To Ansua
## Contents

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>Preface</td>
<td></td>
</tr>
<tr>
<td>0.1</td>
<td>Scope of this Book</td>
<td>9</td>
</tr>
<tr>
<td>0.2</td>
<td>The Readership</td>
<td>9</td>
</tr>
<tr>
<td>0.3</td>
<td>About the Author</td>
<td>10</td>
</tr>
<tr>
<td>0.4</td>
<td>Acknowledgments</td>
<td>11</td>
</tr>
<tr>
<td>1</td>
<td>Foreign Exchange Options</td>
<td>13</td>
</tr>
<tr>
<td>1.1</td>
<td>A Journey through the History Of Options</td>
<td>13</td>
</tr>
<tr>
<td>1.2</td>
<td>Technical Issues for Vanilla Options</td>
<td>15</td>
</tr>
<tr>
<td>1.2.1</td>
<td>Value</td>
<td>16</td>
</tr>
<tr>
<td>1.2.2</td>
<td>A Note on the Forward</td>
<td>18</td>
</tr>
<tr>
<td>1.2.3</td>
<td>Greeks</td>
<td>18</td>
</tr>
<tr>
<td>1.2.4</td>
<td>Identities</td>
<td>20</td>
</tr>
<tr>
<td>1.2.5</td>
<td>Homogeneity based Relationships</td>
<td>21</td>
</tr>
<tr>
<td>1.2.6</td>
<td>Quotation</td>
<td>22</td>
</tr>
<tr>
<td>1.2.7</td>
<td>Strike in Terms of Delta</td>
<td>26</td>
</tr>
<tr>
<td>1.2.8</td>
<td>Volatility in Terms of Delta</td>
<td>26</td>
</tr>
<tr>
<td>1.2.9</td>
<td>Volatility and Delta for a Given Strike</td>
<td>26</td>
</tr>
<tr>
<td>1.2.10</td>
<td>Greeks in Terms of Deltas</td>
<td>27</td>
</tr>
<tr>
<td>1.3</td>
<td>Volatility</td>
<td>30</td>
</tr>
<tr>
<td>1.3.1</td>
<td>Historic Volatility</td>
<td>31</td>
</tr>
<tr>
<td>1.3.2</td>
<td>Historic Correlation</td>
<td>34</td>
</tr>
<tr>
<td>1.3.3</td>
<td>Volatility Smile</td>
<td>35</td>
</tr>
<tr>
<td>1.3.4</td>
<td>At-The-Money Volatility Interpolation</td>
<td>41</td>
</tr>
<tr>
<td>1.3.5</td>
<td>Volatility Smile Conventions</td>
<td>44</td>
</tr>
<tr>
<td>1.3.6</td>
<td>At-The-Money Definition</td>
<td>44</td>
</tr>
<tr>
<td>1.3.7</td>
<td>Interpolation of the Volatility on Maturity Pillars</td>
<td>45</td>
</tr>
<tr>
<td>1.3.8</td>
<td>Interpolation of the Volatility Spread between Maturity Pillars</td>
<td>45</td>
</tr>
<tr>
<td>1.3.9</td>
<td>Volatility Sources</td>
<td>46</td>
</tr>
<tr>
<td>1.3.10</td>
<td>Volatility Cones</td>
<td>47</td>
</tr>
<tr>
<td>1.3.11</td>
<td>Stochastic Volatility</td>
<td>47</td>
</tr>
</tbody>
</table>
1.3.12 Exercises ........................................ 47

1.4 Basic Strategies containing Vanilla Options .......................... 48
1.4.1 Call and Put Spread .................................. 48
1.4.2 Risk Reversal .......................................... 51
1.4.3 Risk Reversal Flip .................................... 53
1.4.4 Straddle .................................................. 54
1.4.5 Strangle ................................................. 56
1.4.6 Butterfly ................................................ 58
1.4.7 Seagull .................................................. 60
1.4.8 Exercises .............................................. 62

1.5 First Generation Exotics ................................................. 62
1.5.1 Barrier Options ........................................ 62
1.5.2 Digital Options, Touch Options and Rebates ..................... 73
1.5.3 Compound and Instalment ................................ 84
1.5.4 Asian Options ........................................... 97
1.5.5 Lookback Options ...................................... 107
1.5.6 Forward Start, Ratchet and Cliquet Options .................... 116
1.5.7 Power Options .......................................... 119
1.5.8 Quanto Options ........................................ 127
1.5.9 Exercises ............................................... 130

1.6 Second Generation Exotics .............................................. 137
1.6.1 Corridors ............................................... 137
1.6.2 Faders ................................................... 140
1.6.3 Exotic Barrier Options .................................. 143
1.6.4 Pay-Later Options ..................................... 154
1.6.5 Step up and Step down Options ............................ 157
1.6.6 Spread and Exchange Options ................................ 157
1.6.7 Baskets .................................................. 160
1.6.8 Best-of and Worst-of Options ............................. 167
1.6.9 Options and Forwards on the Harmonic Average .............. 172
1.6.10 Variance and Volatility Swaps ............................ 174
1.6.11 Exercises ............................................... 178

2 Structured Products ................................................................ 183
2.1 Forward Products .................................................. 183
2.1.1 Outright Forward ........................................ 184
2.1.2 Participating Forward ..................................... 185
2.1.3 Fade-In Forward .......................................... 187
2.1.4 Knock-Out Forward ....................................... 189
2.1.5 Shark Forward ........................................... 191
2.1.6 Fader Shark Forward ..................................... 194
<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1.7</td>
<td>Butterfly Forward</td>
<td>196</td>
</tr>
<tr>
<td>2.1.8</td>
<td>Range Forward</td>
<td>199</td>
</tr>
<tr>
<td>2.1.9</td>
<td>Range Accrual Forward</td>
<td>201</td>
</tr>
<tr>
<td>2.1.10</td>
<td>Accumulative Forward</td>
<td>205</td>
</tr>
<tr>
<td>2.1.11</td>
<td>Boomerang Forward</td>
<td>211</td>
</tr>
<tr>
<td>2.1.12</td>
<td>Amortizing Forward</td>
<td>212</td>
</tr>
<tr>
<td>2.1.13</td>
<td>Auto-Renewal Forward</td>
<td>214</td>
</tr>
<tr>
<td>2.1.14</td>
<td>Double Shark Forward</td>
<td>216</td>
</tr>
<tr>
<td>2.1.15</td>
<td>Forward Start Chooser Forward</td>
<td>216</td>
</tr>
<tr>
<td>2.1.16</td>
<td>Free Style Forward</td>
<td>217</td>
</tr>
<tr>
<td>2.1.17</td>
<td>Boosted Spot/Forward</td>
<td>217</td>
</tr>
<tr>
<td>2.1.18</td>
<td>Time Option</td>
<td>218</td>
</tr>
<tr>
<td>2.1.19</td>
<td>Exercises</td>
<td>219</td>
</tr>
<tr>
<td>2.2.1</td>
<td>Shark Forward Series</td>
<td>224</td>
</tr>
<tr>
<td>2.2.2</td>
<td>Collar Extra Series</td>
<td>227</td>
</tr>
<tr>
<td>2.2.3</td>
<td>Exercises</td>
<td>228</td>
</tr>
<tr>
<td>2.3.1</td>
<td>Dual Currency Deposit/Loan</td>
<td>230</td>
</tr>
<tr>
<td>2.3.2</td>
<td>Performance Linked Deposits</td>
<td>232</td>
</tr>
<tr>
<td>2.3.3</td>
<td>Tunnel Deposit/Loan</td>
<td>235</td>
</tr>
<tr>
<td>2.3.4</td>
<td>Corridor Deposit/Loan</td>
<td>238</td>
</tr>
<tr>
<td>2.3.5</td>
<td>Turbo Deposit/Loan</td>
<td>242</td>
</tr>
<tr>
<td>2.3.6</td>
<td>Tower Deposit/Loan</td>
<td>244</td>
</tr>
<tr>
<td>2.3.7</td>
<td>Exercises</td>
<td>247</td>
</tr>
<tr>
<td>2.4.1</td>
<td>Cross Currency Swap</td>
<td>251</td>
</tr>
<tr>
<td>2.4.2</td>
<td>Hanseatic Swap</td>
<td>253</td>
</tr>
<tr>
<td>2.4.3</td>
<td>Turbo Cross Currency Swap</td>
<td>255</td>
</tr>
<tr>
<td>2.4.4</td>
<td>Buffered Cross Currency Swap</td>
<td>259</td>
</tr>
<tr>
<td>2.4.5</td>
<td>Flip Swap</td>
<td>259</td>
</tr>
<tr>
<td>2.4.6</td>
<td>Corridor Swap</td>
<td>262</td>
</tr>
<tr>
<td>2.4.7</td>
<td>Double-No-Touch linked Swap</td>
<td>265</td>
</tr>
<tr>
<td>2.4.8</td>
<td>Range Reset Swap</td>
<td>267</td>
</tr>
<tr>
<td>2.4.9</td>
<td>Basket Spread Swap</td>
<td>268</td>
</tr>
<tr>
<td>2.4.10</td>
<td>Exercises</td>
<td>268</td>
</tr>
<tr>
<td>2.5.1</td>
<td>Gold Participation Note</td>
<td>270</td>
</tr>
<tr>
<td>2.5.2</td>
<td>Basket-linked Note</td>
<td>272</td>
</tr>
<tr>
<td>2.5.3</td>
<td>Issuer Swap</td>
<td>272</td>
</tr>
<tr>
<td>2.5.4</td>
<td>Moving Strike Turbo Spot Unlimited</td>
<td>274</td>
</tr>
</tbody>
</table>
2.6  Hybrid FX Products ........................................... 275

3  Practical Matters ............................................. 279

3.1  The Traders’ Rule of Thumb ................................. 279
  3.1.1  Cost of Vanna and Volga ............................. 280
  3.1.2  Observations ............................................. 283
  3.1.3  Consistency check ....................................... 283
  3.1.4  Abbreviations for First Generation Exotics ........... 286
  3.1.5  Adjustment Factor ...................................... 286
  3.1.6  Volatility for Risk Reversals, Butterflies and Theoretical Value 287
  3.1.7  Pricing Barrier Options ............................... 287
  3.1.8  Pricing Double Barrier Options ....................... 288
  3.1.9  Pricing Double-No-Touch Options .................... 288
  3.1.10 Pricing European Style Options ...................... 289
  3.1.11 No-Touch Probability ................................. 289
  3.1.12 The Cost of Trading and its Implication on the Market Price of One-touch Options 289
  3.1.13 Example .................................................. 290
  3.1.14 Further Applications ................................... 291
  3.1.15 Exercises ................................................. 292

3.2  Bid–Ask Spreads ............................................. 292
  3.2.1  One Touch Spreads ..................................... 293
  3.2.2  Vanilla Spreads ......................................... 293
  3.2.3  Spreads for First Generation Exotics ................ 294
  3.2.4  Minimal Bid–Ask Spread ............................... 294
  3.2.5  Bid–Ask Prices .......................................... 294
  3.2.6  Exercises .................................................. 294

3.3  Settlement .................................................... 295
  3.3.1  The Black-Scholes Model for the Actual Spot ....... 297
  3.3.2  Cash Settlement .......................................... 297
  3.3.3  Delivery Settlement ..................................... 298
  3.3.4  Options with Deferred Delivery ....................... 299
  3.3.5  Exercises .................................................. 300

3.4  On the Cost of Delayed Fixing Announcements ........... 300
  3.4.1  The Currency Fixing of the European Central Bank 301
  3.4.2  Model and Payoff ....................................... 302
  3.4.3  Analysis Procedure ................................. 302
  3.4.4  Error Estimation ....................................... 303
  3.4.5  Analysis of EUR-USD ............................... 306
  3.4.6  Conclusion ............................................... 309
FX Options and Structured Products

4 Hedge Accounting under IAS 39

4.1 Introduction ........................................................................................................ 311

