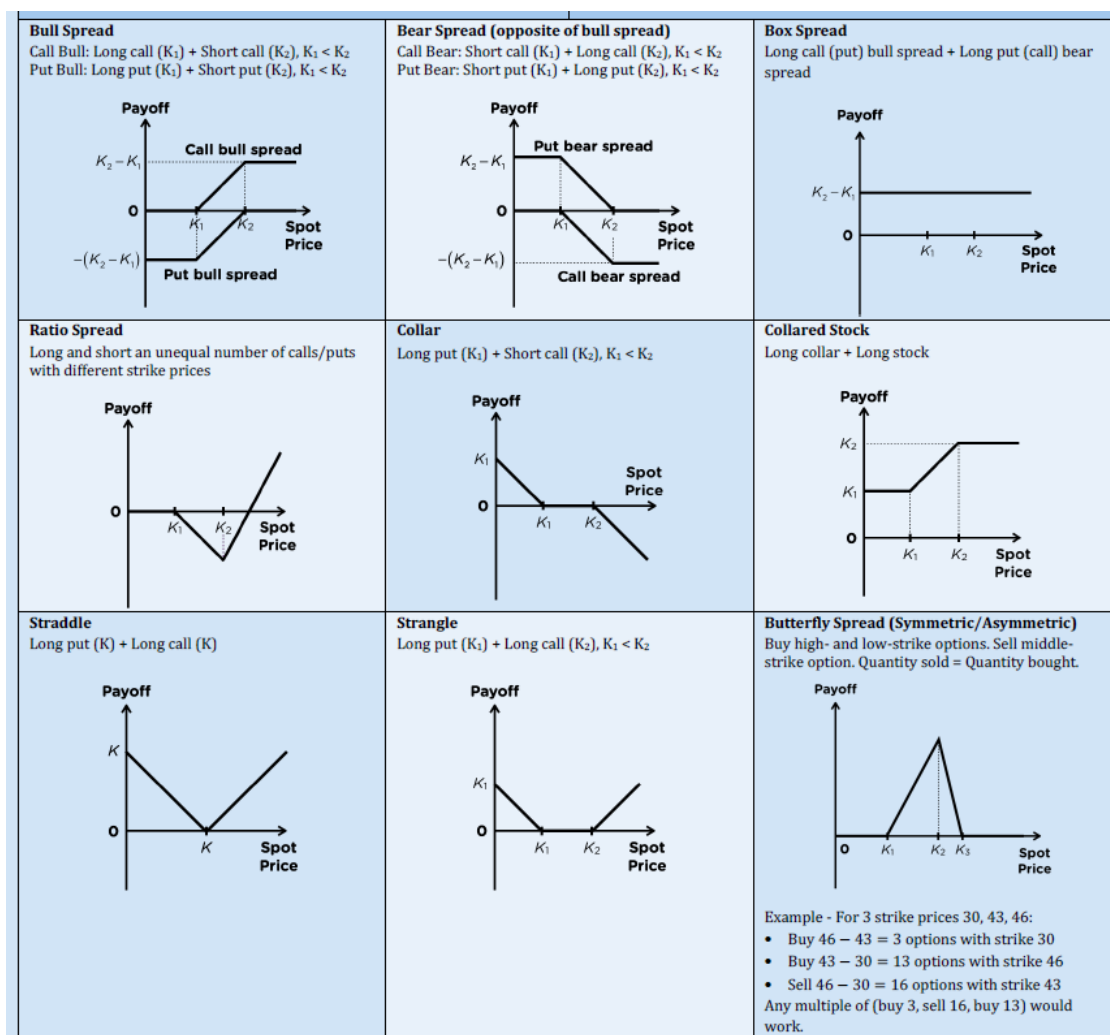


Figure 13.0.1: Stock Option Strategies

#### Definition 14.0.1 Why Exotic Option?

The exotic options are developed to provide a unique hedge for a firm's underlying assets, tax and regulatory purposes, and speculation on future market. 4 factors need to be considered

