

## **Note on Cubic Spline Valuation Methodology**

### **THE CUBIC SPLINE METHODOLOGY**

A model for yield curve takes traded yields for available tenors as input and generates the curve through interpolation and curve fitting, so as to minimize the error between traded and model prices. Cubic Spline methodology has been chosen by FIMMDA as it allows minimum error while giving a smooth, continuous curve, which is essential for correct pricing of debt securities. The technical details of the yield curve construction, optimization, smoothing is given in Annexure 1.

#### **A. Process of the methodology updated till 1st Oct, 2016**

The methodology for generation of the yield curve and the valuation for G-Secs are Highlighted below: -

- a) **Identification of Nodal Points\*\*\***: On the first working day of every month, the FIMMDA Valuation Committee would identify “**Nodal Points**” (one bond per calendar year tenor) from the outstanding stock of Government of India Securities. A GOI Security would qualify to be a “**Nodal Points**” if it qualifies the following criteria:
- i. There will be only ONE **Nodal Point** for a calendar year of maturity (2017, 2018, 2019 .....2041, etc.).
  - ii. The “**Nodal Points**” should have had a minimum number of 50 trades and minimum volume of Rs.500 Crores traded both on the NDS-OM and PDO-NDS, in the immediate preceding month.
  - iii. If a **Nodal Point** security fails to meet the above criteria in the subsequent month, it would still qualify to be a **Nodal Point** if it meets the criteria of 50 trades and 500 Cr, volume. *(further discussion to take place for amendment)*

**Identification of “Nodal Point\*\* or Nodal Point\*”**: As there are certain “important input tenors” for getting a realistic Yield Curve (viz. 1 to 7 year, and 10 years), it would be necessary to identify GOI securities called “**Nodal Point\*\* or Nodal Point\***” in the tenors 1 to 7 years and 10 years in case they do not satisfy the criteria to be a “**Nodal Point\*\*\***”. A “**Nodal Point\*\* or Nodal Point\***” is therefore a security in a particular calendar year tenor (1 -7 years and 10 years) which does not have the minimum trades and volumes (50 and Rs 500 crores) to qualify for a “**Nodal Point\*\*\***”, for the aforementioned “important input tenor”. These inputs are required, so that the Model Generated Yield Curve is more representative of market behavior. If more than one security is traded in a tenor qualify for a **Nodal Point\*\*\* or Nodal point \*\* or Nodal Point\***, the security selected as a nodal point would be the one with the highest product (i.e Total Trades\*Total Volumes), in the tenor.

- b) **Selection of Bonds for curve construction:** From the Universe of all outstanding bonds :
- i. For each year only one bond would be taken for curve construction.
  - ii. The bond selected for curve construction should have traded during the day, and should preferably be a **Nodal Point\*\*\* or Nodal Point\*\* or Nodal Point\*** as mentioned in step (a) and (b) above.
  - iii. Once a Nodal Point is decided for a month, it should be taken as input for curve construction throughout the month irrespective of its level of trading volume during the month.

Filter: For substituting the model prices with the LTPs for a **Nodal Point** and non-**Nodal Point** security, a daily criterion is calculated.

Identify the **Nodal Point** with largest number of Trades (T1) and Volumes (V1) and also the **Nodal Point** with Minimum Number of Trades (T2) and Volumes (V2).

The daily criterion is a ratio of:

% of T2/T1

% of V2/V1

All the last traded Government Securities prices/yield on NDS – OM platform will replace the model generated prices/yield in the Valuation sheet irrespective of crossing the filter criteria.

**Modification in the computation of Ratios for criteria based selection of LTP/LTY:** A 3 month moving average of the ratio calculation as above will be used for the computation criteria for LTP/LTY.

After discussion, it was decided that w.e.f. 1st July 2016:

- To select the nodal point with the lowest number of trades amongst the nodal points having trades above 50 in a month; to select the nodal point with the lowest volume amongst the nodal points having volume above Rs.500 crore in a month
- Daily Filter criteria will be calculated as per the present rule described above.

