Kriging of financial term-structures

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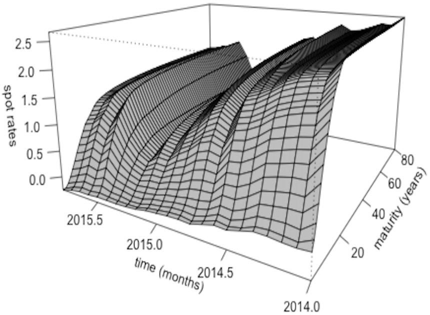
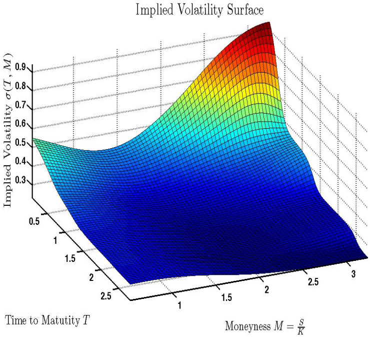
Motivation

- Financial term-structures describes the evolution of some financial or economic quantities as a function of time horizon.
- **Examples** : interest-rates, bond yields, credit spreads, implied default probabilities, implied volatilities.
- **Applications** : valuation of financial and insurance products, risk management





The term-structure construction problem

Several constraints have to be considered

- Compatibility with market information : at a given date t_0, the curve under construction $T \to P(t_0, T)$ shall be compatible with observed prices of some reference products.
- Arbitrage-free construction : this translates into some specific shape properties such as positivity, monotonicity, convexity or bounds on the curve values
- Additional conditions can be required : minimum degree of smoothness, control of local convexity

The term-structure construction problem

1) Compatibility with market information :

- At time t_0, we observe the market quotes $S_1, \ldots, S_n$ of n liquidly traded instruments
- The values of these products depend on the value of the curve at m input locations $X = (\tau_1, \ldots, \tau_m)$

The vector of output values $P(t_0, X) := (P(t_0, \tau_1), \ldots, P(t_0, \tau_m))^\top$ satisfies a linear system of the form

$$A \cdot P(t_0, X) = \boldsymbol{b},$$

where

- A is a $n \times m$ real-valued matrix
- $\boldsymbol{b}$ is a n-dimensional column vector

$n < m \Longrightarrow$ indirect and partial information on the curve values at $\tau_1, \ldots, \tau_m$

2) No-arbitrage assumption :

$T \to P(t_0, T)$ is typically a monotonic bounded function

Range of arbitrage-free OIS discount curves

We observe the quoted par rates S_i of an OIS with maturities T_i, $i = 1, \dots, n$

1) Compatibility with market quotes :

The curve $T \to P(t_0, T)$ of **OIS discount factors** is such that

$$S_i \sum_{k=1}^{p_i - 1} \delta_k P(t_0, t_k) + (S_i \delta_{p_i} + 1)\, P(t_0, T_i) = 1, \quad i = 1, \dots, n$$

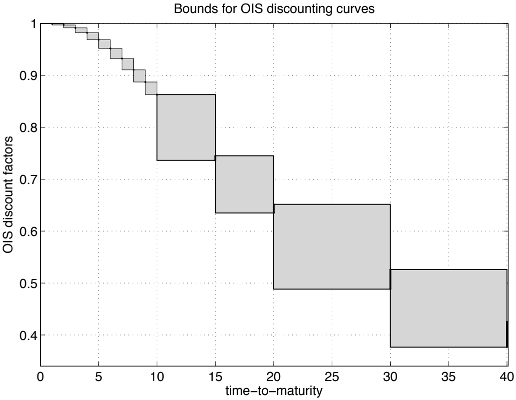
- $t_1 < \cdots < t_{p_i} = T_i$: fixed-leg payment dates (annual time grid)
- δ_k : year fraction of period (t_{k-1}, t_k)

2) No-arbitrage assumption :

$T \to P(t_0, T)$ is a decreasing function such that $P(t_0, t_0) = 1$

Range of arbitrage-free OIS discount curves

- $n = 14$ liquidly traded maturities $1, 2, \ldots, 10, 15, 20, 30, 40$ years.
- $m = 40$ points involved in the market-fit linear system
- No-arbitrage bounds on OIS discount factors