1. Will the hedge be effective?
2. Cost of strategy?
3. Is pricing model needed?
4. How is the position reversed?

#### Definition 14.0.2 American Option Transformation

1. Restrict early exercise time—**Bermudan option**
2. lock out period
3. Changing strike price

#### Definition 14.0.3 Types of Exotic Options

1. **Gap Options:** two strike prices,  $X_2$  is referred as the trigger price  
For a **gap call Options:**  $X_2 > X_1$ , when  $X_2$  is reached, the payoff is  $S_T - X_1$   
For a **gap put Options:**  $X_2 < X_1$ , when  $X_2$  is reached, the payoff is  $X_1 - S_T$
2. **Forward Start Options** are options that begin their existence at some time in the future
3. **Compound Options:** coc, cop, poc, pop
4. **Chooser Options:** choose to be a put or a call
5. **Barrier options:** down-and-in, down-and-out, up-and-in, up-and-out
  - a) Usually cheaper
  - b) Vega usually always positive for standard options, but maybe negative for barrier options
  - c) (down-and-in)+(down-and-out)=standard option=(up-and-in)+(up-and-out)
6. **Binary Options:**  
**cash-or-nothing call** pays fixed amount  $Q$

$$c_{cash} = Qe^{-rT}N(d_2)$$

**asset-or-nothing call** pays the value of the stock when the contract is initiated if the stock price ends up above the strike price at expiration

$$c_{asset} = S_0 e^{-\delta T} N(d_1)$$

7. **Shout Options:** allows the owner to pick a date when he shouts to the option seller, the owner receives the  $\max(shout, K)$
8. **Asian Options:** average price or average strike
9. **Exchange Options:** one asset for another asset
10. **Basket options:** underlying asset is a basket of assets (rainbow options)
11. **Volatility Swap/Variance Swap:** exchange volatility/variance based on a notional value

#### Definition 14.0.4 Option Replication

1. Dynamic Options Replication: requires frequent trading, which is really costly
2. Static options replication: a short portfolio of actively traded options that approximates the option position to be hedged is constructed



### Theorem 15.0.1 Forward Price

$$F_{0,T} = S_0 e^{(r-\delta+\lambda)T}$$

where  $\delta$  is the leasing rate and  $\lambda$  is the storage cost.

A synthetic commodity forward price can be derived by combining a long position on a commodity forward,  $F_{0,T}$  and a long zero-coupon bond that pays  $F_{0,T}$  at time  $T$ .

### Exercise 15.1 Cash-and-carry arbitrage

#### EXAMPLE: Futures cash-and-carry arbitrage

Assume the spot price of gold is \$900/oz., that the 1-year futures price is \$975/oz., and that an investor can borrow or lend funds at 5%. Storage costs are 2% annually. **Calculate** the arbitrage profit.

**Answer:**

The futures price, according to the no-arbitrage principle, should be:

$$F_{0,T} = \$900e^{(0.05 + 0.02)1} = \$965$$

Instead, it's trading at \$975. That means the futures contract is overpriced, so we should conduct cash and carry arbitrage by going short in the futures contract, buying gold in the spot market, and borrowing money to pay for the purchase. If we borrow \$900 to fund the purchase of gold, we must repay \$965 after 1 year (at maturity of the futures contract).

Today		1 Year From Today	
Transaction	Cash Flow	Transaction	Cash Flow
Short futures	\$0	Settle short position by delivering gold	+\$975
Buy gold in spot market	-\$900		
Borrow at 5%	+\$900	Repay loan	-\$965
Total cash flow	\$0	Total cash flow = arbitrage profit	+\$10

The riskless profit is equal to the difference between the futures contract proceeds and the loan payoff, or  $\$975 - \$965 = \$10$ . Notice that this profit is equal to the difference between the actual futures price of \$975 and the no-arbitrage price of \$965.