For the segments 16-40 years, the no. of trades and volume calculated as per the filter criteria or 3 trades and Rs25 crores whichever is less will be the daily filter criteria for considering the securities traded yields to be input into the Matlab yield curve generation

Note: Considering the time stipulation for reporting the OTC deals on Reported Deals section, they will be considered for valuation, in the absence of sufficient trades on NDS-OM.

- iv. For tenors 1-7 years and 10 years (“important input tenors”), if the “**Nodal Point**” identified, has not traded on a particular day, but some other bond in these tenors has traded and passed the “Filter” criteria, then that bond’s yield and price would be used for curve construction.
- v. With a view to adopt the FASB and IFRS Level 1, 2, and 3 criteria, the level 2 criteria of Fair Valuation is adopted. Thus in case there are no trades in any **Nodal Point** on a particular day, a “**Market Observable & Tradable**” MOT input would be used. The “Market Observable and Tradable” input is one in which the **Nodal Point** has “bids” and “offers” aggregating a minimum of Rs.10 crores each and a maximum spread of 10 basis points at 12 noon, 2pm and 4 pm. The weighted average “mid-yield” of the particular security across the three time-frames would then be used as an input for curve construction.  
**For IIB** the minimum bid/offer can be Rs.5 crores each at only two times: 12 noon and 4 pm.  
*(And for FRB please refer to the document Valuation of FRBs under G Sec Valuation tab on FIMMDA’s website: [www.fimmda.org](http://www.fimmda.org))*
- vi. For tenors 1-7 years and 10 years (“important input tenors”), and for other tenors (for which “**Nodal Point**” bonds had been identified on the first working day of the month ) if no **Nodal Point** has traded, or no other traded bond which has passed the “filter” criteria is available, or a Market Observable & Tradable input is not available, “**Proxy Yields**” would have to be used for the selected **Nodal Point** securities.(Computation of Proxy Yields is dealt with in subsequent paragraphs).
- vii. For tenors 1-7 years and 10 years (“important input tenors”), Market Observable & Tradable” (MOT) inputs if available, would be used for “input” provided:
  - a) The MOT passes the traded data “Filter” criteria (total of bid and offer amount to be equal or greater than the Filter amount, and total number of bids and offers to be equal or higher than the Filter number of trades), and the MOT is available with 10 bp spreads in the specified times.
  - b) The total of traded numbers and amount PLUS the MOT passes the traded “Filter Criteria”.
- viii. For other tenors i.e. 8 yrs., 9 yrs., and above 10 yrs., any bond (whether **Nodal Point** or not) which has traded and passed the “Filter” criteria would be used as an input for Curve Construction (provided in the particular tenor there is no other security which has sufficient trades to qualify for inputting during curve construction). If more than one bond has traded in a particular tenor, the bond with the highest number of trades on the particular day would be taken.
- ix. For other tenors i.e. 8 yrs., 9 yrs., and above 10 yrs., any bond (whether **Nodal Point** or not), “Market Observable & Tradable” (MOT) inputs if available, would be used for “input” provided:
  - a) The MOT passes the traded data “Filter” criteria (total of bid and offer amount to be equal or greater than the Filter amount, and total number of bids and

offers to be equal or higher than the Filter number of trades), and the MOT is available with 10 bp spreads in the specified times.

- b) The total of traded numbers and amount PLUS the MOT passes the traded “Filter Criteria.
  
- x. Proxy calculation of 30 year bond, the difference in yield of preceding tenor, provided it has traded, will be added to previous day’s 30 year yield to arrive at that day’s proxy yield.
  
- xi. Proxy Calculation for 40-year tenor point: Govt/RBI introduced a new 40 year tenor security (November 2015). The present cubic spline curve generates yields up to 30 year only. While we work towards extension of the cubic spline to 40 years, the procedure for calculation of a proxy for the 40 year tenor( if not traded) will be the difference in yield of preceding tenor, traded/MOT/proxy between the preceding day and that day which will be added to the previous days 40 year yield (traded/MOT/proxy)
  
- xii. Other criteria: The other criteria in selecting inputs for the curve construction are
  - If a new bond has been issued during the month and the bond meets FIMMDA’s criteria for being a **Nodal Point** Bond (but not designated as such) then the new bond would be taken into curve construction, if:
    - a) It passes the “Day-End Filter Criteria”.
    - b) There is no other paper in the respective tenor exist or has not been used as an “Input Point” (i.e. either a **Nodal Point\*\*\*/ Nodal Point\*\* or Nodal Point\***)
    - c) If an existing paper qualifying for a “**Nodal Point**” is already trading, then
      - i. The yield of the new paper is “Lower” than the existing **Nodal Point**
      - ii. The yield of the new paper is “Higher” than the existing **Nodal Point**, but the volume and number of trades are more than existing security.

