CHAPTER 1
Introduction: The Valuation of Derivative Portfolios
1.1 What this book is about 1
1.2 Prices and Values
   1.2.1 Before the Fall... 4
   1.2.2 The Post-Crisis World... 5
1.3 Trade Economics in Derivative Pricing
   1.3.1 The Components of a Price 6
   1.3.2 Risk-Neutral Valuation 8
   1.3.3 Hedging and Management Costs 11
   1.3.4 Credit Risk: CVA/DVA 11
   1.3.5 FVA 13
   1.3.6 Regulatory Capital and KVA 14
1.4 Post-Crisis Derivative Valuation or How I Learned to Stop Worrying and
   Love FVA 16
   1.4.1 The FVA Debate and the Assault on Black-Scholes-Merton 16
   1.4.2 Different Values for Different Purposes 19
   1.4.3 Summary: The Valuation Paradigm Shift 21
1.5 Reading this Book 21

PART ONE
CVA and DVA: Counterparty Credit Risk and Credit Valuation Adjustment

CHAPTER 2
Introducing Counterparty Risk 25
2.1 Defining Counterparty Risk 25
   2.1.1 Wrong-way and Right-way Risk 27
2.2 CVA and DVA: Credit Valuation Adjustment and Debit Valuation Adjustment Defined  
2.3 The Default Process  
  2.3.1 Example Default: The Collapse of Lehman Brothers  
2.4 Credit Risk Mitigants  
  2.4.1 Netting  
  2.4.2 Collateral/Security  
  2.4.3 Central Clearing and Margin  
  2.4.4 Capital  
  2.4.5 Break Clauses  
  2.4.6 Buying Protection  

CHAPTER 3  
CVA and DVA: Credit and Debit Valuation Adjustment Models  
3.1 Introduction  
  3.1.1 Close-out and CVA  
3.2 Unilateral CVA Model  
  3.2.1 Unilateral CVA by Expectation  
  3.2.2 Unilateral CVA by Replication  
3.3 Bilateral CVA Model: CVA and DVA  
  3.3.1 Bilateral CVA by Expectation  
  3.3.2 Bilateral CVA by Replication  
  3.3.3 DVA and Controversy  
3.4 Modelling Dependence between Counterparties  
  3.4.1 Gaussian Copula Model  
  3.4.2 Other Copula Models  
3.5 Components of a CVA Calculation Engine  
  3.5.1 Monte Carlo Simulation  
  3.5.2 Trade Valuation and Approximations  
  3.5.3 Expected Exposure Calculation  
  3.5.4 Credit Integration  
3.6 Counterparty Level CVA vs. Trade Level CVA  
  3.6.1 Incremental CVA  
  3.6.2 Allocated CVA  
3.7 Recovery Rate/Loss-Given-Default Assumptions  

CHAPTER 4  
CDS and Default Probabilities  
4.1 Survival Probabilities and CVA  
4.2 Historical versus Implied Survival Probabilities  
4.3 Credit Default Swap Valuation  
  4.3.1 Credit Default Swaps  
  4.3.2 Premium Leg  
  4.3.3 Protection Leg  
  4.3.4 CDS Value and Breakeven Spread
4.4 Bootstrapping the Survival Probability Function 72
  4.4.1 Upfront Payments 74
  4.4.2 Choice of Hazard Rate Function and CVA: CVA Carry 75
  4.4.3 Calibration Problems 76
4.5 CDS and Capital Relief 77
4.6 Liquid and Illiquid Counterparties 78
  4.6.1 Mapping to Representative CDS 79
  4.6.2 Mapping to Baskets and Indices 80
  4.6.3 Cross-sectional Maps 81

CHAPTER 5
Analytic Models for CVA and DVA 83
  5.1 Analytic CVA Formulae 83
  5.2 Interest Rate Swaps 84
    5.2.1 Unilateral CVA 84
    5.2.2 Bilateral CVA 86
  5.3 Options: Interest Rate Caplets and Floorlets 86
  5.4 FX Forwards 88

CHAPTER 6
Modelling Credit Mitigants 91
  6.1 Credit Mitigants 91
  6.2 Close-out Netting 91
  6.3 Break Clauses 93
    6.3.1 Mandatory Break Clauses 93
    6.3.2 Optional Break Clauses 93
  6.4 Variation Margin and CSA Agreements 97
    6.4.1 Simple Model: Modifying the Payout Function 97
    6.4.2 Modelling Collateral Directly 99
    6.4.3 Lookback Method 101
    6.4.4 Modelling Downgrade Triggers in CSA Agreements 102
  6.5 Non-financial Security and the Default Waterfall 107