- Definition 15.0.1**
1. **Contango:** upward sloping forward curve with  $r > \delta$
  2. **Backwardation:** downward sloping forward curve with  $r < \delta$

**Definition 15.0.2 Convenience Yield:** The convenience yield is only relevant when a commodity is stored (i.e., in a carry market). A convenience yield cannot be earned by the average investor who does not have a business reason for holding the commodity. Thus, we have a range for the  $F_{0,T}$

$$S_0 e^{(r+\lambda-c)T} \leq F_{0,T} \leq S_0 e^{(r+\lambda)T}$$



Arbitrage-free conditions dictate that continuous lease rates should be equal to either

1. Risk-adjusted required return on commodity investment minus the expected price appreciation of the commodity

$$\delta = \alpha - \frac{1}{T} [E(S_T)/S_0]$$

2. The risk-free rate minus the forward premium on the commodity

$$\delta = r - \frac{1}{T} [F_{0,T}/S_0]$$

**Definition 15.0.3 Types of commodity forward prices**

1. **Gold Forward Prices:** positive leasing rate
2. **Corn Forward Prices:** the corn forward curve increases until harvest time, drops sharply and then slopes upward again after harvest time is over.
3. **Electricity Forward Prices:** not storable commodity
4. **Natural Gas Forward Prices:** constant production and seasonal demand, expensive to store. Peaks in the fall usually.
5. **Oil Forward Prices:** better to transport than natural gas, more stable long-run forward price

**Definition 15.0.4 Commodity Spread** results from a commodity that is an input in the production process of the other commodities.

1. crush spread: soybean
2. crack spread: crude oil, we need to know the notation

**EXAMPLE: Pricing a crack (commodity) spread**

Suppose we plan on buying crude oil in one month to produce gasoline and kerosene for sale in two months. The 1-month futures price for crude oil is currently \$30/barrel. The 2-month futures prices for gasoline and heating oil are \$41/barrel and \$31.50/barrel, respectively. **Calculate** the 5-3-2 crack (commodity) spread.

**Answer:**

The 5-3-2 spread tells us the amount of gross margin that can be locked in by buying five barrels of oil and producing three barrels of gasoline and two barrels of heating oil.

$$\text{gross margin for a 5-3-2 spread} = (3 \times \$41) + (2 \times \$31.50) - (5 \times \$30) = \$123 + \$63 - \$150 = \$36 \text{ for five barrels, or } \$7.20/\text{barrel}$$

- Definition 15.0.5**
1. **Strip Hedge:** Entering multiple future contracts as a long party, matching the maturities and quantities with their obligations under fixed price agreement
  2. **Stack Hedge:** oil producer would enter into a one-month futures contract equaling the total value of the year's promised deliveries and redo this every month to reduce transaction

costs. **stack and roll**

3. **Cross Hedge:** a futures contract that is highly correlated with the underlying exposure is selected, this will introduce a basis risk, and usually evaluated based on
  - a) The liquidity of the futures contract
  - b) The correlation between the underlying for the futures contract and the assets being hedged
  - c) The maturity of the futures contract—Used for weather derivatives for agriculture

### Definition 16.0.1 Forms of Clearing

1. **Clearing** is the process of reconciling and matching contracts between counterparties from the time the commitments are made until settlement
2. **Direct Clearing** is a mechanism for bilaterally reconciling commitments between two counterparties, a **clearing ring** is used to reduce counterparty exposure among more members.
3. **Complete Clearing** refers to clearing through a CCP

	Exchange-Traded Derivatives	OTC Derivatives
<b>Terms</b>	Standardized	Custom, negotiable
<b>Maturity</b>	Standardized	Negotiable, non-standard
<b>Liquidity</b>	Strong	Weak
<b>Credit risk</b>	Little (CCP guarantee)	High (bilateral)

**Figura 16.0.1:** *Differences Between Exchange and OTC*

### Classes of OTC Derivatives

1. Interest rate
2. Foreign exchange
3. Equity
4. Commodity
5. Credit derivatives

**Definition 16.0.2 Special Purpose Vehicles (SPVs)** are bankruptcy remote legal entities set up by a parent firm to shield the SPV from any financial distress of the firm.

