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A Commentary by Harley Bassman:

The Convexity Maven

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Value Concepts from the Credit Suisse Trading Desk
August 27, 2013

"The FVA: Forward Volatility Agreement"

Explained in full replicative detail **by Danielle N. Mohney**

Summary:

A Forward Volatility Agreement (FVA) is a forward on a vanilla swaption straddle. The buyer agrees to purchase a straddle on a specified date (the strike date) for a price that is determined today. The option becomes a standard option on strike date and is struck at the usual ISDA fixing time at the then current ATM forward rate.

Keeping the option "unstruck" until strike date gives the buyer concentrated and relatively constant exposure to Implied Volatility while mitigating exposure to the usually tricky delta, gamma, and theta inherent in a standard option. Thus, the FVA demands reduced management for a user wishing to hedge, or take a view on, changes in implied volatility. The FVA uniquely offers the risk management tool of *"Volatility as an Asset Class"*.

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A Case Study Example: An investor believes that implied volatility looks cheap but does not have a strong view on the near-term actual volatility of interest rates. Moreover, he does not care to manage the "greek risk" inherent in owning options. Via an FVA, the investor can buy a six-month forward option on 1y10y (aka 6m1y10y) at XYZbps.

Today (T_0): Customer commits to buy a 1y10y straddle in 6m for a price of XYZbps.

Strike date ($T_{0.5}$): At the standard ISDA fixing time, the straddle is struck at the ATM forward rate. The Customer then has a few choices. He can be delivered a vanilla 1y10y straddle by paying the XYZbps premium as a "regular way" purchase. He can then hold the position or he can sell it at any time to Credit Suisse (or to another counter-party via an assignment). In the alternative, he can "cash settle" the contract with Credit Suisse versus the bid-side of the market. If this bid-side price is above his contracted price, the Customer is paid the difference, if it is lower, the Customer pays Credit Suisse. In this latter format, the FVA is a reduced management financial tool that can be employed to buy pure *"Volatility as an Asset Class"*.

Expiry date ($T_{1.5}$): If the Customer elects to take delivery and hold the option until the final expiry date, he will exercise the payer or receiver side of the straddle into a 10y swap on this date. The swap will settle "regular way", t+2 from the expiry date.

Maturity date ($T_{11.5}$): The swap matures.

A Challenge: The FVA Replication Process

As a forward rate can be (mostly) replicated with spot rates, an FVA can be (partially) replicated using vanilla options. As such, it would be helpful to review the replication of forward rates.

The 1y10y rate, for example, can be replicated with 1y and 11y rates. One can gain a short exposure to the forward rate by paying the 11y rate and receiving the 1y rate, DV01-weighted using the following property:

$$DV01_{1,10} * r_{1,10} = DV01_{11} * r_{11} - DV01_1 * r_1$$

Thus, one could replicate the exposure of paying 100k/bp of the 1y10y rate by doing the following trades:

- Pay $DV01_{11}/DV01_{1,10}$ * 100k/bp of the 11y rate
- Rec $DV01_1/DV01_{1,10}$ * 100k/bp of the 1y rate

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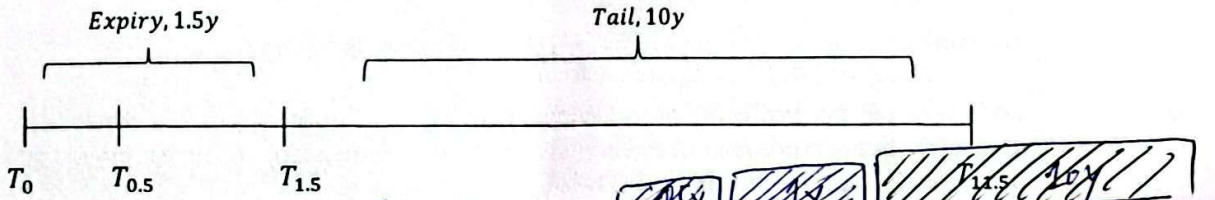
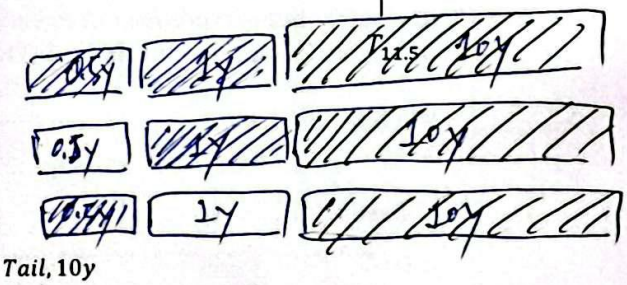
To replicate the FVA, we need to buy the variance from T_0 to $T_{1.5}$ and sell back the variance from T_0 to $T_{0.5}$ (we are locking in the expected diffusion of the rate from $T_{0.5}$, when the option is struck, to $T_{1.5}$, when it expires).

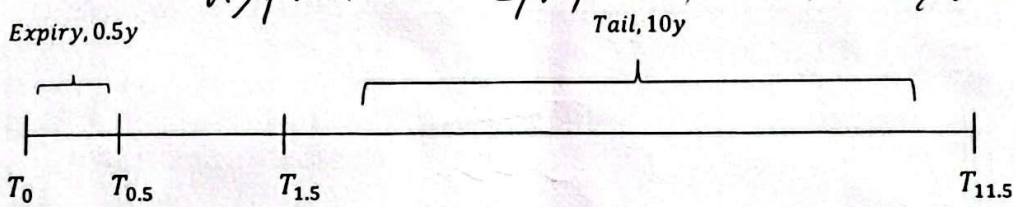
To do this, we buy a 1.5y10y straddle and sell a 0.5y expiry option on the same rate. This second option is an option on a forward rate – a 0.5y option on the 1y10y rate. An option on a forward rate is known as an (almost) vanilla "mid-curve" option.

A graphical explanation might be helpful. We buy 1.5y into10y:

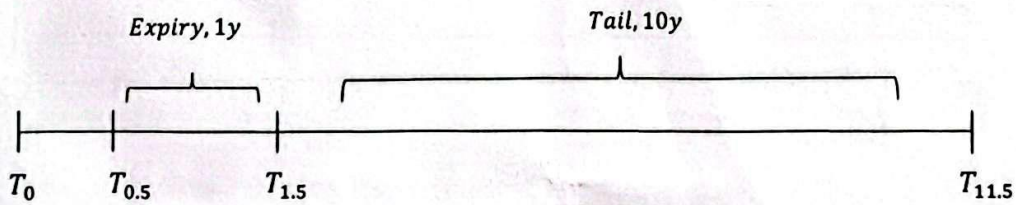




And sell 0.5y into the 1y10y forward rate:



To gain exposure to 1y10y swaption vol, 6m forward:



As such, one can gain exposure to 100k/nv of 6m forward 1y10y by doing the following:

-Buy 160k/nv 18m10y
-Sell 60k/nv 6m expiry options on the 1y10y rate (6m1y10y mid-curve)

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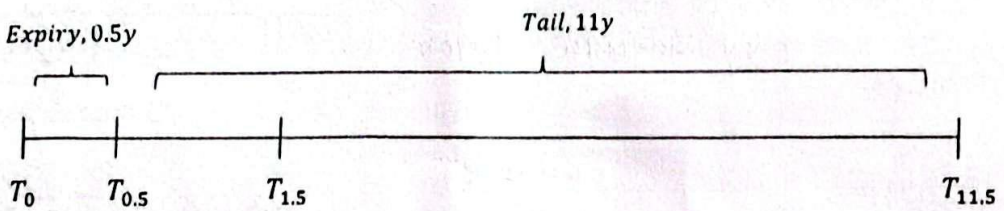
There is slippage here due to stochastic volatility and skew effects since these options are struck at a fixed-strike determined at T_0, while the FVA has no fixed-strike before the Strike Date. This is the most complete replication we can achieve without more exotic options. (The calculations for the ratios above are discussed in the Appendix of this primer.) **NOTE: The critical "value add" for the FVA product is that it can never be "fully replicated" via a limited series of fixed-strike options.**

We have now reduced the trade to two struck options; a vanilla option and an option on a forward rate (mid-curve option).

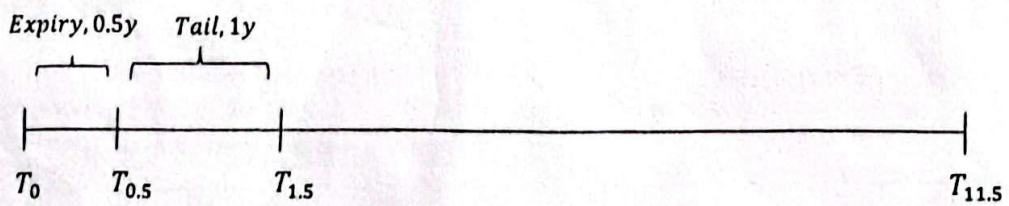
We can (approximately) replicate the mid-curve with vanilla options as well.

Let's consider the profile of the mid-curve option again. Replication of this profile is analogous to the replication of forward swaps previously detailed. To mimic the exposure of the 6m1y10y mid-curve option:

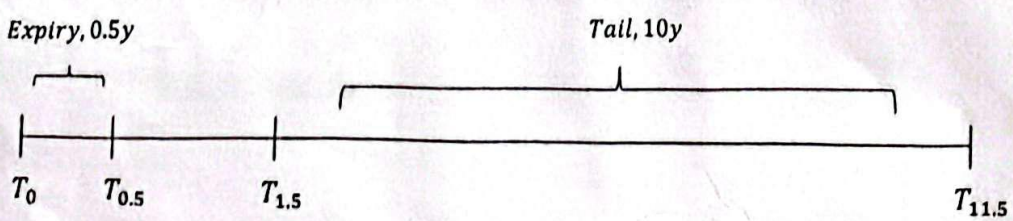
We buy 6m11y:



And sell 6m1y:



Leaving us with exposure to the 6m1y10y mid-curve:



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Thus, one can approximately replicate a -60k/nv exposure on the 6m1y10y mid-curve by:

-Sell 66k/nv 6m11y
-Buy 6k/nv 6m1y

This vanilla replication is an approximation as it fails to incorporate the correlation exposure from the mid-curve. (This too will be addressed in the Appendix.)

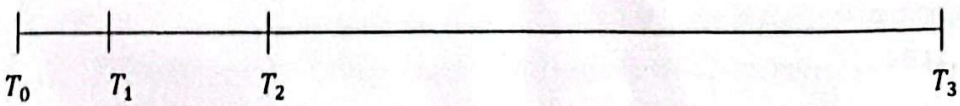
In summary, we have developed an intuitive framework for the pricing of a Forward Volatility Agreement. As per our example of buying a 6m1y10y FVA, we have effectively created a long position in 18m10y (our predominant exposure), a short position in 6m11y, and a long position in 6m1y. While this is not a closed-form solution, it does capture the main risk vectors and identifies the general risk structure. The Appendix will now further detail the mathematics behind this replication process.

Appendix

For readers with backgrounds in other asset classes who are not accustomed to seeing normal volatility, we include a brief note on the topic. We measure the diffusion process in terms of absolute changes (basis point moves in the forward rate), signifying $r_t - r_{t-1} \sim N(\mu, \sigma^2)$. Thus, σ is notation for the standard deviation of absolute changes in the forward rate, in basis points per year.

Calculating the Implied Forward Volatility of the FVA

We generalize our framework below.



We define an FVA as a straddle that is struck at time T_1 and expires on T_2 into a swap that matures on T_3. The mid-curve in our replication is struck on T_0, expiring on T_1 into a swap starting on T_2 and maturing on T_3.

As variance is proportional to time, it follows that:

$$(T_2 - T_1)\sigma_{FVA}^2 = (T_2 - T_0)\sigma_{T_2,T_3}^2 - (T_1 - T_0)\sigma_{MC}^2$$

Target on same swap
no correlation needed

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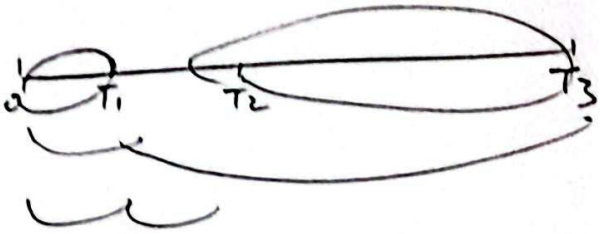

The implied volatility of the mid-curve can be calculated using the DV01-weighted spread option formula. If $DV01_{T1,T2}$ is the DV01 of a swap that starts on T_1 and matures on T_2:

$$\sigma_{MC} = \sqrt{\frac{DV01^2_{T1,T3}\sigma^2_{T1,T3} + DV01^2_{T1,T2}\sigma^2_{T1,T2} - 2\rho_{(T1,T3),(T1,T2)}DV01_{T1,T3}\sigma_{T1,T3}DV01_{T1,T2}\sigma_{T1,T2}}{DV01^2{}_{T2,T3}}}$$

The only variable that is not readily transparent in the market is the implied correlation between the T_1, T_2 and T_1, T_3 rates. One could calculate this level using historical delivered correlation, or back out the market implied correlation from a T_1 expiry option on the $T_3 - T_1, T_2 - T_1$ spread. Practically, the forward volatility of the mid-curve trades above the level implied using a correlation of one (partially because this replication approach ignores skew effects that give value to the forward volatility.)

Using the above formulas, we can calculate the implied forward volatility using only vanilla options and the DV01s of the forwards:

$$\sigma_{FVA} = \sqrt{\frac{(T_2 - T_0)\sigma^2_{T_2,T_1} - (T_1 - T_0)\frac{DV01^2_{T1,T3}\sigma^2_{T1,T3} + DV01^2_{T1,T2}\sigma^2_{T1,T2} - 2\rho_{(T1,T3),(T1,T2)}DV01_{T1,T3}\sigma_{T1,T3}DV01_{T1,T2}\sigma_{T1,T2}}{DV01^2{}_{T2,T3}}}{T_2 - T_1}}$$

Vega Calculations:

The price of the FVA is equal to:

$$P_{FVA} = \sqrt{\frac{2}{\pi}}\sqrt{T_2 - T_1}\,\sigma_{FVA}\;DV01_{T2,T3}\,(1 + \frac{r_{T0,T1}}{2})^{2(T_1 - T_0)}$$

Thus, the vega is:

$$\frac{\partial P_{FVA}}{\partial \sigma_{FVA}} = \sqrt{\frac{2}{\pi}}\sqrt{T_2 - T_1}\;DV01_{T2,T3}\,(1 + \frac{r_{T0,T1}}{2})^{2(T_1 - T_0)}$$

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Using the chain rule, we can calculate the sensitivity of the normal volatility to a change in implied normal volatility of the vanilla and the mid-curve:

$$\frac{\partial \sigma_{FVA}}{\partial \sigma_{T2,T3}} = \frac{1}{2}\sqrt{\frac{T_2 - T_1}{(T_2 - T_0)\sigma_{2,3}^2 - (T_1 - T_0)\sigma_{MC}^2}}\ \frac{2(T_2 - T_0)\sigma_{2,3}}{T_2 - T_1}$$

$$\frac{\partial \sigma_{FVA}}{\partial \sigma_{MC}} = \frac{1}{2}\sqrt{\frac{T_2 - T_1}{(T_2 - T_0)\sigma_{2,3}^2 - (T_1 - T_0)\sigma_{MC}^2}}\ \frac{2(T_1 - T_0)\sigma_{MC}}{T_2 - T_1}$$

Thus, the normal vega is:

$$\frac{\partial P_{FVA}}{\partial \sigma_{T2,T3}} = \frac{1}{2}\sqrt{\frac{T_2 - T_1}{(T_2 - T_0)\sigma_{2,3}^2 - (T_1 - T_0)\sigma_{MC}^2}}\ \frac{2(T_2 - T_0)\sigma_{2,3}}{T_2 - T_1}\sqrt{\frac{2}{\pi}} * \sqrt{T_2 - T_1} * DV01_{T2,T3} * (1 + \frac{r_{T0,T1}}{2})^{2(T_1 - T_0)}$$

$$\frac{\partial P_{FVA}}{\partial \sigma_{MC}} = \frac{1}{2}\sqrt{\frac{T_2 - T_1}{(T_2 - T_0)\sigma_{2,3}^2 - (T_1 - T_0)\sigma_{MC}^2}}\ \frac{2(T_1 - T_0)\sigma_{MC}}{T_2 - T_1}\sqrt{\frac{2}{\pi}} * \sqrt{T_2 - T_1} * DV01_{T2,T3} * (1 + \frac{r_{T0,T1}}{2})^{2(T_1 - T_0)}$$

We apply the same logic to generate vega sensitivities of the vanillas to replicate the mid-curve option:

$$\frac{\partial \sigma_{MC}}{\partial \sigma_{T1,T3}} = \frac{1}{2}\frac{1}{\sqrt{DV01_{T1,T3}^2\sigma_{T1,T3}^2 + DV01_{T1,T2}^2\sigma_{T1,T2}^2 - 2\rho_{(T1,T3),(T1,T2)}DV01_{T1,T3}\sigma_{T1,T3}DV01_{T1,T2}\sigma_{T1,T2}}}\ \frac{2DV01_{T1,T3}^2\sigma_{T1,T3} - 2\rho_{(T1,T3),(T1,T2)}DV01_{T1,T3}DV01_{T1,T2}\sigma_{T1,T2}}{DV01_{T2,T3}}$$

$$\frac{\partial \sigma_{MC}}{\partial \sigma_{T1,T2}} = \frac{1}{2}\frac{1}{\sqrt{DV01_{T1,T3}^2\sigma_{T1,T3}^2 + DV01_{T1,T2}^2\sigma_{T1,T2}^2 - 2\rho_{(T1,T3),(T1,T2)}DV01_{T1,T3}\sigma_{T1,T3}DV01_{T1,T2}\sigma_{T1,T2}}}\ \frac{2DV01_{T1,T3}^2\sigma_{T1,T2} - 2\rho_{(T1,T3),(T1,T2)}DV01_{T1,T3}DV01_{T1,T2}\sigma_{T1,T3}}{DV01_{T2,T3}}$$

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$$\frac{\partial P_{MC}}{\partial \sigma_{T1,T3}} = \frac{1}{2} \frac{1}{\sqrt{DV01^2_{T1,T3}\sigma^2_{T1,T3} + DV01^2_{T1,T2}\sigma^2_{T1,T2} - 2\rho_{(T1,T3),(T1,T2)}DV01_{T1,T3}\sigma_{T1,T3}DV01_{T1,T2}\sigma_{T1,T2}}} \frac{2DV01^2_{T1,T3}\sigma_{T1,T3} - 2\rho_{(T1,T3),(T1,T2)}DV01_{T1,T3}DV01_{T1,T2}\sigma_{T1,T2}}{DV01_{T2,T3}} \sqrt{\frac{2}{\pi}} * \sqrt{T_1 - T_0} * DV01_{T2,T3}$$

$$\frac{\partial P_{MC}}{\partial \sigma_{T1,T2}} = \frac{1}{2} \frac{1}{\sqrt{DV01^2_{T1,T3}\sigma^2_{T1,T3} + DV01^2_{T1,T2}\sigma^2_{T1,T2} - 2\rho_{(T1,T3),(T1,T2)}DV01_{T1,T3}\sigma_{T1,T3}DV01_{T1,T2}\sigma_{T1,T2}}} \frac{2DV01^2_{T1,T2}\sigma_{T1,T2} - 2\rho_{(T1,T3),(T1,T2)}DV01_{T1,T3}DV01_{T1,T2}\sigma_{T1,T3}}{DV01_{T2,T3}} \sqrt{\frac{2}{\pi}} * \sqrt{T_1 - T_0} * DV01_{T2,T3}$$

An Example: 6m1y10y

We return to our initial example: A Customer would like to purchase 100k/nv exposure to a 6m1y10y FVA.

At this rate level, the DV01 of the 18m10y rate is 8.6, that's equivalent to approximately 146mm notional of the FVA.

Let's make the following volatility surface assumptions: The normal volatility for the 6m1y is 37bp, the 6m11y is 99bp, the 1y10y is 100bp, and the 18m10y is 99bp. Additionally, the DV01 of the 6m1y is 1.0 and the DV01 of 6m11y is 9.6. For simplicity, we use a 6-month discount factor of one. Finally, we assume a correlation of one for the mid-curve.

Using these assumptions, the normal volatility of the 6m1y10y mid-curve is 107bp; where $\frac{\partial \sigma_{FVA}}{\partial \sigma_{18m10y}}$ is 1.6 and $\frac{\partial \sigma_{FVA}}{\partial \sigma_{MC}}$ is 0.6. So for a 100k/nv exposure FVA, we need to buy 160k 18m10y and sell 60k of the 6m1y10y mid-curve. Since $\frac{\partial P_{18m10y}}{\partial \sigma_{18m10y}}$ is 8.4bp, we need to buy 186mm 18m10y. We calculate that $\frac{\partial P_{MC}}{\partial \sigma_{MC}}$ is 4.9bp, so we need to sell 116mm of the mid-curve.

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This leads to the ultimate value added proposition – when the Spot Implied Volatility of a 1y10y is trading at 100nv, a client can purchase it six months forward at 95nv, a 5% discount to the spot level.

On a practical note, we should highlight that most clients trade notionally neutral in the vanilla and the mid-curve fixed-strike options when attempting a replication. While this is fine for a terminal replication, it does not match the actual vega exposure of the FVA at inception; as such, there can be considerable mark-to-market variation.

If you have fully absorbed this appendix and sample application, we look forward to helping you duplicate our modeling process. If instead you have just paged to the end looking to see if we have any new colors to offer, we will just close by reminding you that the FVA is a truly special product in that it allows an investor to gain exposure to *Volatility as an Asset Class* (executed on your existing ISDA) without the need to engage in a costly and complicated "replication process".

In a nutshell, the FVA is just plain old-fashioned Financial Engineering in the classic manner of traditional Wall Street.

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Managing Smile Risk

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Abstract

Market smiles and skews are usually managed by using local volatility models *a la* Dupire. We discover that the dynamics of the market smile predicted by local vol models is opposite of observed market behavior: when the price of the underlying decreases, local vol models predict that the smile shifts to higher prices; when the price increases, these models predict that the smile shifts to lower prices. Due to this contradiction between model and market, delta and vega hedges derived from the model can be unstable and may perform worse than naive Black-Scholes' hedges.

To eliminate this problem, we derive the *SABR* model, a stochastic volatility model in which the forward value satisfies

$$d\hat{F} = \hat{\alpha}\hat{F}^{\beta}\, dW_1$$
$$d\hat{\alpha} = \nu\hat{\alpha}\, dW_2$$

and the forward $\hat{F}$ and volatility $\hat{\alpha}$ are correlated: $dW_1 dW_2 = \rho dt$. We use singular perturbation techniques to obtain the prices of European options under the SABR model, and from these prices we obtain explicit, closed-form algebraic formulas for the implied volatility as functions of today's forward price $f = \hat{F}(0)$ and the strike K. These formulas immediately yield the market price, the market risks, including *vanna* and *volga* risks, and show that the SABR model captures the correct dynamics of the smile. We apply the SABR model to USD interest rate options, and find good agreement between the theoretical and observed smiles.

Key words. smiles, skew, dynamic hedging, stochastic vols, volga, vanna

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1 Introduction

European options are often priced and hedged using Black's model, or, equivalently, the Black-Scholes model. In Black's model there is a one-to-one relation between the price of a European option and the volatility parameter σ_B. Consequently, option prices are often quoted by stating the *implied volatility* σ_B, the unique value of the volatility which yields the option's dollar price when used in Black's model. In theory, the volatility σ_B in Black's model is a constant. In practice, options with different strikes K require different volatilities σ_B to match their market prices. See figure 1. Handling these market *skews* and *smiles* correctly is critical to fixed income and foreign exchange desks, since these desks usually have large exposures across a wide range of strikes. Yet the inherent contradiction of using different volatilities for different options makes it difficult to successfully manage these risks using Black's model.