4.2 Financial Instruments ....................................................................................... 313
  4.2.1 Overview ...................................................................................................... 313
  4.2.2 General Definition ...................................................................................... 315
  4.2.3 Financial Assets ......................................................................................... 316
  4.2.4 Financial Liabilities .................................................................................... 316
  4.2.5 Offsetting of Financial Assets and Financial Liabilities ......................... 317
  4.2.6 Equity Instruments .................................................................................... 318
  4.2.7 Compound Financial Instruments .............................................................. 319
  4.2.8 Derivatives ................................................................................................. 319
  4.2.9 Embedded Derivatives .............................................................................. 322
  4.2.10 Classification of Financial Instruments .................................................. 325

4.3 Evaluation of Financial Instruments ................................................................. 329
  4.3.1 Initial Recognition ...................................................................................... 329
  4.3.2 Initial Measurement ................................................................................... 330
  4.3.3 Subsequent Measurement ......................................................................... 331
  4.3.4 Derecognition ............................................................................................. 335

4.4 Hedge Accounting .............................................................................................. 337
  4.4.1 Overview ...................................................................................................... 337
  4.4.2 Types of Hedges ......................................................................................... 338
  4.4.3 Basic Requirements ................................................................................... 341
  4.4.4 Stopping Hedge Accounting ..................................................................... 346

4.5 Methods for Testing Hedge Effectiveness ......................................................... 347
  4.5.1 Fair Value Hedge ....................................................................................... 347
  4.5.2 Cash Flow Hedge ....................................................................................... 352

4.6 Testing for Effectiveness - A Case Study of the Forward Plus ...................... 355
  4.6.1 Simulation of Exchange Rates .................................................................... 356
  4.6.2 Calculation of the Forward Plus Value ...................................................... 358
  4.6.3 Calculation of the Forward Rates ............................................................... 362
  4.6.4 Calculation of the Forecast Transaction’s Value ........................................ 363
  4.6.5 Dollar-Offset Ratio - Prospective Test for Effectiveness ......................... 364
  4.6.6 Variance Reduction Measure - Prospective Test for Effectiveness ........... 366
  4.6.7 Regression Analysis - Prospective Test for Effectiveness ......................... 367
  4.6.8 Result .......................................................................................................... 368
  4.6.9 Retrospective Test for Effectiveness .......................................................... 371

4.7 Conclusion ........................................................................................................... 385

4.8 Relevant Original Sources for Accounting Standards ..................................... 385

4.9 Exercises ............................................................................................................ 386
5 Foreign Exchange Markets

5.1 A Tour through the Market

5.1.1 Statement by GFI Group (Fenics), 25 October 2005

5.1.2 Interview with ICY Software, 14 October 2005

5.1.3 Interview with Bloomberg, 12 October 2005

5.1.4 Interview with Murex, 8 November 2005

5.1.5 Interview with SuperDerivatives, 17 October 2005

5.1.6 Interview with Lucht Probst Associates, 27 February 2006

5.2 Software and System Requirements

5.2.1 Fenics

5.2.2 Position Keeping

5.2.3 Pricing

5.2.4 Straight Through Processing

5.2.5 Disclaimers

5.3 Trading and Sales

5.3.1 Proprietary Trading

5.3.2 Sales-Driven Trading

5.3.3 Inter Bank Sales

5.3.4 Branch Sales

5.3.5 Institutional Sales

5.3.6 Corporate Sales

5.3.7 Private Banking

5.3.8 Listed FX Options

5.3.9 Trading Floor Joke
Chapter 0

Preface

0.1 Scope of this Book

Treasury management of international corporates involves dealing with cash flows in different currencies. Therefore the natural service of an investment bank consists of a variety of money market and foreign exchange products. This book explains the most popular products and strategies with a focus on everything beyond vanilla options.

It explains all the FX options, common structures and tailor-made solutions in examples with a special focus on the application with views from traders and sales as well as from a corporate client perspective.

It contains actually traded deals with corresponding motivations explaining why the structures have been traded. This way the reader gets a feeling how to build new structures to suit clients’ needs.

The exercises are meant to practice the material. Several of them are actually difficult to solve and can serve as incentives to further research and testing. Solutions to the exercises are not part of this book, however they will be published on the web page of the book, www.mathfinance.com/FXOptions/.

0.2 The Readership

Prerequisite is some basic knowledge of FX markets as for example taken from the Book Foreign Exchange Primer by Shami Shamah, Wiley 2003, see [90]. The target readers are

- Graduate students and Faculty of Financial Engineering Programs, who can use this book as a textbook for a course named structured products or exotic currency options.
• Traders, Trainee Structurers, Product Developers, Sales and Quants with interest in the FX product line. For them it can serve as a source of ideas and as well as a reference guide.

• Treasurers of corporates interested in managing their books. With this book at hand they can structure their solutions themselves.

The readers more interested in the quantitative and modeling aspects are recommended to read Foreign Exchange Risk by J. Hakala and U. Wystup, Risk Publications, London, 2002, see [50]. This book explains several exotic FX options with a special focus on the underlying models and mathematics, but does not contain any structures or corporate clients’ or investors’ view.

0.3 About the Author

Uwe Wystup is also CEO of MathFinance AG, a global network of quants specializing in Quantitative Finance, Exotic Options advisory and Front Office Software Production. Previously he was a Financial Engineer and Structurer in the FX Options Trading Team at Commerzbank. Before that he worked for Deutsche Bank, Citibank, UBS and Sal. Oppenheim jr. & Cie. He is founder and manager of the web site MathFinance.de and the MathFinance Newsletter. Uwe holds a PhD in mathematical finance from Carnegie Mellon University. He also lectures on mathematical finance for Goethe University Frankfurt, organizes the Frankfurt MathFinance Colloquium and is founding director of the Frankfurt MathFinance Institute. He has given several seminars on exotic options, computational finance and volatility modeling. His area of specialization are the quantitative aspects and the design of structured products of foreign

Figure 1: Uwe Wystup, professor of Quantitative Finance at HfB Business School of Finance and Management in Frankfurt, Germany.
exchange markets. He published a book on *Foreign Exchange Risk* and articles in *Finance and Stochastics* and the *Journal of Derivatives*. Uwe has given many presentations at both universities and banks around the world. Further information on his curriculum vitae and a detailed publication list is available at www.mathfinance.com/wystup/.

0.4 Acknowledgments

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Chapter 1

Foreign Exchange Options

FX Structured Products are tailor-made linear combinations of FX Options including both vanilla and exotic options. We recommend the book by Shamah [90] as a source to learn about FX Markets with a focus on market conventions, spot, forward and swap contracts, vanilla options. For pricing and modeling of exotic FX options we suggest Hakala and Wystup [50] or Lipton [71] as useful companions to this book.

The market for structured products is restricted to the market of the necessary ingredients. Hence, typically there are mostly structured products traded the currency pairs that can be formed between USD, JPY, EUR, CHF, GBP, CAD and AUD. In this chapter we start with a brief history of options, followed by a technical section on vanilla options and volatility, and deal with commonly used linear combinations of vanilla options. Then we will illustrated the most important ingredients for FX structured products: the first and second generation exotics.

1.1 A Journey through the History Of Options

The very first options and futures were traded in ancient Greece, when olives were sold before they had reached ripeness. Thereafter the market evolved in the following way.

16th century Ever since the 15th century tulips, which were liked for their exotic appearance, were grown in Turkey. The head of the royal medical gardens in Vienna, Austria, was the first to cultivate those Turkish tulips successfully in Europe. When he fled to Holland because of religious persecution, he took the bulbs along. As the new head of the botanical gardens of Leiden, Netherlands, he cultivated several new strains. It was from these gardens that avaricious traders stole the bulbs to commercialize them, because tulips were a great status symbol.

17th century The first futures on tulips were traded in 1630. As of 1634, people could
buy special tulip strains by the weight of their bulbs, for the bulbs the same value was chosen as for gold. Along with the regular trading, speculators entered the market and the prices skyrocketed. A bulb of the strain “Semper Octavian” was worth two wagonloads of wheat, four loads of rye, four fat oxen, eight fat swine, twelve fat sheep, two hogsheads of wine, four barrels of beer, two barrels of butter, 1,000 pounds of cheese, one marriage bed with linen and one sizable wagon. People left their families, sold all their belongings, and even borrowed money to become tulip traders. When in 1637, this supposedly risk-free market crashed, traders as well as private individuals went bankrupt. The government prohibited speculative trading; the period became famous as Tulipmania.

18th century  In 1728, the Royal West-Indian and Guinea Company, the monopolist in trading with the Caribbean Islands and the African coast issued the first stock options. Those were options on the purchase of the French Island of Ste. Croix, on which sugar plantings were planned. The project was realized in 1733 and paper stocks were issued in 1734. Along with the stock, people purchased a relative share of the island and the valuables, as well as the privileges and the rights of the company.

19th century  In 1848, 82 businessmen founded the Chicago Board of Trade (CBOT). Today it is the biggest and oldest futures market in the entire world. Most written documents were lost in the great fire of 1871, however, it is commonly believed that the first standardized futures were traded as of 1860. CBOT now trades several futures and forwards, not only T-bonds and treasury bonds, but also options and gold.

In 1870, the New York Cotton Exchange was founded. In 1880, the gold standard was introduced.

20th century

• In 1914, the gold standard was abandoned because of the war.

• In 1919, the Chicago Produce Exchange, in charge of trading agricultural products was renamed to Chicago Mercantile Exchange. Today it is the most important futures market for Eurodollar, foreign exchange, and livestock.

• In 1944, the Bretton Woods System was implemented in an attempt to stabilize the currency system.

• In 1970, the Bretton Woods System was abandoned for several reasons.

• In 1971, the Smithsonian Agreement on fixed exchange rates was introduced.

• In 1972, the International Monetary Market (IMM) traded futures on coins, currencies and precious metal.
• In 1973, the CBOE (Chicago Board of Exchange) firstly traded call options; four years later also put options. The Smithsonian Agreement was abandoned; the currencies followed managed floating.

• In 1975, the CBOT sold the first interest rate future, the first future with no “real” underlying asset.

• In 1978, the Dutch stock market traded the first standardized financial derivatives.

• In 1979, the European Currency System was implemented, and the European Currency Unit (ECU) was introduced.

• In 1991, the Maastricht Treaty on a common currency and economic policy in Europe was signed.

• In 1999, the Euro was introduced, but the countries still used cash of their old currencies, while the exchange rates were kept fixed.

21st century

In 2002, the Euro was introduced as new money in the form of cash.

1.2 Technical Issues for Vanilla Options

We consider the model geometric Brownian motion

$$dS_t = (r_d - r_f)S_t \, dt + \sigma S_t \, dW_t$$

(1.1)

for the underlying exchange rate quoted in FOR-DOM (foreign-domestic), which means that one unit of the foreign currency costs FOR-DOM units of the domestic currency. In case of EUR-USD with a spot of 1.2000, this means that the price of one EUR is 1.2000 USD. The notion of foreign and domestic do not refer the location of the trading entity, but only to this quotation convention. We denote the (continuous) foreign interest rate by $r_f$ and the (continuous) domestic interest rate by $r_d$. In an equity scenario, $r_f$ would represent a continuous dividend rate. The volatility is denoted by $\sigma$, and $W_t$ is a standard Brownian motion. The sample paths are displayed in Figure 1.1. We consider this standard model, not because it reflects the statistical properties of the exchange rate (in fact, it doesn’t), but because it is widely used in practice and front office systems and mainly serves as a tool to communicate prices in FX options. These prices are generally quoted in terms of volatility in the sense of this model.

Applying Itô’s rule to $\ln S_t$ yields the following solution for the process $S_t$

$$S_t = S_0 \exp \left\{ (r_d - r_f - \frac{1}{2}\sigma^2)t + \sigma W_t \right\},$$

(1.2)

which shows that $S_t$ is log-normally distributed, more precisely, $\ln S_t$ is normal with mean $\ln S_0 + (r_d - r_f - \frac{1}{2}\sigma^2)t$ and variance $\sigma^2t$. Further model assumptions are
1. There is no arbitrage
2. Trading is frictionless, no transaction costs
3. Any position can be taken at any time, short, long, arbitrary fraction, no liquidity constraints

The payoff for a vanilla option (European put or call) is given by
\[ F = [\phi(S_T - K)]^+ \tag{1.3} \]

where the contractual parameters are the strike $K$, the expiration time $T$ and the type $\phi$, a binary variable which takes the value $+1$ in the case of a call and $-1$ in the case of a put. The symbol $x^+$ denotes the positive part of $x$, i.e., $x^+ \triangleq \max(0, x) \triangleq 0 \lor x$.

