

CLOSED-FORM FORMULA PRICING

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Linear IRD – The building blocks

Zero coupon bonds:

- The basic building block is the ZC bond, its price is tractable under HW.
- Denoting x_t^j the value of x at (t, j) , the ZC price is:

$$P(t, T, x_t^j) = \frac{P^M(0, T)}{P^M(0, t)} \exp \left(A(t, T) - B(t, T) x_t^j \right)$$

- where:

$$B(t, T) = \frac{1 - e^{-a(T-t)}}{a}$$

$$A(t, T) = -\frac{1}{2} \theta(t) B(t, T)^2$$

- With $P^M(0, u) = e^{-R^M(0, u) \times u}$ is read from the market's curve.

LIBOR estimation:

- The value at (t, j) of LIBOR index with start date s , end date e and tenor δ can be deduced from the zero coupon prices:

$$\frac{P(t, s, x_t^j)}{P(t, e, x_t^j)} = 1 + \delta \times L(t, s, e, x_t^j) \Leftrightarrow L(t, s, e, x_t^j) = \frac{1}{\delta} \left(\frac{P(t, s, x_t^j)}{P(t, e, x_t^j)} - 1 \right)$$

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Linear IRD – Interest rates swaps

- These two building blocks give us the price of the IRS (e.g. received):

$$MV(t) = MV_{\text{fixed leg}}(t) - MV_{\text{floating leg}}(t)$$

- The fixed leg price is given by the keyword `IRFixedStream(amounts, payment_dates)`:

$$MV_{\text{fixed leg}}(t) = \sum_{k=1}^{\text{fixed flows}} \underbrace{N \times DCF_k \times SR}_{\text{amounts}} \times P(t, T_k^p)$$

- While the floating leg price is given by `IRLiborStream(amounts, payment_dates, libors_info, forward_curve)`:

$$MV_{\text{floating leg}}(t) = \sum_{k=1}^{\text{floating flows}} \underbrace{N \times DCF_k}_{\text{amounts}} \times L(t, T_{k-1}, T_k) \times P(t, T_k^p)$$

- For a vanilla IRS, two different curves can be involved:
 - $L(t, T_{k-1}, T_k)$ are computed using the forward estimation curve;
 - $P(t, T_k)$ are computed using the discount curve.



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Optional IRD – Options on ZC bond

Options on ZC bond:

- > In HW framework, The ZC bond price is lognormal;
- > As a result, the ZC bond option can be calculated analytically using Black formula using two inputs:

- The forward ZC bond price:

$$F(t, T_1, T_2) = \frac{P(t, T_2)}{P(t, T_1)}$$

- The forward ZC bond variance is given by:

$$\Sigma(t, T_1, T_2)^2 = B(T_1, T_2)^2 \int_t^{T_1} e^{-2a(T_1-u)} \sigma^2(u) du$$

- > The ZC bond option with strike K is then:

$$ZCBondOption = P(t, T_1) * BlackForward(F(t, T_1, T_2), \Sigma(t, T_1, T_2), K)$$

- Where:

$$BlackForward(F, \Sigma, K) = \eta FN(\eta d_+) - \eta KN(\eta d_-)$$

- N is the standard cumulative gaussian, η is a coefficient equal to 1 for a call and -1 for a put, and:

$$d_{\pm} = \frac{\ln\left(\frac{F}{K}\right)}{\Sigma} \pm \frac{\Sigma}{2}$$

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Optional IRD – Cap / Floors

Cap / Floors are strips of ZC bond call / put options:

- A cap / floor is a strip of caplets / floorlets.
- The value of each caplet, with fixing date T_f , payment date T_p , nominal N and strike K is:

$$MV(t) = N \times \delta \times \mathbb{E}^{\mathbb{Q}} \left[e^{-\int_t^{T_p} r(s) ds} (L(T_f, T_p) - K)^+ | \mathcal{F}_t \right]$$

■ Remark: this is the vanilla case where the **payment date** and the **libor end date** are the same.

- Switching to the T_f forward measure :

$$MV(t) = N \times \delta \times P(t, T_f) \times \mathbb{E}^{T_f} \left[P(T_f, T_p) (L(T_f, T_p) - K)^+ | \mathcal{F}_t \right]$$

Where $P(t, T)$ is the zero coupon using the discount curve.

- Replacing the LIBOR by its definition: $L(T_f, T_p) = \frac{1}{\delta} \left(\frac{1}{P^L(T_f, T_p)} - 1 \right)$ in the payoff leads to:

$$P(T_f, T_p) (L(T_f, T_p) - K)^+ = \frac{1}{\delta} \left(\frac{P(T_f, T_p)}{P^L(T_f, T_p)} - P(T_f, T_p) - \delta K P(T_f, T_p) \right)^+ = \frac{(1 + \delta K) P(0, T_p) P^L(0, T_f)}{\delta P(0, T_f) P^L(0, T_p)} \left(\frac{1}{1 + \delta K} - P^L(T_f, T_p) \right)^+$$

Where $P^D(t, T)$ is the zero coupon using the estimation curve (Libor curve).

- The caplet / floorlet is equivalent to $(1 + \delta K) \frac{P(0, T_p) P^L(0, T_f)}{P(0, T_f) P^L(0, T_p)}$ ZC bond put / call options, for which we have an analytic formula under HW:

$$MV(t) = N(1 + \delta K) \frac{P(0, T_p) P^L(0, T_f)}{P(0, T_f) P^L(0, T_p)} P(t, T_f) \text{BlackForwardPut} \left(F^L(t, T_f, T_p), \frac{1}{1 + \delta K}, \Sigma(t, T_f, T_p)^2 \right)$$

Where $F^L(t, T_1, T_2)$ is the forward zero coupon (using Libor curve) starting at T_1 and maturing at T_2 seen from date t .

EMEA



PARIS

MUREX S.A.S.
15 Boulevard de l'Amiral
Bruix
75116 Paris, France
Tel + 33 1 44 05 32 00



BEIRUT

MUREX Systems
Kantari Corner Center
14th floor Fakhreddine Street
Mina El Hosn
Beirut, Lebanon
Tel + 961 1 356 000



NEW YORK

MUREX North America
810 Seventh Avenue
Floor 14, New York,
NY10019 - USA
Tel + 1 212 381 4300



SINGAPORE

MUREX Southeast Asia
Marina Bay Financial Center Tower 2
10 Marina Boulevard #19-01
Singapore 018983
Tel + 65 6216 02 88

Contact



murex.com



linkedin.com/company/murex



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