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The development of *local volatility models* by Dupire [2], [3] and Derman-Kani [4], [5] was a major advance in handling smiles and skews. Local volatility models are self-consistent, arbitrage-free, and can be calibrated to precisely match observed market smiles and skews. Currently these models are the most popular way of managing smile and skew risk. However, as we shall discover in section 2, the *dynamic* behavior of smiles and skews predicted by local vol models is exactly *opposite* the behavior observed in the marketplace: when the price of the underlying asset *decreases*, local vol models predict that the smile shifts to *higher* prices; when the price *increases*, these models predict that the smile shifts to *lower* prices. In reality, asset prices and market smiles move in the *same* direction. This contradiction between the model and the marketplace tends to de-stabilize the delta and vega hedges derived from local volatility models, and often these hedges perform worse than the naive Black-Scholes' hedges.

To resolve this problem, we derive the SABR model, a stochastic volatility model in which the asset price and volatility are correlated. Singular perturbation techniques are used to obtain the prices of European options under the SABR model, and from these prices we obtain a closed-form algebraic formula for the implied volatility as a function of today's forward price f and the strike K. This closed-form formula for the implied volatility allows the market price and the market risks, including *vanna* and *volga* risks, to be obtained immediately from Black's formula. It also provides good, and sometimes spectacular, fits to the implied volatility curves observed in the marketplace. See Figure 1.1. More importantly, the formula shows that the SABR model captures the correct dynamics of the smile, and thus yields stable hedges.

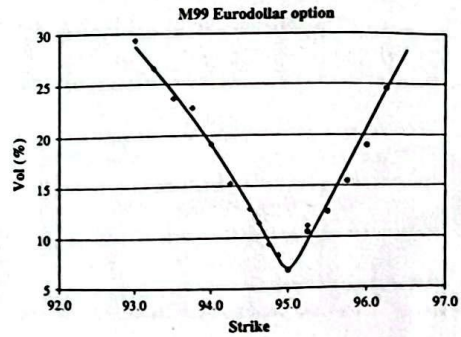

Fig. 1.1 Implied volatility for the June 99 Eurodollar options. Shown are close-of-day values along with the volatilities predicted by the SABR model. Data taken from Bloomberg information services on March 23, 1999

2 Reprise

Consider a European call option on an asset $\mathcal{A}$ with *exercise date* t_{ex}, *settlement date* t_{set}, and *strike* K. If the holder exercises the option on t_{ex}, then on the settlement date t_{set} he receives the underlying asset $\mathcal{A}$ and pays the strike K. To derive the value of the option, define $\hat{A}(t)$ to be the forward price of the asset for a forward contract that matures on the settlement date t_{set}, and define $f = \hat{A}(0)$ to be today's forward price. Also let $D(t)$ be the *discount factor* for date t; that is, let $D(t)$ be the value today of \$1 to be delivered on date t. Martingale pricing theory [6-9] asserts that under the "usual conditions," there is a measure, known as the forward measure, under which the value of a European option can be written as the expected value of the payoff. The value of a call options is

$$V_{call} = D(t_{set})\, E\left\{[\hat{A}(t_{ex}) - K]^+ \,|\, \mathfrak{F}_0\right\}. \tag{2.1a}$$

and the value of the corresponding European put is

$$\begin{aligned} V_{put} &= D(t_{set})\, E\left\{[K - \hat{F}(t_{ex})]^+ \,|\, \mathfrak{F}_0\right\} \\ &= V_{call} + D(t_{set})[K - f]. \end{aligned} \tag{2.1b}$$

Here the expectation E is over the forward measure, and "$|\mathfrak{F}_0$" can be interpretted as "given all information available at $t = 0$." Martingale pricing theory [6-9] also shows that the forward price $\hat{F}(t)$ is a Martingale under this measure, so the Martingale representation theorem shows that $\hat{F}(t)$ obeys

$$d\hat{F} = C(t, *)\, dW, \qquad \hat{F}(0) = f, \tag{2.1c}$$

for some coefficient $C(t, *)$, where dW is Brownian motion in this measure. The coefficient $C(t, *)$ may be deterministic or random, and may depend on any information that can be resolved by time t. This is as far as the fundamental theory of arbitrage free pricing goes. In particular, one cannot determine the coefficient $C(t, *)$ on purely theoretical grounds. Instead one must postulate a mathematical *model* for $C(t, *)$.

European swaptions fit within an indentical framework. Consider a European swaption with exercise date t_{ex} and fixed rate (strike) R_{fix}. Let $\hat{R}_s(t)$ be the swaption's forward swap rate as seen at date t, and let $R_0 = \hat{R}_s(0)$ be the forward swap rate as seen today. In [9] Jamshidean shows that one can choose a measure in which the value of a payer swaption is

$$V_{pay} = L_0 E\left\{[\hat{R}_s(t_{ex}) - R_{fix}]^+ \,|\, \mathcal{F}_0\right\}, \tag{2.2a}$$

and the value of a receiver swaption is

$$\begin{aligned} V_{rec} &= L_0 E\left\{[R_{fix} - \hat{R}_s(t_{ex})]^+ \,|\, \mathcal{F}_0\right\} \\ &= V_{pay} + L_0[R_{fix} - R_0]. \end{aligned} \tag{2.2b}$$

Here the *level* L_0 is today's value of the annuity, which is a known quantity, and E is the expectation over the *level measure* of Jamshidean [9]. In Appendix A it is also shown that the PV01 of the forward swap; like the

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discount factor rate $\hat{R}_r(t)$ is a Martingale in this measure, so once again

$$d\hat{R}_r = C(t, *)\, dW, \qquad \hat{R}_r(0) = R_0, \tag{2.2c}$$

where dW is Brownian motion. As before, the coefficient $C(t, *)$ may be deterministic or random, and cannot be determined from fundamental theory. Apart from notation, this is identical to the framework provided by equations (2.1a–2.1c) for European calls and puts. Caplets and floorlets can also be included in this picture, since they are just one period payer and receiver swaptions. For the remainder of the paper, we adopt the notation of (2.1a–2.1c) for general European options.

2.1 Black's model and implied volatilities. To go any further requires postulating a model for the coefficient $C(t, *)$. In [10], Black postulated that the coefficient $C(t, *)$ is $\sigma_B \hat{F}(t)$, where the *volatilty* σ_B is a constant. The forward price $\hat{F}(t)$ is then geometric Brownian motion:

$$d\hat{F} = \sigma_B \hat{F}(t)\, dW, \qquad \hat{F}(0) = f. \tag{2.3}$$

Evaluating the expected values in (2.1a, 2.1b) under this model then yields Black's formula,

$$V_{call} = D(t_{set})[fN(d_1) - KN(d_2)], \tag{2.4a}$$

$$V_{put} = V_{call} + D(t_{set})[K - f], \tag{2.4b}$$

where

$$d_{1,2} = \frac{\log f/K \pm \frac{1}{2}\sigma_B^2 t_{ex}}{\sigma_B \sqrt{t_{ex}}}, \tag{2.4c}$$

for the price of European calls and puts, as is well-known [10], [11], [12].

All parameters in Black's formula are easily observed, except for the volatility σ_B. An option's *implied volatility* is the value of σ_B that needs to be used in Black's formula so that this formula matches the market price of the option. Since the call (and put) prices in (2.4a – 2.4c) are increasing functions of σ_B, the volatility σ_B implied by the market price of an option is unique. Indeed, in many markets it is standard practice to quote prices in terms of the implied volatility σ_B; the option's dollar price is then recovered by substituting the agreed upon σ_B into Black's formula.

The derivation of Black's formula presumes that the volatility σ_B is a constant for each underlying asset A. However, the implied volatility needed to match market prices nearly always varies with both the strike K and the time-to-exercise t_{ex}. See Figure 2.1. Changing the volatility σ_B means that a *different* model is being used for the underlying asset for each K and t_{ex}. This causes several problems managing large books of options.

The first problem is pricing exotics. Suppose one needs to price a call option with strike K_1 which has, say, a down-and-out knock-out at $K_2 < K_1$. Should we use the implied volatility at the call's strike K_1, the implied volatility at the barrier K_2, or some combination of the two to price this option? Clearly, this option cannot be priced without a single, self-consistent, model that works for all strikes without "adjustments."

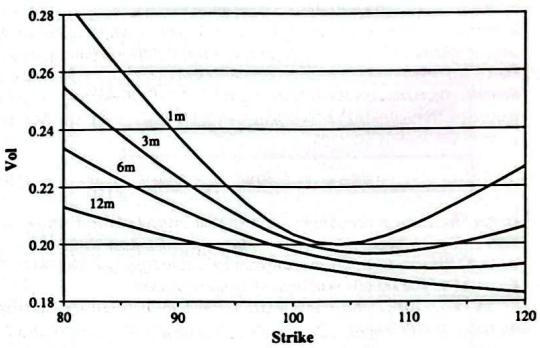

Fig. 2.1 Implied volatility $\sigma_B(K)$ as a function of the strike K for 1 month, 3 month, 6 month, and 12 month European options on an asset with forward price 100.

The second problem is hedging. Since *different* models are being used for *different* strikes, it is not clear that the delta and vega risks calculated at one strike are consistent with the same risks calculated at other strikes. For example, suppose that our 1 month option book is long high strike options with a total Δ risk of $+\$1MM$, and is long low strike options with a Δ of $-\$1MM$. Is our is our option book really Δ-neutral, or do we have residual delta risk that needs to be hedged? Since different models are used at each strike, it is not clear that the risks offset each other. Consolidating vega risk raises similar concerns. Should we assume parallel or proportional shifts in volatility to calculate the total vega risk of our book? More explicitly, suppose that σ_B is 20% at $K = 100$ and 24% at $K = 90$, as shown for the 1m options in Figure 2.1 Should we calculate vega by bumping σ_B by, say, 0.2% for both options? Or by bumping σ_B by 0.2% for the first option and by 0.24% for the second option? These questions are critical to effective book management, since this requires consolidating the delta and vega risks of *all* options on a given asset before hedging, so that only the net exposure of the book is hedged. Clearly one cannot answer these questions without a model that works for all strikes K.

The third problem concerns evolution of the implied volatility curve $\sigma_B(K)$. Since the implied volatility σ_B depends on the strike K, it is likely to also depend on the current value f of the forward price: $\sigma_B = \sigma_B(f, K)$. In this case there would be systematic changes in σ_B as the forward price f of the underlying changes See Figure 2.1. Some of the vega risks of Black's model would actually be due to changes in the price of the underlying asset, and should be hedged more properly (and cheaply) as delta risks.

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2.2 Local volatility models. An apparent solution to these problems is provided by the local volatility model of Dupire [2], which is also attributed to Derman [4], [5]. In an insightful work, Dupire essentially argued that Black was to bold in setting the coefficient $C(t, *)$ to $\sigma_B \hat{F}$. Instead one should only assume that C is Markovian: $C = C(t, \hat{F})$. Re-writing $C(t, \hat{F})$ as $\sigma_{loc}(t, \hat{F})\hat{F}$ then yields the "local volatility model," where the forward price of the asset is

$$d\hat{F} = \sigma_{loc}(t, \hat{F})\hat{F}dW, \qquad \hat{F}(0) = f, \tag{2.5a}$$

in the forward measure. Dupire argued that instead of theorizing about the unknown local volatility function $\sigma_{loc}(t, \hat{F})$, one should obtain $\sigma_{loc}(t, \hat{F})$ directly from the marketplace by "calibrating" the local volatility model to market prices of liquid European options.

In calibration, one starts with a given local volatility function $\sigma_{loc}(t, \hat{F})$, and evaluates

$$V_{call} = D(t_{set})\, E\left\{[\hat{F}(t_{ex}) - K]^+ | \hat{F}(0) = f\right\} \tag{2.5b}$$

$$\equiv V_{put} + D(t_{set})(f - K) \tag{2.5c}$$

to obtain the theoretical prices of the options; one then varies the local volatility function $\sigma_{loc}(t, \hat{F})$ until these theoretical prices match the actual market prices of the option for each strike K and exercise date t_{ex}. In practice liquid markets usually exist only for options with specific exercise dates $t^1_{ex}, t^2_{ex}, t^3_{ex}, \ldots$; for example, for 1m, 2m, 3m, 6m, and 12m from today. Commonly the local vols $\sigma_{loc}(t, \hat{F})$ are taken to be piecewise constant in time:

$$\begin{aligned} \sigma_{loc}(t, \hat{F}) &= \sigma^{(1)}_{loc}(\hat{F}) && \text{for } t < t^1_{ex}, \\ \sigma_{loc}(t, \hat{F}) &= \sigma^{(j)}_{loc}(\hat{F}) && \text{for } t^{j-1}_{ex} < t < t^j_{ex} \qquad j = 2, 3, \ldots J \\ \sigma_{loc}(t, \hat{F}) &= \sigma^{(J)}_{loc}(\hat{F}) && \text{for } t > t^J_{ex} \end{aligned} \tag{2.6}$$

One first calibrates $\sigma^{(1)}_{loc}(\hat{F})$ to reproduce the option prices at t^1_{ex} for all strikes K, then calibrates $\sigma^{(2)}_{loc}(\hat{F})$ to reproduce the option prices at t^2_{ex}, for all K, and so forth. This calibration process can be greatly simplified by using the results in [13] and [14]. There we solve to obtain the prices of European options under the local volatility model (2.5a–2.5c), and from these prices we obtain explicit algebraic formulas for the implied volatility of the local vol models.

Once $\sigma_{loc}(t, \hat{F})$ has been obtained by calibration, the local volatility model is a single, self-consistent model which correctly reproduces the market prices of calls (and puts) for all strikes K and exercise dates t_{ex} without "adjustment." Prices of exotic options can now be calculated from this model without ambiguity. This model yields consistent delta and vega risks for all options, so these risks can be consolidated across strikes. Finally, perturbing f and re-calculating the option prices enables one to determine how the implied volatilites change with changes in the underlying asset price. Thus, the local volatility model thus provides *a* method of pricing and hedging options in the presence of market smiles and skews. It is perhaps the most popular method of managing exotic equity and foreign exchange options. Unfortunately, the local volatility model predicts the *wrong dynamics* of the implied volatility curve, which leads to inaccruate and often unstable hedges.

To illustrate the problem, consider the special case in which the local vol is a function of $\hat{F}$ only:

$$d\hat{F} = \sigma_{loc}(\hat{F})\hat{F}dW, \qquad \hat{F}(0) = f. \tag{2.7}$$

In [13] and [14] singular perturbation methods were used to analyze this model. There it was found that European call and put prices are given by Black's formula (2.4a-2.4c) with the implied volatility

$$\sigma_B(K, f) = \sigma_{loc}\left(\frac{1}{2}[f + K]\right)\left\{1 + \frac{1}{24}\frac{\sigma''_{loc}(\frac{1}{2}[f + K])}{\sigma_{loc}(\frac{1}{2}[f + K])}(f - K)^2 + \cdots\right. . \tag{2.8}$$

On the right hand side, the first term dominates the solution and the second term provides a much smaller correction The omitted terms are very small, usually less than 1% of the first term.

The behavior of local volatility models can be largely understood by examining the first term in (2.8). The implied volatility depends on both the strike K and the current forward price f. So supppose that today the forward price is f_0 and the implied volatility curve seen in the marketplace is $\sigma^0_B(K)$. Calibrating the model to the market clearly requires choosing the local volatility to be

$$\sigma_{loc}(\hat{F}) = \sigma^0_B(2\hat{F} - f_0)\{1 + \cdots\}. \tag{2.9}$$

Now that the model is calibrated, let us examine its predictions. Suppose that the forward value changes from f_0 to some new value f. From (2.8), (2.9) we see that the model predicts that the new implied volatility curve is

$$\sigma_B(K, f) = \sigma^0_B(K + f - f_0)\{1 + \cdots\} \tag{2.10}$$

for an option with strike K, given that the current value of the forward price is f. In particular, if the forward price f_0 *increases* to f, the implied volatility curve moves to the *left*; if f_0 *decreases* to f, the implied volatility curve moves to the *right*. *Local volatility models predict that the market smile/skew moves in the* opposite *direction as the price of the underlying asset.* This is opposite to typical market behavior, in which smiles and skews move in the *same* direction as the underlying.

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To demonstrate the problem concretely, suppose that today's implied volatility is a perfect smile

$$\sigma_B^0(K) = \alpha + \beta[K - f_0]^2 \tag{2.11a}$$

around today's forward price f_0. Then equation (2.8) implies that the local volatility is

$$\sigma_{loc}(\hat{F}) = \alpha + 3\beta(\hat{F} - f_0)^2 + \cdots. \tag{2.11b}$$

As the forward price f evolves away from f_0 due to normal market fluctuations, equation (2.8) predicts that the implied volatility is

$$\sigma_B(K, f) = \alpha + \beta\left[K - \left(\tfrac{3}{2}f_0 - \tfrac{1}{2}f\right)\right]^2 + \tfrac{3}{4}\beta(f - f_0)^2 + \cdots. \tag{2.11c}$$

The implied volatility curve not only moves in the opposite direction as the underlying, but the curve also shifts upward regardless of whether f increases or decreases. Exact results are illustrated in Figures 2.2 – 2.4. There we assumed that the local volatility $\sigma_{loc}(\hat{F})$ was given by (2.11b), and used finite difference methods to obtain essentially exact values for the option prices, and thus implied volatilites.

Hedges calculated from the local volatility model are wrong. To see this, let $BS(f, K, \sigma_B, t_{ex})$ be Black's formula (2.4a–2.4c) for, say, a call option. Under the local volatility model, the value of a call option is given by Black's formula

$$V_{call} = BS(f, K, \sigma_B(K, f), t_{ex}) \tag{2.12a}$$

with the volatility $\sigma_B(K, f)$ given by (2.8). Differentiating with respect to f yields the Δ risk

$$\Delta \equiv \frac{\partial V_{call}}{\partial f} = \frac{\partial BS}{\partial f} + \frac{\partial BS}{\partial \sigma_B}\frac{\partial \sigma_B(K, f)}{\partial f}. \tag{2.12b}$$

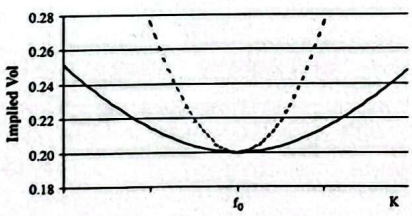

Fig. 2.2 Exact implied volatility $\sigma_B(K, f_0)$ (solid line) obtained from the local volatility $\sigma_{loc}(\hat{F})$ (dashed line):

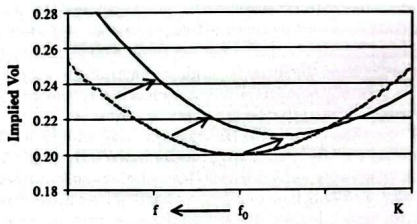

Fig. 2.3 Implied volatility $\sigma_B(K, f)$ if the forward price *decreases* from f_0 to f (solid line).

predicted by the local volatility model. The first term is clearly the Δ risk one would calculate from Black's model using the implied volatility from the market. The second term is the local volatility model's correction to the Δ risk, which consists of the Black vega risk multiplied by the *predicted* change in σ_B due to changes in the underlying forward price f. In real markets the implied volatily moves in the *opposite* direction as the direction predicted by the model. Therefore, the correction term needed for real markets should have the *opposite sign* as the correction predicted by the local volatility model. *The original Black model yields more accurate hedges than the local volatility model, even though the local vol model is self-consistent across strikes and Black's model is inconsistent.*

Local volatility models are also peculiar theoretically. Using any function for the local volatility $\sigma_{loc}(t, \hat{F})$ *except* for a power law,

$$C(t, *) = \alpha(t)\,\hat{F}^{\beta}, \tag{2.13}$$

$$\sigma_{loc}(t, \hat{F}) = \alpha(t)\,\hat{F}^{\beta}/\hat{F} = \alpha(t)\,/\hat{F}^{1-\beta}, \tag{2.14}$$

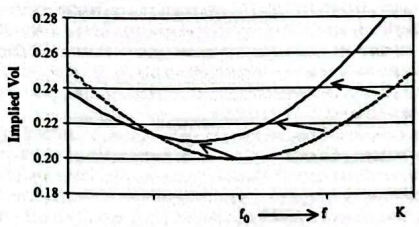

Fig. 2.4 Implied volatility $\sigma_B(K, f)$ if the forward prices *increases* from f_0 to f (solid line).

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introduces an intrinsic "length scale" for the forward price $\hat{F}$ into the model. That is, the model becomes inhomogeneous in the forward price $\hat{F}$. Although intrinsic length scales are theoretically possible, it is difficult to understand the financial origin and meaning of these scales [15], and one naturally wonders whether such scales should be introduced into a model without specific theoretical justification.

2.3 The SABR model. The failure of the local volatility model means that we cannot use a Markovian model based on a single Brownian motion to manage our smile risk. Instead of making the model non-Markovian, or basing it on non-Brownian motion, we choose to develop a two factor model. To select the second factor, we note that most markets experience both relatively quiescent and relatively chaotic periods. This suggests that volatility is not constant, but is itself a random function of time. Respecting the preceding discusion, we choose the unknown coefficient $C(t, *)$ to be $\hat{\alpha}\hat{F}^{\beta}$, where the "volatility" $\hat{\alpha}$ is itself a stochastic process. Choosing the simplest reasonable process for $\hat{\alpha}$ now yields the "stochastic-$\alpha\beta\rho$ model," which has become known as the *SABR model*. In this model, the forward price and volatility are

$$d\hat{F} = \hat{\alpha}\hat{F}^{\beta}\, dW_1, \qquad \hat{F}(0) = f \tag{2.15a}$$

$$d\hat{\alpha} = \nu\hat{\alpha}\, dW_2, \qquad \hat{\alpha}(0) = \alpha \tag{2.15b}$$

under the forward measure, where the two processes are correlated by:

$$dW_1\, dW_2 = \rho dt. \tag{2.15c}$$

Many other stochastic volatility models have been proposed, for example [16], [17], [18], [19]. However, the SABR model has the virtue of being the simplest stochastic volatility model which is homogenous in $\hat{F}$ and $\hat{\alpha}$. We shall find that the SABR model can be used to accurately fit the implied volatility curves observed in the marketplace for any single exercise date t_{ex}. More importantly, it predicts the correct dynamics of the implied volatility curves. This makes the SABR model an effective means to manage the smile risk in markets where each asset only has a single exercise date; these markets include the swaption and caplet/floorlet markets.

As written, the SABR model may or may not fit the observed *volatility surface* of an asset which has European options at several different exercise dates; such markets include foreign exchange options and most equity options. Fitting volatility surfaces requires the *dynamic SABR model* which is discussed in an Appendix.

It has been claimed by many authors that stochastic volatility models are models of incomplete markets, because the stochastic volatility risk cannot be hedged. This is not true. It is true that the risk to changes in $\hat{\alpha}$ (the vega risk) cannot be hedged by buying or selling the underlying asset. However, vega risk can be hedged by buying or selling options on the asset in exactly the same way that Δ-hedging is used to neutralize the risks to changes in the price $\hat{F}$. In practice, vega risks are hedged by buying and selling options as a matter of routine, so whether the market would be complete if these risks were not hedged is a moot question.