1.2.1 Value

In the Black-Scholes model the value of the payoff $F$ at time $t$ if the spot is at $x$ is denoted by $v(t, x)$ and can be computed either as the solution of the Black-Scholes partial differential
equation

\[ v_t - rdv + (rd - rf)xv_x + \frac{1}{2}\sigma^2x^2v_{xx} = 0, \quad (1.4) \]
\[ v(T, x) = F. \quad (1.5) \]

or equivalently (Feynman-Kac-Theorem) as the discounted expected value of the payoff-function,

\[ v(x, K, T, t, \sigma, rd, rf, \phi) = e^{-rd\tau}E[F]. \quad (1.6) \]

This is the reason why basic financial engineering is mostly concerned with solving partial differential equations or computing expectations (numerical integration). The result is the Black-Scholes formula

\[ v(x, K, T, t, \sigma, rd, rf, \phi) = \phi e^{-rd\tau}[fN(d_+) - KN(d_-)]. \quad (1.7) \]

We abbreviate

- \( x \): current price of the underlying
- \( \tau \triangleq T - t \): time to maturity
- \( f \triangleq E[S_T|S_t = x] = xe^{(rd-rf)\tau} \): forward price of the underlying
- \( \theta_{\pm} \triangleq \frac{rd-rf}{\sigma} \pm \frac{\sigma}{2} \)
- \( d_{\pm} \triangleq \ln \frac{xf^{\pm}}{K} \pm \frac{\sigma^2}{4}\tau \)
- \( n(t) \triangleq \int_{-\infty}^{\infty} n(t) \, dt = 1 - N(-x) \)

The Black-Scholes formula can be derived using the integral representation of Equation (1.6)

\[ v = e^{-rd\tau}E[F] = e^{-rd\tau}E[[\phi(S_T - K)]^+] = e^{-rd\tau} \int_{-\infty}^{\infty} \left[ \phi \left( xe^{(rd-rf-\frac{1}{2}\sigma^2)\tau + \sigma\sqrt{\tau}y} - K \right) \right]^+ n(y) \, dy. \quad (1.8) \]

Next one has to deal with the positive part and then complete the square to get the Black-Scholes formula. A derivation based on the partial differential equation can be done using results about the well-studied heat-equation.
1.2.2 A Note on the Forward

The forward price $f$ is the strike which makes the time zero value of the forward contract

$$ F = S_T - f $$

equal to zero. It follows that $f = \mathbb{E}[S_T] = x e^{(r_d - r_f)T}$, i.e. the forward price is the expected price of the underlying at time $T$ in a risk-neutral setup (drift of the geometric Brownian motion is equal to cost of carry $r_d - r_f$). The situation $r_d > r_f$ is called contango, and the situation $r_d < r_f$ is called backwardation. Note that in the Black-Scholes model the class of forward price curves is quite restricted. For example, no seasonal effects can be included. Note that the value of the forward contract after time zero is usually different from zero, and since one of the counterparties is always short, there may be risk of default of the short party. A futures contract prevents this dangerous affair: it is basically a forward contract, but the counterparties have to a margin account to ensure the amount of cash or commodity owed does not exceed a specified limit.

1.2.3 Greeks

Greeks are derivatives of the value function with respect to model and contract parameters. They are an important information for traders and have become standard information provided by front-office systems. More details on Greeks and the relations among Greeks are presented in Hakala and Wystup [50] or Reiss and Wystup [84]. For vanilla options we list some of them now.

(Spot) Delta.

$$ \frac{\partial v}{\partial x} = \phi e^{-r_f \tau} N(\phi d_+) $$

(1.10)

Forward Delta.

$$ \frac{\partial v}{\partial f} = \phi e^{-r_d \tau} N(\phi d_+) $$

(1.11)

Driftless Delta.

$$ \phi N(\phi d_+) $$

(1.12)

Gamma.

$$ \frac{\partial^2 v}{\partial x^2} = e^{-r_f \tau} \frac{n(d_+)}{x \sigma \sqrt{\tau}} $$

(1.13)
FX Options and Structured Products

Speed.
\[ \frac{\partial^3 v}{\partial x^3} = -e^{-rf\tau} n(d_+) \left( \frac{d_+}{\sigma\sqrt{\tau}} + 1 \right) \] (1.14)

Theta.
\[ \frac{\partial v}{\partial t} = -e^{-rf\tau} n(d_+) x\sigma \frac{2}{2\sqrt{\tau}} \]
\[ + \phi [r_f x e^{-rf\tau} N(\phi d_+) - r_d K e^{-rd\tau} N(\phi d_-)] \] (1.15)

Charm.
\[ \frac{\partial^2 v}{\partial x \partial \tau} = -\phi r_f e^{-rf\tau} N(\phi d_+) + \phi e^{-rf\tau} n(d_+) \frac{2(r_d - r_f)\tau - d_- \sigma \sqrt{\tau}}{2\tau \sigma \sqrt{\tau}} \] (1.16)

Color.
\[ \frac{\partial^3 v}{\partial x^2 \partial \tau} = -e^{-rf\tau} n(d_+) \frac{x}{2\tau \sqrt{\tau}} \left[ 2r_f \tau + 1 + \frac{2(r_d - r_f)\tau - d_- \sigma \sqrt{\tau}}{2\tau \sigma \sqrt{\tau}} \right] d_+ \] (1.17)

Vega.
\[ \frac{\partial v}{\partial \sigma} = x e^{-rf\tau} \sqrt{\tau} n(d_+) \] (1.18)

Volga.
\[ \frac{\partial^2 v}{\partial \sigma^2} = x e^{-rf\tau} \sqrt{\tau} n(d_+) \frac{d_+ d_-}{\sigma} \] (1.19)

Volga is also sometimes called vomma or volgamma.

Vanna.
\[ \frac{\partial^2 v}{\partial \sigma \partial x} = -e^{-rf\tau} n(d_+) \frac{d_-}{\sigma} \] (1.20)

Rho.
\[ \frac{\partial v}{\partial r_d} = \phi K \tau e^{-rd\tau} N(\phi d_-) \] (1.21)
\[ \frac{\partial v}{\partial r_f} = -\phi x \tau e^{-rf\tau} N(\phi d_+) \] (1.22)
Dual Delta.

\[ \frac{\partial v}{\partial K} = -\phi e^{-rd\tau} \mathcal{N}(\phi d_-) \]  

(1.23)

Dual Gamma.

\[ \frac{\partial^2 v}{\partial K^2} = e^{-rd\tau} \frac{n(d_-)}{K\sigma\sqrt{\tau}} \]  

(1.24)

Dual Theta.

\[ \frac{\partial v}{\partial T} = -v_t \]  

(1.25)

1.2.4 Identities

\[ \frac{\partial d_\pm}{\partial \sigma} = -\frac{d_\pm}{\sigma} \]  

(1.26)
\[ \frac{\partial d_\pm}{\partial r_d} = \frac{\sqrt{\tau}}{\sigma} \]  

(1.27)
\[ \frac{\partial d_\pm}{\partial r_f} = -\frac{\sqrt{\tau}}{\sigma} \]  

(1.28)

\[ xe^{-r_f\tau} n(d_+) = Ke^{-rd\tau} n(d_-). \]  

(1.29)
\[ \mathcal{N}(\phi d_-) = \mathbb{P}[\phi S_T \geq \phi K] \]  

(1.30)
\[ \mathcal{N}(\phi d_+) = \mathbb{P}[\phi S_T \leq \phi \frac{f^2}{K}] \]  

(1.31)

The put-call-parity is the relationship

\[ v(x, K, T, t, \sigma, r_d, r_f, +1) - v(x, K, T, t, \sigma, r_d, r_f, -1) = xe^{-r_f\tau} - Ke^{-rd\tau}, \]  

(1.32)

which is just a more complicated way to write the trivial equation \( x = x^+ - x^- \).

The put-call delta parity is

\[ \frac{\partial v(x, K, T, t, \sigma, r_d, r_f, +1)}{\partial x} - \frac{\partial v(x, K, T, t, \sigma, r_d, r_f, -1)}{\partial x} = e^{-r_f\tau}. \]  

(1.33)

In particular, we learn that the absolute value of a put delta and a call delta are not exactly adding up to one, but only to a positive number \( e^{-r_f\tau} \). They add up to one approximately if either the time to expiration \( \tau \) is short or if the foreign interest rate \( r_f \) is close to zero.
Whereas the choice $K = f$ produces identical values for call and put, we seek the delta-symmetric strike $\hat{K}$ which produces absolutely identical deltas (spot, forward or driftless). This condition implies $d_+ = 0$ and thus

$$\hat{K} = fe^{\frac{\sigma^2}{2}T},$$

(1.34)

in which case the absolute delta is $e^{-rt/2}$. In particular, we learn, that always $\hat{K} > f$, i.e., there can’t be a put and a call with identical values and deltas. Note that the strike $\hat{K}$ is usually chosen as the middle strike when trading a straddle or a butterfly. Similarly the dual-delta-symmetric strike $\hat{K} = fe^{-\frac{\sigma^2}{2}T}$ can be derived from the condition $d_- = 0$.

### 1.2.5 Homogeneity based Relationships

We may wish to measure the value of the underlying in a different unit. This will obviously effect the option pricing formula as follows.

$$av(x, K, T, t, \sigma, r_d, r_f, \phi) = v(ax, aK, T, t, \sigma, r_d, r_f, \phi)$$

for all $a > 0$. (1.35)

Differentiating both sides with respect to $a$ and then setting $a = 1$ yields

$$v = xv_x + K v_K.$$  

(1.36)

Comparing the coefficients of $x$ and $K$ in Equations (1.7) and (1.36) leads to suggestive results for the delta $v_x$ and dual delta $v_K$. This space-homogeneity is the reason behind the simplicity of the delta formulas, whose tedious computation can be saved this way.

We can perform a similar computation for the time-affected parameters and obtain the obvious equation

$$v(x, K, T, t, \sigma, r_d, r_f, \phi) = v(x, K, \frac{T}{a}, \frac{t}{a}, \sqrt{a}\sigma, ar_d, ar_f, \phi)$$

for all $a > 0$. (1.37)

Differentiating both sides with respect to $a$ and then setting $a = 1$ yields

$$0 = \tau v_t + \frac{1}{2} \sigma v_{\sigma} + r_d v_{r_d} + r_f v_{r_f}.$$  

(1.38)

Of course, this can also be verified by direct computation. The overall use of such equations is to generate double checking benchmarks when computing Greeks. These homogeneity methods can easily be extended to other more complex options.

By put-call symmetry we understand the relationship (see [6], [7],[16] and [19])

$$v(x, K, T, t, \sigma, r_d, r_f, +1) = \frac{K}{f} v(x, \frac{f^2}{K}, T, t, \sigma, r_d, r_f, -1).$$  

(1.39)
The strike of the put and the strike of the call result in a geometric mean equal to the forward $f$. The forward can be interpreted as a geometric mirror reflecting a call into a certain number of puts. Note that for at-the-money options ($K = f$) the put-call symmetry coincides with the special case of the put-call parity where the call and the put have the same value.

Direct computation shows that the rates symmetry

$$\frac{\partial v}{\partial r_d} + \frac{\partial v}{\partial r_f} = -\tau v \quad (1.40)$$

holds for vanilla options. This relationship, in fact, holds for all European options and a wide class of path-dependent options as shown in [84].