CHAPTER 7
Wrong-way and Right-way Risk for CVA 109
  7.1 Introduction: Wrong-way and Right-way Risks 109
    7.1.1 Modelling Wrong-way Risk and CVA 110
  7.2 Distributional Models of Wrong-way/Right-way Risk 111
    7.2.1 Simple Model: Increased Exposure 111
    7.2.2 Copula Models 111
    7.2.3 Linear Models and Discrete Models 114
  7.3 A Generalised Discrete Approach to Wrong-way Risk 116
  7.4 Stochastic Credit Models of Wrong-way/Right-way Risk 118
    7.4.1 Sovereign Wrong-way Risk 119
  7.5 Wrong-way/Right-way Risk and DVA 119
PART TWO
FVA: Funding Valuation Adjustment

CHAPTER 8
The Discount Curve 123
8.1 Introduction 123
8.2 A Single Curve World 123
8.3 Curve Interpolation and Smooth Curves 126
8.4 Cross-currency Basis 127
8.5 Multi-curve and Tenor Basis 128
8.6 OIS and CSA Discounting 129
  8.6.1 OIS as the Risk-free Rate 129
  8.6.2 OIS and CSA Discounting 131
  8.6.3 Multi-currency Collateral and the Collateral Option 134
8.7 Conclusions: Discounting 138

CHAPTER 9
Funding Costs: Funding Valuation Adjustment (FVA) 139
9.1 Explaining Funding Costs 139
  9.1.1 What is FVA? 139
  9.1.2 General Principle of Funding Costs 145
9.2 First Generation FVA: Discount Models 145
9.3 Double Counting and DVA 146
9.4 Second Generation FVA: Exposure Models 147
  9.4.1 The Burgard-Kjaer Semi-Replication Model 148
9.5 Residual FVA and CSAs 160
9.6 Asymmetry 161
  9.6.1 Case 1: Corporate vs. Bank Asymmetry 161
  9.6.2 Case 2: Bank vs. Bank Asymmetry 162
9.7 Risk Neutrality, Capital and the Modigliani-Miller Theorem 162
  9.7.1 No Market-wide Risk-neutral Measure 162
  9.7.2 Consequences 165
  9.7.3 The Modigliani-Miller Theorem 165
9.8 Wrong-way/Right-way Risk and FVA 166

CHAPTER 10
Other Sources of Funding Costs: CCPs and MVA 167
10.1 Other Sources of Funding Costs 167
  10.1.1 Central Counterparty Funding Costs 167
  10.1.2 Bilateral Initial Margin 170
  10.1.3 Rating Agency Volatility Buffers and Overcollateralisation 170
  10.1.4 Liquidity Buffers 170
10.2 MVA: Margin Valuation Adjustment by Replication 171
  10.2.1 Semi-replication with no Shortfall on Default 174
10.3 Calculating MVA Efficiently 175
  10.3.1 Sizing the Problem 175
  10.3.2 Aside: Longstaff-Schwartz for Valuations and Expected Exposures 176
10.3.3 Calculating VaR inside a Monte Carlo 179
10.3.4 Case Study: Swap Portfolios 182
10.3.5 Adapting LSAC to VaR under Delta-Gamma Approximation 184
10.4 Conclusions on MVA 184

CHAPTER 11
The Funding Curve 187
11.1 Sources for the Funding Curve 187
  11.1.1 Term Funding 188
  11.1.2 Rolling Funding 188
11.2 Internal Funding Curves 188
  11.2.1 Bank CDS Spread 188
  11.2.2 Bank Bond Spread 189
  11.2.3 Bank Bond-CDS Basis 189
  11.2.4 Bank Treasury Transfer Price 190
  11.2.5 Funding Strategy Approaches 190
11.3 External Funding Curves and Accounting 191
11.4 Multi-currency/Multi-asset Funding 192

PART THREE
KVA: Capital Valuation Adjustment and Regulation

CHAPTER 12
Regulation: the Basel II and Basel III Frameworks 195
12.1 Introducing the Regulatory Capital Framework 195
  12.1.1 Economic Capital 196
  12.1.2 The Development of the Basel Framework 196
  12.1.3 Pillar I: Capital Types and Choices 201
12.2 Market Risk 202
  12.2.1 Trading Book and Banking Book 202
  12.2.2 Standardised Method 202
  12.2.3 Internal Model Method (IMM) 204
12.3 Counterparty Credit Risk 205
  12.3.1 Weight Calculation 205
  12.3.2 EAD Calculation 206
  12.3.3 Internal Model Method (IMM) 208
12.4 CVA Capital 209
  12.4.1 Standardised 209
  12.4.2 Advanced 211
12.5 Other Sources of Regulatory Capital 213
  12.5.1 Incremental Risk Charge (IRC) 213
  12.5.2 Leverage Ratio 213
12.6 Forthcoming Regulation with Pricing Impact 214
  12.6.1 Fundamental Review of the Trading Book 214
  12.6.2 Revised Standardised Approach to Credit Risk 218
  12.6.3 Bilateral Initial Margin 220
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>12.6.4</td>
<td>Prudent Valuation</td>
<td>220</td>
</tr>
<tr>
<td>12.6.5</td>
<td>EMIR and Frontloading</td>
<td>224</td>
</tr>
</tbody>
</table>

