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# Option pricing in exponential Lévy models with transaction costs

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## Abstract

In this thesis we present a new model for pricing European call options in presence of proportional transaction costs, when the stock price follows a general exponential Lévy process. The model is a generalization of the celebrated work of Davis, Panas and Zariphopoulou, where the value of the option is defined as the utility indifference price. This approach requires the solution of a stochastic singular control problem in finite time. We introduce the general formulation of the problem, and derive the associated Hamilton-Jacobi-Bellman equation (HJB), which is a nonlinear partial integro-differential equation, with the form of a variational inequality. We prove that the value function of the problem is a solution of the HJB equation in the viscosity sense. The original problem is then simplified for the specific case of the exponential utility function, under the assumption of absence of default for the investor's portfolio. We solve numerically the optimization problems using the Markov chain approximation method. We also apply the multinomial method to the Variance Gamma process, which is an alternative and more efficient approach to discretize the continuous time process. We provide a numerical scheme and prove that it is monotone, stable and consistent and that the solution converges to the viscosity solution of the original HJB equation. Several numerical solutions are presented for both the original problem and the simplified problem. Numerical results are obtained for the cases of diffusion, Merton and Variance Gamma processes. We provide convergence and time complexity analysis and comparisons with option prices computed using the standard martingale pricing theory.

**Keywords:** option pricing, Lévy processes, transaction costs, Markov chain approximation, singular control.

## Resumo alargado

Na área da Matemática Financeira, um dos problemas fundamentais é a determinação do “preço justo” de uma opção. Este problema não é trivial e para o resolver é necessário considerar um modelo estocástico adequado para a dinâmica do ativo financeiro subjacente e também algumas hipóteses sobre o funcionamento do mercado.

Uma solução para o problema de avaliação de opções foi apresentada pela primeira vez no célebre artigo de Fischer Black e Myron Scholes ([Black and Scholes, 1973]). No modelo de Black-Scholes standard assume-se um mercado sem fricções, onde a taxa de juro é constante e o processo de preço do ativo subjacente é um movimento Browniano geométrico. Este modelo é, ainda hoje, um dos modelos mais usados para avaliar opções e definir estratégias de cobertura de risco. As razões para a popularidade deste modelo prendem-se sobretudo com o facto dele fornecer fórmulas fechadas para o cálculo do preço das opções mais simples e permitir estratégias de cobertura de risco facilmente implementáveis.

Apesar do modelo de Black-Scholes ser bastante popular, a aplicação do modelo pressupõe hipóteses que não refletem as verdadeiras características observadas empiricamente no mercado. Em particular, a hipótese de que o processo de preço do ativo subjacente é um movimento Browniano geométrico, o que implica uma distribuição dos retornos logarítmicos Gaussiana, é frequentemente rejeitada através de análises estatísticas rigorosas dos dados empíricos. As distribuições empíricas dos retornos logarítmicos são habitualmente caracterizadas por uma maior massa na vizinhança do centro da distribuição e por caudas pesadas (quando comparadas com a distribuição normal).

De forma a ultrapassar a inconsistência entre o movimento Browniano geométrico e os dados empíricos, vários autores consideraram processos estocásticos alternativos para descrever a dinâmica dos preços do ativo sub-

jacente. Em particular, os processos de Lévy tornaram-se relativamente populares nas últimas duas décadas e são bons candidatos para reproduzir de forma mais precisa as distribuições empíricas dos retornos logarítmicos. Estes processos têm boas propriedades analíticas e incluem processos associados a distribuições com caudas pesadas. Os processos de Lévy são, essencialmente, processos estocásticos com incrementos independentes e estacionários, que satisfazem também a propriedade de continuidade estocástica. Nesta tese consideraremos em geral processos de Lévy para modelar o processo de preço do ativo subjacente e, em particular, consideraremos como principais exemplos o movimento Browniano, o modelo de difusão com saltos de Merton e o processo “Variance Gamma”, que é um processo de atividade infinita.

A hipótese de mercado sem fricções, que é assumida no modelo de Black-Scholes standard, é também francamente irrealista, porque os mercados financeiros são habitualmente caracterizados por diferentes tipos de taxas cobradas aos investidores sempre que estes realizam transações. Em particular, as transações realizadas em tempo contínuo, tal como prescritas pelo modelo de Black-Scholes, não são praticáveis na realidade. Além disso, a presença de custos ou taxas de transação impede a replicação perfeita do “payoff” da opção.

Nesta tese apresentamos um novo modelo para avaliação de opções na presença de custos de transação, considerando que o processo de preço do ativo subjacente é um processo de Lévy exponencial. O modelo proposto é a generalização do modelo introduzido inicialmente por [Hodges and Neuberger, 1989] e mais tarde formalizado por [Davis et al., 1993], onde apenas o termo de difusão é considerado na dinâmica do preço. No modelo estudado nesta tese introduzimos também a possibilidade de incumprimento (ou “default”) para a carteira do investidor. No nosso modelo, o preço de uma opção é definido usando o conceito de “preço de indiferença”, considerando funções de utilidade e a teoria de otimização de carteiras em tempo contínuo. O preço de uma opção é o valor que faz com que a escolha de um investidor seja indiferente (em termos da utilidade esperada da riqueza final) entre as possibilidades de ter uma carteira com uma opção e ter uma carteira com a opção substituída por um prémio de risco fixo. Na presença de custos de transação, a carteira de replicação perfeita não pode ser implementada. Como consequência, a estratégia de cobertura de risco deixa de ser uma estratégia sem risco. A estratégia de cobertura de risco ótima consiste em manter o valor da carteira dentro de uma região designada por “região de não transação”. Considerando a abordagem descrita em [De Vallière et al., 2016], formulamos o nosso problema de avaliação de opções com custos de transação como um problema de controlo singular ótimo e deduzimos a equação de Hamilton-Jacobi-Bellman (HJB) para este problema. Esta equação é uma equação integro-diferencial parcial (EIDP), que toma a forma de uma desigualdade variacional. Assumimos que a função

valor do problema é contínua e satisfaz o princípio de programação dinâmica. Sob esta hipótese, provamos que a função valor é uma solução da equação HJB. Esta solução deve ser interpretada como uma solução de viscosidade para o problema. O problema de otimização original é complexo e obter uma aproximação numérica para a solução é, do ponto de vista computacional, um processo bastante intenso. Para simplificar o problema considerámos o caso particular de um investidor com grandes recursos de crédito, de forma a ignorar a possibilidade de “default”. Sob esta hipótese, e devido às propriedades da função utilidade exponencial, é possível reduzir o número de variáveis do problema e obter uma versão tridimensional do mesmo e da equação HJB associada.

Um algoritmo é proposto para obter soluções numéricas para o problema original e para o problema simplificado. No entanto, foi dada maior ênfase ao problema simplificado, uma vez que neste caso a complexidade computacional é menor e foi possível realizar mais estudos numéricos. A abordagem numérica baseia-se no método de aproximação por cadeias de Markov proposto em [Kushner and Dupuis, 2001]. A dinâmica da carteira é aproximada por uma cadeia de Markov em tempo discreto. Uma forma de construir a cadeia de Markov é através da discretização do gerador infinitesimal do processo, usando um método de diferenças finitas explícito. Este tipo de construção é imediata para processos de atividade finita como o processo de difusão com saltos de Merton, mas para processos de atividade infinita, como o processo “Variance-Gamma”, não é claro como obter as probabilidades de transição por este método. Um procedimento alternativo habitual é aproximar a componente de martingala dos “saltos pequenos” do processo de atividade infinita por um movimento Browniano com a mesma variância, de forma a remover a singularidade da medida de Lévy na vizinhança da origem. Relativamente ao método numérico, este consiste essencialmente em criar um algoritmo de programação dinâmica recursivo, de forma a calcular a função valor no instante  $t$  a partir do seu valor no instante  $t + \Delta t$ . Em [Kushner and Dupuis, 2001], os autores provaram que a função valor obtida através de um algoritmo de programação dinâmica discreta deste tipo converge para a função valor do problema original usando um argumento de convergência em probabilidade. De forma a provar a convergência do nosso esquema numérico, usamos outra abordagem, baseada no método de prova de convergência para a solução de viscosidade introduzido em [Barles and Souganidis, 1991]. Provamos que o esquema é monótono, estável e consistente. Provamos também que a solução obtida pelo esquema numérico converge para a solução de viscosidade da equação HJB.

Exemplos numéricos são apresentados para os casos particulares em que a dinâmica do preço do ativo subjacente é dada por: (i) Movimento Browniano; (ii) Processo de difusão com saltos de Merton; (iii) Processo “Variance-Gamma”. Comparamos os resultados obtidos pelo nosso modelo com os preços obtidos ao resolver a EIDP deduzida a partir da teoria de avaliação

pelo método de martingala standard. Para pequena aversão ao risco e para custos de transação nulos, o nosso modelo replica os preços obtidos a partir da EIDP com boa precisão. As EIDP foram resolvidas através do esquema de diferenças finitas do tipo implícito-explícito proposto em [Cont and Voltchkova, 2005a].

Nesta tese discutimos também o método multinomial proposto em [Yamada and Primbs, 2001], que é um método alternativo que permite obter as probabilidades de transição da cadeia de Markov aproximadas. Aplicamos este método ao processo “Variance Gamma”, o qual é previamente aproximado por um processo de saltos com os mesmos quatro primeiros momentos e depois é discretizado no tempo e no espaço. Comparamos os resultados obtidos pelo método multinomial com os resultados obtidos a partir da solução da EIDP para o caso de opções Europeias e Americanas standard. Aplicamos também o método multinomial ao modelo com custos de transação proposto nesta tese. Neste método não há necessidade de discretizar o gerador infinitesimal para a construção da cadeia de Markov. Uma vez que o número de ramos no método multinomial proposto é mantido fixo e igual a cinco, a complexidade computacional é mais pequena.

**Palavras-chave:** preços de opções, processos de Lévy, custos de transação, aproximação da cadeia de Markov, controlo singular.

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## Introduction

The problem of pricing a European call option was first solved mathematically in the paper of [Black and Scholes, 1973]. Even if it is quite evident that this model is too simplistic to represent the real features of the market, it is still nowadays one of the most used models to price and hedge options. The reason for its success is that it gives a closed form solution for the option price, and that the hedging strategy is easily implementable. The Black-Scholes model considers a *complete* market, i.e. a market where it is possible to create a portfolio containing cash and shares of the underlying stocks, such that following a particular trading strategy it is always possible to replicate the payoff of the option. In this framework, this particular portfolio is called *replicating portfolio* and the trading strategy to hedge the option is called *delta hedge*. However, this model does not consider many features that characterize the real market.

In the Black-Scholes model the stock price follows a geometric Brownian motion. This is equivalent to assume that the log-returns are normally distributed. However, a rigorous statistical analysis of financial data reveals that the normality assumption is not a very good approximation of reality (see [Cont, 2001]). Indeed, it is easy to see that empirical log-return distributions have more mass around the origin and along the tails (*heavy tails*). This means that normal distribution underestimates the probability of large positive and negative log-returns, and considers them just as rare events. In the real market instead, log-returns manifest frequently high peaks, that come more and more evident when looking at short time scales. The log-returns peaks correspond to sudden large changes in the price, which are called *jumps*. There is a huge literature of option pricing models considering an underlying process with discontinuous paths. Most of these models assume the log-price dynamics to be a *Lévy process*.

A second issue of the Black-Scholes model is that it does not consider the presence of budget constraints and market frictions i.e. bid/ask spread or transaction fees. The securities in the market are traded with a bid-ask spread, and this means that there are two prices for the same security. But the Black-Scholes formula just gives one price. Moreover, the replicating portfolio cannot be perfectly implemented, since the delta-hedging strategy involves continuous time trading. This is impractical because the presence of transaction costs makes it infinitely costly. Another feature that needs to be considered is the presence of budget constraints in the real market. A limit in the available budget, or (most commonly) a restriction in the possibility of selling short, clearly restricts the set of hedging strategies of the investor.

Many authors attempted to include the presence of proportional transaction costs in option pricing models. In [Leland, 1985], in order to avoid continuous trading, the author specifies a finite number of trading dates. He obtains a Black-Scholes-like nonlinear partial differential equation (PDE) with an adjusted volatility term, that takes into account the transaction costs. However, trading at fixed dates is not optimal, and the option price goes to infinity as the number of dates grows. Further work in this direction has been done by [Boyle and Vorst, 1992], which consider a multi-period binomial model (see [Cox et al., 1979]) with transaction costs. Here again, the cost of the replicating portfolio depends on the number of time periods. Recent developments in this direction are for instance [Mocioalca, 2007], [Florescu et al., 2014] and [Sengupta, 2014] who consider different features of the market such as jumps, stochastic volatility and stochastic interest rate respectively.

A different approach has been introduced by [Hodges and Neuberger, 1989]. The authors use an alternative definition of the option price called *indifference price*, based on the concepts of *expected utility* and *certainty equivalent*. An overview of these concepts applied to several incomplete market models can be found in [Carmona (Editor), 2009]. As long as the perfect replicating portfolio is no longer implementable in presence of transaction costs, the hedging strategy cannot be anymore riskless. The model has to take into account the risk profile of the writer/buyer to describe his trading preferences. [Hodges and Neuberger, 1989] define the option price as the value that makes an investor indifferent between holding a portfolio with an option and without, in terms of expected utility of the final wealth. They show that it is impossible to hedge perfectly the option. The optimal strategy is to keep the portfolio's values within a band called *no transaction region*. Using numerical experiments, they verify that this strategy outperforms the one proposed in [Leland, 1985]. This approach has been further developed in [Davis et al., 1993], where the problem is formulated rigorously as a singular stochastic optimal control problem. The authors prove that the value function of the optimization problem can be interpreted as the

solution of the associated Hamilton-Jacobi-Bellman (HJB) equation in the viscosity sense. They prove also that the solution of the proposed numerical scheme, based on the *Markov chain approximation*, converges to the viscosity solution. Numerical methods for this model are presented in [Davis and Panas, 1994], [Clewlow and Hodges, 1997] and [Monoyios, 2003], [Monoyios, 2004]. In [Whalley and Wilmott, 1997] and [Barles and Soner, 1998] the problem is simplified by using asymptotic analysis methods for small levels of transaction costs. The authors, starting from the general HJB variational inequality, derive a simpler non-linear PDE for the option price. Further developments are presented in the thesis work of [Damgaard, 1998], where the author studies the robustness of the model from a theoretical and numerical point of view. He found that under certain conditions the model is quite robust with respect to the choice of the utility function.

In this thesis the main goal is to develop and analyze a model for pricing options when the market is incomplete due to the presence of jumps in the stock dynamics and transaction costs. The topics of the thesis are based on the articles [Cantarutti and Guerra, 2018], [Cantarutti et al., 2018] and on the contributed chapter [Cantarutti et al., 2017], published in the book of [Ehrhardt et al., 2017].

Portfolio selection models with transaction costs and Lévy processes have already been introduced in the financial literature, see for instance [Framstad et al., 1999], [Benth et al., 2001] and [De Vallière et al., 2016], but these models have never been used to price options.

In this thesis we present a model that is a generalization of [Davis et al., 1993]. We analyze the theoretical properties of the model, and prove the existence of a viscosity solution of the nonlinear Partial Integro-Differential Equation (PIDE) associated with the optimization problem. We also develop numerical methods to solve the problem under different assumptions, i.e. ignoring the default event and not. We present new numerical results and compare them with numerical values obtained from standard reference models. We also prove that the proposed numerical scheme is monotone, stable and consistent, and its solution converges to the viscosity solution of the continuous problem.

In Chapter 1, we introduce the general theory of Lévy processes, with a deeper focus on the specific Lévy processes used in this thesis i.e. the *Merton* and *Variance Gamma* processes. In Chapter 2 we make a small summary of the main assumptions and theorems of the *No arbitrage theory* for derivative pricing. After that we present the most common numerical finite differences methods used to solve the option pricing PIDEs. The Chapter 3 is a digression based on the paper [Cantarutti and Guerra, 2018] on the applications of the multinomial method to solve option pricing problems under the Variance Gamma model. In Chapter 4 we present the optimal control theory for regular and singular controls, and the definition of viscosity solution. In Chapter 5, we will develop the model for option pricing in presence of proportional

transaction costs. This model is a singular stochastic control problem, which is a generalization of the model proposed in [Davis et al., 1993]. We derive the HJB equation associated with the optimization problem, and prove that the value function can be interpreted as the viscosity solution of this HJB equation. In Chapter 6 we describe the numerical methods used to solve the optimization problems introduced in Chapter 5, and present several numerical results. In the first part of the chapter, we consider the simplified problem where the number of variables is reduced by one, thanks to the assumption of no default and the property of the exponential utility. These topics are also analyzed in [Cantarutti et al., 2018] and [Cantarutti et al., 2017].

In the end of the chapter, we solve the general problem with four variables, considering the possibility of default. We also show that the moment matching method developed for the Variance Gamma process, can be applied to these kind of problems with good performances.

At the end of each chapter we provide a conclusive section containing a summary of the main presented concepts, and their relevance for the thesis.

## Modeling with Lévy Processes

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In mathematical finance, Lévy processes are a powerful tool to describe the observed reality of financial markets. Usually it is common to model the market dynamics in a continuous time setting by means of the *log-returns*



$$\log S_{t+\Delta t} - \log S_t = \log \left( \frac{S_{t+\Delta t}}{S_t} \right), \quad (1.1)$$

where  $S_t$  is the spot price of a financial asset at time  $t$ .

Log-returns are preferred to the *relative price change*  $(S_{t+\Delta t} - S_t)/S_t$ , because the sum of log-returns over  $n$  consecutive periods is the log-return of the period  $n\Delta t$ . The reason to use the log-returns rather than modeling directly the prices  $\{S_t\}_{t \geq 0}$ , is that they have better statistical properties. Furthermore, log-returns can assume negative values, and thus can be modeled by distributions with “nicer” analytical properties.

Since the renowned paper of [Black and Scholes, 1973], a common assumption is that  $t$ -log-returns are normally distributed as  $\mathcal{N}(\mu t, \sigma^2 t)$ . This is largely due to the fact that the normal distribution as well as the continuous-time process it generates (Brownian motion) has nice analytical properties. Under this assumption, the dynamics of log-returns follows the Brownian motion process

$$\log \left( \frac{S_t}{S_0} \right) = \mu t + \sigma W_t, \quad (1.2)$$

with constant drift  $\mu \in \mathbb{R}$  and constant volatility  $\sigma > 0$ .

This model guarantees positiveness of the prices. By Itô formula, we obtain the stochastic differential equation for the price

$$\frac{dS_t}{S_t} = \left( \mu + \frac{1}{2} \sigma^2 \right) dt + \sigma dW_t. \quad (1.3)$$

The process  $S_t$  is called *geometric Brownian motion*.

By the way, a thorough look at data collections from various areas of finance, reveals that the normality assumption is not a very good approximation of reality. Indeed, empirical return distributions have substantially more mass around the origin and along the tails (*heavy tails*), see [Cont, 2001]. This means that the normal distribution underestimates the probability of large positive and negative returns. In the real market instead, returns manifest frequently high peaks, that come more and more evident when looking at short time scales. The return peaks correspond to sudden large changes in the price, that cannot be reproduced by the dynamics of the Brownian motion.

The Brownian motion, which is a scale invariant process with continuous paths, can be a good approximation for long time scales ( $\Delta t \sim$  months to years), but is not a good model to reproduce the peaks of the log-returns at short time scales.

In the last thirty years, a lot of research has been done on processes with jumps and their applications to financial derivatives.

Lévy processes belong to the bigger family of semimartingales. If  $\{X_t\}_{t \geq 0}$  is a Lévy process, there are relevant quantities such as the stochastic integral

$\int_0^t \phi dX_t$  or any non-linear function  $f(t, X_t)$  that are not Lévy processes anymore. For some applications it is important to consider the larger class of processes of *semimartingales*, which is closed with respect to integration and non-linear transformations. A general theory for semimartingales, is presented in the books of [Protter, 2004] and [Jacod and Shiryaev, 2002]. [Sato, 1999] is a complete reference book for the theory of Lévy processes and their analytical properties. [Applebaum, 2009] presents Lévy processes with more emphasis on stochastic calculus and stochastic differential equations (SDEs). For a comprehensive guide to applications of Lévy processes in finance some good sources are the books of [Cont and Tankov, 2003] and [Schoutens, 2003].

Among the most popular Lévy processes applied to finance, it is worth to mention:

- the Merton jump-diffusion model [Merton, 1976]
- the Kou jump-diffusion model [Kou, 2002]
- the  $\alpha$ -stable [Mandelbrot, 1963], [Cont et al., 1997], [Kabasinskas et al., 2009]
- the Variance-Gamma (VG) [Madan and Seneta, 1990], [Madan et al., 1998]
- the Normal-Inverse-Gaussian (NIG) [Barndorff-Nielsen, 1997]
- hyperbolic Lévy processes [Eberlein and Keller, 1995]
- Carr-Geman-Madan-Yor (CGMY) model [Carr et al., 2002]

This chapter reviews the most important points concerning the theory of Lévy processes and the stochastic calculus applied to jump processes. A remarkable emphasis is given to the presentation of the exponential Lévy models used in this thesis: the *Merton model* and the *Variance Gamma model*.

## 1.1 Properties of Lévy processes

### 1.1.1 Basic definitions

Let  $\{X_t\}_{t \geq 0}$  be a stochastic process taking values in  $\mathbb{R}^n$ , defined on a probability space  $(\Omega, \mathcal{F}, \{\mathcal{F}_t\}_{t \geq 0}, \mathbb{P})$ , where we assume  $\{\mathcal{F}_t\}_{t \geq 0}$  is the natural filtration<sup>1</sup>.

---

<sup>1</sup>The natural filtration is defined as  $\mathcal{F}_t = \sigma\{X_s : 0 \leq s \leq t\}$ . Any process  $\{X_t\}_{t \geq 0}$  is adapted to its own filtration.

**Definition 1.1.1.** We say that  $\{X_t\}_{t \geq 0}$  is a **Lévy Process** if the following conditions hold:

(L1)  $X_0 = 0$ .

(L2)  $\{X_t\}_{t \geq 0}$  has independent increments i.e.  $X_t - X_s$  is independent of  $\mathcal{F}_s$  for any  $t > s \geq 0$ .

(L3)  $\{X_t\}_{t \geq 0}$  has stationary increments i.e. for any  $s, t \geq 0$ , the distribution of  $X_{t+s} - X_t$  does not depend on  $t$ .

(L4)  $\{X_t\}_{t \geq 0}$  is stochastically continuous:  $\forall \epsilon > 0$  and  $\forall t \geq 0$

$$\lim_{h \rightarrow 0} \mathbb{P}(|X_{t+h} - X_t| > \epsilon) = 0.$$

It is well known (see [Protter, 2004] Chapter 1, Theorem 30) that a Lévy process has a modification with “càdlàg” paths, i.e. paths which are right-continuous and have left limits.

Lévy processes are intrinsically connected with infinitely divisible distributions. In particular the Lévy-Khintchine formula for infinitely divisible random variables, is an essential tool for the classification of the Lévy processes by the form of their characteristic functions.

In the following, let us present some basic definitions. In  $\mathbb{R}^n$  we indicate a vector of random variables with  $X = (X^1, \dots, X^n)$ .<sup>2</sup>

**Definition 1.1.2.** Let  $X$  be a random variable taking values in  $\mathbb{R}^n$ . The **Characteristic function**  $\phi_X : \mathbb{R}^n \rightarrow \mathbb{C}$  of  $X$ , is defined by

$$\begin{aligned} \phi_X(u) &= \mathbb{E}[e^{i(u, X)}] \\ &= \int_{\Omega} e^{i(u, X)} \mathbb{P}(d\omega) \\ &= \int_{\mathbb{R}^n} e^{i(u, x)} f_X(dx). \end{aligned} \tag{1.4}$$

for each  $u \in \mathbb{R}^n$ . We indicated with  $f_X$  the **probability density function (pdf)** of  $X$ .

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<sup>2</sup> Let us recall some basic definitions. We denote the inner product for  $x, y \in \mathbb{R}^n$  by

$$(x, y) := \sum_{i=1}^n x_i y_i,$$

and the Euclidean norm by

$$|x| := \sqrt{(x, x)}.$$

For each  $1 \leq j \leq n$  and  $p \in \mathbb{N}$ , if  $\mathbb{E}[|(X^j)^p|] < \infty$ , then

$$\mathbb{E}\left[(X^j)^p\right] = i^{-p} \frac{\partial^p}{\partial u_j^p} \phi_X(u) \Big|_{u=0}. \quad (1.5)$$

With this property it is straightforward to compute the moments of each component of the random vector, as long as we know the analytic form of the characteristic function. The following properties hold for all  $p > 0$ :

- $\mathbb{E}[|X|^p] < \infty$  if and only if  $\mathbb{E}[|(X^j)|^p] < \infty$  for each  $1 \leq j \leq n$ .
- If  $\mathbb{E}[|X|^p] < \infty$  then  $\mathbb{E}[|X|^q] < \infty$  for all  $0 < q < p$ .

For more information see Sections 1.1.2 and 1.1.6 of [Applebaum, 2009].

**Definition 1.1.3.** Let  $X$  be a random variable taking values in  $\mathbb{R}^n$ . We say that  $X$  is **infinitely divisible** if for all  $m \in \mathbb{N}$  there exist i.i.d. random variables  $X_1^{(m)}, \dots, X_m^{(m)}$  such that

$$X \stackrel{d}{=} X_1^{(m)} + \dots + X_m^{(m)}. \quad (1.6)$$

The superscript  $(m)$  is to remember that the random variables depend on the initial choice of  $m \in \mathbb{N}$ .

**Theorem 1.1.1.** A Lévy process  $\{X_t\}_{t \geq 0}$  is infinitely divisible for each  $t \geq 0$ .

*Proof.* For each  $n \in \mathbb{N}$  we can write

$$X_t = (X_1^{(m)})_t + \dots + (X_m^{(m)})_t$$

where  $(X_k^{(m)})_t = X_{\frac{kt}{m}} - X_{\frac{(k-1)t}{m}}$  are i.i.d. by Definition 1.1.1. □

The opposite implication also holds.

**Theorem 1.1.2.** Every infinitely divisible distribution is the distribution of a Lévy process.

A proof of the previous theorem can be found in [Applebaum, 2009] (Corollary 1.4.6).

Other properties of infinitely divisible distribution and connections with Lévy processes can be found in Chapter 2 of [Sato, 1999].

### 1.1.2 Lévy-Khintchine representation

We now present a beautiful formula, first established by Paul Lévy and A.Ya. Khintchine in the 1930s which gives a characterization of every infinitely divisible random variable.

**Definition 1.1.4.** Let  $\nu(dx)$  be a Borel measure defined in  $\mathbb{R}^n$ . We say it is a **Lévy measure** if it satisfies

$$\nu(\{0\}) = 0, \quad (1.7)$$

$$\int_{\mathbb{R}^n} (1 \wedge x^2) \nu(dx) < \infty. \quad (1.8)$$

The characteristic function of an infinitely divisible random variable has the following **Lévy Khintchine representation**:

**Theorem 1.1.3.** Let  $X$  be an infinitely divisible random variable. Then there exist  $b \in \mathbb{R}^n$ , a positive definite  $n \times n$  matrix  $A$  and a Lévy measure  $\nu$  on  $\mathbb{R}^n$ , such that  $\forall u \in \mathbb{R}^n$ :

$$\begin{aligned} \phi_X(u) &= \mathbb{E}[e^{i(u,X)}] \\ &= e^{\eta(u)} \\ &= \exp \left[ \left( i(b, u) - \frac{1}{2}(u, Au) + \int_{\mathbb{R}^n} (e^{i(u,x)} - 1 - i(u, x) \mathbb{1}_{(|x|<1)}(x)) \nu(dx) \right) \right]. \end{aligned} \quad (1.9)$$

A proof can be found in [Applebaum, 2009] (Theorem 1.2.14). We call the map  $\eta : \mathbb{R}^n \rightarrow \mathbb{C}$ , the **Lévy symbol**.

Now we can easily find the Lévy Khintchine representation for a Lévy process

**Theorem 1.1.4.** If  $\{X_t\}_{t \geq 0}$  is a Lévy process, then

$$\phi_{X_t}(u) = e^{t\eta(u)}, \quad (1.10)$$

where  $\eta$  is the Lévy symbol of the random variable  $X_t$  at  $t = 1$ .

For a proof of this theorem see Theorem 1.3.3 in [Applebaum, 2009]. The triplet  $(b, A, \nu)$  is called **Lévy triplet**, and completely characterizes the Lévy process.

### 1.1.3 Random measures

A convenient tool for analyzing the jumps of a Lévy process is the random measure of the jumps. The jump process  $\{\Delta X_t\}_{t \geq 0}$  associated to the Lévy process  $\{X_t\}_{t \geq 0}$  is defined, for each  $t \geq 0$ , by

$$\Delta X_t = X_t - X_{t-} \quad (1.11)$$

where  $X_{t-} = \lim_{s \uparrow t} X_s$ .

In the following, we indicate with  $\mathcal{B}(\mathbb{R}^n)$  the Borel  $\sigma$ -algebra of  $\mathbb{R}^n$ , i.e. the smallest  $\sigma$ -algebra of subsets of  $\mathbb{R}^n$  that contains all the open sets.

**Definition 1.1.5.** Consider a set  $A \in \mathcal{B}(\mathbb{R}^n \setminus \{0\})$ . We define the **random measure** of the jumps of the process  $\{X_t\}_{t \geq 0}$  by

$$\begin{aligned} N^X(t, A)(\omega) &= \#\{s \in [0, t] : \Delta X_s(\omega) \in A\} \\ &= \sum_{0 \leq s \leq t} \mathbb{1}_A(\Delta X_s(\omega)). \end{aligned} \quad (1.12)$$

For each  $\omega \in \Omega$  and for each  $0 \leq t < \infty$ , the map

$$A \rightarrow N^X(t, A)(\omega)$$

is a counting measure on  $\mathcal{B}(\mathbb{R}^n \setminus \{0\})$ .

We say that  $A \in \mathcal{B}(\mathbb{R}^n \setminus \{0\})$  is *bounded below* if  $0 \notin \bar{A}$  (zero does not belong to the closure of  $A$ ).

- For each  $A$  bounded below, the process  $\{N^X(t, A)(\omega)\}_{t \geq 0}$  is a Poisson process with intensity

$$\mu(A) = \mathbb{E}[N^X(1, A)] \quad (1.13)$$

- If  $A_1, \dots, A_m \in \mathcal{B}(\mathbb{R}^n \setminus \{0\})$  are disjoint and bounded below and  $t_1, \dots, t_m \in \mathbb{R}^+$  are distinct, then the random variables  $N(t_1, A_1), \dots, N(t_m, A_m)$  are independent.

(see [Applebaum, 2009] Theorem 2.3.5).

A random measure satisfying the properties above is called **Poisson random measure**.

If  $A$  is not bounded below, it is possible to have  $\mu(A) = \infty$ .

We can also define the **Compensated Poisson random measure**. For each  $t \geq 0$  and  $A$  bounded below, let us define:

$$\tilde{N}(t, A) = N(t, A) - t\mu(A). \quad (1.14)$$

This is a martingale-valued measure, i.e. for each  $A$  the process  $\{\tilde{N}(t, A)\}_{t \geq 0}$  is a martingale.

Now we can define the integration with respect to a random measure:

**Definition 1.1.6.** Let  $N$  be the Poisson random measure associated to a Lévy process  $\{X_t\}_{t \geq 0}$ , and let  $f : \mathbb{R}^n \rightarrow \mathbb{R}^n$  be a Borel-measurable function. For any  $A$  bounded below, we define the **Poisson integral** of  $f$  as

$$\int_A f(x) N(t, dx)(\omega) = \sum_{x \in A} f(x) N(t, \{x\})(\omega). \quad (1.15)$$

Since  $N(t, \{x\}) \neq 0 \Leftrightarrow \Delta X_s = x$  for at least one  $s \in [0, t]$ , we have

$$\int_A f(x) N(t, dx)(\omega) = \sum_{0 \leq s \leq t} f(\Delta X_s) \mathbb{1}_A(\Delta X_s). \quad (1.16)$$

The Poisson integral has the following important properties:

**Theorem 1.1.5.** *For  $t \geq 0$  and for any  $A$  bounded below, the random variable  $\int_A f(x) N(t, dx)$  has the characteristic function*

$$\mathbb{E} \left[ \exp \left( iu \int_A f(x) N(t, dx) \right) \right] = \exp \left( t \int_{\mathbb{R}^n} [e^{iux} - 1] \mu_{A,f}(dx) \right), \quad (1.17)$$

where  $\mu_{A,f}(B) = \mu(A \cap f^{-1}(B))$  for each  $B \in \mathcal{B}(\mathbb{R}^n)$ .