One can directly verify the relationship the foreign-domestic symmetry

$$\frac{1}{x}v(x, K, T, t, \sigma, r_d, r_f, \phi) = Kv\left(\frac{1}{x}, \frac{1}{K}, T, t, \sigma, r_f, r_d, -\phi\right). \quad (1.41)$$

This equality can be viewed as one of the faces of put-call symmetry. The reason is that the value of an option can be computed both in a domestic as well as in a foreign scenario. We consider the example of $S_t$ modeling the exchange rate of EUR/USD. In New York, the call option $(S_T - K)^+$ costs $v(x, K, T, t, \sigma, r_{USD}, r_{EUR}, 1)$ USD and hence $v(x, K, T, t, \sigma, r_{USD}, r_{EUR}, 1)/x$ EUR. This EUR-call option can also be viewed as a USD-put option with payoff $K\left(\frac{1}{x} - \frac{1}{S_T}\right)^+$. This option costs $Kv\left(\frac{1}{x}, \frac{1}{K}, T, t, \sigma, r_{EUR}, r_{USD}, -1\right)$ EUR in Frankfurt, because $S_t$ and $\frac{1}{S_t}$ have the same volatility. Of course, the New York value and the Frankfurt value must agree, which leads to (1.41). We will also learn later, that this symmetry is just one possible result based on change of numeraire.

### 1.2.6 Quotation

#### Quotation of the Underlying Exchange Rate

Equation (1.1) is a model for the exchange rate. The quotation is a permanently confusing issue, so let us clarify this here. The exchange rate means how much of the domestic currency are needed to buy one unit of foreign currency. For example, if we take EUR/USD as an exchange rate, then the default quotation is EUR-USD, where USD is the domestic currency and EUR is the foreign currency. The term *domestic* is in no way related to the location of the trader or any country. It merely means the numeraire currency. The terms *domestic*, *numeraire* or *base currency* are synonyms as are *foreign* and *underlying*. Throughout this book we denote with the slash (/) the currency pair and with a dash (-) the quotation. The slash (/) does not mean a division. For instance, EUR/USD can also be quoted in either EUR-USD, which then means how many USD are needed to buy one EUR, or in USD-EUR, which then means how many EUR are needed to buy one USD. There are certain market standard quotations listed in Table 1.1.
<table>
<thead>
<tr>
<th>currency pair</th>
<th>default quotation</th>
<th>sample quote</th>
</tr>
</thead>
<tbody>
<tr>
<td>GBP/USD</td>
<td>GPB-USD</td>
<td>1.8000</td>
</tr>
<tr>
<td>GBP/CHF</td>
<td>GBP-CHF</td>
<td>2.2500</td>
</tr>
<tr>
<td>EUR/USD</td>
<td>EUR-USD</td>
<td>1.2000</td>
</tr>
<tr>
<td>EUR/GBP</td>
<td>EUR-GBP</td>
<td>0.6900</td>
</tr>
<tr>
<td>EUR/JPY</td>
<td>EUR-JPY</td>
<td>135.00</td>
</tr>
<tr>
<td>EUR/CHF</td>
<td>EUR-CHF</td>
<td>1.5500</td>
</tr>
<tr>
<td>USD/JPY</td>
<td>USD-JPY</td>
<td>108.00</td>
</tr>
<tr>
<td>USD/CHF</td>
<td>USD-CHF</td>
<td>1.2800</td>
</tr>
</tbody>
</table>

Table 1.1: Standard market quotation of major currency pairs with sample spot prices

Trading Floor Language

We call one million a *buck*, one billion a *yard*. This is because a billion is called ‘milliarde’ in French, German and other languages. For the British Pound one million is also often called a *quid*.

Certain currency pairs have names. For instance, GBP/USD is called *cable*, because the exchange rate information used to be sent through a cable in the Atlantic ocean between America and England. EUR/JPY is called the *cross*, because it is the cross rate of the more liquidly traded USD/JPY and EUR/USD.

Certain currencies also have names, e.g. the New Zealand Dollar NZD is called a *kiwi*, the Australian Dollar AUD is called *Aussie*, the Scandinavian currencies DKR, NOK and SEK are called *Scandies*.

Exchange rates are generally quoted up to five relevant figures, e.g. in EUR-USD we could observe a quote of 1.2375. The last digit ‘5’ is called the *pip*, the middle digit ‘3’ is called the *big figure*, as exchange rates are often displayed in trading floors and the big figure, which is displayed in bigger size, is the most relevant information. The digits left to the big figure are known anyway, the pips right of the big figure are often negligible. To make it clear, a rise of USD-JPY 108.25 by 20 pips will be 108.45 and a rise by 2 big figures will be 110.25.

Quotation of Option Prices

Values and prices of vanilla options may be quoted in the six ways explained in Table 1.2.
Table 1.2: Standard market quotation types for option values. In the example we take \( \text{FOR}=\text{EUR}, \text{DOM}=\text{USD}, S_0=1.2000, r_d=3.0\%, r_f=2.5\%, \sigma=10\%, K=1.2500, T=1 \text{ year}, \phi=+1 \) (call), notional = 1,000,000 EUR = 1,250,000 USD. For the pips, the quotation 291.48 USD pips per EUR is also sometimes stated as 2.9148% USD per 1 EUR. Similarly, the 194.32 EUR pips per USD can also be quoted as 1.9432% EUR per 1 USD.

The Black-Scholes formula quotes \( d \text{ pips} \). The others can be computed using the following instruction.

\[
d \text{ pips} \leftrightarrow \%f \times \frac{S_0}{K} \times \%d \leftrightarrow f \text{ pips} \times \frac{S_0}{K} \times d \text{ pips}
\]

\( (1.42) \)

**Delta and Premium Convention**

The spot delta of a European option without premium is well known. It will be called \( \text{raw spot delta} \, \delta_{\text{raw}} \) now. It can be quoted in either of the two currencies involved. The relationship is

\[
\delta_{\text{reverse}}^{\text{raw}} = -\delta_{\text{raw}} \frac{S}{K}.
\]

\( (1.43) \)

The delta is used to buy or sell spot in the corresponding amount in order to hedge the option up to first order.

For consistency the premium needs to be incorporated into the delta hedge, since a premium in foreign currency will already hedge part of the option’s delta risk. To make this clear, let us consider EUR-USD. In the standard arbitrage theory, \( v(x) \) denotes the value or premium in USD of an option with 1 EUR notional, if the spot is at \( x \), and the raw delta \( v_x \) denotes the number of EUR to buy for the delta hedge. Therefore, \( xv_x \) is the number of USD to sell. If now the premium is paid in EUR rather than in USD, then we already have \( \frac{1}{x} \) EUR, and the number of EUR to buy has to be reduced by this amount, i.e. if EUR is the premium currency, we need to buy \( v_x - \frac{1}{x} \) EUR for the delta hedge or equivalently sell \( xv_x - v \) USD.
The entire FX quotation story becomes generally a mess, because we need to first sort out which currency is domestic, which is foreign, what is the notional currency of the option, and what is the premium currency. Unfortunately this is not symmetric, since the counterpart might have another notion of domestic currency for a given currency pair. Hence in the professional inter bank market there is one notion of delta per currency pair. Normally it is the left hand side delta of the *Fenics* screen if the option is traded in left hand side premium, which is normally the standard and right hand side delta if it is traded with right hand side premium, e.g. EUR/USD lhs, USD/JPY lhs, EUR/JPY lhs, AUD/USD rhs, etc... Since OTM options are traded most of the time the difference is not huge and hence does not create a huge spot risk.

Additionally the standard delta per currency pair [left hand side delta in *Fenics* for most cases] is used to quote options in volatility. This has to be specified by currency.

This standard inter bank notion must be adapted to the real delta-risk of the bank for an automated trading system. For currencies where the risk-free currency of the bank is the base currency of the currency it is clear that the delta is the raw delta of the option and for risky premium this premium must be included. In the opposite case the risky premium and the market value must be taken into account for the base currency premium, such that these offset each other. And for premium in underlying currency of the contract the market-value needs to be taken into account. In that way the delta hedge is invariant with respect to the risky currency notion of the bank, e.g. the delta is the same for a USD-based bank and a EUR-based bank.

**Example**

We consider two examples in Table 1.3 and 1.4 to compare the various versions of deltas that are used in practice.

<table>
<thead>
<tr>
<th>delta ccy</th>
<th>prem ccy</th>
<th>Fenics</th>
<th>formula</th>
<th>delta</th>
</tr>
</thead>
<tbody>
<tr>
<td>% EUR</td>
<td>EUR</td>
<td>lhs</td>
<td>$\delta_{raw} - P$</td>
<td>44.72</td>
</tr>
<tr>
<td>% EUR</td>
<td>USD</td>
<td>rhs</td>
<td>$\delta_{raw}$</td>
<td>49.15</td>
</tr>
<tr>
<td>% USD</td>
<td>EUR</td>
<td>rhs [flip F4]</td>
<td>$-(\delta_{raw} - P) S/K$</td>
<td>-44.72</td>
</tr>
<tr>
<td>% USD</td>
<td>USD</td>
<td>lhs [flip F4]</td>
<td>$-(\delta_{raw}) S/K$</td>
<td>-49.15</td>
</tr>
</tbody>
</table>

Table 1.3: 1y EUR call USD put strike $K = 0.9090$ for a EUR–based bank. Market data: spot $S = 0.9090$, volatility $\sigma = 12\%$, EUR rate $r_f = 3.96\%$, USD rate $r_d = 3.57\%$. The raw delta is 49.15%EUR and the value is 4.427%EUR.
<table>
<thead>
<tr>
<th>delta ccy</th>
<th>prem ccy</th>
<th>Fenics</th>
<th>formula</th>
<th>delta</th>
</tr>
</thead>
<tbody>
<tr>
<td>% EUR</td>
<td>EUR</td>
<td>lhs</td>
<td>$\delta_{\text{raw}} - P$</td>
<td>72.94</td>
</tr>
<tr>
<td>% EUR</td>
<td>USD</td>
<td>rhs</td>
<td>$\delta_{\text{raw}}$</td>
<td>94.82</td>
</tr>
<tr>
<td>% USD</td>
<td>EUR</td>
<td>rhs [flip F4]</td>
<td>$-(\delta_{\text{raw}} - P)S/K$</td>
<td>-94.72</td>
</tr>
<tr>
<td>% USD</td>
<td>USD</td>
<td>lhs [flip F4]</td>
<td>$-\delta_{\text{raw}}S/K$</td>
<td>-123.13</td>
</tr>
</tbody>
</table>

Table 1.4: 1y call EUR call USD put strike $K = 0.7000$ for a EUR–based bank. Market data: spot $S = 0.9090$, volatility $\sigma = 12\%$, EUR rate $r_f = 3.96\%$, USD rate $r_d = 3.57\%$. The raw delta is $94.82\%$EUR and the value is $21.88\%$EUR.

### 1.2.7 Strike in Terms of Delta

Since $v_x = \Delta = \phi e^{-r_f \tau} N(\phi d_+)$ we can retrieve the strike as

$$K = x \exp \left\{ -\phi N^{-1}(\phi \Delta e^{r_f \tau})\sigma \sqrt{\tau} + \sigma \theta_+ \tau \right\}. \quad (1.44)$$

### 1.2.8 Volatility in Terms of Delta

The mapping $\sigma \mapsto \Delta = \phi e^{-r_f \tau} N(\phi d_+)$ is not one-to-one. The two solutions are given by

$$\sigma_{\pm} = \frac{1}{\sqrt{\tau}} \left\{ \phi N^{-1}(\phi \Delta e^{r_f \tau}) \pm \sqrt{(N^{-1}(\phi \Delta e^{r_f \tau}))^2 - \sigma \sqrt{\tau}(d_+ + d_-)} \right\}. \quad (1.45)$$

Thus using just the delta to retrieve the volatility of an option is not advisable.

### 1.2.9 Volatility and Delta for a Given Strike

The determination of the volatility and the delta for a given strike is an iterative process involving the determination of the delta for the option using at-the-money volatilities in a first step and then using the determined volatility to re-determine the delta and to continuously iterate the delta and volatility until the volatility does not change more than $\epsilon = 0.001\%$ between iterations. More precisely, one can perform the following algorithm. Let the given strike be $K$.