1. SPV rating is stronger than the firm's credit rating
2. for issuing financial securities reasons
3. transferring counterparty risk into legal risk

**Definition 16.0.3 Derivatives Product Companies (DPCs)** are set up by firms as bankruptcy remote subsidiaries to originate derivatives products and sell them to investors. A DPC's AAA rating depends on 3 criteria

1. market risk minimization through participating on both sides of the market
2. parent support, with the bankruptcy remote status shielding against the parent's potential distress
3. credit risk and operational risk management through restrictions like limits, margin, and daily mark to market

**Definition 16.0.4 Monoline and Credit Derivative Product Companies (CDPCs)**

1. Monolines are highly-rated insurance companies that provide financial guarantees
2. CDPCs are similar to DPC



1. CCPs give priority to OTC derivatives counterparties to the detriment of other parties, including bondholders. This increases the risk in other markets.
2. Relying on a solid legal framework exposes CCPs and exchange members to legal risk. For example, as seen in the case of SPVs and DPCs, courts may change the priority of claims in a bankruptcy scenario, or courts in different jurisdictions may rule in contradictory ways.
3. Although CCPs share similarities with monolines and CDPCs in that they are highly-rated entities set up to manage counterparty risk, CCPs do not take residual risk in the market given that they maintain a matched book of trades. This is in contrast to monolines and CDPCs, which typically have one-way market exposures.
4. In contrast to monolines and CDPCs, which post no variation margin and often no initial margin, CCPs require members to post both initial and variation margin.

**Definition 17.0.1 Loss mutualization** is a form of insurance and refers to members' contributions to a default fund to cover future losses from member defaults.

**Definition 17.0.2 Conditions to be centrally cleared**

1. Standardization: legal and economic terms should be standard
2. Complexity: transactions need to be easily valued
3. Liquidity: cleared products are typically more liquid than OTC products

**Definition 17.0.3 Conditions to be a clearing member**

1. Admission criteria: credit quality and size
2. Financial commitment: contribute to the CCP's default fund
3. Operational criteria: posting margin, simulating default

**R** It is desirable to have only one CCP but not that feasible due to the following reasons

1. Regional Differences
2. Product Types
3. Regulatory reasons

	<i>OTC Derivatives</i>	<i>CCP/Exchanges</i>
Trading	Bilateral	Bilateral / Centralized
Counterparty	Original trade counterparty	CCP (replaces counterparty)
Participants	All	Clearing members (dealers)
Products	All (including non-standard, exotic)	Standard, vanilla
Margining	Bilateral, custom	Full margining set by CCP (initial, variation)
Loss buffers	Margin, regulatory capital	Initial margin, default fund, CCP capital

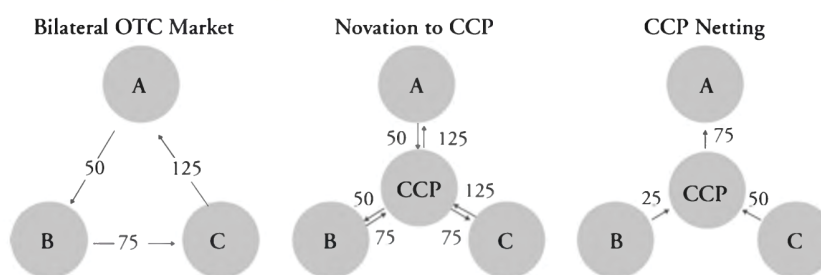
**Definition 17.0.4** 1. Advantages of CCP

- a) transparency
- b) offsetting
- c) loss mutualization
- d) legal and operational efficiency
- e) liquidity
- f) default management

## 2. Disadvantages of CCP

- a) Moral hazard
- b) Adverse selection
- c) Procyclicality
- d) Bifurcation: the separation of trading into cleared and non-cleared products can increase the volatility of cash flow even for hedged products