This is the Theorem 2.3.7 in [Applebaum, 2009]. By differentiation (see eq. 1.5) we can derive:

$$\mathbb{E} \left[ \int_A f(x) N(t, dx) \right] = t \int_A f(x) \mu(dx) \quad \text{for } f \in L^1(A, \mu_A), \quad (1.18)$$

$$\text{Var} \left[ \left| \int_A f(x) N(t, dx) \right| \right] = t \int_A |f(x)|^2 \mu(dx) \quad \text{for } f \in L^2(A, \mu_A). \quad (1.19)$$

For  $f \in L^1(A, \mu_A)$ , we can also define the **compensated Poisson integral**

$$\int_A f(x) \tilde{N}(t, dx) := \int_A f(x) N(t, dx) - t \int_A f(x) \mu(dx), \quad (1.20)$$

The random variable  $\int_A f(x) \tilde{N}(t, dx)$  has characteristic function

$$\mathbb{E} \left[ \exp \left( i(u, \int_A f(x) \tilde{N}(t, dx)) \right) \right] = \exp \left( t \int_{\mathbb{R}^n} [e^{i(u,x)} - 1 - i(u,x)] \mu_{A,f}(dx) \right). \quad (1.21)$$

for each  $B \in \mathcal{B}(\mathbb{R}^n)$ .

The process  $\{\int_A f(x) \tilde{N}(t, dx)\}_{t \geq 0}$  is a martingale. For  $f \in L^2(A, \mu_A)$  it holds

$$\text{Var} \left[ \left| \int_A f(x) \tilde{N}(t, dx) \right| \right] = t \int_A |f(x)|^2 \mu(dx). \quad (1.22)$$

**Theorem 1.1.6.** *The intensity measure  $\mu$  is a Lévy measure.*

See Corollary 2.4.12 in [Applebaum, 2009]. From here on, we always indicate the Lévy measure with the symbol  $\nu$ .

We can further define:

$$\int_{|x| < 1} f(x) \tilde{N}(t, dx) := \lim_{\epsilon \rightarrow 0} \int_{\epsilon < |x| < 1} f(x) \tilde{N}(t, dx), \quad (1.23)$$

that represents the compensated sum of small jumps.

### 1.1.4 Lévy-Itô decomposition

The following is a fundamental theorem which decomposes a general Lévy process in the superposition of independent processes: a drift term, a Brownian motion, a Poisson process with “big jumps” and a compensated Poisson process with “small jumps”.

**Theorem 1.1.7.** *Given a Lévy process  $\{X_t\}_{t \geq 0}$ , there exist  $b \in \mathbb{R}^n$ , a Brownian motion  $W^A$  with diffusion matrix  $A$ , and an independent Poisson random measure  $N$  on  $\mathbb{R}^+ \times \mathbb{R}^n$  such that*

$$X_t = bt + W_t^A + \int_{|x| < 1} x \tilde{N}(t, dx) + \int_{|x| \geq 1} x N(t, dx). \quad (1.24)$$

*This is called the **Lévy-Itô decomposition**.*

For a proof the reader can look at Theorem 2.4.16 in [Applebaum, 2009]. A lot of information on the features of a Lévy process can be derived from the integrability conditions of its Lévy measure. The next theorem shows that finiteness of moments depends only on the frequency of large jumps.

**Theorem 1.1.8.** *Let  $\{X_t\}_{t \geq 0}$  be a Lévy process with Lévy measure  $\nu$ . Then  $\{X_t\}_{t \geq 0}$  has finite  $p$ -moment i.e.  $\mathbb{E}[|X_t|^p] < \infty$  for  $p > 0$  and for all  $t \geq 0$ , if and only if  $\int_{|x| \geq 1} |x|^p \nu(dx) < \infty$ .*

For a proof we refer to [Applebaum, 2009] theorem 2.5.2. In [Sato, 1999] a stronger result is proved (Theorem 25.3).

**Theorem 1.1.9.** *Let  $\{X_t\}_{t \geq 0}$  be a Lévy process with Lévy measure  $\nu$ . Let  $g$  be a non-negative measurable function on  $\mathbb{R}^n$  satisfying the sub-multiplicative property<sup>3</sup>, then  $\{X_t\}_{t \geq 0}$  has finite  $g$ -moment i.e.  $\mathbb{E}[g(X)] < \infty$  for all  $t \geq 0$ , if and only if  $\int_{|x| > 1} g(x) \nu(dx) < \infty$ .*

The theorem 1.1.8 is a special case of the theorem 1.1.9 since  $g(x) = \max\{|x|, 1\}$  is sub-multiplicative. If we consider the sub-multiplicative function  $g(x) = e^{(p, x)}$  with  $p \in \mathbb{R}^n$ , it follows that  $\{X_t\}_{t \geq 0}$  has finite **exponential moment** if for all  $t \geq 0$ :

$$\mathbb{E}[e^{(p, X_t)}] < \infty \quad \Leftrightarrow \quad \int_{|x| \geq 1} e^{(p, x)} \nu(dx) < \infty. \quad (1.25)$$

See [Sato, 1999] theorem 25.17.

The majority of Lévy processes used in finance have finite moments. For practical reasons, it makes sense to assume finite mean and variance of the price process. In this thesis we will model (see Section 1.3) the 1-dimensional dynamics of the prices with the exponential of a Lévy process, i.e.  $S_t = S_0 e^{X_t}$ . Let us introduce the important assumption:

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<sup>3</sup>A function is said to be sub-multiplicative if  $\exists K > 0$  such that  $g(x+y) < Kg(x)g(y)$ .



Assumption **EM** :

In this thesis we consider only 1-dimensional Lévy processes with finite exponential second moment.

According to 1.25 with  $p = 2$  it follows that:

$$\mathbb{E}[S_t^2] < \infty \quad \Leftrightarrow \quad \int_{|x| \geq 1} e^{2x} \nu(dx) < \infty$$

The existence of the exponential 2-moment implies that  $\{X_t\}_{t \geq 0}$  has finite  $p$ -moment for all  $p \in \mathbb{N}$ .

If we assume that  $\{X_t\}_{t \geq 0}$  has finite first moment, we can simplify the Lévy-Itô formula, by adding the finite terms  $\pm \int_{|x| \geq 1} xt \nu(dx)$  to (1.24). The last term becomes a martingale and the new drift becomes  $b' = b + \int_{|x| \geq 1} x \nu(dx)$ .

The new decomposition has the form:

$$X_t = b't + W_t^A + \int_{\mathbb{R}^n} x \tilde{N}(t, dx). \quad (1.26)$$

The Lévy-Khintchine formula 1.10 becomes

$$\phi_X(u) = \exp \left[ t \left( i(u, b') - \frac{1}{2}(u, Au) + \int_{\mathbb{R}^n} (e^{i(u, x)} - 1 - i(u, x)) \nu(dx) \right) \right]. \quad (1.27)$$

Because in (1.26) the only non martingale term is the drift, we see that the drift term  $b' = \mathbb{E}[X_{t=1}]$ .

## 1.2 Infinitesimal Generator and stochastic calculus

Lévy processes belong to the big family of Markov processes. Therefore, all the general properties of Markov processes apply to Lévy processes as well. In this section, we do not go too deep in the big field of semigroups theory, but we just present the fundamental definitions and theorems necessary to define the infinitesimal generator of a Lévy process.

We also present the Itô formula for any Lévy stochastic integral, and the sufficient conditions for the existence of solutions of the SDEs considered in this chapter.

### 1.2.1 Infinitesimal generator of a Markov process

Let us denote with  $B_b(\mathbb{R}^n)$  the linear space of all bounded Borel measurable functions  $f : \mathbb{R}^n \rightarrow \mathbb{R}$ . Let  $C_b(\mathbb{R}^n)$  be the subspace of  $B_b(\mathbb{R}^n)$  containing continuous functions, and  $C_0(\mathbb{R}^n)$  be the subspace of  $C_b(\mathbb{R}^n)$  containing

continuous functions such that  $\lim_{|x| \rightarrow \infty} f(x) = 0$ . The spaces introduced above are all Banach spaces under the norm  $\|f\| = \sup\{|f(x)| : x \in \mathbb{R}^n\}$ . We also denote with  $C_0^n(\mathbb{R}^n)$  the set of  $f \in C_0(\mathbb{R}^n)$  such that  $f$  is  $n$  time differentiable and the partial derivatives of  $f$  with order  $\leq n$  belong to  $C_0(\mathbb{R}^n)$ .

Let us also recall some definitions of operators in a Banach space  $B$ . A linear operator  $\mathcal{L}$  is a mapping from a linear subspace  $D_{\mathcal{L}}$  of  $B$  into  $B$  such that

$$\mathcal{L}(af + bg) = a\mathcal{L}f + b\mathcal{L}g \quad f, g \in D_{\mathcal{L}} \quad a, b \in \mathbb{R}.$$

The set  $D_{\mathcal{L}}$  is the domain of  $\mathcal{L}$ . A linear operator is called bounded if  $D_{\mathcal{L}} = B$  and  $\|\mathcal{L}\| := \sup_{\|f\| \leq 1} \|\mathcal{L}f\|$  is finite. If the previous conditions are not satisfied, the operator is called unbounded.

**Definition 1.2.1.** Let  $\{X_t\}_{t \geq 0}$  be an adapted process on the probability space  $(\Omega, \mathcal{F}, \mathbb{P})$  equipped with a filtration  $\{\mathcal{F}_t\}_{t \geq 0}$ . We say that  $\{X_t\}_{t \geq 0}$  is a **Markov process** if for all  $f \in B_b(\mathbb{R}^n)$  and  $0 \leq s \leq t < \infty$

$$\mathbb{E}[f(X_t) | \mathcal{F}_s] = \mathbb{E}[f(X_t) | X_s]. \quad (1.28)$$

The property (1.28) is called **Markov property**. We can define the **stochastic evolution** of a Markov process as

$$(T_{s,t}f)(x) = \mathbb{E}[f(X_t) | X_s = x], \quad (1.29)$$

for every  $f \in B_b(\mathbb{R}^n)$  and  $0 \leq s \leq t < \infty$ . The family of operators  $T_{s,t} : B_b(\mathbb{R}^n) \rightarrow B_b(\mathbb{R}^n)$  satisfies

1.  $T_{s,t}$  is linear for each  $0 \leq s \leq t < \infty$ .
2.  $T_{s,s} = I$  for each  $s \geq 0$ .
3.  $T_{r,s}T_{s,t} = T_{r,t}$  for each  $0 \leq r \leq s \leq t < \infty$
4.  $f > 0 \Rightarrow T_{s,t}f > 0$ .
5.  $T_{s,t}$  is a contraction, i.e.  $\|T_{s,t}\| < 1$  for each  $0 \leq s \leq t < \infty$ .
6.  $T_{s,t}(1) = 1$ .

See Theorem 3.1.2 in [Applebaum, 2009]. An immediate consequence of condition 5 is that  $T_{s,t}$  is a bounded operator.

**Definition 1.2.2.** We can define the **transition probability** as the mapping  $p_{s,t}(x, B) : \mathbb{R}^n \times \mathcal{B}(\mathbb{R}^n) \rightarrow [0, 1]$ , with  $0 \leq s \leq t < \infty$  as:

$$p_{s,t}(x, B) := T_{s,t}\mathbb{1}_B(x) = P(X_t \in B | X_s = x). \quad (1.30)$$

It is related with the semigroup operator as follows:

$$(T_{s,t}f)(x) = \int_{\mathbb{R}^n} f(y)p_{s,t}(x, dy). \quad (1.31)$$

The transition probabilities satisfy the properties

1. The maps  $x \rightarrow p_{s,t}(x, A)$  are measurable for each  $A \in \mathcal{B}(\mathbb{R}^n)$ .
2.  $p_{s,t}(x, \cdot)$  is a probability measure on  $\mathcal{B}(\mathbb{R}^n)$  for each  $x \in \mathbb{R}^n$ .
3.  $p_{s,s}(x, B) = \mathbb{1}_B(x)$  for  $s \geq 0$ .
4. For  $0 \leq r \leq s \leq t$  it satisfies the **Chapman-Kolmogorov** equation

$$p_{r,t}(x, B) = \int_{\mathbb{R}^n} p_{r,s}(x, dy)p_{s,t}(y, B). \quad (1.32)$$

**Definition 1.2.3.** We say that the transition probability is **time homogeneous** if

$$p_{s,t}(x, B) = p_{0,t-s}(x, B). \quad (1.33)$$

**Definition 1.2.4.** We say that the transition probability is **translation invariant** if

$$p_{s,t}(x, B) = p_{s,t}(0, B - x), \quad (1.34)$$

where  $B - x = \{y - x : y \in B\}$ .

**Theorem 1.2.1.** Every Lévy process is a time homogeneous and translation invariant Markov process.

For a proof of this theorem, we refer to Theorems (10.4) and (10.5) in [Sato, 1999].

A Markov process is said to be time homogeneous if the associated stochastic evolution operator satisfies  $T_{s,t} = T_{0,t-s}$  for all  $0 \leq s \leq t < \infty$ . This is analogous to require that the transition probabilities are time homogeneous (can be verified by using (1.2.3) and (1.31)). We indicate the operator  $T_{0,t}$  as  $T_t$ . For a time homogeneous Markov process, the condition 3 for the stochastic evolution operators (1.29) becomes:

$$T_{s+t} = T_s T_t \quad \forall s, t \geq 0. \quad (1.35)$$

Any family of linear operators on a Banach space that satisfies (1.35) is called **semigroup**.

**Definition 1.2.5.** The operator  $T_t$  associated with a time homogeneous Markov process, is called **Feller semigroup** if:

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1.  $T_t : C_0(\mathbb{R}^n) \rightarrow C_0(\mathbb{R}^n)$  for all  $t \geq 0$ ,
2. The map  $t \rightarrow T_t$  with  $t \geq 0$  is strongly continuous at 0, i.e.

$$\lim_{t \downarrow 0} \|T_t f - f\| = 0.$$

The homogeneous Markov process associated with the Feller semigroup is called **Feller process**.

In the definition of Feller semigroup, we used the space  $C_0(\mathbb{R}^n)$  although some authors prefer to use  $C_b(\mathbb{R}^n)$ . The space  $C_0(\mathbb{R}^n)$  has nicer analytical properties than  $C_b(\mathbb{R}^n)$  and allows to prove important probabilistic theorems. In particular, when replacing  $C_0(\mathbb{R}^n)$  by  $C_b(\mathbb{R}^n)$ , the condition 2 above may fail.

**Definition 1.2.6.** The *infinitesimal generator*  $\mathcal{L}$  of the Feller semigroup  $T_t$  is defined by

$$\mathcal{L}f = \lim_{t \downarrow 0} \frac{T_t f - f}{t}. \quad (1.36)$$

The domain  $D_{\mathcal{L}}$  of  $\mathcal{L}$  is the subspace of  $C_0(\mathbb{R}^n)$  such that the limit above exists.

In general  $\mathcal{L}$  is a linear (possibly unbounded) operator. Among the many properties of the infinitesimal generator, it is possible to prove (see Hille-Yosida, Theorem 31.3 in [Sato, 1999]) that  $\mathcal{L}$  is closed and that  $D_{\mathcal{L}}$  is dense in  $C_0(\mathbb{R}^n)$ . For more information we refer to Chapter 1 of [Ethier and Kurtz, 2005].

The following theorem gives an explicit form for the infinitesimal generator of a general Lévy process.

**Theorem 1.2.2.** Let  $\{X_t\}_{t \geq 0}$  be a Lévy process with Lévy triplet  $(b, A, \nu)$ . Let  $T_t$  be the associated Feller-semigroup with generator  $\mathcal{L}$ . For each  $f \in C_0^2(\mathbb{R}^n)$ ,  $t \geq 0$ ,  $x \in \mathbb{R}^n$ ,  $\mathcal{L}$  has the form:

$$\begin{aligned} (\mathcal{L}f)(x) &= \sum_{j=1}^n b_j \frac{\partial f}{\partial x_j}(x) + \frac{1}{2} \sum_{i,j=1}^n A_{i,j} \frac{\partial^2 f}{\partial x_i \partial x_j}(x) \\ &\quad + \int_{\mathbb{R}^n} \left( f(x+y) - f(x) - \sum_{j=1}^n y_j \frac{\partial f}{\partial x_j}(x) \mathbb{1}_{\{|y| < 1\}}(y) \right) \nu(dy). \end{aligned} \quad (1.37)$$

A proof of this theorem can be found in [Sato, 1999] (Theorem 31.5).

In the more general framework of Section 4.1, we will show that for processes with finite second moment, the operator  $\mathcal{L}$  is well defined also for functions that do not vanish at infinity, but have polynomial growth (see Definition 2.1.7) of second order.

### 1.2.2 The Itô formula

Following Section 4.2.2 of [Applebaum, 2009], we call  $\mathcal{P}_2(T, E)$  with  $E \in \mathcal{B}(\mathbb{R}^n)$ , the set of all functions  $f : [0, T] \times E \times \Omega \rightarrow \mathbb{R}$  satisfying the two conditions:

1. Predictable<sup>4</sup>.
2.  $\mathbb{P}\left(\int_0^T \int_E |f(t, x)|^2 \nu(dx) dt < \infty\right) = 1$ .

An  $\mathbb{R}^n$  valued stochastic process  $\{Y_t\}_{t \geq 0}$  is a **Lévy stochastic integral** if it can be written as a superposition of an ordinary integral, an Itô integral and a Poisson and compensated Poisson integrals.

$$\begin{aligned} Y_t^i &= Y_0^i + \int_0^t G_s^i ds + \int_0^t F_s^i dW(s) \\ &\quad + \int_0^t \int_{|x| < 1} H^i(s, x) \tilde{N}(ds, dx) \\ &\quad + \int_0^t \int_{|x| \geq 1} K^i(s, x) N(ds, dx), \end{aligned} \tag{1.38}$$

for  $1 \leq i \leq n$  and  $t > 0$ .  $Y_0$  is a  $\mathcal{F}_0$ -measurable random variable. The expression (1.38) has the differential form

$$\begin{aligned} dY_t &= G_t dt + F_t dW_t \\ &\quad + \int_{|x| < 1} H(t, x) \tilde{N}(dt, dx) + \int_{|x| \geq 1} K(t, x) N(dt, dx). \end{aligned} \tag{1.39}$$

where we dropped the indexes and used the convention that integrals are taken on each component. In order for (1.38) to be well defined, for each  $1 \leq i \leq n$ , the processes  $|G_s^i|^{1/2}$  and  $F_s^i$  are in  $\mathcal{P}_2(T, \{0\})$ . The function  $H^i(s, x) \in \mathcal{P}_2(T, \{|x| < 1\})$  and  $K^i(s, x)$  have to be predictable.

Now let us introduce the most important formula in stochastic calculus: the **Itô's formula**.

**Theorem 1.2.3.** *If  $Y_t$  is the Lévy stochastic integral (1.38), for each  $f \in$*

---

<sup>4</sup>Given the probability space  $(\Omega, \mathcal{F}, \{\mathcal{F}_t\}_{t \in [0, T]}, \mathbb{P})$  and  $E \in \mathcal{B}(\mathbb{R}^n)$ . A function  $f : [0, T] \times E \times \Omega \rightarrow \mathbb{R}$  is said to be **predictable**, if for each  $0 \leq t \leq T$  the mapping  $(x, \omega) \rightarrow f(t, x, \omega)$  is  $\mathcal{B}(E) \otimes \mathcal{F}_t$ -measurable, and for each  $x \in E$  and  $\omega \in \Omega$  the mapping  $t \rightarrow f(t, x, \omega)$  is left-continuous.

If  $f$  is predictable, the process  $t \rightarrow f(t, x, \cdot)$  for each  $x \in E$ , is adapted.

$C^2(\mathbb{R}^n)$  we have

$$\begin{aligned}
df(Y_t) = & \sum_{j=1}^n \frac{\partial f}{\partial y_j}(Y_{t-}) G_t^j dt + \sum_{j=1}^n \frac{\partial f}{\partial y_j}(Y_{t-}) F_t^j dW_t \\
& + \frac{1}{2} \sum_{j=1}^n \frac{\partial^2 f}{\partial y_j^2}(Y_{t-}) (F_t^j)^2 dt \\
& + \int_{|x| \geq 1} [f(Y_{t-} + K(t, x)) - f(Y_{t-})] N(dt, dx) \\
& + \int_{|x| < 1} [f(Y_{t-} + H(t, x)) - f(Y_{t-})] \tilde{N}(dt, dx) \\
& + \int_{|x| < 1} [f(Y_{t-} + H(t, x)) - f(Y_{t-}) - \sum_{j=1}^n \frac{\partial f}{\partial y_j}(Y_{t-}) H^j(t, x)] \nu(dx) dt.
\end{aligned} \tag{1.40}$$

For a complete proof see [Applebaum, 2009] Theorem 4.4.7. The terms in the first two lines are the same as in the diffusion case. The other terms are due to the discontinuous part of the process.

Let us introduce also the **Itô product rule**.

**Theorem 1.2.4.** *If  $Y_t^1$  and  $Y_t^2$  are  $\mathbb{R}$ -valued stochastic integrals of the form (1.38), then for all  $t \geq 0$ , with probability 1 we have*

$$d(Y_t^1 \cdot Y_t^2) = Y_{t-}^1 dY_t^2 + Y_{t-}^2 dY_t^1 + d[Y_t^1, Y_t^2], \tag{1.41}$$

where the quadratic variation term is

$$\begin{aligned}
d[Y_t^1, Y_t^2] = & F_t^1 F_t^2 dt \\
& + \int_{|x| < 1} H^1(t, x) H^2(t, x) N(dt, dx) \\
& + \int_{|x| \geq 1} K^1(t, x) K^2(t, x) N(dt, dx).
\end{aligned}$$

The proof of this theorem can be obtained by a direct application of the Itô's formula (1.40) to the product of  $Y_t^1$  and  $Y_t^2$ . See Theorem 4.4.13 of [Applebaum, 2009].

The next theorem establishes the useful **Dynkin formula** for Lévy processes:

**Theorem 1.2.5.** *Let  $\{X_t\}_{t \geq 0}$  be a Lévy process, and let  $f \in C_0^2(\mathbb{R}^n)$ . Let  $\tau$  be a stopping time<sup>5</sup> such that  $\mathbb{E}_x[\tau] < \infty$ , then*

$$\mathbb{E}_x[f(X_\tau)] = f(x) + \mathbb{E}_x \left[ \int_0^\tau \mathcal{L}f(X_s) ds \right], \tag{1.42}$$

where  $\mathcal{L}$  is the infinitesimal generator as in eq. (1.37).

<sup>5</sup>A stopping time is a random variable  $\tau : \Omega \rightarrow \mathbb{R}_+$  such that  $\{w \in \Omega : \tau(w) \leq t\} \in \mathcal{F}_t$ .

*Proof.* This result comes by applying Itô's formula (1.40) to  $f(X_s)$ , integrating in  $[0, \tau]$  and taking expectation conditioned by  $X_0 = x$ .  $\square$

### 1.2.3 Existence and uniqueness

Let us consider, for simplicity, a time-homogeneous SDE like:

$$\begin{aligned} dY_t &= b(Y_{t-})dt + \sigma(Y_{t-})dW_t \\ &+ \int_{|x|<c} F(Y_{t-}, x)\tilde{N}(dt, dx) + \int_{|x|\geq c} G(Y_{t-}, x)N(dt, dx), \end{aligned} \quad (1.43)$$

with  $\{W_t\}_{t\geq 0}$  a  $d$ -dimensional Brownian motion. The functions  $b : \mathbb{R}^n \rightarrow \mathbb{R}^n$ ,  $\sigma : \mathbb{R}^n \rightarrow \mathbb{R}^{n \times d}$ ,  $F : \mathbb{R}^n \times \mathbb{R}^n \rightarrow \mathbb{R}^n$  and  $G : \mathbb{R}^n \times \mathbb{R}^n \rightarrow \mathbb{R}^n$  are measurable. The constant  $c \in [0, \infty]$  give us the freedom to specify the size of the big and small jumps. Usually, a common choice is  $c = 1$ , as we did for the differential form of a Lévy-type stochastic integral (1.39), and the Lévy-Itô decomposition (1.24). If we want to put both large and small jumps in the same integral, we choose  $c = \infty$  or  $c = 0$ .

Let us choose  $c = \infty$  and write the SDE in the following form:

$$\begin{aligned} dY_t &= b(Y_{t-})dt + \sigma(Y_{t-})dW_t \\ &+ \int_{\mathbb{R}^n} F(Y_{t-}, x)\tilde{N}(dt, dx). \end{aligned} \quad (1.44)$$

Let us introduce two conditions:

(C1) **Lipschitz condition** There exist  $K_1 > 0$ , such that  $\forall y_1, y_2 \in \mathbb{R}^n$ ,

$$\begin{aligned} |b(y_1) - b(y_2)| + \|\sigma(y_1) - \sigma(y_2)\| \\ + \int_{\mathbb{R}^n} |F(y_1, x) - F(y_2, x)|\nu(dx) \leq K_1|y_1 - y_2|. \end{aligned} \quad (1.45)$$

(C2) **Linear growth condition.** There exist  $K_2 > 0$ , such that  $\forall y \in \mathbb{R}^n$ ,

$$|b(y)|^2 + \|\sigma(y)\|^2 + \int_{\mathbb{R}^n} |F(y, x)|^2\nu(dx) \leq K_2(1 + |y|^2). \quad (1.46)$$

Where for every  $(d \times n)$  matrix, the norm is defined as

$$\|\sigma\|^2 = \sum_{i=1}^d \sum_{j=1}^n [\sigma_{i,j}]^2. \quad (1.47)$$

If  $\nu$  is finite, then condition **C2** is a consequence of **C1**. If it is possible to write  $F(y, x) = H(y)\rho(x)$ , with  $H$  Lipschitz and  $\rho$  satisfying:

$$\int_{\mathbb{R}^n} |\rho(x)|^2\nu(dx) < \infty, \quad (1.48)$$

then again the growth condition is a consequence of the Lipschitz condition.

**Theorem 1.2.6.** *Given the conditions **C1**, **C2**, there exists a unique strong solution  $Y_t$  of (1.44) with initial condition  $Y_{t=0} = Y_0$ . The process  $\{Y_t\}_{t \geq 0}$  is càdlàg and  $\mathcal{F}_t$ -adapted.*

A proof of existence and uniqueness based on Picard iteration, can be found in [Applebaum, 2009] (Theorem 6.2.3). For more information we refer to Chapter 3.2 of [Gihman and Skorohod, 1979] (Theorem 3.4) where the time inhomogeneous case is considered.

**Theorem 1.2.7.** *Let us consider the Feller semigroup associated with the Feller process described by the SDE (1.43). For each  $f \in C_0^2(\mathbb{R}^n)$ ,  $t \geq 0$ ,  $x \in \mathbb{R}^n$ , the infinitesimal generator  $\mathcal{L}$  has the form:*

$$\begin{aligned} (\mathcal{L}f)(x) = & \sum_{j=1}^n b_j(x) \frac{\partial f}{\partial x_j}(x) + \frac{1}{2} \sum_{i,j=1}^n A_{i,j}(x) \frac{\partial^2 f}{\partial x_i \partial x_j}(x) \\ & + \int_{|y| < c} \left( f(x + F(x, y)) - f(x) - \sum_{j=1}^n F^j(x, y) \frac{\partial f}{\partial x_j}(x) \right) \nu(dy) \\ & + \int_{|y| \geq c} \left( f(x + G(x, y)) - f(x) \right) \nu(dy). \end{aligned} \quad (1.49)$$

with  $A(x) = \sigma(x)\sigma^T(x)$ .

The proof can be obtained by the application of the Itô lemma, see Theorem 6.7.4 of [Applebaum, 2009], where the author also show that  $C_0^2(\mathbb{R}^n) \subseteq D_{\mathcal{L}}$ .

## 1.3 Exponential Lévy models

Finally we are able to generalize the equation (1.2) for the process of the log-returns<sup>6</sup>. We write:

$$\log \left( \frac{S_t}{S_0} \right) = X_t, \quad (1.50)$$

where  $X_t$  is a one dimensional Lévy process with triplet  $(b, \sigma^2, \nu)$ .

The name **exponential Lévy model** comes from the expression written as:

$$S_t = S_0 e^{X_t}, \quad (1.51)$$

---

<sup>6</sup> It is also possible to generalize the differential equation (1.3). The modified SDE is called *geometric Lévy process* and its solution is the *Doleans-Dade exponential* of a Lévy process. The two approaches are equivalent (see propositions 8.22 in [Cont and Tankov, 2003]). In this thesis we choose to use exponential Lévy models.



### 1.3.1 Exponential Lévy SDE

In order to obtain an SDE for the process (1.51), we apply Itô formula (1.40), and we consider the Lévy-Itô decomposition (1.24) for  $X_t$ , written in the differential form like (1.39).

$$\begin{aligned} dS_t &= S_0 e^{X_{t-}} b dt + S_0 e^{X_{t-}} \sigma dW_t + \frac{1}{2} S_0 e^{X_{t-}} \sigma^2 dt \\ &\quad + \int_{|x| \geq 1} (S_0 e^{X_{t-}+x} - S_0 e^{X_{t-}}) N(dt, dx) \\ &\quad + \int_{|x| < 1} (S_0 e^{X_{t-}+x} - S_0 e^{X_{t-}}) \tilde{N}(dt, dx) \\ &\quad + \int_{|x| < 1} (S_0 e^{X_{t-}+x} - S_0 e^{X_{t-}} - x S_0 e^{X_{t-}}) \nu(dx) dt. \end{aligned}$$

After some substitutions we can see that the resulting equation, as expected, is a generalization of the equation (1.3).

$$\begin{aligned} \frac{dS_t}{S_{t-}} &= (b + \frac{1}{2} \sigma^2) dt + \sigma dW_t \\ &\quad + \int_{|x| < 1} (e^x - x - 1) \nu(dx) dt \\ &\quad + \int_{|x| \geq 1} (e^x - 1) N(dt, dx) + \int_{|x| < 1} (e^x - 1) \tilde{N}(dt, dx). \end{aligned} \tag{1.52}$$

Thanks to the assumption **EM** (Section 1.1.4) we can simplify this equation. First we look at the integrability conditions:

- $\int_{|x| \geq 1} e^x \nu(dx) < \infty$  by **EM**.
- $\int_{|x| \geq 1} 1 \nu(dx) < \infty$  by Definition 1.1.4.

We can add and subtract  $\pm \int_{|x| \geq 1} (e^x - 1) \nu(dx) dt$  and obtain the final form

$$\begin{aligned} \frac{dS_t}{S_{t-}} &= \left( b + \frac{1}{2} \sigma^2 + \int_{\mathbb{R}} (e^x - 1 - x \mathbb{1}_{|x| < 1}) \nu(dx) \right) dt \\ &\quad + \sigma dW_t + \int_{\mathbb{R}} (e^x - 1) \tilde{N}(dt, dx). \end{aligned} \tag{1.53}$$

If we set

$$\mu := b + \frac{1}{2} \sigma^2 + \int_{\mathbb{R}} (e^x - 1 - x \mathbb{1}_{|x| < 1}) \nu(dx) \tag{1.54}$$

we have an SDE of type (1.44).

$$dS_t = \mu S_{t-} dt + \sigma S_{t-} dW_t + \int_{\mathbb{R}} S_{t-} (e^x - 1) \tilde{N}(dt, dx). \tag{1.55}$$

The same equation can be derived quickly by considering the Lévy-Itô form (1.26) for  $X_t$ :

$$\begin{aligned} dS_t &= S_0 e^{X_{t-}} \left( b + \int_{|x| \geq 1} x \nu(dx) \right) dt + S_0 e^{X_{t-}} \sigma dW_t + \frac{1}{2} S_0 e^{X_{t-}} \sigma^2 dt \\ &\quad + \int_{\mathbb{R}} (S_0 e^{X_{t-}+x} - S_0 e^{X_{t-}}) \tilde{N}(dt, dx) + \int_{\mathbb{R}} (S_0 e^{X_{t-}+x} - S_0 e^{X_{t-}} - x S_0 e^{X_{t-}}) \nu(dx) dt \\ &= S_{t-} \left[ \mu dt + \sigma dW_t + \int_{\mathbb{R}} (e^x - 1) \tilde{N}(dt, dx) \right]. \end{aligned}$$

It is easy to check that the coefficients of this equation satisfy the conditions (1.45)–(1.46). For this purpose let us define  $\rho(x) = e^x - 1$  and let us verify that it satisfies the integrability condition (1.48): We write

$$\int_{\mathbb{R}} (e^x - 1)^2 \nu(dx) = \int_{|x| \geq 1} (e^x - 1)^2 \nu(dx) + \int_{|x| < 1} (e^x - 1)^2 \nu(dx),$$

- For  $|x| \geq 1$  the three integrals  $\int_{|x| \geq 1} e^{2x} \nu(dx)$ ,  $\int_{|x| \geq 1} (-2e^x) \nu(dx)$ ,  $\int_{|x| \geq 1} \nu(dx)$  are finite by assumption **EM** and by (1.8).
- For  $|x| < 1$ :

$$(e^x - 1)^2 = x^2 \left( \frac{e^x - 1}{x} \right)^2 < x^2 (e - 1)^2.$$

The Definition 1.8 of Lévy measure says  $\int_{|x| < 1} |x|^2 \nu(dx) < \infty$ , so

$$\int_{|x| < 1} (e^x - 1)^2 \nu(dx) < (e - 1)^2 \int_{|x| < 1} |x|^2 \nu(dx) < \infty.$$

So we have checked that the equation (1.55) admits a unique solution which is given by the exponential Lévy process (1.51).