In all other cases, the existing security will continue to be an input point.

- For the tenors less than 1-year tenor, the lowest tenor traded T-Bill would be used and it would be extrapolated till overnight period

The valuation committee noted that maturity date of the traded T-Bill does not impact the yield curve. However the yield of the traded T-Bill is impacting the yield curve up to 1st year tenor. It was decided to continue the present practice of inputting of the recent cut-off yield of 91-Day T-Bill as first input. FIMMDA will do further analysis by inputting all the T-Bill traded yields (crossing the filter). When the residual tenor of

traded T-Bill is more than 6 months, the yield is to be input by converting T-Bill yield to G-sec yield.

- Only G-Secs without features like floating coupon, embedded options etc. would be used as inputs for curve construction.

**B. Base liquid zero rate curve and par-yield curve generation:** - Based on the above data, a base liquid zero rate curve based on Cubic Spline approach is generated. Further a smoothing technique is applied to ensure that the forward rate curve is smooth. The par-yield curve is generated from the zero-rate curve.

**C. Computation of illiquidity:** - The illiquidity factor is calculated based on the yield differential between the yield of a traded bond and the model generated par yield for the same bond's residual tenor on that day. It would be generated every Tuesday on a 4-week moving average basis. The process of calculating the illiquidity factor is elaborated in "Illiquidity Factor" below.

**D. Valuation & Substitution of Model Prices**

"Market Observable & Tradable" (MOT) inputs if available, would be used for substituting model prices for bonds which have not traded. The "Market Observable and Tradable" input is one in which the bond has "bids" and "offers" aggregating a minimum of Rs.10 crores and a maximum spread of 10 basis points at 12 noon, 2 pm and 4 pm. The weighted average "mid-yield" of the particular security across the three time-frames would then be used to substitute the model price. (This is done to give a more market related shape to the yield curve, in tenor segments where lack of traded inputs leads to the Cubic Spline model tending to give an unrealistic curvature "trough" or "hump")

The conditions for using MOT as for "substitution" would be as under:

- i. The MOT would need to be available at three time periods 12 noon, 2 pm, and 4 pm (subject to change).
- ii. For **Nodal Points**, maximum spread of 10 bps and Rs.10 crores (bid-offer total) would be required.
- iii. For all other bonds, the total number of bids and offers and total of bid and offer amount with spread of 10 bps, and total amount equal to or above the minimum "Filter" set for recognition of traded prices as input and substitution, would be required.
- iv. **For other tenors** i.e. 8 yrs., 9 yrs., and above 10 yrs., any bond (whether **Nodal Point\*\*\* or Nodal Point\*\* or Nodal Point\*** or not), "Market Observable & Tradable" (MOT) data if available, would be used for "substitution" provided:
  - a. The MOT passes the traded data "Filter" criteria (total of bid and offer amount to be equal or greater than the Filter amount, and total number of

- bids and offers to be equal or higher than the Filter number of trades), and the MOT is available with 10 bp spreads in the specified times.
- b. The total of traded numbers and amount PLUS the MOT passes the traded “Filter Criteria.
  - v. The procedure outlined in (d) above would be used even for those bonds which are not **Nodal Points**, but are in tenors in which these **Nodal Points** exist. (E.g. 8.08 % 2022, and 8.13 % - 2022 in the 2022 tenor, where the **Nodal Points** is 8.15 % -2022; or 7.80 %- 2021, and 10.25 % - 2021 in the 2021 tenor, where the **Nodal Point** is 8.89 % -2021).