The SABR model (2.15a–2.15c) is analyzed in Appendix B. There singular perturbation techniques are used to obtain the prices of European options. From these prices, the options' implied volatility $\sigma_B(K, f)$ is then obtained. The upshot of this analysis is that under the SABR model, the price of European options is given by Black's formula,

$$V_{call} = D(t_{ex})\{fN(d_1) - KN(d_2)\}, \tag{2.16a}$$

$$V_{put} = V_{call} + D(t_{ex})[K - f], \tag{2.16a}$$

with

$$d_{1,2} = \frac{\log f/K \pm \frac{1}{2}\sigma_B^2 t_{ex}}{\sigma_B\sqrt{t_{ex}}}, \tag{2.16c}$$

where the implied volatility $\sigma_B(f, K)$ is given by

$$\begin{aligned}\sigma_B(K, f) &= \frac{\alpha}{(fK)^{(1-\beta)/2}\left\{1 + \frac{(1-\beta)^2}{24}\log^2 f/K + \frac{(1-\beta)^4}{1920}\log^4 f/K + \cdots\right\}} \cdot \left(\frac{z}{x(z)}\right) \\ &\cdot \left\{1 + \left[\frac{(1-\beta)^2}{24}\frac{\alpha^2}{(fK)^{1-\beta}} + \frac{1}{4}\frac{\rho\beta\nu\alpha}{(fK)^{(1-\beta)/2}} + \frac{2-3\rho^2}{24}\nu^2\right] t_{ex} + \cdots.\right.\end{aligned} \tag{2.17a}$$

Here

$$z = \frac{\nu}{\alpha}(fK)^{(1-\beta)/2}\log f/K, \tag{2.17b}$$

and $x(z)$ is defined by

$$x(z) = \log\left\{\frac{\sqrt{1 - 2\rho z + z^2} + z - \rho}{1 - \rho}\right\}. \tag{2.17c}$$

For the special case of at-the-money options, options struck at $K = f$, this formula reduces to

$$\begin{aligned}\sigma_{ATM} = \sigma_B(f, f) = \frac{\alpha}{f^{(1-\beta)}}\Bigg\{1 + \Bigg[\frac{(1-\beta)^2}{24}\frac{\alpha^2}{f^{2-2\beta}} \\ + \frac{1}{4}\frac{\rho\beta\alpha\nu}{f^{(1-\beta)}} + \frac{2-3\rho^2}{24}\nu^2\Bigg] t_{ex} + \cdots.\end{aligned} \tag{2.18}$$

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These formulas are the main result of this paper. Although it appears formidable, the formula is explicit and only involves elementary trignometric functions. Implementing the SABR model for vanilla options is very easy, since once this formula is programmed, we just need to send the options to a Black pricer. In the next section we examine the qualitative behavior of this formula, and how it can be used to managing smile risk.

The complexity of the formula is needed for accurate pricing. Omitting the last line of (2.17a), for example, can result in a relative error that exceeds three per cent in extreme cases. Although this error term seems small, it is large enough to be required for accurate pricing. The omitted terms "$+\cdots$" are *much, much* smaller. Indeed, even though we have derived more accurate expressions by continuing the perturbation expansion to higher order, (2.17a – 2.17c) is the formula we use to value and hedge our vanilla swaptions, caps, and floors. We have not implemented the higher order results, believing that the increased precision of the higher order results is superfluous.

There are two special cases of note: $\beta = 1$, representing a stochastic log normal model), and $\beta = 0$, representing a stochastic normal model. The implied volatility for these special cases is obtained in the last section of Appendix B.

3 Managing Smile Risk

The complexity of the above formula for $\sigma_B(K,f)$ obscures the qualitative behavior of the SABR model. To make the model's phenomenology and dynamics more transparent, note that formula (2.17a – 2.17c) can be approximated as

$$\sigma_B(K,f) = \frac{\alpha}{f^{1-\beta}}\left\{1 - \frac{1}{2}(1-\beta-\rho\lambda)\log K/f + \frac{1}{12}\left[(1-\beta)^2 + (2-3\rho^2)\lambda^2\right]\log^2 K/f + \cdots,\right. \tag{3.1a}$$

provided that the strike K is not too far from the current forward f. Here the ratio

$$\lambda = \frac{\nu}{\alpha} f^{1-\beta} \tag{3.1b}$$

measures the strength ν of the volatility of volatility (the "volvol") compared to the local volatility $\alpha/f^{1-\beta}$ at the current forward. Although equations (3.1a–3.1b) should not be used to price real deals, they are accurate enough to depict the qualitative behavior of the SABR model faithfully.

As f varies during normal trading, the curve that the ATM volatility $\sigma_B(f,f)$ traces is known as the *backbone*, while the *smile* and *skew* refer to the implied volatility $\sigma_B(K,f)$ as a function of strike K for a fixed f. That is, the market smile/skew gives a snapshot of the market prices for different strikes K at a given instance, when the forward f has a specific price. Figures 3.1 and 3.2. show the dynamics of the smile/skew predicted by the SABR model.

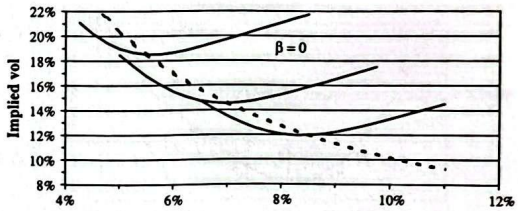

Fig. 3.1 Backbone and smiles for $\beta = 0$. As the forward f varies, the implied volatiliity $\sigma_B(f,f)$ of ATM options traverses the backbone (dashed curve). Shown are the smiles $\sigma_B(K,f)$ for three different values of the forward. Volatility data from 1 into 1 swaption on 4/28/00, courtesy of Cantor-Fitzgerald.

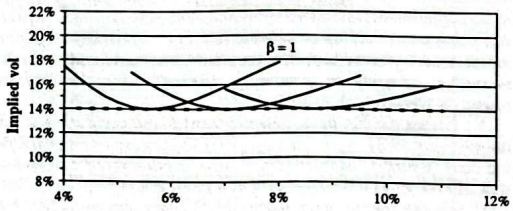

Fig. 3.2 Backbone and smiles as above, but for $\beta = 1$.

Let us now consider the implied volatility $\sigma_B(K,f)$ in detail. The first factor $\alpha/f^{1-\beta}$ in (3.1a(is the implied volatility for at-the-money (ATM) options, options whose strike K equals the current forward f. So the backbone traversed by ATM options is essentially $\sigma_B(f,f) = \alpha/f^{1-\beta}$ for the SABR model. The backbone is almost entirely determined by the exponent β, with the exponent $\beta = 0$ (a stochastic Gaussian model) giving a steeply downward sloping backbone, and the exponent $\beta = 1$ giving a nearly flat backbone.

The second term $-\frac{1}{2}(1-\beta-\rho\lambda)\log K/f$ represents the skew, the slope of the implied volatility with respect to the strike K. The $-\frac{1}{2}(1-\beta)\log K/f$ part is the *beta skew*, which is downward sloping since $0 \le \beta \le 1$. It arises because the "local volatility" $\hat{\alpha}\hat{F}^{\beta}/\hat{F}^{1} = \hat{\alpha}/\hat{F}^{1-\beta}$ is a decreasing function of the forward price. The second part $\frac{1}{2}\rho\lambda\log K/f$ is the *vanna* skew, the skew caused by the correlation between the volatility and the asset price. Typically the volatility and asset price are negatively correlated, so on average, the volatility α would decrease (increase) when the forward f increases (decreases). It thus seems unsurprising that a negative correlation ρ causes a downward sloping vanna skew.

It is interesting to compare the skew to the slope of the backbone. As f changes to f' the ATM vol changes to

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$$\sigma_B(f',f') = \frac{\alpha}{f'^{1-\beta}}\left\{1-(1-\beta)\frac{f'-f}{f}+\cdots\right\}. \tag{3.2a}$$

Near $K=f$, the β component of skew expands as

$$\sigma_B(K,f) = \frac{\alpha}{f^{1-\beta}}\left\{1-\frac{1}{2}(1-\beta)\frac{K-f}{f}+\cdots\right\}. \tag{3.2b}$$

so the slope of the backbone $\sigma_B(f,f)$ is twice as steep as the slope of rthe smile $\sigma_B(K,f)$ due to the β-component of the skew.

The last term in (3.1a) also contains two parts. The first part $\frac{1}{12}(1-\beta)^2\log^2 K/f$ appears to be a smile (quadratic) term, but it is dominated by the downward sloping beta skew, and, at reasonable strikes K, it just modifies this skew somewhat. The second part $\frac{1}{12}(2-3\rho^2)\lambda^2\log^2 K/f$ is the smile induced by the *volga* (vol-gamma) effect. Physically this smile arises because of "adverse selection": unusually large movements of the forward $\hat{F}$ happen more often when the volatility α increases, and less often when α decreases, so strikes K far from the money represent, on average, high volatility environments.

3.1 Fitting market data. The exponent β and correlation ρ affect the volatility smile in similar ways. They both cause a downward sloping skew in $\sigma_B(K,f)$ as the strike K varies. From a single market snapshot of $\sigma_B(K,f)$ as a function of K at a given f, it is difficult to distinguish between the two parameters. This is demonstrated by figure 3.3. There we fit the SABR parameters α, ρ, ν with $\beta=0$ and then re-fit the parameters α, ρ, ν with $\beta=1$. Note that there is no substantial difference in the quality of the fits, despite the presence of market noise. This matches our general experience: market smiles can be fit equally well with any specific value of β. In particular, β cannot be determined by fitting a market smile since this would clearly amount to "fitting the noise."

Figure 3.3 also exhibits a common data quality issue. Options with strikes K away from the current forward f trade less frequently than at-the-money and near-the-money options. Consequently, as K moves away from f, the volatility quotes become more suspect because they are more likely to be out-of-date and not represent bona fide offers to buy or sell options.

Suppose for the moment that the exponent β is known or has been selected. Taking a snapshot of the market yields the implied volatility $\sigma_B(K,f)$ as a function of the strike K at the current forward price f. With β given, fitting the SABR model is a straightforward procedure. The three parameters α, ρ, and ν have different effects on the curve: the parameter α mainly controls the overall height of the curve, changing the correlation ρ controls the curve's skew, and changing the vol of vol ν controls how much smile the curve exhibits. Because of the widely seperated roles these parameters play, the fitted parameter values tend to be very stable, even in the presence of large amounts of market noise.

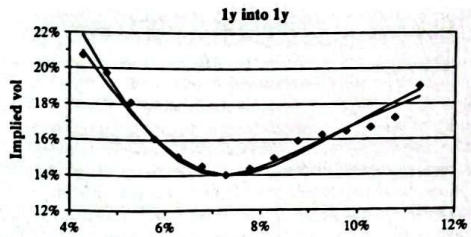

Fig. 3.3 Implied volatilities as a function of strike. Shown are the curves obtained by fitting the SABR model with exponent $\beta=0$ and with $\beta=1$ to the 1y into 1y swaption vol observed on 4/28/00. As usual, both fits are equally good. Data courtesy of Cantor-Fitzgerald.

The exponent β can be determined from historical observations of the "backbone" or selected from "aesthetic considerations." Equation (2.18) shows that the implied volatility of ATM options is

$$\log\sigma_B(f,f) = \log\alpha-(1-\beta)\log f+\log\left\{1+\left[\frac{(1-\beta)^2}{24}\frac{\alpha^2}{f^{2-2\beta}}+\frac{1}{4}\frac{\rho\beta\alpha\nu}{f^{(1-\beta)}}+\frac{2-3\rho^2}{24}\nu^2\right]t_{ex}+\cdots\right\} \tag{3.3}$$

The exponent β can be extracted from a log log plot of historical observations of f, σ_{ATM} pairs. Since both f and α are stochastic variables, this fitting procedure can be quite noisy, and as the $[\cdots]t_{ex}$ term is typically less than one or two per cent, it is usually ignored in fitting β.

Selecting β from "aesthetic" or other *a priori* considerations usually results in $\beta=1$ (stochastic lognormal), $\beta=0$ (stochastic normal), or $\beta=\frac{1}{2}$ (stochastic CIR) models. Proponents of $\beta=1$ cite log normal models as being "more natural," or believe that the horizontal backbone best represents their market. These proponents often include desks trading foreign exchange options. Proponents of $\beta=0$ usually believe that a normal model, with its symmetric break-even points, is a more effective tool for managing risks, and would claim that $\beta=0$ is essential for trading markets like Yen interest rates, where the forwards f can be negative or near zero. Proponents of $\beta=\frac{1}{2}$ are usually US interest rate desks that have developed trust in CIR models.

It is usually more convenient to use the at-the-money volatility $\sigma_{ATM}, \beta, \rho$, and ν as the SABR parameters instead of the original parameters α, β, ρ, ν. The parameter α is then found whenever needed by inverting (2.18) on the fly; this inversion is numerically easy since the $[\cdots]t_{ex}$ term is small. With this parameterization, fitting the SABR model requires fitting ρ and ν to the implied volatility curve, with σ_{ATM} and β given. In many markets, the ATM volatilities need to be updated frequently, say once or twice a day, while the smiles and skews need to be

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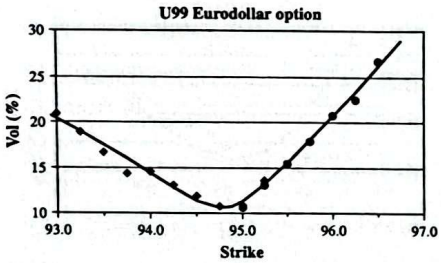

Fig.3.4 Volatility of the Sep 99 EDF options

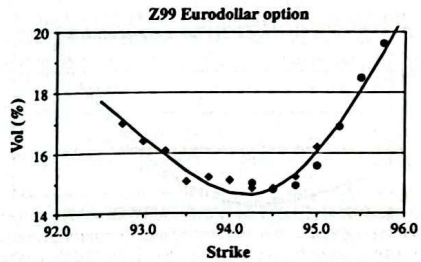

Fig. 3.5 Volatility of the Dec 99 EDF options

updated infrequently, say once or twice a month. With the new parameterization, σ_{ATM} can be updated as often as needed, with ρ, ν (and β) updated only as needed.

Let us apply SABR to options on US dollar interest rates. There are three key groups of European options on US rates: Eurodollar future options, caps/floors, and European swaptions. Eurodollar future options are exchange-traded options on the 3 month Libor rate; like interest rate futures, EDF options are quoted on $100(1 - r_{Libor})$. Figure 1.1 fits the SABR model (with $\beta = 1$) to the implied volatility for the June 99 contracts, and figures 3.4–3.7 fit the model (also with $\beta = 1$) to the implied volatility for the September 99, December 99, and March 00 contracts. All prices were obtained from Bloomberg Information Services on March 23, 1999. Two points are shown for the same strike where there are quotes for both puts and calls. Note that market liquidity dries up for the later contracts, and for strikes that are too far from the money. Consequently, more market noise is seen for these options.

Caps and floors are sums of caplets and floorlets; each caplet and floorlet is a European option on the 3 month Libor rate. We do not consider the cap/floor market here because the broker-quoted cap prices must be "stripped" to obtain the caplet volatilities before SABR can be applied.

A *m year into n year* swaption is a European option with m years to the exercise date (the maturity); if it is exercised, then one receives an n year swap (the tenor, or underlying) on the 3 month Libor rate. See Appendix A. For almost all maturities and tenors, the US swaption market is liquid for at-the-money swaptions, but is ill-liquid for swaptions struck away from the money. Hence, market data is somewhat suspect for swaptions that are not struck near the money. Figures 3.8–3.11 fits the SABR model (with $\beta = 1$) to the prices of m into5Y swaptions observed on April 28, 2000. Data supplied courtesy of Cantor-Fitzgerald.

We observe that the smile and skew depend heavily on the time-to-exercise for Eurodollar future options and swaptions. The smile is pronounced for short-dated options and flattens for longer dated options;

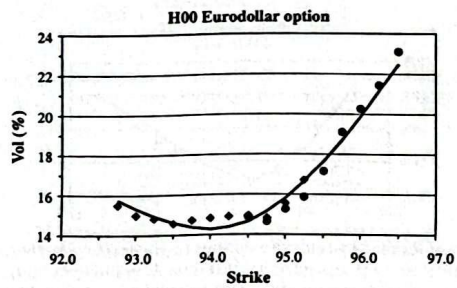

Fig. 3.6 Volatility of the Mar 00 EDF options

the skew is overwhelmed by the smile for short-dated options, but is important for long-dated options. This picture is confirmed tables 3.1 and 3.2. These tables show the values of the vol of vol ν and correlation ρ obtained by fitting the smile and skew of each "m into n" swaption, again using the data from April 28, 2000. Note that the vol of vol ν is very high for short dated options, and decreases as the time-to-exercise increases, while the correlations starts near zero and becomes substantially negative. Also note that there is little dependence of the market skew/smile on the length of the underlying swap; both ν and ρ are fairly constant across each row. This matches our general experience: in most markets there is a strong smile for short-dated options which relaxes as the time-to-expiry increases; consequently the volatility of volatility ν is large for short dated options and smaller for long-dated options, regardless of the particular underlying. Our experience with correlations is less clear: in some markets a nearly flat skew for short maturity options develops into a strongly downward sloping skew for longer maturities. In other markets there is a strong downward skew for all option maturities, and in still other markets the skew is close to zero for all maturities.

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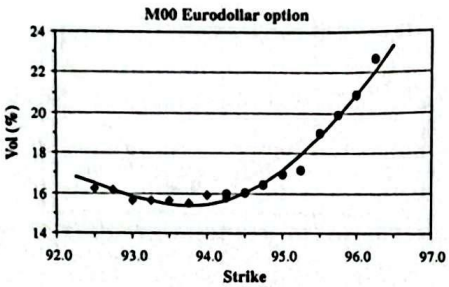

Fig. 3.7 Volatility of the Jun 00 EDF options

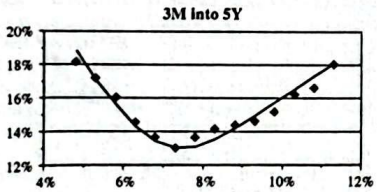

Fig. 3.8 Volatilities of 3 month into 5 year swaption

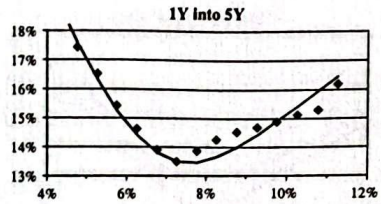

Fig. 3.9 Volatilities of 1 year into 1 year swaptions

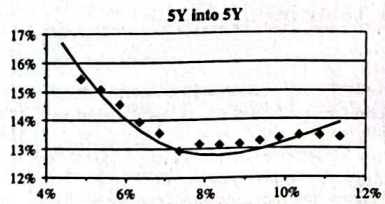

Fig. 3.10 Volatilities of 5 year into 5 year swaptions

3.2. Managing smile risk. After choosing β and fitting ρ, ν, and either α or σ_{ATM}, the SABR model

$$d\hat{F} = \hat{\alpha}\hat{F}^{\beta}\, dW_1, \qquad \hat{F}(0) = f \tag{3.4a}$$

$$d\hat{\alpha} = \nu\hat{\alpha}\, dW_2, \qquad \hat{\alpha}(0) = \alpha \tag{3.4b}$$

with

$$dW_1\, dW_2 = \rho\, dt \tag{3.4c}$$

fits the smiles and skews observed in the market quite well, especially considering the quality of price quotes away from the money. Let us take for granted that it fits well enough. Then we have a single, self-consistent model that fits the option prices for all strikes K without "adjustment," so we can use this model to price exotic options without ambiguity. The SABR model also predicts that whenever the forward price f changes, the the implied volatility curve shifts in the *same* direction and by the *same* amount as the price f. This predicted dynamics of the smile matches market experience. If $\beta < 1$, the "backbone" is downward sloping, so the shift in the implied volatility curve is not purely horizontal. Instead, this curve shifts up and down as the at-the-money point traverses the backbone. Our experience suggests that the parameters ρ and ν are very stable (β is assumed to be a given constant), and need to be re-fit only every few weeks. This stability may be because the SABR model reproduces the usual dynamics of smiles and skews. In contrast, the at-the-money volatility σ_{ATM}, or, equivalently, α may need to be updated every few hours in fast-paced markets.

Since the SABR model is a single self-consistent model for all strikes K, the risks calculated at one strike are consistent with the risks calculated at other strikes. Therefore the risks of all the options on the same asset can be added together, and only the residual risk needs to be hedged.

Let us set aside the Δ risk for the moment, and calculate the other risks. Let $BS(f, K, \sigma_B, t_{ex})$ be Black's formula (2.4a–2.4c) for, say, a call option. According to the SABR model, the value of a call is

$$V_{call} = BS(f, K, \sigma_B(K, f), t_{ex}) \tag{3.5}$$

where the volatility $\sigma_B(K, f) \equiv \sigma_B(K, f; \alpha, \beta, \rho, \nu)$ is given by equations (2.17a–2.17c). Differentiating@ footnote:{In practice risks are calculated by finite differences: valuing the option at α, re-valuing the option after

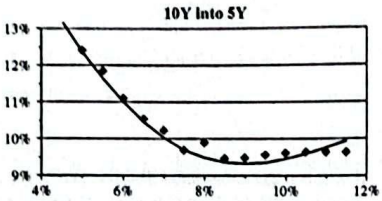

Fig. 3.11 Volatilities of 10 year into 5 year options

TABLE 3.1
VOLATILITY OF VOLATILITY ν FOR EUROPEAN SWAPTIONS. ROWS ARE TIME–TO–EXERCISE; COLUMNS ARE TENOR OF THE UNDERLYING SWAP.

	1Y	2Y	3Y	4Y	5Y	7Y	10Y
1M	76.2%	75.4%	74.6%	74.1%	75.2%	73.7%	74.1%
3M	65.1%	62.0%	60.7%	60.1%	62.9%	59.7%	59.5%
6M	57.1%	52.6%	51.4%	50.8%	49.4%	50.4%	50.0%
1Y	59.8%	49.3%	47.1%	46.7%	46.0%	45.6%	44.7%
3Y	42.1%	39.1%	38.4%	38.4%	36.9%	38.0%	37.6%
5Y	33.4%	33.2%	33.1%	32.6%	31.3%	32.3%	32.2%
7Y	30.2%	29.2%	29.0%	28.2%	26.2%	27.2%	27.0%
10Y	26.7%	26.3%	26.0%	25.6%	24.8%	24.7%	24.5%

TABLE 3.2
MATRIX OF CORRELATIONS ρ BETWEEN THE UNDERLYING AND THE VOLATILITY FOR EUROPEAN SWAPTONS.

	1Y	2Y	3Y	4Y	5Y	7Y	10Y
1M	4.2%	−0.2%	−0.7%	−1.0%	−2.5%	−1.8%	−2.3%
3M	2.5%	−4.9%	−5.9%	−6.5%	−6.9%	−7.6%	−8.5%
6M	5.0%	−3.6%	−4.9%	−5.6%	−7.1%	−7.0%	−8.0%
1Y	−4.4%	−8.1%	−8.8%	−9.3%	−9.8%	−10.2%	−10.9%
3Y	−7.3%	−14.3%	−17.1%	−17.1%	−16.6%	−17.9%	−18.9%
5Y	−11.1%	−17.3%	−18.5%	−18.8%	−19.0%	−20.0%	−21.6%
7Y	−13.7%	−22.0%	−23.6%	−24.0%	−25.0%	−26.1%	−28.7%
10Y	−14.8%	−25.5%	−27.7%	−29.2%	−31.7%	−32.3%	−33.7%

bumping the forward to $\alpha + \delta$, and then subtracting to determine the risk This saves differentiating complex formulas such as (2.17a–2.17c). with respect to α yields the vega risk, the risk to overall changes in volatility:

$$\frac{\partial V_{call}}{\partial \alpha} = \frac{\partial BS}{\partial \sigma_B} \cdot \frac{\partial \sigma_B(K, f; \alpha, \beta, \rho, \nu)}{\partial \alpha}. \tag{3.6}$$

This risk is the change in value when α changes by a unit amount. It is traditional to scale vega so that it represents the change in value when the ATM volatility changes by a unit amount. Since $\delta\sigma_{ATM} = (\partial\sigma_{ATM}/\partial\alpha)\,\delta\alpha$, the vega risk is

$$\text{vega} = \frac{\partial V_{call}}{\partial \alpha} = \frac{\partial BS}{\partial \sigma_B} \cdot \frac{\frac{\partial \sigma_B(K, f; \alpha, \beta, \rho, \nu)}{\partial \alpha}}{\frac{\partial \sigma_{ATM}(f; \alpha, \beta, \rho, \nu)}{\partial \alpha}} \tag{3.7a}$$

where $\sigma_{ATM}(f) = \sigma_B(f, f)$ is given by (2.18). Note that to leading order, $\partial\sigma_B/\partial\alpha \approx \sigma_B/\alpha$ and $\partial\sigma_{ATM}/\partial\alpha \approx \sigma_{ATM}/\alpha$, so the vega risk is roughly given by

$$\text{vega} \approx \frac{\partial BS}{\partial \sigma_B} \cdot \frac{\sigma_B(K, f)}{\sigma_{ATM}(f)} = \frac{\partial BS}{\partial \sigma_B} \cdot \frac{\sigma_B(K, f)}{\sigma_B(f, f)}. \tag{3.7b}$$

Qualitatively, then, vega risks at different strikes are calculated by bumping the implied volatility at each strike K by an amount that is proportional to the implied volatiity $\sigma_B(K, f)$ at that strike. That is, in using equation (3.7a), we are essentially using proportional, and not parallel, shifts of the volatility curve to calculate the total vega risk of a book of options.