Input data : OIS swap rates as of May, 31st 2013.
Source : Cousin and Niang (2014)

Range of arbitrage-free CDS-implied survival functions

We observe at time t_0 the fair spreads S_i of a CDS with maturities T_i, $i = 1, \ldots, n$

1) Compatibility with market quotes :

The curve $T \to P(t_0, T)$ of (risk-neutral) **survival probabilities** is such that

$$S_i \sum_{k=1}^{p_i} \delta_k D(t_0, t_k) P(t_0, t_k) = -(1 - R) \int_{t_0}^{T_i} D(t_0, u) dP(t_0, u), \quad i = 1, \ldots, n$$

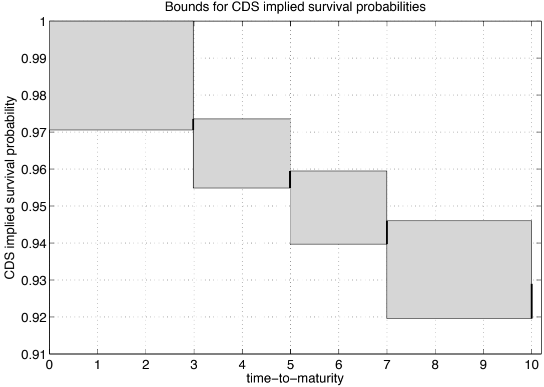
- $t_1 < \cdots < t_p = T_i$: trimestrial premium payment dates, δ_k : year fraction of period (t_{k-1}, t_k)
- $D(t_0, T)$ is the discount factor associated with maturity date T
- R : expected recovery rate of the reference entity

2) No-arbitrage assumption :

$T \to P(t_0, T)$ is a decreasing function such that $P(t_0, t_0) = 1$

Range of arbitrage-free CDS-implied survival functions

- $n = 4$ liquidly traded maturities $3, 5, 7, 10$ years.
- $m = 40$ points involved in the market-fit linear system
- No-arbitrage bounds on the issuer implied survival distribution function



Input data : CDS spreads of AIG as of December 17, 2007, $R = 40\%$,
$D(t, T) = \exp(-3\%(T - t))$

From spline interpolation to kriging

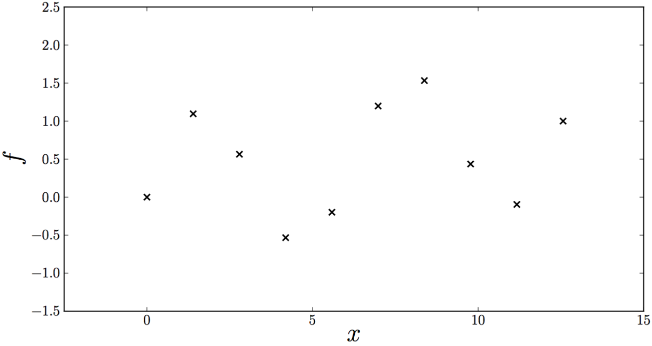
In practice, financial term-structures are constructed using deterministic interpolation techniques.

- Parametric approaches : Nelson-Siegel or Svensson models (used by most central banks)
- Non-parametric interpolation methods : shape-preserving spline techniques (lack of interpretability but better ability to fit the data).

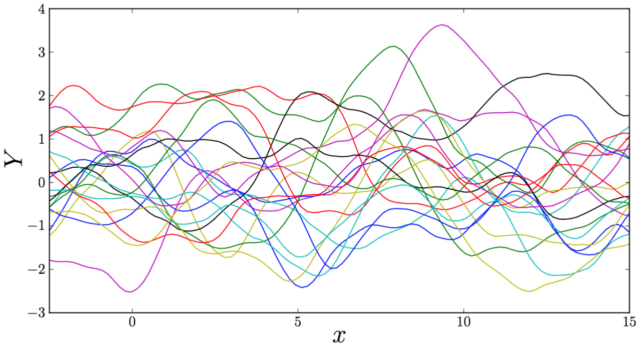
Could we propose an arbitrage-free interpolation method that additionally allows for quantification of uncertainty ?

