



Interest Rate Dynamics, Derivatives Pricing, and Risk Management (Lecture Notes in Economics and Mathematical Systems)

Lin Chen

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There are two types of term structure models in the literature: the equilibrium models and the no-arbitrage models. And there are, correspondingly, two types of interest rate derivatives pricing formulas based on each type of model of the term structure. The no-arbitrage models are characterized by the work of Ho and Lee (1986), Heath, Jarrow, and Morton (1992), Hull and White (1990 and 1993), and Black, Derman and Toy (1990). Ho and Lee (1986) invent the no-arbitrage approach to the term structure modeling in the sense that the model term structure can fit the initial (observed) term structure of interest rates. There are a number of disadvantages with their model. First, the model describes the whole volatility structure by a single parameter, implying a number of unrealistic features. Furthermore, the model does not incorporate mean reversion. Black-Derman-Toy (1990) develop a model along the lines of Ho and Lee. They eliminate some of the problems of Ho and Lee (1986) but create a new one: for a certain specification of the volatility function, the short rate can be mean-reverting rather than mean-reverting. Heath, Jarrow and Morton (1992) (HJM) construct a family of continuous models of the term structure consistent with the initial term structure data.

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