### **Proxy yield**

(Approved by Board in Dec, 2015 and applied from Jan, 2016)

For any year if the Nodal Point does not trade on a particular day, then proxy yield for that tenor has to be generated. Proxy yield would be generated as follows:

For Nodal Point that did not get traded, the proxy yield would be calculated by adding a factor to that bond’s traded/proxy yield of the previous day. The factor would be calculated as follows:

- a. Difference in yield is computed for the traded Nodal Point security of the tenor immediately preceding the tenor for which proxy yield is required. Similar difference in yield is computed for immediately succeeding tenor.
- b. Average of the difference in yield of the two tenors (traded on the day) is computed as the factor.
- c. If no preceding Nodal Point is traded then the factor would be the difference in yield of the immediate succeeding traded Nodal Point; or
- d. If no succeeding Nodal Point is traded, then the factor would be the difference in yield of the immediate preceding traded Nodal Point.
- e. If both preceding and succeeding Nodal Points are not traded on both days, then the difference between the proxy yields will be used as the factor.

*In a scenario of (e), earlier, it was being computed manually and proxy input into the system. Recently, FIMMDA implemented automation of G-sec valuation and during implementation it was found difficult to implement sub point (e), ie when the proxy had to be calculated in the absence of both preceding and succeeding securities. The system was unable to compute in such a scenario. So, to proceed with automation the rule is amended as follows:*

*Revised (e). If both preceding and succeeding Nodal Points are not traded on that day as well as the previous day, then the difference between the preceding Nodal Point yields irrespective of traded/proxy on both days will be used as the factor.*

***Proxy for the 1<sup>st</sup> year:** As per the methodology, there is no filter for the tenors 1-7 years. In cases where there is no trade in 1<sup>st</sup> year, as per proxy rules, it was computed from the 2<sup>nd</sup> year tenor if traded. We have come across case where even the second year was not traded. Earlier, we used to compute the same manually out of the immediately preceding traded tenor (from*

*the 2<sup>nd</sup> or 3<sup>rd</sup> year whichever is traded) But in automation, it was found difficult to give a formula for such cases. So, for automation purposes, we amended the rule as under:*

- f. **Proxy calculation for 1<sup>st</sup> Year paper:** If 1<sup>st</sup> year paper is not traded nor has MOT, and we are unable to use point©, the proxy will be calculated by using the difference between previous day's 1<sup>st</sup> Year paper and the 2<sup>nd</sup> year paper and adding the same to previous day's 1<sup>st</sup> year paper.*

Illiquidity factor (Approved by Board on 10th Dec, 2015. The back testing and parallel run were completed successfully and the process implemented w.e.f 1st march 2016).

- For each bond (other than Nodal Point) the illiquidity factor is calculated as the difference in the traded yield (any trade without applying filter criteria) and model generated yield.
- No illiquidity factor will be calculated if a security is not traded on a particular day.
- Similar exercise is done daily and the moving average for the past 4 weeks (calendar) is calculated for each security.
- Further, an average of positive illiquidity spreads for all the bonds (other than Nodal Point) maturing in a particular tenor is also calculated (Tenor average illiquidity factor).
- If a particular bond has traded for more than 5 days in the past 4 weeks then the 4-week average illiquidity value calculated for that particular bond would be used as the illiquidity factor.
- If a particular bond has traded for less than 5 days in the past 4-weeks, then the average illiquidity value calculated for all the bonds maturing in a particular tenor would be used as the illiquidity factor.
- 4 week moving averages would be calculated on every Tuesday based on the immediate preceding 4 weeks and applied for the valuations during the week.
- If none of the bonds maturing in a particular tenor have traded in the past 4 weeks then the average of the illiquidity factor of immediate next and immediate previous tenors would be used. For example if none of the bonds maturing in 2027 have traded in the last 4 weeks, then illiquidity factor would be calculated as the average of illiquidity factor for 2026 (say 8 bps) and 2028 (say 2 bps) i.e. 5 bps. When there are no trades beyond a particular tenor say beyond 2045, then the illiquidity factor applicable to the immediate preceding available traded tenor, say, 2039 would be applied.

