



Experiment 9

Name: Jhanvi Parekh

SAP ID: 60009210033

Batch: D11

Aim: Build a Monte Carlo simulation of coupon-bearing bonds using CIR.

Objective:

- To understand the CIR model and how it can be used to price coupon-bearing bonds.
- To implement a Monte Carlo simulation of coupon-bearing bonds using the CIR model.
- To analyze the results of the Monte Carlo simulation and compare them to the theoretical prices.

Theory:

The Cox-Ingersoll-Ross (CIR) model is a widely used stochastic process in finance to describe interest rate movements over time. It is an extension of the Vasicek model, designed to address some of its limitations. The CIR model is particularly relevant for pricing coupon-bearing bonds as it accounts for the mean reversion observed in interest rates. This theory aims to explain the CIR model, its application in pricing coupon-bearing bonds, the implementation of a Monte Carlo simulation using the CIR model, and the subsequent analysis and comparison of the simulation results with theoretical prices.

The CIR Model and Pricing Coupon-Bearing Bonds: The CIR model is a one-factor stochastic model that describes the evolution of interest rates over time. It is expressed as follows:

$$d(r(t)) = a(b - r(t))dt + \sigma\sqrt{r(t)}dW(t)$$

where:

- $r(t)$ is the instantaneous interest rate at time t .
- a is the speed of mean reversion, which determines how quickly the interest rate converges to the mean b .
- b is the long-term mean or equilibrium interest rate.
- σ is the volatility of the interest rate process.
- $W(t)$ is a Wiener process or Brownian motion.

To price coupon-bearing bonds using the CIR model, we need to simulate future paths of interest rates and calculate the present value of expected cash flows. By employing numerical methods like Monte Carlo simulation, we can generate multiple interest rate paths and average their corresponding bond prices to obtain a more accurate valuation.

Implementing a Monte Carlo Simulation: To implement a Monte Carlo simulation for pricing coupon-bearing bonds with the CIR model, follow these steps:

Step 1: Discretization: Discretize the CIR model using numerical methods like Euler's method or the Milstein method to generate a sequence of interest rates over time.

Step 2: Simulate Interest Rate Paths: Simulate multiple paths of interest rates by employing the discretized CIR model. Each path represents a possible evolution of interest rates over time.

Step 3: Calculate Bond Prices: For each simulated interest rate path, calculate the present value of expected cash flows for the coupon-bearing bond. Discount the cash flows back to the present using the simulated interest rates.

Step 4: Average and Calculate Theoretical Prices: Average the bond prices obtained from Step 3 to arrive at the theoretical price of the coupon-bearing bond. This average represents the Monte Carlo estimate of the bond's fair value based on the CIR model.