### 1.3.2 The Merton Model

The first jump-diffusion model for the log-prices is the *Merton model*, presented in [Merton, 1976]. In the same paper the author also obtains a closed form solution for the price of an European vanilla option. The Merton model describes the log-price evolution with a Lévy process with a nonzero diffusion component and a finite activity jump process with normal distributed jumps.

$$X_t = \bar{b}t + \sigma W_t + \sum_{i=1}^{N_t} Y_i, \quad (1.56)$$

where  $N_t$  is a Poisson random variable counting the jumps of  $X_t$  in  $[0, t]$ , and  $Y_i \sim \mathcal{N}(\alpha, \xi^2)$  represents the size of the jumps. Using the Poisson integral notation (Def. 1.1.6), the process

$$X_t = \bar{b}t + \sigma W_t + \int_{\mathbb{R}} x N(t, dx)$$

corresponds to the Lévy-Itô decomposition (1.24), where we defined the drift  $\bar{b} := b - \int_{|x| < 1} x \nu(dx)$ .

The Lévy measure of a finite activity Lévy process, can be factorized in the activity  $\lambda$  of the Poisson process and the pdf of the jump size:

$$\begin{aligned} \nu(dx) &= \lambda f_Y(dx), \\ &= \frac{\lambda}{\xi \sqrt{2\pi}} e^{-\frac{(x-\alpha)^2}{2\xi^2}} dx. \end{aligned}$$

such that  $\int_{\mathbb{R}} \nu(dx) = \lambda$ .

Since the term  $\int_{|x| < 1} x \nu(dx)$  is finite, the jump process has **finite variation**. However, the Merton model has infinite variation due to the presence of the diffusion component.

The Lévy exponent has the following form:

$$\eta(u) = i\bar{b}u - \frac{1}{2}\sigma^2 u^2 + \lambda \left( e^{i\alpha u - \frac{\xi^2 u^2}{2}} - 1 \right). \quad (1.57)$$

Using the formula for the moments (1.5) we obtain:

$$\begin{aligned} \mathbb{E}[X_t] &= t(\bar{b} + \lambda\alpha). \\ \text{Var}[X_t] &= t(\sigma^2 + \lambda\xi^2 + \lambda\alpha^2). \\ \text{Skew}[X_t] &= \frac{t\lambda(3\xi^2\alpha + \alpha^3)}{(\text{Var}[X_t])^{3/2}}. \\ \text{Kurt}[X_t] &= \frac{t\lambda(3\xi^3 + 6\alpha^2\xi^2 + \alpha^4)}{(\text{Var}[X_t])^2}. \end{aligned} \quad (1.58)$$

The stock price SDE (1.55) has the following form:

$$\frac{dS_t}{S_{t-}} = \bar{\mu}dt + \sigma dW_t + \int_{\mathbb{R}} (e^x - 1) \tilde{N}(dt, dx).^7 \quad (1.59)$$

with

$$\bar{\mu} := \bar{b} + \frac{1}{2}\sigma^2 + \int_{\mathbb{R}} (e^x - 1)\nu(dx).$$

---

<sup>7</sup>In the literature, the jump part is often indicated with the not rigorous notation  $(J-1)dN_t$ , where  $J$  is lognormal distributed and  $dN_t$  is the infinitesimal variation of the Poisson process.

### 1.3.3 The Variance Gamma process

The *variance gamma* process is a pure jump Lévy process with infinite activity. The first presentation with applications in finance is due to [Madan and Seneta, 1990]. The model presented in their paper is however a symmetric VG model, where there is only an additional parameter which controls the kurtosis, while the skewness is still not considered.

The non-symmetric VG process is described in [Madan et al., 1998] where a closed form solution for European vanilla options is also presented.

The VG process is obtained by time changing a Brownian motion with drift. The new time variable is a random variable  $T_t$  whose increments are Gamma distributed with density  $T_t \sim \Gamma(\mu t, \kappa t)$ <sup>8</sup>.

$$f_{T_t}(x) = \frac{\left(\frac{\mu}{\kappa}\right)^{\frac{\mu^2 t}{\kappa}}}{\Gamma\left(\frac{\mu^2 t}{\kappa}\right)} x^{\frac{\mu^2 t}{\kappa}-1} e^{-\frac{\mu x}{\kappa}}. \quad (1.60)$$

The process  $\{T_t\}_{t \geq 0}$  is called **subordinator**. In general a subordinator is a one dimensional Lévy process that is non-decreasing almost surely. Therefore it is consistent to be a time variable.

The characteristic function of  $T_t$  is:

$$\phi_{T_t}(u) = \left( \frac{1}{1 - i u \frac{\kappa}{\mu}} \right)^{\frac{\mu^2 t}{\kappa}}. \quad (1.61)$$

The Lévy measure is:

$$\nu^{T_t}(dx) = \begin{cases} \frac{\mu^2 e^{-\frac{\mu}{\kappa}x}}{\kappa x} dx, & \text{for } x > 0, \\ 0 & \text{otherwise.} \end{cases} \quad (1.62)$$

If we consider a Brownian motion with drift  $X_t = \theta t + \bar{\sigma} W_t$  and substitute the time variable with the gamma subordinator  $T_t \sim \Gamma(t, \kappa t)$  ( $\mu = 1$ ), we obtain the **variance gamma** process:

$$X_{T_t} = \theta T_t + \bar{\sigma} W_{T_t}. \quad (1.63)$$

It depends on three parameters:

- $\bar{\sigma}$ , the volatility of the Brownian motion
- $\kappa$ , the variance of the Gamma process

---

<sup>8</sup>Usually the Gamma distribution is parametrized by a shape and scale positive parameters  $X \sim \Gamma(\rho, \theta)$ . The random variable  $X_t \sim \Gamma(\rho t, \theta)$  has pdf  $f_{X_t}(x) = \frac{\theta^{-\rho t}}{\Gamma(\rho t)} x^{\rho t-1} e^{-\frac{x}{\theta}}$  and has  $\mathbb{E}[X_t] = \rho \theta t$  and  $\text{Var}[X_t] = \rho \theta^2 t$ . Here we use a parametrization as in [Madan et al., 1998] such that  $\mathbb{E}[X_t] = \mu t$  and  $\text{Var}[X_t] = \kappa t$ , so  $\theta = \frac{\kappa}{\mu}$ ,  $\rho = \frac{\mu^2}{\kappa}$ .

- $\theta$ , the drift of the Brownian motion

The VG is a process with **finite variation**. Every process with finite variation can be written as the difference of two increasing processes. In this case the two increasing processes are Gamma processes:

$$X_t = Y_t^p - Y_t^n, \quad (1.64)$$

with  $Y_t^p \sim \Gamma(\mu_p t, \kappa_p t)$  and  $Y_t^n \sim \Gamma(\mu_n t, \kappa_n t)$ . For the specific relation between the parameters  $\mu_p, \kappa_p, \mu_n, \kappa_n$  and  $\bar{\sigma}, \kappa, \theta$  we refer to [Madan et al., 1998].

The probability density function of  $X_t$  can be computed conditioning on the realization of  $T_t$ :

$$\begin{aligned} f_{X_t}(x) &= \int_y f_{X_t, T_t}(x, y) dy = \int_y f_{X_t|T_t}(x|y) f_{T_t}(y) dy \\ &= \int_0^\infty \frac{1}{\bar{\sigma} \sqrt{2\pi y}} e^{-\frac{(x-\theta y)^2}{2\bar{\sigma}^2 y}} \frac{y^{\frac{t}{\kappa}-1}}{\kappa^{\frac{t}{\kappa}} \Gamma(\frac{t}{\kappa})} e^{-\frac{y}{\kappa}} dy \\ &= \frac{2 \exp(\frac{\theta x}{\bar{\sigma}^2})}{\kappa^{\frac{t}{\kappa}} \sqrt{2\pi} \bar{\sigma} \Gamma(\frac{t}{\kappa})} \left( \frac{x^2}{2\bar{\sigma}^2 + \theta^2} \right)^{\frac{t}{2\kappa} - \frac{1}{4}} K_{\frac{t}{\kappa} - \frac{1}{2}} \left( \frac{1}{\bar{\sigma}^2} \sqrt{x^2 \left( \frac{2\bar{\sigma}^2}{\kappa} + \theta^2 \right)} \right), \end{aligned} \quad (1.65)$$

where the function  $K$  is a modified Bessel function of the second kind (see [Madan et al., 1998] for the computations).

The characteristic function can be obtained by conditioning too:

$$\begin{aligned} \phi_{X_t}(u) &= \left( 1 - i\kappa \left( u\theta + \frac{i}{2} \bar{\sigma}^2 u^2 \right) \right)^{-\frac{t}{\kappa}} \\ &= \left( 1 - i\theta\kappa u + \frac{1}{2} \bar{\sigma}^2 \kappa u^2 \right)^{-\frac{t}{\kappa}}. \end{aligned}$$

The VG Lévy measure is

$$\nu^{X_t}(dx) = \frac{e^{\frac{\theta x}{\bar{\sigma}^2}}}{\kappa |x|} \exp \left( -\frac{\sqrt{\frac{2}{\kappa} + \frac{\theta^2}{\bar{\sigma}^2}}}{\bar{\sigma}} |x| \right) dx, \quad (1.66)$$

and the Lévy exponent is

$$\eta(u) = -\frac{1}{\kappa} \log \left( 1 - i\theta\kappa u + \frac{1}{2} \bar{\sigma}^2 \kappa u^2 \right). \quad (1.67)$$

Using the formula for the moments (1.5) we obtain:

$$\begin{aligned}\mathbb{E}[X_t] &= t\theta. \\ \text{Var}[X_t] &= t(\bar{\sigma}^2 + \theta^2\kappa). \\ \text{Skew}[X_t] &= \frac{t(2\theta^3\kappa^2 + 3\bar{\sigma}^2\theta\kappa)}{(\text{Var}[X_t])^{3/2}}. \\ \text{Kurt}[X_t] &= \frac{t(3\bar{\sigma}^4\kappa + 12\bar{\sigma}^2\theta^2\kappa^2 + 6\theta^4\kappa^3)}{(\text{Var}[X_t])^2}.\end{aligned}\tag{1.68}$$

The Lévy-Itô decomposition (1.24) for any pure jump finite variation process i.e  $\int_{|x|<1} x\nu(dx) < \infty$ , can be written as

$$X_t = \tilde{b}t + \int_{\mathbb{R}} xN(t, dx)\tag{1.69}$$

with  $\tilde{b} = b - \int_{|x|<1} x\nu(dx)$ . We can apply the Itô formula to (1.51) to obtain the stock price SDE for a finite variation process:

$$\begin{aligned}\frac{dS_t}{S_{t-}} &= \tilde{b}dt + \int_{\mathbb{R}} (e^x - 1)N(dt, dx). \\ &= \left(b + \int_{\mathbb{R}} (e^x - 1 - x\mathbb{1}_{|x|<1}(x))\nu(dx)\right)dt + \int_{\mathbb{R}} (e^x - 1)\tilde{N}(dt, dx).\end{aligned}\tag{1.70}$$

Consider the process (1.63). We can take its expectation

$$\mathbb{E}[X_{T_t}] = \theta\mathbb{E}[T_t] + \bar{\sigma}\mathbb{E}[W_{T_t}] = \theta t,$$

which is equal to the expectation of (1.69). Using (1.18) we obtain

$$\begin{aligned}\mathbb{E}[X_t] &= \tilde{b}t + \mathbb{E}\left[\int_{\mathbb{R}} xN(t, dx)\right] \\ &= t\left(\tilde{b} + \int_{\mathbb{R}} x\nu(dx)\right),\end{aligned}\tag{1.71}$$

and therefore  $\tilde{b} = \theta - \int_{\mathbb{R}} x\nu(dx)$ .

We can compute the integral using the explicit formula (1.66) for the Lévy measure. Let us call

$$A = \frac{\theta}{\bar{\sigma}^2} \quad \text{and} \quad B = \frac{|\theta|}{\bar{\sigma}^2} \sqrt{1 + \frac{2\bar{\sigma}^2}{\kappa\theta^2}}$$

with  $A < B$ , and solve the integral:

$$\begin{aligned}\int_{\mathbb{R}} \frac{x}{\kappa|x|} e^{Ax-B|x|} &= \int_0^\infty \frac{1}{\kappa} e^{(A-B)x} - \int_{-\infty}^0 \frac{1}{\kappa} e^{(A+B)x} \\ &= \frac{1}{\kappa} \frac{2A}{B^2 - A^2} \\ &= \theta.\end{aligned}$$

As expected,  $\tilde{b} = 0$ .

The Lévy-Itô decomposition for the VG process in (1.63) is simply

$$X_t = \int_{\mathbb{R}} x N(t, dx). \quad (1.72)$$

All the information is contained in the Lévy measure (1.66), which completely describes the process. Even if the process has been created by Brownian subordination, it has no diffusion component. The Lévy triplet is

$$\left( \int_{|x| < 1} x \nu(dx), 0, \nu \right). \quad (1.73)$$

The SDE for the stock price following an **exponential VG** is

$$\frac{dS_t}{S_{t-}} = \int_{\mathbb{R}} (e^x - 1) N(dt, dx). \quad (1.74)$$

### 1.3.4 Infinitesimal Generator for exponential Lévy processes

This section derives the infinitesimal generator for the stock price process under the *Merton* and the *Variance Gamma* models.

The stock price SDE (1.55), has the form (1.43) with  $c = \infty$ . Using (1.49), the corresponding infinitesimal generator is:

$$\begin{aligned} \mathcal{L}^S f(s) &= \mu s \frac{\partial f(s)}{\partial s} + \frac{1}{2} \sigma^2 s^2 \frac{\partial^2 f(s)}{\partial s^2} \\ &+ \int_{\mathbb{R}} \left[ f(se^x) - f(s) - s(e^x - 1) \frac{\partial f(s)}{\partial s} \right] \nu(dx). \end{aligned} \quad (1.75)$$

Let us derive the infinitesimal generators for the Merton and VG processes described by the SDEs (1.59) and (1.74):

- **Merton model generator:**

Under the representation with  $c = \infty$ , the 1-dim generator  $\mathcal{L}^M$  has the form:

$$\begin{aligned} (\mathcal{L}^M f)(s) &= \bar{\mu} s \frac{\partial f(s)}{\partial s} + \frac{1}{2} \sigma^2 s^2 \frac{\partial^2 f(s)}{\partial s^2} \\ &+ \int_{\mathbb{R}} (f(se^x) - f(s) - s(e^x - 1) \frac{\partial f(s)}{\partial s}) \nu(dx), \end{aligned} \quad (1.76)$$

with

$$\bar{\mu} = \bar{b} + \frac{1}{2} \sigma^2 + m$$

and we defined the parameter

$$m := \int_{\mathbb{R}} (e^x - 1) \nu(dx) = \lambda \left( e^{\alpha + \frac{1}{2} \xi^2} - 1 \right). \quad (1.77)$$

Under the equivalent representation with  $c = 0$ , the generator is:

$$\begin{aligned} (\mathcal{L}^M f)(s) &= \left( \bar{b} + \frac{1}{2} \sigma^2 \right) s \frac{\partial f(s)}{\partial s} + \frac{1}{2} \sigma^2 s^2 \frac{\partial^2 f(s)}{\partial s^2} \\ &+ \int_{\mathbb{R}} (f(se^x) - f(s)) \nu(dx). \end{aligned} \quad (1.78)$$

• **Variance Gamma generator:**

Using the representation with  $c = 0$ , the generator  $\mathcal{L}^{VG}$  is:

$$(\mathcal{L}^{VG} f)(s) = \int_{\mathbb{R}} (f(se^x) - f(s)) \nu(dx). \quad (1.79)$$

Under  $c = \infty$  we obtain the equivalent form:

$$(\mathcal{L}^{VG} f)(s) = ws \frac{\partial f(s)}{\partial s} + \int_{\mathbb{R}} \left( f(se^x) - f(s) - s(e^x - 1) \frac{\partial f(s)}{\partial s} \right) \nu(dx), \quad (1.80)$$

where we introduced the new parameter

$$w := \int_{\mathbb{R}} (e^x - 1) \nu(dx) = -\frac{1}{\kappa} \log \left( 1 - \theta \kappa - \frac{1}{2} \bar{\sigma}^2 \kappa \right). \quad (1.81)$$

In order to calculate the integral, we use the following relation between the Lévy measure and the transition probability (1.2.2) of the process:

$$\nu(dx) = \lim_{t \rightarrow 0} \frac{1}{t} p_{0,t}(0, dx). \quad (1.82)$$

This relation is presented by [Cont and Tankov, 2003] in Chapter 3.6, and a proof can be found in Corollary 8.9 of [Sato, 1999].

Let us compute first the expected value of the exponential VG process

$$\begin{aligned} \mathbb{E}[e^{X_t}] &= \phi_{X_t}(-i) = \exp \left( -\frac{t}{\kappa} \log(1 - \theta \kappa - \frac{1}{2} \bar{\sigma}^2 \kappa) \right) \\ &= e^{wt} \end{aligned}$$

where we called  $w = -\frac{1}{\kappa} \log(1 - \theta \kappa - \frac{1}{2} \bar{\sigma}^2 \kappa)$ . The integral becomes

$$\begin{aligned} \int_{\mathbb{R}} (e^x - 1) \nu(dx) &= \int_{\mathbb{R}} (e^x - 1) \lim_{t \rightarrow 0} \frac{1}{t} p_{0,t}(0, dx) \\ &= \lim_{t \rightarrow 0} \frac{1}{t} \mathbb{E}[e^{X_t} - 1] \\ &= w. \end{aligned}$$

Remember that since the VG has finite variation, the integral is finite because the integrand is  $e^x - 1 = x + \mathcal{O}(x^2)$ , so we can always take the limit outside the integral.



## 1.4 Cumulants

The cumulant generating function  $H_{X_t}(u)$  of  $X_t$  is defined as the natural logarithm of its characteristic function (see [Cont and Tankov, 2003]). Using the Lévy-Khintchine representation for the characteristic function (1.10), it is easy to find its relation with the Lévy symbol:

$$\begin{aligned} H_{X_t}(u) &= \log(\phi_{X_t}(u)) \\ &= t\eta(u) \\ &= \sum_{n=1}^{\infty} c_n \frac{(iu)^n}{n!} \end{aligned} \quad (1.83)$$

The **cumulants** of a Lévy process are thus defined by

$$c_n = \frac{t}{i^n} \frac{\partial^n \eta(u)}{\partial u^n} \Big|_{u=0}. \quad (1.84)$$

The cumulants are closely related to the central moments  $\mu_n$ :

$$\mu_0 = 1, \quad \mu_1 = 0, \quad \mu_n = \sum_{k=1}^n \binom{n-1}{k-1} c_k \mu_{n-k} \quad \text{for } n > 1. \quad (1.85)$$

For a Poisson process with finite first  $n$  moments, all the information about the cumulants is contained inside the Lévy measure. Let us expand in Taylor series the exponential

$$e^{iux} \approx 1 + iux - \frac{u^2 x^2}{2} - \frac{i u^3 x^3}{3!} + \frac{u^4 x^4}{4!} + \dots$$

The Lévy symbol corresponding to the representation (1.69), for a process with finite variation with  $\tilde{b} = b - \int_{|x|<1} x\nu(dx)$  becomes

$$\begin{aligned} t\eta(u) &= i\tilde{b}ut + t \int_{\mathbb{R}} (e^{iux} - 1)\nu(dx) \\ &= i\left(b - \int_{|x|<1} x\nu(dx)\right)ut + iut \int_{\mathbb{R}} x\nu(dx) - \frac{u^2}{2}t \int_{\mathbb{R}} x^2\nu(dx) \\ &\quad - \frac{i u^3}{3!}t \int_{\mathbb{R}} x^3\nu(dx) + \frac{u^4}{4!}t \int_{\mathbb{R}} x^4\nu(dx) + \dots \\ &= ic_1u - \frac{c_2u^2}{2} - \frac{ic_3u^3}{3!} + \frac{c_4u^4}{4!} + \dots \end{aligned} \quad (1.86)$$

with  $c_1 = t(b + \int_{|x|\geq 1} x\nu(dx))$ .

## 1.5 Chapter conclusions

In this chapter we present the main theoretical features of Lévy processes in a quite general setting. In this thesis we model the log-price dynamics by using stochastic differential equations involving Lévy processes. For this purpose it is important to present a complete framework containing all the tools needed in the next chapters. Starting with the basic definition of a Lévy process and the form of its characteristic function, we then introduce the concept of *random measures* which is a method to describe the jumps of the process, and the important *Lévy-Itô decomposition* that permits to decompose any Lévy process into the superposition of a Brownian motion with drift and two jump processes. We then introduce the assumption of finite exponential second moment, called assumption **EM**, which is recurrent throughout the thesis.

The concept of *infinitesimal generator* and the *Itô formula* are presented in a general form in Section 1.2, where we also discussed the hypothesis for the existence of a unique solution of the Lévy-type SDE. All these concepts are applied in Section 1.3 to the specific case of exponential Lévy processes. We derive the exponential Lévy SDE and the form of the infinitesimal generator associated to the process. These formulas are fundamental in the thesis and will be used several times in Chapter 2 for the derivation of the pricing PIDE, and in Chapter 5 for the derivation of the dynamic programming equation associated with the main problem of the thesis.

In the end of the chapter we introduce two of the most popular Lévy processes used in finance, i.e. the *Merton model* and the *Variance Gamma model*. They are used throughout the thesis as practical examples in the numerical calculations. In Chapter 2 we present the numerical solution of the Merton and VG pricing PIDEs and in Chapter 6 we solve numerically the pricing problem under transaction costs considering these two processes. Furthermore, the entire Chapter 3 is dedicated to the application of the multinomial method to the pricing problem under VG process.



## The martingale approach to option pricing

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In mathematical finance, one of the key issues is to find the fair price of a financial derivative. A financial derivative is a security whose value depends on the price of one or more basic securities such as stocks or bonds (the so called **underlying assets**). A **European call** option on a security with price process  $\{S_t\}_{t \geq 0}$ , is the right to buy the security at the predetermined exercise price  $K$  (also called **strike**). This right may be exercised at the expiration date  $T$  (also called **maturity**) of the option. The call option can be purchased at the price  $C_{t_0}$  at time  $t_0 = 0 < T$ . A **European put** option is similar, but gives the owner the right to sell the underlying asset at the strike price at maturity. In contrast to European options, **American options** can be exercised at any time between the writing and the expiration of the contract. The value of the option at the exercise time  $\tau$  such that  $0 \leq \tau \leq T$ , is called **payoff**, and has the form

$$\text{Call: } C_\tau = \max\{S_\tau - K, 0\}$$

$$\text{Put: } P_\tau = \max\{K - S_\tau, 0\}$$

Because of the max operator in the payoff, the options are nonlinear instruments.

Determining the correct price of an option is not a simple task. It requires a stochastic model for the dynamics of the underlying price and several assumptions on the market. The solution of this problem has been presented for the first time in the celebrated paper [Black and Scholes, 1973]. The standard Black-Scholes (BS) model is built on the concept of **ideal market**, where all the following conditions are fulfilled:

1. *There are no arbitrage possibilities* (see Definition 2.1.3).
2. *Exists a risk free asset  $B$  with dynamics*

$$dB_t = r_t B_t dt \tag{2.1}$$

*where  $r_t$  is the deterministic risk free interest rate.*

3. *It is possible to borrow and lend any amount of cash, even fractional, at the risk free rate.*
4. *It is possible to buy and sell any amount, even fractional, of the stock. This includes short selling.*
5. *The market is frictionless.*
6. *For  $\mu \in \mathbb{R}$  and  $\sigma > 0$ , the underlying stock process  $\{S_t\}_{t \geq 0}$  follows the geometric Brownian motion*

$$\frac{dS_t}{S_t} = \mu dt + \sigma dW_t. \tag{2.2}$$

7. *The stock does not pay dividends.*

This is a modern formulation, taken from [Musiela and Rutkowski, 2005], of the original assumptions presented in the article [Black and Scholes, 1973]. By relaxing one or more of the previous hypothesis, it is possible to develop new models that usually are generalizations of the standard BS model. For instance, it is common to relax the hypothesis (7) in order to extend the model to stocks that pay dividends. In this thesis we will not do it.

The hypothesis of *frictionless market* implies that the cost of trading is zero. This means that: all investors are price takers (no market impact), all parties have the same access to the relevant information, there are no transaction costs or commissions, and all assets are assumed to be perfectly divisible and liquid. Transaction costs can be divided in two categories: costs that are proportional to the price of the traded security, and fixed costs.

In this thesis we relax the hypothesis (5) by introducing proportional transaction costs, and the hypothesis (6) by replacing the geometric Brownian motion with an exponential Lévy process.

In this chapter, we present the basic concepts of the “No-arbitrage” pricing theory and the numerical algorithms based on the finite difference method. We will see that the pricing model can always be represented by a partial integro-differential equation (PIDE) when the stock dynamics follows an exponential Lévy process.

## 2.1 No arbitrage theory

All the mathematical framework for derivative pricing is based on the concept of **No-Arbitrage**.

It is convenient to introduce some useful definitions.

**Definition 2.1.1.** *Let us consider a financial market containing a stock with price process  $\{S_t\}_{t \geq 0}$  defined on the probability space  $(\Omega, \mathcal{F}, \{\mathcal{F}_t\}_{t \geq 0}, \mathbb{P})$ .*

*A **financial derivative** (or contingent claim)<sup>1</sup> with maturity  $T$  is any  $\mathcal{F}_T$ -measurable random variable  $\mathcal{X}$ .*

*A financial derivative is called “simple” if it is of the form  $\mathcal{X} = \Phi(S_T)$ . The function  $\Phi$  is called the **payoff**.*

We see that European call and put options are simple financial derivatives. All European path dependent options are examples of non-simple derivatives. In thesis we will consider only simple derivatives. Also American-style contracts are included into this definition if we replace the maturity date  $T$  with the exercise date  $\tau$  such that  $\tau \leq T$ . However, in this chapter we do not consider such instruments because their pricing formula requires the introduction of a more complex framework i.e. optimal stopping theory.

**Definition 2.1.2.** *Let us consider a stock with (càdlàg) price process  $\{S_t\}_{t \geq 0}$  and a risk free asset with process  $\{B_t\}_{t \geq 0}$ .*

1. *A **portfolio** is a pair of predictable processes  $(\alpha_t, \beta_t)_{t \geq 0}$  describing the amount of each asset held by the investor.*
2. *The value of such a portfolio at time  $t$  is*

$$\Theta_t = \alpha_t S_t + \beta_t B_t.$$

*The process  $\{\Theta_t\}_{t \geq 0}$  is called **portfolio value process**.*

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<sup>1</sup> With the term “contingent claim” some authors indicate only contracts with an optionality. In this thesis we follow the nomenclature of [Björk, 2009] and [Musiela and Rutkowski, 2005].

3. A portfolio  $(\alpha_t, \beta_t)_{t \geq 0}$  is said to be **self-financing** if

$$\Theta_t = \Theta_0 + \int_{0+}^t \alpha_u dS_u + \int_{0+}^t \beta_u dB_u. \quad (2.3)$$

The meaning of equation (2.3) is that the value of the portfolio at time  $t$  is equal to the initial value  $\Theta_0$  plus the capital gain between 0 and  $t$ .

**Definition 2.1.3.** An **arbitrage** is a self-financing portfolio value process  $\{\Theta_t\}_{t \geq 0}$  satisfying  $\Theta_0 = 0$  and also for some  $T > 0$

$$\mathbb{P}(\Theta_T \geq 0) = 1 \quad \text{and} \quad \mathbb{P}(\Theta_T > 0) > 0.$$

An arbitrage is a trading strategy such that an investor starts with zero capital and at some later time  $T$  he is sure to have lost no money and furthermore has a positive probability of having made a profit.

We can define the discount factor for  $0 \leq s \leq t \leq T$  as

$$D(s, t) = e^{-\int_s^t r_u du}. \quad (2.4)$$

In the following of this thesis we assume a constant interest rate  $r_u = r$  for all  $u \in [0, T]$ .

It is common to indicate with  $\mathbb{P}$  the physical probability measure and with  $\mathbb{Q}$  a risk neutral measure, also called equivalent martingale measure (EMM).

**Definition 2.1.4.** Given the asset price process  $\{S_t\}_{t \geq 0}$  defined on the probability space  $(\Omega, \mathcal{F}, \{\mathcal{F}_t\}_{t \geq 0}, \mathbb{P})$ , we say that the probability measure  $\mathbb{Q}$  is an **EMM** if it verifies the following two properties:

$$\mathbb{Q} \sim \mathbb{P}: \quad \forall A \in \mathcal{F} \quad \mathbb{Q}(A) = 0 \Leftrightarrow \mathbb{P}(A) = 0, \quad (2.5)$$

$$D(0, t)S_t = \mathbb{E}^{\mathbb{Q}}[D(0, T)S_T | \mathcal{F}_t] \quad \text{for } 0 \leq t \leq T. \quad (2.6)$$

Our main problem is to determine the fair price  $\Pi_t(\mathcal{X})$  of the derivative  $\mathcal{X}$  at time  $t$  (with  $0 \leq t \leq T$ ). There are some minimal requirements that  $\Pi_t(\mathcal{X})$  should verify to qualify as a pricing rule:

1. It should be possible to price a derivative using only the information given at time  $t$ .
2. A derivative with a positive payoff should have a positive value.
3. Linearity.

In [Cont and Tankov, 2003] (see Proposition 9.1), the authors prove that any arbitrage-free linear pricing rule  $\Pi_t(\mathcal{X})$  satisfying the properties above, is represented by the *risk neutral* pricing rule

$$D(0, t)\Pi_t(\mathcal{X}) = \mathbb{E}^{\mathbb{Q}}[D(0, T)\mathcal{X} | \mathcal{F}_t] \quad \text{for } 0 \leq t \leq T, \quad (2.7)$$

where  $\mathbb{Q}$  is an EEM.

The concept of arbitrage is related with the existence of an equivalent martingale measure through the **first fundamental theorem of asset pricing**.

**Theorem 2.1.1.** *A market model does not admit arbitrage if and only if there exists a risk-neutral probability measure.*

For a detailed proof we refer to the academic literature on this topic i.e. [Harrison and Kreps, 1979], [Harrison and Pliska, 1981], [Schachermayer, 2002], [Delbaen and Schachermayer, 1998]. The general No-arbitrage theory of asset pricing is a fundamental and sophisticated theory of mathematical finance with several important developments in the last forty years, and we do not discuss it in details in this thesis. For a general presentation of this theory we refer to [Björk, 2009] (Chapter 10.2). For a comprehensive introduction, considering discontinuous processes, we refer to [Cont and Tankov, 2003] (Chapter 9.1).

Another important concept originating in the Black-Scholes model is the concept of perfect hedge.

**Definition 2.1.5.** *A self-financing portfolio  $(\alpha_t, \beta_t)$  is said to be a **perfect hedge** (or **replicating portfolio**) for a derivative  $\mathcal{X}$  if the associated portfolio value process  $\{\Theta_t\}_{t \geq 0}$  satisfies*

$$\mathcal{X} = \Theta_T \quad \mathbb{P} - \text{almost surely.} \quad (2.8)$$

If the market is arbitrage-free and (2.8) holds under  $\mathbb{P}$ , it must hold also under  $\mathbb{Q}$ , since they are equivalent.

