



Interest Rate Cancelable Swap Valuation and Risk

FinPricing

Cancelable Swap

Summary

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- ◆ Bermudan Swaption Payoffs
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Cancelable Swap

Cancelable Swap Definition

- ◆ A cancelable swap gives the holder the right but not the obligation to cancel the swap at predetermined dates prior to maturity.
- ◆ It can be decomposed into a vanilla swap and a Bermudan swaption.
$$PV_{CancelablePayerSwap} = PV_{PayerSwap} - PV_{ReceiverBermudanSwaption}$$
$$PV_{CancelableReceiverSwap} = PV_{ReceiverSwap} - PV_{PayerBermudanSwaption}$$
- ◆ A vanilla swap is well understood. Hence we focus on Bermudan swaption for the rest of this presentation.
- ◆ A Bermudan swaption gives the holder the right but not the obligation to enter an interest rate swap at predefined dates.

Bermudan Swaption Payoffs

- ◆ At the maturity T , the payoff of a Bermudan swaption is given by

$$Payoff(T) = \max(0, V_{swap}(T))$$

where $V_{swap}(T)$ is the value of the underlying swap at T .

- ◆ At any exercise date T_i , the payoff of the Bermudan swaption is given by

$$Payoff(T_i) = \max(V_{swap}(T_i), I(T_i))$$

where $V_{swap}(T_i)$ is the exercise value of the Bermudan swap and $I(T_i)$ is the intrinsic value.

Model Selection Criteria

- ◆ Given the complexity of Bermudan swaption valuation, there is no closed form solution. Therefore, we need to select an interest rate term structure model and a numeric solution to price Bermudan swaptions numerically.
- ◆ The selection of interest rate term structure models
 - ◆ Popular interest rate term structure models:
Hull-White, Linear Gaussian Model (LGM), Quadratic Gaussian Model (QGM), Heath Jarrow Morton (HJM), Libor Market Model (LMM).
 - ◆ HJM and LMM are too complex.
 - ◆ Hull-White is inaccurate for computing sensitivities.
 - ◆ Therefore, we choose either LGM or QGM.

Model Selection Criteria (Cont)

- ◆ The selection of numeric approaches
 - ◆ After selecting a term structure model, we need to choose a numeric approach to approximate the underlying stochastic process of the model.
 - ◆ Commonly used numeric approaches are tree, partial differential equation (PDE), lattice and Monte Carlo simulation.
 - ◆ Tree and Monte Carlo are notorious for inaccuracy on sensitivity calculation.
 - ◆ Therefore, we choose either PDE or lattice.
- ◆ Our decision is to use LGM plus lattice.

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LGM Model

- ◆ The dynamics

$$dX(t) = \alpha(t)dW$$

where X is the single state variable and W is the Wiener process.

- ◆ The numeraire is given by

$$N(t, X) = (H(t)X + 0.5H^2(t)\zeta(t))/D(t)$$

- ◆ The zero coupon bond price is

$$B(t, X; T) = D(T)\exp(-H(t)X - 0.5H^2(t)\zeta(t))$$

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LGM Assumption

- ◆ The LGM model is mathematically equivalent to the Hull-White model but offers
 - ◆ Significant improvement of stability and accuracy for calibration.
 - ◆ Significant improvement of stability and accuracy for sensitivity calculation.
- ◆ The state variable is normally distributed under the appropriate measure.
- ◆ The LGM model has only one stochastic driver (one-factor), thus changes in rates are perfectly correlated.

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LGM calibration

- ◆ Match today's curve
At time $t=0$, $X(0)=0$ and $H(0)=0$. Thus $Z(0,0;T)=D(T)$. In other words, the LGM automatically fits today's discount curve.
- ◆ Select a group of market swaptions.
- ◆ Solve parameters by minimizing the relative error between the market swaption prices and the LGM model swaption prices.

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Valuation Implementation

- ◆ Calibrate the LGM model.
- ◆ Create the lattice based on the LGM: the grid range should cover at least 3 standard deviations.
- ◆ Calculate the underlying swap value at each final note.
- ◆ Conduct backward induction process iteratively rolling back from final dates until reaching the valuation date and also Compare exercise values with intrinsic values at each exercise date.
- ◆ The value at the valuation date is the price of the Bermudan swaption.

- ◆ The final value of the cancelable swap is given by

$$PV_{\text{CancelablePayerSwap}} = PV_{\text{PayerSwap}} - PV_{\text{ReceiverBermudanSwaption}}$$

$$PV_{\text{CancelableReceiverSwap}} = PV_{\text{ReceiverSwap}} - PV_{\text{PayerBermudanSwaption}}$$

Cancelable Swap

A real world example

cancelable swap definition		
Counterparty	xxx	
Buy or sell	Buy	
Payer or receiver	Payer	
Currency	USD	
Settlement	Physical	
Trade date	9/12/2012	
Underlying swap definition	Leg 1	Leg2
Day Count	dcAct360	dcAct360
Leg Type	Fixed	Float
Notional	250000	250000
Payment Frequency	1	1
Pay Receive	Receive	Pay
Start Date	9/14/2012	9/14/2012
End Date	9/14/2022	9/14/2022
Fix rate	0.0398	NA
Index Type	NA	LIBOR
Index Tenor	NA	1M
Index Day Count	NA	dcAct360
Exercise Schedules		
Exercise Type	Notification Date	Settlement Date
Call	1/12/2017	1/14/2017
Call	1/10/2018	1/14/2018



Thanks!



You can find more details at
<https://finpricing.com/faq.html>