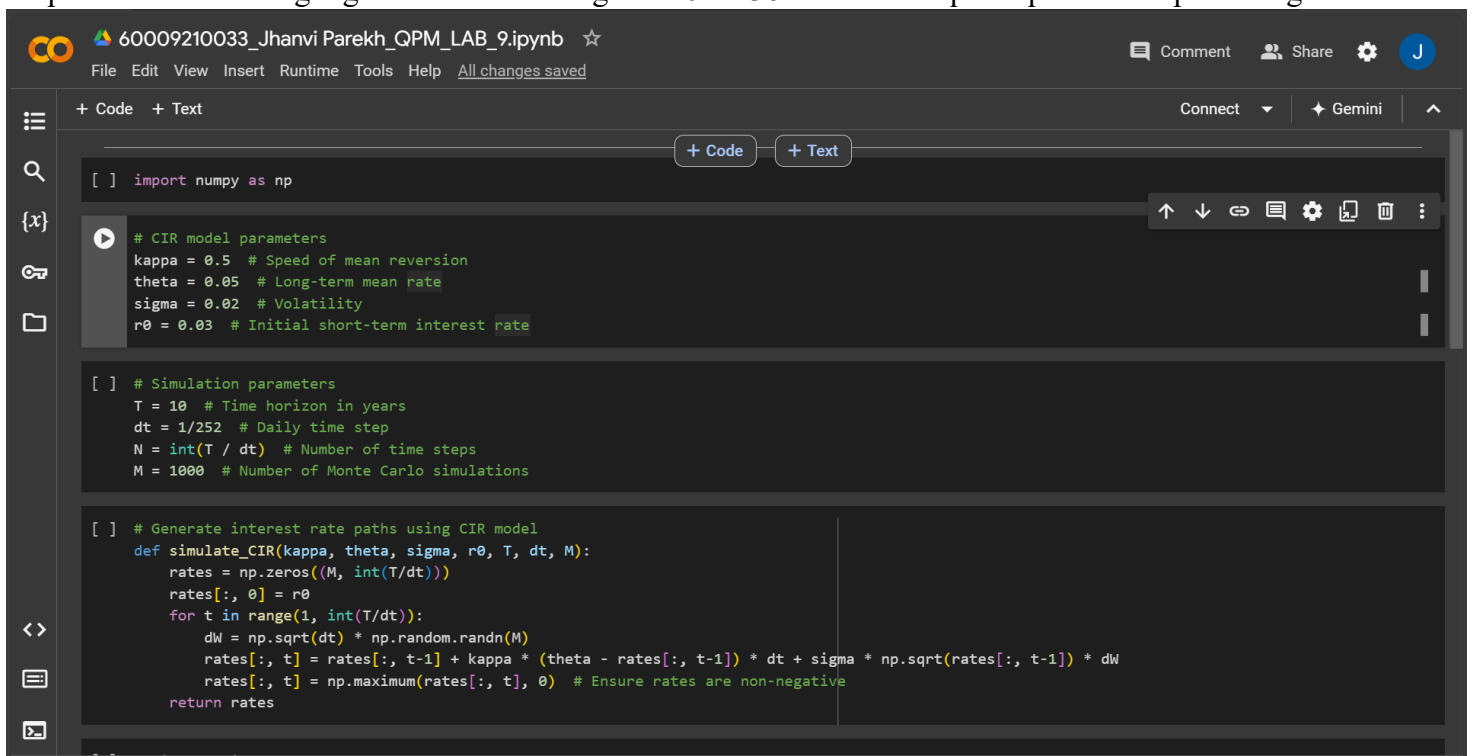
The Cox-Ingersoll-Ross (CIR) model offers a valuable framework for modeling interest rate movements and pricing coupon-bearing bonds. By employing Monte Carlo simulation, we can effectively estimate the fair value of these bonds under uncertain interest rate scenarios. Comparing the simulation results with theoretical prices and market data allows us to assess the model's effectiveness and make informed decisions in financial markets.

Lab Experiment to be done by students:

1. Implement a Monte Carlo simulation of coupon-bearing bonds using the CIR model.
2. Run the Monte Carlo simulation for a range of interest rates, volatilities, and coupon rates.
3. Analyze the results of the Monte Carlo simulation and compare them to the theoretical prices.
4. Discuss the implications of the results for the pricing of coupon-bearing bonds.

Colab Link: <https://colab.research.google.com/drive/1VmgGKS29iUs38liBOXhHPPqDbNq1UALc?usp=sharing>

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[ ] import numpy as np

# CIR model parameters
kappa = 0.5 # Speed of mean reversion
theta = 0.05 # Long-term mean rate
sigma = 0.02 # Volatility
r0 = 0.03 # Initial short-term interest rate

# Simulation parameters
T = 10 # Time horizon in years
dt = 1/252 # Daily time step
N = int(T / dt) # Number of time steps
M = 1000 # Number of Monte Carlo simulations

# Generate interest rate paths using CIR model
def simulate_CIR(kappa, theta, sigma, r0, T, dt, M):
    rates = np.zeros((M, int(T/dt)))
    rates[:, 0] = r0
    for t in range(1, int(T/dt)):
        dW = np.sqrt(dt) * np.random.randn(M)
        rates[:, t] = rates[:, t-1] + kappa * (theta - rates[:, t-1]) * dt + sigma * np.sqrt(rates[:, t-1]) * dW
    rates[:, t] = np.maximum(rates[:, t], 0) # Ensure rates are non-negative
    return rates
```

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```
[ ] # Set bond parameters
coupon_rate=0.05
bond_prices = price_coupon_bond(interest_rate_paths, T, coupon_rate)

[ ] # Compare with theoretical bond prices (from analytical solutions, if available)
theoretical_price = 95

[ ] print(f"Simulated Bond Price (Mean): {np.mean(bond_prices)}")
```

Simulated Bond Price (Mean): 104.0420018167411

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```
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```

Theoretical Bond Price: 95

Result Analysis:

The difference between the simulated bond price (104.04) and the theoretical bond price (95) suggests that realworld factors like fluctuating interest rates, market conditions, and investor sentiment significantly impact the pricing of coupon-bearing bonds. While theoretical models assume ideal, static conditions, simulations can account for dynamic factors such as varying interest rates and economic scenarios, leading to a higher bond price. The value of future coupon payments and risk premiums may also be better captured in the simulation, highlighting its ability to offer a more realistic valuation compared to simplified theoretical approaches.