

Correlating Market Models

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In recent years the LIBOR Market Model (LMM) (Brace, Gatarek & Musiela (BGM) 1997, Jamshidian 1997, Miltersen, Sandmann & Sondermann 1997) has gained acceptance as a practical and versatile model of interest rate dynamics. Based within a HJM (Heath, Jarrow & Morton, 1992) framework, the model concentrates on describing market observable forward LIBORs, rather than the mathematically abstract instantaneous forward rates, and has the advantage of pricing interest rate caps and floors in a manner consistent with the popular Black (1976) formula. Though not strictly consistent from a theoretical viewpoint, pricing swaptions by application of the Black formula is also standard practice and has been shown to be a highly accurate approximation within the LMM framework (see eg. Brace, Dun & Barton 2001).

The key task for any practical implementation of an interest rate model is the calibration of the model to market prices, i.e. one requires that the LMM model parameters be consistent with liquid prices for at-the-money caps and swaptions. The main feature differentiating approaches to calibration of the LMM is how they treat correlation between forward LIBORs of different maturities.

In theory, swaption prices carry information about correlation between forward LIBORs. However, calibration techniques in which correlation is an output typically struggle to simultaneously fit the caps and swaptions as well as produce reasonable yield curve correlations (eg BGM 1997, Gatarek 2000, Hull 2000, Dun 2000 and the methods described in the book by Brigo and Mercurio 2001). On the other hand, approaches which take the correlations explicitly as an input to the calibration (eg. Pedersen 1998, Wu 2002) report very encouraging results. Brace & Womersley (2000) use a semidefinite programming technique to simultaneously calibrate volatilities and correlations to swaption and caplet prices. However, they recognise that the problem is highly underdetermined and resolve this by optimising to select the closest possible fit to historically estimated correlations. Rebonato (1999) attributes this indeterminacy to the fact that volatilities can depend on both calendar and maturity time. Unfortunately, this

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cannot be resolved by making volatilities depend solely on *time to maturity*, since under this assumption one cannot even fit observed prices for at-the-money caps on days when the implied volatilities are sloping steeply downward with respect to cap length.

Given the current state of the literature, the question of which is the most appropriate way to calibrate the LMM thus hinges on how the calibration method should deal with correlation. The aim of the present paper is to answer this question by exploring two points:

1. Is there sufficient information contained in swaption prices to calibrate correlation?
2. What are the consequences of the calibration problem being highly underdetermined? In particular, does it mean that the prices calculated using a calibrated LMM, e.g. for Bermudan swaptions or for spread options, are arbitrary and unreliable?

To this end, we conduct a series of experiments using the Pedersen (1998) calibration approach. After briefly summarising this method, we review the different concepts of correlation relevant to the LMM. The potential inconsistency between historical and implied correlation is found not to be an issue. We analyse the sensitivity of swaption prices and the calibrated volatility levels to correlations, and also study the trade-off between fitting correlations and fitting a calendar-time dependence of volatility. Subsequently, we discuss the effects of calibration ambiguity on derivatives priced off the calibrated model.

Pedersen Calibration

In the LMM, volatility and correlation are described via the vector volatility function $\gamma(t, T)$, dependent on *calendar time* t and *maturity time* T . The Pedersen calibration method employs a completely non-parametric description of this volatility, where the i^{th} factor is given by

$$\gamma_i(t, T) = \gamma_i'(t, x) = \gamma'_{i,j,k} \text{ for } t \in [t_{j-1}, t_j), x \in [x_{k-1}, x_k)$$

where $x = T - t$ is *forward time* and $t_j, j = 1, \dots, n_{cal}$, and $x_k, k = 1, \dots, n_{for}$ define respectively the calendar and forward time intervals for which the piece-wise constant volatility applies. For a model containing n_{fac} factors, this approach requires $n_{fac} \cdot n_{cal} \cdot n_{for}$ parameters to fully define the volatility, a number which can soon become computationally cumbersome for reasonable choices of the number of factors and the granularity of calendar and forward time.

Pedersen reduces the number of parameters by specifying the volatility in terms of a $n_{cal} \times n_{for}$ matrix (termed the *volatility grid*) and a $n_{for} \times n_{for}$ matrix of yield curve correlations. Thus the volatility grid allows for the specification of both calendar and forward time dependence, while correlation is assumed to be constant. The correlations are exogenous inputs, typically determined via analysis of historical data, and the Pedersen volatility $\gamma'_{i,j,k}$ is derived from the volatility grid and the correlation matrix via principal components analysis (PCA). This approach has the advantage that multi-factor calibrations are straightforward to determine, with the number of factors in the volatility function simply equal to the number of dominant eigenvectors extracted from the PCA.

