

CONTENTS

PREFACE	v
ABOUT THE AUTHORS	ix
1. STANDARD PRODUCTS AND MARKETS	1
1.1. Introduction to Financial Markets	1
1.1.1. Definition of financial markets	1
1.1.2. The different derivatives markets	2
1.1.3. Importance of the derivatives	3
1.1.4. Cash or spot vs. derivatives markets	5
1.1.5. History of financial markets	6
1.1.6. Listed markets vs. OTC markets	8
1.1.7. Shares and dividends	8
1.1.8. Typology of the markets participants	10
1.2. Presentation of the Trading Room and Group	
Description	11
1.2.1. Different functionality of the trading room	11
1.2.2. Job description	11
1.2.2.1. Trader	11
1.2.2.2. Sales/originators/structurors	12
1.2.2.3. Quant/IT/analyst support	12
1.2.2.4. Middle office/back office support	12
1.3. Flow Business, Prop Trading and Exotic	13

1.3.1.	Definition	13
1.3.2.	Hedge fund business	13
1.3.3.	Key differences	13
1.3.4.	Market making	14
1.3.5.	ECN and electronic trading platform	14
1.4.	Ethic and Deontology	15
1.4.1.	History	15
1.4.1.1.	Barings	15
1.4.1.2.	ENRON	16
1.4.1.3.	LTCM	17
1.4.2.	Insider trading	18
1.4.3.	Money laundering	19
1.5.	Summary	19
	References	20
2.	THE VANILLA PRODUCTS	21
2.1.	Interest and Usage of Products	22
2.1.1.	Interest and usage of products	22
2.1.2.	Derivatives description	22
2.1.3.	The hedging purpose	23
2.1.3.1.	Hedging with forward contract	23
2.1.3.2.	Hedging with options	24
2.1.4.	The speculation	25
2.1.5.	The arbitrage	26
2.2.	Pricing of Future Contract	27
2.2.1.	Trading futures: Margin call and trading account	27
2.2.1.1.	The future contract	27
2.2.1.2.	Product specification	28
2.2.2.	Futures vs. forward	30
2.2.3.	Forward and futures prices	30
2.2.3.1.	Forward pricing	30
2.2.3.2.	Futures prices	31
2.3.	Options	33
2.3.1.	Definition and features	33
2.3.2.	Call-put parity	35

2.3.3.	Option strategies: call, put, straddle, strangle, spread and butterfly	35
2.3.3.1.	Call/put option	36
2.3.3.2.	Straddle	37
2.3.3.3.	Strangle	38
2.3.3.4.	Butterfly	39
2.3.4.	Warrants	40
2.4.	Summary	41
	References	42
3.	INTRODUCTION TO FINANCIAL MODELING	43
3.1.	A Bit of History	43
3.2.	Usage of Models	48
3.2.1.	Risk categories	48
3.2.1.1.	Market risk	48
3.2.1.2.	Counterparty risk	50
3.2.1.3.	Operational risk	50
3.2.1.4.	Model risk	52
3.2.2.	What are models for?	53
3.2.2.1.	As a predictor	53
3.2.2.2.	As an “interpolator” or “extrapolator”	53
3.2.3.	Simple versus complicated models	55
3.2.4.	Warnings	56
3.2.5.	Special warnings: calibration issues	58
3.3.	Reasonable Mathematical Basis for Financial Modeling	59
3.3.1.	Modeling framework	59
3.3.1.1.	Words on probability	60
3.3.1.2.	Types of computations	61
3.3.1.3.	Ito processes and Ito/Doblin formula	62
3.3.1.4.	Usage of Brownian motion	64
3.3.2.	Risk neutral probability	67
3.3.2.1.	Example of the one factor case	67
3.3.2.2.	The n factor case	69

3.3.2.3. The two currency case	73
3.4. Summary	77
References	78
4. THE BLACK–SCHOLES MODEL	79
4.1. Model History	79
4.2. Initial Problems	80
4.3. Model Hypothesis	82
4.3.1. Lognormal distribution and constant volatility	82
4.3.2. Assumptions	82
4.4. Black–Scholes Partial Differential Equation	83
4.5. Black–Scholes Formulae for Call and Put Options	85
4.6. Implied Volatility and Smile	86
4.7. Hedging Strategies	86
4.7.1. Naked and cover positions	87
4.7.2. Delta hedging	87
4.7.3. Stop and loss strategy	87
4.8. The Derivative Function of the Price or Greeks	90
4.8.1. Delta	90
4.8.2. Theta	91
4.8.3. Gamma	92
4.8.4. Vega	92
4.9. Black–Scholes Robustness	94
4.10. Black–Scholes Extensions	95
4.10.1. Volatility: deterministic function of time	95
4.10.2. Dividend	95
4.10.3. Normal and shifted lognormal models	96
4.11. Summary	97
References	98
5. FIXED INCOME BASIS	99
5.1 Simple Instruments	99
5.1.1. Markets conventions	99
5.1.2. LIBOR rates	100
5.1.3. Repo rate	101