The initial value  $\Theta_0$  is the price of the derivative at time 0. Using (2.8) and (2.3), under  $\mathbb{Q}$  we can write  $D(0, T)\mathcal{X} = \Theta_0 + \int_{0+}^T \alpha_t d(D(0, t)S_t)$ . Since the discounted price  $D(0, t)S_t$  under  $\mathbb{Q}$  is a martingale, the stochastic integral  $\int_{0+}^T \alpha_t d(D(0, t)S_t)$  is a martingale as well. By taking the expectation we obtain:

$$\Pi_0(\mathcal{X}) = \mathbb{E}^{\mathbb{Q}}[D(0, T)\mathcal{X} | \mathcal{F}_t] = \Theta_0. \quad (2.9)$$

Moreover, the initial value  $\Theta_0$  is unique, since two replicating strategies with different initial values lead to an arbitrage.

**Definition 2.1.6.** *A market model is said to be **complete** if the payoff of every derivative security can be perfectly hedged.*

In a complete market, the unique price of a financial derivative corresponds to the initial capital  $\Theta_0$  needed to set up a perfect hedge.

The completeness of a market is connected with the uniqueness of the EMM through the **second fundamental theorem of asset pricing**.



**Theorem 2.1.2.** *Consider a market model that has a risk-neutral probability measure. The model is complete if and only if the risk-neutral probability measure is unique.*

The theorem as stated above holds in discrete time models. In continuous time this formulation is not rigorous. It is necessary to carefully define the set of admissible trading strategies, contingent claims and the notion of martingale measure. In the case where the stock process has unbounded jumps, which is the case of most exponential Lévy models, a rigorous formulation is quite difficult and we refer to [Cherny and Shiryaev, 2002] and [Kabanov, 2001] for more information.

The ideal market assumed by Black and Scholes is complete (see Theorem 8.3 of [Björk, 2009]). However, the majority of the models used in finance are not.

In this thesis we analyze a market model that is not complete. The introduction of proportional transaction costs prevents to trade continuously in time as suggested by the replicating portfolio strategy, because the cost of trading would be infinity. On the other hand, if we consider exponential Lévy models, we again obtain an incomplete market in general, except for some particular cases i.e. when the driving noise is a Brownian motion or a pure Poisson process.

In a complete market there is only one arbitrage-free way to price a financial derivative, and the price is defined as the cost to replicate the derivative's payoff. In an incomplete market, instead, the notion of perfect replication does not exist. Therefore the hedging strategy will only approximate the payoff of the derivative. Different ways to measure the risk of trading lead to different ways to hedge the derivative. In this thesis we focus on the approach based on the concept of *utility maximization* (see Chapter 5).

In the following of this chapter we consider a frictionless market where the stock price follows an exponential Lévy process. In such a market, the class of EMM is infinite, i.e. there are infinite EMMs such that the discounted stock prices are martingales. This means that for every financial derivative there are infinite prices satisfying the condition of no-arbitrage.

In order to overcome this problem, there are several methods to select the best EMM to use in the pricing formula (2.7) (see [Cont and Tankov, 2003], Chapter 10). However, the best approach is to derive the model parameters directly from the prices of derivatives (usually European call and put options with different strikes and maturities) already quoted in the market. The process of choosing the risk neutral parameters for a model that reproduces the prices in the market is called *model calibration*. In this chapter all the parameters of the Lévy processes used for the pricing purpose, are intended to be risk neutral parameters obtained by a calibration process.

### 2.1.1 Derivation of the price PIDE

In an arbitrage-free market, if the price process  $\{S_t\}_{t \geq 0}$  follows an exponential Lévy process, we can express the price of any simple financial derivative  $\mathcal{X}$  as a function of the current time  $t \in [0, T]$  and current stock price  $s = S_t$ , i.e.  $\Pi_t(\mathcal{X}) = V(t, s)$ . This is a direct consequence of the Markov property (1.28) applied to the formula (2.7). In this section we show that  $V(t, s)$  can be obtained by solving a partial integro-differential equation (PIDE).

First of all, let us define the space of continuous functions that have polynomial growth of order  $p$  at infinity.

**Definition 2.1.7.** For  $E \subseteq \mathbb{R}^n$  and for  $p \geq 0$ , let us define the space:

$$\mathcal{C}_p(E) = \left\{ \phi \in C^0(E) : \sup_E \frac{|\phi(x)|}{1 + |x|^p} < \infty \right\}. \quad (2.10)$$

For functions with time dependence, e.g.  $\phi : [0, T] \times \mathbb{R}^n \rightarrow \mathbb{R}$ , we maintain the same notation but specify the domain:

$$\mathcal{C}_p([0, T] \times \mathbb{R}^n) = \left\{ \phi \in C^0([0, T] \times \mathbb{R}^n) : \sup_{[0, T] \times \mathbb{R}^n} \frac{|\phi(t, x)|}{1 + |x|^p} < \infty \right\}. \quad (2.11)$$

We consider only the case  $p = 2$ , because we are working with underlying processes with finite second moment. (see assumption **EM** in Section 1.1.4).

The following theorem will be useful.

**Theorem 2.1.3.** Let  $\{X_t\}_{t \geq 0}$  be a Lévy process with Lévy triplet  $(b, \sigma, \nu)$ , satisfying the assumption **EM**. The process  $\{S_t\}_{t \geq 0}$  defined by  $S_t = e^{X_t}$  is a martingale if and only if

$$b + \frac{1}{2}\sigma^2 + \int_{\mathbb{R}} (e^z - 1 - z\mathbb{1}_{\{|z| < 1\}})\nu(dz) = 0. \quad (2.12)$$

*Proof.* The SDE for the process  $\{e^{X_t}\}_{t \geq 0}$  has been derived in Eq. (1.53). The exponential Lévy process is a martingale if and only if the drift is zero.  $\square$

Let us consider a stock price process described by the *exponential Lévy model*

$$S_t = S_0 e^{L_t} = S_0 e^{rt + X_t} \quad (2.13)$$

where  $\{X_t\}_{t \geq 0}$  is a Lévy process with Lévy triplet  $(b, \sigma, \nu)$ . Under a risk neutral measure  $\mathbb{Q}$ , the process  $\{L_t\}_{t \geq 0}$  is a Lévy process with triplet  $(r + b, \sigma, \nu)$  satisfying (2.12). The discounted price is a  $\mathbb{Q}$ -martingale:

$$\mathbb{E}^{\mathbb{Q}}[e^{-rt} S_t | S_0] = \mathbb{E}^{\mathbb{Q}}[S_0 e^{X_t} | S_0] = S_0, \quad (2.14)$$

such that  $\mathbb{E}^{\mathbb{Q}}[e^{X_t}|X_0 = 0] = 1$ .

In Chapter 1 we derived the infinitesimal generator for an exponential Lévy process in Eq. (1.75) and the parameter  $\mu$  in (1.54). We can repeat the same computation that led to Eq. (1.53) for the process  $L_t = X_t + rt$  and define the new parameter

$$\mu := r + b + \frac{1}{2}\sigma^2 + \int_{\mathbb{R}} (e^z - 1 - z\mathbb{1}_{|z|<1})\nu(dz) \quad (2.15)$$

Using the condition (2.12) we obtain the fundamental relation

$$\mu = r. \quad (2.16)$$

The risk neutral dynamics of (2.13) is described by the SDE:

$$dS_t = rS_t dt + \sigma S_t dW_t + \int_{\mathbb{R}} S_{t-}(e^z - 1)\tilde{N}(dt, dz). \quad (2.17)$$

For  $f \in C^2(\mathbb{R}^+) \cap \mathcal{C}_2(\mathbb{R}^+)$ , the associated infinitesimal generator is:

$$\begin{aligned} \mathcal{L}^S f(s) &= rs \frac{\partial f(s)}{\partial s} + \frac{1}{2}\sigma^2 s^2 \frac{\partial^2 f(s)}{\partial s^2} \\ &+ \int_{\mathbb{R}} \left[ f(se^z) - f(s) - s(e^z - 1) \frac{\partial f(s)}{\partial s} \right] \nu(dz). \end{aligned} \quad (2.18)$$

The derivative pricing function  $V(t, s)$  with  $t \in [0, T]$  and  $s \in \mathbb{R}^+$ , can be obtain by solving a pricing PIDE according to the following theorem.

**Theorem 2.1.4.** *Let us consider an arbitrage free market, where the underlying stock price follows the exponential Lévy process (2.13). Let also assume that  $V(t, s) \in C^{1,2}([t_0, T] \times \mathbb{R}^+)$  and the derivatives  $\frac{\partial V}{\partial t}$ ,  $\frac{\partial V}{\partial s}$  and  $\frac{\partial^2 V}{\partial s^2}$  are bounded. Therefore  $V(t, s)$  satisfies the PIDE*

$$\frac{\partial V(t, s)}{\partial t} + \mathcal{L}^S V(t, s) - rV(t, s) = 0 \quad (2.19)$$

$$V(T, s) = \Phi(s), \quad (2.20)$$

where  $\mathcal{L}^S$  is the infinitesimal generator in (2.18).

*Proof.* Let us consider the formula (2.7) together with the Markov property (1.28). For any stopping time  $\tau$  such that  $0 \leq t \leq \tau \leq T$ , we can use the law of iterated expectations:

$$\begin{aligned} D(0, t)V(t, s) &= \mathbb{E}^{\mathbb{Q}} \left[ \mathbb{E}^{\mathbb{Q}} [D(0, T)V(T, S_T) | S_\tau] \middle| S_t = s \right] \\ &= \mathbb{E}^{\mathbb{Q}} [D(0, \tau)V(\tau, S_\tau) | S_t = s]. \end{aligned}$$

We can write  $D(0, \tau)V(\tau, S_\tau) = D(0, t)V(t, s) + \int_t^\tau d(D(t, u)V(u, S_u))du$ . Using the Itô product rule (1.41) we get:

$$0 = \mathbb{E}^\mathbb{Q} \left[ \int_t^\tau e^{-r(u-t)} \left( \frac{\partial V(u, S_{u-})}{\partial u} + \mathcal{L}^S V(u, S_{u-}) - rV(u, S_{u-}) \right) du \middle| S_t = s \right] \quad (2.21)$$

$$+ \mathbb{E}^\mathbb{Q} \left[ \int_t^\tau e^{-r(u-t)} \frac{\partial V(u, S_{u-})}{\partial s} \sigma S_{u-} dW_u \middle| S_t = s \right] \quad (2.22)$$

$$+ \mathbb{E}^\mathbb{Q} \left[ \int_t^\tau e^{-r(u-t)} \int_{\mathbb{R}} (V(u, S_{u-}e^z) - V(u, S_{u-})) \tilde{N}(du, dz) \middle| S_t = s \right] \quad (2.23)$$

where we introduced the explicit expression of the discount factor (2.4) with constant  $r$ . The terms inside the expectations in the second and third lines are martingales only if their expectations are finite. Let us look at the integrability condition for the term (2.22).

$$\begin{aligned} & \mathbb{E}^\mathbb{Q} \left[ \int_t^\tau \left| e^{-r(u-t)} \frac{\partial V(u, S_{u-})}{\partial s} \sigma S_{u-} \right|^2 du \middle| S_t = s \right] \\ & \leq \sigma^2 C^2 \mathbb{E}^\mathbb{Q} \left[ \int_t^\tau |e^{-r(u-t)} S_{u-}|^2 du \middle| S_t = s \right] \\ & < \sigma^2 C^2 \mathbb{E}^\mathbb{Q} \left[ \int_t^T \left| \sup_{u \in [t, T]} e^{-r(u-t)} S_{u-} \right|^2 du \middle| S_t = s \right] \\ & = \sigma^2 C^2 (T - t) \mathbb{E}^\mathbb{Q} \left[ \left| \sup_{u \in [t, T]} e^{-r(u-t)} S_{u-} \right|^2 \middle| S_t = s \right] \\ & \leq 4\sigma^2 C^2 (T - t) \mathbb{E}^\mathbb{Q} \left[ |e^{-r(T-t)} S_{T-}|^2 \middle| S_t = s \right] \\ & = 4\sigma^2 C^2 (T - t) e^{-2r(T-t)} \mathbb{E}^\mathbb{Q} [S_{T-}^2 | S_t = s] < \infty, \end{aligned}$$

where in the second line we used the fact that the partial derivative is bounded by a constant  $C$ . In the third line we considered the integral over  $[t, T]$ , which is greater than the integral over  $[t, \tau]$  almost surely, since the integrand is positive. We also introduce the supremum of the martingale term  $e^{-r(u-t)} S_{u-}$ . In the fifth line we used the Doob martingale inequality<sup>2</sup> and in the last line we used the finite variance assumption.

<sup>2</sup> The Doob martingale inequality says that if  $\{X_t\}_{t \in [0, T]}$  is a martingale, then

$$\mathbb{E} \left[ \sup_{t \in [0, T]} |X_t|^2 \right] \leq 4\mathbb{E} [|X_T|^2].$$

The term (2.23) is well defined if

$$\begin{aligned}
& \mathbb{E}^{\mathbb{Q}} \left[ \int_t^\tau \int_{\mathbb{R}} \left| e^{-r(u-t)} (V(u, S_u e^z) - V(u, S_u)) \right|^2 \nu(dz) dt \middle| S_t = s \right] \\
& \leq \mathbb{E}^{\mathbb{Q}} \left[ \int_t^\tau \int_{\mathbb{R}} \left| e^{-r(u-t)} C S_u (e^z - 1) \right|^2 \nu(dz) dt \middle| S_t = s \right] \\
& \leq C^2 \int_{\mathbb{R}} (e^z - 1)^2 \nu(dz) \mathbb{E}^{\mathbb{Q}} \left[ \int_t^T \left| e^{-r(u-t)} S_u \right|^2 dt \middle| S_t = s \right] < \infty.
\end{aligned}$$

In the second line we used the Lipschitz property of  $V(t, s)$ <sup>3</sup>. In the third line, the integral  $\int_{\mathbb{R}} (e^z - 1)^2 \nu(dz)$  is finite, as we have already verified in Section 1.3.1. In order to verify that the expectation is also finite, we can apply the same argument used above i.e. considering the supremum and the Doob martingale inequality.

Now let us consider (2.21). By definition, the terms inside the integral are all continuous and are all dominated by some polynomial functions of order  $p \in [0, 2]$  that do not depend on  $\tau$ . We can divide both sides by  $(\tau - t)$  and take the limit for  $\tau \rightarrow t$ . Using the mean value theorem, there exists  $u \in [t, \tau]$  such that

$$\lim_{u \rightarrow t} \mathbb{E}^{\mathbb{Q}} \left[ e^{-r(u-t)} \left( \frac{\partial V(u, S_u)}{\partial u} + \mathcal{L}^S V(u, S_u) - rV(u, S_u) \right) \middle| S_t = s \right] = 0.$$

When  $\tau \rightarrow t$  also  $u \rightarrow t$ . Thanks to the dominated convergence theorem we can take the limit inside the expectation and conclude the proof.  $\square$

In practice, the hypothesis of the theorem above are rarely satisfied. The payoff  $\Phi$  is usually not in the domain of  $\mathcal{L}$  and sometimes is not even differentiable, e.g. call/put options. For these reasons, the option price should be considered a solution of (2.19) in a weaker sense. The notion of *viscosity solution* allows to cover this case. We will introduce it in Section 4.3. For a complete exposition on this topic, we refer to [Cont and Voltchkova, 2005b]. The authors prove that, in a general setting, option prices in exponential Lévy models correspond to viscosity solutions of the pricing PIDE.

Putting together the Eq. (2.19) and (2.18) we obtain the PIDE for the

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<sup>3</sup>A  $C^1(\mathbb{R})$  function  $f$  with bounded derivative is Lipschitz. Let  $a, b \in \mathbb{R}$  with  $a < b$ , by the mean value theorem there exists  $c \in [a, b]$  such that  $f(b) - f(a) = f'(c)(b - a)$ . Using  $|f'(c)| \leq C$ , we obtain the Lipschitz condition

$$f(b) - f(a) \leq C(b - a).$$

option price with the associated boundary conditions.

$$\begin{aligned} & \frac{\partial V(t, s)}{\partial t} - rV(t, s) + rs \frac{\partial V(t, s)}{\partial s} + \frac{1}{2} \sigma^2 s^2 \frac{\partial^2 V(t, s)}{\partial s^2} \\ & + \int_{\mathbb{R}} \left[ V(t, se^z) - V(t, s) - s(e^z - 1) \frac{\partial V(t, s)}{\partial s} \right] \nu(dz) = 0. \end{aligned} \quad (2.24)$$

CALL:

- Terminal:

$$V(T, s) = \max(s - K, 0),$$

- Lateral:

$$V(t, 0) = 0 \quad \text{and} \quad V(t, s) \underset{s \rightarrow \infty}{\sim} s - Ke^{-r(T-t)}.$$

PUT:

- Terminal:

$$V(T, s) = \max(K - s, 0),$$

- Lateral:

$$V(t, 0) = Ke^{-r(T-t)} \quad \text{and} \quad V(t, s) \underset{s \rightarrow \infty}{=} 0.$$

While the terminal conditions are simply the payoffs of the respective options, in order to obtain the lateral condition we need to consider the asymptotic behavior of the option for  $s = 0$  and for  $s \rightarrow \infty$ . When the stock price is much higher than the strike, a call option is almost sure to be exercised. The current value of the call option will thus be approximately equal to the stock price minus the (discounted) strike price. The opposite applies to a put option, which is almost sure to not be exercised. Its value will be approximately zero. On the other hand, if the stock price is much less than the strike, a call option is likely to not be exercised, and has approximately zero value. A put option instead, will be exercised with high probability and its value corresponds to the (discounted) exercise price.

### 2.1.2 PIDE in log-variable

In order to have a simpler PIDE expression, it turns out that it is better to work with a Lévy process instead of its exponential. So let us invert Eq. (1.51) and consider  $X_t = \log\left(\frac{S_t}{S_0}\right)$  with dynamics described by the SDE

$$dX_t = \left( b + \int_{|x| \geq 1} x \nu(dx) \right) dt + \sigma dW_t + \int_{\mathbb{R}} z \tilde{N}(dt, dz), \quad (2.25)$$

of the form in Eq. (1.26). It is better to reformulate the equation with the parameter  $\mu$ , since it will be easier to make the substitution (2.16). Using

the Itô formula, and considering Eq. (1.55) representing the dynamics of  $S_t$ , we obtain

$$\begin{aligned}
dX_t &= d\left(\log \frac{S_t}{S_0}\right) = \frac{1}{S_t} S_t \mu dt + \frac{1}{S_t} S_t \sigma dW - \frac{1}{2} \frac{1}{S_t^2} S_t^2 \sigma^2 dt \\
&\quad + \int_{\mathbb{R}} (\log(S_t + S_t(e^z - 1)) - \log(S_t)) \tilde{N}(dt, dz) \\
&\quad + \int_{\mathbb{R}} (\log(S_t + S_t(e^z - 1)) - \log(S_t) - \frac{1}{S_t} S_t(e^z - 1)) \nu(dz) dt \\
&= (\mu - \frac{1}{2} \sigma^2) dt + \sigma dW + \int_{\mathbb{R}} z \tilde{N}(dt, dz) \\
&\quad + \int_{\mathbb{R}} (z - (e^z - 1)) \nu(dz) dt \\
&= \left( \mu - \frac{1}{2} \sigma^2 - \int_{\mathbb{R}} (e^z - 1 - z) \nu(dz) \right) dt + \sigma dW + \int_{\mathbb{R}} z \tilde{N}(dt, dz).
\end{aligned}$$

For  $f \in C^2(\mathbb{R}) \cap \mathcal{C}_2(\mathbb{R})$ , the corresponding infinitesimal generator is:

$$\begin{aligned}
\mathcal{L}^X f(x) &= \left( \mu - \frac{1}{2} \sigma^2 - \int_{\mathbb{R}} (e^z - 1 - z) \nu(dz) \right) \frac{\partial f(x)}{\partial x} \\
&\quad + \frac{1}{2} \sigma^2 \frac{\partial^2 f(x)}{\partial x^2} + \int_{\mathbb{R}} (f(x+z) - f(x) - z \frac{\partial f(x)}{\partial x}) \nu(dz).
\end{aligned} \tag{2.26}$$

Alternatively, this can be obtained by a change of variables in Eq (2.24),  $s = e^x$  and  $\tilde{V}(t, x) := V(t, s)$ . The differential operators change according to

$$s \frac{\partial}{\partial s} = \frac{\partial}{\partial x}, \quad s^2 \frac{\partial^2}{\partial s^2} = \frac{\partial^2}{\partial x^2} - \frac{\partial}{\partial x}. \tag{2.27}$$

After the change of variables, the option PIDE, using (2.16), becomes

$$\begin{aligned}
&\frac{\partial \tilde{V}(t, x)}{\partial t} - r \tilde{V}(t, x) + \left( r - \frac{1}{2} \sigma^2 - \int_{\mathbb{R}} (e^z - 1 - z) \nu(dz) \right) \frac{\partial \tilde{V}(t, x)}{\partial x} \\
&+ \frac{1}{2} \sigma^2 \frac{\partial^2 \tilde{V}(t, x)}{\partial x^2} + \int_{\mathbb{R}} (\tilde{V}(t, x+z) - \tilde{V}(t, x) - z \frac{\partial \tilde{V}(t, x)}{\partial x}) \nu(dz) = 0.
\end{aligned} \tag{2.28}$$

With boundary conditions:

CALL:

- Terminal:

$$\tilde{V}(T, x) = \max(e^x - K, 0),$$

- Lateral:

$$\tilde{V}(t, x) \underset{x \rightarrow -\infty}{=} 0 \quad \text{and} \quad \tilde{V}(t, x) \underset{x \rightarrow \infty}{\sim} e^x - K e^{-r(T-t)}.$$

PUT:

- Terminal:

$$\tilde{V}(T, x) = \max(K - e^x, 0),$$

- Lateral:

$$\tilde{V}(t, x) \underset{x \rightarrow -\infty}{\sim} = Ke^{-r(T-t)} \quad \text{and} \quad \tilde{V}(t, x) \underset{x \rightarrow \infty}{=} 0.$$

## 2.2 Finite difference methods

Finite difference methods are a technique for obtaining numerical solutions of PDEs and PIDEs. The idea underlying finite-difference methods is to replace the partial derivatives occurring in the PDE by the finite differences approximations defined below. Let  $V(t, x) \in C^{1,2}$ , for a small but not infinitesimal  $\Delta x > 0$ , we can define the **forward difference** as

$$\frac{\partial V(t, x)}{\partial x} \approx \frac{V(t, x + \Delta x) - V(t, x)}{\Delta x}. \quad (2.29)$$

The **backward difference** is defined as

$$\frac{\partial V(t, x)}{\partial x} \approx \frac{V(t, x) - V(t, x - \Delta x)}{\Delta x} \quad (2.30)$$

and the **central difference** is defined as

$$\frac{\partial V(t, x)}{\partial x} \approx \frac{V(t, x + \Delta x) - V(t, x - \Delta x)}{2\Delta x}. \quad (2.31)$$

Analogous approximations can be introduced for the time derivative  $\frac{\partial V(t, x)}{\partial t}$  for a small  $\Delta t > 0$ . The use of the forward or backward difference approximation for  $\frac{\partial V(t, x)}{\partial t}$  leads to the **explicit** or **implicit** finite difference schemes respectively. Usually the central difference is not used for the time derivative because it may lead to bad numerical schemes (specifically, unstable schemes). For the space variable instead, it is quite common to approximate the first order derivative by central differences.

For second order derivatives in space, we can define the **symmetric central difference** approximation as

$$\begin{aligned} \frac{\partial^2 V(t, x)}{\partial x^2} &\approx \frac{\frac{V(t, x + \Delta x) - V(t, x)}{\Delta x} - \frac{V(t, x) - V(t, x - \Delta x)}{\Delta x}}{\Delta x} \\ &= \frac{V(t, x + \Delta x) + V(t, x - \Delta x) - 2V(t, x)}{\Delta x^2}. \end{aligned}$$

When considering PIDEs there is an additional integral term to discretize, and can be replaced by Riemann sums. But first it is necessary to localize the problem and truncate the integral.



Since numerical computations can only be performed on a finite domain, the first step is to reduce the PIDE to a bounded domain. The initial problem

$$\frac{\partial V(t, x)}{\partial t} + \mathcal{L}^X V(t, x) - rV(t, x) = 0 \quad \text{for } t, x \in [t_0, T] \times \mathbb{R}$$

is restricted to the finite domain  $[t_0, T] \times [A_1, A_2]$ , with  $A_1, A_2 \in \mathbb{R}$ . In order to have a well posed problem, we need to impose the boundary conditions for  $V(t, x)$  everywhere outside  $[t_0, T] \times [A_1, A_2]$ , and not only at the lateral boundaries  $A_1$  and  $A_2$ .

The next step is to replace the domain  $[t_0, T] \times [A_1, A_2]$  by a discrete grid: For  $n = 0, 1, \dots, N \in \mathbb{N}$ , define the discrete time step  $\Delta t = \frac{T-t_0}{N}$  such that  $t_n = t_0 + n\Delta t$ . For  $i = 0, 1, \dots, M \in \mathbb{N}$ , define the discrete space step  $\Delta x = \frac{A_2-A_1}{M}$  such that  $x_i = A_1 + i\Delta x$ . The grid is divided into equally spaced **nodes** of distance  $\Delta x$  in the x-axis, and of distance  $\Delta t$  in the t-axis. The mesh points have the form  $(t_0 + n\Delta t, A_1 + i\Delta x)$ . At this point we concern ourselves only with the values of  $V(t, x)$  on the mesh nodes. We write

$$V(t_0 + n\Delta t, A_1 + i\Delta x) = V_i^n.$$

The integral terms in (2.28) are restricted to the bounded domain  $[-B_1, B_2]$ , with  $B_1, B_2 \in \mathbb{R}$ .

$$\begin{aligned} & \frac{\partial V(t, x)}{\partial t} - rV(t, x) + \left( r - \frac{1}{2}\sigma^2 - \int_{-B_1}^{B_2} (e^z - 1 - z)\nu(dz) \right) \frac{\partial V(t, x)}{\partial x} \\ & + \frac{1}{2}\sigma^2 \frac{\partial^2 V(t, x)}{\partial x^2} + \int_{-B_1}^{B_2} (V(t, x+z) - V(t, x) - z \frac{\partial V(t, x)}{\partial x}) \nu(dz) = 0 \\ & \text{for } t, x \in [t_0, T] \times ]-A_1, A_2[. \end{aligned} \quad (2.32)$$

The computational domain of interest becomes  $[t_0, T] \times [A_1 - B_1, A_2 + B_2]$ , where in the regions  $[t_0, T] \times [A_1 - B_1, A_1]$  and  $[t_0, T] \times [A_2, A_2 + B_2]$  we need to define the boundary conditions.

In order to solve the problem (2.32) we consider the **IMEX** (Implicit-Explicit) method proposed in [Cont and Voltchkova, 2005a]. The integro-differential operator

$$\frac{\partial V(t, x)}{\partial t} + \mathcal{L}V(t, x) - rV(t, x) = 0$$

is split in two parts:

$$\frac{\partial V(t, x)}{\partial t} + DV(t, x) + JV(t, x) - rV(t, x) = 0$$

where  $D$  and  $J$  stand for the differential and integral parts of  $\mathcal{L}$ , respectively. We can replace  $DV(t, x)$  by a finite difference approximated operator

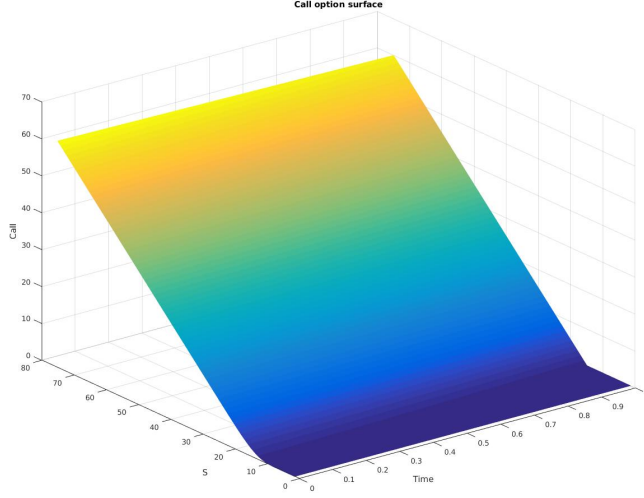


Figure 2.1: Call option surface obtained by solving the Black-Scholes PDE. It is computed with the parameters in Table 2.1

$D_\Delta V(t, x)$  and  $JV(t, x)$  by the operator  $J_\Delta V(t, x)$  obtained through **Riemann sums**<sup>4</sup> approximation, and use the following IMEX time-stepping scheme:

$$\frac{V_i^{n+1} - V_i^n}{\Delta t} + D_\Delta V^n + J_\Delta V^{n+1} - rV^n = 0. \quad (2.33)$$

We treat the integral part with an explicit time stepping in order to avoid the inversion of the dense matrix  $J_\Delta$ . In the next sections let us discuss about the application of the IMEX scheme to the numerical solution of the PIDE (2.28) for the BS, Merton and VG processes.

### 2.2.1 Black and Scholes PDE

The [Black and Scholes, 1973] model assumes a geometric Brownian motion for the dynamics of the underlying, as we saw in (2.2). It corresponds to the exponential of a Lévy process  $\{X_t\}_{t \geq 0}$  with triplet  $(b, \sigma, 0)$ , with Lévy measure  $\nu = 0$ . The BS PDE (2.28) in log-variables turns out to be

$$\frac{\partial V(t, x)}{\partial t} + \left(r - \frac{1}{2}\sigma^2\right) \frac{\partial V(t, x)}{\partial x} + \frac{1}{2}\sigma^2 \frac{\partial^2 V(t, x)}{\partial x^2} - rV(t, x) = 0. \quad (2.34)$$

The Lévy measure is identically null and therefore there is no integral term. The domain is restricted to  $[t_0, T] \times [A_1, A_2]$ . We apply the IMEX scheme,

<sup>4</sup>The discretization of the integral depends on the activity of the Lévy process under consideration. We will see in the next sections the two cases of finite and infinite activity.

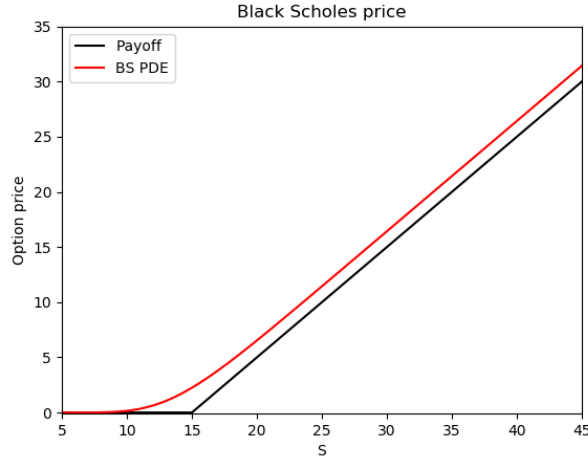


Figure 2.2: Price of a call option at time  $t = 0$  with parameters in Table 2.1.

that in this case is a fully implicit scheme. The discretized equation becomes

$$\begin{aligned} \frac{V_i^{n+1} - V_i^n}{\Delta t} + \left(r - \frac{1}{2}\sigma^2\right) \frac{V_{i+1}^n - V_{i-1}^n}{2\Delta x} \\ + \frac{1}{2}\sigma^2 \frac{V_{i+1}^n + V_{i-1}^n - 2V_i^n}{\Delta x^2} - rV_i^n = 0. \end{aligned} \quad (2.35)$$

Rearranging the terms:

$$\begin{aligned} V_i^{n+1} = & V_i^n \left(1 + r\Delta t + \sigma^2 \frac{\Delta t}{h_x^2}\right) \\ & + V_{i+1}^n \left(-\left(r - \frac{1}{2}\sigma^2\right) \frac{\Delta t}{2\Delta x} + \frac{1}{2}\sigma^2 \frac{\Delta t}{\Delta x^2}\right) \\ & + V_{i-1}^n \left(\left(r - \frac{1}{2}\sigma^2\right) \frac{\Delta t}{2\Delta x} + \frac{1}{2}\sigma^2 \frac{\Delta t}{\Delta x^2}\right). \end{aligned}$$

We can rename the coefficients such that:

$$V_i^{n+1} = aV_{i-1}^n + bV_i^n + cV_{i+1}^n,$$

and write it in matrix form:

$$\begin{pmatrix} V_1^{n+1} \\ V_2^{n+1} \\ \vdots \\ V_{M-2}^{n+1} \\ V_{M-1}^{n+1} \end{pmatrix} = \underbrace{\begin{pmatrix} b & c & 0 & \cdots & 0 \\ a & b & c & 0 & 0 \\ 0 & \ddots & \ddots & \ddots & 0 \\ \vdots & 0 & a & b & c \\ 0 & 0 & 0 & a & b \end{pmatrix}}_{\mathcal{D}} \cdot \begin{pmatrix} V_1^n \\ V_2^n \\ \vdots \\ V_{M-2}^n \\ V_{M-1}^n \end{pmatrix} + \underbrace{\begin{pmatrix} aV_0^n \\ 0 \\ \vdots \\ 0 \\ cV_M^n \end{pmatrix}}_{\text{B (boundary terms)}}$$

The system

$$V_i^{n+1} = \mathcal{D}V_i^n + B \quad \text{for} \quad 1 \leq i \leq M-1$$

can be solved easily for  $V_i^n$  by inverting<sup>5</sup> the matrix  $\mathcal{D}$ .

| BS Parameters |     |     |          |
|---------------|-----|-----|----------|
| $K$           | $T$ | $r$ | $\sigma$ |
| 15            | 1   | 0.1 | 0.25     |

Table 2.1: Option parameters and diffusion process parameters.