The Pedersen calibration applies a numerical optimisation technique to the volatility grid until a sufficiently close fit is obtained between the market-observed and model-implied prices of vanilla interest rate caps and swaptions. Additional smoothness constraints are applied to the grid (in both the calendar and forward time dimensions) in order to further reduce the degrees of freedom in the optimisation, as well as promote a more reasonable form of the solution. With such a large number of parameters available, smoothing also reduces the likelihood of the calibration *over-fitting* the input data.

Yield Curve Correlation

In practice, yield curve correlation is described in terms of correlations between forward LIBORs, where it is assumed that these rates follow a joint lognormal distribution (that is, the natural logarithm of the forward rates is jointly normally distributed). Assuming both this and that the distribution is constant in time allows the yield curve correlations to be determined from a time series of historical yield curve data. The result of such an analysis on AUD data is shown in Figure 1.

Correlations in the LMM can be approximated from the volatility function via an analysis of the *quadratic covariation* of the forward LIBORs. For a series of consecutive LIBORs running between equi-spaced maturity points T_i , such an analysis reveals that at any one instant t , the j^{th} and k^{th} LIBORs are correlated as

$$\rho_{j,k} = \frac{\gamma(t, T_j) \cdot \gamma(t, T_k)}{|\gamma(t, T_j)| |\gamma(t, T_k)|}$$

This is termed *instantaneous correlation* and needs to be integrated over time before we can obtain something that has any intuitive meaning or practical use. The integration can be performed in two ways; the first keeps the LIBOR maturity points constant, leading to the expression

$$\rho_{j,k} = \frac{\int_0^T \gamma(s, T_j) \cdot \gamma(s, T_k) ds}{\sqrt{\int_0^T |\gamma(s, T_j)|^2 ds \int_0^T |\gamma(s, T_k)|^2 ds}}. \quad (1)$$

This is called *terminal correlation* and while it is important in the pricing of derivatives such as European spread options, it cannot be determined easily from historical correlation. Terms of this type also enter into the calculation of swaption prices, thus theoretically market prices for swaptions carry information about terminal correlation. If one were to speak of *implied correlation*, this would be the appropriate correlation concept.

The second way to integrate instantaneous correlation moves the LIBOR maturity points along with calendar time

$$\rho_{j,k} = \frac{\int_0^T \gamma(s, T_j + s) \cdot \gamma(s, T_k + s) ds}{\sqrt{\int_0^T |\gamma(s, T_j + s)|^2 ds \int_0^T |\gamma(s, T_k + s)|^2 ds}} \quad (2)$$

and thus represents correlations between LIBORs with a fixed time to maturity. This is analogous to what is happening when we calculate historical correlations from past yield curve data, and for this reason we term this *pseudo-historical correlation*.

Equations (1) and (2) are only approximations to the correlation as they assume the contribution of the level dependent drift term in the stochastic differential equation (SDE) for the LIBORs to be negligible.

Correlation in the Pedersen Calibration

Calibration involves fitting market prices, implying that we require *terminal* correlations. Using a calibration method which takes correlation estimated from historical data as an input thus raises the question whether the distinction between (1) and (2) has any significant impact on correlations in a calibrated model. One would say that this is not the case if the pseudo-historical

correlations generated by a calibrated model closely match the (historical) correlations, which were input into the calibration. In passing, this would also resolve the issue whether the contribution of the level dependent drift term is indeed negligible for purposes of calibration.

Consider Figure 2, which displays pseudo-historical correlations resulting from calibration to AUD cap and swaption data from the 4th January 2002. The historical correlations of Figure 1 were employed as inputs to the calibration, and 1, 3 and 8 factor volatility functions produced. Equation (2) was used to calculate the correlations. As could be expected, a single factor model implies almost perfect correlation between all parts of the yield curve, while 3 and 8 factor models are not only successful in producing correlation of a plausible shape, but also closely match the shape and magnitude of the input historical correlations. This thus gives us the comforting result that historical correlations fed into the Pedersen calibration method can be successfully recovered as output from the other end of the model. This is not a trivial observation, since the estimation of historical correlations assumes time homogeneity (i.e. dependence of volatilities only on time to maturity, not calendar time), while calibrated volatilities typically violate this assumption.

To analyse the *terminal* correlations as defined by Equation (1), consider Figure 3. The correlations for a point 3 years in the future are displayed, calculated analytically for a calibrated 3 factor model. The results are compared against the correlations observed within a Monte Carlo simulation of the model with the same volatility function, and can be seen to agree favourably, providing further evidence that the influence of the level dependent drift can be ignored. We also see that compared to the historical correlation, terminal correlations show greater interdependence, with all the values shifted closer towards perfect correlation.

While not shown in this article, all these results can also be extended to swap rate correlations, with terminal correlations showing values closer to unity, and model predicted *pseudo-historical* correlations matching those contained in the historical yield curve data. This is noteworthy in that historical *swap rate* correlations are matched even though it is the *LIBOR* correlations that are fed into the model. While these results were produced on AUD data, they are equally applicable to USD data.