1. Choose $\sigma_0 = \text{at-the-money volatility}$ from the volatility matrix.
2. Calculate $\Delta_{n+1} = \Delta(\text{Call}(K, \sigma_n))$.
3. Take $\sigma_{n+1} = \sigma(\Delta_{n+1})$ from the volatility matrix, possibly via a suitable interpolation.
4. If $|\sigma_{n+1} - \sigma_n| < \epsilon$, then quit, otherwise continue with step 2.
In order to prove the convergence of this algorithm we need to establish convergence of the recursion

\[
\Delta_{n+1} = e^{-r\tau}N(d_+(\Delta_n)) = e^{-r\tau}N\left(\frac{\ln(S/K) + (r_d - r_f + \frac{1}{2}\sigma^2(\Delta_n))\tau}{\sigma(\Delta_n)\sqrt{\tau}}\right)
\]

for sufficiently large \(\sigma(\Delta_n)\) and a sufficiently smooth volatility smile surface. We must show that the sequence of these \(\Delta_n\) converges to a fixed point \(\Delta^* \in [0, 1]\) with a fixed volatility \(\sigma^* = \sigma(\Delta^*)\).

This proof has been carried out in [15] and works like this. We consider the derivative

\[
\frac{\partial \Delta_{n+1}}{\partial \Delta_n} = -e^{-r\tau}n\left(d_+(\Delta_n)\right)\frac{d_-(\Delta_n)}{\sigma(\Delta_n)} \cdot \frac{\partial}{\partial \Delta_n}\sigma(\Delta_n).
\]

The term

\[-e^{-r\tau}n\left(d_+(\Delta_n)\right)\frac{d_-(\Delta_n)}{\sigma(\Delta_n)}\]

converges rapidly to zero for very small and very large spots, being an argument of the standard normal density \(n\). For sufficiently large \(\sigma(\Delta_n)\) and a sufficiently smooth volatility surface in the sense that \(\frac{\partial}{\partial \Delta_n}\sigma(\Delta_n)\) is sufficiently small, we obtain

\[
\left|\frac{\partial}{\partial \Delta_n}\sigma(\Delta_n)\right| \Delta = q < 1.
\]

Thus for any two values \(\Delta_{n+1}^{(1)}, \Delta_{n+1}^{(2)}\), a continuously differentiable smile surface we obtain

\[
|\Delta_{n+1}^{(1)} - \Delta_{n+1}^{(2)}| < q|\Delta_n^{(1)} - \Delta_n^{(2)}|,
\]

due to the mean value theorem. Hence the sequence \(\Delta_n\) is a contraction in the sense of the fixed point theorem of Banach. This implies that the sequence converges to a unique fixed point in \([0, 1]\), which is given by \(\sigma^* = \sigma(\Delta^*)\).

### 1.2.10 Greeks in Terms of Deltas

In Foreign Exchange markets the moneyness of vanilla options is always expressed in terms of deltas and prices are quoted in terms of volatility. This makes a ten-delta call a financial object as such independent of spot and strike. This method and the quotation in volatility makes objects and prices transparent in a very intelligent and user-friendly way. At this point we list the Greeks in terms of deltas instead of spot and strike. Let us introduce the quantities

\[
\Delta_+ \triangleq \phi e^{-r\tau}N(\phi d_+) \text{ spot delta},
\]

\[
\Delta_- \triangleq -\phi e^{-r\tau}N(\phi d_-) \text{ dual delta},
\]
which we assume to be given. From these we can retrieve
\[
\begin{align*}
    d_+ &= \phi N^{-1}(e^{r_f \tau} \Delta_+), \\
    d_- &= \phi N^{-1}(-e^{r_d \tau} \Delta_-).
\end{align*}
\]

(1.52)  

(1.53)

**Interpretation of Dual Delta**

The dual delta introduced in (1.23) as the sensitivity with respect to strike has another - more practical - interpretation in a foreign exchange setup. We have seen in Section 1.2.5 that the domestic value
\[
v(x, K, \tau, \sigma, r_d, r_f, \phi)
\]
corresponds to a foreign value
\[
v\left(\frac{1}{x}, \frac{1}{K}, \tau, \sigma, r_f, r_d, -\phi\right)
\]
up to an adjustment of the nominal amount by the factor \(xK\). From a foreign viewpoint the delta is thus given by
\[
-\phi e^{-r_d \tau} N \left( -\frac{\ln(\frac{K}{x}) + (r_f - r_d + \frac{1}{2} \sigma^2 \tau)}{\sigma \sqrt{\tau}} \right)
\]
\[
= -\phi e^{-r_d \tau} N \left( \frac{\ln(\frac{x}{K}) + (r_d - r_f - \frac{1}{2} \sigma^2 \tau)}{\sigma \sqrt{\tau}} \right)
\]
\[
= \Delta_-, 
\]
(1.56)

which means the dual delta is the delta from the foreign viewpoint. We will see below that foreign rho, vega and gamma do not require to know the dual delta. We will now state the Greeks in terms of \(x, \Delta_+, \Delta_-, r_d, r_f, \tau, \phi\).

**Value.**
\[
v(x, \Delta_+, \Delta_-, r_d, r_f, \tau, \phi) = x \Delta_+ + x \Delta_- \frac{e^{-r_f \tau} n(d_+)}{e^{-r_d \tau} n(d_-)}
\]
(1.57)

**Spot Delta.**
\[
\frac{\partial v}{\partial x} = \Delta_+ 
\]
(1.58)

**Forward Delta.**
\[
\frac{\partial v}{\partial f} = e^{(r_f-r_d) \tau} \Delta_+ 
\]
(1.59)
Gamma.
\[
\frac{\partial^2 v}{\partial x^2} = e^{-r_f \tau} \frac{n(d_+)}{x(d_+ - d_-)}
\] (1.60)

Taking a trader’s gamma (change of delta if spot moves by 1%) additionally removes the spot dependence, because
\[
\Gamma_{\text{trader}} = \frac{x}{100} \frac{\partial^2 v}{\partial x^2} = e^{-r_f \tau} \frac{n(d_+)}{100(d_+ - d_-)}
\] (1.61)

Speed.
\[
\frac{\partial^3 v}{\partial x^3} = -e^{-r_f \tau} \frac{n(d_+)}{x^2(d_+ - d_-)^2} (2d_+ - d_-)
\] (1.62)

Theta.
\[
\frac{1}{x} \frac{\partial v}{\partial t} = -e^{-r_f \tau} \frac{n(d_+)(d_+ - d_-)}{2\tau}
\]
\[
+ \left[ r_f \Delta_+ + r_d \Delta_- \frac{e^{-r_f \tau} n(d_+)}{e^{-r_f \tau} n(d_-)} \right]
\] (1.63)

Charm.
\[
\frac{\partial^2 v}{\partial x \partial \tau} = -\phi r_f e^{-r_f \tau} N(\phi d_+) + \phi e^{-r_f \tau} n(d_+) \frac{2(r_d - r_f)\tau - d_- (d_+ - d_-)}{2\tau (d_+ - d_-)}
\] (1.64)

Color.
\[
\frac{\partial^3 v}{\partial x^2 \partial \tau} = -e^{-r_f \tau} n(d_+) \frac{2r_f \tau + 1 + \frac{2(r_d - r_f)\tau - d_- (d_+ - d_-)}{2\tau (d_+ - d_-)}}{2x\tau (d_+ - d_-)} d_+
\] (1.65)

Vega.
\[
\frac{\partial v}{\partial \sigma} = x e^{-r_f \tau} \sqrt{\tau} n(d_+)
\] (1.66)

Volga.
\[
\frac{\partial^2 v}{\partial \sigma^2} = x e^{-r_f \tau} \tau n(d_+) \frac{d_+ d_-}{d_+ - d_-}
\] (1.67)
30

Vanna.

\[ \frac{\partial^2 v}{\partial \sigma \partial x} = -e^{-r_f \tau} n(d_+) \frac{\sqrt{\tau} d_-}{d_+ - d_-} \]  

(1.68)

Rho.

\[ \frac{\partial v}{\partial r_d} = -x\tau \Delta - e^{-r_f \tau} n(d_+) \]  

(1.69)

\[ \frac{\partial v}{\partial r_f} = -x\tau \Delta_+ \]  

(1.70)

Dual Delta.

\[ \frac{\partial v}{\partial K} = \Delta_- \]  

(1.71)

Dual Gamma.

\[ K^2 \frac{\partial^2 v}{\partial K^2} = x^2 \frac{\partial^2 v}{\partial x^2} \]  

(1.72)

Dual Theta.

\[ \frac{\partial v}{\partial T} = -v_t \]  

(1.73)

As an important example we consider vega.

Vega in Terms of Delta

The mapping \( \Delta \mapsto v_\sigma = x e^{-r_f \tau} \sqrt{\tau} n(N^{-1}(e^{r_f \tau} \Delta)) \) is important for trading vanilla options. Observe that this function does not depend on \( r_d \) or \( \sigma \), just on \( r_f \). Quoting vega in % foreign will additionally remove the spot dependence. This means that for a moderately stable foreign term structure curve, traders will be able to use a moderately stable vega matrix. For \( r_f = 3\% \) the vega matrix is presented in Table 1.5.

1.3 Volatility

Volatility is the annualized standard deviation of the log-returns. It is the crucial input parameter to determine the value of an option. Hence, the crucial question is where to derive the volatility from. If no active option market is present, the only source of information is estimating the historic volatility. This would give some clue about the past. In liquid currency
Table 1.5: Vega in terms of Delta for the standard maturity labels and various deltas. It shows that one can vega hedge a long 9M 35 delta call with 4 short 1M 20 delta puts.

Pairs volatility is often a traded quantity on its own, which is quoted by traders, brokers and real-time data pages. These quotes reflect views of market participants about the future.

Since volatility normally does not stay constant, option traders are highly concerned with hedging their volatility exposure. Hedging vanilla options’ vega is comparatively easy, because vanilla options have convex payoffs, whence the vega is always positive, i.e. the higher the volatility, the higher the price. Let us take for example a EUR-USD market with spot 1.2000, USD- and EUR rate at 2.5%. A 3-month at-the-money call with 1 million EUR notional would cost 29,000 USD at at volatility of 12%. If the volatility now drops to a value of 8%, then the value of the call would be only 19,000 USD. This monotone dependence is not guaranteed for non-convex payoffs as we illustrate in Figure 1.2.

### 1.3.1 Historic Volatility

We briefly describe how to compute the historic volatility of a time series

\[ S_0, S_1, \ldots, S_N \]  

(1.74)
of daily data. First, we create the sequence of log-returns

\[ r_i = \ln \frac{S_i}{S_{i-1}}, \quad i = 1, \ldots, N. \]  

(1.75)

Then, we compute the average log-return

\[ \bar{r} = \frac{1}{N} \sum_{i=1}^{N} r_i. \]  

(1.76)
their variance

\[ \hat{\sigma}^2 = \frac{1}{N - 1} \sum_{i=1}^{N} (r_i - \bar{r})^2, \]  

(1.77)

and their standard deviation

\[ \hat{\sigma} = \sqrt{\frac{1}{N - 1} \sum_{i=1}^{N} (r_i - \bar{r})^2}. \]  

(1.78)

The annualized standard deviation, which is the volatility, is then given by

\[ \hat{\sigma}_a = \sqrt{B} \left( \frac{1}{N - 1} \sum_{i=1}^{N} (r_i - \bar{r})^2 \right), \]  

(1.79)

where the annualization factor \( B \) is given by

\[ B = \frac{N}{k} d, \]  

(1.80)

and \( k \) denotes the number of calendar days within the time series and \( d \) denotes the number of calendar days per year. The is done to press the trading days into the calendar days.

Assuming normally distributed log-returns, we know that \( \hat{\sigma}^2 \) is \( \chi^2 \)-distributed. Therefore, given a confidence level of \( p \) and a corresponding error probability \( \alpha = 1 - p \), the \( p \)-confidence interval is given by

\[ \left[ \hat{\sigma}_a \sqrt{\frac{N - 1}{\chi^2_{N-1,1-p/2}}}, \hat{\sigma}_a \sqrt{\frac{N - 1}{\chi^2_{N-1,1-\alpha/2}}} \right], \]  

(1.81)

where \( \chi^2_{n,p} \) denotes the \( p \)-quantile of a \( \chi^2 \)-distribution\(^1\) with \( n \) degrees of freedom.