Using the parameters in Table 2.1 we can solve the linear system and plot the solution in Figures 2.1 and 2.2.

### 2.2.2 Merton PIDE

We presented the Merton model in Section 1.3.2. Let us recall that the jump component of the Merton process has finite activity,  $\nu(\mathbb{R}) = \lambda < \infty$ . Following Eq. (2.28), the Merton PIDE in log-variables has the following form:

$$\begin{aligned} & \frac{\partial V(t, x)}{\partial t} - rV(t, x) + \left(r - \frac{1}{2}\sigma^2 - m\right) \frac{\partial V(t, x)}{\partial x} \\ & + \frac{1}{2}\sigma^2 \frac{\partial^2 V(t, x)}{\partial x^2} + \int_{\mathbb{R}} V(t, x+z)\nu(dz) - \lambda V(t, x) = 0. \end{aligned} \quad (2.36)$$

with  $m$  defined in (1.77). Since we have to restrict the problem to a bounded region, we consider the equation (2.32):

$$\begin{aligned} & \frac{\partial V(t, x)}{\partial t} - rV(t, x) + \left(r - \frac{1}{2}\sigma^2 - \hat{m}\right) \frac{\partial V(t, x)}{\partial x} \\ & + \frac{1}{2}\sigma^2 \frac{\partial^2 V(t, x)}{\partial x^2} + \int_{-B_1}^{B_2} V(t, x+z)\nu(dz) - \hat{\lambda}V(t, x) = 0. \end{aligned}$$

with  $\hat{m} = \int_{-B_1}^{B_2} (e^z - 1)\nu(dz)$  and  $\hat{\lambda} = \int_{-B_1}^{B_2} \nu(dz)$ .

For  $0 < K_1 < K_2$  we choose  $B_1, B_2$  such that  $[-B_1, B_2] = [(-K_1 - 1/2)\Delta x, (K_2 + 1/2)\Delta x]$ . Let us discretize the integral as follows:

$$\int_{-B_1}^{B_2} V(t_n, x_i + z)\nu(dz) \approx \sum_{k=-K_1}^{K_2} \nu_k V_{i+k}^n \quad (2.37)$$

---

<sup>5</sup> Matrix inversion is a slow operation and there are plenty of efficient algorithms that permit to solve a linear system with no need of matrix inversion. In this thesis we solved all the linear systems occurring after the implicit discretization of a PDE (or PIDE) with the LU decomposition method.

where

$$\nu_k = \int_{(k-\frac{1}{2})\Delta x}^{(k+\frac{1}{2})\Delta x} \nu(z) dz, \quad \text{for } -K_1 \leq k \leq K_2. \quad (2.38)$$

We have that  $\hat{\lambda} = \sum_{k=-K_1}^{K_2} \nu_k$ . For large values of  $B_1$  and  $B_2$ , the parameter  $\hat{\lambda}$  is a good approximation for  $\lambda$ , since

$$\lambda = \lim_{B_1, B_2 \rightarrow \infty} \hat{\lambda} = \lim_{B_1, B_2 \rightarrow \infty} \int_{-B_1}^{B_2} \nu(dz).$$

The discretized equation using the IMEX scheme becomes:

$$\begin{aligned} & \frac{V_i^{n+1} - V_i^n}{\Delta t} + \left(r - \frac{1}{2}\sigma^2 - \hat{m}\right) \frac{V_{i+1}^n - V_{i-1}^n}{2\Delta x} \\ & + \frac{1}{2}\sigma^2 \frac{V_{i+1}^n + V_{i-1}^n - 2V_i^n}{\Delta x^2} - (r + \hat{\lambda})V_i^n + \sum_{k=-K_1}^{K_2} \nu_k V_{i+k}^{n+1} = 0. \end{aligned} \quad (2.39)$$

Rearranging the terms:

$$\begin{aligned} \underbrace{V_i^{n+1} + \Delta t \sum_{k=-K_1}^{K_2} \nu_k V_{i+k}^{n+1}}_{\tilde{V}_i^{n+1}} &= V_i^n \left(1 + (r + \hat{\lambda})\Delta t + \sigma^2 \frac{\Delta t}{\Delta x^2}\right) \\ &+ V_{i+1}^n \left(-\left(r - \frac{1}{2}\sigma^2 - \hat{m}\right) \frac{\Delta t}{2\Delta x} + \frac{1}{2}\sigma^2 \frac{\Delta t}{\Delta x^2}\right) \\ &+ V_{i-1}^n \left(\left(r - \frac{1}{2}\sigma^2 - \hat{m}\right) \frac{\Delta t}{2\Delta x} + \frac{1}{2}\sigma^2 \frac{\Delta t}{\Delta x^2}\right). \end{aligned}$$

We can rename the coefficients:

$$\tilde{V}_i^{n+1} = aV_{i-1}^n + bV_i^n + cV_{i+1}^n,$$

and solve the system for  $V_i^n$ :

$$\begin{cases} \tilde{V}_i^{n+1} = V_i^{n+1} + \Delta t \sum_{k=-K_1}^{K_2} \nu_k V_{i+k}^{n+1} \\ V_i^n = \mathcal{D}^{-1} \left( \tilde{V}_i^{n+1} - B \right) \quad \text{for } 1 \leq i \leq M-1 \end{cases}$$

where  $\mathcal{D}$  is the tridiagonal matrix formed by the coefficients  $a, b, c$ , and with boundary terms  $B = (aV_0^n, 0, \dots, 0, cV_M^n)$ .

In Figure 2.3 we computed the BS and Merton curves using the parameters in Tables 2.1 and 2.2. The Merton curve is everywhere higher than the BS curve. This is a consequence of the additional jump component in the Merton process that increases the total variance. The two processes have same diffusion component  $\sigma$ , but the Merton process has total variance  $\sigma^2 + \lambda\xi^2 + \lambda\alpha^2$ , while the diffusion process has only variance  $\sigma^2$ .

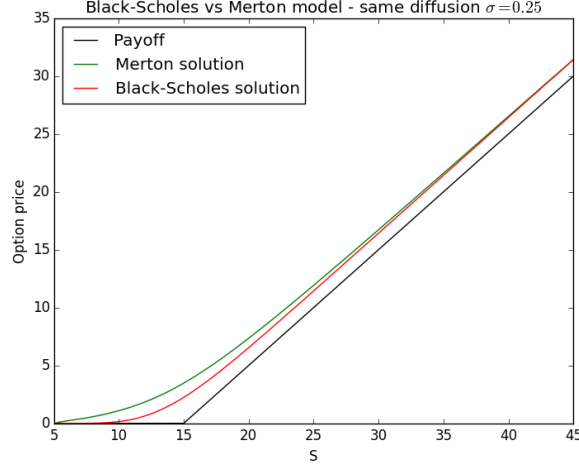


Figure 2.3: Comparison of prices of a call option at time  $t = 0$  for BS and Merton models. The parameters are in Tables 2.1 and 2.2 (first line).

| Merton parameters |     |     |     |          |          |       |           |
|-------------------|-----|-----|-----|----------|----------|-------|-----------|
| Figure            | $K$ | $T$ | $r$ | $\sigma$ | $\alpha$ | $\xi$ | $\lambda$ |
| Fig. 2.3          | 15  | 1   | 0.1 | 0.25     | 0        | 0.5   | 0.8       |
| Fig. 2.4          | 15  | 1   | 0.1 | 0.1      | 0        | 1.8   | 0.01      |

Table 2.2: Option's parameters and Merton process parameters.

In order to investigate the effect of the heavy tails on the shape of the option curve, let us consider the second set of parameters in Table 2.2. Under these parameters, the Merton distribution has a very high kurtosis ( $\kappa = 97.32$ ). In Figure 2.4 we compare the Merton curve with a BS curve computed using the volatility parameter  $\sigma_{BS} = \sqrt{\sigma^2 + \lambda\xi^2 + \lambda\alpha^2}$ . In this way, the differences in the shape are only due to the kurtosis, since both processes have zero skewness and equal mean and variance.

As expected, the BS curve is smaller than the Merton curve in the *deep out of the money* region (in the picture 2.4 this region corresponds to  $S < 12$ ). This is a consequence of the heavy tails distribution of the Merton process, that assigns more probability to large movements of the underlying, i.e. a deep out of the money option has more probability to return *in the money* (where  $S > K$ ).

### 2.2.3 Variance Gamma PIDE

We introduced the Variance Gamma process in Section 1.3.3. The VG process has infinite activity i.e.  $\nu(\mathbb{R}) = \infty$  and has the triplet presented in

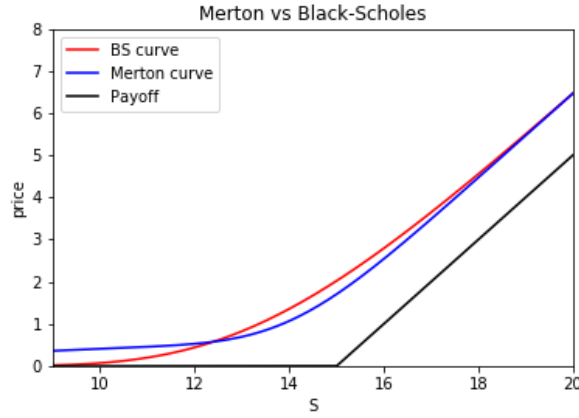


Figure 2.4: Comparison of prices of a call option at time  $t = 0$  for Merton and BS models with same standard deviation. The Merton parameters are those in the second line of the Table 2.2, while the diffusion parameter  $\sigma$  for the BS prices is chosen such that the variances of the two processes are the same.

(1.73).

From the general PIDE pricing formula (2.28), we obtain the VG PIDE for a function  $V \in C^{1,1}([0, T] \times \mathbb{R}) \cap \mathcal{C}_2([0, T] \times \mathbb{R})$ :

$$\frac{\partial V(t, x)}{\partial t} + (r - w) \frac{\partial V(t, x)}{\partial x} + \int_{\mathbb{R}} [V(t, x + z) - V(t, x)] \nu(dz) = rV(t, x). \quad (2.40)$$

with  $w$  defined in (1.81).

Unfortunately, it is not possible to apply the IMEX discretization directly to this equation. The Lévy measure has a singularity in the origin, that should be removed before the discretization.

An idea to overcome this problem, that can be applied to any Lévy processes with infinite activity, is presented in [Cont and Voltchkova, 2005a]. The authors propose to approximate the process  $\{X_t\}_{t \geq 0}$  by an appropriate finite activity process with a modified diffusion component. The “small jumps” martingale component is approximated by a Brownian motion with same variance. After fixing a truncation parameter  $\epsilon > 0$ , the integrals in the SDE are split in two domains:  $\{|z| < \epsilon\}$  and  $\{|z| \geq \epsilon\}$ . The integrand on the domain  $\{|z| < \epsilon\}$ , is approximated by the Taylor expansion  $e^z - 1 - z =$

$\frac{z^2}{2} + \mathcal{O}(z^3)$  such that

$$\begin{aligned}
dX_t &= \left( \mu - \frac{1}{2}\sigma^2 - \int_{\mathbb{R}} (e^z - 1 - z)\nu(dz) \right) dt + \sigma dW_t + \int_{\mathbb{R}} z\tilde{N}(dt, dz) \\
&= \left( \mu - \frac{1}{2}\sigma^2 - \int_{|z|<\epsilon} (e^z - 1 - z)\nu(dz) - \int_{|z|\geq\epsilon} (e^z - 1 - z)\nu(dz) \right) dt \\
&\quad + \sigma dW_t + \underbrace{\int_{|z|<\epsilon} z\tilde{N}(dt, dz)}_{\sigma_\epsilon dW_t} + \int_{|z|\geq\epsilon} z\tilde{N}(dt, dz) \\
&= \left( \mu - \frac{1}{2}(\sigma^2 + \sigma_\epsilon^2) - w_\epsilon + \lambda_\epsilon \theta_\epsilon \right) dt + (\sigma + \sigma_\epsilon) dW_t + \int_{|z|\geq\epsilon} z\tilde{N}(dt, dz),
\end{aligned} \tag{2.41}$$

where we defined the new parameters

$$\begin{aligned}
\sigma_\epsilon^2 &:= \int_{|z|<\epsilon} z^2 \nu(dz), & w_\epsilon &:= \int_{|z|\geq\epsilon} (e^z - 1)\nu(dz), \\
\lambda_\epsilon &:= \int_{|z|\geq\epsilon} \nu(dz), & \theta_\epsilon &:= \frac{1}{\lambda_\epsilon} \int_{|z|\geq\epsilon} z \nu(dz).
\end{aligned} \tag{2.42}$$

The process  $\int_{|z|\geq\epsilon} z\tilde{N}(dt, dz)$  is a compensated Poisson process with finite activity  $\lambda_\epsilon$  and variance  $\sigma_\epsilon^2 = \int_{|z|\geq\epsilon} z^2 \nu(dz)$ .

For the VG process, where  $\sigma = 0$  the approximated dynamics is thus

$$dX_t = \left( \mu - \frac{1}{2}\sigma_\epsilon^2 - w_\epsilon + \lambda_\epsilon \theta_\epsilon \right) dt + \sigma_\epsilon dW_t + \int_{|z|\geq\epsilon} z\tilde{N}(dt, dz), \tag{2.43}$$

where the parameters are obtained from the Lévy measure (1.66).

For any  $V \in C^2(\mathbb{R}) \cap C_2(\mathbb{R})$ , the infinitesimal generator associated with (2.43) has a “jump-diffusion” form

$$\begin{aligned}
\mathcal{L}^{VG}V(x) &= \left( \mu - \frac{1}{2}\sigma_\epsilon^2 - w_\epsilon \right) \frac{\partial V}{\partial x} + \frac{1}{2}\sigma_\epsilon^2 \frac{\partial^2 V}{\partial x^2} \\
&\quad + \int_{|z|\geq\epsilon} V(x+z)\nu(dz) - \lambda_\epsilon V(x).
\end{aligned} \tag{2.44}$$

The same result can be obtained directly from the infinitesimal generator (2.26) with  $\sigma = 0$ :

$$\begin{aligned}
\mathcal{L}^{VG}V(x) &= \mu \frac{\partial V}{\partial x} + \int_{|z|<\epsilon} \left[ V(x+z) - V(x) - (e^z - 1) \frac{\partial V}{\partial x} \right] \nu(dz) \\
&\quad + \int_{|z|\geq\epsilon} \left[ V(x+z) - V(x) - (e^z - 1) \frac{\partial V}{\partial x} \right] \nu(dz),
\end{aligned}$$

In the integral term on the domain  $\{|z| < \epsilon\}$ , we have to assume a smooth enough  $V$  such that we can use the following Taylor approximation



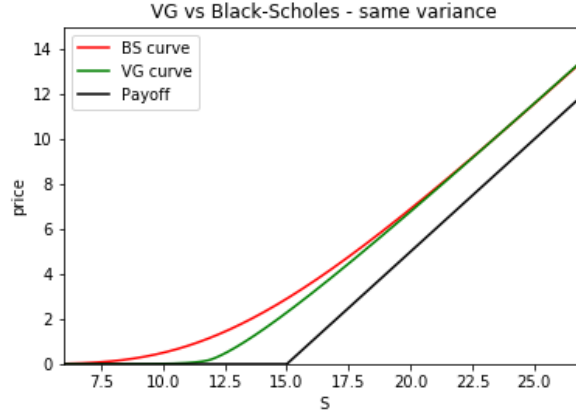


Figure 2.5: **Negative skewness:** Comparison of call option curves at  $t = 0$  for VG and BS models. The VG parameters are in Table (2.3). The BS curve is computed with a  $\sigma_{BS} = \sqrt{\bar{\sigma}^2 + \theta^2 \kappa}$ , such that the two processes have same variance.

- $V(x + z) = V(x) + \frac{\partial V}{\partial x} z + \frac{1}{2} \frac{\partial^2 V}{\partial x^2} z^2 + \mathcal{O}(z^3)$ .
- $e^z - 1 = z + \frac{z^2}{2} + \mathcal{O}(z^3)$ .

Considering only the terms up to the second order, the integral for  $\{|z| < \epsilon\}$  is

$$\int_{|z| < \epsilon} \frac{z^2}{2} \left[ \frac{\partial^2 V}{\partial x^2} - \frac{\partial V}{\partial x} \right] \nu(dz) = \frac{\sigma_\epsilon^2}{2} \left[ \frac{\partial^2 V}{\partial x^2} - \frac{\partial V}{\partial x} \right],$$

and we get again the infinitesimal generator (2.44). Using this generator and equations (2.19) and (2.16), the final PIDE is thus

$$\begin{aligned} \frac{\partial V(t, x)}{\partial t} + \left( r - \frac{1}{2} \sigma_\epsilon^2 - w_\epsilon \right) \frac{\partial V(t, x)}{\partial x} + \frac{1}{2} \sigma_\epsilon^2 \frac{\partial^2 V(t, x)}{\partial x^2} \\ + \int_{|z| \geq \epsilon} V(t, x + z) \nu(dz) = (\lambda_\epsilon + r) V(t, x). \end{aligned} \quad (2.45)$$

| VG parameters |     |     |     |          |                |          |
|---------------|-----|-----|-----|----------|----------------|----------|
| Figure        | $K$ | $T$ | $r$ | $\theta$ | $\bar{\sigma}$ | $\kappa$ |
| Fig. 2.5      | 15  | 1   | 0.1 | -0.2     | 0.2            | 2.5      |
| Fig. 2.6      | 15  | 1   | 0.1 | 0.2      | 0.2            | 2.5      |

Table 2.3: Option's parameters and VG process parameters.

This equation is almost identical to equation (2.36), except for the truncation in the integral. At this point we can restrict the computational domain on  $[A_1, A_2]$  and the integral region on  $[-B_1, B_2]$  and using the same

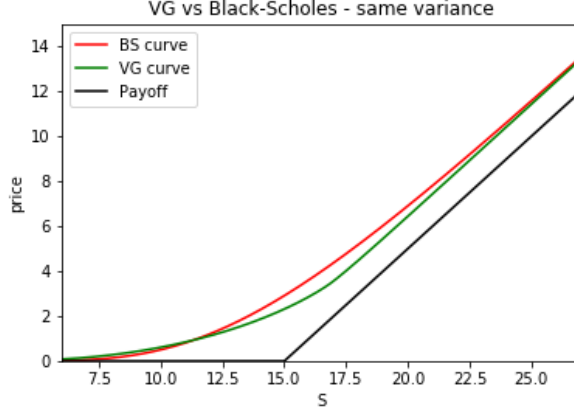


Figure 2.6: **Positive skewness:** Comparison of call option curves at  $t = 0$  for VG and BS models. The VG parameters are in Table 2.3. The BS curve is computed with a  $\sigma_{BS} = \sqrt{\bar{\sigma}^2 + \theta^2 \kappa}$ , such that the two processes have same variance.

discretization used for the Merton PIDE, we can solve the problem with the IMEX scheme.

Using the parameters in Table 2.3 we compute VG call option prices and compare them with BS prices with volatility  $\sigma_{BS} = \sqrt{\bar{\sigma}^2 + \theta^2 \kappa}$ , such that the two processes have same variance. In this way, only the features coming from skewness and kurtosis should pop up. Under this choice of parameters the VG process has standard deviation equal to 0.37, skewness (in absolute value) 3.05 and kurtosis 14.38. The sign of the skewness is determined by the sign of the parameter  $\theta$ .

In Figures 2.5 and 2.6 we compare the BS and VG curves. This example wants to show how different the shape of the VG curves can be by modifying the skewness parameter.

The reader can consult [Schoutens, 2003] for further information on Merton and VG processes and on general numerical tests and calibration of exponential Lévy processes.

#### 2.2.4 Numerical convergence analysis

In Table 2.4 we compare the ATM (*at the money*) prices of a European call option computed with the algorithms presented in the previous sections, with the prices obtained by closed formulas. For the BS model, we used the well known closed formula presented in the paper [Black and Scholes, 1973]. In order to compute the Merton price we use the semi-closed formula derived in [Merton, 1976], and for the VG price we used the semi-closed

|        | Closed formula | PDE/PIDE |
|--------|----------------|----------|
| BS     | 2.246368       | 2.246352 |
| Merton | 3.477645       | 3.477468 |
| VG     | 1.987006       | 1.987089 |

Table 2.4: Option prices with  $S_0 = K = 15$  and  $T = 1$ . Black Scholes parameters are in Table 2.1. Merton parameters are in the first line of Table 2.2. The Variance Gamma parameters are  $\theta = -0.1$ ,  $\bar{\sigma} = 0.2$ ,  $\kappa = 0.1$ .

formula of [Madan et al., 1998]. The PIDE prices are obtained by solving the equations (2.34), (2.36) and (2.45). In this analysis we consider the same sets of parameters that we will use in Chapter 6 (see Table 6.2).

It is a common practice to select the upper-bound and lower-bound of the price as a multiple of the strike price. In our case we set  $S_{max} = 6K$  and  $S_{min} = K/6$ . According to this choice, we set  $A_1 = \log(K/6)$  and  $A_2 = \log(6K)$  for all the three considered problems.

For the Merton PIDE we set  $B_1 = B_2 = 5\sigma_M$ , with  $\sigma_M = \sqrt{\lambda\xi^2 + \lambda\alpha^2}$ . For the VG PIDE we set  $B_1 = B_2 = 5\sigma_{VG}$ , with  $\sigma_{VG} = \sqrt{\bar{\sigma}^2 + \theta^2\kappa}$ . In both cases, the parameters  $B_1$  and  $B_2$  are multiple of the standard deviation of the respective jump processes. The parameters  $A_1$ ,  $A_2$ ,  $B_1$  and  $B_2$  are very important and should be set as large as possible in order to have an accurate result.

| space steps | BS       | Merton   | VG       |
|-------------|----------|----------|----------|
| 50          | 2.268400 | 3.495694 | 2.032549 |
| 100         | 2.251734 | 3.481931 | 2.014171 |
| 200         | 2.247682 | 3.478573 | 2.004308 |
| 400         | 2.246682 | 3.477744 | 1.998356 |
| 800         | 2.246433 | 3.477537 | 1.994912 |
| 1600        | 2.246371 | 3.477486 | 1.992661 |
| 3200        | 2.246356 | 3.477473 | 1.990863 |
| 6400        | 2.246352 | 3.477469 | 1.989213 |

Table 2.5: Convergence table. Fixed 12000 time steps.

The PDE/PIDE prices in Table 2.4 are obtained by dividing the space interval  $[A_1, A_2]$  in  $M = 16000$  steps and the time interval  $[t_0, T]$  in  $N = 12000$  steps. We can see that BS and VG prices are accurate up to the fourth decimal digit and Merton is accurate up to the third decimal digit. In the following analysis we assume they are the correct limiting value of the numerical algorithm, and indicate them by  $V^* = \lim_{M, N \rightarrow \infty} V^{M, N}$ .

In Tables 2.5 we computed option prices  $V^M$ , by varying the number of space steps  $M$  and keeping the time steps fixed  $N = 12000$ . In Table 2.6 we

| time steps | BS       | Merton   | VG       |
|------------|----------|----------|----------|
| 50         | 2.242021 | 3.440676 | 0.998308 |
| 100        | 2.244216 | 3.459215 | 1.295962 |
| 200        | 2.245297 | 3.468434 | 1.554740 |
| 400        | 2.245834 | 3.473032 | 1.741888 |
| 800        | 2.246102 | 3.475328 | 1.858731 |
| 1600       | 2.246235 | 3.476475 | 1.924853 |
| 3200       | 2.246302 | 3.477048 | 1.960160 |
| 6400       | 2.246335 | 3.477335 | 1.978422 |

Table 2.6: Convergence table. Fixed 16000 space steps.

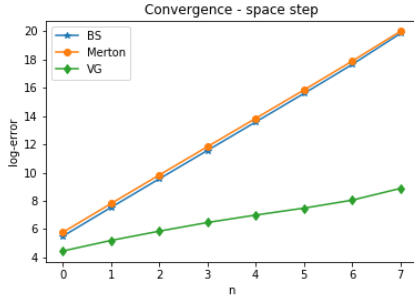


Figure 2.7: Log-error of the prices in Table 2.5.

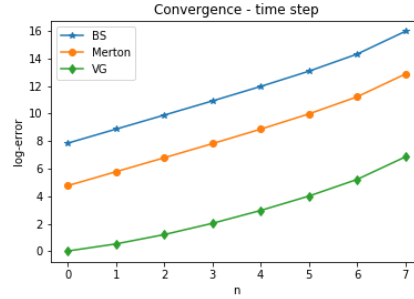


Figure 2.8: Log-error of the prices in Table 2.6.

did the opposite i.e. we computed  $V^N$  for different values of  $N$  and constant  $M = 16000$ . From these values it is possible to investigate how the error changes with respect to the discretization step.

Let us consider for instance the space discretization. If we define the error  $\varepsilon_M = |V^M - V^*|$ , we can assume that it has a polynomial relation with the discretization step  $\Delta x = \frac{A_2 - A_1}{M}$  i.e.  $\varepsilon_M \propto (\frac{1}{M})^p$ , where  $p$  is the **order of convergence**. In the Table 2.5 we chose  $M$  in a smart way such that  $M = 50 \cdot 2^n$ , for  $0 \leq n \leq 7$ . We can take the  $\log_2$  on both sides such that

$$-\log_2 \varepsilon_n = C + np, \quad (2.46)$$

where  $C \in \mathbb{R}$  is a constant of proportionality. The same analysis can be done for the time discretization.

The theoretical order of convergence of the implicit scheme applied to the BS PDE is  $p = 2$  for the space discretization and  $p = 1$  for the time discretization. For a discussion on the convergence rate for IMEX schemes applied to PIDEs we refer to [Cont and Voltchkova, 2005a] (Section 6.4). Since the theoretical analysis of convergence for IMEX schemes is a wide

topic, in this thesis we just perform a numerical convergence analysis.

In the two pictures 2.7 and 2.8 we plotted the log-error  $-\log_2 \varepsilon_n$  for the values in the Tables 2.5 and 2.6 respectively. It turns out that both the BS and Merton prices have a quadratic error ( $p = 2$ ) in space, while VG prices have a convergence order much smaller ( $p \sim 0.8$ ). It is worth to mention that in our algorithm we choose the truncation parameter  $\epsilon = 1.5\Delta x$ . This choice not only influences the convergence of the numerical scheme, but also the convergence of the Brownian approximation, since the parameters in (2.42) depend on  $\epsilon$ .

According to the results of Figure 2.8, the time error is linear ( $p = 1$ ) for all the three models.

## 2.3 Chapter conclusions

This chapter exposes in brief the main concepts of the “No-arbitrage”, or “martingale”, pricing theory.

This is the most common approach used to price financial derivatives. The well known Black-Scholes model is included in this framework as a special case when the stock dynamics follows a geometric Brownian motion. The martingale pricing theory applies to all exponential Lévy processes that satisfy the assumption **EM**. For the purpose of this thesis, the contents of this chapter are quite important because we will use them to make comparisons with the more complex models introduced in the next chapters.

In Section 2.1 we present the fundamental concepts necessary to define the pricing function of a derivative contract. Then we prove that this pricing function is the solution of a partial integro-differential equation when the stock dynamics follows an exponential Lévy process.

In the second part of the chapter, Section 2.2, we describe the algorithm used for the numerical solution of the Black-Scholes PDE and the Merton and VG PIDEs. We explain how to discretize the PIDE using the IMEX finite difference method proposed in [Cont and Voltchkova, 2005a]. We also provide a numerical convergence analysis of this method. The numerical results of this chapter will be used for comparison in Chapters 3 and 6. In Chapter 3 we compare the prices obtained by the multinomial method with those obtained by solving the VG PIDE. In Chapter 6, instead, we will see that when the transaction costs go to zero, the prices obtained from the transaction costs model are equal to the prices obtained by the martingale pricing theory.

## Multinomial methods for Variance Gamma

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In this thesis we decided to work with the Variance Gamma (VG) process because it has nice analytical properties and it reproduces quite well the statistical features of the stock dynamics (see for instance [Cont and Tankov, 2003] and [Ait-Sahalia and Jacod, 2012]).

To support this statement, we present in Figure 3.1 some examples of histograms of daily log-returns of the four indices: the **S&P 500** Stock Index, the **KOSPI** (Korea Composite Stock Price Index), **XAO** (All Ordinaries Australian Index) and **TAIEX** (Taiwan Capitalization weighted Stock Index). In the pictures we show the fit of the Normal and Variance Gamma (VG) densities, using the market data. It is clear that the VG density reproduces much better the high peaks near the origin and the heavy tails of the empirical distribution.

The VG process was first presented in the context of option pricing in [Madan and Milne, 1991], where it has been used for pricing European options. European vanilla options can be easily priced by the analytical

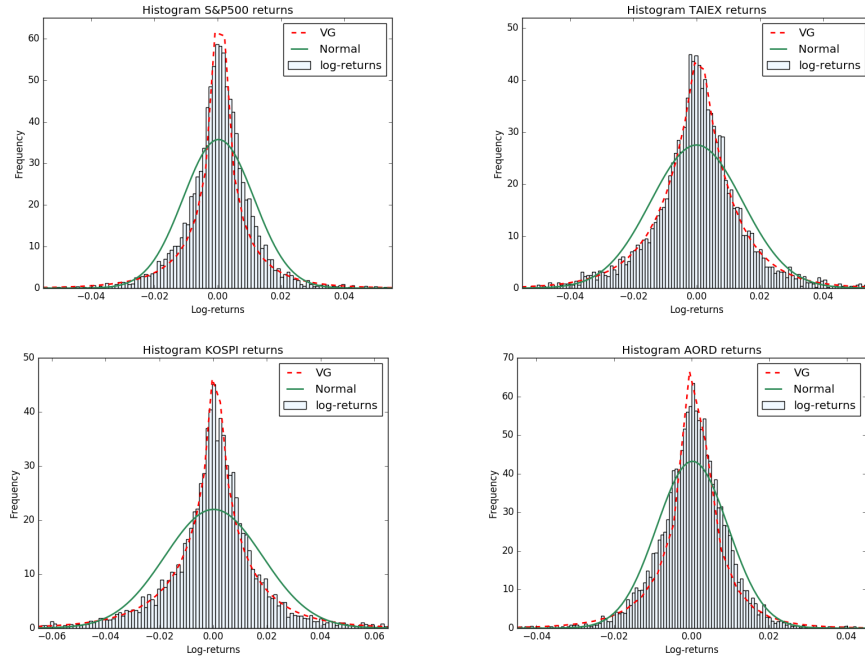


Figure 3.1: Histograms of daily log-returns for S&P500, KOSPI, XAO and TAIEX, from 1 January 1988 to 9 December 2016. Source: Yahoo Finance. The dashed line corresponds to the VG density (1.65). The continuous line is the normal density. The parameters are obtained by the *method of moments*. For more details on the parameter estimation for the VG density we refer to [Seneta, 2004].

formula presented in [Madan et al., 1998] and exotic options can be priced numerically by several common techniques. Monte Carlo methods for VG are presented in [Fu, 2000]. A finite difference scheme for the VG Partial Integro-Differential Equation (PIDE) is described in [Cont and Voltchkova, 2005a]. In [Carr and Madan, 1998], the authors show how to price options by a Fourier transform approach. The problem for American options is considered in [Almendral, 2005], [Almendral and Oosterlee, 2007] and [Hirsa and Madan, 2001], where the authors present different finite difference schemes to solve the American VG PIDE.