Illiquidity Factor in a tenor where new security is issued:

When a new paper is issued, the new paper starts trading at lower yield and the existing papers in that tenor continue to trade at old levels. The traded volume of new paper qualifies it to become a nodal point. When the yield of new paper is input as nodal point, the yield curve for that tenor is pulled down. The model generated yield for all other securities in that tenor is lowered in alignment with the new paper. To the model generated yield, illiquidity factor (IF) is to be added for valuing illiquid papers in that tenor. For illiquid papers, illiquidity factor prior to issue of new paper

will be low because of higher model generated yield. Therefore, the 4 week moving average IF for that paper will be also low. So, 4 week moving average IF for a non-nodal point paper will be calculated as under:

If the non-nodal point paper is traded on the day of issue of new paper, the difference between its traded yield and model generated yield will be IF. If not traded, the difference between the non-nodal point paper's previous day's traded yield and the traded yield of new paper will be the IF. Like this the IF will be calculated for the second preceding day if there was trade in the non-nodal point paper. Calculation of 4 week moving average will be started afresh from the day the new paper was issued. The inputs will be IF of the day when the new paper was issued (T+0) or T-1 or T-2 depending upon when the illiquid paper in that tenor was last traded. This will ensure availability of IF for that paper even if it does not trade after T+0.

If the illiquid paper was not traded on T+0, T-1 or T-2, then the paper will not have its own 4 week moving average IF. In that case IF for the tenor would be used.

Illiquidity Factor for the tenor will be the average of 4 week moving average IF calculated for other papers (other than new paper/nodal point). Here also, calculation of 4 week moving average will be started afresh from the day the new paper was issued.

If none of the illiquid papers in the tenor had a trade on T+0, T-1 or T-2 then the difference between the traded yield of the new paper and the model generated yield for the illiquid paper on T-1 will be the IF.

If all the illiquid papers in the tenor do not trade continuously for 4 weeks then the IF used for the day of issue of new paper would continue to be used till the effect of new paper on the model generated yield disappears.

Yield Change:

- a. If, after adding the "Illiquidity Factor", the non-traded bonds in a particular tenor show a yield which is lower than the yield of a traded bond whose volume and trades have passed the filter for recognition for valuation purposes, the model - determined yield (including the IF) would be increased to equal the yield of the traded bond. Thus:

Yield of a non-traded bond in a particular tenor would be = or > than the yield of the traded bond with the lowest yield in that tenor.

- b. If there are no trades in a particular tenor, the Model Yield plus the IF would give the final yield for valuation of bonds in that tenor.

### To Summarise

1. The methodology of curve construction is broadly two steps

**Step 1:** Select "Input" Tenors

**Step 2:** (i) Substitute traded and Minimum Observable Tradable (MOT) prices in Model Generated Curve

(ii) Add Illiquidity factors for non-input bonds.



**STEP 1**

2. "Mandatory" input tenors are: 91 DTB, 1-7 yrs and 10 yrs.
3. Additional inputs
  - a. "**Nodal Point**" bonds selected at the beginning of the month. (which may or may not be in 1-7 yrs and 10 yrs)
  - b. Minimum Observable Tradable data (MOT)
  - c. MOT plus sparsely traded data total of which crosses minimum criteria (Filter)
4. If no inputs are available for Step 1, calculate the "Proxy Yields".

**STEP 2**

5. All "Input" prices/yields are substituted in the Model generated curve (including the ones from 'point 3')
6. Calculate "Illiquidity Factors" - 4 week Moving Average or 3 days Moving Average and add to the Model Price of all "non - input" securities for arriving at the closing valuation price and yield.

**FRB Valuation: Please refer the separate item under the G SEC VALUATIONS**

## Annexure 1

A detailed description of the Pienaar Choudhry method for extraction Zero rates and Par Yields from Traded Bond Prices