Figure 1: Multilateral Offsetting

**Figura 17.0.1:** How Novation and Netting Can Help Increasing Efficiency

#### **Definition 18.0.1 Risks Caused by CCPs**

1. Default Risk
2. Model Risk
3. Liquidity Risk
4. Operational Risk
5. Legal Risk
6. Other Risks
  - a) Investment risk refers to the risk of losses of margin funds resulting from investment actions performed within or outside of the stated investment policy.
  - b) Settlement and payment risk
  - c) Foreign exchange risk
  - d) Custody risk
  - e) Concentration risk refers to the risk of clearing members, margins, or both that are located in a single geographic area. Essentially, it is a lack of diversification.
  - f) Sovereign risk: foreign government default on its debt obligation
  - g) Wrong-way risk refers to the risk that exposure to a counterparty is negatively correlated the credit quality of the counterparty

#### **Definition 18.0.2 Lessons learned from CCP Failures**

1. Operational risk must be controlled to the maximum extent possible.
2. Variation margins should be recalculated often and collected quickly
3. Initial margins and default funds should be sufficiently large in order to withstand significant negative asset value declines as well as increased return correlations during a crisis
4. CCPs must actively monitor positions, penalize overly concentrated positions, and promptly liquidate hedge extremely large positions.
5. CCPs must have one or more external sources of liquidity to avoid default due to illiquidity



**Definition 19.0.1 Net Position Exposure on a Currency** Let **CUR** be a specific foreign currency.

$$\text{net CUR exposure} = (\text{CUR assets} - \text{CUR liabilities}) + (\text{CUR bought} - \text{CUR sold})$$



1. Match foreign currency assets with its liabilities on the balance sheet
2. Be long the currency in one component and short the currency in the other component

**Definition 19.0.2** The potential gain/loss exposure to a foreign currency (FC) is a function of the size of the position and the potential change in the value of the foreign currency

$$\text{\$ Gain/Loss in CUR} = \text{net CUR exposure (in \$)} \times \% \Delta \$ / \text{CUR}$$

**Definition 19.0.3 Types of FX Trading Activities**

1. Enabling customers to participate in international commercial business transaction
2. Enabling customers to take positions in real or financial foreign investments
3. Offsetting exposure in a given currency for hedging purposes
4. Speculating on foreign currencies in search of profit

**Theorem 19.0.1 Interest Rate Parity**

$$\text{Forward} = \text{Spot} \left( \frac{1 + r_{DC}}{1 + r_{FC}} \right)^T$$

Forward and spot are denoted in  $DC/FC$  as well!

For a continuous compounded rate version, we have

$$\mathbf{Forward} = \mathbf{Spot} \times e^{(r_{DC} - r_{FC})T}$$

**Theorem 19.0.2** Purchasing Power Parity (PPP)

$$\% \Delta S(\mathbf{DC/FC}) = \mathbf{inflation}(DC) - \mathbf{inflation}(FC)$$

#### **Definition 20.0.1 Methods for Retiring Bonds**

1. **Call Provision:**
  - a) Fixed-price call: call back the bonds at a specific price
  - b) Make-whole call: market rates determine the call price
2. **Sinking fund provision:** issuing firm retires a specified portion of the debt each year as outlined in the indenture—similar to a maintenance and replacement fund
3. **Tender Offers:** the firm openly indicates an interest in buying back a certain dollar amount of bonds or, more often, all of the bonds at a set price