As an example let us take the 256 ECB-fixings of EUR-USD from 4 March 2003 to 3 March 2004 displayed in Figure 1.3. We get \( N = 255 \) log-returns. Taking \( k = d = 365 \), we obtain

\[ \bar{r} = \frac{1}{N} \sum_{i=1}^{N} r_i = 0.0004166, \]

\[ \hat{\sigma}_a = \sqrt{B} \left( \frac{1}{N - 1} \sum_{i=1}^{N} (r_i - \bar{r})^2 \right) = 10.85\%, \]

and a 95\% confidence interval of [9.99\%, 11.89\%].

---

\(^1\)values and quantiles of the \( \chi^2 \)-distribution and other distributions can be computed on the internet, e.g. at [http://www.wiso.uni-koeln.de/ASPSamp/eswf/html/allg/surfstat/tables.htm](http://www.wiso.uni-koeln.de/ASPSamp/eswf/html/allg/surfstat/tables.htm).
1.3.2 Historic Correlation

As in the preceding section we briefly describe how to compute the historic correlation of two time series $x_0, x_1, \ldots, x_N$, $y_0, y_1, \ldots, y_N$, of daily data. First, we create the sequences of log-returns

$$X_i = \ln \frac{x_i}{x_{i-1}}, \quad i = 1, \ldots, N,$$
$$Y_i = \ln \frac{y_i}{y_{i-1}}, \quad i = 1, \ldots, N.$$  

(1.82)

Then, we compute the average log-returns

$$\bar{X} = \frac{1}{N} \sum_{i=1}^{N} X_i,$$
$$\bar{Y} = \frac{1}{N} \sum_{i=1}^{N} Y_i.$$  

(1.83)
their variances and covariance

\[
\hat{\sigma}_X^2 = \frac{1}{N - 1} \sum_{i=1}^{N} (X_i - \overline{X})^2, \quad (1.84)
\]

\[
\hat{\sigma}_Y^2 = \frac{1}{N - 1} \sum_{i=1}^{N} (Y_i - \overline{Y})^2, \quad (1.85)
\]

\[
\hat{\sigma}_{XY} = \frac{1}{N - 1} \sum_{i=1}^{N} (X_i - \overline{X})(Y_i - \overline{Y}), \quad (1.86)
\]

and their standard deviations

\[
\hat{\sigma}_X = \sqrt{\frac{1}{N - 1} \sum_{i=1}^{N} (X_i - \overline{X})^2}, \quad (1.87)
\]

\[
\hat{\sigma}_Y = \sqrt{\frac{1}{N - 1} \sum_{i=1}^{N} (Y_i - \overline{Y})^2}. \quad (1.88)
\]

The estimate for the correlation of the log-returns is given by

\[
\hat{\rho} = \frac{\hat{\sigma}_{XY}}{\hat{\sigma}_X \hat{\sigma}_Y}. \quad (1.89)
\]

This correlation estimate is often not very stable, but on the other hand, often the only available information. More recent work by Jäkel [37] treats robust estimation of correlation. We will revisit FX correlation risk in Section 1.6.7.

1.3.3 Volatility Smile

The Black-Scholes model assumes a constant volatility throughout. However, market prices of traded options imply different volatilities for different maturities and different deltas. We start with some technical issues how to imply the volatility from vanilla options.

Retrieving the Volatility from Vanilla Options

Given the value of an option. Recall the Black-Scholes formula in Equation (1.7). We now look at the function \(v(\sigma)\), whose derivative (vega) is

\[
v'(\sigma) = xe^{-rT}\sqrt{T}n(d_+). \quad (1.90)
\]

The function \(\sigma \mapsto v(\sigma)\) is
1. strictly increasing,
2. concave up for \( \sigma \in [0, \sqrt{2|\ln F - \ln K|/T}) \),
3. concave down for \( \sigma \in (\sqrt{2|\ln F - \ln K|/T, \infty}) \)

and also satisfies

\[
\begin{align*}
  v(0) &= \left[ \phi(xe^{-rfT} - Ke^{-rdT}) \right]^{+}, \\
  v(\infty, \phi = 1) &= xe^{-rfT}, \\
  v(\infty, \phi = -1) &= Ke^{-rdT}, \\
  v'(0) &= xe^{-rfT}\sqrt{T}/\sqrt{2\pi I_{I{F = K}}},
\end{align*}
\]

In particular the mapping \( \sigma \mapsto v(\sigma) \) is invertible. However, the starting guess for employing Newton’s method should be chosen with care, because the mapping \( \sigma \mapsto v(\sigma) \) has a saddle point at

\[
\left( \sqrt{2T|\ln F/K|}, \phi e^{-rdT}\left\{ \sqrt{2T|\ln F/K|}^{+} - K\mathcal{N}\left( \phi \sqrt{2T|\ln F/K|^{+}} \right) \right\} \right), \tag{1.95}
\]

as illustrated in Figure 1.4.

To ensure convergence of Newton’s method, we are advised to use initial guesses for \( \sigma \) on the same side of the saddle point as the desired implied volatility. The danger is that a large initial guess could lead to a negative successive guess for \( \sigma \). Therefore one should start with small initial guesses at or below the saddle point. For at-the-money options, the saddle point is degenerate for a zero volatility and small volatilities serve as good initial guesses.

**Visual Basic Source Code**

```visualbasic
Function VanillaVolRetriever(spot As Double, rd As Double, rf As Double, strike As Double, T As Double, type As Integer, GivenValue As Double) As Double
  Dim func As Double
  Dim dfunc As Double
  Dim maxit As Integer 'maximum number of iterations
  Dim j As Integer
  Dim s As Double

  'first check if a volatility exists, otherwise set result to zero
  If GivenValue < Application.Max _
    (0, type * (spot * Exp(-rf * T) - strike * Exp(-rd * T))) Or _
    (type = 1 And GivenValue > spot * Exp(-rf * T)) Or _
    (type = -1 And GivenValue > strike * Exp(-rd * T)) Then
```
Figure 1.4: Value of a European call in terms of volatility with parameters $x = 1$, $K = 0.9$, $T = 1$, $r_d = 6\%$, $r_f = 5\%$. The saddle point is at $\sigma = 48\%$.

```
VanillaVolRetriever = 0
Else
' there exists a volatility yielding the given value,
' now use Newton's method:
' the mapping vol to value has a saddle point.
' First compute this saddle point:
saddle = Sqr(2 / T * Abs(Log(spot / strike) + (rd - rf) * T))
```
If saddle > 0 Then
    VanillaVolRetriever = saddle * 0.9
Else
    VanillaVolRetriever = 0.1
End If
maxit = 100
For j = 1 To maxit Step 1
    func = Vanilla(spot, strike, VanillaVolRetriever, rd, rf, T, type, value) - GivenValue
    dfunc = Vanilla(spot, strike, VanillaVolRetriever, rd, rf, T, type, vega)
    VanillaVolRetriever = VanillaVolRetriever - func / dfunc
    If VanillaVolRetriever <= 0 Then VanillaVolRetriever = 0.01
    If Abs(func / dfunc) <= 0.0000001 Then j = maxit
Next j
End If
End Function

Market Data

Now that we know how to imply the volatility from a given value, we can take a look at the market. We take EUR/GBP at the beginning of April 2005. The at-the-money volatilities for various maturities are listed in Table 1.6. We observe that implied volatilities are not constant, but depend on the time to maturity of the option as well as on the current time. This shows that the Black-Scholes assumption of a constant volatility is not fully justified looking at market data. We have a term structure of volatility as well as a stochastic nature of the term structure curve as time passes.

Besides the dependence on the time to maturity (term structure) we also observe different implied volatilities for different degrees of moneyness. This effect is called the volatility smile. The term structure and smile together are called a volatility matrix or volatility surface, if it is graphically displayed. Various possible reasons for this empirical phenomenon are discussed among others by Bates, e.g. in [7].

In Foreign Exchange Options markets implied volatilities are generally quoted and plotted against the deltas of out-of-the-money call and put options. This allows market participants to ask various partners for quotes on a 25-Delta call, which is spot independent. The actual strike will be set depending on the spot if the trade is close to being finalized. The at-the-money option is taken to be the one that has a strike equal to the forward, which is equivalent to the value of the call and the put being equal. Other types of at-the-money are discussed
<table>
<thead>
<tr>
<th>Date</th>
<th>Spot</th>
<th>1 Week</th>
<th>1 Month</th>
<th>3 Month</th>
<th>6 Month</th>
<th>1 Year</th>
<th>2 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-Apr-05</td>
<td>0.6864</td>
<td>4.69</td>
<td>4.83</td>
<td>5.42</td>
<td>5.79</td>
<td>6.02</td>
<td>6.09</td>
</tr>
<tr>
<td>4-Apr-05</td>
<td>0.6851</td>
<td>4.51</td>
<td>4.88</td>
<td>5.34</td>
<td>5.72</td>
<td>5.99</td>
<td>6.07</td>
</tr>
<tr>
<td>5-Apr-05</td>
<td>0.6840</td>
<td>4.66</td>
<td>4.95</td>
<td>5.34</td>
<td>5.70</td>
<td>5.97</td>
<td>6.03</td>
</tr>
<tr>
<td>6-Apr-05</td>
<td>0.6847</td>
<td>4.65</td>
<td>4.91</td>
<td>5.39</td>
<td>5.79</td>
<td>6.05</td>
<td>6.12</td>
</tr>
<tr>
<td>7-Apr-05</td>
<td>0.6875</td>
<td>4.78</td>
<td>4.97</td>
<td>5.39</td>
<td>5.79</td>
<td>6.01</td>
<td>6.10</td>
</tr>
<tr>
<td>8-Apr-05</td>
<td>0.6858</td>
<td>4.76</td>
<td>5.00</td>
<td>5.41</td>
<td>5.78</td>
<td>6.00</td>
<td>6.09</td>
</tr>
</tbody>
</table>

Table 1.6: EUR/GBP implied volatilities in % for at-the-money vanilla options. Source: BBA (British Bankers Association), http://www.bba.org.uk.

in Section 1.3.6. Their delta is

$$\frac{\partial v}{\partial x} = \phi e^{-r\tau}N\left(\phi \frac{1}{2} \sigma \sqrt{\tau}\right),$$

(1.96)

for a small volatility $\sigma$ and short time to maturity $\tau$, a number near $\phi50\%$. This is no more true for long-term vanilla options. Further market information are the implied volatilities for puts and calls with a delta of $\phi25\%$. Other or additional implied volatilities for other deltas such as $\phi10\%$ and $\phi35\%$ are also quoted. Volatility matrices for more delta pillars are usually interpolated.

Symmetric Decomposition

Generally in Foreign Exchange, volatilities are decomposed into a symmetric part of the smile reflecting the convexity and a skew-symmetric part of the smile reflecting the skew. The way this works is that the market quotes risk reversals (RR) and butterflies (BF) or strangles, see Sections 1.4.2 and 1.4.5 for the description of the products and Figure 1.5 for the payoffs. Here we are talking about the respective volatilities to use to price the products. Sample quotes are listed in Tables 1.7 and 1.8. The relationship between risk reversal and strangle/butterfly quotes and the volatility smile are graphically explained in Figure 1.6.

The relationship between risk reversal quoted in terms of volatility (RR) and butterfly/strangle
Figure 1.5: The risk reversal (upper payoff) is a skew symmetric product, the butterfly (lower payoff) a symmetric product.

(BF) quoted in terms of volatility and the volatilities of 25-delta calls and puts are given by

\[
\begin{align*}
\sigma_+ &= \text{ATM} + BF + \frac{1}{2}RR, \\
\sigma_- &= \text{ATM} + BF - \frac{1}{2}RR, \\
RR &= \sigma_+ - \sigma_-, \\
BF &= \frac{\sigma_+ + \sigma_-}{2} - \sigma_0,
\end{align*}
\]

(1.97) (1.98) (1.99) (1.100)

where \( \sigma_0 \) denotes the at-the-money volatility of both put and call, \( \sigma_+ \) the volatility of an out-of-the-money call (usually \( 25 - \Delta \)) and \( \sigma_- \) the volatility of an out-of-the-money put (usually \( 25 - \Delta \)). Our sample market data is given in terms of RR and BF. Translated into implied volatilities of vanillas we obtain the data listed in Table 1.9 and Figure 1.7.
Table 1.7: EUR/GBP 25 Delta Risk Reversal in %. Source: BBA (British Bankers Association). This means that for example on 4 April 2005, the 1-month 25-delta EUR call was priced with a volatility of 0.15% higher than the EUR put. At that moment the market apparently favored calls indicating a belief in an upward movement.