Classical kriging

A function f is only known at a limited number of points $x_1, \ldots, x_n$



The (unknown) function f is assumed to be a sample path of a Gaussian process Y



Definition : Gaussian process (GP) or Gaussian random field

A Gaussian process is a collection of random variables, any finite number of which have (consistent) joint Gaussian distributions.

A Gaussian process $\left(Y(x), x \in \mathbb{R}^d\right)$ is characterized by its mean function

$$\mu : x \in \mathbb{R}^d \longrightarrow \mathbb{E}(Y(x)) \in \mathbb{R}.$$

and its covariance function

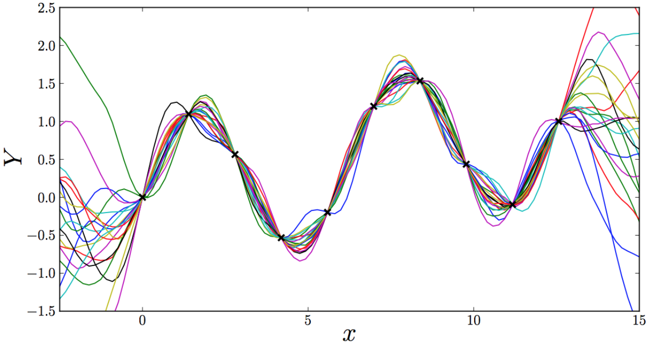
$$K : (x, x') \in \mathbb{R}^d \times \mathbb{R}^d \longrightarrow \mathrm{Cov}(Y(x), Y(x')) \in \mathbb{R}.$$

Table: Some popular covariance functions $K(x, x')$ used in 1D kriging methods.

Name	Expression	Class
Gaussian	$\sigma^2 \exp\left(-\frac{(x-x')^2}{2\theta^2}\right)$	$\mathcal{C}^\infty$
Matérn 5/2	$\sigma^2 \left(1 + \frac{\sqrt{5}\lvert x-x'\rvert}{\theta} + \frac{5(x-x')^2}{3\theta^2}\right) \exp\left(-\frac{\sqrt{5}\lvert x-x'\rvert}{\theta}\right)$	$\mathcal{C}^2$
Matérn 3/2	$\sigma^2 \left(1 + \frac{\sqrt{3}\lvert x-x'\rvert}{\theta}\right) \exp\left(-\frac{\sqrt{3}\lvert x-x'\rvert}{\theta}\right)$	$\mathcal{C}^1$
Exponential	$\sigma^2 \exp\left(-\frac{\lvert x-x'\rvert}{\theta}\right)$	$\mathcal{C}^0$

Classical kriging

The estimation of f relies on the conditional distribution of Y given the observed values $y_i = f(x_i)$ at points x_i, $i = 1, \ldots, n$.



Classical kriging

- $\boldsymbol{X} = (x_1, \ldots, x_n)^\top \in \mathbb{R}^{n \times d}$: some design points
- $\boldsymbol{y} = (y_1, \ldots, y_n)^\top \in \mathbb{R}^n$: observed values of f at these points
- $Y(\boldsymbol{X}) = (Y(x_1), \ldots, Y(x_n))^\top$: vector composed of Y at point $\boldsymbol{X}$

The conditional process is still a Gaussian Process

Let Y be a GP with mean μ and covariance function K. The conditional process $Y \mid Y(\boldsymbol{X}) = \boldsymbol{y}$ is a GP with mean function

$$\eta(x) = \mu(x) + \boldsymbol{k}(x)^\top \mathbb{K}^{-1}(\boldsymbol{y} - \boldsymbol{\mu}), \quad x \in \mathbb{R}^d$$

and covariance function $\tilde{K}$ given by

$$\tilde{K}(x, x') = K(x, x') - \boldsymbol{k}(x)^\top \mathbb{K}^{-1} \boldsymbol{k}(x'), \quad x, x' \in \mathbb{R}^d$$

where $\boldsymbol{\mu} = \mu(X) = (\mu(x_1), \ldots, \mu(x_n))^\top$, $\mathbb{K}$ is the covariance matrix of $Y(\boldsymbol{X})$ and $\boldsymbol{k}(x) = (K(x, x_1), \ldots, K(x, x_n))^\top$