### CHAPTER 13

**KVA: Capital Valuation Adjustment**

- 13.1 Introduction: Capital Costs in Pricing | 227
- 13.1.1 Capital, Funding and Default | 227
- 13.2 Extending Semi-replication to Include Capital | 228
- 13.3 The Cost of Capital | 232
- 13.4 KVA for Market Risk, Counterparty Credit Risk and CVA Regulatory Capital
  - 13.4.1 Standardised Approaches | 232
  - 13.4.2 IMM Approaches | 233
- 13.5 The Size of KVA | 233
- 13.6 Conclusion: KVA | 237

### CHAPTER 14

**CVA Risk Warehousing and Tax Valuation Adjustment (TVA)**

- 14.1 Risk Warehousing XVA | 239
- 14.2 Taxation | 239
- 14.3 CVA Hedging and Regulatory Capital | 240
- 14.4 Warehousing CVA Risk and Double Semi-Replication | 240

### CHAPTER 15

**Portfolio KVA and the Leverage Ratio**

- 15.1 The Need for a Portfolio Level Model | 247
- 15.2 Portfolio Level Semi-replication | 248
- 15.3 Capital Allocation
  - 15.3.1 Market Risk | 254
  - 15.3.2 Counterparty Credit Risk (CCR) | 255
  - 15.3.3 CVA Capital | 255
  - 15.3.4 Leverage Ratio | 256
  - 15.3.5 Capital Allocation and Uniqueness | 257
- 15.4 Cost of Capital to the Business | 257
- 15.5 Portfolio KVA | 258
- 15.6 Calculating Portfolio KVA by Regression | 258

### PART FOUR

**XVA Implementation**

### CHAPTER 16

**Hybrid Monte Carlo Models for XVA: Building a Model for the Expected-Exposure Engine**

- 16.1 Introduction | 263
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>16.1.1</td>
<td>Implementing XVA</td>
<td>263</td>
</tr>
<tr>
<td>16.1.2</td>
<td>XVA and Monte Carlo</td>
<td>263</td>
</tr>
<tr>
<td>16.1.3</td>
<td>XVA and Models</td>
<td>264</td>
</tr>
<tr>
<td>16.1.4</td>
<td>A Roadmap to XVA Hybrid Monte Carlo</td>
<td>267</td>
</tr>
<tr>
<td>16.2</td>
<td>Choosing the Calibration: Historical versus Implied</td>
<td>268</td>
</tr>
<tr>
<td>16.2.1</td>
<td>The Case for Historical Calibration</td>
<td>268</td>
</tr>
<tr>
<td>16.2.2</td>
<td>The Case for Market Implied Calibration</td>
<td>281</td>
</tr>
<tr>
<td>16.3</td>
<td>The Choice of Interest Rate Modelling Framework</td>
<td>285</td>
</tr>
<tr>
<td>16.3.1</td>
<td>Interest Rate Models (for XVA)</td>
<td>286</td>
</tr>
<tr>
<td>16.3.2</td>
<td>The Heath-Jarrow-Morton (HJM) Framework and Models of the Short Rate</td>
<td>286</td>
</tr>
<tr>
<td>16.3.3</td>
<td>The Brace-Gaterak-Musiela (BGM) or Market Model Framework</td>
<td>305</td>
</tr>
<tr>
<td>16.3.4</td>
<td>Choice of Numeraire</td>
<td>313</td>
</tr>
<tr>
<td>16.3.5</td>
<td>Multi-curve: Tenor and Cross-currency Basis</td>
<td>314</td>
</tr>
<tr>
<td>16.3.6</td>
<td>Close-out and the Choice of Discount Curve</td>
<td>318</td>
</tr>
<tr>
<td>16.4</td>
<td>FX and Cross-currency Models</td>
<td>319</td>
</tr>
<tr>
<td>16.4.1</td>
<td>A Multi-currency Generalised Hull-White Model</td>
<td>320</td>
</tr>
<tr>
<td>16.4.2</td>
<td>The Triangle Rule and Options on the FX Cross</td>
<td>322</td>
</tr>
<tr>
<td>16.4.3</td>
<td>Models with FX Volatility Smiles</td>
<td>324</td>
</tr>
<tr>
<td>16.5</td>
<td>Inflation</td>
<td>327</td>
</tr>
<tr>
<td>16.5.1</td>
<td>The Jarrow-Yildirim Model (using Hull-White Dynamics)</td>
<td>327</td>
</tr>
<tr>
<td>16.5.2</td>
<td>Other Approaches</td>
<td>336</td>
</tr>
<tr>
<td>16.6</td>
<td>Equities</td>
<td>337</td>
</tr>
<tr>
<td>16.6.1</td>
<td>A Simple Log-normal Model</td>
<td>337</td>
</tr>
<tr>
<td>16.6.2</td>
<td>Dividends</td>
<td>339</td>
</tr>
<tr>
<td>16.6.3</td>
<td>Indices and Baskets</td>
<td>339</td>
</tr>
<tr>
<td>16.6.4</td>
<td>Managing Correlations</td>
<td>340</td>
</tr>
<tr>
<td>16.6.5</td>
<td>Skew: Local Volatility and Other Models</td>
<td>340</td>
</tr>
<tr>
<td>16.7</td>
<td>Commodities</td>
<td>342</td>
</tr>
<tr>
<td>16.7.1</td>
<td>Precious Metals</td>
<td>342</td>
</tr>
<tr>
<td>16.7.2</td>
<td>Forward-based Commodities</td>
<td>342</td>
</tr>
<tr>
<td>16.7.3</td>
<td>Electricity and Spark Spreads</td>
<td>347</td>
</tr>
<tr>
<td>16.8</td>
<td>Credit</td>
<td>348</td>
</tr>
<tr>
<td>16.8.1</td>
<td>A Simple Gaussian Model</td>
<td>349</td>
</tr>
<tr>
<td>16.8.2</td>
<td>JCIR++</td>
<td>350</td>
</tr>
<tr>
<td>16.8.3</td>
<td>Other Credit Models, Wrong-way Risk Models and Credit Correlation</td>
<td>351</td>
</tr>
</tbody>
</table>