Since ρ and ν are determined by fitting the implied volatility curve observed in the marketplace, the SABR model has risks to ρ and ν changing. Borrowing terminology from foreign exchange desks, vanna is the risk to ρ changing and volga (vol gamma) is the risk to ν changing:

$$\text{vanna} = \frac{\partial V_{call}}{\partial \rho} = \frac{\partial BS}{\partial \sigma_B} \cdot \frac{\partial \sigma_B(K, f; \alpha, \beta, \rho, \nu)}{\partial \rho}, \tag{3.8a}$$

$$\text{volga} = \frac{\partial V_{call}}{\partial \nu} = \frac{\partial BS}{\partial \sigma_B} \cdot \frac{\partial \sigma_B(K, f; \alpha, \beta, \rho, \nu)}{\partial \nu}. \tag{3.8b}$$

Vanna basically expresses the risk to the skew increasing, and volga expresses the risk to the smile becoming more pronounced. These risks are easily calculated by using finite differences on the formula for σ_B in equations (2.17a–2.17c). If desired, these risks can be hedged by buying or selling away-from-the-money options.

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The delta risk expressed by the SABR model depends on whether one uses the parameterization α, β, ρ, ν or $\sigma_{ATM}, \beta, \rho, \nu$. Suppose first we use the parameterization α, β, ρ, ν, so that $\sigma_B(K, f) \equiv \sigma_B(K, f; \alpha, \beta, \rho, \nu)$. Differentiating respect to f yields the Δ risk

$$\Delta \equiv \frac{\partial V_{call}}{\partial f} = \frac{\partial BS}{\partial f} + \frac{\partial BS}{\partial \sigma_B}\frac{\partial \sigma_B(K, f; \alpha, \beta, \rho, \nu)}{\partial f}. \tag{3.9}$$

The first term is the ordinary Δ risk one would calculate from Black's model. The second term is the SABR model's correction to the Δ risk. It consists of the Black vega times the *predicted* change in the implied volatility σ_B caused by the change in the forward f. As discussed above, the predicted change consists of a sideways movement of the volatility curve in the same direction (and by the same amount) as the change in the forward price f. In addition, if $\beta < 1$ the volatility curve rises and falls as the at-the-money point traverses up and down the backbone. There may also be minor changes to the shape of the skew/smile due to changes in f.

Now suppose we use the parameterization $\sigma_{ATM}, \beta, \rho, \nu$. Then α is a function of σ_{ATM} and f defined implicitly by (2.18). Differentiating (3.5) now yields the Δ risk

$$\Delta \equiv \frac{\partial BS}{\partial f} + \frac{\partial BS}{\partial \sigma_B}\left\{\frac{\partial \sigma_B(K, f; \alpha, \beta, \rho, \nu)}{\partial f} + \frac{\partial \sigma_B(K, f; \alpha, \beta, \rho, \nu)}{\partial \alpha}\frac{\partial \alpha(\sigma_{ATM}, f)}{\partial f}\right\}. \tag{3.10}$$

The delta risk is now the risk to changes in f with σ_{ATM} held fixed. The last term is just the change in α needed to keep σ_{ATM} constant while f changes. Clearly this last term must just cancel out the vertical component of the backbone, leaving only the sideways movement of the implied volatilty curve. Note that this term is zero for $\beta = 1$.

Theoretically one should use the Δ from equation (3.9) to risk manage option books. In many markets, however, it may take several days for volatilities σ_B to change following significant changes in the forward price f. In these markets, using Δ from (3.10) is a *much* more effective hedge. For suppose one used Δ from equation (3.9). Then, when the volatility σ_{ATM} did not immediately change following a change in f, one would be forced to re-mark α to compensate, and this re-marking would change the Δ hedges. As σ_{ATM} equilibrated over the next few days, one would mark α back to its original value, which would change the Δ hedges back to their original value. This "hedging chatter" caused by market delays can prove to be costly.

Appendix A. Analysis of the SABR Model

Here we use singular perturbation techniques to price European options under the SABR model. Our analysis is based on a small volatility expansion, where we take both the volatility $\hat{\alpha}$ and the "volvol" ν to be small. To carry out this analysis in a systematic fashion, we re-write $\hat{\alpha} \longrightarrow \varepsilon\hat{\alpha}$, and $\nu \longrightarrow \varepsilon\nu$, and analyze

$$d\hat{F} = \varepsilon\hat{\alpha}C(\hat{F})\,dW_1, \tag{A.1a}$$

$$d\hat{\alpha} = \varepsilon\nu\hat{\alpha}\,dW_2, \tag{A.1b}$$

with

$$dW_1 dW_2 = \rho dt, \tag{A.1c}$$

in the limit $\varepsilon \ll 1$. This is the *distinguished limit* [21], [22] in the language of singular perturbation theory. After obtaining the results we replace $\varepsilon\hat{\alpha} \longrightarrow \hat{\alpha}$, and $\varepsilon\nu \longrightarrow \nu$ to get the answer in terms of the original variables. We first analyze the model with a general $C(\hat{F})$, and then specialize the results to the power law $\hat{F}^\beta$. This is notationally simpler than working with the power law throughout, and the more general result may prove valuable in some future application.

We first use the forward Kolmogorov equation to simplify the option pricing problem. Suppose the economy is in state $\hat{F}(t) = f$, $\hat{\alpha}(t) = \alpha$ at date t. Define the probability density $p(t, f, \alpha; T, F, A)$ by

$$\begin{aligned} p(t, f, \alpha; T, F, A)\,dF\,dA = \text{prob}\Big\{ & F < \hat{F}(T) < F + dF,\ A < \hat{\alpha}(T) \\ & < A + dA \,\Big|\, \hat{F}(t) = f,\ \hat{\alpha}(t) = \alpha \Big\}. \end{aligned} \tag{A.2}$$

As a function of the *forward variables* T, F, A, the density p satisfies the forward Kolmogorov equation (the Fokker-Planck equation)

$$\begin{aligned} p_T = & \tfrac{1}{2}\varepsilon^2 A^2 [C^2(F)\,p]_{FF} \\ & + \varepsilon^2\rho\nu [A^2 C(F)\,p]_{FA} + \tfrac{1}{2}\varepsilon^2\nu^2 [A^2 p]_{AA} \qquad \text{for } T > t, \end{aligned} \tag{A.3a}$$

with

$$p = \delta(F - f)\,\delta(A - \alpha) \quad \text{at } T = t, \tag{A.3b}$$

as is well-known [24], [25], [26]. Here, and throughout, we use subscripts to denote partial derivatives.

Let $V(t, f, \alpha)$ be the value of a European call option at date t, when the economy is in state $\hat{F}(t) = f$, $\hat{\alpha}(t) = \alpha$. Let t_{ex} be the option's exercise date, and let K be its strike. Omitting the discount factor $D(t_{ex})$, which factors out exactly, the value of the option is

$$\begin{aligned} V(t, f, \alpha) &= E\Big\{[\hat{F}(t_{ex}) - K]^+ \,\Big|\, \hat{F}(t) = f,\ \hat{\alpha}(t) = \alpha\Big\} \\ &= \int_{-\infty}^{\infty}\int_{K}^{\infty} (F - K)\,p(t, f, \alpha; t_{ex}, F, A)\,dF\,dA. \end{aligned} \tag{A.4}$$

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See (2.1a). Since

$$p(t,f,\alpha;t_{ex},F,A)=\delta(F-f)\,\delta(A-\alpha)+\int_t^{t_{ex}} p_T(t,f,\alpha;T,F,A)\,dT, \quad \text{(A.5)}$$

we can re-write $V(t,f,\alpha)$ as

$$V(t,f,\alpha)=[f-K]^+ + \int_t^{t_{ex}}\int_K^{\infty}\int_{-\infty}^{\infty}(F-K)\,p_T(t,f,\alpha;T,F,A)\,dA\,dF\,dT. \quad \text{(A.6)}$$

We substitute (A.3a) for p_T into (A.6). Integrating the A derivatives $\varepsilon^2\rho\nu[A^2C(F)\,p]_{FA}$ and $\frac{1}{2}\varepsilon^2\nu^2[A^2p]_{AA}$ over all A yields zero. Therefore our option price reduces to

$$V(t,f,\alpha)=[f-K]^+ + \frac{1}{2}\varepsilon^2\int_t^{t_{ex}}\int_{-\infty}^{\infty}\int_K^{\infty}A^2\,(F-K)\,[C^2(F)\,p]_{FF}\,dF\,dA\,dT, \quad \text{(A.7)}$$

where we have switched the order of integration. Integrating by parts twice with respect to F now yields

$$V(t,f,\alpha)=[f-K]^+ + \frac{1}{2}\varepsilon^2C^2(K)\int_t^{t_{ex}}\int_{-\infty}^{\infty}A^2p(t,f,\alpha;T,K,A)\,dA\,dT. \quad \text{(A.8)}$$

The problem can be simplified further by defining

$$P(t,f,\alpha;T,K)=\int_{-\infty}^{\infty}A^2p(t,f,\alpha;T,K,A)\,dA. \quad \text{(A.9)}$$

Then P satisfies the backward's Kolmogorov equation [24], [25], [26]

$$P_t+\frac{1}{2}\varepsilon^2\alpha^2C^2(f)\,P_{ff}+\varepsilon^2\rho\nu\alpha^2C(f)\,P_{f\alpha}+\frac{1}{2}\varepsilon^2\nu^2\alpha^2P_{\alpha\alpha}=0, \qquad \text{for } t<T \quad \text{(A.10a)}$$

$$P=\alpha^2\delta(f-K), \qquad \text{for } t=T. \quad \text{(A.10b)}$$

Since t does not appear explicitly in this equation, P depends only on the combination $T-t$, and not on t and T separately. So define

$$\tau=T-t, \qquad \tau_{ex}=t_{ex}-t. \quad \text{(A.11)}$$

Then our pricing formula becomes

$$V(t,f,\alpha)=[f-K]^+ + \frac{1}{2}\varepsilon^2C^2(K)\int_0^{\tau_{ex}}P(\tau,f,\alpha;K)\,d\tau \quad \text{(A.12)}$$

where $P(\tau,f,\alpha;K)$ is the solution of the problem

$$P_\tau=\frac{1}{2}\varepsilon^2\alpha^2C^2(f)\,P_{ff}+\varepsilon^2\rho\nu\alpha^2C(f)\,P_{f\alpha}+\frac{1}{2}\varepsilon^2\nu^2\alpha^2P_{\alpha\alpha}, \quad \text{for } \tau>0. \quad \text{(A.13a)}$$

$$P=\alpha^2\delta(f-K), \qquad \text{for } \tau=0. \quad \text{(A.13b)}$$

In this appendix we solve (A.13a), (A.13b) to obtain $P(\tau,f,\alpha;K)$, and then substitute this solution into (A.12) to obtain the option value $V(t,f,\alpha)$. This yields the option price under the SABR model, but the resulting formulas are awkward and not very useful. To cast the results in a more usable form, we re-compute the option price under the normal model

$$d\hat{F}=\sigma_N\,dW, \quad \text{(A.14a)}$$

and then equate the two prices to determine which normal volatility σ_N needs to be used to reproduce the option's price under the SABR model. That is, we find the "implied normal volatility" of the option under the SABR model. By doing a second comparison between option prices under the log normal model

$$d\hat{F}=\sigma_B\hat{F}\,dW \quad \text{(A.14b)}$$

and the normal model, we then convert the implied normal volatility to the usual implied log-normal (Black-Scholes) volatility. That is, we quote the option price predicted by the SABR model in terms of the option's implied volatility.

A.1 Singular perturbation expansion. Using a straightforward perturbation expansion would yield a Gaussian density to leading order,

$$P=\frac{\alpha}{\sqrt{2\pi\varepsilon^2C^2(K)\,\tau}}\,e^{-\frac{(f-K)^2}{2\varepsilon^2\alpha^2C^2(K)\tau}}\{1+\cdots\}. \quad \text{(A.15a)}$$

Since the "$+\cdots$" involves powers of $(f-K)/\varepsilon\alpha C(K)$, this expansion would become inaccurate as soon as $(f-K)\,C'(K)/C(K)$ becomes a significant fraction of 1; i.e., as soon as $C(f)$ and $C(K)$ are significantly different. Stated differently, small changes in the exponent cause much greater changes in the probability density. A better approach is to re-cast the series as

$$P=\frac{\alpha}{\sqrt{2\pi\varepsilon^2C^2(K)\,\tau}}\,e^{-\frac{(f-K)^2}{2\varepsilon^2\alpha^2C^2(K)\tau}\{1+\cdots\}} \quad \text{(A.15b)}$$

and expand the exponent, since one expects that only small changes to the exponent will be needed to effect the much larger changes in the density. This expansion also describes the basic physics better — P is essentially a Gaussian probability density which tails off faster or slower

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depending on whether the "diffusion coefficient" $C(f)$ decreases or increases.

We can refine this approach by noting that the exponent is the integral

$$\frac{(f-K)^2}{2\varepsilon^2\alpha^2C^2(K)\tau}\{1+\cdots\}=\frac{1}{2\tau}\left(\frac{1}{\varepsilon\alpha}\int_K^f\frac{df'}{C(f')}\right)^2\{1+\cdots\}. \tag{A.16}$$

Suppose we define the new variable

$$z=\frac{1}{\varepsilon\alpha}\int_K^f\frac{df'}{C(f')}. \tag{A.17}$$

so that the solution P is essentially $e^{-z^2/2}$. To leading order, the density is Gaussian in the variable z, which is determined by how "easy" or "hard" it is to diffuse from K to f, which closely matches the underlying physics. The fact that the Gaussian changes by orders of magnitude as z^2 increases should be largely irrelevent to the quality of the expansion. This approach is directly related to the geometric optics technique that is so successful in wave propagation and quantum electronics [27], [22]. To be more specific, we shall use the near identity transform method to carry out the geometric optics expansion. This method, pioneered in [28], transforms the problem order-by-order into a simple canonical problem, which can then be solved trivially. Here we obtain the solution only through $O(\varepsilon^2)$, truncating all higher order terms.

Let us change variables from f to

$$z=\frac{1}{\varepsilon\alpha}\int_K^f\frac{df'}{C(f')}, \tag{A.18a}$$

and to avoid confusion, we define

$$B(\varepsilon\alpha z)=C(f). \tag{A.18b}$$

Then

$$\frac{\partial}{\partial f}\longrightarrow\frac{1}{\varepsilon\alpha C(f)}\frac{\partial}{\partial z}=\frac{1}{\varepsilon\alpha B(\varepsilon\alpha z)}\frac{\partial}{\partial z},\qquad \frac{\partial}{\partial\alpha}\longrightarrow\frac{\partial}{\partial\alpha}-\frac{z}{\alpha}\frac{\partial}{\partial z}. \tag{A.19a}$$

and

$$\frac{\partial^2}{\partial f^2}\longrightarrow\frac{1}{\varepsilon^2\alpha^2B^2(\varepsilon\alpha z)}\left\{\frac{\partial^2}{\partial z^2}-\varepsilon\alpha\frac{B'(\varepsilon\alpha z)}{B(\varepsilon\alpha z)}\frac{\partial}{\partial z}\right\}. \tag{A.19b}$$

$$\frac{\partial^2}{\partial f\partial\alpha}\longrightarrow\frac{1}{\varepsilon\alpha B(\varepsilon\alpha z)}\left\{\frac{\partial^2}{\partial z\partial\alpha}-\frac{z}{\alpha}\frac{\partial^2}{\partial z^2}-\frac{1}{\alpha}\frac{\partial}{\partial z}\right\}. \tag{A.19c}$$

$$\frac{\partial^2}{\partial\alpha^2}\longrightarrow\frac{\partial^2}{\partial\alpha^2}-\frac{2z}{\alpha}\frac{\partial^2}{\partial z\partial\alpha}+\frac{z^2}{\alpha^2}\frac{\partial^2}{\partial z^2}+\frac{2z}{\alpha^2}\frac{\partial}{\partial z}. \tag{A.19d}$$

Also,

$$\delta(f-K)=\delta(\varepsilon\alpha zC(K))=\frac{1}{\varepsilon\alpha C(K)}\delta(z). \tag{A.19e}$$

Therefore, (A.12) through (A.13b) become

$$V(t,f,a)=[f-K]^+ +\frac{1}{2}\varepsilon^2C^2(K)\int_0^{\tau_m}P(\tau,z,\alpha)\,d\tau, \tag{A.20}$$

where $P(\tau,z,\alpha)$ is the solution of

$$P_\tau=\frac{1}{2}\left(1-2\varepsilon\rho\nu z+\varepsilon^2\nu^2z^2\right)P_{zz}-\frac{1}{2}\varepsilon a\frac{B'}{B}P_z+(\varepsilon\rho\nu-\varepsilon^2\nu^2z)(\alpha P_{z\alpha}-P_z)$$
$$+\frac{1}{2}\varepsilon^2\nu^2\alpha^2P_{\alpha\alpha}\qquad\text{for }\tau>0 \tag{A.21a}$$

$$P=\frac{\alpha}{\varepsilon C(K)}\delta(z)\qquad\text{at }\tau=0. \tag{A.21b}$$

Accordingly, let us define $\hat{P}(\tau,z,\alpha)$ by

$$\hat{P}=\frac{\varepsilon}{\alpha}C(K)P. \tag{A.22}$$

In terms of $\hat{P}$, we obtain

$$V(t,f,a)=[f-K]^+ +\frac{1}{2}\varepsilon\alpha C(K)\int_0^{\tau_m}\hat{P}(\tau,z,\alpha)\,d\tau, \tag{A.23}$$

where $\hat{P}(\tau,z,\alpha)$ is the solution of

$$\hat{P}_\tau=\frac{1}{2}\left(1-2\varepsilon\rho\nu z+\varepsilon^2\nu^2z^2\right)\hat{P}_{zz}-\frac{1}{2}\varepsilon a\frac{B'}{B}\hat{P}_z+(\varepsilon\rho\nu-\varepsilon^2\nu^2z)\alpha\hat{P}_{z\alpha}$$
$$+\frac{1}{2}\varepsilon^2\nu^2(\alpha^2\hat{P}_{\alpha\alpha}+2\alpha\hat{P}_\alpha)\qquad\text{for }\tau>0, \tag{A.24a}$$

$$\hat{P}=\delta(z)\qquad\text{at }\tau=0. \tag{A.24b}$$

To leading order $\hat{P}$ is the solution of the standard diffusion problem $\hat{P}_\tau=\frac{1}{2}\hat{P}_{zz}$ with $\hat{P}=\delta(z)$ at $\tau=0$. So it is a Gaussian to leading order. The next stage is to transform the problem to the standard diffusion problem through $O(\varepsilon)$, and then through $O(\varepsilon^2)$, ... This is the near identify transform method which has proven so powerful in near Hamiltonian systems [28].

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Note that the variable α does not enter the problem for $\hat{P}$ until $O(\varepsilon)$, so

$$\hat{P}(\tau, z, \alpha) = \hat{P}_0(\tau, z) + \hat{P}_1(\tau, z, \alpha) + \cdots \tag{A.25}$$

Consequently, the derivatives $\hat{P}_{z\alpha}$, $\hat{P}_{\alpha\alpha}$, and $\hat{P}_\alpha$ are all $O(\varepsilon)$. Recall that we are only solving for $\hat{P}$ through $O(\varepsilon^2)$. So, through this order, we can rewrite our problem as

$$\hat{P}_\tau = \frac{1}{2}\left(1 - 2\varepsilon\rho\nu z + \varepsilon^2\nu^2 z^2\right)\hat{P}_{zz} - \frac{1}{2}\varepsilon a\frac{B'}{B}\hat{P}_z + \varepsilon\rho\nu\alpha\hat{P}_{z\alpha} \qquad \text{for } \tau > 0 \tag{A.26a}$$

$$\hat{P}^* = {}^*\delta(z) \qquad \text{at } \tau = 0. \tag{A.26b}$$

Let us now eliminate the $\frac{1}{2}\varepsilon a(B'/B)\hat{P}_z$ term. Define $H(\tau, z, \alpha)$ by

$$\hat{P} = \sqrt{C(f)/C(K)}H \equiv \sqrt{B(\varepsilon\alpha z)/B(0)}H. \tag{A.27}$$

Then

$$\hat{P}_z = \sqrt{B(\varepsilon\alpha z)/B(0)}\left\{H_z + \frac{1}{2}\varepsilon\alpha\frac{B'}{B}H\right\}, \tag{A.28a}$$

$$\hat{P}_{zz} = \sqrt{B(\varepsilon\alpha z)/B(0)}\left\{H_{zz} + \varepsilon\alpha\frac{B'}{B}H_z + \varepsilon^2\alpha^2\left[\frac{B''}{2B} - \frac{B'^2}{4B^2}\right]H\right\}, \tag{A.28b}$$

$$\hat{P}_{z\alpha} = \sqrt{B(\varepsilon\alpha z)/B(0)}\left\{H_{z\alpha} + \frac{1}{2}\varepsilon z\frac{B'}{B}H_z + \frac{1}{2}\varepsilon\alpha\frac{B'}{B}H_\alpha + \frac{1}{2}\varepsilon\frac{B'}{B}H + O(\varepsilon^2)\right\} \tag{A.28c}$$

The option price now becomes

$$V(t, f, a) = [f - K]^+ + \frac{1}{2}\varepsilon\alpha\sqrt{B(0)\,B(\varepsilon\alpha z)}\int_0^{\tau_m} H(\tau, z, \alpha)\,d\tau, \tag{A.29}$$

where

$$\begin{aligned} H_\tau &= \frac{1}{2}\left(1 - 2\varepsilon\rho\nu z + \varepsilon^2\nu^2 z^2\right)H_{zz} - \frac{1}{2}\varepsilon^2\rho\nu\alpha\frac{B'}{B}(zH_z - H) \\ &\quad + \varepsilon^2\alpha^2\left(\frac{1}{4}\frac{B''}{B} - \frac{3}{8}\frac{B'^2}{B^2}\right)H + \varepsilon\rho\nu\alpha\left(H_{z\alpha} + \frac{1}{2}\varepsilon\alpha\frac{B'}{B}H_\alpha\right) \qquad \text{for } \tau > 0 \end{aligned} \tag{A.30a}$$

$$H = \delta(z) \qquad \text{at } \tau = 0. \tag{A.30b}$$

Equations (A.30a), (A.30b) are independent of α to leading order, and at $O(\varepsilon)$ they depend on α only through the last term $\varepsilon\rho\nu\alpha(H_{z\alpha} + \frac{1}{2}\varepsilon\alpha\frac{B'}{B}H_\alpha)$. As above, since A.30a is independent of α to leading order, we can conclude that the α derivatives H_α and $H_{z\alpha}$ are no larger than $O(\varepsilon)$, and so the last term is actually no larger than $O(\varepsilon^2)$. Therefore H is independent of α until $O(\varepsilon^2)$ and the α derivatives are actually no larger than $O(\varepsilon^2)$. Thus, the last term is actually only $O(\varepsilon^3)$, and can be neglected since we are only working through $O(\varepsilon^2)$. So,

$$\begin{aligned} H_\tau &= \frac{1}{2}\left(1 - 2\varepsilon\rho\nu z + \varepsilon^2\nu^2 z^2\right)H_{zz} - \frac{1}{2}\varepsilon^2\rho\nu\alpha\frac{B'}{B}(zH_z - H) \\ &\quad + \varepsilon^2\alpha^2\left(\frac{1}{4}\frac{B''}{B} - \frac{3}{8}\frac{B'^2}{B^2}\right)H \qquad \text{for } \tau > 0 \end{aligned} \tag{A.31a}$$

$$H = \delta(z) \qquad \text{at } \tau = 0. \tag{A.31b}$$

There are no longer any α derivatives, so we can now treat α as a parameter instead of as an independent variable. That is, we have succeeded in effectively reducing the problem to one dimension.