#### **Definition 20.0.2 Types of Risks Related to Bonds**

1. Credit spread risk focuses on the difference between a corporate bond's yield and the yield on a comparable-maturity benchmark Treasury security. The difference is known as the credit spread
2. Event risk addresses the adverse consequences from possible events such as mergers, recapitalizations, restructurings, acquisitions, leveraged buyouts...
3. Businessman's risk refers to bonds with a rating at the bottom rung of the investment-grade category, short term it is volatile
4. Fallen angels: downgraded investment-grade bonds
5. restructurings and leveraged buyouts may increase the credit risk of a company today the point where the bonds become non-investment grade
6. **High-Yield Bond Structure**
  - Reset bonds: reset coupon payment based on market
  - Deferred-interest bonds: deep discount, so no interest in early years
  - Step-up bonds: low interest in early years but higher interest in later years
  - Payment-in-kind bonds: pay interest with additional bonds

#### **Definition 20.0.3 Default Rates**

1. **Issuer default rate** number of issuers that defaulted over a year divided by the total total

- number of issuer at the beginning of the year
2. **Dollar default rate** the par value of all bonds that defaulted in a given calendar year divided by the total par value of all bonds outstanding during the year
  3. **Recovery rate** is the amount received as a proportion of the total obligation after a bond defaults



1. Bond rating agencies only handles default risk but not credit risk since it would be accessed by the the credit spread duration
2. Zero coupon bond has low reinvestment risk

**Definition 21.0.1 Credit Guarantees**

1. **Government Loans** GNMA Ginnie Mae
2. **Converntional Loans** government-sponsored enterprises, FHLMC, FNMA

**Definition 21.0.2 Other Factors That Influence Prepayments**

1. Seasonality: summertime—greatest risk
2. Age of mortgage pool: refinancing in later years
3. Personal: marital breakdown, family issues...
4. Housing prices: rising housing price will result in higher prepayment risk
5. Refinancing burnout: people who cannot refinance...

**Prepayment Speed** Let  $CPR$  be the conditional prepayment rate, which is the annula rate at which a mortgage pool balance is assumed to be prepaid during the life of the pool. A mortgage pool's  $CPR$  issue a function of past prepayment rates and expected future economic conditions.

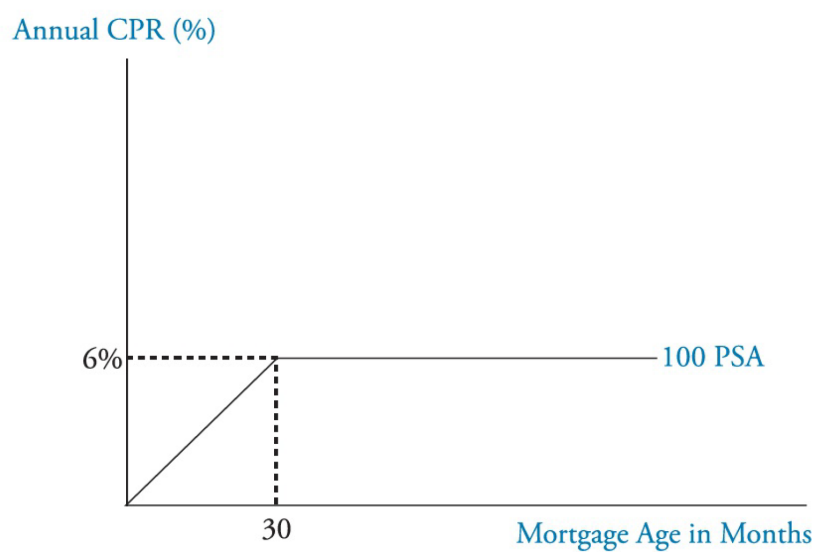
$$CPR = 1 - (1 - SMM)^{12}$$

where  $SMM$  is the single monthly mortality rate.

The PSA standard benchmark is referred to as 100% PSA (or just 100 PSA). 100 PSA (see [Figure 51.4](#)) assumes the following graduated CPRs for 30-year mortgages:

- CPR = 0.2% for the first month after origination, increasing by 0.2% per month up to 30 months. For example, the CPR in month 14 is  $14(0.2\%) = 2.8\%$ .
- CPR = 6% for months 30 to 360.

**Figure 51.4: 100 PSA**



Remember that the CPRs are expressed as annual rates.