The tree method was first introduced by [Cox et al., 1979] for a market where the log-price can change only in two different ways: an upward jump, or a downward jump. For this reason the model is called *binomial model*. The authors prove that when the number of time steps goes to infinity, the discrete random walk of the log-price converges to the Brownian motion and the option price converges to the Black-Scholes price. The *multinomial model* is a generalization of the binomial model, and at each

time step it considers more than just two possible future states. A general multinomial method for pricing European and American options under exponential Lévy processes is described in [Maller et al., 2006]. In [Kellezi and Webber, 2006] the authors consider a multinomial method for general exponential Lévy processes based on the moment matching condition. Other methods based on the moment matching condition are for instance [Hainaut and MacGilchrist, 2010], with applications to the Normal Inverse Gaussian process, and [Ssebugenyi and Konlack, 2013] with applications to the VG process. In the present work we consider a multinomial discretization based on the cumulant matching condition as explained in [Yamada and Primbs, 2001], [Yamada and Primbs, 2003] and [Yamada and Primbs, 2004].

In Section 3.1 we review the construction of the multinomial tree, following the method of moment matching proposed in [Yamada and Primbs, 2001]. We prove that the multinomial tree converges to the continuous time jump process that we have introduced to approximate the VG process. In Section 3.2, we describe the algorithm for pricing options with the multinomial method and show the numerical results for European and American options.

### 3.1 The multinomial method

In this section we introduce the multinomial method proposed in [Yamada and Primbs, 2004]. The stock price is represented by a Markov chain with  $L$  possible future states at each time. In this setting, the time  $t \in [t_0, T]$  is discretized as  $t_n = t_0 + n\Delta t$  for  $n = 0, \dots, N$  and  $\Delta t = (T - t_0)/N$ . We denote the stock price at time  $t_n$  as  $S_{t_n} = S_n$ .

Let us consider the up/down factors  $u > d > 0$ , and write the discrete evolution of the stock price  $S_n$  as:

$$S_{n+1} = u^{L-l} d^{l-1} S_n \quad l = 1, \dots, L \quad (3.1)$$

where each future state has transition probability  $p_l$ , satisfying  $\sum_{l=1}^L p_l = 1$ . The value of the stock at time  $t_n$  can assume  $j \in [1, \dots, n(L-1) + 1]$  possible values:

$$S_n^{(j)} = u^{n(L-l)+1-j} d^{j-1} S_0. \quad (3.2)$$

The multinomial tree is recombining if  $u/d = c$ , for  $c > 1$ . In the present work we only consider five branches,  $L = 5$ . As we will see in the next sections this number of branches is enough to model the features of a stochastic process up to its fourth moment.

#### 3.1.1 Moment matching

In order to determine the parameters of the Markov chain we require that its local moments are equal to that of the continuous process. Let us consider a



VG process with drift  $(r - w)$ , where  $w$  is the martingale correction defined in (1.81):

$$\begin{aligned} Y_{t+\Delta t} - Y_t &= (r - w)\Delta t + \int_{\mathbb{R}} xN(\Delta t, dx) \\ &= (r - w + \theta)\Delta t + \int_{\mathbb{R}} x\tilde{N}(\Delta t, dx) \end{aligned} \quad (3.3)$$

The parameter  $\theta = \int_{\mathbb{R}} x\nu(dx) = \mathbb{E}[\int_{\mathbb{R}} xN(1, dx)]$  is the expected value of the VG process in (1.63), when  $\Delta t = 1$ . The integral with respect to the compensated Poisson measure  $\tilde{N}(\Delta t, dx)$  is a martingale as discussed in Section 1.1.3.

We can pass to log-prices  $Y_n = \log(S_n)$  in the discrete Eq. (3.1), and write it as the sum of a drift component and a random variable with  $L$  possible outcomes:

$$\begin{aligned} \Delta Y &= Y_{n+1} - Y_n = (L - l)\log(u) + (l - 1)\log(d) \\ &= \bar{b}\Delta t + (L - 2l + 1)\alpha(\Delta t). \end{aligned} \quad (3.4)$$

The term  $\bar{b}\Delta t$  is the drift term, while the term  $l$  is a random variable that takes values in  $\{1, 2, \dots, L\}$  with probability  $p_l$ . It has to satisfy the martingale condition:

$$\mathbb{E}[(L - 2l + 1)\alpha(\Delta t)] = \alpha(\Delta t) \sum_{l=1}^L p_l(L - 2l + 1) = 0,$$

and  $\alpha(\Delta t)$  is a function of  $\Delta t$ .

The corresponding up/down factors have the following representation:

$$u = \exp\left(\frac{b}{L-1} + \alpha(\Delta t)\right) \quad d = \exp\left(\frac{b}{L-1} - \alpha(\Delta t)\right), \quad (3.5)$$

and we can readily see that if  $u/d$  is a constant, then the tree recombines.

Given the mean  $c_1 = \mathbb{E}[\Delta Y] = \bar{b}\Delta t$ , the  $k$ -central moment is:

$$\mathbb{E}[(\Delta Y - c_1)^k] = \alpha(\Delta t)^k \mathbb{E}[(L - 2l + 1)^k]. \quad (3.6)$$

The moment matching condition requires that the central moments of the discrete process (3.4) are equal to the central moments of the continuous process (3.3):

$$\alpha(\Delta t)^k \mathbb{E}[(L - 2l + 1)^k] = \mu_k. \quad (3.7)$$

We fix  $L = 5$ , and using the relation between central moments and cumulants (Eq. (1.85)) we solve the linear system of equations for the transition

probabilities:

$$\begin{aligned}
p_1 &= \frac{1}{196\alpha(t)^4} \left[ \frac{3}{2}c_2^2 - 2c_2\alpha(t)^2 + 2c_3\alpha(t) + \frac{1}{2}c_4 \right] \\
p_2 &= \frac{1}{196\alpha(t)^4} \left[ -6c_2 + 32c_2\alpha(t)^2 - 4c_3\alpha(t) - 2c_4 \right] \\
p_3 &= 1 + \frac{1}{196\alpha(t)^4} \left[ 3c_4 + 9c_2^2 - 60c_2\alpha(t)^2 \right] \\
p_4 &= \frac{1}{196\alpha(t)^4} \left[ -6c_2 + 32c_2\alpha(t)^2 + 4c_3\alpha(t) - 2c_4 \right] \\
p_5 &= \frac{1}{196\alpha(t)^4} \left[ \frac{3}{2}c_2^2 - 2c_2\alpha(t)^2 - 2c_3\alpha(t) + \frac{1}{2}c_4 \right].
\end{aligned} \tag{3.8}$$

The drift parameter corresponds to  $\bar{b} = r - w + \theta$ . The only missing term to find is  $\alpha(\Delta t)$ . This is a function of the time increment  $\Delta t$  and can be determined using the higher order terms in the moment matching condition together with the condition of positive probabilities.

Recall that the well known binomial model [Cox et al., 1979] assumes the value  $\alpha(\Delta t) = \sigma\sqrt{\Delta t}$ , that represents the volatility of the increments in the time interval  $\Delta t$ . In the trinomial model, the parameter  $\alpha(\Delta t)$  assumes the value  $\alpha(\Delta t) = \frac{1}{2}\sigma\sqrt{3\Delta t}$ , see for instance [Yamada and Primbs, 2001]. For the multinomial method a good representation for  $\alpha(\Delta t)$  is:

$$\alpha(\Delta t) = \sqrt{c_2} \sqrt{\frac{3 + \bar{\kappa}}{12}}, \tag{3.9}$$

where  $\bar{\kappa} = c_4/c_2^2$  is the excess of kurtosis<sup>1</sup>. We refer to [Yamada and Primbs, 2004] for the derivation. This choice guarantees that the probabilities  $p_i$  for  $i = 1 \dots 5$  are always positive and sum to one. We can replace the expression (3.9) inside (3.8), to obtain the simpler form:

$$\begin{aligned}
[p_1, p_2, p_3, p_4, p_5] &\approx \left[ \frac{3 + \bar{\kappa} + s\sqrt{9 + 3\bar{\kappa}}}{4(3 + \bar{\kappa})^2}, \frac{3 + \bar{\kappa} - s\sqrt{9 + 3\bar{\kappa}}}{2(3 + \bar{\kappa})^2}, \right. \\
&\quad \left. \frac{3 + 2\bar{\kappa}}{2(3 + \bar{\kappa})}, \frac{3 + \bar{\kappa} + s\sqrt{9 + 3\bar{\kappa}}}{2(3 + \bar{\kappa})^2}, \frac{3 + \bar{\kappa} - s\sqrt{9 + 3\bar{\kappa}}}{4(3 + \bar{\kappa})^2} \right],
\end{aligned} \tag{3.10}$$

where  $s = c_3/\sqrt{c_2^3}$  is the skewness.

**Remark 1.** *The standard deviation of every Lévy process with finite second moment follows the square root propagation rule. This means that the term  $\alpha(\Delta t)$  has to be proportional to the square root of  $\Delta t$ . In the binomial and trinomial models, the proportionality constant is explicit, while for the pentanomial method it is implicit in the formula (3.9). Expanding the formula using the expression (1.68) for the cumulants, it is possible to check that the square root rule is satisfied at first order in  $\sqrt{\Delta t}$ .*

<sup>1</sup>We use the bar over  $\kappa$ , to distinguish the kurtosis from the variance of the gamma process  $\kappa$ .

### 3.1.2 Convergence

We call a generic jump process (1.69) with first four cumulants  $c_1, c_2, c_3, c_4$  as in (1.68), the *approximated process*  $X^A$ . The cumulant generating function of the increment  $\Delta X^A$  has the following series representation (see Section 1.4):

$$H_{\Delta X^A}(u) = ic_1 u - \frac{c_2 u^2}{2} - \frac{ic_3 u^3}{3!} + \frac{c_4 u^4}{4!} + \mathcal{O}(u^5). \quad (3.11)$$

We are interested in the approximation of a VG process with drift (3.3), therefore we require that  $c_1 = \bar{b}\Delta t = (r - w + \theta)\Delta t$ .

**Theorem 3.1.1.** *The increments of the discrete Markov chain (3.4) and the increments of the approximated process  $X^A$  have the same distribution by construction.*

*Proof.* The idea of the proof is to show that the cumulant generating function of the discrete process (3.4) coincides with that of the approximated process (3.11). We prove it by using the moment matching condition (3.7).

$$\begin{aligned} H_{\Delta Y}(u) &= \log(\phi_{\Delta Y}(u)) = \log\left(\mathbb{E}[e^{iu\Delta Y}]\right) \\ &= \log\left(\mathbb{E}\left[e^{iu(\bar{b}\Delta t + (L-2l+1)\alpha(\Delta t))}\right]\right) \\ &= iu\bar{b}\Delta t + \log\left(\mathbb{E}\left[e^{iu((L-2l+1)\alpha(\Delta t))}\right]\right). \end{aligned} \quad (3.12)$$

We can expand the exponential function in Taylor series and use the moment matching condition (3.7) to obtain:

$$\begin{aligned} H_{\Delta Y}(u) &= iu\bar{b}\Delta t + \log\left(\sum_{k=0}^{\infty} \frac{(iu)^k}{k!} (\alpha(\Delta t))^k \mathbb{E}\left[(L-2l+1)^k\right]\right) \\ &= iu\bar{b}\Delta t + \log\left(\sum_{k=0}^{\infty} \frac{(iu)^k}{k!} \mu_k\right) \\ &= iuc_1 + \sum_{k=0}^{\infty} \frac{(iu)^k}{k!} c_k \\ &= H_{\Delta X^A}(u), \end{aligned} \quad (3.13)$$

□

**Remark 2.** *All the cumulants of  $\Delta X^A$  are equal to the cumulants of the Markov chain (3.4) by construction, but only the first four are equal to the VG cumulants. When all the cumulants  $c_i$ , for  $0 \leq i \leq n$ , are equal to the VG cumulants, the approximated process  $X^A$  converges to the original VG process for  $n \rightarrow \infty$ . In order to describe  $n$  cumulants, we need  $n+1$  branches.*

Therefore, when the number of cumulants of  $\Delta X^A$  that are equal to those of the VG goes to infinity, the number of branches has to go to infinity as well. We assume that five branches ( $L = 5$ ) are enough to describe the main features of the underlying process and, at the same time, keep the numerical problem simple.

**Theorem 3.1.2.** *The distribution of the pentanomial tree at time  $N$  converges to the distribution of a compound Poisson process at time  $N$  with  $L = 5$  possible jump sizes and activity  $\lambda = \frac{3}{2\kappa N}$ , when  $\Delta t \rightarrow 0$ .*

For the proof of this theorem we refer to Section 4.2 of [Yamada and Primbs, 2004]. The authors first define the jump sizes and their respective probabilities, and then prove that when  $\Delta t \rightarrow 0$  the characteristic function of the pentanomial tree converges to the characteristic function of the compound Poisson process.

## 3.2 Numerical results

In this section we present the steps to implement the algorithm for pricing European and American options with the multinomial method. Then we compare the results with those obtained by the PIDE method and Black-Scholes model.

### 3.2.1 Algorithm

We suggest the following algorithm for pricing with the multinomial method:

1. Compute the transition probabilities vector (3.10).
2. Compute the up/down factors  $u$  and  $d$  (3.5) and the vector of prices  $S_N$  at terminal time  $N$  as in Eq. (3.2).
3. Evaluate the payoff of the option  $V^N(S_N)$  at terminal time  $N$ .
4. Given the option values at time  $t_{n+1}$  compute the values at time  $t_n$ . The value is the conditional expectation:

$$V^n(s_n^{(k)}) = e^{-r\Delta t} \mathbb{E}^{\mathbb{Q}} \left[ V^{n+1}(S_{n+1}) \middle| S_n^{(k)} = s_n^{(k)} \right]. \quad (3.14)$$

5. If computing the price of an American option, the value at the previous time level is the maximum between the conditional expectation and the intrinsic value of the option. For an American put we have:

$$V^n(s_n^{(k)}) = \max \left\{ e^{-r\Delta t} \mathbb{E}^{\mathbb{Q}} \left[ V^{n+1}(S_{n+1}) \middle| S_n^{(k)} = s_n^{(k)} \right], K - s_n^{(k)} \right\}. \quad (3.15)$$

6. Iterate the algorithm until the initial time  $t_0$ .

In all the numerical computations of this chapter we consider the risk neutral VG parameters in Table 3.1. These parameters correspond to the parameters used in [Cantarutti and Guerra, 2018].

| Parameters |          |          |          |
|------------|----------|----------|----------|
| $r$        | $\theta$ | $\sigma$ | $\kappa$ |
| 0.06       | -0.1     | 0.2      | 0.2      |

Table 3.1:  $r$  is the risk free interest rate and  $\theta, \sigma, \kappa$  are the risk neutral VG parameters.

**Remark 3.** *In practice, the risk neutral parameters of the VG model should be calibrated from market prices of European vanilla options, using the closed pricing formula of [Madan et al., 1998]. Then, this risk neutral VG model can be used to price exotic derivatives for which there are no closed formulas. The multinomial method is particularly suitable for American-style options, since Monte Carlo and PIDEs methods are in general more difficult to implement. For this reason, tree methods are quite popular among practitioners.*

### 3.2.2 European options

We compare the numerical results for European call and put options obtained with the multinomial and the PIDE approaches. We solve the VG PIDE following the IMEX method introduced in Section 2.2.3. The details of the implementation are presented in Section 2.2.4.

Following the algorithm proposed in the previous section, we solve the option pricing problem using the multinomial method. The number of time steps for all the computations presented in the following pictures is  $N = 2000$ . The Table 3.2 shows a convergence analysis for the prices of European calls, puts and American puts. We can see that the convergence is quite fast. Figures 3.2 and 3.3 show the single prices obtained by the multinomial method compared with the curve obtained by solving the PIDE. In Table 3.3 we compare directly the call/put numerical values obtained with the two methods.

### 3.2.3 American options

In this section we present the numerical results obtained with the multinomial method algorithm for American put options, and compare them with the PIDE method (see fig. 3.4). The PIDE (2.45) is modified in order to

| $N$  | Eu. Call   | Eu. Put    | Time  | Am. Put    | Time  |
|------|------------|------------|-------|------------|-------|
| 50   | 4.41873125 | 2.08928091 | 0.001 | 2.36765911 | 0.007 |
| 100  | 4.41960265 | 2.09015381 | 0.002 | 2.37255454 | 0.02  |
| 200  | 4.41997010 | 2.09052201 | 0.004 | 2.37480218 | 0.07  |
| 400  | 4.42013640 | 2.09068869 | 0.01  | 2.37587117 | 0.29  |
| 800  | 4.42021515 | 2.09076762 | 0.03  | 2.37639131 | 1.09  |
| 1000 | 4.42023054 | 2.09078306 | 0.04  | 2.37649417 | 1.67  |
| 1500 | 4.42025089 | 2.09080345 | 0.06  | 2.37663070 | 3.79  |
| 2000 | 4.42026098 | 2.09081357 | 0.10  | 2.37669869 | 6.80  |
| 2500 | 4.42026701 | 2.09081962 | 0.16  | 2.37673941 | 10.65 |
| 3000 | 4.42027102 | 2.09082364 | 0.2   | 2.37676652 | 14.78 |

Table 3.2: Convergence table for ATM European and American options with strike  $K = 40$  and  $T = 1$ . The time unit is in seconds.

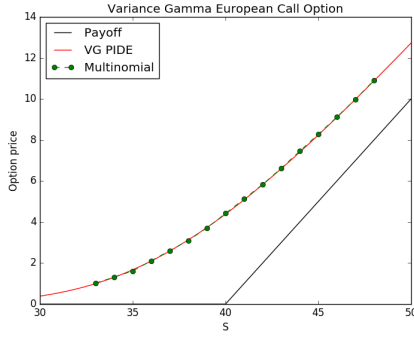


Figure 3.2: European call option with strike  $K = 40$  and time to maturity 1 year.

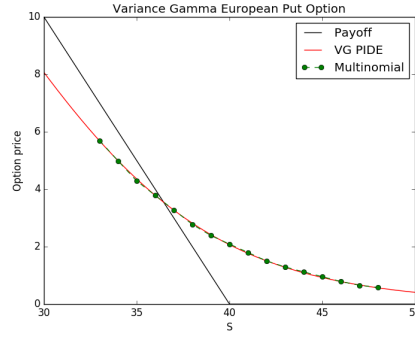


Figure 3.3: European put option with strike  $K = 40$  and time to maturity 1 year.

take into account the early exercise feature:

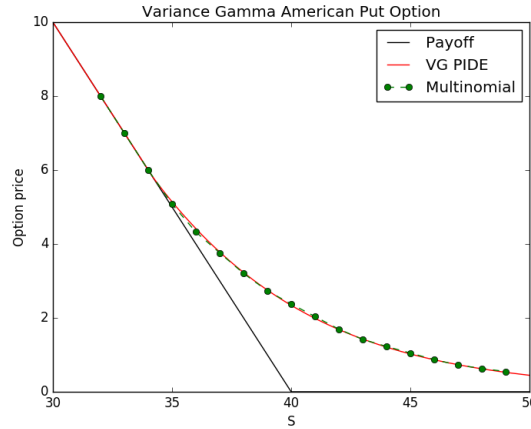
$$\min \left\{ -\frac{\partial V(t, x)}{\partial t} - \left( r - \frac{1}{2}\sigma_\epsilon^2 - w_\epsilon \right) \frac{\partial V(t, x)}{\partial x} - \frac{1}{2}\sigma_\epsilon^2 \frac{\partial^2 V(t, x)}{\partial x^2} + (\lambda_\epsilon + r)V(t, x) \right. \quad (3.16)$$

$$\left. - \int_{|z| \geq \epsilon} V(t, x+z) \nu(dz), \left( V(t, x) - (K - e^x)^+ \right) \right\} = 0.$$

To solve this equation we use the same discretization and same settings used in Sections 2.2.3 and 2.2.4 for the European option problem.

The numerical values obtained by multinomial and PIDE methods are collected in Tab. 3.4. The run times for the multinomial algorithm are shown in the convergence Table 3.2.

| Different methods |           |            |          |           |
|-------------------|-----------|------------|----------|-----------|
| $S_0$             | PIDE Call | Multi Call | PIDE Put | Multi Put |
| 36                | 2.1036    | 2.1131     | 3.7842   | 3.7837    |
| 38                | 3.1163    | 3.1051     | 2.7893   | 2.7756    |
| 40                | 4.4162    | 4.4203     | 2.0852   | 2.0908    |
| 42                | 5.8335    | 5.8309     | 1.5050   | 1.5014    |
| 44                | 7.4417    | 7.4524     | 1.1132   | 1.1229    |

Table 3.3: European Options, with strike  $K = 40$  and  $T = 1$ .Figure 3.4: American put option with strike  $K = 40$  and time to maturity 1 year. Comparison of PIDE prices and multinomial prices.

In Table 3.4, we consider also European and American put option prices calculated with the Black-Scholes (BS) models. The BS volatility is chosen equal to the VG volatility  $\sigma^{BS} = (\sigma^2 + \theta^2 \kappa)$ . As expected, the deep OTM (out of the money) prices computed under VG are higher than the corresponding prices computed under BS. This is a consequence of the shape of the VG density function (1.65), which has *heavier tails* than the normal distribution. This means that the probability of a deep OTM option to return in the money, is higher if calculated with the VG model than BS, and therefore we get higher option prices.

The Black-Scholes prices are computed using a binomial algorithm. The same values can be obtained using the multinomial algorithm for the VG process and setting  $\theta = \kappa = 0$  and  $\sigma = \sigma^{BS}$ . Recall that under the Black-Scholes model, the log-returns follow a Brownian motion. Looking at the definition of the VG process (1.63), it is evident that when  $\theta$  and  $\kappa$  are zero,

| Prices comparison |            |            |            |            |                 |
|-------------------|------------|------------|------------|------------|-----------------|
| $S_0$             | BS Eu. Put | VG Eu. Put | BS Am. Put | VG Am. Put | VG Am. PIDE Put |
| 30                | 8.1316     | 8.0809     | 10         | 10         | 10              |
| 32                | 6.5292     | 6.4055     | 8          | 8          | 8               |
| 34                | 5.1169     | 4.9851     | 6.0894     | 6          | 6               |
| 36                | 3.9150     | 3.7837     | 4.5415     | 4.3173     | 4.3982          |
| 38                | 2.9263     | 2.7756     | 3.3264     | 3.2034     | 3.2195          |
| 40                | 2.1388     | 2.0908     | 2.3924     | 2.3767     | 2.3531          |
| 42                | 1.5322     | 1.5014     | 1.6911     | 1.6947     | 1.6849          |
| 44                | 1.0766     | 1.1229     | 1.1755     | 1.2267     | 1.2118          |
| 46                | 0.7433     | 0.7858     | 0.8043     | 0.8699     | 0.8650          |
| 48                | 0.5049     | 0.5787     | 0.5425     | 0.6310     | 0.6221          |
| 50                | 0.3384     | 0.4259     | 0.3612     | 0.4661     | 0.4480          |
| 52                | 0.2238     | 0.3015     | 0.2376     | 0.3242     | 0.3222          |
| 55                | 0.1178     | 0.1909     | 0.1243     | 0.2051     | 0.1990          |
| 60                | 0.0386     | 0.0880     | 0.0404     | 0.0942     | 0.0913          |

Table 3.4: Values for European and American put options using Black-Scholes (binomial) and Variance Gamma (multinomial) methods. Strike  $K = 40$  and  $T = 1$ . The BS volatility have same value of the VG volatility  $\sigma^{BS} = (\sigma^2 + \theta^2 \kappa) = 0.2049$ . The last column presents values of American options computed with the PIDE method using a grid with  $M = 16000$  and  $N = 12000$  steps.

the process becomes a Brownian motion:

$$X_t^{VG} \xrightarrow{\theta, \kappa \rightarrow 0} \sigma W_t.$$

It follows that the price process converges to the Geometric Brownian Motion:

$$S_t = S_0 e^{(r-w)t + X_t} \xrightarrow{\theta, \kappa \rightarrow 0} S_0 e^{(r - \frac{1}{2}\sigma^2)t + \sigma W_t}$$

where:

$$\begin{aligned} \lim_{\theta, \kappa \rightarrow 0} w &= \lim_{\theta, \kappa \rightarrow 0} -\frac{1}{\kappa} \log(1 - \theta\kappa - \frac{1}{2}\sigma^2\kappa) \\ &= -\frac{1}{2}\sigma^2. \end{aligned}$$

### 3.3 Chapter conclusions

In this chapter we make a small digression from the main theme of the thesis by presenting the application of a multinomial approximation for option



pricing using the Variance Gamma model. The main results of this chapter are published in the paper [Cantarutti and Guerra, 2018].

The VG process is approximated by a general jump process that has the same first four cumulants of the original VG process. We show that by construction the multinomial method has the same distribution of the approximated process. We provide numerical results for European and American options and compare them with results obtained by PIDE methods, and with Black–Scholes prices.

Pricing vanilla call and put European options under the VG model is quite simple, and the best approach is to use the closed formula derived in [Madan et al., 1998]. The advantage of the multinomial method is in the computation of American options prices, where there is no closed formula and all the other approaches, such as PIDEs and Least Squares Monte Carlo (proposed in [Longstaff and Schwartz, 2001] for diffusion processes), are difficult to implement.

It turns out that the multinomial method is straightforward to implement. The algorithm does not involve any matrix multiplications, matrix inversions or decompositions as for PIDEs. Moreover, the IMEX scheme requires also the computation of an integral such as (6.12), which in general can be computationally expensive.

In order to show the ease of use of this algorithm, in Chapter 6 we applied it to solve the option pricing problem with transaction costs, with good performances.

## HJB equation and viscosity solution

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In this chapter we present a brief introduction to the use of the **dynamic programming principle** for solving stochastic control problems. The fundamental equation of dynamic programming is a nonlinear evolution equation for the **value function**. The value function is the optimum value of the payoff considered as a function of the initial data. This principle was introduced in the 1950s by Bellman, see [Bellman, 1957]. For controlled Lévy processes, the approach yields a certain nonlinear PIDE, usually of first or second order, called **Hamilton-Jacobi-Bellman** (HJB) equation.

The theory of viscosity solutions, provides a convenient framework in which to study HJB equations. Typically, the value function is not smooth enough to satisfy the HJB in the classical sense. However, under certain assumptions, it is the unique viscosity solution of the HJB equation with appropriate boundary conditions. A general review of the theory of viscosity solutions is presented in [Crandall et al., 1992].

The first notion of viscosity solution has been introduced by [Crandall and Lions, 1983] for first order partial differential equations. The theory has been immediately extended by [Lions, 1983] for second order PDEs. Uniqueness results for general second order equations are presented in [Jensen, 1988], [Ishii, 1989] and [Ishii and P.L., 1990]. The main development of these works is the *Ishii's lemma*, which plays a key role in most of the uniqueness proofs. The viscosity solution theory has been further extended by [Soner, 1986a], [Soner, 1986b] and [Sayah, 1991] for piecewise deterministic processes with random jumps. An important paper for viscosity solutions of Lévy-type PIDEs (PIDEs involving the generator of a Lévy process) is [Barles and Imbert, 2008], where the Ishii's lemma is extended. Further important contributions that deserve to be mentioned are [Pham, 1998], that analyzes HJB equations for optimal stopping problems under Lévy processes and [Cont and Voltchkova, 2005b] that analyze the solution of linear PIDEs derived from option pricing problems (plain vanilla and barrier options) for finite and infinite activity Lévy processes.

## 4.1 Optimal control framework

We consider a framework where the state of the system  $X_t$ , is governed by the following controlled SDE with values in  $\mathbb{R}^n$ :

$$\begin{aligned} dX_t = & b(t, X_{t-}, \alpha_t)dt + \sigma(t, X_{t-}, \alpha_t)dW_t \\ & + \int_{\mathbb{R}^n} \gamma(t, X_{t-}, \alpha_t, z)\tilde{N}(dt, dz). \end{aligned} \quad (4.1)$$

where we consider a  $d$ -dimensional Brownian motion. The coefficients  $b : [0, T] \times \mathbb{R}^n \times A \rightarrow \mathbb{R}^n$ ,  $\sigma : [0, T] \times \mathbb{R}^n \times A \rightarrow \mathbb{R}^{n \times d}$ ,  $\gamma : [0, T] \times \mathbb{R}^n \times A \times \mathbb{R}^n \rightarrow \mathbb{R}^n$  are continuous functions with respect to  $(t, x, a)$  and  $\gamma(t, x, a, \cdot)$  is also bounded uniformly in  $a \in A$  in any neighborhood of  $z = 0$ .

In this chapter we use the same compact notation introduced for (1.39), where all the indexes are suppressed. The expression (4.1) corresponds to the component-wise equation

$$\begin{aligned} dX_t^i = & b^i(t, X_{t-}, \alpha_t)dt + \sum_{j=1}^d \sigma^{i,j}(t, X_{t-}, \alpha_t)dW_t^j \\ & + \int_{\mathbb{R}^n} \gamma^i(t, X_{t-}, \alpha_t, z)\tilde{N}(dt, dz). \end{aligned} \quad (4.2)$$

for  $1 \leq i \leq n$ .

In the following, we will work with the *Wiener-Poisson filtration*  $\{\mathcal{F}_t\}_{t \geq 0}$  obtained from the natural filtrations of the Brownian motion and the compensated Poisson random measure. We define the filtration  $\{\mathcal{F}_t\}_{t \geq 0}$  as the

right-continuous completed revision<sup>1</sup> of  $\{\mathcal{F}_t^W \otimes \mathcal{F}_t^{\tilde{N}}\}_{t \geq 0}$ , where  $\mathcal{F}_t^W = \sigma\{W_s : 0 \leq s \leq t\}$  and  $\mathcal{F}_t^{\tilde{N}} = \sigma\{\tilde{N}(s, B) : 0 \leq s \leq t, B \in \mathcal{B}(\mathbb{R}^n \setminus \{0\})\}$ . For more information on the Wiener-Poisson filtration we refer to Section 5.1 of [Bouchard and Touzi, 2011].

We indicate with  $\mathcal{A}$  the space of controls. This space comprises all predictable processes  $\alpha : [0, T] \times \Omega \rightarrow A$ , with respect to  $\{\mathcal{F}_t\}_{t \geq 0}$ . In this section we assume a compact<sup>2</sup> set  $A \subset \mathbb{R}^m$ . In this thesis we only consider Markovian controls such that  $\alpha_t := \alpha(t, X_{t-})$ . The function  $\alpha(t, x) : [0, T] \times \mathbb{R}^n \rightarrow A$  must be a measurable function, and in order to guarantee existence and uniqueness of a solution of (4.1), we assume it satisfies the Lipschitz condition with respect to  $x$ .

In Section 1.2.3, we presented existence and uniqueness conditions for a time-homogeneous SDE. Following Chapter 3.3 of [Gihman and Skorohod, 1979], we can extend those conditions for the more general SDE in (4.1). Let us consider a function  $\rho : \mathbb{R}^n \rightarrow \mathbb{R}$  satisfying (1.48). We have the following:

(C1) **Lipschitz condition** There exist  $K > 0$ , such that  $\forall x, y \in \mathbb{R}^n, \forall t \in [0, T]$  and  $\forall a \in A$

$$|b(t, x, a) - b(t, y, a)| + \|\sigma(t, x, a) - \sigma(t, y, a)\| \leq K|x - y|, \quad (4.3)$$

$$|\gamma(t, x, a, z) - \gamma(t, y, a, z)| \leq |\rho(z)| |x - y|. \quad (4.4)$$

**Theorem 4.1.1.** *The assumptions (4.3) and (4.4) ensure that for each Lipschitz Markov control  $\alpha \in \mathcal{A}$ , there exists a unique strong solution of (4.1) with given initial conditions.*

See discussion in Chapter 3.3 of [Gihman and Skorohod, 1979] (page 156).

Note that the Lipschitz conditions (4.3) and (4.4) together with the continuity of  $b, \sigma, \gamma$ , imply the growth conditions:

$$|b(t, x, a)| + \|\sigma(t, x, a)\| \leq \tilde{K}|1 + |x|| \quad (4.5)$$

$$|\gamma(t, x, a, z)| \leq |\tilde{\rho}(z)|(1 + |x|) \quad (4.6)$$

for  $\tilde{\rho}$  satisfying (1.48) and  $\tilde{K} > 0$ .