5.1.4.	Duration	102
5.2	Bootstrapping and Curve Fitting	104
5.3	Introduction to Swaps	105
5.3.1.	Vanilla swaps	105
5.3.2.	Cross-currency swaps	106
5.3.3.	Forward starting swaps	109
5.3.4.	LIBOR-in-arrears swaps	110
5.3.5.	CMT and CMS swaps	110
5.4	Convexity Adjustment	111
5.4.1.	Convexity correction	111
5.4.2.	LIBOR-in-arrears swap	112
5.4.3.	CMS/CMT/spread lock	114
5.4.4.	Replication	116
5.5	Vanilla Interest Rate Options	120
5.5.1.	Interest rate caps and floors	120
5.5.2.	European swaptions	122
5.5.3.	Spread options	123
5.6	Summary	123
	References	124
6.	SMILE MODELING	125
6.1.	Smile and Digital Models	125
6.1.1.	Target market	126
6.2.	Smile Models (Basic European Models)	127
6.2.1.	The Merton model	128
6.2.1.1.	Influence of the jumps (a la Merton) on the smile	129
6.2.2.	Local volatility models (a la Dupire)	129
6.2.3.	The CEV model	131
6.2.3.1.	Extrapolation issues	133
6.2.3.2.	Robustness issues	133
6.2.4.	Stochastic volatility models	134
6.2.4.1.	An analytical formula	135
6.2.4.2.	Heston model and Fourier transform	136

6.2.4.3.	Lewis model and the preservative approach	136
6.2.4.4.	SABR model and link to Riemannian geometry	138
6.2.5.	Connection between the SABR and the “complex” BS models	142
6.2.5.1.	Expected local time and vanilla option prices	142
6.2.5.2.	Expected local time and probability density	144
6.2.5.3.	Explicit computation of the local time for stochastic models	145
6.2.5.4.	Fast computation of the SABR stochastic integral and connection with BS model	146
6.2.5.5.	Application to CMS replication pricing	148
6.2.6.	Volatility and variance swap: Log and parabola contracts	152
6.2.6.1.	Contract definition	152
6.2.6.2.	Replication strategy and pricing	153
6.2.6.3.	Variance swap in the Heston model	154
6.2.6.4.	Variance swap in the mean reverting lognormal model	154
6.2.6.5.	Application 1: Computation of expected volatility	155
6.2.6.6.	Application 2: Computation of the variance call	156
6.3.	Summary	156
	References	157
7.	YIELD CURVE MODELING	159
7.1.	Model Typology	159
7.1.1.	Short rates	159
7.1.2.	Market (LIBOR and swap rate) models	160
7.1.3.	Markov functional models	161

7.2.	Heath–Jarrow–Morton Framework	163
7.2.1.	Philosophy	163
7.2.2.	Forward bond volatility and drift	164
7.3.	Short Rate Models	165
7.3.1.	HW 1,2,...,nF	165
7.3.1.1.	Diffusion equation	165
7.3.1.2.	Model’s calibration	167
7.3.1.3.	Pricing of caplets	167
7.3.1.4.	Pricing of swaptions	168
7.3.1.5.	Example of calibration of the model	169
7.3.2.	Cox–Ingersoll–Ross model	170
7.3.2.1.	Diffusion equation	170
7.3.2.2.	Reconstruction formulae	170
7.3.2.3.	Remark	171
7.3.3.	Black–Karasinski model	172
7.3.3.1.	Diffusion equation	172
7.3.3.2.	Remarks	172
7.4.	Market Model (BGM)	173
7.4.1.	Motivations	173
7.4.2.	Diffusion	173
7.4.3.	Interpolation	175
7.4.4.	Handling drift	177
7.4.5.	Calibration: Relation vol Swap vol Fra	178
7.5.	Extension to Smile	180
7.5.1.	Short-rate model extension and Cheyette	180
7.5.1.1.	Quadratic Gaussian model	180
7.5.1.2.	Cheyette model	181
7.5.1.3.	Swaption pricing approximation in Cheyette	182
7.5.2.	BGM extension: constant elasticity of variance (CEV) (Cox and Ross, 1976), SFRM	183
7.5.3.	Stochastic volatility with BGM models	184
7.6.	Summary	184
	References	186