Table 1.8: EUR/GBP 25 Delta Strangle in %. Source: BBA (British Bankers Association). This means that for example on 4 April 2005, the 1-month 25-delta EUR call and the 1-month 25-delta EUR put are on average quoted with a volatility of 0.15% higher than the 1-month at-the-money calls and puts. The result is that the 1-month EUR call is quoted with a volatility of 4.88% + 0.075% and the 1-month EUR put is quoted with a volatility of 4.88% − 0.075%.

1.3.4 At-The-Money Volatility Interpolation

The interpolation takes into account the effect of reduced volatility on weekends and on days closed in the global main trading centers London or New York and the local market, e.g. Tokyo for JPY-trades. The change is done for the one-day forward volatility. There is a reduction in the one-day forward variance of 25% for each London and New York closed day. For
Figure 1.6: Risk reversal and butterfly in terms of volatility for a given FX vanilla option smile.

<table>
<thead>
<tr>
<th>Maturity</th>
<th>25 delta put</th>
<th>at-the-money</th>
<th>25 delta call</th>
</tr>
</thead>
<tbody>
<tr>
<td>1M</td>
<td>4.890</td>
<td>4.830</td>
<td>5.070</td>
</tr>
<tr>
<td>3M</td>
<td>5.465</td>
<td>5.420</td>
<td>5.695</td>
</tr>
<tr>
<td>1Y</td>
<td>6.030</td>
<td>6.020</td>
<td>6.330</td>
</tr>
</tbody>
</table>

Table 1.9: EUR/GBP implied volatilities in % of 1 April 2005. Source: BBA (British Bankers Association). They are computed based on the market data displayed in Tables 1.6, 1.7 and 1.8 using Equations (1.97) and (1.98).

Local market holidays there is a reduction of 25%, where local holidays for EUR are ignored. Weekends are accounted by a reduction to 15% variance. The variance on trading days is adjusted to match the volatility on the pillars of the ATM–volatility curve exactly.
The procedure starts from the two pillars $t_1, t_2$ surrounding the date $t_r$ in question. The ATM forward volatility for the period is calculated based on the consistency condition

$$\sigma^2(t_1)(t_1 - t_0) + \sigma^2_f(t_1, t_2)(t_2 - t_1) = \sigma^2(t_2)(t_2 - t_0),$$

(1.101)

whence

$$\sigma_f(t_1, t_2) = \sqrt{\frac{\sigma^2(t_2)(t_2 - t_0) - \sigma^2(t_1)(t_1 - t_0)}{t_2 - t_1}}.$$  

(1.102)

For each day the factor is determined and from the constraint that the sum of one-day forward variances matches exactly the total variance the factor for the enlarged one day business
variances $\alpha(t)$ with $t$ business day is determined.

$$\sigma^2(t_1, t_2)(t_2 - t_1) = \sum_{t=t_1}^{t_2} \alpha(t)\sigma^2_f(t, t+1)$$

(1.103)

The variance for the period is the sum of variances to the start and sum of variances to the required date.

$$\sigma^2(t_r) = \sqrt{\sigma^2(t_1)(t_1 - t_0) + \sum_{t=t_1}^{t_r} \alpha(t)\sigma^2_f(t, t+1)}$$

(1.104)

1.3.5 Volatility Smile Conventions

The volatility smile is quoted in terms of delta and one at-the-money pillar. We recall that there are several notions of delta

- spot delta $e^{-r_f \tau} N(d_+)$,
- forward delta $e^{-r_d \tau} N(d_+)$,
- driftless delta $N(d_+)$,

and there is the premium which might be included in the delta. It is important to specify the notion that is used to quote the smile. There are three different deltas concerning plain vanilla options.

1.3.6 At-The-Money Definition

There is one specific at-the-money pillar in the middle. There are at least three notions for the meaning of at-the-money (ATM).

**Delta parity:** delta call = - delta put

**Value parity:** call value = put value

**Fifty delta:** call delta = 50% and put delta = 50%

Moreover, these notions use different versions of delta, namely either spot, forward, or driftless and premium included or excluded.

The standard for all currencies one can stick to is spot delta parity with premium included [left hand side Fenics delta for call and put is the same] or excluded [right hand side Fenics delta] is used.
1.3.7 Interpolation of the Volatility on Maturity Pillars

To determine the spread to at-the-money we can take a kernel interpolation in one dimension to compute the volatility on the delta pillars. Given \( N \) points \( (X_n, y_n), n = 1, \ldots, N \), where \( X = (x^1, x^2) \in \mathcal{R}^2 \) and \( y \in \mathcal{R} \), a “smooth” interpolation of these points is given by a “smooth” function \( g: \mathcal{R}^2 \to \mathcal{R} \) which suffices

\[
g(X_n) = y_n \quad (n = 1, \ldots, N). \tag{1.105}
\]

The kernel approach is

\[
g(X) = g_{\lambda, \alpha_1, \ldots, \alpha_N}(X) \triangleq \frac{1}{\Gamma_{\lambda}(X)} \sum_{n=1}^{N} \alpha_n K_{\lambda}(\|X - X_n\|), \tag{1.106}
\]

where

\[
\Gamma_{\lambda}(x) \triangleq \sum_{n=1}^{N} K_{\lambda}(\|X - X_n\|) \tag{1.107}
\]

and \( \|\cdot\| \) denotes the Euclidean norm. The required smoothness may be achieved by using analytic kernels \( K_{\lambda} \), for instance \( K_{\lambda}(u) \equiv e^{-\frac{u^2}{2\lambda^2}} \).

The idea behind this approach is as follows. The parameters which solve the interpolation conditions (1.105) are \( \alpha_1, \ldots, \alpha_n \). The parameter \( \lambda \) determines the “smoothness” of the resulting interpolation \( g \) and should be fixed according to the nature of the points \( (X_n, y_n) \). If these points yield a smooth surface, a “large” \( \lambda \) might yield a good fit, whereas in the opposite case when for neighboring points \( X_k, X_n \) the appropriate values \( y_k, y_n \) vary significantly, only a small \( \lambda \), that means \( \lambda \ll \min_{n,k} \|X_k - X_n\| \), can provide the needed flexibility.

For the set of delta pillars of \( 10\%, 25\%, ATM, -25\%, -10\% \) one can use \( \lambda = 25\% \) for a smooth interpolation.

1.3.8 Interpolation of the Volatility Spread between Maturity Pillars

The interpolation of the volatility spread to ATM uses the interpolation of the spread on the two surrounding maturity pillars for the initial Black–Scholes delta of the option. The spread is interpolated using square root of time where \( \tilde{\sigma} \) is the volatility spread,

\[
\tilde{\sigma}(t) = \tilde{\sigma}_1 + \frac{\sqrt{t} - \sqrt{t_1}}{\sqrt{t_2} - \sqrt{t_1}} (\tilde{\sigma}_2 - \tilde{\sigma}_1). \tag{1.108}
\]

The spread is added to the interpolated ATM volatility as calculated above.
1.3.9 Volatility Sources

1. BBA, the British Bankers Association, provides historic smile data for all major currency pairs in spreadsheet format at http://www.bba.org.uk.

2. Olsen Associates (http://www.olson.ch) can provide tic data of historic spot rates, from which the historic volatilities can be computed.

3. Bloomberg, not really the traditional FX data source, contains both implied volatilities and historic volatilities.

4. Reuters pages such as FXMOX, SGFXVOL01, and others are commonly used and contain mostly implied volatilities. JYSKEOPT is a common reference for volatilities of Scandinavia (scandie-vols). NMRC has some implied volatilities for precious metals.

5. Telerate pages such as 4720, see Figure 1.8, delivers implied volatilities.

6. Cantorspeed 90 also provides implied volatilities.

Figure 1.8: Telerate page 4720 quoting currency option volatilities
1.3.10 Volatility Cones

Volatility cones visualize whether current at-the-money volatility levels for various maturities are high or low compared to a recent history of these implied volatilities. This indicates to a trader or risk taker whether it is currently advisable to buy volatility or sell volatility, i.e. to buy vanilla options or to sell vanilla options. We fix a time horizon of historic observations of mid market at-the-money implied volatility and look at the maximum, the minimum that traded over this time horizon and compare this with the current volatility level. Since long term volatilities tend to fluctuate less than short term volatility levels, the chart of the minimum and the maximum typically looks like a part of a cone. We illustrate this in Figure 1.9 based on the data provided in Table 1.10.

<table>
<thead>
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<th>maturity</th>
<th>low</th>
<th>high</th>
<th>current</th>
</tr>
</thead>
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<tr>
<td>1M</td>
<td>7.60</td>
<td>13.85</td>
<td>11.60</td>
</tr>
<tr>
<td>2M</td>
<td>7.80</td>
<td>12.40</td>
<td>11.10</td>
</tr>
<tr>
<td>3M</td>
<td>7.90</td>
<td>11.40</td>
<td>10.85</td>
</tr>
<tr>
<td>6M</td>
<td>8.00</td>
<td>11.00</td>
<td>10.40</td>
</tr>
<tr>
<td>12M</td>
<td>8.20</td>
<td>10.75</td>
<td>10.00</td>
</tr>
</tbody>
</table>

Table 1.10: Sample data of a volatility cone in USD-JPY for a 9 months time horizon from 6 Sept 2003 to 24 Feb 2005

1.3.11 Stochastic Volatility

Stochastic volatility models are very popular in FX Options, whereas jump diffusion models can be considered as the cherry on the cake. The most prominent reason for the popularity is very simple: FX volatility is stochastic as is shown for instance in Figure 1.10. Treating stochastic volatility in detail here is way beyond the scope of this book. A more recent overview can be found in the article *The Heston Model and the Smile* by Weron and Wystup [23].

1.3.12 Exercises

1. For the market data in Tables 1.6, 1.7 and 1.8 determine a smile matrix for at-the-money and the 25-deltas. Also compute the corresponding strikes for the three pillars or moneyness.

2. Taking the smile of the previous exercise, implement the functions for interpolation to generate a suitable implied volatility for any given time to maturity and any strike or delta.
3. Using the historic data, generate a volatility cone for USD-JPY.

4. It is often believed that an at-the-money (in the sense that the strike is set equal to the forward) vanilla call has a delta near 50%. What can you say about the delta of a 15 year at-the-money USD-JPY call if USD rates are at 5%, JPY rates are at 1% and the volatility is at 11%?

1.4 Basic Strategies containing Vanilla Options

Linear Combinations of vanillas are quite well known and have been explained in several text books including the one by Spies [93]. Therefore, we will restrict our attention in this section to the most basic strategies.