Recall that, in our term-structure construction problem, the (unknown) real function f satisfies some linear equality constraints of the form

$$A \cdot f(X) = \boldsymbol{b}, \tag{1}$$

where

- A is a given matrix of dimension $n \times m$
- $X = (x_1, \ldots, x_m)^\top \in \mathbb{R}^{m \times d}$
- $f(X) = (f(x_1), \ldots, f(x_m))^\top \in \mathbb{R}^m$
- $\boldsymbol{b} \in \mathbb{R}^n$

Extension to linear equality constraints

- $X = (x_1, \ldots, x_m)^\top \in \mathbb{R}^{m \times d}$: some design points
- $\boldsymbol{b} = (b_1, \ldots, b_n)^\top \in \mathbb{R}^n$: right-hand side of the linear system
- $Y(X) = (Y(x_1), \ldots, Y(x_m))$: vector composed of Y at point $\boldsymbol{X}$

The conditional process is still a Gaussian Process

Let Y be a GP with mean μ and covariance function K. The conditional process $Y \mid AY(X) = \boldsymbol{b}$ is a GP with mean function

$$\eta(x) = \mu(x) + (A\boldsymbol{k}(x))^\top \left(A\mathbb{K}A^\top\right)^{-1} (\boldsymbol{b} - A\boldsymbol{\mu}), \quad x \in \mathbb{R}^d$$

and covariance function $\tilde{K}$ given by

$$\tilde{K}(x, x') = K(x, x') - (A\boldsymbol{k}(x))^\top \left(A\mathbb{K}A^\top\right)^{-1} A\boldsymbol{k}(x'), \quad x, x' \in \mathbb{R}^d$$

where $\boldsymbol{\mu} = \mu(X) = (\mu(x_1), \ldots, \mu(x_m))^\top$, $\mathbb{K}$ is the covariance matrix of $Y(X)$, $\boldsymbol{k}(x) = (K(x, x_1), \ldots, K(x, x_m))^\top$

Extension to monotonicity constraints

New formulation of the problem : estimation of an unknown function f given that

$$\begin{cases} A \cdot f(X) = \boldsymbol{b} \\ f \in \mathcal{M} \end{cases}$$

where $\mathcal{M}$ is the set of (say) non-increasing functions.

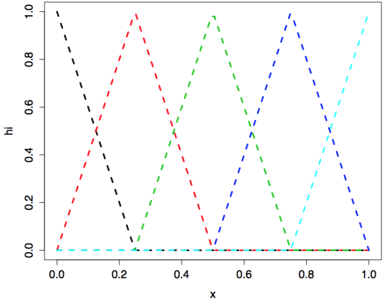
Problem : The conditional process is not a Gaussian process anymore.

- How to cope with the infinite-dimensional monotonicity constraints ?
- Which estimator could we propose for the term-structure ?

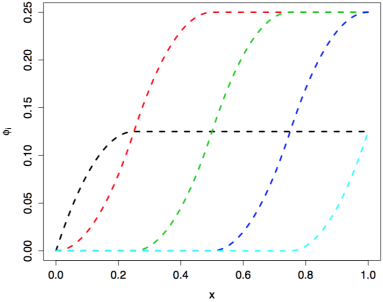
Proposed methodology : On an interval $D = [\underline{x}, \overline{x}]$ of $\mathbb{R}$, we construct a finite-dimensional approximation of Y for which the monotonicity constraint is easy to check.

- Regular subdivision $u_0 < \ldots < u_N$ of D with a constant mesh δ
- Set of increasing basis functions $(\phi_i)_{i=0,\ldots,N}$ defined on this subdivision

$$h_i(x) := \max\left(1 - \frac{|x-u_i|}{\delta}, 0\right)$$



$$\phi_i(x) = \int_{\underline{x}}^{x} h_i(u)du$$



Extension to monotonicity constraints (1D case)

Proposition (Maatouk and Bay, 2014b)

Let Y be a zero-mean GP with covariance function K and with almost surely differentiable paths.

- The finite-dimensional process Y^N defined on D by

$$Y^N(x) = Y(u_0) + \sum_{j=0}^{N} Y'(u_j)\phi_j(x)$$

  uniformly converges to Y, almost surely.