*FIMMDA was entrusted with the task of developing a suitable model for the yield curve generation and streamlining the process for arriving at the prices for the G-Secs. Nelson Siegel Svensson and cubic spline zero curve were considered. A model based on Nelson Siegel Svensson provides a smooth zero curve; however it suffers from the demerit of a relatively higher price errors. This is because the model cannot incorporate multiple changes in curvature across various tenors. A cubic spline curve was considered to be appropriate for the Indian markets as the curve tracks the input price of various tenors and thereby produces a lower model error. In this approach the traded or proxy yields serve as the input for curve construction and a cubic spline is used to interpolate between the input yields to generate the curve. The cubic spline is a series of curves that is continuous at all the points. Each curve of the spline is of third order and has the form  $Y = ax^3 + bx^2 + cx + d$  where  $Y$  is zero-rate for the tenor ' $x$ '.*

In the current method an optimization function is used to fit a natural cubic spline based zero curve to a set of traded bond prices. A yield curve is generated from the cubic spline based zero curve. The base research paper used as reference is authored by Rod Peinaar and Moorad Choudhry<sup>1</sup>. A simple cubic spline based implementation gives a good fit but leads to wavy forward curve. Hence a further smoothing constraint is applied to the optimization procedure that generates a curve which has minimum curvature and minimum price error. This smoothing leads to a better behavior of forward rates extracted from the zero rate curve.

The zero rate curve thus obtained is also used to extract par-yields for different maturities.

What is a cubic spline function?

A cubic spline function is a piecewise cubic polynomial function that passes through a given set of points in a smooth fashion. . The function takes the form  $f = a_i + b_i\Delta + c_i\Delta^2 + d_i\Delta^3$ ; where ' $i$ ' represents the portion of the time axis where we want to measure zero-rate. If  $T_i$  represents the time to maturity of a traded bond, then between  $T_i$  and  $T_{i+1}$ ,  $\Delta$  takes values from 0 to  $T_{i+1} - T_i$ .

The time axis is divided in to regions by "knot points" at times  $T_i$  (usually the traded bond maturity in years). As we can see there is a different set of coefficients ( $a_i, b_i, c_i, d_i, \dots$ ) describing the zero-rate curve between every  $T_i$  and  $T_{i+1}$ . The value of the cubic spline function as well as its first and second derivatives are the same when measured from either side of the knot point.

For example, consider three consecutively maturing bonds, with maturity dates 14/06/2015, 17/08/2016 and 28/08/2017.

The current date is 29/07/2010; the time to maturity for each of these bonds is 4.875 years, 6.05 and 7.0805556 years respectively. So within the cubic spline framework the zero-rate between 4.875 and 6.05 years is described by one set of coefficients ( $a, b, c, d, \dots$ ) and between 6.05 years and 7.08 years is described by another set of parameters ( $a_{i+1}, b_{i+1}, c_{i+1}, d_{i+1}, \dots$ ). The value of  $\Delta$  varies from 0 to (6.05-4.875=1.175) between 4.875 and 6.05 years. Similarly  $\Delta$  takes the values from 0 to 1.0305 between 6.05 and 7.08 years. The zero-rate for 4.875 years is  $a_i$ , while that for 6.05 years is  $a_{i+1}$ .

Based on the constraints applicable for natural cubic spline (discussed in Annexure 1(a) ) it is possible to describe the ( $b, c, d, \dots$ ) coefficients in terms of the  $a$  coefficients and the maturities  $T_i$ . So in the optimization set-up the problem is to find values of  $a_i$  such that the squared difference between the model generated prices and traded prices is least

Pricing a coupon-bond given a zero rate curve

Suppose the values of the  $a_i$  coefficients for the cubic spline are as follows

Dates	$a_i$ coefficients
29/07/2010	5.60%
02/07/2011	6.108%
03/09/2013	7.047%
14/06/2015	7.550%
17/08/2016	7.712%
28/08/2017	7.762%
03/05/2020	7.776%
15/02/2022	8.064%
02/07/2040	8.331%

Then as discussed earlier it is possible to obtain zero-rates (guesses) for any maturity. Consider the bond with coupon 9.39% and maturity date 02/07/2011. The (model) price for this bond is obtained using discount factors obtained from zero rates (see diagram below).

9.39 bond maturity i.e. 02/07/2011		
Coupon Dates	Discount factors obtained by converting zero-rates	
	Coupons	PV for coupon
02/01/2011	4.695	0.975503799
02/07/2011	104.695	0.945683949
		4.57999033
		99.0062871
Dirty Price	103.586277	
Accrued interest	0.70425	
Clean Price	102.882027	

This clean price is the model price of the coupon bond.