Swaption Sensitivity

It is commonly known that swaptions are dependent on correlations within the yield curve, but there is little in the academic literature about how strong this dependence really is. To test this, we have chosen three significantly different matrices representing a spectrum of possible yield curve correlations, as shown in Figure 4. The matrices include one implying perfect correlation, the historical matrix used previously, and an altered version of the historical matrix implying low correlations between rates.

The effect of these correlation matrices on swaption prices is displayed in the upper graph in Figure 5 where, in each case, the correlation is altered while holding the Pedersen *volatility grid* constant. For clarity, we represent swaption prices in terms of their Black implied volatilities. From the graph it is evident that even large changes in correlation lead to only minor adjustments in the swaption volatility, suggesting that correlation has only a second order effect on swaption prices. If anything, these results are an exaggeration of the true effect, as we have not corrected for the effect of the scaling of the Pedersen volatility function that occurs during the PCA. As a consequence of this, it is evident that *swaptions do not contain much correlation information*. This has previously been observed by Brigo/Mercurio (2001). However, in the calibration method applied here, we do not see the difficulties they encountered when fixing correlations and adjusting volatility levels to calibrate cap and swaption prices. Here, the fit to market prices is good (see Table A) and the correlation structure (Figures 2 and 3) and volatility grid (Figure 6) appear reasonable. We achieve results of similar quality when running the Pedersen calibration on the data from Chapter 7 of Brigo & Mercurio, as well as for the case of steeply downward sloping volatility considered problematic in Brace & Womersley (2000).

The second graph in Figure 5 shows the effect of using identical vanilla instruments yet different correlation matrices as inputs to the *calibration* routine. In each case the swaptions are calibrated equally well, demonstrating that the Pedersen routine is flexible enough to fit all the swaptions regardless of the correlation specified. While this indicates the significant power of the routine, it also means that it is extremely important to get the input correlation right in the first place, as the calibration won't tell us if our correlation is unreasonable.

Correlation vs Calendar Time Dependence

In addition to the observation that swaption prices are not very sensitive to correlation, the trade-off between fitting correlations and fitting a calendar-time dependence of volatility, to which Rebonato alludes in his 1999 book, is another potential explanation of why one can reconcile nearly any arbitrary correlation structure with market prices for caps and swaptions. Taking this a step further, one might suggest that there is a choice to either hold the correlation fixed and achieve the fit by adjusting the calendar-time dependence of volatility, or vice versa. This would mean that not only is there some uncertainty about the correct price of correlation-dependent exotics relative to the market prices of vanilla products, but also about the correct price of instruments which are sensitive to how total volatility to a given time horizon is distributed over calendar time. The latter consequence is potentially far more important, since it affects Bermudan swaptions.

However, it turns out that even radically varying the input correlation matrix does not result in a substantial change in the calendar-time dependence of the calibrated volatilities, as can be seen in Figure 6. Unsurprisingly, this also means that Bermudan swaption prices are not much affected, see Figure 7. It would appear that the calendar-time dependence of the calibrated volatilities is more driven by the volatility levels implicit in observed prices, rather than the need to reconcile these prices with a given correlation structure. This is quite natural considering that on some days cap prices alone (which do not depend on correlation) force a calendar-time dependence of volatility in order to achieve a fit.

This also goes to explain why practical experience with calibration on market data rarely is in line with the intuitive result that more factors (i.e. permitting a higher rank for the forward LIBOR covariance matrix) reduces the calendar-time dependence of calibrated volatilities. This expected effect can be demonstrated on simulated data (i.e. volatilities will be time-dependent in a two-factor model calibrated to prices generated from a four-factor model without time-dependence), however, real data appear to have a certain level of intrinsic calendar-time dependence of volatility levels. Another version of the calibration procedure, where time dependence (or the lack thereof) is an input and the correlation structure is determined by the calibration, would therefore be quite unstable.

Correlations and Exotic Options

Getting the correlation right is essential for the pricing of some exotics highly dependent on correlations. Let us illustrate this with a simple example of a spread option between LIBOR and a swap rate.

Consider a one year option which pays one dollar for each basis point by which the spread (spot 3m LIBOR to 3y swap rate) exceeds a pre-specified strike. The option price will be highly dependent on the LIBOR/swap rate correlation, and can be valued either analytically via an approximate formula as done here (following the approach of Dun 2000) or by straightforward Monte Carlo simulation. The option prices for the three different calibrations of the previous section are displayed in Table B. Recall that these calibrations have been performed to the same vanilla instruments, and differ only in the correlation matrix employed.

The results exhibit significant differences for each calibration, and demonstrate that calibration to caps and swaptions alone is insufficient for accurate pricing of exotic options sensitive to correlation.