- Y^N is non-decreasing (resp. non-increasing) on D if and only if $Y'(u_j) \geq 0$ (resp. $Y'(u_j) \leq 0$) for all $j = 0, \ldots, N$.

- Let $\xi := (Y(u_0), Y'(u_0), \ldots, Y'(u_N))^\top$, then $\xi \sim \mathcal{N}(0, \Gamma^N)$ where

$$\Gamma^N = \begin{bmatrix} K(u_0, u_0) & \frac{\partial K}{\partial x'}(u_0, u_j) \\ \frac{\partial K}{\partial x}(u_i, u_0) & \frac{\partial^2 K}{\partial x \partial x'}(u_i, u_j) \end{bmatrix}_{0 \leq i,j \leq N}$$

Extension to monotonicity constraints (1D case)

For a given covariance function K, we assume that the unknown function f is a sample path of the GP

$$Y^N(x) = \eta + \sum_{j=0}^{N} \xi_j \phi_j(x), \qquad x \in D,$$

where $\boldsymbol{\xi} := (\eta, \xi_0, \ldots, \xi_N)^\top \sim \mathcal{N}(0, \Gamma^N)$.

Kriging f is equivalent to find the conditional distribution of Y^N given

$$\begin{cases} A \cdot Y^N(X) = \boldsymbol{b} & \text{linear equality condition} \\ \xi_j \leq 0, \ j = 0, \ldots, N & \text{monotonicity constraint} \end{cases}$$

Or equivalently, to find the distribution of the truncated Gaussian vector $\boldsymbol{\xi} \sim \mathcal{N}(0, \Gamma^N)$ given

$$\begin{cases} A \cdot \Phi \cdot \boldsymbol{\xi} = \boldsymbol{b} & \text{linear equality condition} \\ \xi_j \leq 0, \; j = 0, \ldots, N & \text{monotonicity constraint} \end{cases}$$

where Φ is a $m \times (N+2)$ matrix defined as

$$\Phi_{i,j} := \begin{cases} 1 & \text{for } i = 1, \ldots, m \text{ and } j = 1, \\ \phi_{j-2}(x_i) & \text{for } i = 1, \ldots, m \text{ and } j = 2, \ldots, N+2. \end{cases}$$

Which estimator could we use for f ?

We consider the mode of the truncated gaussian process (most probable path) :

$$M_K^N(x \mid A, \boldsymbol{b}) = \nu + \sum_{j=0}^{N} \nu_j \phi_j(x),$$

where $\boldsymbol{\nu} = (\nu, \nu_0, \ldots, \nu_N)^\top \in \mathbb{R}^{N+2}$ is the solution of the following convex optimization problem :

$$\boldsymbol{\nu} = \arg \min_{\boldsymbol{c} \in \mathcal{C} \cap \mathcal{I}(A, \boldsymbol{b})} \left(\frac{1}{2} \boldsymbol{c}^\top \left(\Gamma^N \right)^{-1} \boldsymbol{c} \right),$$

with

- $\mathcal{C} = \left\{ \boldsymbol{\xi} \in \mathbb{R}^{N+2} \ : \ \xi_j \leq 0, \ j = 0, \ldots, N \right\}$
- $\mathcal{I}(A, \boldsymbol{b}) = \left\{ \boldsymbol{\xi} \in \mathbb{R}^{N+2} \ : \ A \cdot \Phi \cdot \boldsymbol{\xi} = \boldsymbol{b} \right\}$

Efficient simulation of the truncated Gaussian vector

1) Simulate a truncated vector $\boldsymbol{\xi}$ given the linear equality constraint :

$$Z \sim \{\boldsymbol{\xi} \mid B \cdot \boldsymbol{\xi} = \boldsymbol{b}\} \sim \mathcal{N}\left((B\Gamma^N)^\top \left(B\Gamma^N B^\top\right)^{-1} \boldsymbol{b}, \Gamma^N - \left(B\Gamma^N\right)^\top \left(B\Gamma^N B^\top\right)^{-1} B\Gamma^N\right)$$

where $B = A \cdot \Phi$.