Let us now remove the H_z term through $O(\varepsilon^2)$. To leading order, $B'(\varepsilon\alpha z)/B(\varepsilon\alpha z)$ and $B''(\varepsilon\alpha z)/B(\varepsilon\alpha z)$ are constant. We can replace these ratios by

$$b_1 = B'(\varepsilon\alpha z_0)/B(\varepsilon\alpha z_0), \qquad b_2 = B''(\varepsilon\alpha z_0)/B(\varepsilon\alpha z_0), \tag{A.32}$$

commiting only an $O(\varepsilon)$ error, where the constant z_0 will be chosen later. We now define $\hat{H}$ by

$$H = e^{\varepsilon^2\rho\nu\alpha b_1 z^2/4}\hat{H}. \tag{A.33}$$

Then our option price becomes

$$V(t, f, a) = [f - K]^+ + \frac{1}{2}\varepsilon\alpha\sqrt{B(0)\,B(\varepsilon\alpha z)}e^{\varepsilon^2\rho\nu\alpha b_1 z^2/4}\int_0^{\tau_m}\hat{H}(\tau, z)\,d\tau, \tag{A.34}$$

where $\hat{H}$ is the solution of

$$\begin{aligned} \hat{H}_\tau &= \frac{1}{2}\left(1 - 2\varepsilon\rho\nu z + \varepsilon^2\nu^2 z^2\right)\hat{H}_{zz} + \varepsilon^2\alpha^2\left(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\right)\hat{H} \\ &\quad + \frac{3}{4}\varepsilon^2\rho\nu\alpha b_1\hat{H} \qquad \text{for } \tau > 0 \end{aligned} \tag{A.35a}$$

$$\hat{H} = \delta(z) \qquad \text{at } \tau = 0. \tag{A.35b}$$

We've almost beaten the equation into shape. We now define

$$\begin{aligned} x &= \frac{1}{\varepsilon\nu}\int_0^{\varepsilon\nu z}\frac{d\zeta}{\sqrt{1 - 2\rho\zeta + \zeta^2}} \\ &= \frac{1}{\varepsilon\nu}\log\left(\frac{\sqrt{1 - 2\varepsilon\rho\nu z + \varepsilon^2\nu^2 z^2} - \rho + \varepsilon\nu z}{1 - \rho}\right), \end{aligned} \tag{A.36a}$$

which can be written implicitly as

$$\varepsilon\nu z = \sinh\varepsilon\nu x - \rho(\cosh\varepsilon\nu x - 1). \tag{A.36b}$$

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In terms of x, our problem is

$$V(t,f,a) = [f-K]^+ + \frac{1}{2}\varepsilon\alpha\sqrt{B(0)\,B(\varepsilon\alpha z)}\,e^{\varepsilon^2\rho\nu\alpha b_1 z^2/4}\int_0^{\tau_m}\hat{H}(\tau,x)\,d\tau, \quad \text{(A.37)}$$

with

$$\hat{H}_\tau = \frac{1}{2}\hat{H}_{xx} - \frac{1}{2}\varepsilon\nu I'(\varepsilon\nu z)\,\hat{H}_x + \varepsilon^2\alpha^2\left(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\right)\hat{H} + \frac{3}{4}\varepsilon^2\rho\nu\alpha b_1\hat{H} \quad \text{for } \tau > 0 \quad \text{(A.38a)}$$

$$\hat{H} = \delta(x) \quad \text{at } \tau = 0. \quad \text{(A.38b)}$$

Here

$$I(\zeta) = \sqrt{1 - 2\rho\zeta + \zeta^2}. \quad \text{(A.39)}$$

The final step is to define Q by

$$\hat{H} = I^{1/2}(\varepsilon\nu z(x))\,Q = \left(1 - 2\varepsilon\rho\nu z + \varepsilon^2\nu^2 z^2\right)^{1/4} Q. \quad \text{(A.40)}$$

Then

$$\hat{H}_x = I^{1/2}(\varepsilon\nu z)\left[Q_x + \frac{1}{2}\varepsilon\nu I'(\varepsilon\nu z)\,Q\right]. \quad \text{(A.41a)}$$

$$\hat{H}_{xx} = I^{1/2}(\varepsilon\nu z)\left[Q_{xx} + \varepsilon\nu I' Q_x + \varepsilon^2\nu^2\left(\frac{1}{2}I''I + \frac{1}{4}I'I'\right)Q\right]. \quad \text{(A.41b)}$$

and so

$$V(t,f,a) = [f-K]^+ + \frac{1}{2}\varepsilon\alpha\sqrt{B(0)\,B(\varepsilon\alpha z)}\,I^{1/2}(\varepsilon\nu z)\,e^{\frac{1}{4}\varepsilon^2\rho\nu\alpha b_1 z^2}\int_0^{\tau_m} Q(\tau,x)\,d\tau, \quad \text{(A.42)}$$

where Q is the solution of

$$Q_\tau = \frac{1}{2}Q_{xx} + \varepsilon^2\nu^2\left(\frac{1}{4}I''I - \frac{1}{8}I'I'\right)Q + \varepsilon^2\alpha^2\left(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\right)Q + \frac{3}{4}\varepsilon^2\rho\nu\alpha b_1 Q \quad \text{(A.43a)}$$

for $\tau > 0$, with

$$Q = \delta(x) \quad \text{at } \tau = 0. \quad \text{(A.43b)}$$

As above, we can replace $I(\varepsilon\nu z), I'(\varepsilon\nu z), I''(\varepsilon\nu z)$ by the constants $I(\varepsilon\nu z_0), I'(\varepsilon\nu z_0), I''(\varepsilon\nu z_0)$, and commit only $O(\varepsilon)$ errors. Define the constant κ by

$$\kappa = \nu^2\left(\frac{1}{4}I''(\varepsilon\nu z_0)\,I(\varepsilon\nu z_0) - \frac{1}{8}\left[I'(\varepsilon\nu z_0)\right]^2\right) + \alpha^2\left(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\right) + \frac{3}{4}\rho\nu\alpha b_1. \quad \text{(A.44)}$$

where z_0 will be chosen later. Then through $O(\varepsilon^2)$, we can simplify our equation to

$$Q_\tau = \frac{1}{2}Q_{xx} + \varepsilon^2\kappa Q \quad \text{for } \tau > 0. \quad \text{(A.45a)}$$

$$Q = \delta(x) \quad \text{at } \tau = 0. \quad \text{(A.45b)}$$

The solution of A.45a, A.45b is clearly

$$Q = \frac{1}{\sqrt{2\pi\tau}}e^{-x^2/2\tau}e^{\varepsilon^2\kappa\tau} = \frac{1}{\sqrt{2\pi\tau}}e^{-x^2/2\tau}\frac{1}{\left(1 - \frac{2}{3}\kappa\varepsilon^2\tau + \cdots\right)^{3/2}} \quad \text{(A.46)}$$

through $O(\varepsilon^2)$.

This solution yields the option price

$$V(t,f,a) = [f-K]^+ + \frac{1}{2}\varepsilon\alpha\sqrt{B(0)\,B(\varepsilon\alpha z)}\,I^{1/2}(\varepsilon\nu z)\,e^{\frac{1}{4}\varepsilon^2\rho\nu\alpha b_1 z^2} \cdot \int_0^{\tau_m}\frac{1}{\sqrt{2\pi\tau}}e^{-x^2/2\tau}e^{\varepsilon^2\kappa\tau}\,d\tau. \quad \text{(A.47)}$$

Observe that this can be written as

$$V(t,f,a) = [f-K]^+ + \frac{1}{2}\frac{f-K}{x}\int_0^{\tau_m}\frac{1}{\sqrt{2\pi\tau}}e^{-x^2/2\tau}e^{\varepsilon^2\theta}e^{\varepsilon^2\kappa\tau}\,d\tau, \quad \text{(A.48a)}$$

where

$$\varepsilon^2\theta = \log\left(\frac{\varepsilon\alpha z}{f-K}\sqrt{B(0)\,B(\varepsilon\alpha z)}\right) + \log\left(\frac{xI^{1/2}(\varepsilon\nu z)}{z}\right) + \frac{1}{4}\varepsilon^2\rho\nu\alpha b_1 z^2 \quad \text{(A.48b)}$$

Moreover, quite amazingly,

$$e^{\varepsilon^2\kappa\tau} = \frac{1}{\left(1 - \frac{2}{3}\kappa\varepsilon^2\tau\right)^{3/2}} = \frac{1}{\left(1 - 2\varepsilon^2\tau\frac{\theta}{x^2}\right)^{3/2}} + O(\varepsilon^4), \quad \text{(A.48c)}$$

through $O(\varepsilon^2)$. This can be shown by expanding $\varepsilon^2\theta$ through $O(\varepsilon^2)$, and noting that $\varepsilon^2\theta/x^2$ matches $\kappa/3$. Therefore our option price is

$$V(t,f,a) = [f-K]^+ + \frac{1}{2}\frac{f-K}{x}\int_0^{\tau_m}\frac{1}{\sqrt{2\pi\tau}}e^{-x^2/2\tau}e^{\varepsilon^2\theta}\frac{d\tau}{\left(1 - \frac{2\tau}{x^2}\varepsilon^2\theta\right)^{3/2}}. \quad \text{(A.49)}$$

and changing integration variables to

$$q = \frac{x^2}{2\tau}. \quad \text{(A.50)}$$

reduces this to

$$V(t,f,a) = [f-K]^+ + \frac{|f-K|}{4\sqrt{\pi}}\int_{\frac{x^2}{2\tau_m}}^{\infty}\frac{e^{-q+\varepsilon^2\theta}}{\left(q - \varepsilon^2\theta\right)^{3/2}}dq. \quad \text{(A.51)}$$

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That is, the value of a European call option is given by

$$V(t,f,a) = [f-K]^+ + \frac{|f-K|}{4\sqrt{\pi}} \int_{\frac{z^2}{2\tau_{cx}} - \varepsilon^2\theta}^{\infty} \frac{e^{-q}}{q^{3/2}} dq, \qquad \text{(A.52a)}$$

with

$$\varepsilon^2\theta = \log\left(\frac{\varepsilon\alpha z}{f-K}\sqrt{B(0)\,B(\varepsilon\alpha z)}\right) + \log\left(\frac{x^{1/2}(\varepsilon\nu z)}{z}\right) + \frac{1}{4}\varepsilon^2\rho\nu\alpha b_1 z^2, \qquad \text{(A.52b)}$$

through $O(\varepsilon^2)$.

A.2. Equivalent normal volatility. Equations (A.52a) and (A.52a) are a formula for the dollar price of the call option under the SABR model. The utility and beauty of this formula is not overwhelmingly apparent. To obtain a useful formula, we convert this dollar price into the equivalent implied volatilities. We first obtain the implied *normal* volatility, and then the standard *log normal* (Black) volatility.

Suppose we repeated the above analysis for the ordinary *normal model*

$$d\hat{F} = \sigma_N\, dW, \qquad \hat{F}(0) = f. \qquad \text{(A.53a)}$$

where the normal volatily σ_N is constant, not stochastic. (This model is also called the *absolute* or *Gaussian* model). We would find that the option value for the normal model is exactly

$$V(t,f) = [f-K]^+ + \frac{|f-K|}{4\sqrt{\pi}} \int_{\frac{(f-K)^2}{2\tau_{cx}\sigma_N^2}}^{\infty} \frac{e^{-q}}{q^{3/2}} dq \qquad \text{(A.53b)}$$

This can be seen by setting $C(f)$ to 1, setting $\varepsilon\alpha$ to σ_N and setting ν to 0 in A.52a, A.52b. Working out this integral then yields the exact European option price

$$V(t,f) = (f-K)\mathcal{N}\left(\frac{f-K}{\sigma_N\sqrt{\tau_{cx}}}\right) + \sigma_N\sqrt{\tau_{cx}}\,\mathcal{G}\left(\frac{f-K}{\sigma_N\sqrt{\tau_{cx}}}\right), \qquad \text{(A.54a)}$$

for the normal model, where $\mathcal{N}$ is the normal distribution and $\mathcal{G}$ is the Gaussian density

$$\mathcal{G}(q) = \frac{1}{\sqrt{2\pi}} e^{-q^2/2}. \qquad \text{(A.54b)}$$

From A.53b it is clear that the option price under the normal model matches the option price under the SABR model A.52a, A.52a if and only if we choose the normal volatility σ_N to be

$$\frac{1}{\sigma_N^2} = \frac{x^2}{(f-K)^2}\left\{1 - 2\varepsilon^2\frac{\theta}{x^2}\tau_{cx}\right\}. \qquad \text{(A.55)}$$

Taking the square root now shows the option's *implied normal* (absolute) *volatility* is given by

$$\sigma_N = \frac{f-K}{x}\left\{1 + \varepsilon^2\frac{\theta}{x^2}\tau_{cx} + \cdots\right\} \qquad \text{(A.56)}$$

through $O(\varepsilon^2)$.

Before continuing to the implied *log normal* volatility, let us seek the simplest possible way to re-write this answer which is correct through $O(\varepsilon^2)$. Since $x = z[1 + O(\varepsilon)]$, we can re-write the answer as

$$\sigma_N = \left(\frac{f-K}{z}\right)\left(\frac{z}{x(z)}\right)\{1 + \varepsilon^2(\phi_1 + \phi_2 + \phi_3)\tau_{cx} + \cdots\}, \qquad \text{(A.57a)}$$

where

$$\frac{f-K}{z} = \frac{\varepsilon\alpha(f-K)}{\int_K^f \frac{df'}{C(f')}} = \left(\frac{1}{f-K}\int_K^f \frac{df'}{\varepsilon\alpha C(f')}\right)^{-1}.$$

This factor represents the average difficulty in diffusing from today's forward f to the strike K, and would be present even if the volatility were not stochastic.

The next factor is

$$\frac{z}{x(z)} = \frac{\zeta}{\log\left(\frac{\sqrt{1-2\rho\zeta+\zeta^2}-\rho+\zeta}{1-\rho}\right)}, \qquad \text{(A.57b)}$$

where

$$\zeta = \varepsilon\nu z = \frac{\nu}{\alpha}\int_K^f \frac{df'}{C(f')} = \frac{\nu}{\alpha}\frac{f-K}{C(f_{av})}\{1 + O(\varepsilon^2)\}. \qquad \text{(A.57c)}$$

Here $f_{av} = \sqrt{fK}$ is the geometric average of f and K. (The arithmetic average could have been used equally well at this order of accuracy). This factor represents the main effect of the stochastic volatility.

The coefficients ϕ_1, ϕ_2, and ϕ_3 provide relatively minor corrections. Through $O(\varepsilon^2)$ these corrections are

$$\begin{aligned}\varepsilon^2\phi_1 &= \frac{1}{z^2}\log\left(\frac{\varepsilon\alpha z}{f-K}\sqrt{C(f)\,C(K)}\right) \\ &= \frac{2\gamma_2 - \gamma_1^2}{24}\varepsilon^2\alpha^2 C^2(f_{av}) + \cdots\end{aligned} \qquad \text{(A.57d)}$$

$$\varepsilon^2\phi_2 = \frac{1}{z^2}\log\left(\frac{x}{z}\left[1 - 2\varepsilon\rho\nu z + \varepsilon^2\nu^2 z^2\right]^{1/4}\right) = \frac{2-3\rho^2}{24}\varepsilon^2\nu^2 + \cdots \qquad \text{(A.57e)}$$

$$\varepsilon^2\phi_3 = \frac{1}{4}\varepsilon^2\rho\alpha\nu\frac{B'(\varepsilon\nu z_0)}{B(\varepsilon\nu z_0)} = \frac{1}{4}\varepsilon^2\rho\nu\alpha\gamma_1 C(f_{av}) + \cdots \qquad \text{(A.57f)}$$

where

$$\gamma_1 = \frac{C'(f_{av})}{C(f_{av})}, \qquad \gamma_2 = \frac{C''(f_{av})}{C(f_{av})}. \qquad \text{(A.57g)}$$

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Let us briefly summarize before continuing. Under the *normal model*, the value of a European call option with strike K and exercise date τ_{ex} is given by (A.54a), (A.54b). For the SABR model,

$$d\hat{F} = \varepsilon\hat{\alpha}C(\hat{F})\,dW_1, \qquad \hat{F}(0) = f \tag{A.58a}$$

$$d\hat{\alpha} = \varepsilon\nu\hat{\alpha}\,dW_2, \qquad \hat{\alpha}(0) = \alpha \tag{A.58b}$$

$$dW_1 dW_2 = \rho\,dt, \tag{A.58c}$$

the value of the call option is given by the same formula, at least through $O(\varepsilon^2)$, provided we use the implied normal volatility

$$\begin{aligned}\sigma_N(K) = {} & \frac{\varepsilon\alpha(f-K)}{\int_K^f \frac{df'}{C(f')}} \cdot \left(\frac{\zeta}{\hat{x}(\zeta)}\right) \\ & \cdot \left\{1 + \left[\frac{2\gamma_2 - \gamma_1^2}{24}\alpha^2 C^2(f_{av}) + \frac{1}{4}\rho\nu\alpha\gamma_1 C(f_{av}) \right.\right. \\ & \left.\left. + \frac{2-3\rho^2}{24}\nu^2\right]\varepsilon^2\tau_{ex} + \cdots\right\}.\end{aligned} \tag{A.59a}$$

Here

$$f_{av} = \sqrt{fK}, \qquad \gamma_1 = \frac{C'(f_{av})}{C(f_{av})}, \qquad \gamma_2 = \frac{C''(f_{av})}{C(f_{av})}, \tag{A.59b}$$

$$\zeta = \frac{\nu}{\alpha}\frac{f-K}{C(f_{av})}, \qquad \hat{x}(\zeta) = \log\left(\frac{\sqrt{1-2\rho\zeta+\zeta^2}-\rho+\zeta}{1-\rho}\right). \tag{A.59c}$$

The first two factors provide the dominant behavior, with the remaining factor $1 + |\cdots|\varepsilon^2\tau_{ex}$ usually provideing corrections of around 1% or so.

One can repeat the analysis for a European put option, or simply use call/put parity. This shows that the value of the put option under the SABR model is

$$V_{put}(f, \alpha, K) = (K-f)\mathcal{N}\left(\frac{K-f}{\sigma_N\sqrt{\tau_{ex}}}\right) + \sigma_N\sqrt{\tau_{ex}}\,\mathcal{G}\left(\frac{K-f}{\sigma_N\sqrt{\tau_{ex}}}\right) \tag{A.60}$$

where the implied normal volatility σ_N is given by the same formulas (A.59a – A.59c) as the call.

We can revert to the original units by replacing $\varepsilon\alpha \longrightarrow \alpha$, $\varepsilon\nu \longrightarrow \nu$ everywhere in the above formulas; this is equivalent to setting ε to 1 everywhere.

A. 3. Equivalent Black vol. With the exception of JPY traders, most traders prefer to quote prices in terms of Black (log normal) volatilities, rather than normal volatilities. To derive the implied Black volatility, consider Black's model

$$d\hat{F} = \varepsilon\sigma_B\hat{F}dW, \qquad \hat{F}(0) = f, \tag{A.61}$$

where we have written the volatility as $\varepsilon\sigma_B$ to stay consistent with the preceding analysis. For Black's model, the value of a European call with strike K and exercise date τ_{ex} is

$$V_{call} = f\mathcal{N}(d_1) - K\mathcal{N}(d_2), \tag{A.62a}$$

$$V_{put} = V_{call} + D(t_{ex})[K-f], \tag{A.62b}$$

with

$$d_{1,2} = \frac{\log f/K \pm \frac{1}{2}\varepsilon^2\sigma_B^2\tau_{ex}}{\varepsilon\sigma_B\sqrt{\tau_{ex}}}, \tag{A.62c}$$

where we are omitting the overall factor $D(t_{ex})$ as before.

We can obtain the implied normal volatility for Black's model by repeating the preceding analysis for the SABR model with $C(f) = f$ and $\nu = 0$. Setting $C(f) = f$ and $\nu = 0$ in (A.59a – A.59c) shows that the normal volatility is

$$\sigma_N(K) = \frac{\varepsilon\sigma_B(f-K)}{\log f/K}\left\{1 - \frac{1}{24}\varepsilon^2\sigma_B^2\tau_{ex} + \cdots\right\}. \tag{A.63}$$

through $O(\varepsilon^2)$. Indeed, in [14] it is shown that the implied normal volatility for Black's model is

$$\sigma_N(K) = \varepsilon\sigma_B\sqrt{fK}\,\frac{1 + \frac{1}{24}\log^2 f/K + \frac{1}{1920}\log^4 f/K + \cdots}{1 + \frac{1}{24}\left(1 - \frac{1}{120}\log^2 f/K\right)\varepsilon^2\sigma_B^2\tau_{ex} + \frac{1}{5760}\varepsilon^4\sigma_B^4\tau_{ex}^2 + \cdots} \tag{A.64}$$

through $O(\varepsilon^4)$. We can find the implied Black vol for the SABR model by setting σ_N obtained from Black's model in equation (A.63) equal to σ_N obtained from the SABR model in (A.59a – B.59c). Through $O(\varepsilon^2)$ this yields

$$\begin{aligned}\sigma_B(K) = {} & \frac{\alpha\log f/K}{\int_K^f \frac{df'}{C(f')}} \cdot \left(\frac{\zeta}{\hat{x}(\zeta)}\right) \cdot \\ & \left\{1 + \left[\frac{2\gamma_2 - \gamma_1^2 + 1/f_{av}^2}{24}\alpha^2 C^2(f_{av}) + \frac{1}{4}\rho\nu\alpha\gamma_1 C(f_{av}) \right.\right. \\ & \left.\left. + \frac{2-3\rho^2}{24}\nu^2\right]\varepsilon^2\tau_{ex} + \cdots\right\}\end{aligned} \tag{A.65}$$

This is the main result of this article. As before, the implied log normal volatility for puts is the same as for calls, and this formula can be re-cast in terms of the original variables by simpley setting ε to 1.