1.4.1 Call and Put Spread

A Call Spread is a combination of a long and a short Call option. It is also called capped call. The motivation to do this is the fact that buying a simple call may be too expensive and the buyer wishes to lower the premium. At the same time he does not expect the underlying exchange rate to appreciate above the strike of the short Call option.
Bibliography


Index

absolute derivative, 320
accrued forward, 201
accumulative forward, 142, 205
American lookback options, 108
American style corridor, 138
American style forward, 218
amortizing forward, 212
annualization factor, 33
Asian option, 97
asymmetric power options, 119
at-the-money, 44
Aussie, 23
auto-renewal forward, 214
average option, 97
back-office, 407
backwardation, 18, 184
barrier monitoring, 67
barrier option crisis, 69
barrier options, 62
base currency, 22
basis adjustment, 352
basket options, 160
basket-linked note, 272
best-of options, 167
bid-ask spreads, 292
big figure, 23
Black-Scholes formula, 17
Black-Scholes partial differential equation, 17
Bloomberg, 392
bonus forward, 199
bonus swap, 262
boomerang forward, 211
boosted forward, 217
boosted spot, 217
branch sales, 409
Bretton Woods, 14
British Bankers' Association, 46
buck, 23
buffered cross currency swap, 259
butterfly, 58, 281
butterfly deposit, 249
butterfly forward, 196
cable, 23
call spread, 48
capped call, 48
capped put, 48
cash flow hedge, 340, 352
cash settlement, 297
charm, 19
Chicago Mercantile Exchange, 14
chooser forward, 223
chooser option, 180
classification of financial instruments, 325
cliquet, 119
collar, 51
collar extra series, 227
color, 19
compound financial instrument, 319
compound option, 84
compound option on the forward, 299
conditional derivative, 320
contango, 18, 184
contingent payment, 157
contingent rebate structure, 220
convertible bond, 319
convexity, 39
corporate sales, 410
correlation, 164
correlation hedge, 164
corridor, 137
corridor deposit, 238
corridor forward, 201
corridor loan, 241
corridor swap, 262
credit spread, 273
critical term match, 348
cross, 23
cross currency swap, 251
cross currency swap with protection of the
final exchange notional, 253
currency swap, 185
DAX linked deposit, 248
DCD, 230
deferred cash-settlement, 300
deferred delivery, 276, 299
deferred payment, 178
delayed fixing announcements, 300
delivery date, 178, 296
delivery settlement, 298
delta, 18
delta quotation convention, 24
delta-symmetric strike, 20
deposits, 229
derecognition, 335
derivative (accountant’s definition), 319
derivatives trading process engineering, 408
digital barrier options, 143
digital options, 73
discretely monitored barrier option, 302
dollar-offset method, 348
DOM, 15
domestic, 15, 22
double barrier option, 66
double barrier options, 288
double shark forward, 216
double-no-touch, 81
double-no-touch linked deposit, 235
double-no-touch linked swap, 265
double-one-touch, 83
driftless delta, 18
dual currency deposit, 230
dual currency loan, 232
dual delta, 20
dual gamma, 20
dual theta, 20
ECB fixing, 301
ECU, 15
embedded derivatives, 322
enhanced deposit, 230
Euro, 15
European Currency Unit (ECU), 15
European style corridor, 138
European style options, 289
exchange option, 158, 178
expiration date, 178
expiry date, 296
expiry spot date, 296
fade-in forward, 187
fade-in option, 140
fade-out call, 178
fade-out option, 140
fader, 140
fader forward extra, 196
fader forward plus, 194
fader shark forward, 194
fair value hedge, 339, 347
FAS 133, 353
Fenics, 387, 407
Fenics view, 407
first generation exotics, 62
fixed strike average option, 99
fixing, 139
fixing date, 296
fixing schedule, 139
FX Options and Structured Products

fixing source, 139
fixing spot date, 296
flexible deals, 407
flip swap, 259
floating strike, 99
fluffy barrier options, 144
FOR, 15
foreign, 15, 22
foreign exchange committee, 73
foreign-domestic symmetry, 22
forward contract, 184
forward contracts (accounting issues), 330
forward delta, 18
forward extra, 191
forward plus, 191
forward plus plus, 192
forward plus with extra strike, 192
forward start corridor swap, 267
forward start options, 116
forward super plus, 192
forward variance swap, 176
forward volatility, 86, 117, 135
front-office, 407
FX as an asset class, 270
FX swap, 185
FX swap rate, 185

gamma, 18
geometric average price call, 99
geometric Brownian motion, 15
GFI group, 387
gold performance note, 270
gold price linked deposit, 248
gold windowed knock-out range accrual deposit, 249
Greeks, 18
Greeks in terms of deltas, 27
hanseatic swap, 253
harmonic average contracts, 172
hedge accounting, 311, 337
hedge amortized costs, 352
hedge effectiveness, 344
hedge fair value (HFV), 351
hedge of a net investment, 341
hedging instruments, 342
hi-lo option, 108
Himalaya options, 171
hindsight options, 107
historic correlation, 34
historic volatility, 31
hit option, 67
homogeneity, 21
horizon date, 296
horizon spot date, 296
host contract, 322
hybrid products, 275
IAS 39, 311
ICOM, 73
ICY software, 388
independent derivative, 322
instalment option, 86, 88
instalment options with a continuous payment plan, 96
institutional sales, 409
inter bank sales, 409
interest rate swap, 251
issuer swap, 272
James Bond range, 154
kiwi, 23
knock-in options, 62
knock-in-knock-out options, 153
knock-out forward, 189
knock-out options, 62
leveraged forward, 186
limited risk options, 108
listed FX option, 410
loans, 229
long term FX options, 275
lookback gamma asymmetry, 114
lookback options, 107
lookback straddle, 108
LPA, 404
Lucht Probst Associates (LPA), 404
Maastrich Treaty, 15
madonna option, 171
margin account, 18
margin requirements, 321
master agreement (ICOM), 73
mean subtracted, 178
middle-office, 407
Milano strategy, 224
MNC, 410
mountain range options, 171
multi currency deposit, 249
multi-currency protection, 160
multiple strike option, 171
Murex, 396
NDF, 185
no-touch, 75
no-touch option, 67
no-touch probability, 289
non-deliverable forward, 185
non-resurrecting corridor, 138
numeraire currency, 22
occupation time derivatives, 144
off-balance sheet transaction, 319
one-touch, 73, 289
one-touch (digital) option, 67
onion deposit, 244
onion loan, 244
option on the Euclidian distance, 171
option on the forward, 299
option on the maximum norm, 171
options on the maximum/minimum of several underlyings, 167
outright forward, 184
outside barrier option, 67, 146
overhedge, 208, 279
Parasian barrier option, 145
Parasian style knock-out, 207
Parisian barrier option, 145
Parisian option pricing, 179
parity risk, 209
partial barrier option, 143
partial lookback options, 108
participating forward, 185
participation notes, 270
pay-later options, 154
pay-later price, 156
performance linked deposits, 232
performance notes, 270
perpetual no-touch, 131
perpetual one-touch, 131
pin risk, 121
pip, 23
power options, 119
power reverse dual currency bond, 276
power straddle, 120
PRDC, 276
preferred share, 319
premium value date, 178
private banking, 410
proprietary trading, 409
put spread, 48
put-call delta parity, 20
put-call parity, 185
put-call symmetry, 21
put-call-parity, 20
pyramid option, 171
quanto barrier, 145
quanto capped call, 271
quanto digital put, 130
quanto drift adjustment, 127
quanto options, 127
quanto vanilla, 129
quid, 23
quotation, 22
range accrual forward, 201
range deposit, 235
range forward, 199
range note, 238
range option, 108
range reset swap, 267
rates symmetry, 22
rebates, 67, 73
rebates, delta, 76
recognition, 329
regression analysis, 350, 367
regular barrier option, 65
regular knock-out, 65
regular way contracts, 322
resetable barrier option, 145
resurrecting corridor, 138
reverse convertible deposit, 230
reverse knock-out, 65
rho, 19
risk controlling, 408
risk reversal, 39, 51, 281
risk reversal flip, 53
sales-driven trading, 409
scandie vols, 46
Scandies, 23
seagull, 60
second generation exotics, 137
self-quanto, 137
self-quanto forward, 136
series of strategies, 224
settlement, 295
shark forward, 191
shark forward series, 224
shout forward, 218
single barrier option, 66
skew, 39
soft barrier option, 144
soft strike option, 121
space-homogeneity, 21
speed, 19
spot delta, 18
spot value date, 178
spread options, 157
static hedge for barrier options, 70
step option, 144, 157
stochastic volatility, 47
STP, 407
straddle, 54
straight through processing, 407
strangle, 56
strike in terms of delta, 26
strike-bonus option, 112
strike-out, 65, 131, 136
structured forward products, 183
subsequent measurement, 331
SuperDerivatives, 289, 400
swap, 185
swap points, 185
swap rate, 185
symmetric power options, 119
symmetric power straddle, 120
synthetic forward, 185
tetrahedron, 164
theta, 19
three range deposit, 244
three range loan, 244
time option, 218
time-homogeneity, 21
touch options, 73
tower deposit, 244
tower loan, 244
trade date, 178
trader’s gamma, 29
traders’ rule of thumb, 279
transatlantic barrier option, 146
triangular currency market, 164
triple currency deposit, 249
tulipmania, 14
tunnel deposit, 235
tunnel loan, 238
turbo cross currency swap, 255
turbo deposit, 242
turbo loan, 242
turbo note, 274
two-touch, 81

underlying, 22
US-GAAP, 348

vanilla option, 16
vanilla-one-touch duality, 131
vanna, 19, 279
vanna-volga pricing, 279
variability reduction method, 349
variance swap, 174
vega, 19
vega in terms of delta, 30
vega matrix, 30
volatility, 30
volatility cones, 47
volatility smile, 35, 38
volatility swaps, 175
volatility, term structure of, 38
volga, 19, 279
volgamma, 19
vomma, 19

wedding cake, 244
weighted Monte Carlo, 165
window barrier, 143
window barrier option, 143
worst-of options, 167

yard, 23
## FX Options and Structured Products

<table>
<thead>
<tr>
<th>Formula</th>
<th>Description</th>
</tr>
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<tr>
<td>digital((\phi, K))</td>
<td>(\lim_{n \to \infty} n[\text{vanilla}(K) - \text{vanilla}(K + \phi/n)])</td>
</tr>
<tr>
<td>knock-in</td>
<td>vanilla - knock-out</td>
</tr>
<tr>
<td>EKO((\phi, K, B))</td>
<td>(\text{vanilla}(\phi, K) - \text{vanilla}(\phi, B) - \text{digital}(B)\phi(B - K))</td>
</tr>
<tr>
<td>EDKOCall((K, L, H)) (K &lt; L &lt; H)</td>
<td>call((L)) - call((H)) + ((L - K))[\text{digital}(L) - \text{digital}(H)]</td>
</tr>
<tr>
<td>vanilla((K))</td>
<td>(\text{digital}<em>{\text{for}} - K \cdot \text{digital}</em>{\text{dom}})</td>
</tr>
<tr>
<td>RKO((\phi, K, B))</td>
<td>KO((-\phi, K, B)) - KO((-\phi, B, B)) - (\phi(B - K))NT((B))</td>
</tr>
<tr>
<td>(D)OT</td>
<td>(e^{-rT} \cdot \text{(D)NT})</td>
</tr>
<tr>
<td>DOT_{for}(L, H, S_0, r_d, r_f, \sigma)</td>
<td>(S_0 \cdot \text{DOT}_{\text{dom}}\left(\frac{1}{H}, \frac{1}{L}, \frac{1}{S_0}, r_f, r_d, \sigma\right))</td>
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<tr>
<td>DOT_{for}(L, H)</td>
<td>([H \cdot \text{DKOCall}(K = L, L, H) + L \cdot \text{DKOPut}(K = H, L, H)]/[(H - L)S_0])</td>
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</tr>
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<td>two-touch(L, H)</td>
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</tr>
<tr>
<td>second DNT(A &lt; B &lt; C &lt; D)</td>
<td>DNT((A, C)) + DNT((B, D)) - DNT((B, C))</td>
</tr>
<tr>
<td>KIKO(L = ko, H = ki)</td>
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<td>call((K)) - put((K))</td>
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<td>straddle(K)</td>
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</tr>
<tr>
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<td>call((K_+)) + put((K_-)) - call_{\text{ATM}} - put_{\text{ATM}}</td>
</tr>
<tr>
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<td>forward + RKO</td>
</tr>
<tr>
<td>bonus forward</td>
<td>forward + DNT</td>
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<tr>
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<td>forward + DKO straddle</td>
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<tr>
<td>accrued forward</td>
<td>forward + corridor</td>
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<tr>
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<td>call - (P)%put</td>
</tr>
<tr>
<td>fade-in forward</td>
<td>forward + fade-in vanilla</td>
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<tr>
<td>dcd((r &gt; \text{market}))</td>
<td>(\text{deposit}(r = \text{market}) - \text{vanilla})</td>
</tr>
<tr>
<td>range deposit((r &gt; \text{market}))</td>
<td>(\text{deposit}(r &lt; \text{market}) + \text{DNT})</td>
</tr>
<tr>
<td>performance note((r_{\text{max}} &gt; \text{market}))</td>
<td>(\text{deposit}(r &lt; \text{market}) + \text{call})</td>
</tr>
</tbody>
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**Table 5.1: Common Replication Strategies and Structures**