2) Simulate

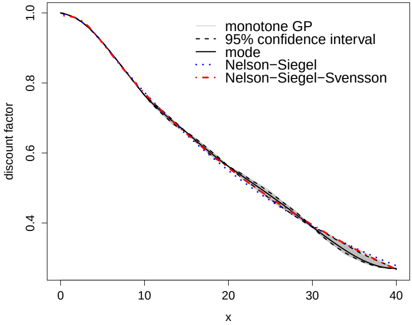
$$\{Z \mid \xi_j \leq 0, j = 0, \ldots, N\} \sim \{\boldsymbol{\xi} \mid B \cdot \boldsymbol{\xi} = \boldsymbol{b} \text{ and } \xi_j \leq 0, j = 0, \ldots, N\}$$

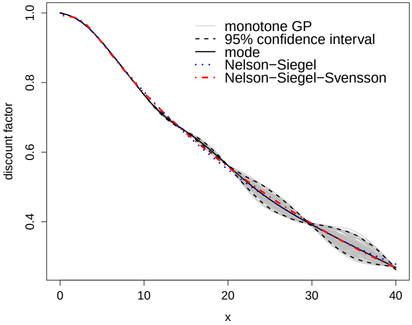
by an accelerated rejection sampling method (we use the method proposed in Maatouk and Bay, 2014a)

3) The corresponding sample curves $Y^N(\cdot) = \eta + \sum_{j=0}^{N} \xi_j \phi_j(\cdot)$ satisfies the constraints on the entire domain D.

Kriging of OIS discount curves

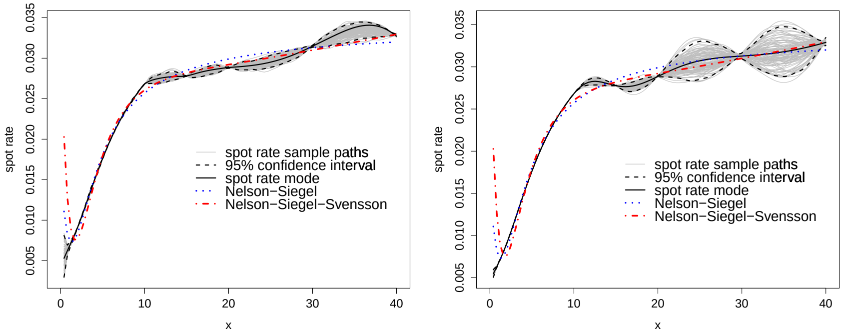
- We compare two covariance functions : Gaussian and Matérn 5/2
- Hyper-parameters θ and σ are estimated using cross-validation
- Comparison with Nelson-Siegel and Svensson curve fitting





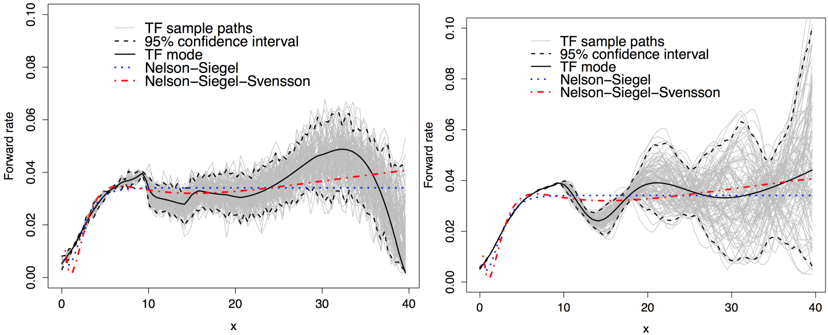
Discount curves. $N = 50$, 100 sample paths. Left : Gaussian covariance function. Right : Matérn 5/2 covariance function. OIS data of 03/06/2010.

Corresponding spot rate curves : $-\frac{1}{x} \log P(x)$



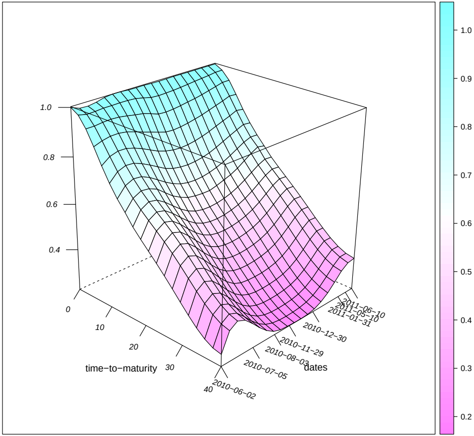
Spot rate curves. Left : Gaussian covariance function. Right : Matérn 5/2 covariance function. OIS data of 03/06/2010. The black solid line is the most likely spot rate curve $-\frac{1}{x} \log M_K^N (x \mid A, \boldsymbol{b})$.