**Definition 4.1.1.** *Let us indicate with  $\mathcal{T}_{t_1, t_2}$  the set of all stopping times in  $[t_1, t_2]$  adapted to  $\{\mathcal{F}_s\}_{s \in [t_1, t_2]}$ .*

<sup>1</sup> A filtration is said to be complete if it contains all the sets with  $\mathbb{P}$ -measure zero. A filtration is right-continuous if  $\mathcal{F}_{t+} = \mathcal{F}_t$  for all  $t \geq 0$ . Given a filtration, we can always enlarge it such that it satisfies the completeness and right continuity property. The right-continuity property is always satisfied by filtrations generated by Lévy processes (see Theorem 2.1.10 in [Applebaum, 2009]).

<sup>2</sup>The assumption of a compact set  $A$  is a strong assumption. It will be relaxed in the next sections.

**Theorem 4.1.2.** *Let us consider the process described by (4.1) and the hypothesis (4.3) and (4.4) satisfied. For any  $k \in [0, 2]$ , there exist  $C > 0$  such that  $\forall t \in [0, T]$ , for  $h \geq t$ ,  $x, y \in \mathbb{R}^n$ ,  $\alpha \in \mathcal{A}$  and  $\tau \in \mathcal{T}_{t,h}$*

$$\mathbb{E}_{t,x}[|X_\tau|^k] \leq C(1 + |x|^k) \quad (4.7)$$

$$\mathbb{E}_{t,x}[|X_\tau - x|^k] \leq C(1 + |x|^k)(h - t)^{k/2} \quad (4.8)$$

$$\mathbb{E}_{t,x}\left[\left(\sup_{t \leq s \leq h} |X_s - x|\right)^k\right] \leq C(1 + |x|^k)(h - t)^{k/2} \quad (4.9)$$

$$\mathbb{E}_{t,x,y}[|X_\tau - Y_\tau|^k] \leq C|x - y|^2 \quad (4.10)$$

where we used the simple notation  $\mathbb{E}_{t,x}[\cdot]$  to indicate the expectation conditioned on the initial value  $X_t = x$ . This theorem corresponds to the Lemma 3.1 in [Pham, 1998].

Lévy processes and, more in general, all controlled processes with dynamics (4.1), are **stochastically continuous** i.e. satisfy the following corollary.

**Corollary 4.1.1.** *A process  $\{X_t\}_{t \geq 0}$  starting at  $x = X_0$  and solution of (4.1), for each  $\alpha \in \mathcal{A}$  taking values in the compact set  $A$ , and for each  $\rho > 0$ , satisfies*

$$\mathbb{P}\left(|X_t - x| \geq \rho\right) \xrightarrow[t \rightarrow 0]{} 0. \quad (4.11)$$

*Proof.* By the Markov inequality

$$\begin{aligned} \mathbb{P}\left(|X_t - x| \geq \rho\right) &\leq \frac{\mathbb{E}_x[|X_t - x|]}{\rho} \\ &\leq \frac{C}{\rho}(1 + |x|)\sqrt{t} \end{aligned}$$

where we used (4.8), with  $C > 0$ . Taking the limit  $t \rightarrow 0$  proves the theorem.  $\square$

Now we are interested in the infinitesimal generator associated to the controlled SDE (4.1).

For  $\delta > 0$ , let us define the following two useful integral operators.

For  $\phi \in C^{1,2}([0, T] \times \mathbb{R}^n)$  we define the operator:

$$\mathcal{I}^{1,\delta,a}(t, x, \phi) = \int_{|z| \leq \delta} \left[ \phi(t, x + \gamma(t, x, a, z)) - \phi(t, x) - D_x \phi(t, x) \cdot \gamma(t, x, a, z) \right] \nu(dz) \quad (4.12)$$

where  $D_x \phi$  corresponds to the gradient of  $\phi$ .

For  $\phi \in \mathcal{C}_2([0, T] \times \mathbb{R}^n)$  (see Definition 2.1.7) and  $p \in \mathbb{R}^n$ , we define the

operator:

$$\mathcal{I}^{2,\delta,a}(t, x, p, \phi) = \int_{|z|>\delta} \left[ \phi(t, x + \gamma(t, x, a, z)) - \phi(t, x) - p \cdot \gamma(t, x, a, z) \right] \nu(dz) \quad (4.13)$$

We can check that the integral operators  $\mathcal{I}^{1,\delta,a}$  and  $\mathcal{I}^{2,\delta,a}$  are well defined.

Let us consider the integral (4.12). For  $|z| \leq \delta$  we know that  $\gamma(t, x, a, z)$  is bounded, therefore we call  $\bar{\gamma}(t, x, a) = \sup_{|z| \leq \delta} |\gamma(t, x, a, z)|$  for fixed  $t, x$  and uniformly in  $a$ . We can use a first order Taylor approximation on  $\phi(t, x + \gamma(t, x, a, z))$  and consider the Lagrange remainder. For  $y \in (x, \gamma(t, x, a, z))$ , we can write:

$$\begin{aligned} & \left| \phi(t, x + \gamma(t, x, a, z)) - \phi(t, x) - D_x \phi(t, x) \cdot \gamma(t, x, a, z) \right| \\ &= \left| \frac{1}{2} \gamma(t, x, a, z)^T \cdot D_{xx} \phi(t, y) \cdot \gamma(t, x, a, z) \right| \\ &\leq \frac{1}{2} \left\| D_{xx} \phi(t, y) \right\| |\gamma(t, x, a, z)|^2 \\ &\leq \frac{1}{2} \left\| D_{xx} \phi(t, y) \right\| |\rho(z)(1 + |x|)|^2 \\ &\leq \frac{1}{2} M |\rho(z)(1 + |x|)|^2. \end{aligned}$$

where we used the Schwarz inequality and  $M = \sup_{y \in [x, \bar{\gamma}(t, x, a)]} \|D_{xx} \phi(t, y)\|$ . Thanks to (1.48) we can see that the integral is well defined.

Let us consider the integral (4.13) on  $|z| \geq \delta$ .

$$\begin{aligned} & \left| \phi(t, x + \gamma(t, x, a, z)) - \phi(t, x) - p \cdot \gamma(t, x, a, z) \right| \\ &\leq |\phi(t, x + \gamma(t, x, a, z))| + |\phi(t, x)| + |p \cdot \gamma(t, x, a, z)| \\ &\leq C(1 + |\rho(z)|^2)(1 + |x|^2). \end{aligned}$$

By definition  $\phi \in \mathcal{C}_2([0, T] \times \mathbb{R}^n)$  has quadratic growth. Then we use (4.6) for  $|\gamma(t, x, a, z)|$ . Again, thanks to (1.48) we verify that the integral is well defined.

Finally, for  $\phi \in C^{1,2}([0, T] \times \mathbb{R}^n) \cap \mathcal{C}_2([0, T] \times \mathbb{R}^n)$  we can define the **controlled integro-differential operator** as:

$$\mathcal{L}^a(t, x, \phi) := \mathcal{D}^a \phi(t, x) + \mathcal{I}^a(t, x, \phi) \quad (4.14)$$

with

$$\mathcal{D}^a \phi(t, x) := D_x \phi(t, x) \cdot b(t, x, a) + \frac{1}{2} \text{Tr} \left[ \sigma(t, x, a)^T D_x^2 \phi(t, x) \sigma(t, x, a) \right] \quad (4.15)$$

where  $Tr$  indicates the trace of a matrix, and

$$\begin{aligned} \mathcal{I}^a(t, x, \phi) &:= \mathcal{I}^{1, \delta, a}(t, x, \phi) + \mathcal{I}^{2, \delta, a}(t, x, D_x \phi, \phi) \\ &= \int_{\mathbb{R}^n} \left[ \phi(t, x + \gamma(t, x, a, z)) - \phi(t, x) - D_x \phi(t, x) \cdot \gamma(t, x, a, z) \right] \nu(dz). \end{aligned} \quad (4.16)$$

Starting from the definition of the infinitesimal generator and using the Itô lemma, it is possible to prove that the operator (4.14) is the infinitesimal generator of the process (4.1). See [Gihman and Skorohod, 1979] pages 179-180.

This operator is a generalization of the previously defined operators (1.37) and (1.49). We have seen that those operators are well defined for functions that vanish at infinity. Under the additional assumption that Lévy processes have finite second moment, we have just seen that the operator (4.14) is well defined also for functions with quadratic growth.

The **Lévy operator** (1.37) is a special case of (4.14), obtained by setting  $\gamma(t, x, a, z) = z$ ,  $\delta = 1$  and  $p = 0$ . The integral term becomes:

$$\begin{aligned} \mathcal{I}_L(t, x, \phi) &= \mathcal{I}^{1, 1, 0}(t, x, \phi) + \mathcal{I}^{2, 1, 0}(t, x, 0, \phi) \\ &= \int_{\mathbb{R}^n} \left[ \phi(t, x + z) - \phi(t, x) - D_x \phi(t, x) \cdot z \mathbb{1}_{|z| < 1}(z) \right] \nu(dz) \end{aligned}$$

The finite second moment assumption ensures that (1.48) is finite for  $\rho(z) = z$ , thanks to Theorem (1.1.8).

#### 4.1.1 Dynamic Programming Principle

Define the cylindrical region  $Q = [t_0, T) \times \mathcal{O}$ , with  $\mathcal{O} \subseteq \mathbb{R}^n$  an open set. We define the first exit time from  $Q$  as

$$\tau = \inf\{s \geq t_0 : (s, X_s) \notin Q\}. \quad (4.17)$$

Note that  $\tau$  is the exit time from  $\mathcal{O}$  if  $X_s$  exits before time  $T$ . If  $X_s \in \mathcal{O} \forall s \in [t_0, T)$  then  $\tau = T$ . If  $\mathcal{O} = \mathbb{R}^n$ , then the set  $Q$  does not have lateral boundaries but only a terminal boundary at  $\{T\} \times \mathbb{R}^n$ .

Let us consider two continuous functions  $f : [0, T] \times \mathbb{R}^n \times A \rightarrow \mathbb{R}$  and  $g : ([0, T) \times \mathbb{R}^n \setminus \mathcal{O}) \cup (\{T\} \times \mathbb{R}^n) \rightarrow \mathbb{R}$  satisfying the conditions:

$$|f(t, x, a)| \leq C(1 + |x|^p), \quad |g(t, x)| \leq \tilde{C}(1 + |x|^p) \quad (4.18)$$

for suitable non negative constants  $C$ ,  $\tilde{C}$  and  $p$ .

Let us denote by  $\mathcal{A}_{t,x}$  the set of processes  $\alpha \in \mathcal{A}$  such that

$$\mathbb{E}_{t,x} \left[ \int_t^\tau |f(s, X_s, \alpha_s)| ds + g(\tau, X_\tau) \right] < \infty. \quad (4.19)$$

**Remark 4.** Under the current assumptions of a compact set  $A$ , continuous function  $f$  and finite second moment of  $\{X_t\}_{t \in [t_0, T]}$ , we can use (4.18) with  $p \in [0, 2]$  and (4.9), to check that  $\mathcal{A}_{t,x} = \mathcal{A}$ .

We can define the **objective function**

$$J(t, x; \alpha) = \mathbb{E}_{t,x} \left[ \int_t^\tau f(s, X_s, \alpha_s) ds + g(\tau, X_\tau) \right]. \quad (4.20)$$

Our goal is to maximize the objective function over the set  $\mathcal{A}_{t,x}$ . Let us introduce the **value function**

$$V(t, x) = \sup_{\alpha \in \mathcal{A}_{t,x}} J(t, x, \alpha). \quad (4.21)$$

If the optimal control  $\alpha^*$  exists, we can write  $V(t, x) = J(t, x, \alpha^*)$ . We also always assume that the value function is measurable. The continuity of  $V(t, x)$  can be proved under different assumptions. For instance, in Lemma 3.15 of [Gihman and Skorohod, 1979] the continuity is proved for  $p = 0$  in (4.18). In Proposition 3.3 of [Pham, 1998] the authors prove the continuity of  $V(t, x)$  assuming Lipschitz  $f$  and  $g$ .

The dynamic programming principle (DPP) is a fundamental principle in the theory of stochastic control. It is formulated as follows.

**Dynamic Programming Principle:**

- For all  $\alpha \in \mathcal{A}_{t,x}$  and all stopping time  $\theta \in \mathcal{T}_{t,\tau}$

$$V(t, x) \geq \mathbb{E}_{t,x} \left[ \int_t^\theta f(s, X_s, \alpha_s) ds + V(\theta, X_\theta) \right]. \quad (4.22)$$

- For all  $\epsilon > 0$ , there exists  $\alpha \in \mathcal{A}_{t,x}$  such that  $\forall \theta \in \mathcal{T}_{t,\tau}$

$$V(t, x) \leq \mathbb{E}_{t,x} \left[ \int_t^\theta f(s, X_s, \alpha_s) ds + V(\theta, X_\theta) \right] + \epsilon. \quad (4.23)$$

Since  $\epsilon$  is arbitrary, we can write the DPP in the following form

$$V(t, x) = \sup_{\alpha \in \mathcal{A}_{t,x}} \mathbb{E}_{t,x} \left[ \int_t^\theta f(s, X_s, \alpha_s) ds + V(\theta, X_\theta) \right]. \quad (4.24)$$

The proof of the DPP is very technical, and can be found in many textbooks and articles on stochastic control theory, with slight variations in the hypothesis. For instance, a proof for diffusion processes can be found in Chapter 3.3 of [Pham, 2009], where the author assumes the growth condition (4.18) with  $p = 2$ . In [Fleming and Soner, 2005], the authors present



several problems under diffusion dynamics assuming (4.18). However, in the proof provided in Chapter 4.7,  $f$  and  $g$  are assumed to be bounded.

A discussion on the proof of the DPP for processes of type (4.1) and with growth conditions (4.18) with  $p = 1$  can be found in [Pham, 1998], where the author considers a more general combined optimal control and optimal stopping problem. Another proof in this direction is presented in [Zalinescu, 2011], where the author considers pure jump symmetric processes. In [Goldys and Wu, 2016] the authors consider processes of type (4.1) with no assumptions on the finiteness of the moments, but assuming  $f$  and  $g$  bounded.

Note that all these proofs assume a compact control set  $A$ .

An admissible control  $\alpha \in \mathcal{A}_{t,x}$  is  $\epsilon$ -optimal conditioned on  $(t, x)$  if and only if it is  $\epsilon$ -optimal on every  $\mathcal{A}_{\theta, X_\theta}$  with  $\theta \in \mathcal{T}_{t,\tau}$ . In order to determine the  $\epsilon$ -optimal control  $\alpha_t$ , it suffices to consider the DPP with a stopping time  $\theta$  arbitrarily close to  $t$ .

#### 4.1.2 HJB equation (formal derivation)

In this section we assume that the value function is continuously differentiable and obtain a formal nonlinear PIDE satisfied by the value function. In general however, the value function is not necessarily differentiable, and the notion of *viscosity solution* should be considered. The Hamilton-Jacobi-Bellman equation (HJB) is the infinitesimal version of the DPP. It describes the local behavior of the value function when the stopping time  $\theta$  converges to  $t$ . The HJB equation is also called **dynamic programming equation**.

Let us consider the stopping time  $\theta = t + h$ , with  $h > 0$ , in the DPP (4.22) and a constant control  $\alpha_s = a$  for  $s \in [t, \theta]$ . Subtract  $V(t, x)$  from both sides and then divide by  $h$ . This yields

$$\begin{aligned} 0 &\geq \mathbb{E}_{t,x} \left[ \int_t^{t+h} f(s, X_s, a) ds + V(t+h, X_{t+h}) - V(t, x) \right] \\ &\geq \mathbb{E}_{t,x} \left[ \frac{1}{h} \int_t^{t+h} f(s, X_s, a) + \left( \frac{\partial V}{\partial s} + \mathcal{L}^a V \right)(s, X_s) ds \right]. \end{aligned}$$

where we used the Dynkin formula (Eq. 1.2.5) assuming  $V \in C^{1,2}$ , with  $\mathcal{L}^a$  the integro-differential operator 4.14. By sending  $h \rightarrow 0$  and using the mean value theorem we obtain the equation:

$$\frac{\partial V(t, x)}{\partial t} + \left( f(t, x, a) + \mathcal{L}^a V(t, x) \right) \leq 0. \quad (4.25)$$

Since this hold true for every  $a \in A$ , we can write

$$-\frac{\partial V(t, x)}{\partial t} - \sup_{a \in A} \left( f(t, x, a) + \mathcal{L}^a V(t, x) \right) \geq 0. \quad (4.26)$$

On the other hand, if we suppose that the optimal control  $\alpha^*$  exists, then:

$$0 = \mathbb{E}_{t,x} \left[ \int_t^{t+h} f(s, X_s^*, \alpha_s^*) ds + V(t+h, X_{t+h}^*) - V(t, x) \right], \quad (4.27)$$

where  $X^*$  is the optimal state, solution of (4.1), under the control  $\alpha^*$ . Using similar arguments as above we obtain:

$$-\frac{\partial V(t, x)}{\partial t} - \left( f(t, x, \alpha_t^*) + \mathcal{L}^{\alpha_t^*} V(t, x) \right) = 0. \quad (4.28)$$

We can combine the two results (4.26), (4.28) in a single compact equation i.e. the **dynamic programming equation**:

$$-\frac{\partial V(t, x)}{\partial t} - \sup_{a \in A} \left( f(t, x, a) + \mathcal{L}^a V(t, x) \right) = 0. \quad (4.29)$$

**Remark 5.** In the previous sections we worked under the assumption that  $A$  is compact. But in general, the HJB (4.29) is well defined also for non-compact sets  $A$ , as long as the supremum in  $a \in A$  is finite. When  $A$  is compact and  $b, \sigma, \gamma$  and  $f$  are continuous with respect to  $a$ , the supremum is always attained. In Section 4.2 we will see that when  $A$  is unbounded, and the supremum in  $a \in A$  is not finite, the HJB equation becomes a variational inequality.

Let us define the Hamiltonian function

$$0 = -\frac{\partial V(t, x)}{\partial t} - \mathcal{H}(t, x, D_x V, D_{xx} V, \mathcal{I}^a(t, x, V))$$

where for  $(t, x, p, M, I^a) \in Q \times \mathbb{R}^n \times S^n \times \mathbb{R}$ .<sup>3</sup>

$$\begin{aligned} \mathcal{H}(t, x, p, M, I^a) = & \sup_{a \in A} \left( f(t, x, a) + b(t, x, a)p \right. \\ & \left. + \frac{1}{2} \text{Tr}(\sigma(t, x, a) \sigma^T(t, x, a) M) + I^a \right) \end{aligned} \quad (4.30)$$

The regular terminal and lateral boundary conditions of this nonlinear PIDE are:

$$V(T, x) = g(T, x). \quad (4.31)$$

$$V(t, x) = g(t, x) \quad \text{for} \quad (t, x) \in [0, T) \times (\mathbb{R}^n \setminus \mathcal{O}). \quad (4.32)$$

---

<sup>3</sup>  $S^n$  is the set of symmetric matrices of dimension  $n$ .

## 4.2 Singular control

In the previous section, the theory of stochastic control for generalized jump-diffusion processes is presented under the assumption that the control process takes values in a compact space. In this section this assumption is relaxed, and the control space  $A$  is assumed to be unbounded. When the problem coefficients are linear functions of the control, the form (4.29) of the HJB equation is no more valid. In Section 4.2.1 we present a formal derivation of the HJB equation, that under these assumptions has the form of a **variational inequality**. A rigorous basis to this derivation can be given a posteriori by means of a verification theorem, or by considering the viscosity solution framework. For more details we refer to Chapter 8.4 of [Fleming and Soner, 2005] or to Theorem 5.2 of [Øksendal and Sulem, 2007].

When considering  $A$  unbounded and a linear dependence of the coefficients on  $\alpha$ , in general there are no optimal controls, and  $\epsilon$ -optimal controls take arbitrarily large values. For this reason it is convenient to reformulate the problem by introducing a new control variable  $\xi$  defined as

$$\xi_t = \int_0^t \hat{\alpha}_s du_s, \quad (4.33)$$

with

$$\hat{\alpha}_s := \begin{cases} \frac{\alpha_s}{|\alpha_s|} & \text{if } \alpha_s \neq 0 \\ 0 & \text{if } \alpha_s = 0. \end{cases} \quad \text{and} \quad u_t = \int_0^t |\alpha_s| ds. \quad (4.34)$$

In order to obtain optimal controls we enlarge the class of controls to admit  $\xi_t$  which may not be an absolutely continuous function of  $t$ . But we assume that  $\xi_t$  is a càdlàg, predictable, non-decreasing function with bounded variation on every time interval  $[0, T]$ . In Section 4.2.2 we present the general formulation for **singular control** problems. The name *singular* comes from the fact that the control process  $\xi$  can be singular with respect to the Lebesgue measure  $dt$ .

### 4.2.1 Derivation of the variational inequality

When the control space  $A$  is unbounded, the Hamiltonian (4.30) may take infinite values. Let us assume that  $A$  is a closed cone in  $\mathbb{R}^m$  i.e.

$$a \in A, \quad \lambda > 0 \implies \lambda a \in A. \quad (4.35)$$

Let us assume also that the control influences linearly the dynamics of the system and the function  $f$  as follows

$$\begin{aligned} b(t, x, a) &= \hat{b}(t, x) + \kappa(t, x)a, & \sigma(t, x, a) &= \hat{\sigma}(t, x), \\ \gamma(t, x, a, z) &= \hat{\gamma}(t, x, z), & f(t, x, a) &= \hat{f}(t, x) + h(t, x)a, \end{aligned} \quad (4.36)$$

where  $\kappa : [0, T] \times \mathbb{R}^n \rightarrow \mathbb{R}^{n \times m}$  is continuous and Lipschitz and  $h : [0, T] \times \mathbb{R}^n \rightarrow \mathbb{R}^m$  is a continuous function with polynomial growth of same order of  $f$ . Let us indicate with  $\hat{I}$  the integral operator (4.16) containing  $\hat{\gamma}(t, x, z)$ . The Hamiltonian becomes

$$\begin{aligned} \mathcal{H}(t, x, p, M, \hat{I}) = & \left( \hat{f}(t, x) + p \hat{b}(t, x) \right. \\ & \left. + \frac{1}{2} \text{Tr}(\sigma(t, x) \sigma^T(t, x) M) + \hat{I} \right) + \underbrace{\sup_{a \in A} \left( (p \kappa(t, x) + h(t, x)) a \right)}_{\hat{H}(t, x, p)} \end{aligned}$$

If for some  $a \in A$  and for fixed  $(t, x)$  we have  $(p \kappa(t, x) + h(t, x)) a > 0$ , then  $\hat{H}(t, x, p) = \infty$ . We can define

$$H(t, x, p) = \sup_{a \in \hat{K}} \left( (p \kappa(t, x) + h(t, x)) a \right) \quad \text{with} \quad \hat{K} = \{a \in A : |a| = 1\} \quad (4.37)$$

such that

$$\hat{H}(t, x, p) = \begin{cases} \infty, & \text{if } H(t, x, p) > 0 \\ 0, & \text{if } H(t, x, p) \leq 0. \end{cases} \quad (4.38)$$

Using this last equation together with the HJB (4.29) with  $a = 0$  we have the following two equations:

$$\begin{cases} \frac{\partial V(t, x)}{\partial t} + \hat{f}(t, x) + \mathcal{L}^{a=0} V(t, x) \leq 0. \\ H(t, x, D_x V(t, x)) \leq 0. \end{cases} \quad (4.39)$$

Now, suppose  $H(t, x, D_x V(t, x)) < 0$ . Then  $\hat{H}(t, x, p) = 0$  and the optimal control is indeed  $a = 0$ , with the uncontrolled HJB equal to zero:

$$H(t, x, D_x V(t, x)) < 0 \implies \frac{\partial V(t, x)}{\partial t} + \hat{f}(t, x) + \mathcal{L}^{a=0} V(t, x) = 0. \quad (4.40)$$

The last equation can be written in a more compact form. We have the following **variational inequality**:

$$\max \left\{ \frac{\partial V(t, x)}{\partial t} + \hat{f}(t, x) + \mathcal{L}^{a=0} V(t, x), H(t, x, D_x V(t, x)) \right\} = 0 \quad \text{for } (t, x) \in Q. \quad (4.41)$$

#### 4.2.2 Singular control formulation

Let us consider a state system governed by the following SDE:

$$\begin{aligned} dX_t = & \hat{b}(t, X_{t-}) dt + \hat{\sigma}(t, X_{t-}) dW_t \\ & + \int_{\mathbb{R}} \hat{\gamma}(t, X_{t-}, z) \tilde{N}(dt, dz) + \kappa(t, X_{t-}) d\xi_t. \end{aligned} \quad (4.42)$$

where the coefficients  $\hat{b} : [0, T] \times \mathbb{R}^n \rightarrow \mathbb{R}^n$ ,  $\hat{\sigma} : [0, T] \times \mathbb{R}^n \rightarrow \mathbb{R}^{n \times d}$ ,  $\hat{\gamma} : [0, T] \times \mathbb{R}^n \times \mathbb{R}^n \rightarrow \mathbb{R}^{n \times l}$ ,  $\kappa : [0, T] \times \mathbb{R}^n \rightarrow \mathbb{R}^{n \times m}$  are continuous and Lipschitz. The  $m$ -dimensional process  $\xi : [0, T] \times \Omega \rightarrow \mathbb{R}^m$  is a predictable, càdlàg, bounded variation, non-decreasing process, with  $\xi_{0-} = 0$ . Let us denote with  $\Pi$  the space of all controls  $\xi$  and with  $\Pi_{t,x}$  the subset dependent on the current state  $(t, x)$ .

For  $\tau$  defined in (4.17), the objective function is:

$$J^\xi(t, x) = \mathbb{E}_{t,x} \left[ \int_t^\tau f(s, X_s) ds + \int_t^\tau h(s, X_{s-}) d\xi_s + g(\tau, X_\tau) \right], \quad (4.43)$$

with  $\hat{f} : [0, T] \times \mathbb{R}^n \rightarrow \mathbb{R}$ ,  $h : [0, T] \times \mathbb{R}^n \rightarrow \mathbb{R}^m$  and  $g : ([0, T] \times \mathbb{R}^n \setminus \mathcal{O}) \cup (\mathbb{R}^n \times \{T\}) \rightarrow \mathbb{R}$  continuous and with polynomial growth of a suitable order  $p \geq 0$ . The value function is

$$V(t, x) = \sup_{\Pi_{t,x}} J^\xi(t, x). \quad (4.44)$$

Under certain assumptions, it can be proved that the value function (4.44) is a viscosity solution of a variational inequality with form (4.41).

A straightforward modification of (4.22) and (4.23) yields the expressions:

**DPP for singular control:**

- For all  $\xi \in \Pi_{t,x}$  and all stopping time  $\theta \in \mathcal{T}_{t,\tau}$ :

$$V(t, x) \geq \mathbb{E}_{t,x} \left[ \int_t^\theta f(s, X_s) ds + \int_t^\theta h(s, X_{s-}) d\xi_s + V(\theta, X_\theta) \right]. \quad (4.45)$$

- For all  $\epsilon > 0$ , there exists  $\xi \in \Pi_{t,x}$  such that  $\forall \theta \in \mathcal{T}_{t,\tau}$ :

$$V(t, x) \leq \mathbb{E}_{t,x} \left[ \int_t^\theta f(s, X_s) ds + \int_t^\theta h(s, X_{s-}) d\xi_s + V(\theta, X_\theta) \right] + \epsilon. \quad (4.46)$$

**Assumption:**

We assume that the value function (4.44) satisfies the DPP for singular control problem, under the hypothesis presented in this section. For the purpose of this thesis, we require that it holds for  $f = h = 0$  and for  $g$  satisfying

$$\mathbb{E}_{t,x} \left[ g(\tau, X_\tau) \right] < \infty \quad (4.47)$$

for all  $\xi \in \Pi_{t,x}$ .

To our knowledge, there is no proof of the DPP for singular control under the assumptions presented in this section.

In [Fleming and Soner, 2005] the authors formulate the DPP in Chapter 8.5

for diffusion processes, without providing a proof.

In [De Vallière et al., 2016] the authors prove the DPP for a singular-regular control problem with infinite horizon. The singular control influences only the state dynamics, described by a geometric Lévy process. The function  $f$ , instead, is affected by the regular control i.e.  $f(t, \alpha_t) = e^{-\beta t} \mathcal{U}(\alpha_t)$ , with  $\beta > 0$  and  $\mathcal{U} : A \rightarrow \mathbb{R}^+$  a concave function such that  $\mathcal{U}(0) = 0$  and  $\frac{\mathcal{U}(x)}{x} \rightarrow 0$  as  $x \rightarrow \infty$ .

### 4.3 Viscosity solutions theory

This section is dedicated to the definition of viscosity solutions. In the literature there are different definitions of viscosity solution depending on the context. For instance, the theory presented in [Pham, 2009] considers only the PDE case, while in [Cont and Tankov, 2003] only linear PIDEs are considered. Other important references are [Fleming and Soner, 2005], [Pham, 1998] and [Barles and Imbert, 2008] among others. In the general discontinuous viscosity solutions approach, there is no need to prove a priori the continuity of the value function  $V$ . The continuity will actually follow from a strong comparison principle.

Here we present the definition for continuous viscosity solutions introduced in [De Vallière et al., 2016], which is suitable for the problem proposed in this thesis (Chapter 5).

#### 4.3.1 Definition viscosity solution

Let us consider a general parabolic problem:

$$\begin{cases} F(t, x, u, D_t u, D_x u, D_{xx} u, \mathcal{I}(t, x, u)) = 0 & \text{for } (t, x) \in Q \\ u(t, x) = g(t, x) & \text{for } (t, x) \notin Q \end{cases} \quad (4.48)$$

where  $g \in C^0 \cap \mathcal{C}_2([0, T] \times (\mathbb{R}^n \setminus \mathcal{O}))$  is a given function and  $F$  is a continuous function that satisfies the following elliptic/parabolic local and non local conditions. For all  $t \in [0, T]$ ;  $x \in \mathcal{O}$ ;  $r, \hat{r} \in \mathbb{R}$ ;  $q, \hat{q} \in \mathbb{R}$ ;  $p \in \mathbb{R}^n$ ;  $M, \hat{M} \in \mathcal{S}^n$ ;  $\mathcal{I}, \hat{\mathcal{I}} \in \mathbb{R}$ :

- $r \leq \hat{r} \implies F(t, x, r, q, p, M, \mathcal{I}) \leq F(t, x, \hat{r}, q, p, M, \mathcal{I})$
- $q \leq \hat{q} \implies F(t, x, r, q, p, M, \mathcal{I}) \geq F(t, x, r, \hat{q}, p, M, \mathcal{I})$
- $M \leq \hat{M} \implies F(t, x, r, q, p, M, \mathcal{I}) \geq F(t, x, r, q, p, \hat{M}, \mathcal{I})$
- $\mathcal{I} \leq \hat{\mathcal{I}} \implies F(t, x, r, q, p, M, \mathcal{I}) \geq F(t, x, r, q, p, M, \hat{\mathcal{I}})$ .

where the matrix ordering is intended with this meaning:

$$\hat{M} \geq M \Leftrightarrow \hat{M} - M \text{ is positive semi-definite.}$$

Having in mind our specific problem, we will assume that the viscosity subsolution and supersolution are continuous on  $[0, T] \times \mathbb{R}^n$ . We can now introduce the definitions:

**Definition 4.3.1.** *A continuous function  $u$  is a **viscosity subsolution** of (4.48) if for any  $(\bar{t}, \bar{x}) \in [0, T] \times \mathbb{R}^n$  and any test function  $\phi \in C^{1,2}([0, T] \times \mathbb{R}^n) \cap \mathcal{C}_2([0, T] \times \mathbb{R}^n)$  such that  $u - \phi$  has a global maximum at  $(\bar{t}, \bar{x})$  the following is satisfied:*

$$F\left(\bar{t}, \bar{x}, u(\bar{t}, \bar{x}), D_t\phi(\bar{t}, \bar{x}), D_x\phi(\bar{t}, \bar{x}), D_{xx}\phi(\bar{t}, \bar{x}), \mathcal{I}(\bar{t}, \bar{x}, \phi(\bar{t}, \bar{x}))\right) \leq 0 \quad (4.49)$$

for  $(\bar{t}, \bar{x}) \in Q$ .