8.	INFLATION	187
8.1.	Vanilla Products	187
8.1.1.	History of inflation markets	187
8.1.2.	Swap: YoY, zero coupon and bond	188
8.1.3.	Option: Cap, floor and swaption	189
8.1.4.	Pricing example	191
8.2.	Vanilla Product Pricing	192
8.2.1.	Presentation	192
8.2.2.	Curve modeling	193
8.2.3.	Convexity adjustment	194
8.3.	Seasonality	194
8.3.1.	Motivations and static seasonality modeling	194
8.3.2.	Parametric estimation of seasonality	198
8.3.3.	Parametric vs. non-parametric	200
8.3.4.	Pricing impact on various inflation linked derivatives	205
8.4.	Hybrid model	207
8.4.1.	Jarrow–Yildirim model	207
8.4.2.	Mercurio model	210
8.4.3.	Market model	213
8.4.4.	Index equity model	218
8.5.	Summary	219
	References	219
9.	HYBRID MODELS	221
9.1.	Basis Hybrid	221
9.1.1.	Bermuda option	222
9.1.2.	Model	222
9.1.2.1.	Forward forex rate	222
9.1.2.2.	Basis margin	225
9.2.	Forex Hybrids	226
9.2.1.	Market, products and models	226
9.2.2.	Short rates model	228
9.2.2.1.	Theoretical model	228

9.2.2.2.	Underlying future price	229
9.2.2.3.	Implementation details	230
9.2.2.4.	Basis curves	232
9.2.2.5.	Smile issue	233
9.2.3.	LIBOR market model	235
9.2.3.1.	Diffusion overview	235
9.2.3.2.	Pricing method	236
9.2.4.	Equity hybrids	237
9.2.5.	Credit hybrids	238
9.2.6.	Alternative structured products	240
9.3.	Summary	240
	References	241
10.	PRODUCT CATALOG AND USAGE	243
10.1.	Typology	243
10.1.1.	Investment vs. hedging	243
10.1.2.	Investment products: high-risk products	245
10.1.2.1.	High-coupon strategy	245
10.1.2.2.	Yield curve slope strategy	245
10.1.2.3.	Callability	245
10.1.2.4.	Bet strategy: corridor and digital	245
10.1.2.5.	Quanto strategy	245
10.1.2.6.	Currency convergence trade	246
10.1.2.7.	Hedging products: low premium	246
10.1.2.8.	Zero-premium strategy	246
10.1.2.9.	Customized products	247
10.1.2.10.	Barrier options	247
10.1.3.	Product typology	248
10.2.	Products Catalog	248
10.2.1.	European options	248
10.2.2.	Asian options	250
10.2.3.	Hawaiian options	253
10.2.4.	Barrier options	253
10.2.5.	Lookback and extensions	254

10.2.6.	PNL and passport options	254
10.2.7.	Simple correlation/multi-asset options	255
10.2.8.	Option on options	256
10.2.9.	Chooser options	256
10.3.	Equity Derivatives	257
10.3.1.	Complex correlation/multi-asset options	257
10.4.	Exotic Interest Rates Products	262
10.4.1.	Averaging amortizing compounding/ accreting swap	262
10.4.2.	Autocap, chooser cap, flexi cap	262
10.4.3.	Callable reverse floater	263
10.4.4.	Target redemption note (TARN)	264
10.4.5.	Callable snowball	270
10.4.6.	Callable spread options	273
10.4.7.	New types of underlying and options	273
10.4.8.	Management of a trading book	273
10.4.9.	Risk class	274
10.4.9.1.	Interest rate risk	274
10.4.9.2.	Volatility risk	274
10.4.9.3.	Basis risk	274
10.4.9.4.	Smile	274
10.4.9.5.	Correlation	275
10.4.9.6.	Foreign exchange	275
10.4.10.	Risk management	275
10.4.10.1.	Delta, Gamma, Vega hedging	276
10.4.11.	PNL explanations (Greeks)	276
10.5.	Summary	276
	References	276
11.	THIRD GENERATION TRADING SYSTEM AND ITS UNDERMINING COPERNICAN REVOLUTION	279
11.1.	The New Generation of Trading Systems	279
11.2.	Motivation for a Generic Pricer	281
11.2.1.	Product innovation	281
11.2.2.	Reactivity, flexibility and efficiency	282