**CHAPTER 17**

**Monte Carlo Implementation**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>17.1</td>
<td>Introduction</td>
<td>353</td>
</tr>
<tr>
<td>17.2</td>
<td>Errors in Monte Carlo</td>
<td>353</td>
</tr>
<tr>
<td>17.2.1</td>
<td>Discretisation Errors</td>
<td>354</td>
</tr>
<tr>
<td>17.2.2</td>
<td>Random Errors</td>
<td>357</td>
</tr>
<tr>
<td>17.3</td>
<td>Random Numbers</td>
<td>359</td>
</tr>
<tr>
<td>17.3.1</td>
<td>Pseudo-random Number Generators</td>
<td>359</td>
</tr>
</tbody>
</table>
17.3.2 Quasi-random Number Generators 364
17.3.3 Generating Normal Samples 369
17.4 Correlation 372
17.4.1 Correlation Matrix Regularisation 372
17.4.2 Inducing Correlation 373
17.5 Path Generation 375
17.5.1 Forward Induction 375
17.5.2 Backward Induction 375

CHAPTER 18
Monte Carlo Variance Reduction and Performance Enhancements 377
18.1 Introduction 377
18.2 Classic Methods 377
18.2.1 Antithetics 377
18.2.2 Control Variates 378
18.3 Orthogonalisation 379
18.4 Portfolio Compression 381
18.5 Conclusion: Making it Go Faster! 382

CHAPTER 19
Valuation Models for Use with Monte Carlo Exposure Engines 383
19.1 Valuation Models 383
19.1.1 Consistent or Inconsistent Valuation? 384
19.1.2 Performance Constraints 384
19.1.3 The Case for XVA Valuation Consistent with Trade Level Valuations 385
19.1.4 The Case for Consistent XVA Dynamics 386
19.1.5 Simulated Market Data and Valuation Model Compatibility 387
19.1.6 Valuation Differences as a KPI 387
19.1.7 Scaling 387
19.2 Implied Volatility Modelling 388
19.2.1 Deterministic Models 388
19.2.2 Stochastic Models 389
19.3 State Variable-based Valuation Techniques 389
19.3.1 Grid Interpolation 390
19.3.2 Longstaff-Schwartz 391

CHAPTER 20
Building the Technological Infrastructure 393
20.1 Introduction 393
20.2 System Components 393
20.2.1 Input Data 394
20.2.2 Calculation 401
20.2.3 Reporting 405
20.3 Hardware 405
20.3.1 CPU 406
20.3.2 GPU and GPGPU 406
## PART SIX

### The Future

#### CHAPTER 23

**The Future of Derivatives?**

23.1 Reflecting on the Years of Change... 465
23.2 The Market in the Future
  23.2.1 Products 466
  23.2.2 CCPs, Clearing and MVA 466
  23.2.3 Regulation, Capital and KVA 467
  23.2.4 Computation, Automation and eTrading 467
  23.2.5 Future Models and Future XVA 468

Bibliography 469

Index 489