Pricing a T-bill given a zero-rate curve

The price of the T-bill is taken as 100 times the discount factor (from zero rates) for the maturity of the T-bill.

Fitting the zero-curve to reproduce traded bond prices

Let  $P$  represent the traded bond price (either T-bill or coupon bond) and  $\hat{P}$  model price (produced as above using a guess of the zero-curve). The values of coefficients ( $b, c, d, \dots$ ) can be found from coefficient  $a$ . So by modifying  $a$  coefficient (using an optimization algorithm Levenberg Marquardt algorithm has been used in the current implementation) the cumulative price difference  $\sum (\hat{P} - P)^2$  between the model price and traded price of the traded bonds is minimized.

Smoothing of zero-rate curve

To ensure that smooth forward rates are obtained from the zero-rate curve, a curvature term is added to the minimization of price differences. So instead of minimizing  $\sum (\hat{P} - P)^2$

(bond price difference),  $\sum (\hat{P} - P)^2 + \int \lambda(t) * [f'']^2$  is minimized. The start point for this minimization is taken as the curve obtained by simply matching bond prices from the previous step.

$f$  represents the zero-rate curve and  $f''$  the second derivative of the curve.

Here  $\lambda(t)$  ( $t$  being time in years or maturity of the traded bond) is a function that augments the curvature, it is also called the VRP (variable roughness penalty) function.

Using this form of minimization leads to smoother curve but with possible mismatch in model price of bonds and traded price of bonds.

In the current implementation  $\lambda(t)$  is same as suggested by Daniel F. Waggoner<sup>2</sup>. It is a

$$\lambda(t) = 0.1 \text{ for } t < 1$$

stepwise function and takes the following values:  $\lambda(t) = 100 \text{ for } 1 \leq t < 10$

$$\lambda(t) = 100000 \text{ for } 10 \leq t$$

**Results:** Once the zero rate is obtained by the above method the par yield is derived from it. Par yield (or par rate) is the coupon rate for which the price of a coupon bond is equal to its par-value. For various maturities such as 0.25 years, 0.5 years..., let  $C$  represent the

par-yield. Then one can solve the equation  $C = \frac{1 - df_{mat}}{\sum_k df_k}$ , to obtain the par-yield for that

maturity. Here  $df_{mat}$  represents the discount factor for the maturity date of the imaginary bond (say for 1.5 years maturity) and  $df_k$  represents the discount factors for the K-th coupon payment date of this imaginary coupon-bond. Again the discount factors are obtained from the zero-rate curve obtained from optimization earlier.





Nurturing Markets,  
Widening Horizons

Regd. Office: 2nd Floor, UNITED INDIA BUILDING,  
Next to RBI Amar Bldg Monetary Museum,  
Sir P.M. Road, Fort, Mumbai 400 001.  
Tel: 022- 2269 0321- 26  
Fax: 2262 6454

Thus as a first step the  $c_i$  coefficient s are obtained from the  $a_i$  coefficient s and then the remaining coefficients are obtained using equations (A) and (B).  
Once all coefficients are obtained we have our zero-rate curve.

References:

1 "Fitting the term structure of interest rates: the practical implementation of cubic spline methodology"

[http://www.yieldcurve.com/Mktresearch/files/PienaarChoudhry\\_CubicSpline2.pdf](http://www.yieldcurve.com/Mktresearch/files/PienaarChoudhry_CubicSpline2.pdf)

2 "Spline methods for extracting interest rate curves from coupon bond prices"

<http://www.frbatlanta.org/filelegacydocs/Wp9710.pdf>

[http://en.wikipedia.org/wiki/Par\\_yield](http://en.wikipedia.org/wiki/Par_yield)

[http://en.wikipedia.org/wiki/Tridiagonal\\_matrix\\_algorithm](http://en.wikipedia.org/wiki/Tridiagonal_matrix_algorithm)

[http://en.wikipedia.org/wiki/Natural\\_cubic\\_spline](http://en.wikipedia.org/wiki/Natural_cubic_spline)