Corresponding forward rate curves : $-\frac{d}{dx}\log P(x)$



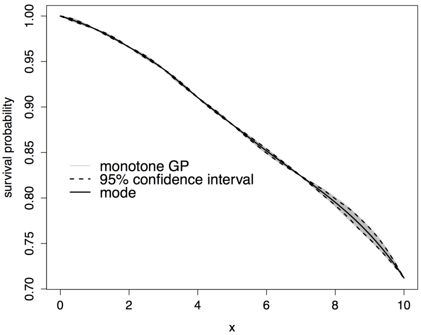
Spot rate curves. Left : Gaussian covariance function. Right : Matérn 5/2 covariance function. OIS data of 03/06/2010. The black solid line is the most likely forward rate curve $-\frac{d}{dx}\log M_K^N(x \mid A, \boldsymbol{b})$.

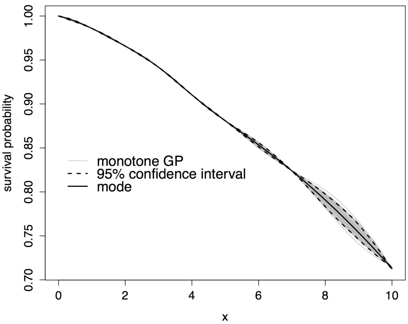
The previous approach can be extended in dimension 2.



Dicount curves. OIS discount factors as a function of time-to-maturities and quotation dates.

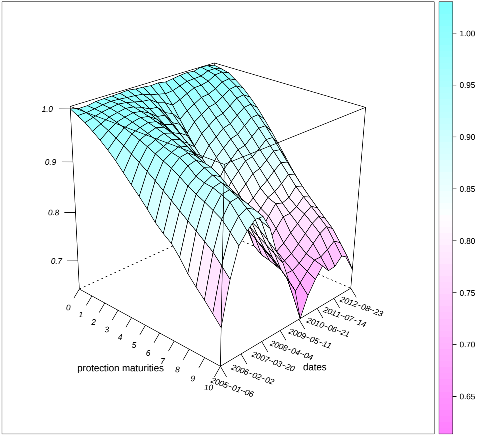
Implied survival function of the Russian sovereign debt





CDS implied survival curves. $N = 50$, 100 sample paths. Left : Gaussian covariance function. Right : Matérn 5/2 covariance function. CDS spreads as of 06/01/2005.

The previous approach can be extended in dimension 2.

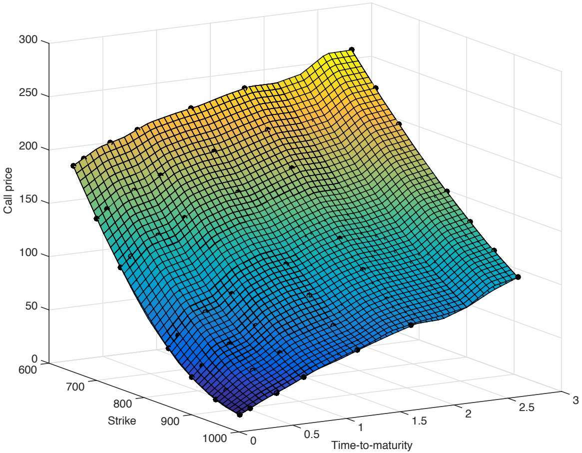


Survival curves. CDS implied survival probabilities as a function of time-to-maturities and quotation dates.

Perspectives

- Impact of curve uncertainty on the assessment of related products and their associated hedging strategies
- What if the underlying market quotes are not reliable due to e.g. market illiquidity (data observed with a noise) ?
- Kriging of arbitrage-free volatility surfaces ?

Kriging of arbitrage-free volatility surface



Thanks for your attention.

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