Conclusion

The problem of calibrating the LIBOR Market Model to at-the-money caps and swaptions in a single currency has essentially been solved. Techniques now exist which allow good fits to the market to be obtained in reasonable amounts of computational time, with the added benefit of incorporating correlation information into the calibration.

However, it must be recognised that swaptions are insufficiently sensitive to correlation and the calibration problem is too underdetermined to extract correlation information from market prices. This means that almost arbitrary dependence structures can be reconciled with market prices by appropriately adjusting volatility levels. Thus lacking any additional, liquidly traded, correlation sensitive instruments to which to calibrate, we are left with taking historically estimated correlation as an input to the calibration. This implies that methods which take this approach are preferable to those which risk instability or over-fitting by attempting to calibrate both correlation and volatility levels to market prices.

Specifically, the Pedersen (1998) calibration method studied here shows remarkable robustness, achieving satisfactory results against Brigo & Mercurio's criteria (cf. their Chapter 7.5): Small calibration error, regular correlation structures and a relatively smooth evolution of the term structure of volatilities over time. In addition, it is encouraging that historically estimated correlations fed into the model are faithfully reproduced in the model output. The fact that the calendar time dependence is not quite as stable as one might wish from a theoretical point of view appears to be a feature of the data and the LMM itself, rather than the calibration method, since the input correlation structure and the number of factors has little impact on the calendar time dependence of calibrated volatilities. This is perhaps most akin to the calibration of the drift in an interest rate term structure model of the Hull/White (1990) type to observed bond prices – there, too, the time dependence is simply driven by the data without any further qualitative justification.

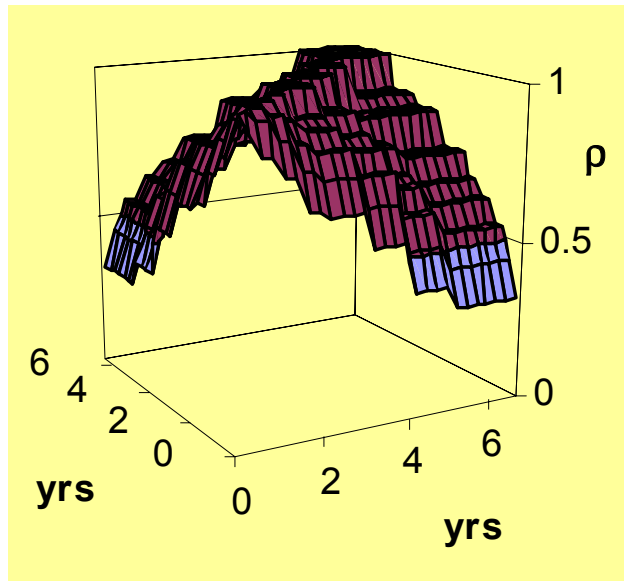
The fact that we cannot reliably extract the 'market's view' of correlation from liquidly traded instruments means that pricing exotic derivatives off a calibrated LMM is subject to an important caveat: For exotics very sensitive to correlation, such as spread options, one is effectively calculating the price on the basis of a historical estimate. This should be treated with the same amount of caution as one would a Black/Scholes price calculated using historical volatility. Fortunately, by transaction volume, the most important type of non-standard interest rate derivative is not affected by this: Bermudan swaption prices do not react significantly when the LMM is calibrated to a different correlation structure.

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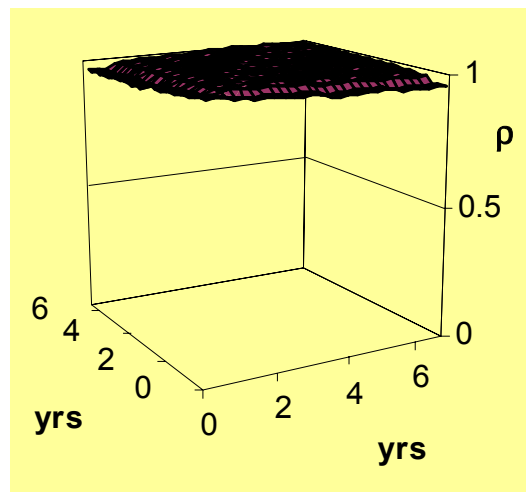
Figure 1. Historical correlation from yield curve time series analysis



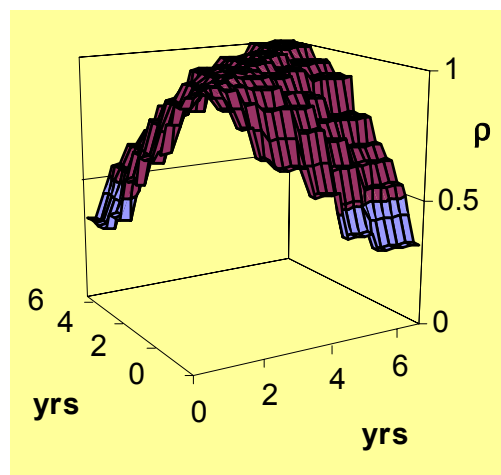
Historical AUD forward LIBOR correlations based on the assumption that rates are jointly lognormally distributed. Calculated from the movements of consecutive 3 month forward LIBORs from May 1995 to January 2002.