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A.4. Stochastic β model. As originally stated, the SABR model consists of the special case $C(f) = f^{\beta}$:

$$d\hat{F} = \varepsilon\hat{\alpha}\hat{F}^{\beta}\,dW_1, \qquad \hat{F}(0) = f \tag{A.66a}$$

$$d\hat{\alpha} = \varepsilon\nu\hat{\alpha}\,dW_2, \qquad \hat{\alpha}(0) = \alpha \tag{A.66b}$$

$$dW_1\,dW_2 = \rho\,dt. \tag{A.66c}$$

Making this substitution in (A.58a–A.58b) shows that the implied *normal* volatility for this model is

$$\sigma_N(K) = \frac{\varepsilon\alpha(1-\beta)(f-K)}{f^{1-\beta}-K^{1-\beta}}\cdot\left(\frac{\zeta}{\hat{x}(\zeta)}\right) \cdot\left\{1+\left[\frac{-\beta(2-\beta)\alpha^2}{24f_{av}^{2-2\beta}}+\frac{\rho\alpha\nu\beta}{4f_{av}^{1-\beta}}+\frac{2-3\rho^2}{24}\nu^2\right]\varepsilon^2\tau_{ex}+\cdots\right\} \tag{A.67a}$$

through $O(\varepsilon^2)$, where $f_{av} = \sqrt{fK}$ as before and

$$\zeta = \frac{\nu}{\alpha}\frac{f-K}{f_{av}^{\beta}}, \qquad \hat{x}(\zeta) = \log\left(\frac{\sqrt{1-2\rho\zeta+\zeta^2}-\rho+\zeta}{1-\rho}\right). \tag{A.67b}$$

We can simplify this formula by expanding

$$f-K = \sqrt{fK}\log f/K\left\{1+\frac{1}{24}\log^2 f/K+\frac{1}{1920}\log^4 f/K+\cdots\right., \tag{A.68a}$$

$$f^{1-\beta}-K^{1-\beta} = (1-\beta)(fK^{(1-\beta)/2})\log f/K \cdot\left\{1+\frac{(1-\beta)^2}{24}\log^2 f/K+\frac{(1-\beta)^4}{1920}\log^4 f/K+\cdots\right. \tag{A.68b}$$

and neglecting terms higher than fourth order. This expansion reduces the implied normal volatility to

$$\sigma_N(K) = \varepsilon\alpha(fK)^{\beta/2}\frac{1+\frac{1}{24}\log^2 f/K+\frac{1}{1920}\log^4 f/K+\cdots}{1+\frac{(1-\beta)^2}{24}\log^2 f/K+\frac{(1-\beta)^4}{1920}\log^4 f/K+\cdots}\cdot\left(\frac{\zeta}{\hat{x}(\zeta)}\right) \cdot\left\{1+\left[\frac{-\beta(2-\beta)\alpha^2}{24(fK)^{1-\beta}}+\frac{\rho\alpha\nu\beta}{4(fK)^{(1-\beta)/2}}+\frac{2-3\rho^2}{24}\nu^2\right]\varepsilon^2\tau_{ex}+\cdots\right\}. \tag{A.69a}$$

where

$$\zeta = \frac{\nu}{\alpha}(fK)^{(1-\beta)/2}\log f/K, \qquad \hat{x}(\zeta) = \log\left(\frac{\sqrt{1-2\rho\zeta+\zeta^2}-\rho+\zeta}{1-\rho}\right). \tag{A.69b}$$

This is the formula we use in pricing European calls and puts.

To obtain the implied Black volatility, we equate the implied normal volatility $\sigma_N(K)$ for the SABR model obtained in (A.69a – A.69b) to the implied normal volatility for Black's model obtained in (A.63). This shows that the implied Black volatility for the SABR model is

$$\sigma_B(K) = \frac{\varepsilon\alpha}{(fK)^{(1-\beta)/2}}\frac{1}{1+\frac{(1-\beta)^2}{24}\log^2 f/K+\frac{(1-\beta)^4}{1920}\log^4 f/K+\cdots}\cdot\left(\frac{\zeta}{\hat{x}(\zeta)}\right) \cdot\left\{1+\left[\frac{(1-\beta)^2\alpha^2}{24(fK)^{1-\beta}}+\frac{\rho\alpha\nu\beta}{4(fK)^{(1-\beta)/2}}+\frac{2-3\rho^2}{24}\nu^2\right]\varepsilon^2\tau_{ex}+\cdots\right\}, \tag{A.69c}$$

through $O(\varepsilon^2)$, where ζ and $\hat{x}(\zeta)$ are given by (A.69b) as before. Apart from setting ε to 1 to recover the original units, this is the formula quoted in section 2, and fitted to the market in section 3.

A.5. Special cases Two special cases are worthy of special treatment: the stochastic normal model ($\beta = 0$) and the stochastic log normal model ($\beta = 1$). Both these models are simple enough that the expansion can be continued through $O(\varepsilon^4)$. For the stochastic *normal* model ($\beta = 0$) the implied volatilities of European calls and puts are

$$\sigma_N(K) = \varepsilon\alpha\left\{1+\frac{2-3\rho^2}{24}\varepsilon^2\nu^2\tau_{ex}+\cdots\right\} \tag{A.70a}$$

$$\sigma_B(K) = \varepsilon\alpha\frac{\log f/K}{f-K}\cdot\left(\frac{\zeta}{\hat{x}(\zeta)}\right)\cdot\left\{1+\left[\frac{\alpha^2}{24fK}+\frac{2-3\rho^2}{24}\nu^2\right]\varepsilon^2\tau_{ex}+\cdots\right\} \tag{A.70b}$$

through $O(\varepsilon^4)$, where

$$\zeta = \frac{\nu}{\alpha}\sqrt{fK}\log f/K, \qquad \hat{x}(\zeta) = \log\left(\frac{\sqrt{1-2\rho\zeta+\zeta^2}-\rho+\zeta}{1-\rho}\right). \tag{A.70c}$$

For the stochastic log normal model ($\beta = 1$) the implied volatilities are

$$\sigma_N(K) = \varepsilon\alpha\frac{f-K}{\log f/K}\cdot\left(\frac{\zeta}{\hat{x}(\zeta)}\right)\cdot\left\{1+\left[-\frac{1}{24}\alpha^2+\frac{1}{4}\rho\alpha\nu+\frac{1}{24}(2-3\rho^2)\nu^2\right]\varepsilon^2\tau_{ex}+\cdots\right\} \tag{A.71a}$$

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$$\sigma_B(K) = \varepsilon\alpha \cdot \left(\frac{\zeta}{\hat{x}(\zeta)}\right) \cdot \left\{1 + \left[\frac{1}{4}\rho\alpha\nu + \frac{1}{24}(2 - 3\rho^2)\nu^2\right]\varepsilon^2\tau_{\alpha} + \cdots\right\} \tag{A.71b}$$

through $O(\varepsilon^4)$, where

$$\zeta = \frac{\nu}{\alpha}\log f/K, \qquad \hat{x}(\zeta) = \log\left(\frac{\sqrt{1 - 2\rho\zeta + \zeta^2} - \rho + \zeta}{1 - \rho}\right). \tag{A.71c}$$

Appendix B. Analysis of the Dynamic SABR Model.

We use *effective medium theory* [23] to extend the preceding analysis to the dynamic SABR model. As before, we take the volatility $\gamma(t)\hat{\alpha}$ and "volvol" $\nu(t)$ to be small, writng $\gamma(t) \longrightarrow \varepsilon\gamma(t)$, and $\nu(t) \longrightarrow \varepsilon\nu(t)$, and analyze

$$d\hat{F} = \varepsilon\gamma(t)\hat{\alpha}C(\hat{F})\,dW_1, \tag{B.1a}$$

$$d\hat{\alpha} = \varepsilon\nu(t)\hat{\alpha}dW_2, \tag{B.1b}$$

with

$$dW_1 dW_2 = \rho(t)\,dt, \tag{B.1c}$$

in the limit $\varepsilon \ll 1$. We obtain the prices of European options, and from these prices we obtain the implied volatity of these options. After obtaining the results, we replace $\varepsilon\gamma(t) \longrightarrow \gamma(t)$.and $\varepsilon\nu(t) \longrightarrow \nu(t)$ to get the answer in terms of the original variables.

Suppose the economy is in state $\hat{F}(t) = f$, $\hat{\alpha}(t) = \alpha$ at date t. Let $V(t, f, \alpha)$ be the value of, say, a European call option with strike K and exercise date t_{α}. As before, define the transition density $p(t, f, \alpha; T, F, A)$ by

$$p(t, f, \alpha; T, F, A)\,dF\,dA \equiv \text{prob}\left\{F < \hat{F}(T) < F + dF,\ A < \hat{\alpha}(T) < A + dA \mid \hat{F}(t) = f,\ \hat{\alpha}(t) = \alpha\right\} \tag{B.2a}$$

and define

$$P(t, f, \alpha; T, K) = \int_{-\infty}^{\infty} A^2 p(t, f, \alpha; T, K, A)\,dA. \tag{B.2b}$$

Repeating the analysis in Appendix B through equation (A.10a), (A.10b) now shows that the option price is given by

$$V(t, f, a) = [f - K]^+ + \frac{1}{2}\varepsilon^2 C^2(K)\int_t^{t_{\alpha}} \gamma^2(T)\,P(t, f, \alpha; T, K)\,dT, \tag{B.3}$$

where $P(t, f, \alpha; T, K)$ is the solution of the backwards problem

$$P_t + \frac{1}{2}\varepsilon^2\left\{\gamma^2\alpha^2C^2(f)P_{ff} + 2\rho\gamma\nu\alpha^2C(f)P_{f\alpha} + \nu^2\alpha^2P_{\alpha\alpha}\right\} = 0, \qquad \text{for } t < T \tag{B.4a}$$

$$P = \alpha^2\delta(f - K), \text{ for } t = T. \tag{B.4b}$$

We eliminate $\gamma(t)$ by defining the new time variable

$$s = \int_0^t \gamma^2(t')\,dt', \quad s' = \int_0^T \gamma^2(t')\,dt', \quad s_{\alpha} = \int_0^{t_{\alpha}} \gamma^2(t')\,dt'. \tag{B.5}$$

Then the option price becomes

$$V(t, f, a) = [f - K]^+ + \frac{1}{2}\varepsilon^2C^2(K)\int_s^{s_{\alpha}} P(s, f, \alpha; s', K)\,ds', \tag{B.6}$$

where $P(s, f, \alpha; s', K)$ solves the forward problem

$$P_s + \frac{1}{2}\varepsilon^2\left\{\alpha^2C^2(f)P_{ff} + 2\eta(s)\alpha^2C(f)P_{f\alpha} + \upsilon^2(s)\alpha^2P_{\alpha\alpha}\right\} = 0 \quad \text{for } s < s' \tag{B.7a}$$

$$P = \alpha^2\delta(f - K), \qquad \text{for } s = s'. \tag{B.7b}$$

Here

$$\eta(s) = \rho(t)\nu(t)/\gamma(t), \qquad \upsilon(s) = \nu(t)/\gamma(t). \tag{B.8}$$

We solve this problem by using an *effective media* strategy [23]. In this strategy our objective is to determine which constant values $\bar{\eta}$ and $\bar{\upsilon}$ yield the same option price as the the time dependent coefficients $\eta(s)$ and $\upsilon(s)$. If we could find these constant values, this would reduce the problem to the non-dynamic SABR model solved in Appendix B.

We carry out this strategy by applying the same series of *time-independent* transformations that was used to solve the non-dynamic SABR model in Appendix B, defining the transformations in terms of the (as yet unknown) constants $\bar{\eta}$ and $\bar{\upsilon}$. The resulting problem is relatively complex, more complex than the canonical problem obtained in Appedix B. We use a regular perturbation expansion to solve this problem, and once we have solved this problem, we choose $\bar{\eta}$ and $\bar{\upsilon}$ so that all terms arising from the time dependence of $\eta(t)$ and $\upsilon(t)$ cancel out. As we shall see, this simultaneously determines the "effective" parameters and allows us to use the analysis in Appendix B to obtain the implied volatility of the option.

B.1 Transformation. As in Appendix B, we change independent variables to

$$z = \frac{1}{\varepsilon\alpha}\int_K^f \frac{df'}{C(f')}, \tag{B.9a}$$

and define

$$B(\varepsilon\alpha z) = C(f). \tag{B.9b}$$

We then change dependent variables from P to $\hat{P}$, and then to H:

$$\hat{P} = \frac{\varepsilon}{\alpha}C(K)\,P, \tag{B.9c}$$

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$$H = \sqrt{C(K)/C(f)}\,\hat{P} \equiv \sqrt{B(0)/B(\varepsilon\alpha z)}\,\hat{P}. \tag{B.9d}$$

Following the reasoning in Appendix B, we obtain

$$V(t, f, a) = [f - K]^+ + \frac{1}{2}\varepsilon\alpha\sqrt{B(0)\,B(\varepsilon\alpha z)}\int_s^{s_m} H(s, z, \alpha; s')\,ds', \tag{B.10}$$

where $H(s, z, \alpha; s')$ is the solution of

$$\begin{aligned} &H_s + \frac{1}{2}\left(1 - 2\varepsilon\eta z + \varepsilon^2 v^2 z^2\right) H_{zz} - \frac{1}{2}\varepsilon^2\eta\alpha\frac{B'}{B}(zH_z - H) \\ &\quad + \varepsilon^2\alpha^2\left(\frac{1}{4}\frac{B''}{B} - \frac{3}{8}\frac{B'^2}{B^2}\right) H = 0 \end{aligned} \tag{B.11a}$$

for $s < s'$, and

$$H = \delta(z) \qquad \text{at } s = s' \tag{B.11b}$$

through $O(\varepsilon^2)$. See (A.29), (A.31a), and (A.31b). There are no α derivatives in equations (B.11a), (B.11b), so we can treat α as a parameter instead of a variable. Through $O(\varepsilon^2)$ we can also treat B'/B and B''/B as constants:

$$b_1 \equiv \frac{B'(\varepsilon\alpha z_0)}{B(\varepsilon\alpha z_0)}, \qquad b_2 \equiv \frac{B''(\varepsilon\alpha z_0)}{B(\varepsilon\alpha z_0)}, \tag{B.12}$$

where z_0 will be chosen later. Thus we must solve

$$\begin{aligned} &H_s + \frac{1}{2}\left(1 - 2\varepsilon\eta z + \varepsilon^2 v^2 z^2\right) H_{zz} - \frac{1}{2}\varepsilon^2\eta\alpha b_1(zH_z - H) \\ &\quad + \varepsilon^2\alpha^2\left(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\right) H = 0 \quad \text{for } s < s', \end{aligned} \tag{B.13a}$$

$$H = \delta(z) \qquad \text{at } s = s'. \tag{B.13b}$$

At this point we would like to use a time-independent transformation to remove the zH_z term from equation (B.13a). It is not possible to cancel this term exactly, since the coefficient $\eta(s)$ is time dependent. Instead we use the transformation

$$H = e^{\frac{1}{2}\varepsilon^2\alpha b_1\delta z^2}\hat{H}, \tag{B.14}$$

where the constant δ will be chosen later. This transformation yields

$$\begin{aligned} &\hat{H}_s + \frac{1}{2}\left(1 - 2\varepsilon\eta z + \varepsilon^2 v^2 z^2\right)\hat{H}_{zz} - \frac{1}{2}\varepsilon^2\alpha b_1(\eta - \delta)\,z\hat{H}_z \\ &\quad + \frac{1}{4}\varepsilon^2\alpha b_1(2\eta + \delta)\,\hat{H} + \varepsilon^2\alpha^2\left(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\right)\hat{H} = 0 \qquad \text{for } s < s', \end{aligned}$$

$$\hat{H} = \delta(z) \qquad \text{at } s = s', \tag{B.15a}$$

through $O(\varepsilon^2)$. Later the constant δ will be selected so that the change in the option price caused by the term $\frac{1}{2}\varepsilon^2\alpha b_1\eta z\hat{H}_z$ is exactly offset by the change in price due to $\frac{1}{2}\varepsilon^2\alpha b_1\delta z\hat{H}_z$ term. In this way to the transformation cancels out the zH_z term "on average."

In a similar vein we define

$$I(\varepsilon\bar{v}z) = \sqrt{1 - 2\varepsilon\bar{\eta}z + \varepsilon^2\bar{v}^2 z^2}, \tag{B.16a}$$

and

$$x = \frac{1}{\varepsilon\bar{v}}\int_0^{\varepsilon\bar{v}z}\frac{d\zeta}{I(\zeta)} = \frac{1}{\varepsilon\bar{v}}\log\left(\frac{\sqrt{1 - 2\varepsilon\bar{\eta}z + \varepsilon^2\bar{v}^2 z^2} - \bar{\eta}/\bar{v} + \varepsilon\bar{v}z}{1 - \bar{\eta}/\bar{v}}\right), \tag{B.16b}$$

where the constants $\bar{\eta}$ and $\bar{v}$ will be chosen later. This yields

$$\begin{aligned} &\hat{H}_s + \frac{1}{2}\frac{1 - 2\varepsilon\eta z + \varepsilon^2 v^2 z^2}{1 - 2\varepsilon\bar{\eta}z + \varepsilon^2\bar{v}^2 z^2}\left(\hat{H}_{xx} - \varepsilon\bar{v}I'(\varepsilon\bar{v}z)\,\hat{H}_x\right) - \frac{1}{2}\varepsilon^2\alpha b_1(\eta - \delta)\,x\hat{H}_x \\ &\quad + \frac{1}{4}\varepsilon^2\alpha b_1(2\eta + \delta)\,\hat{H} + \varepsilon^2\alpha^2\left(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\right)\hat{H} = 0 \qquad \text{for } s < s', \end{aligned} \tag{B.17a}$$

$$\hat{H} = \delta(x) \qquad \text{at } s = s', \tag{B.17b}$$

through $O(\varepsilon^2)$. Here we used $z = x + \cdots$ and $z\hat{H}_z = x\hat{H}_x + \cdots$ to leading order to simplify the results. Finally, we define

$$\hat{H} = I^{1/2}(\varepsilon\bar{v}z)\,Q. \tag{B.18}$$

Then the price of our call option is

$$\begin{aligned} V(t, f, a) = {} & [f - K]^+ + \frac{1}{2}\varepsilon\alpha\sqrt{B(0)\,B(\varepsilon\alpha z)}\,I^{1/2} \\ & \cdot(\varepsilon\bar{v}z)\,e^{\frac{1}{2}\varepsilon^2\alpha b_1\delta z^2}\int_s^{s_m} Q(s, x; s')\,ds', \end{aligned} \tag{B.19}$$

where $Q(s, x; s')$ is the solution of

$$\begin{aligned} &Q_s + \frac{1}{2}\frac{1 - 2\varepsilon\eta z + \varepsilon^2 v^2 z^2}{1 - 2\varepsilon\bar{\eta}z + \varepsilon^2\bar{v}^2 z^2}Q_{xx} - \frac{1}{2}\varepsilon^2\alpha b_1(\eta - \delta)\,xQ_x + \frac{1}{4}\varepsilon^2\alpha b_1(2\eta + \delta)\,Q \\ &\quad + \varepsilon^2\bar{v}^2\left(\frac{1}{4}I''I - \frac{1}{8}I'I'\right)Q + \varepsilon^2\alpha^2\left(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\right)Q = 0 \quad \text{for } s < s', \end{aligned} \tag{B.20a}$$

$$Q = \delta(x) \quad \text{at } s = s', \tag{B.20b}$$

Using

$$z = x - \frac{1}{2}\varepsilon\bar{\eta}x^2 + \cdots, \tag{B.21}$$

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we can simplify this to

$$Q_s + \frac{1}{2}Q_{xx} = \varepsilon(\eta - \bar{\eta})\, xQ_{xx} - \frac{1}{2}\varepsilon^2\left[\upsilon^2 - \bar{\upsilon}^2 - 3\bar{\eta}(\eta - \bar{\eta})\right] x^2 Q_{xx} + \frac{1}{2}\varepsilon^2\alpha b_1(\eta - \delta)(xQ_x - Q) - \frac{3}{4}\varepsilon^2\alpha b_1\delta Q - \varepsilon^2\bar{\upsilon}^2\left(\frac{1}{4}I''I - \frac{1}{8}I'I'\right)Q - \varepsilon^2\alpha^2\left(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\right)Q \quad \text{for } s < s', \tag{B.22a}$$

$$Q = \delta(x) \quad \text{at } s = s', \tag{B.22b}$$

through $O(\varepsilon^2)$. Note that I, I', and I'' can be replaced by the constants $I(\varepsilon\bar{\upsilon}z_0)$, $I'(\varepsilon\bar{\upsilon}z_0)$, and $I''(\varepsilon\bar{\upsilon}z_0)$ through $O(\varepsilon^2)$.

B. 2. Perturbation expansion. Suppose we were to expand $Q(s, x; s')$ as a power series in ε :

$$Q(s, x; s') = Q^{(0)}(s, x; s') + \varepsilon Q^{(1)}(s, x; s') + \varepsilon^2 Q^{(2)}(s, x; s') + \cdots. \tag{B.23}$$

Substituting this expansion into (B.22a), (B.22b) yields the following hierarchy of equations. To leading order we have

$$Q_s^{(0)} + \frac{1}{2}Q_{xx}^{(0)} = 0 \quad \text{for } s < s'. \tag{B.24a}$$

$$Q^{(0)} = \delta(x) \quad \text{at } s = s'. \tag{B.24a}$$

At $O(\varepsilon)$ we have

$$Q_s^{(1)} + \frac{1}{2}Q_{xx}^{(1)} = (\eta - \bar{\eta})\, xQ_{xx}^{(0)} \quad \text{for } s < s', \tag{B.25a}$$

$$Q^{(1)} = 0 \quad \text{at } s = s'. \tag{B.25b}$$

At $O(\varepsilon^2)$ we can break the solution into

$$Q^{(2)} = Q^{(2s)} + Q^{(2a)} + Q^{(2b)}, \tag{B.26}$$

where

$$Q^{(2s)} + \frac{1}{2}Q_{xx}^{(2s)} = -\frac{3}{4}ab_1\delta Q^{(0)} - \bar{\upsilon}^2\left(\frac{1}{4}I''I - \frac{1}{8}I'I'\right)Q^{(0)} - \alpha^2\left(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\right)Q^{(0)} \quad \text{for } s < s', \tag{B.27a}$$

$$Q^{(2s)} = 0 \quad \text{at } s = s', \tag{B.27b}$$

where

$$Q_s^{(2a)} + \frac{1}{2}Q_{xx}^{(2a)} = \frac{1}{2}\alpha b_1(\eta - \delta)\left(xQ_x^{(0)} - Q^{(0)}\right) \quad \text{for } s < s', \tag{B.28a}$$

$$Q^{(2a)} = 0 \quad \text{at } s = s', \tag{B.28b}$$

and where

$$Q_s^{(2b)} + \frac{1}{2}Q_{xx}^{(2b)} = (\eta - \bar{\eta})\, xQ_{xx}^{(1)} - \frac{1}{2}\left[\upsilon^2 - \bar{\upsilon}^2 - 3\bar{\eta}(\eta - \bar{\eta})\right] x^2 Q_{xx}^{(0)} \quad \text{for } s < s', \tag{B.29a}$$

$$Q^{(2b)} = 0 \quad \text{at } s = s'. \tag{B.29b}$$

Once we have solved these equations, then the option price is then given by

$$V(t, f, a) = [f - K]^+ + \frac{1}{2}\varepsilon\alpha\sqrt{B(0)\,B(\varepsilon\alpha z)}\,I^{1/2}(\varepsilon z)\, e^{\frac{1}{2}\varepsilon^2 ab_1\delta z^2} J, \tag{B.30a}$$

where

$$J = \int_s^{s_m} Q^{(0)}(s, x; s')\, ds' + \varepsilon\int_s^{s_m} Q^{(1)}(s, x; s')\, ds' + \varepsilon^2\int_s^{s_m} Q^{(2s)}(s, x; s')\, ds' + \varepsilon^2\int_s^{s_m} Q^{(2a)}(s, x; s')\, ds' + \varepsilon^2\int_s^{s_m} Q^{(2b)}(s, x; s')\, ds' + \cdots. \tag{B.30b}$$

The terms $Q^{(1)}$, $Q^{(2a)}$, and $Q^{(2b)}$ arise from the time-dependence of the coefficients $\eta(s)$ and $\upsilon(s)$. Indeed, if $\eta(s)$ and $\upsilon(s)$ were constant in time, we would have $Q^{(1)} \equiv Q^{(2a)} \equiv Q^{(2b)} \equiv 0$, and the solution would be just $Q^{(s)} \equiv Q^{(0)} + \varepsilon^2 Q^{(2s)}$. Therefore, we will first solve for $Q^{(1)}$, $Q^{(2a)}$, and $Q^{(2b)}$, and then try to choose the constants δ, $\bar{\eta}$, and $\bar{\upsilon}$ so that the last three integrals are zero for all x. In this case, the option price woud be given by

$$V(t, f, a) = [f - K]^+ + \frac{1}{2}\varepsilon\alpha\sqrt{B(0)\,B(\varepsilon\alpha z)}\,I^{1/2}(\varepsilon z) \cdot e^{\frac{1}{2}\varepsilon^2 ab_1\delta z^2}\int_s^{s_m} Q^{(s)}(s, x; s')\, ds', \tag{B.31a}$$

and, through $O(\varepsilon^2)$, $Q^{(s)}$ would be the solution of the static problem

$$Q_s^{(s)} + \frac{1}{2}Q_{xx}^{(s)} = -\frac{3}{4}\varepsilon^2 ab_1\delta Q^{(s)} - \varepsilon^2\bar{\upsilon}^2\left(\frac{1}{4}I''I - \frac{1}{8}I'I'\right)Q^{(s)} - \varepsilon^2\alpha^2\left(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\right)Q^{(s)} \quad \text{for } s < s', \tag{B.31b}$$

$$Q^{(s)} = \delta(x) \quad \text{at } s = s'. \tag{B.31c}$$

This is exactly the time-independent problem solved in Appendix B. See equations (A.42), (A.43a), and (A.43b). So if we can carry out this strategy, we can obtain option prices for the dynamic SABR model by reducing them to the previously-obtained prices for the static model.

