4. BEHAVIORAL VALUE ADJUSTMENTS

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Assets or liabilities with embedded prepayment/extension options can be subject to behavioral risk, due to the unpredictable exercise strategy followed by the option holder not acting purely on the strength of financial convenience. When seen from the viewpoint of the option seller, such behavior results in a lower option value and an additional source of uncertainty in future cash flows. We propose a general framework to model behavioral risk and discuss the pricing of contracts with embedded options by introducing the concept of behavioral risk adjustment (BVA), in line with the recent development of XVA methodology.