11.2.3.	Maintenance and evolution	283
11.2.4.	Front to back, enterprise wide	283
11.3.	Example of an Architecture	284
11.3.1.	Price-it [®] , the Pricing Partners' generic pricer solution	284
11.3.2.	Cash flows vs. events	285
11.3.3.	Decomposition: security, model and numerical methods	286
11.3.4.	Critical tasks for a generic pricer	287
11.3.5.	Parsing system and financial language	288
11.3.5.1.	Interest of a meta language	288
11.3.5.2.	Description of the cash flows with a meta language	288
11.3.5.3.	Referencing	292
11.3.5.4.	Components of the meta language: Functions and operators	293
11.3.5.5.	Standard programming operators	294
11.3.5.6.	Financial operators	294
11.3.5.7.	Parsing the grammar and creating a syntax	296
11.3.5.8.	Example of table of cash flows in a meta language	298
11.3.5.9.	Split between models and numerical methods	299
11.3.5.10.	Generic code and design	300
11.3.5.11.	Split between models and calibration	300
A.	TECHNICAL TOOLBOX	303
A.1.	Stochastic Calculus	303
A.1.1.	Itô formula	303
A.1.2.	Girsanov theorem	304
A.1.3.	Feynman–Kac	305
A.1.4.	Tanaka and local time	307

A.1.5.	Markov property	309
A.1.6.	Risk neutral and numeraire	310
A.1.7.	Copula	313
A.2.	Econometrics	315
A.2.1.	Time series	315
A.2.2.	GARCH and Nelson result	316
A.3.	Numerical Analysis	318
A.3.1.	PCA, Cholesky	318
A.3.2.	Minimizing the errors: Newton–Raphson search	320
A.3.3.	Optimizer: BFGS, conjugate and steepest gradient	322
A.4.	Expansion Technique	326
A.4.1.	Perturbation theory	326
A.4.2.	Taylor series with Malliavin weights	327
A.4.3.	Singular perturbation and the WKB expansion	328
A.4.4.	Spectral expansion	329
A.4.5.	Gram Charlier/Edgeworth	332
A.4.5.1.	Cumulants	332
A.4.5.2.	The cumulant modifying operator (CMO)	333
A.4.5.3.	Application to pricing	333
A.5.	Summary	334
	References	335
B.	MONTE CARLO	337
B.1.	Monte Carlo	337
B.1.1.	Theoretical background: central limit theorem	337
B.1.2.	Pricing European securities using Monte Carlo	338
B.1.3.	Random numbers and quasi Monte Carlo	339
B.1.3.1.	Box-Muller	339
B.1.3.2.	Cumulated density inverse	339
B.1.4.	Notion of discrepancy	340

B.1.5.	Examples of random numbers generation	341
	B.1.5.1. The combined MRG of order 5	341
B.1.6.	Examples of quasi-random numbers generation	342
	B.1.6.1. Halton quasi-random sequences	342
	B.1.6.2. Square quasi-random sequences	343
	B.1.6.3. Sobol sequence	344
B.1.7.	Variance reduction techniques	344
	B.1.7.1. Control variate	344
	B.1.7.2. Importance sampling	345
	B.1.7.3. Antithetic control	347
B.1.8.	Computation of Greeks in Monte Carlo	348
	B.1.8.1. Finite differences	348
	B.1.8.2. Path-wise method	349
	B.1.8.3. Likelihood ratio method	350
	B.1.8.4. Malliavin calculus	351
	B.1.8.5. Stochastic analysis	351
B.1.9.	Extension of Monte Carlo methods for American-style securities pricing	352
	B.1.9.1. Andersen method	353
	B.1.9.2. Longstaff–Schwartz method	356
B.2.	Summary	357
	References	357
C.	TREE AND PDE METHODS	359
C.1.	Trees	359
	C.1.1. Arrow Debreu prices	359
	C.1.2. Computing probabilities in a generated trees	359
	C.1.3. Geometry and boundaries	364
	C.1.4. Smoothing	366
C.2.	Partial Differential Equations	366
	C.2.1. Motivation	366
	C.2.2. Finite difference	368

C.2.3.	Crank Nicholson	370
C.2.4.	Stability and robustness	370
C.2.5.	Finite differences schemes for multi-dimensional PDE: alternating direction iterative (ADI)	372
C.2.6.	Finite elements	376
C.3.	Summary	378
	References	378
INDEX		379