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B.2.1. Leading order analysis The solution of (B.24a), (B.24b) is Gaussian:

$$Q^{(0)} = G(x/\sqrt{\Delta}) \tag{B.32a}$$

where

$$G(x/\sqrt{\Delta}) = \frac{1}{\sqrt{2\pi\Delta}} e^{-x^2/2\Delta}, \quad \Delta = s' - s. \tag{B.32b}$$

For future reference, note that

$$G_x = -\frac{x}{\Delta} G; \quad G_{xx} = \frac{x^2 - \Delta}{\Delta^2} G; \quad G_{xxx} = -\frac{x^3 - 3\Delta x}{\Delta^3} G; \tag{B.33a}$$

$$G_{xxxx} = \frac{x^4 - 6\Delta x^2 + 3\Delta^2}{\Delta^4} G; \quad G_{xxxxx} = -\frac{x^5 - 10\Delta x^3 + 15\Delta^2 x}{\Delta^5} G. \tag{B.33b}$$

$$G_{xxxxxx} = \frac{x^6 - 15\Delta x^4 + 45\Delta^2 x^2 - 15\Delta^3}{\Delta^6} G. \tag{B.33c}$$

B.2.2. Order ε Substituting $Q^{(0)}$ into the equation for $Q^{(1)}$ and using (B.33a) yields

$$\begin{aligned} Q_s^{(1)} + \frac{1}{2} Q_{xx}^{(1)} &= (\eta - \bar{\eta}) \frac{x^3 - \Delta x}{\Delta^2} G \\ &= -(s' - s)(\eta - \bar{\eta}) G_{xxx} - 2(\eta - \bar{\eta}) G_x \quad \text{for } s < s', \end{aligned} \tag{B.34}$$

with the "initial" condition $Q^{(1)} = 0$ at $s = s'$. The solution is

$$Q^{(1)} = A(s, s') G_{xxx} + 2A_{s'}(s, s') G_x \tag{B.35a}$$

$$= \frac{\partial}{\partial s'} \left\{ 2A(s, s') G_x(x/\sqrt{s' - s} \right\}, \tag{B.35b}$$

where

$$A(s, s') = \int_s^{s'} (s' - \bar{s})[\eta(\bar{s}) - \bar{\eta}] d\bar{s}; \qquad A_{s'}(s, s') = \int_s^{s'} [\eta(\bar{s}) - \bar{\eta}] d\bar{s}. \tag{B.35c}$$

This term contributes

$$\int_s^{s_{rt}} Q^{(1)}(s, x; s') ds' = 2A(s, s_{rt}) G_x(x/\sqrt{s_{rt} - s}) \tag{B.36}$$

to the option price. See equations (B.30a), (B.30b). To eliminate this contribution, we chose $\bar{\eta}$ so that $A(s, s_{rt}) = 0$:

$$\bar{\eta} = \frac{\int_s^{s_{rt}} (s_{rt} - \bar{s}) \eta(\bar{s}) d\bar{s}}{\frac{1}{2}(s_{rt} - s)^2}. \tag{B.37}$$

B.2.3. The $\varepsilon^2 Q^{(2a)}$ term From equation (B.28a) we obtain

$$\begin{aligned} Q_s^{(2a)} + \frac{1}{2} Q_{xx}^{(2a)} &= -\frac{1}{2} \alpha b_1 (\eta - \delta) \frac{x^2 + \Delta}{\Delta} G \\ &= -\frac{1}{2} \alpha b_1 (\eta - \delta) \Delta G_{xx} - \alpha b_1 (\eta - \delta) G \end{aligned} \tag{B.38}$$

for $s < s'$, with $Q^{(2a)} = 0$ at $s = s'$. Solving then yields

$$Q^{(2a)} = \frac{\partial}{\partial s'} \left\{ \alpha b_1 \int_s^{s'} (s' - \bar{s})[\eta(\bar{s}) - \delta] d\bar{s} G(x/\sqrt{s' - \bar{s}}) \right\}. \tag{B.39}$$

This term makes a contribution of

$$\int_s^{s_{rt}} Q^{(2a)}(s, x; s') ds' = \alpha b_1 \left(\int_s^{s_{rt}} (s_{rt} - \bar{s})[\eta(\bar{s}) - \delta] d\bar{s} \right) G(x/\sqrt{s_{rt} - s}) \tag{B.40}$$

to the option price, so we choose

$$\delta = \bar{\eta} = \frac{\int_s^{s_{rt}} (s_{rt} - \bar{s})[\eta(\bar{s}) - \delta] d\bar{s}}{\frac{1}{2}(s_{rt} - \bar{s})^2}. \tag{B.41}$$

to eliminate this contribution.

B.2.4. The $\varepsilon^2 Q^{(2b)}$ term Substituting $Q^{(1)}$ and $Q^{(0)}$ into equation (B.29a), we obtain

$$Q_s^{(2b)} + \frac{1}{2} Q_{xx}^{(2b)} = (\eta - \bar{\eta}) A x G_{xxxxx} + 2(\eta - \bar{\eta}) A_s x G_{xxx} - \frac{1}{2} \kappa x^2 G_{xx}, \tag{B.42a}$$

for $s < s'$, where

$$\kappa = v^2(s) - \bar{v}^2 - 3\bar{\eta}[\eta(s) - \bar{\eta}]. \tag{B.42b}$$

This can be re-written as

$$\begin{aligned} Q_s^{(2b)} + \frac{1}{2} Q_{xx}^{(2b)} = &-(\eta - \bar{\eta}) A[\Delta G_{xxxxx} + 5G_{xxxx}] - 2(\eta - \bar{\eta}) A_s[\Delta G_{xxxx} \\ &+ 3G_{xx}] - \frac{1}{2}\kappa[\Delta^2 G_{xxxx} + 5\Delta G_{xx} + 2G] \end{aligned} \tag{B.43}$$

Solving this with the initial condition $Q^{(2b)} = 0$ at $s = s'$ yields

$$\begin{aligned} Q^{(2b)} = &\frac{1}{2} A^2(s, s') G_{xxxxx} + 2A(s, s') A_s(s, s') G_{xxxx} \\ &+ 3\int_s^{s'} [\eta(\bar{s}) - \bar{\eta}] A(\bar{s}, s') d\bar{s} G_{xxxx} + 3A_s^2(s, s') G_{xx} \\ &+ \frac{1}{2}\int_s^{s'} [s' - \bar{s}]^2 \kappa(\bar{s}) d\bar{s} G_{xxxx} + \frac{5}{2}\int_s^{s'} [s' - \bar{s}] \kappa(\bar{s}) d\bar{s} G_{xx} + \int_s^{s'} \kappa(\bar{s}) d\bar{s} G. \end{aligned}$$

This can be written as

$$\begin{aligned} Q^{(2b)} = \frac{\partial}{\partial s'} \Bigg\{ &4A^2(s, s') G_{xx} - 12\int_s^{s'} [\eta(\bar{s}) - \bar{\eta}] A(\bar{s}, s') d\bar{s} G_x \\ &-2\int_s^{s'} (s' - \bar{s})^2 \kappa(\bar{s}) d\bar{s} G_s + \int_s^{s'} (s' - \bar{s}) \kappa(\bar{s}) d\bar{s} G \Bigg\} \end{aligned} \tag{B.45}$$

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Recall that $\bar{\eta}$ was chosen above so that $A(s, s_{cx}) = 0$. Therefore the contribution of $Q^{(2b)}$ to the option price is

$$\int_s^{s_m} Q^{(2b)}(s, x; s')\, ds' = -\Big(12\int_s^{s_m} [\eta(\bar{s}) - \bar{\eta}] A(\bar{s}, s_{cx})\, d\bar{s} + 2\int_s^{s_m} (s_{cx} - \bar{s})^2 \kappa(\bar{s})\, d\bar{s}\Big) G_s(x/\sqrt{s_{cx} - s}) + \Big(\int_s^{s_m} (s_{cx} - \bar{s}) \kappa(\bar{s})\, d\bar{s}\Big) G(x/\sqrt{s_{cx} - s}), \tag{B.46}$$

where $\kappa = v^2(s) - \bar{v}^2 - 3\bar{\eta}[\eta(s) - \bar{\eta}]$.

We can choose the remaining "effective media" parameter $\bar{v}$ to set either the coefficient of $G_s(x/\sqrt{s_{cx} - s})$ or the coefficient of $G(x/\sqrt{s_{cx} - s})$ to zero, but cannot set both to zero to completely eliminate the contribution of the term $Q^{(2b)}$. We choose $\bar{v}$ to set the coefficient of $G_s(x/\sqrt{s_{cx} - s})$ to zero, for reasons that will become apparent in a moment:

$$\bar{v}^2 = \frac{1}{\frac{1}{3}(s_{cx} - \bar{s})^3}\Big\{\int_s^{s_m} (s_{cx} - \bar{s})^2 v^2(\bar{s})\, d\bar{s} - 3\bar{\eta}\int_s^{s_m} (s_{cx} - \bar{s})^2 [\eta(\bar{s}) - \bar{\eta}]\, d\bar{s} - 6\int_s^{s_{cx}}\int_s^{s_1} s_2[\eta(s_1) - \bar{\eta}][\eta(s_2) - \bar{\eta}]\, ds_2\, ds_1. \tag{B.47}$$

Then the remaining contribution to the option price is

$$\int_s^{s_m} Q^{(2b)}(s, x; s')\, ds' = \frac{1}{2}\bar{k}\,(s_{cx} - s)^2\, G(x/\sqrt{s_{cx} - s}) = \frac{1}{2}\bar{k}\,(s_{cx} - s)^2\, Q^{(0)}(s, x; s_{cx}), \tag{B.48a}$$

where

$$\bar{k} = \frac{1}{\frac{1}{2}(s_{cx} - s)^2}\int_s^{s_m} (s_{cx} - \bar{s})[v^2(\bar{s}) - \bar{v}^2]\, d\bar{s}. \tag{B.48b}$$

Here we have used $\int_s^{s_m} (s_{cx} - \bar{s})(\eta(\bar{s}) - \bar{\eta})\, d\bar{s} = 0$ to simplify (B.48b).

B.3. Equivalent volatilities. We can now determine the implied volatility for the dynamic model by mapping the problem back to the static model of Appendix B. Recall from (B.30a), (B.30b) that the value of the option is

$$V(t, f, a) = [f - K]^+ + \frac{1}{2}\varepsilon\alpha\sqrt{B(0)\, B(\varepsilon\alpha z)}\, I^{1/2}(\varepsilon z)\, e^{\frac{1}{4}\varepsilon^2 ab_1\bar{\eta}^2}\, J, \tag{B.49a}$$

where

$$J = \int_s^{s_m} Q^{(0)}(s, x; s')\, ds' + \varepsilon\int_s^{s_m} Q^{(1)}(s, x; s')\, ds' + \varepsilon^2\int_s^{s_m} Q^{(2s)}(s, x; s')\, ds' + \varepsilon^2\int_s^{s_m} Q^{(2a)}(s, x; s')\, ds' + \varepsilon^2\int_s^{s_m} Q^{(2b)}(s, x; s')\, ds' + \cdots, \tag{B.49b}$$

and where we have use $\delta = \bar{\eta}$. We chose the "effective parameters" $\bar{\eta}$ and $\bar{v}$ so that the integrals of $Q^{(1)}$, $Q^{(2a)}$ contribute nothing to J. The integral of $Q^{(2b)}$ then contributed $\frac{1}{2}\varepsilon^2\bar{k}(s_{cx} - s)^2\, Q^{(0)}(s, x; s_{cx})$. The option price is

$$J = \int_s^{s_m} \{Q^{(0)}(s, x; s') + \varepsilon^2 Q^{(2s)}(s, x; s')\}\, ds' + \frac{1}{2}\varepsilon^2\bar{k}\,(s_{cx} - s)^2\, Q^{(0)}(s, x; s_{cx}) + \cdots \tag{B.50a}$$
$$= \int_s^{\hat{s}_{cx}} \{Q^{(0)}(s, x; s') + \varepsilon^2 Q^{(2s)}(s, x; s')\}\, ds' + \cdots$$

through $O(\varepsilon^2)$, where

$$\hat{s}_{cx} = s_{cx} + \frac{1}{2}\varepsilon^2\bar{k}(s_{cx} - s)^2 + \cdots \tag{B.50b}$$

Through $O(\varepsilon^2)$ we can combine $Q^{(s)} = Q^{(0)}(s, x; s') + \varepsilon^2 Q^{(2s)}(s, x; s')$, where $Q^{(s)}$ solves the static problem

$$Q_s^{(s)} + \frac{1}{2}Q_{xx}^{(s)} = -\frac{3}{4}\varepsilon^2 ab_1\delta Q^{(s)} - \varepsilon^2\bar{v}^2\Big(\frac{1}{4}I''I - \frac{1}{8}I'I'\Big) \cdot Q^{(s)} - \varepsilon^2\alpha^2\Big(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\Big)Q^{(s)} \qquad \text{for} \quad s < s', \tag{B.51a}$$

$$Q^{(s)} = \delta(s - s') \qquad \text{at} \quad s = s', \tag{B.51b}$$

This problem is homogeneous in the time s, so its solution $Q^{(s)}$ depends only on the time difference $\tau = s' - s$. The option price is therefore

$$V(t, f, a) = [f - K]^+ + \frac{1}{2}\varepsilon\alpha\sqrt{B(0)\, B(\varepsilon\alpha z)}\, I^{1/2}(\varepsilon z)\, e^{\frac{1}{4}\varepsilon^2 ab_1\bar{\eta}^2}\int_0^{s_m - s} Q^{(s)}(\tau, x)\, d\tau, \tag{B.52}$$

where $Q^s(\tau, x)$ is the solution of

$$Q_\tau^{(s)} - \frac{1}{2}Q_{xx}^{(s)} = \frac{3}{4}\varepsilon^2 ab_1\bar{\eta}Q^{(s)} + \varepsilon^2\bar{v}^2\Big(\frac{1}{4}I''I - \frac{1}{8}I'I'\Big)Q^{(s)} + \varepsilon^2\alpha^2\Big(\frac{1}{4}b_2 - \frac{3}{8}b_1^2\Big)Q^{(s)} \qquad \text{for} \quad \tau > 0, \tag{B.53a}$$

$$Q^s = \delta(x) \qquad \text{at} \quad \tau = 0. \tag{B.53b}$$

The option price defined by (B.52), (B.53a), and (B.53b) is identical to the static model's option price defined by (A.42), (A.43a), and (A.43b), provided we make the identifications

$$v \to \bar{v}, \qquad \rho \to \bar{\eta}/\bar{v} \tag{B.54}$$

$$\tau_{cx} \to \hat{s}_{cx} - s = s_{cx} - s + \tfrac{1}{2}\varepsilon^2\bar{k}\,(s_{cx} - s)^2 \tag{B.55}$$

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in Appendix B for the original non-dynamic SABR model, provided we make the identifications

$$\tau_{\alpha} = \tau + \varepsilon^2 \int_0^{\tau} \bar{\tau}[\nu^2(\bar{\tau}) - \bar{\nu}^2]d\bar{\tau}, \tag{B.56a}$$

$$\nu \to \bar{\eta}/\bar{\nu}, \qquad \nu \to \bar{\nu}. \tag{B.56b}$$

See equations (A.42 – A.43b). Following the reasoning in the preceding Appendix now shows that the European call price is given by the formula

$$V(t, f, K) = (f - K)\mathcal{N}\left(\frac{f-K}{\sigma_N\sqrt{\tau_{\alpha}}}\right) + \sigma_N\sqrt{\tau_{\alpha}}\,\mathcal{G}\left(\frac{f-K}{\sigma_N\sqrt{\tau_{\alpha}}}\right), \tag{B.57}$$

with the implied *normal* volatility

$$\begin{aligned}\sigma_N(K) = {} & \frac{\varepsilon\alpha(f-K)}{\int_K^f \frac{df'}{C(f')}} \cdot \left(\frac{\zeta}{\hat{x}(\zeta)}\right) \cdot \\ & \left\{1 + \left[\frac{2\gamma_2 - \gamma_1^2}{24}\alpha^2 C^2(f_{av}) + \tfrac{1}{4}\bar{\eta}\alpha\gamma_1 C(f_{av})\right.\right. \\ & \left.\left. + \frac{2\bar{\nu}^2 - 3\bar{\eta}^2}{24} + \frac{1}{2}\bar{\theta}\right]\varepsilon^2\tau_{\alpha} + \cdots.\right.\end{aligned} \tag{B.58a}$$

where

$$\zeta = \frac{\bar{\nu}}{\alpha}\frac{f-K}{C(f_{av})}, \qquad \hat{x}(\zeta) = \log\left(\frac{\sqrt{1 - 2\bar{\eta}\zeta/\bar{\nu} + \zeta^2} - \bar{\eta}/\bar{\nu} + \zeta}{1 - \bar{\eta}/\bar{\nu}}\right), \tag{B.58b}$$

$$f_{av} = \sqrt{fK}, \qquad \gamma_1 = \frac{C'(f_{av})}{C(f_{av})}, \qquad \gamma_2 = \frac{C''(f_{av})}{C(f_{av})}, \tag{B.58c}$$

$$\bar{\theta} = \frac{\int_0^{\tau} \bar{\tau}[\nu^2(\bar{\tau}) - \bar{\nu}^2]d\bar{\tau}}{\frac{1}{2}\tau^2}. \tag{B.58d}$$

Equivalently, the option prices are given by Black's formula with the effective Black volatility of

$$\begin{aligned}\sigma_B(K) = {} & \frac{\alpha \log f/K}{\int_K^f \frac{df}{C(f')}} \cdot \left(\frac{\zeta}{\hat{x}(\zeta)}\right) \\ & \cdot \left\{1 + \left[\frac{2\gamma_2 - \gamma_1^2 + 1/f_{av}^2}{24}\alpha^2 C^2(f_{av}) + \tfrac{1}{4}\bar{\eta}\alpha\gamma_1 C(f_{av})\right.\right. \\ & \left.\left. + \frac{2\bar{\nu}^2 - 3\bar{\eta}^2}{24} + \tfrac{1}{2}\bar{\theta}\right]\varepsilon^2\tau_{\alpha} + \cdots\right.\end{aligned}$$

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Quantitative Analytics

Introduction to Interest Rate Convexity

Simon Cedervall

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1 Introduction

This document is a very brief introduction to the pricing of simple interest rate products that feature convexity corrections. We consider two examples, Libor in arrears (LIA) and CMS swaps, and use a heuristic argument in order to relate their value to standard instruments (bonds, swaps, swaptions, caplets). It will be mentioned how to do it with a proper mathematical model as well, but the document is mainly intended for readers who manage to live happily without knowing any measure theory.

2 Libor

To start from the absolute beginning, let us consider a plain Libor forward. We agree with a counterparty to pay at time T_p a fixed rate K in exchange for the Libor rate $L(T_f, T_p)$ fixed at time T_f for the period (T_f, T_p). A standard libor swap works exactly like this, with the modification that we need to average out the "fair K's" for each individual flow to a single rate for the entire fixed leg.

Denote the time t price of a discount bond that pays 1 at time T by $P(t, T)$. Assuming a liquid bond market and that lending and borrowing is always possible at the Libor rates we are referring to, we can statically replicate the floating Libor payment by doing the following, the letters refer to figure 1,

- Buy unit notional amount of discount bond maturing at T_f (a).
- Sell unit notional amount of discount bond maturing at T_p (b).
- At time T_f, receive 1 on the first bond and invest this at the rate $L(T_f, T_p)$ (a+c).
- At time T_p, receive $(1 + \tau L(T_f, T_p))$ and pay 1 on the second bond (c+b) .
- We are left with $\tau L(T_f, T_p)$ (c).
- The initial cost was $P(0, T_f) - P(0, T_p)$, if we finance this by selling the T_p bond (at $P(0, T_p)$ per unit notional) (d), we have at ~~no cost set up future~~ exchange of $\tau L(T_f, T_p)$ against $(P(0, T_f) - P(0, T_p))/P(0, T_p)$.
- The fair fixed amount to offer against the forward libor cashflow is thus $L(0, T_f, T_p) = \frac{1}{\tau}\left(\frac{P(0,T_f)}{P(0,T_p)} - 1\right)$, which we call the forward Libor rate.

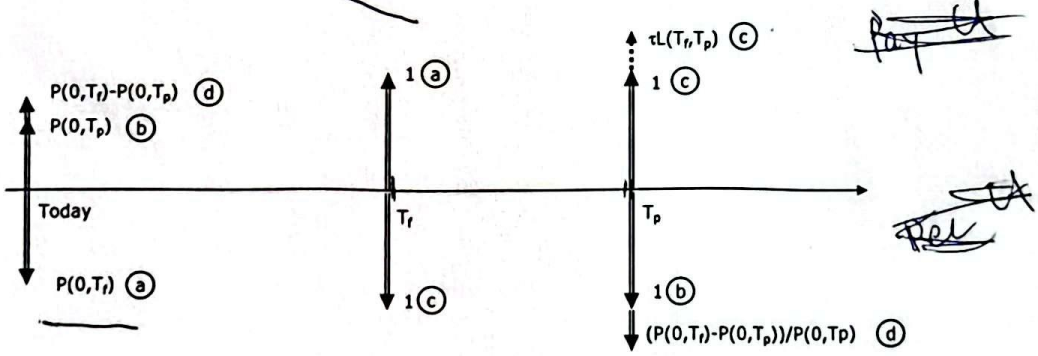
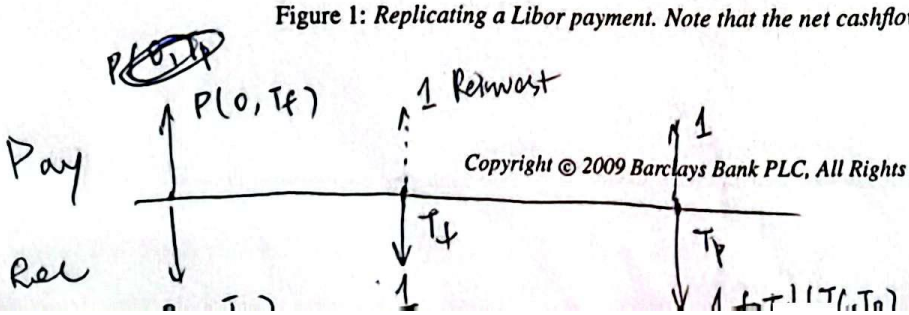


Figure 1: *Replicating a Libor payment. Note that the net cashflows are zero today and at T_f.*



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3 Libor In Arrears

What happens if the payments are made directly at T_f instead? This is the typical case in a LIA swap, where the fixings are taken at the end of each coupon period. We look for the fair forward $L_{LIA}(0, T_f, T_p)$ which is the fixed amount we would agree today to exchange for $L(T_f, T_p)$ at time T_f.