Figure 2. Pseudo-historical correlations for various numbers of factors

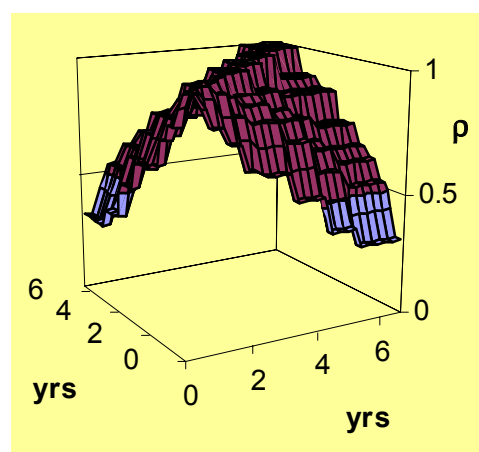
1 Factor



3 Factor



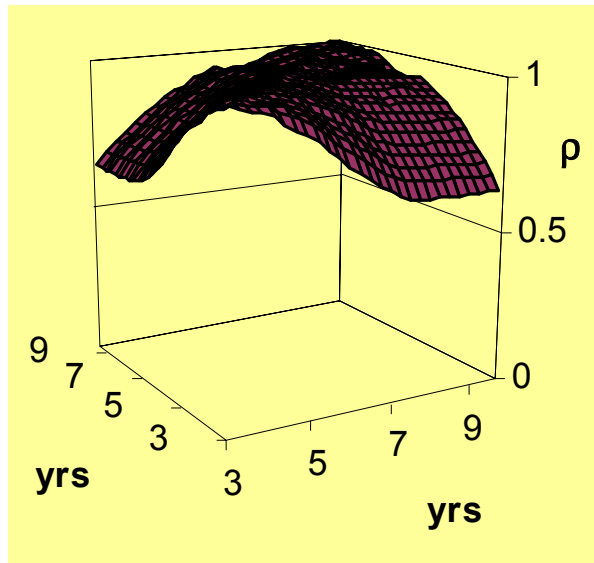
8 Factor



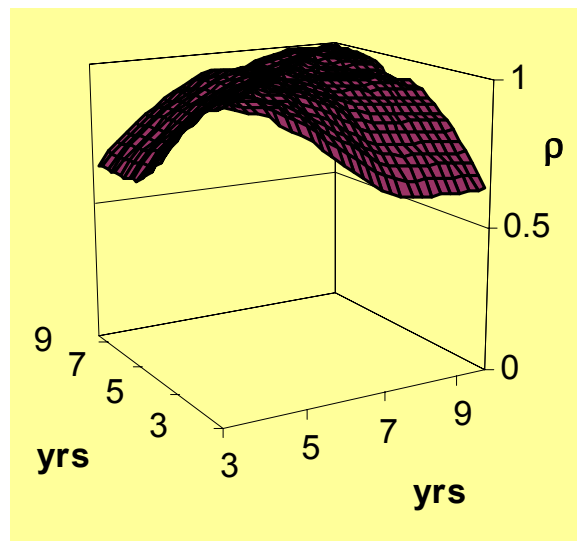
Pseudo-historical correlations calculated using Equation (2), averaging over a period of 3 years. The initial calibration is to cap and swaption data from 4th January 2002, using the historical correlation matrix from Figure 1.

Figure 3. Terminal correlation for a three factor model

Theoretical



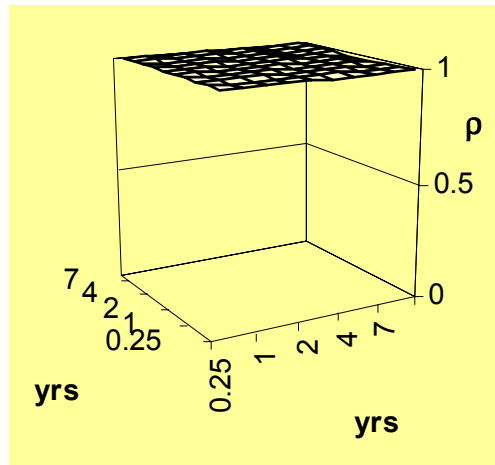
Simulated



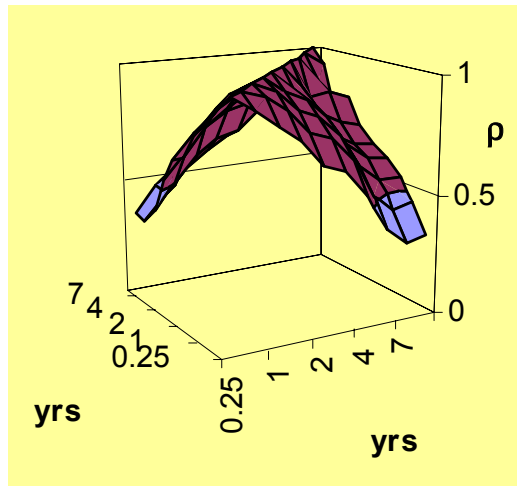
Terminal correlation (i) computed using Equation (1) and (ii) observed within a Monte Carlo simulation for a three factor LMM. All other details as in Figure 2.

