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Discounting, LIBOR, CVA and Funding: Interest Rate and Credit Pricing (Applied Quantitative Finance)

Dr Chris Kenyon, Dr Roland Stamm

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The credit and sovereign debt crises have fundamentally changed the way participants in the global financial markets perceive credit risk. In market practice this is most directly visible from significant bases throughout the interest rate world, especially tenor bases, cross-currency bases, and bond-CDS bases. This means that the curve used for discounting is no longer the curve used for LIBOR (aka Fixing Curve or Forwarding Curve). In the last two years a consensus has emerged that this multi-curve pricing is now standard.

The crises have also altered the perception of banks and governments - they are no longer regarded as zero-risk counterparties. Now both sides of an uncollateralized trade need to consider, and price in, the risk that the other defaults: my CVA is your DVA. Even collateralization does not remove pricing problems: when you post collateral how much do you have to pay for it? This FVA is not symmetric in many ways: whatever it costs you to source it, your counterparty will only pay you OIS. Even worse is that your funding costs are unlikely to be the same as those of all your counterparties.

Discounting, LIBOR, CVA and Funding: Interest Rate and Credit Pricing is the first book to illustrate new ways of pricing interest rate and credit products in the post-crisis markets. Written by two seasoned practitioners, it will enable the readers to understand the many different versions of credit and basis spreads, and to build the appropriate discount curves that take these spreads into account so that collateralized derivatives will be priced correctly. The authors guide the reader through the complexity added by OIS discounting and multi-curve pricing as well as CVA, DVA and FVA.

Derivatives do not exist in a vacuum. Regulators worldwide have reacted strongly to the crises with the introduction of Basel III. Hitherto quants could ignore capital costs and charges, but as of January 2013 this world is gone. *Discounting, LIBOR, CVA and Funding* explains details of Basel III that are important for pricing, especially around the CVA VaR and default exposure capital charges.

This book will be required reading for quantitative practitioners who need to keep up-to-date with the latest developments in derivatives pricing, and will also be of interest to academic researchers and students interested in how instruments are priced in practice.

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