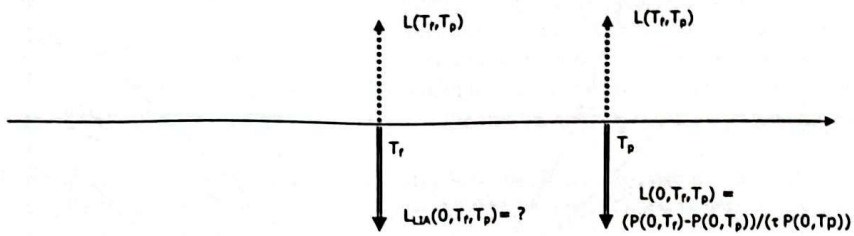

Figure 2: *We know the exchange at T_p has zero present value at time 0. What is the value $L_{LIA}(0, T_f, T_p)$ such that this is true for the T_f exchange as well?*

It is still the same fixing, so in order to compare it with the regular Libor case we will reinvest the payment of $L(T_f, T_p)$ from T_f until T_p, the rate at which we do this is the same as the fixing itself, so at time T_p we receive $L(T_f, T_p)(1 + \tau L(T_f, T_p)) = L(T_f, T_p) + \tau L(T_f, T_p)^2$. We know how to lock in the value of the first term, but what about the second? To save space, we will write $L = L(T_f, T_p)$, $L_0 = L(0, T_f, T_p)$, and please note that L_0 is known today, L not until time T_f. First note that the value of the reinvested LIA payment at time T_p is

$$L + \tau L^2 = L(1 + \tau L_0) + \tau(L - L_0)^2 + \tau L_0(L - L_0)$$

It looks like we made things worse, but this is in order to compare with the time T_p value of the reinvested fixed payment, which is $L_{LIA}(1 + \tau L)$, and we know from the previous section that we can agree today to exchange this for $L_{LIA}(1 + \tau L_0)$ at time T_p. For the three terms in the expression above, we have

- $L(1 + \tau L_0)$, this is just a libor payment. We know from the previous section that we can swap this into a known payment $L_0(1 + \tau L_0)$ at T_p.
- $\tau(L - L_0)^2$, this is a convex term, so we can not apply the previous section. We will deal with it below.
- $\tau L_0(L - L_0)$, this is fixed against floating, and using the argument in the previous section we see that it can be cancelled out completely at no cost. (If we want to hedge a future LIA payment, we have to offset this term with a regular libor payment at T_p, but the cost of setting that hedge up is zero.)

To deal with the second term we need to go to the option market. A (unit notional) libor caplet struck at K pays $\tau(L - K)^+$ at time T_p, and a floorlet pays $\tau(K - L)^+$, where we use the notation $x^+ = \max(x, 0)$. We want to replicate the quadratic term using caplets. This is how to do it, the basic idea is illustrated in figure 3,

- Pick a distance between consecutive strikes Δ
- Buy notional amount Δ of both caplet and floorlet, struck at the money ($K = L_0$).
- At all strikes $L_0 + \Delta, L_0 + 2\Delta, L_0 + 3\Delta, \ldots$, buy caplet at that strike with notional 2Δ.
- At all strikes $L_0 - \Delta, L_0 - 2\Delta, L_0 - 3\Delta, \ldots$, buy floorlet at that strike with notional 2Δ.
- When the rate fixes, there will be $N \approx |L - L_0|/\Delta$ options in the money, each respective in-the-moneyness being approximately $\Delta, 2\Delta, \ldots, N\Delta$. The total payoff is $\tau\left(\sum_{i=1}^{N}(2\Delta) \times (i\Delta) - (N\Delta) \times \Delta\right)$. The last term to correct for the half weight of the at the money option. Since $1 + 2 + \cdots + N = N(N+1)/2$, the payoff is approximately $\tau(N^2\Delta^2 + N\Delta^2 - N\Delta^2) \approx \tau(L - L_0)^2$.

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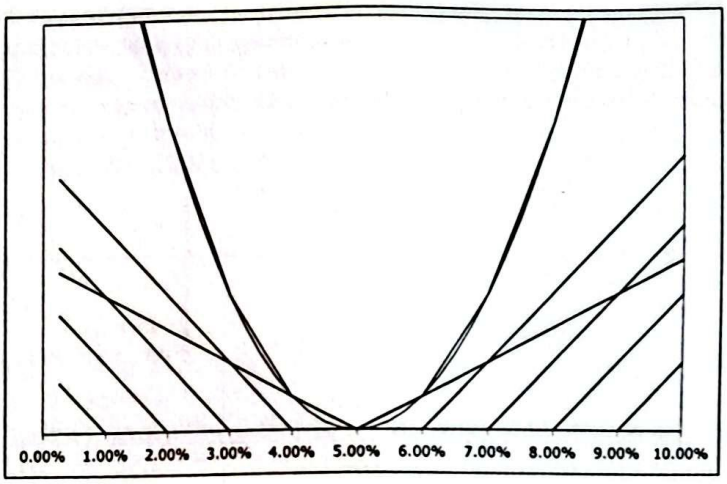

Figure 3: *Illustration of the option portfolio replicating a quadratic function, here with strikes* 1% *apart.*

Going back to the full LIA payment, we recall that getting paid $L(T_f, T_p)$ at T_f is equivalent to getting paid

$$L(1+\tau L_0) + \tau(L-L_0)^2 + \tau L_0(L-L_0)$$

at time T_p, so in order to replicate this we just need to be long a regular Libor payment of

$$(1+\tau L(0,T_f,T_p))L(T_f,T_p)$$

at time T_p, the portfolio of caplets and floorlets described above, and a forward rate agreement that can be entered at zero cost.

We conclude that the amount we can agree today to exchange for $L(T_f, T_p)$ at time T_f is the cost of setting the hedge portfolio up, divided by the discount to payment $P(0,T_f)$

$$\begin{aligned} L_{LIA}(0,T_f,T_p) &= L(0,T_f,T_p)P(0,T_p)\frac{(1+\tau L(0,T_f,T_p))}{P(0,T_f)} + \frac{\sum \text{current option prices}}{P(0,T_f)} \\ &= L(0,T_f,T_p) + P(0,T_f)^{-1}\Delta\text{Straddle}(L(0,T_f,T_p)) + \\ &\quad + 2P(0,T_f)^{-1}\sum_{i=1}^{\infty}(\Delta\text{Caplet}(L(0,T_f,T_p)+i\Delta) + \Delta\text{Floorlet}(L(0,T_f,T_p)-i\Delta)). \end{aligned}$$

The most salient points we wish to note about this is

- This is exact, up to the granularity Δ of the convexity hedge.
- The argument is exact because our payment delay mismatch $(1+\tau L)$ depends on the very same rate L that we are paying. For a payment that happens at some date between T_f and T_p this is no longer the case. Such payments require a bit further consideration, which will be implicitly covered by the next section on CMS.
- Being long a LIA payment is quite clearly being long volatility. Given the distribution of the strikes in the hedge portfolio, we can estimate that it is skew neutral and long smile risk.

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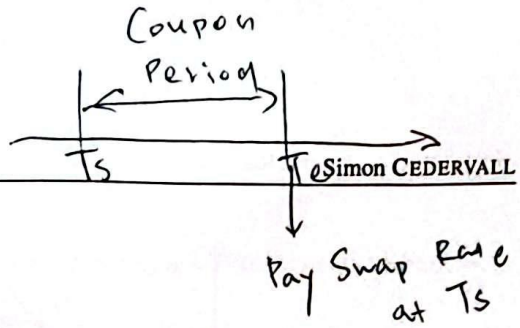


4 CMS

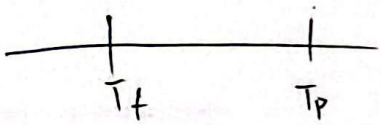
CMS (Constant Maturity Swap) rate products are similar to standard interest rate products in structure, but replace payments of/options on libor rates with similar payoffs depending on swap rates.

We will take as an example a CMS swap where the floating rate payer pays, at the end of each coupon period, a swap rate fixed at the start of the coupon period. The floating leg of such a swap can be priced as a sum of the constituent cashflows, so we will consider only a single coupon. The natural hedging instruments for this cashflow is the forward starting swap naturally linked to the rate fixing, and swaptions on the same underlying. It is not immediately obvious that we need to go to the option market, but we will soon see why it is so.

Denote the forward swap rate at time t by S_t, today is 0, the fixing happens at T_f and the payment at $T_p \geq T_f$. We will aim to find a static portfolio that replicates the CMS payoff. This is not strictly possible, but the attempt will serve well as an illustration.

As opposed to what we did in the previous section, our base for comparison will now be *value at the fixing time* T_f. At that point, the CMS cashflow is worth (assume unit notional and daycount fraction)

$$V_{CMS} = S_{T_f} P(T_f, T_p).$$



For notational consistency we will denote the value of $P(T_f, T_p)$ by V_{bond}.

A payer swap (then spot rather than forward starting) with fixed rate K is worth

$$V_{swap}(K) = (S_{T_f} - K)A(T_f),$$

where the annuity $A(t)$ is the value of a unit notional fixed leg (daycount fractions τ_i)

$$A(t) = \sum_{i=1}^{N} \tau_i P(t, T_i).$$

Finally, payer and receiver swaptions struck at K are worth, respectively

$$V_{pay}(K) = (S_{T_f} - K)^+ A(T_f), \quad V_{rec}(K) = (K - S_{T_f})^+ A(T_f),$$

where we use the notation $x^+ = \max(x, 0)$. Note that these swaptions are physically settled. It is possible to use cash settled swaptions as well, the conclusions would in the end be very similar.

We will now try to go short bonds, swaps and swaptions in order to cancel out all risks of the CMS cashflow. We will add instrument after instrument and measure the corresponding portfolio values V_i *at the fixing date* T_f. Our first portfolio is

$$V_0 = V_{CMS} = S_{T_f} P(T_f, T_p).$$

This is clearly going to be worth money, so we make a naive attempt at making the expected payout zero by selling S_0 of a zero coupon bond

$$V_1 = V_{CMS} - S_0 V_{bond} = (S_{T_f} - S_0)P(T_f, T_p).$$

While this portfolio looks like it might have a fair value of zero (forward rate vs realised rate), it most definitely does not. We will see why.

We can try to neutralise the exposure to the swap rate fixing by shorting a par forward swap. If we sell an amount α of the swap, we get the portfolio

$$(S_{T_f} - S_0)P(T_f, T_p) - \alpha(S_{T_f} - S_0)A(T_f).$$

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$V_{CMS} - S_0 \cdot V_{bond}$

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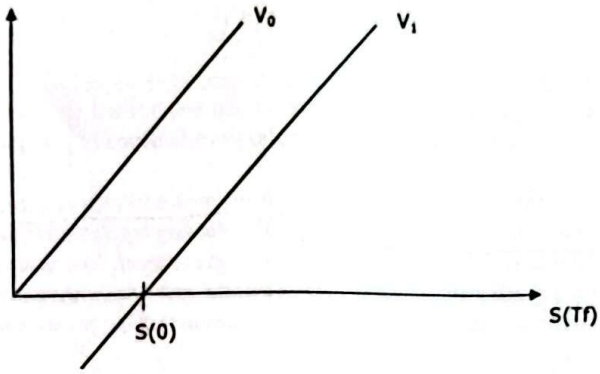

Figure 4: *Time T_f value of portfolios V_0 and V_1, measured in $P(T_f, T_p)$*

The right choice would be $\alpha = P(T_f, T_p)/A(T_f)$ but we do not know that value at time 0, so here is where we will make a small assumption and say that

$$\frac{P(T_f, T_p)}{A(T_f)} \approx \frac{P(0, T_p)}{A(0)}(1 + a(S_{T_f} - S_0)),$$

where the constant 1 has to be what it is in order to avoid arbitrage.

The calculation of a requires some model assumption that links the swap rate to the annuity, we will not consider it here but merely point out that a linear approximation is enough to get the right idea across and by all means quite adequate for practical pricing. The intuitive explanation for the relationship is that when rates go up, the annuity tends to decrease, and we are trying to capture that relationship to first order. It is not unreasonable to try to estimate a from historical data, should one wish to do so (figure 5).

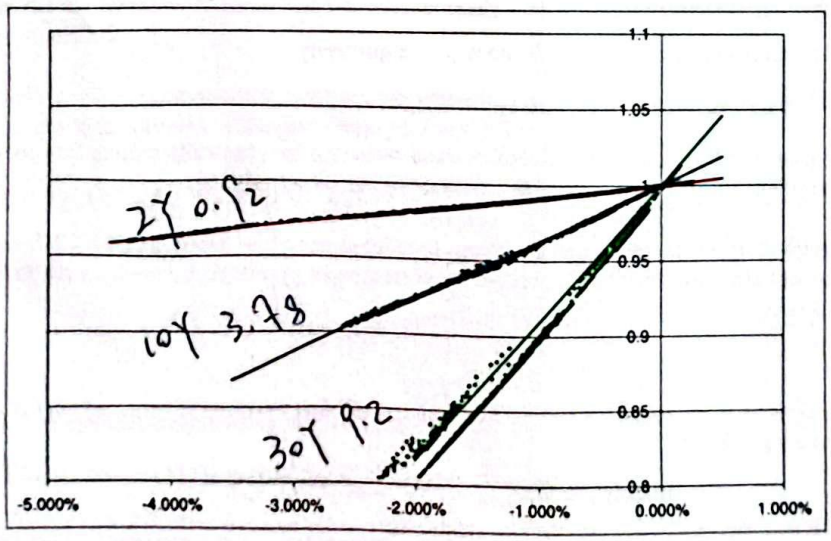

Figure 5: *Regression of $P(t, T_p)/A(t) \times A(0)/P(0, T_p)$ against $S(t) - S(0)$ for 2Y, 10Y and 30Y CMS up until the fixing in September 2009, with $t = 0$ corresponding to November 2001. The estimated values of a are 0.92, 3.78 and 9.2, respectively. Note that the 30Y series exhibit higher variability - it is roughly divided in a part with a closer to 10, and a noisier part with a closer to 9 (Sept 2008-Sept 2009).*

$$\frac{P(T_f, T_p)}{A(T_f)} \cdot \frac{A(0)}{P(0, T_p)} \approx 1 + a(S_{T_f} - S_0)$$

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Going back to the portfolio, we use the approximation above and then set $\alpha = P(0,T_p)/A(0)$, which gives

$$\begin{aligned} V_2 &= V_{CMS} - S_0 V_{bond} - \frac{P(0,T_p)}{A(0)} V_{swap}(S_0) \approx \\ &\approx (S_{T_f} - S_0)A(T_f)\frac{P(0,T_p)}{A(0)}(1 + a(S_{T_f} - S_0)) - \frac{P(0,T_p)}{A(0)}(S_{T_f} - S_0)A(T_f) = \\ &= a\frac{P(0,T_p)}{A(0)} A(T_f)(S_{T_f} - S_0)^2, \end{aligned}$$

where the keen reader will notice the square and think "convexity". We can replicate this quadratic function using swaptions.

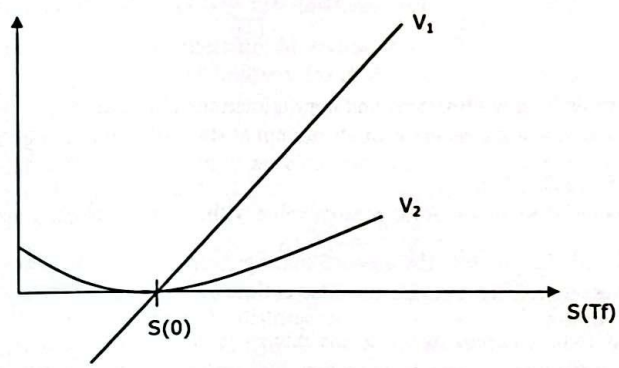

Figure 6: *Time T_f value of portfolios V_1 and V_2, measured in $A(T_f)$*

Reminding ourselves of the time T_f values of payer and receiver swaptions,

$$\begin{aligned} V_{pay}(T_f, K) &= (S_{T_f} - K)^+ A(T_f) \\ V_{rec}(T_f, K) &= (K - S_{T_f})^+ A(T_f), \end{aligned}$$

we see that we can build a "quadratic portfolio" just like we did in the LIA case. That is, pick strikes Δ apart, and buy $W\Delta = 2a\frac{P(0,T_p)}{A(0)}\Delta$ notional amount of the out-of-the-money swaption at each strike (split at-the-money into half payer, half receiver). This portfolio has payoff

$$\begin{aligned} \sum_{\text{ITM options}} (\text{in-the-moneyness}) \times A(T_f) \times W\Delta &\approx \sum_{i=0}^{|S_{T_f} - S_0|/\Delta} (i\Delta) \times A(T_f) \times W\Delta \approx \\ &\approx \int_0^{|S_{T_f} - S_0|} x A(T_f) W dx = a\frac{P(0,T_p)}{A(0)} A(T_f)(S_{T_f} - S_0)^2 \end{aligned}$$

In the end we get our approximate static hedge

$$\begin{aligned} V_3 \approx\ & V_{CMS} - \\ & - S_0 V_{bond} - \\ & - \frac{P(0,T_p)}{A(0)} V_{swap}(S_0) - \\ & - 2a\frac{P(0,T_p)}{A(0)} \left(\frac{\Delta}{2} V_{straddle}(S_0) + \sum_{i=1}^{\infty} (\Delta V_{pay}(S_0 + i\Delta) + \Delta V_{rec}(S_0 - i\Delta)) \right) \approx 0, \end{aligned}$$

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or in other words

$$V_{CMS} \approx S_0 V_{bond} + \frac{P(0,T_p)}{A(0)} V_{swap}(S_0) + \\ + 2a\frac{P(0,T_p)}{A(0)}\left(\frac{\Delta}{2}V_{straddle}(S_0) + \sum_{i=1}^{\infty}(\Delta V_{pay}(S_0+i\Delta) + \Delta V_{rec}(S_0 - i\Delta))\right)$$

If we want to know the forward CMS rate, i.e. the amount of money we can agree today to pay at T_p in order to receive $S(T_f)$, this is simply the cost of setting up the hedge divided by $P(0,T_p)$,

$$S_{CMS}(0) = S_0 + \frac{2a}{A(0)}\left(\frac{\Delta}{2}V_{straddle}(S_0) + \sum_{i=1}^{\infty}(\Delta V_{pay}(S_0+i\Delta) + \Delta V_{rec}(S_0 - i\Delta))\right)$$

So, while we have made both assumptions and approximations along the way (and not been very clear about what a should be), it seems that a decent enough attempt at statically replicating the CMS payoff is given by

- A zero coupon bond $S_0 P(0,T_p)$.
  This is the "naive" calculation of the present value without any convexity adjustments.
- A position of $P(0,T_p)/A(0)$ in the forward starting swap, struck at the forward swap rate.
  Note that this is entered at par so has no value at time 0.
- A portfolio of equal amounts of out of the money swaptions struck at equally spaced strikes (strictly speaking, the at the money strike is half payer, half receiver), with "notional density" $2aP(0,T_p)/A(0)$.
  The value of this portfolio corresponds to the convexity adjustment.

The following points can be made

- For short payment delays, a is positive (when rates go up, the annuity decreases through heavier discounting), so the convexity adjustment (value of the option portfolio) is positive.
- When that is the case the option portfolio, and hence the CMS cashflow, is long volatility.
- The volatility exposure is spread across the entire smile (in theory out to infinite strikes). In practice one would have to limit the convexity hedge to a liquid range of strikes.
- Instead of hedging the convexity/volatility risk with the very granular portfolio of swaptions, we could offset the volatility exposure with an at the money straddle, but then risk still remains at the outstrikes. Since the portfolio contains strikes on both sides of the forward, the skew sensitivity will cancel out to some extent, but there will be smile sensitivity left coming from both low and high strikes. So it is fair to say that the CMS cashflow is long both vol and vol-of-vol.
- CMS caps and floors can be priced by the same argument on "one side only", e.g. for a CMS cap use no bond, replace the swap by a payer swaption and only take the payer part of the convexity portfolio.
- The unknown a turns out to be quite similar between different model assumptions, and historical data of annuity versus rate fixings show a fairly stable relationship. The value of a is however highly dependent on the length of the swap - think sensitivity of the annuity to rates $\Leftrightarrow$ duration.

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5 Some mathematics

Pricing claims on a libor or swap rate has to start with considering a probability measure that is "natural" to that rate. For a libor rate this is the payment date forward measure and for a swap rate the corresponding annuity measure. We will consider the annuity measure with $A(t)$ as numeraire, this has the property that for any asset with value $V(t)$, the ratio $V(t)/A(t)$ is a martingale, i.e.

$$V(0) = A(0)\mathbb{E}^A\left[\frac{V(T)}{A(T)}\right].$$

In particular, the value of a forward starting swap is $(S(t) - K)A(t)$, which means that

$$(S(0) - K)A(0) = A(0)\mathbb{E}^A[S(T) - K] \Rightarrow \mathbb{E}^A[S(T)] = S(0),$$

so the swap rate itself is a martingale in this measure. Moreover, if we have a liquid swaption market we know that $V_{pay}(K) = A(0)\mathbb{E}^A[(S(T) - K)^+]$, and similarly for receivers, from which we can reconstruct the full probability density.

So we have a lot of knowledge about the annuity measure, but this is not enough to price a CMS cashflow. Today's value of the swap rate $S(T_f)$ paid at T_p is

$$V_{CMS}(0) = A(0)\mathbb{E}^A\left[\frac{P(T_f, T_p)S(T_f)}{A(T_f)}\right].$$

While we may have a lot of knowledge about the distribution of $S(T_f)$ in this measure (from swap and swaption market, as explained above), we know nothing of the distribution of $P(T_f, T_p)$ or $A(T_f)$, or their joint dependence with $S(T_f)$. What is perfectly allowable to do, however, is this

$$A(0)\mathbb{E}^A\left[\frac{P(T_f, T_p)S(T_f)}{A(T_f)}\right] = A(0)\mathbb{E}^A\left[\mathbb{E}^A\left[\frac{P(T_f, T_p)}{A(T_f)}\middle| S(T_f)\right] S(T_f)\right].$$

The expression

$$\mathbb{E}^A\left[\frac{P(T_f, T_p)}{A(T_f)}\middle| S(T_f)\right]$$

is the conditional expectation of $P(T_f, T_p)/A(T_f)$ given $S(T_f)$, which is a function of $S(T_f)$ we can call $Q(S(T_f))$. The value of the CMS cashflow is thus

$$V_{CMS}(0) = A(0)\mathbb{E}^A\left[Q(S(T_f))S(T_f)\right]$$

How do we find $Q(x)$? A popular choice is to pick some simple interest model, calibrate it to the market, and simply calculate the conditional expectation above. We may even go one step further and linearise it, in which case we get

$$V_{CMS}(0) = P(0, T_p)\mathbb{E}^A\left[(1 + a(S(T_f) - S(0)))S(T_f)\right],$$

where we have scaled things properly - the rightmost $S(T_f)$ could equally well be any function of the swap rate, for instance the constant 1, which we know must be worth $P(0, T_p)$ today. This is also the reason why we had to have $b = 1$ in the previous section.

We now see that

$$\begin{aligned} V_{CMS}(0) &= P(0, T_p)\mathbb{E}^A\left[S(T_f) + a(S(T_f) - S(0))^2 + aS(0)(S(T_f) - S(0))\right] = \\ &= S(0)P(0, T_p) + a\frac{P(0, T_p)}{A(0)} \times \text{(Quadratic option portfolio)} + 0, \end{aligned}$$

all in agreement with the heuristic argument from the previous section.

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