Figure 4. Input matrices used for correlation testing

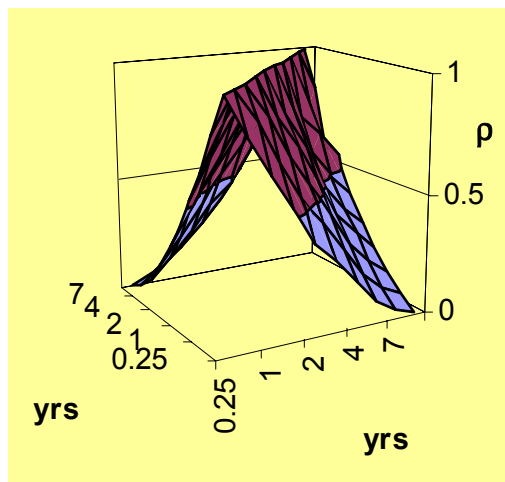
Perfect Correlation



Historical Correlation



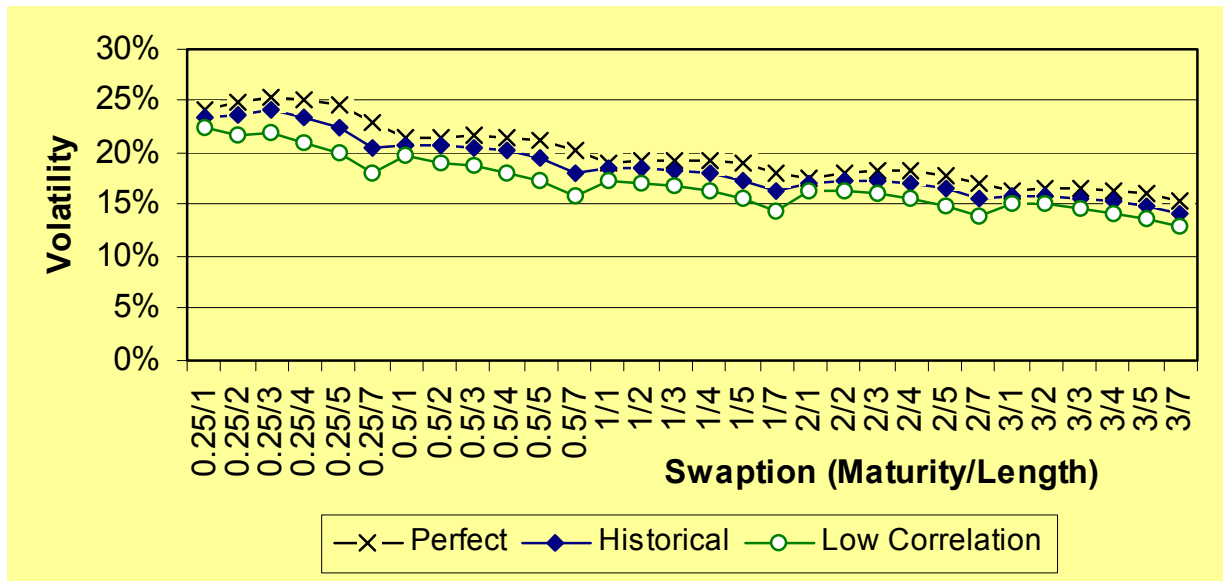
Low Correlation



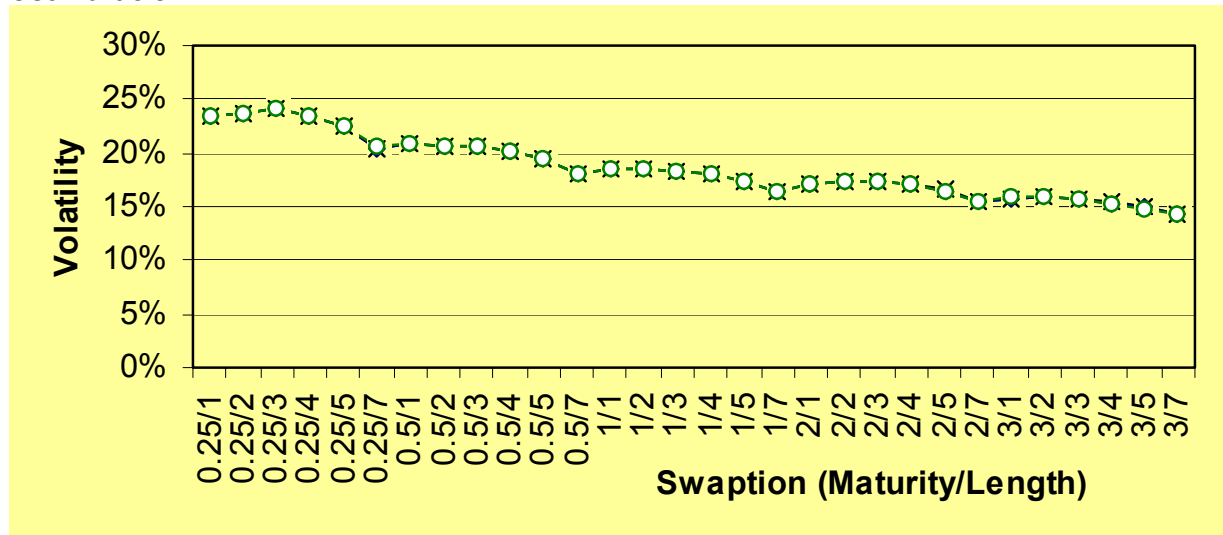
Input correlation matrices employed in the swaption sensitivity and spread option pricing tests.

Figure 5. Sensitivity of swaption prices to correlation

Constant Volatility Grid



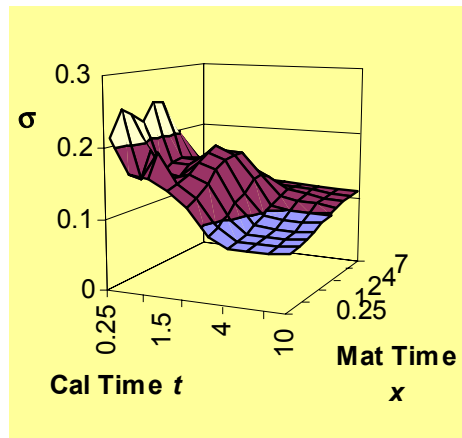
Recalibration



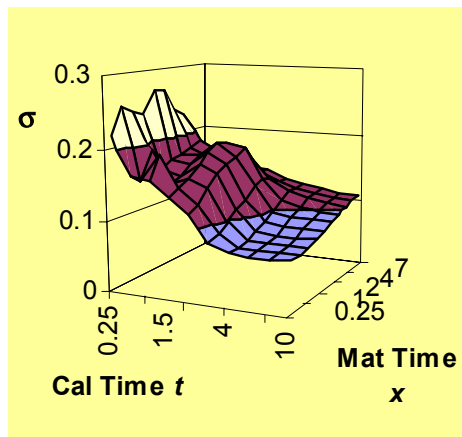
The sensitivities of the calibrated swaption volatilities to the input correlation. The top graph shows the change in swaption volatility when the correlation matrix is altered for a constant volatility grid. The second graph shows best fit swaption volatilities for calibration to the market for different input correlations. All results based on a 3 factor LMM using the correlation matrices from Figure 4. A 2yr/3yr instrument represents a 2 year (European) option on a 3yr swap.

Figure 6. Sensitivity of the volatility grid to correlation

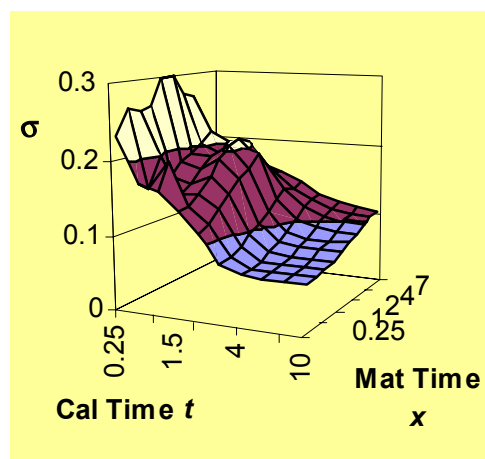
Perfect Correlation



Historical Correlation

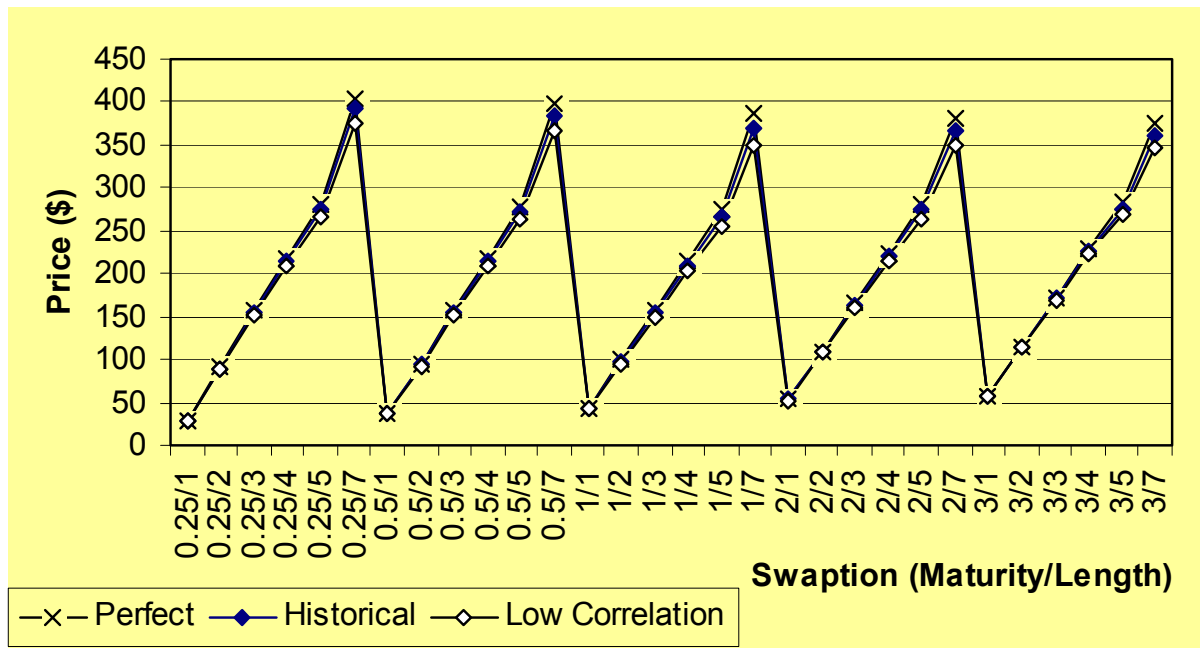


Low Correlation



Sensitivity of the Pedersen & Volatility Grid to calibration using the alternative input correlation matrices of Figure 4. The calendar time (t) dependence shows little change as a result of adjusting the correlation.

Figure 7. Sensitivity of Bermudan swaption prices to correlation



The sensitivity of Bermudan swaption prices to the input correlation. The graph shows Bermudan prices (based on a notional of \$10,000) for the three different calibrations to the market based on the correlation matrices of Figure 4. A 2yr/3yr instrument represents the option to enter into a swap maturing in 2+3 = 5yrs from today at any swap roll date from the 2yr point onwards.

A. Fit to calibrated caps and swaptions

Instrument	Maturity (yrs) / Length (yrs)	Volatility (%)	
		Market	Model
Caps	1	20.0	20.2
	2	18.9	18.2
	3	17.0	17.0
	4	15.6	16.2
	5	14.8	15.5
	7	13.8	14.3
	10	13.1	13.1
Swap- tions	0.25/1	23.6	23.5
	0.25/2	23.9	23.7
	0.25/3	24.2	24.1
	0.25/4	23.4	23.4
	0.25/5	22.6	22.4
	0.25/7	20.5	20.5
	0.5/1	20.7	20.8
	0.5/2	20.6	20.6
	0.5/3	20.5	20.6
	0.5/4	20.0	20.1
	0.5/5	19.5	19.4
	0.5/7	18.2	18.1
	1/1	18.4	18.4
	1/2	18.4	18.5
	1/3	18.3	18.3
	1/4	17.8	18.0
	1/5	17.3	17.4
	1/7	16.2	16.3
	2/1	17.7	17.1
	2/2	17.6	17.4
	2/3	17.5	17.3
	2/4	17.1	17.1
	2/5	16.6	16.5
	2/7	15.5	15.6
	3/1	16.1	15.8
	3/2	16.0	15.8
	3/3	16.0	15.6
	3/4	15.6	15.3
	3/5	15.1	14.9
	3/7	14.1	14.3

The fit to market cap and swaption prices for the 3 factor LMM using historical correlations. Based on AUD data for 4th January 2002.

Table B. LIBOR/Swap Rate Spread Option Prices

	Correlation		
Strike (bp)	Perfect	Histo-ric	Low
-130	\$22.90	\$32.10	\$42.20
-105	\$4.90	\$17.60	\$28.60
-80	\$0.10	\$8.00	\$18.20

LIBOR / swap rate spread option prices for the three different calibrations to the same cap and swaption data. The results are presented for three different strikes (in-, at- and out-of-the-money). Based on a one-year option between a 3 month LIBOR and a 3 year swap rate, with initial forward values of 5.016% and 6.064% respectively. The option pays one dollar for each basis point that the difference (LIBOR ñ Swap Rate) exceeds the strike.