In the same way we define:

**Definition 4.3.2.** *A continuous function  $u$  is a **viscosity supersolution** of (4.48) if for any  $(\bar{t}, \bar{x}) \in [0, T] \times \mathbb{R}^n$  and any test functions  $\phi \in C^{1,2}([0, T] \times \mathbb{R}^n) \cap \mathcal{C}_2([0, T] \times \mathbb{R}^n)$  such that  $u - \phi$  has a global minimum at  $(\bar{t}, \bar{x})$  the following is satisfied:*

$$F\left(\bar{t}, \bar{x}, u(\bar{t}, \bar{x}), D_t\phi(\bar{t}, \bar{x}), D_x\phi(\bar{t}, \bar{x}), D_{xx}\phi(\bar{t}, \bar{x}), \mathcal{I}(\bar{t}, \bar{x}, \phi(\bar{t}, \bar{x}))\right) \geq 0 \quad (4.50)$$

for  $(\bar{t}, \bar{x}) \in Q$ .

When a function is both a viscosity subsolution and supersolution, it is called a **viscosity solution**.

## 4.4 Chapter conclusions

This chapter serves as a brief introduction to the theory of stochastic control for processes with a jump and a diffusion components.

The topics in the initial Section 4.1 follow closely the presentations given in [Gihman and Skorohod, 1979] and [Pham, 1998]. In the same section, we introduce the important *dynamic programming principle*, and derive the HJB equation for “regular” controls. In this presentation we assume a compact control set.

In Section 4.2 we extend the theory to *singular controls*. In this framework the control set is assumed to be unbounded and the class of controls is enlarged in order to contain also non absolute continuous processes. We also presented the Dynamic Programming Principle for singular control problems, and assumed that it is verified by the value function. This assumption

is important because the DPP will be used in the proof of existence of a viscosity solution in Section 5.2.

For completeness, we started the presentation of this chapter with the theory for regular controls. However, in this thesis we are more interested in the theory for singular controls! The reason is that it includes the portfolio optimization problems with transaction costs that we will formulate in Chapter 5.

The end of the chapter is dedicated to the definition of viscosity solution.





## Option pricing with transaction costs

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### 5.1 Portfolio selection problems

In the mathematical finance literature, the first application of stochastic optimal control theory to finance appears in the seminal paper [Merton, 1969]. This is the classical *Merton optimal portfolio problem*, and is formulated as follows. An investor has a portfolio consisting of two assets, one “risk free” asset  $B$ , and one “risky” asset  $S$ . The assets in the portfolio have dynamics

$$\begin{cases} dB_t &= rB_t dt \\ dS_t &= S_t(\mu dt + \sigma dW_t), \end{cases} \quad (5.1)$$

with  $\mu > r$  and  $\sigma > 0$ . We denote by  $\mathcal{W}_t = B_t + S_t$  the wealth at time  $t$ , and by  $\pi_t$  the fraction of wealth invested in the risky asset. In this way,

it is possible to write  $S_t = \pi_t \mathcal{W}_t$  and  $B_t = (1 - \pi_t) \mathcal{W}_t$ . The model also considers the investor consumption  $\{c_t\}_{0 \leq t \leq T}$ . The optimization problem can be formulated considering the utility function of the consumption and the terminal condition. It consists in maximizing the objective function

$$J(x; \pi, c) = \mathbb{E}_x \left[ \int_0^T e^{-\beta t} \mathcal{U}(c_t) dt + g(T, \mathcal{W}_T) \right], \quad (5.2)$$

where  $\beta > 0$  and  $\mathcal{U} : [0, \infty) \rightarrow \mathbb{R}$  is a concave and increasing utility function, such that  $\mathcal{U}(0) = 0$ . In the original article, the function  $g$  is called *bequest valuation function* and is assumed to be concave. We indicate the initial portfolio state with  $x = (B_0, S_0)$ . The wealth  $\mathcal{W}$  takes value in  $\mathcal{O} = (0, \infty)$  and has state dynamics

$$d\mathcal{W}_t = (1 - \pi_t) \mathcal{W}_t r dt + \pi_t \mathcal{W}_t (\mu dt + \sigma dW_t) - c(t) dt. \quad (5.3)$$

The control  $\alpha_t$  is a two dimensional vector  $(\alpha_t^1, \alpha_t^2) = (\pi_t, c_t)$ , with values in  $A = \mathbb{R} \times [0, \infty)$ . This is a finite horizon problem with an objective function of type (4.20) and HJB equation as in (4.29). Even if in this case the control space  $A$  is not compact, the supremum in (4.29) is attained, thanks to the concave structure of the problem.

Merton, using the utility  $\mathcal{U}(c) = \frac{1}{\gamma} c^\gamma$  with  $0 < \gamma < 1$  (of HARA type) obtained an explicit solution for the problem. In particular he found that the optimal control

$$\pi_t^* = \frac{\mu - r}{(1 - \gamma)\sigma^2} \quad (5.4)$$

is a constant and does not depend on the state variables. This means that the optimal fraction of the risky and risk free assets in the portfolio is constant. The line containing all the optimal points in the  $(B, S)$ -plane is the so called **Merton line**.

The Merton portfolio selection problem is the first optimal portfolio problem solved by stochastic control theory methods. In [Merton, 1971] the author extends the results to different utility functions. All the successive models are generalizations of the Merton model, where by the word “generalizations”, we mean that under some particular choices of the parameters, the Merton problem is included in those models as a special case. For what concerns this thesis, we review the main portfolio selection problems that have appeared in the literature, considering the presence of proportional transaction costs. The first portfolio selection model with transaction costs and consumption was introduced by [Constantinides, 1986] and then extended by [Davis and Norman, 1990]. We refer to [Shreve and Soner, 1994] for a viscosity solution approach to the same problem. Other important contributions are [Dai and Yi, 2009], [Dai et al., 2010], [Liu and M., 2002], [Liu and M., 2007], [Benth et al., 2001], [Framstad et al., 1999], [De Vallière et al.,

2016] where the last four articles use Lévy processes to model the stock dynamics. All the cited works are portfolio optimization models formulated as infinite horizon problems, and do not involve the pricing of the options.

Further assumptions are needed when the portfolio process is introduced for the purpose of pricing a derivative contract. The main contributions on option pricing with transaction costs, using the *indifference pricing* approach are [Hodges and Neuberger, 1989] and [Davis et al., 1993]. The problem is formalized as a finite horizon singular stochastic control problem. In this section we present the Davis-Panas-Zariphopoulou (DPZ) model, which is the building block of this thesis, and then extend it following the framework introduced by [De Vallière et al., 2016], that consider the stock dynamics described by Lévy processes.

### 5.1.1 Davis-Panas-Zariphopoulou model

This is the market model with proportional transaction costs presented in [Davis et al., 1993]. The authors consider a portfolio composed by one risk-free asset  $B$  (bank account) paying a fixed interest rate  $r > 0$  and a stock  $S$ . The symbol  $Y$  denotes the number of shares of the stock  $S$  that the investor holds. The state of the portfolio at time  $t \in [t_0, T]$  is  $(B_t^\pi, Y_t^\pi, S_t)$ , and is the solution of the following SDE:

$$\begin{cases} dB_t^\pi &= rB_t^\pi dt - (1 + \theta_b)S_t dL_t + (1 - \theta_s)S_t dM_t \\ dY_t^\pi &= dL_t - dM_t \\ dS_t &= S_t(\mu dt + \sigma dW_t). \end{cases} \quad (5.5)$$

for  $\mu > r$  and  $\sigma > 0$ . The parameters  $\theta_b, \theta_s \geq 0$  are the proportional transaction costs when buying and selling respectively. This portfolio equation is a generalization of the portfolio in the Merton problem (5.1), where a new state variable  $Y$  is considered. The control process  $\{\pi_t\}_{t \in [t_0, T]} := \{(L_t, M_t)\}_{t \in [t_0, T]}$  represents the trading strategy and indicates the cumulative number of shares bought and sold respectively in  $[t_0, T]$ . The strategy  $\pi_t$  is a càdlàg,  $\mathcal{F}_t$ -progressively measurable, nondecreasing process with bounded variation in every finite time interval and such that  $\pi_{t_0^-} = (L_{t_0^-}, M_{t_0^-}) = (0, 0)$ , allowing for an initial transaction at  $t_0$ .

In the discontinuity points of  $L_t$  and  $M_t$  we indicate the process variation with  $\Delta L_t = L_t - L_{t-}$  and  $\Delta M_t = M_t - M_{t-}$ .

**Definition 5.1.1.** We define the **cash value** function  $c(y, s)$  as the value in cash when the shares in the portfolio are liquidated, i.e. long positions are sold and short positions are covered.

$$c(y, s) = \begin{cases} (1 + \theta_b)ys, & \text{if } y \leq 0 \\ (1 - \theta_s)ys, & \text{if } y > 0. \end{cases} \quad (5.6)$$

**Definition 5.1.2.** For  $t \in [t_0, T]$ , we define the **total wealth** process:

$$\mathcal{W}_t^\pi = B_t^\pi + c(Y_t^\pi, S_t). \quad (5.7)$$

We say that a portfolio is solvent if the portfolio's wealth  $\mathcal{W}_t$  is greater than a fixed constant  $-C$ , with  $C \geq 0$  that may depend on the initial wealth and on the parameters in (5.5). This constant may be interpreted as the *credit availability* of the investor.

**Definition 5.1.3.** We define the **solvency region**:

$$\mathcal{S} := \left\{ (b, y, s) \in \mathbb{R} \times \mathbb{R} \times \mathbb{R}^+ : b + c(y, s) > -C \right\}. \quad (5.8)$$

**Definition 5.1.4.** The set of **admissible trading strategies**  $\Pi(t_0, b, y, s)$ , is defined as the set of all right-continuous, nondecreasing,  $\mathcal{F}_t$ -progressively measurable processes  $\{\pi_t\}_{t \in [t_0, T]}$ , such that  $(B_t^\pi, Y_t^\pi, S_t)$  is a solution of (5.5) with initial values  $(B_{t_0}^\pi = b, Y_{t_0}^\pi = y, S_{t_0} = s)$ , and

$$\mathcal{W}_t^\pi \in \mathcal{S} \quad (5.9)$$

for  $t \in [t_0, T]$  almost surely.

**Remark 6.** In the first problem formulation of [Hodges and Neuberger, 1989], the authors consider a portfolio starting with zero total wealth. The writer (or buyer) of the option creates a portfolio at time  $t_0$  with the purpose of hedging the option. It is reasonable to assume that no shares of the underlying stock are contained in the portfolio at time  $t_0$ . In the numerical computations of Chapter 6, we will consider portfolios with zero initial shares and initial cash amount  $B_0$ . The model is able to compute option prices for an investor with any initial number  $Y_0$  of shares if needed.

### Utility maximization

Let us assume an investor builds a portfolio with cash, shares of a stock and in addition he sells or purchases a European call option written on the same stock, with strike price  $K$  and expiration date  $T$ .

From now on, we introduce the superscripts  $w$ ,  $b$  and  $0$  to indicate the writer, buyer and zero-option portfolios respectively. In the zero-option portfolio, the wealth process  $\{\mathcal{W}_t^{0;\pi}\}_{t \in [t_0, T]}$  corresponds to (5.7).

**Definition 5.1.5.** For  $t \in [t_0, T]$ , we define the wealth processes for the writer:

$$\begin{aligned} \mathcal{W}_t^{w;\pi} := & B_t^\pi + c(Y_t^\pi, S_t) \mathbb{1}_{\{t < T\}} \\ & + c(Y_t^\pi, S_t) \mathbb{1}_{\{t=T, S_t(1+\theta_b) \leq K\}} + \left( c(Y_t^\pi - 1, S_t) + K \right) \mathbb{1}_{\{t=T, S_t(1+\theta_b) > K\}} \end{aligned} \quad (5.10)$$

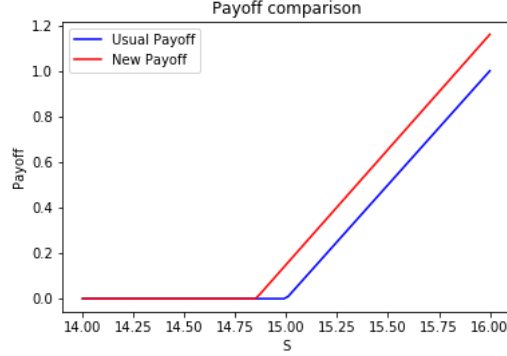


Figure 5.1: Comparison of payoffs of an European Call option with strike  $K = 15$ , in a market with zero costs and in a market with  $\theta_b = 0.01$ .

and the buyer:

$$\begin{aligned} \mathcal{W}_t^{b;\pi} := & B_t^\pi + c(Y_t^\pi, S_t) \mathbb{1}_{\{t < T\}} \\ & + c(Y_t^\pi, S_t) \mathbb{1}_{\{t=T, S_t(1+\theta_b) \leq K\}} + \left( c(Y_t^\pi + 1, S_t) - K \right) \mathbb{1}_{\{t=T, S_t(1+\theta_b) > K\}}. \end{aligned} \quad (5.11)$$

In the case the option is exercised,  $S_T(1 + \theta_b) > K$ , the buyer pays to the writer the strike value  $K$  in cash, and the writer delivers one share to the buyer. In a market with transaction costs the real value (in cash) of a share incorporates the transaction costs. Therefore the buyer does not exercise when  $S_T > K$ , but when  $S_T(1 + \theta_b) > K$ . In Figure 5.1 there is a comparison between the payoff in a market with zero costs (such as in the Black-Scholes model) and a market with transaction costs.

The objective of the investor is to maximize the expected utility of the wealth at terminal time  $T$  over all the admissible strategies. This expectation is conditioned on the current value of cash, number of shares and value of the stock. The sets of trading strategies corresponding to each of the three portfolios, is obtained by using the respective wealth process inside Definition [5.1.4].

**Definition 5.1.6.** *The **value function** of the maximization problem for  $j = w, b, 0$  is defined as:*

$$V^j(t, b, y, s) := \sup_{\pi \in \Pi^j(t, b, y, s)} \mathbb{E}_{t, b, y, s} \left[ \mathcal{U}(\mathcal{W}_T^{j;\pi}) \right], \quad (5.12)$$

where  $\mathcal{U} : \mathbb{R} \rightarrow \mathbb{R}$  is a concave increasing utility function such that  $\mathcal{U}(0) = 0$ .

Let us verify that the assumption (4.47) is satisfied. Let us consider only the case  $j = 0$ , because for  $j = w, b$  the generalization is straightforward.

**Theorem 5.1.1.** *The objective function is finite, i.e.*

$$\mathbb{E}_{t,b,y,s} \left[ \mathcal{U}(\mathcal{W}_T^\pi) \right] < \infty$$

for all  $\pi \in \Pi(t, b, y, s)$ .

*Proof.* Since the utility function is concave, thanks to the Jensen inequality  $\mathbb{E}_{t,b,y,s} [\mathcal{U}(\mathcal{W}_T^\pi)] \leq \mathcal{U}(\mathbb{E}_{t,b,y,s} [\mathcal{W}_T^\pi])$ , it is enough to prove  $\mathbb{E}_{t,b,y,s} [\mathcal{W}_T^\pi] < \infty$ . The wealth at time  $T$  is:

$$\begin{aligned} \mathcal{W}_T^\pi &= B_T^\pi + c(Y_T^\pi, S_T) \\ &\leq B_T^\pi + Y_T^\pi S_T. \end{aligned}$$

where  $B_T^\pi$  is the solution of the first line of (5.5) i.e.

$$B_T^\pi = \frac{b}{\delta(t, T)} - \int_t^T (1 + \theta_b) \frac{S_u}{\delta(u, T)} dL_u + \int_t^T (1 - \theta_s) \frac{S_u}{\delta(u, T)} dM_u$$

with  $\delta(u, T) = e^{-r(T-u)}$ . By definition, a stochastic process has bounded variation if its sample paths have bounded variation for almost all  $\omega \in \Omega$ . Then we can define  $C = \sup_{\omega \in \Omega} (L_T - L_t) < \infty$ .

$$\begin{aligned} \mathbb{E}_{t,b,y,s} \left[ \int_t^T (1 + \theta_b) \frac{S_u}{\delta(u, T)} dL_u \right] &\leq \frac{(1 + \theta_b)}{\delta(t, T)} \mathbb{E}_{t,b,y,s} \left[ \sup_{u \in [t, T]} S_u \int_t^T dL_u \right] \\ &\leq \frac{(1 + \theta_b)}{\delta(t, T)} \mathbb{E}_{t,b,y,s} \left[ \sup_{u \in [t, T]} S_u (L_T - L_t) \right] \\ &\leq \frac{(1 + \theta_b)C}{\delta(t, T)} \mathbb{E}_{t,b,y,s} \left[ \sup_{u \in [t, T]} S_u \right] < \infty. \end{aligned}$$

The term  $\mathbb{E}_{t,b,y,s} [\sup_{u \in [t, T]} S_u]$  is finite because of (4.9). The same argument can be applied to  $\mathbb{E}_{t,b,y,s} [\int_t^T (1 - \theta_s) \frac{S_u}{\delta(u, T)} dM_u]$ .

The term  $Y_T^\pi = L_T - M_T$  is also bounded by a constant  $C$ , and we obtain that  $\mathbb{E}_{t,b,y,s} [Y_T^\pi S_T] \leq C \mathbb{E}_{t,b,y,s} [S_T] < \infty$ . This concludes the proof.  $\square$

The writer (buyer) option price is defined as the amount of cash to add (subtract) to the bank account, such that the maximal expected utility of wealth of the writer (buyer) is the same he could get with the zero-option portfolio.

**Definition 5.1.7.** *The writer price is the value  $p^w > 0$  such that*

$$V^0(t, b, y, s) = V^w(t, b + p^w, y, s), \quad (5.13)$$

*and the buyer price is the value  $p^b > 0$  such that*

$$V^0(t, b, y, s) = V^b(t, b - p^b, y, s). \quad (5.14)$$

### HJB Equation

According to the theory of stochastic optimal control presented in Chapter 4, we can identify the DPZ model within the class of singular control problems described in Section (4.2). Let us re-write the state equation (5.5) for  $X_t^\pi = (B_t^\pi, Y_t^\pi, S_t)$  in the matrix form

$$\begin{aligned} dX_t^\pi &= d \begin{pmatrix} B_t^\pi \\ Y_t^\pi \\ S_t \end{pmatrix} \\ &= \begin{pmatrix} rB_t^\pi \\ 0 \\ \mu S_t \end{pmatrix} dt + \begin{pmatrix} 0 \\ 0 \\ \sigma S_t \end{pmatrix} dW_t \\ &\quad + \underbrace{\begin{pmatrix} -S_t(1+\sigma_b) & S_t(1-\sigma_s) \\ 1 & -1 \\ 0 & 0 \end{pmatrix}}_{\kappa(t, X_t)} \underbrace{\begin{pmatrix} dL_t \\ dM_t \end{pmatrix}}_{d\xi_t}, \end{aligned} \quad (5.15)$$

which can be easily identified with the general equation (4.42). The state  $X_t^\pi$  takes values in  $\mathcal{O}$  corresponding to the solvency region  $\mathcal{S}$ . The value function (5.12) has a cost functional as in (4.43) with  $f$  and  $h$  equal to zero.

According to singular control theory, the HJB equation of a singular control problem is a variational inequality. Here we can obtain the HJB equation of this problem from the general equation (4.41). We omit the subscript of  $V^j$  when the discussion refers to all the three problems. Let us indicate  $x = (b, y, s)$ , then

- $D_x V(t, x) = \left( \frac{\partial V(t, b, y, s)}{\partial b}, \frac{\partial V(t, b, y, s)}{\partial y}, \frac{\partial V(t, b, y, s)}{\partial s} \right)$
- $H(t, x, p) = \sup_{a \in \hat{K}} (p \cdot \kappa(t, x) \cdot a)$  and define  $\hat{K} = \begin{pmatrix} 1 \\ 0 \end{pmatrix} \cup \begin{pmatrix} 0 \\ 1 \end{pmatrix}$
- $H(t, x, D_x V(t, x)) = \max \left\{ \frac{\partial V}{\partial y} - (1 + \theta_b)s \frac{\partial V}{\partial b}, -\left( \frac{\partial V}{\partial y} - (1 - \theta_s)s \frac{\partial V}{\partial b} \right) \right\}$

The resulting HJB equation is

$$\begin{aligned} \max \left\{ \frac{\partial V}{\partial t} + rb \frac{\partial V}{\partial b} + \mu s \frac{\partial V}{\partial s} + \frac{1}{2} \sigma^2 s^2 \frac{\partial^2 V}{\partial s^2}, \right. \\ \left. \frac{\partial V}{\partial y} - (1 + \theta_b)s \frac{\partial V}{\partial b}, -\left( \frac{\partial V}{\partial y} - (1 - \theta_s)s \frac{\partial V}{\partial b} \right) \right\} = 0, \end{aligned} \quad (5.16)$$

for  $(t, b, y, s) \in [t_0, T] \times \mathcal{S}$ . The terminal conditions for the three portfolio problems  $j = 0, w, b$  are:

$$V^j(T, b, y, s) = \mathcal{U}(w^j(b, y, s)) \quad \text{for} \quad (b, y, s) \in \mathcal{S}^j \quad (5.17)$$



with

$$w^0(b, y, s) = b + c(y, s).$$

$$w^w(b, y, s) = b + c(y, s) \mathbb{1}_{\{s(1+\theta_b) \leq K\}} + \left( c(y-1, s) + K \right) \mathbb{1}_{\{s(1+\theta_b) > K\}}.$$

$$w^b(b, y, s) = b + c(y, s) \mathbb{1}_{\{s(1+\theta_b) \leq K\}} + \left( c(y+1, s) - K \right) \mathbb{1}_{\{s(1+\theta_b) > K\}}.$$

The variational inequality (5.16) says that the maximum of three operators is equal to zero. This feature can be interpreted better if we consider the state space divided into three different regions: the **Buy**, the **Sell** and the **No Transaction** (NT) regions.

- **Buy**

$$\begin{cases} \frac{\partial V}{\partial t} + rb \frac{\partial V}{\partial b} + \mu s \frac{\partial V}{\partial s} + \frac{1}{2} \sigma^2 s^2 \frac{\partial^2 V}{\partial s^2} \leq 0 \\ \frac{\partial V}{\partial y} - (1 + \theta_b) s \frac{\partial V}{\partial b} = 0 \\ - \left( \frac{\partial V}{\partial y} - (1 - \theta_s) s \frac{\partial V}{\partial b} \right) \leq 0. \end{cases}$$

- **Sell**

$$\begin{cases} \frac{\partial V}{\partial t} + rb \frac{\partial V}{\partial b} + \mu s \frac{\partial V}{\partial s} + \frac{1}{2} \sigma^2 s^2 \frac{\partial^2 V}{\partial s^2} \leq 0 \\ \frac{\partial V}{\partial y} - (1 + \theta_b) s \frac{\partial V}{\partial b} \leq 0 \\ - \left( \frac{\partial V}{\partial y} - (1 - \theta_s) s \frac{\partial V}{\partial b} \right) = 0. \end{cases}$$

- **No Transaction**

$$\begin{cases} \frac{\partial V}{\partial t} + rb \frac{\partial V}{\partial b} + \mu s \frac{\partial V}{\partial s} + \frac{1}{2} \sigma^2 s^2 \frac{\partial^2 V}{\partial s^2} = 0 \\ \frac{\partial V}{\partial y} - (1 + \theta_b) s \frac{\partial V}{\partial b} \leq 0 \\ - \left( \frac{\partial V}{\partial y} - (1 - \theta_s) s \frac{\partial V}{\partial b} \right) \leq 0. \end{cases}$$

The optimization problem is a free boundary problem, and its solution consists of finding the value function  $V$  and the optimal boundaries that divide the three regions. We assume that the Buy and Sell regions are separated by the NT region. This assumption is reasonable since buying and selling a share at the same time just decreases the total wealth (because of the transaction costs) and therefore makes no sense.

The free boundaries of the NT region completely characterize the investor's trading strategy. The optimal strategy consists in keeping the portfolio process inside the NT region. If the portfolio exits the NT region, the optimal strategy is to trade in order to bring it back to the NT region.

In the Buy and Sell regions the value functions is constant along the directions of the trades. We get respectively:

$$\text{Buy :} \quad V(t, b, y, s) = V(t, b - s(1 + \theta_b) \Delta L_t, y + \Delta L_t, s).$$

Sell :  $V(t, b, y, s) = V(t, b + s(1 - \theta_s)\Delta M_t, y - \Delta M_t, s).$

where  $\Delta L_t$  and  $\Delta M_t$  are the number of shares respectively bought or sold in the trade.

### 5.1.2 DPZ with jumps

The purpose of this thesis is to extend the DPZ model in order to include jumps in the stock dynamics. Following the framework of [De Vallière et al., 2016] let us introduce a market model with proportional transaction costs that consider an exponential Lévy process for the stock dynamics, as in 1.55. The state of the portfolio at time  $t \in [t_0, T]$  is  $(B_t^\pi, Y_t^\pi, S_t)$  and evolves following the SDE:

$$\begin{cases} dB_t^\pi &= rB_t^\pi dt - (1 + \theta_b)S_{t-}dL_t + (1 - \theta_s)S_{t-}dM_t \\ dY_t^\pi &= dL_t - dM_t \\ dS_t &= S_{t-} \left( \mu dt + \sigma dW_t + \int_{\mathbb{R}} (e^z - 1) \tilde{N}(dt, dz) \right). \end{cases} \quad (5.18)$$

The strategy  $\{\pi_t\}_{t \in [t_0, T]}$  is a càdlàg, **predictable**, nondecreasing process with bounded variation, such that  $\pi_{t_0^-} = (L_{t_0^-}, M_{t_0^-}) = (0, 0)$ . Under these assumptions the portfolio process  $\{(B_t^\pi, Y_t^\pi, S_t)\}_{t \in [t_0, T]}$  is càdlàg.

If at time  $t$  there is an unpredictable jump in the stock price  $\Delta S_t = S_t - S_{t-}$ , a possible transaction should happen immediately after the jump. The control process  $\{\pi_t\}_{t \in [t_0, T]}$  is assumed to be predictable, i.e. measurable with respect to the left-continuous filtration generated by  $\{S_{t-}\}_{t \in [t_0, T]}$ . Therefore, a jump in the price and a jump in the control cannot occur simultaneously, almost surely. A deeper digression on this topic can be found in Section 2 of [De Vallière et al., 2016]. If the investor at time  $t$  observes a jump in the price and decides to rebalance his portfolio, he will trade at some time  $u > t$  at the price  $S_{u-}$ . Under this framework, as explained in [De Vallière et al., 2016], the optimal strategy cannot exist.

The definitions of cash value (5.6), of total wealth (5.7), (5.11), (5.10) and the solvency regions (5.8) are kept the same. The set of admissible trading strategy will be changed.

Since the underlying stock follows a process with jumps, it is not guaranteed that the portfolio stays solvent for all  $t \in [t_0, T]$ . When holding short positions, it is possible that a sudden increase in the stock price causes the total wealth to jump out of the solvency region. The same can happen with a downward jump when the investor is long in stocks and negative in cash. The immediate decrease of the stock's price makes him unable to pay the debts. If the investor goes bankrupt, there are no trading strategies to save him.

**Definition 5.1.8.** The first *exit time* from the solvency region is defined as:

$$\tau := \inf\{t \in [t_0, T] : \mathcal{W}_t^\pi \notin \mathcal{S}\}. \quad (5.19)$$

**Definition 5.1.9.** The set of *admissible trading strategies*  $\Pi(t_0, b, y, s)$  is the set of all càdlàg, nondecreasing, predictable, bounded variation processes  $\{\pi_t\}_{t \in [t_0, T]}$  such that  $(B_t^\pi, Y_t^\pi, S_t)$  is a solution of (5.18) with initial values  $(B_{t_0}^\pi = b, Y_{t_0}^\pi = y, S_{t_0} = s)$  and such that  $\mathcal{W}_t^\pi \in \mathcal{S}$  almost surely for all  $t \in [t_0, \tau)$ , and  $\pi_t = \pi_\tau$  for all  $t \geq \tau$ .

The objective of the investor is to maximize the expected utility of the wealth at  $\tau^j \wedge T$  over all the admissible strategies. This expectation is conditioned on the current value of cash, number of shares and value of the stock.

**Definition 5.1.10.** The *value function* of the maximization problem for  $j = w, b, 0$  is defined as:

$$V^j(t, b, y, s) := \sup_{\pi \in \Pi^j(t, b, y, s)} \mathbb{E}_{t, b, y, s} \left[ \mathcal{U}(\mathcal{W}_T^{j; \pi}) \mathbb{1}_{\{\tau^j > T\}} + e^{\beta(T - \tau^j)} \mathcal{U}(\mathcal{W}_{\tau^j}^{j; \pi}) \mathbb{1}_{\{\tau^j \leq T\}} \right], \quad (5.20)$$

where  $\mathcal{U} : \mathbb{R} \rightarrow \mathbb{R}$  is a concave increasing utility function such that  $\mathcal{U}(0) = 0$ , and  $\beta \geq 0$ .

The HJB equation associated to this stochastic control problem is obtained following the same steps we used to derive (5.16). The infinitesimal generator of the price dynamics has the form (1.75) for exponential Lévy processes. The HJB variational inequality is

$$\begin{aligned} \max \left\{ \frac{\partial V^j}{\partial t} + rb \frac{\partial V^j}{\partial b} + \mu s \frac{\partial V^j}{\partial s} + \frac{1}{2} \sigma^2 s^2 \frac{\partial^2 V^j}{\partial s^2} \right. \\ \left. + \int_{\mathbb{R}} \left[ V^j(t, b, y, s e^z) - V^j(t, b, y, s) - s(e^z - 1) \frac{\partial V^j}{\partial s} \right] \nu(dz), \right. \\ \left. \frac{\partial V^j}{\partial y} - (1 + \theta_b) s \frac{\partial V^j}{\partial b}, - \left( \frac{\partial V^j}{\partial y} - (1 - \theta_s) s \frac{\partial V^j}{\partial b} \right) \right\} = 0, \end{aligned} \quad (5.21)$$

for  $(t, b, y, s) \in [t_0, T) \times \mathcal{S}^j$  and  $j = 0, w, b$ . The terminal boundary conditions are given by Eq. (5.17). Since this HJB equation is a PIDE, the non-local integral operator implies to define the lateral conditions not only on the boundary of the solvency region, but also beyond:

$$V^j(t, b, y, s) = e^{\beta(T-t)} \mathcal{U}(b + c(y, s)) \quad \text{for } t \in [t_0, T), (b, y, s) \notin \mathcal{S}, \quad j = 0, w, b. \quad (5.22)$$

### 5.1.3 Variable reduction

In the DPZ model introduced in Section 5.1.1, the portfolio is solvent for every  $t \in [t_0, T]$  and it is always possible to calculate the utility of the wealth at the terminal time  $\mathcal{U}(\mathcal{W}_T^\pi)$ . In the extended model of Section 5.1.2 the stock process can jump, and in presence of short positions the portfolio can go bankrupt at any time before the maturity  $T$ .

With the intention of simplifying the maximization problem (5.20) and reducing the number of variables, we restrict our attention to the case of no bankruptcy. A possible idea is to consider a positive initial wealth, and define the restricted set of admissible strategies as the set of  $\{\pi_t\}_{t \in [t_0, T]}$  such that  $B_t^\pi \geq 0$  and  $Y_t^\pi \geq 0$  for all  $t \in [t_0, T]$  (see [Benth et al., 2002]). However, in order to implement a hedging strategy, we are interested in portfolios containing short positions as well. So, we can assume that the investor has a very large credit availability  $C$  in the sense that

$$\mathbb{P}(\tau > T) \underset{C \rightarrow \infty}{\approx} 1. \quad (5.23)$$

In practical terms, we ignore the possibility of default. The solvency region becomes  $\mathcal{S} = \mathbb{R}^2 \times \mathbb{R}^+$  and no lateral boundary conditions are imposed.

As in [Davis et al., 1993], for  $\gamma > 0$ , we consider the exponential utility function

$$\mathcal{U}(x) := 1 - e^{-\gamma x}. \quad (5.24)$$

Thanks to (5.23) and (5.24) we can remove  $\{B_t^\pi\}_{t \in [t_0, T]}$  from the state dynamics. By solving (5.18) we get

$$B_T^\pi = \frac{B_t^\pi}{\delta(t, T)} - \int_t^T (1 + \theta_b) \frac{S_u}{\delta(u, T)} dL_u + \int_t^T (1 - \theta_s) \frac{S_u}{\delta(u, T)} dM_u \quad (5.25)$$

where  $\delta(u, T) = e^{-r(T-u)}$ . Using together (5.23), (5.24) and (5.25), and the wealth processes (5.7), (5.10), (5.11), we obtain for  $B_t^\pi = b$ ,  $Y_t^\pi = y$ ,  $S_t = s$  and  $j = 0, w, b$ :

$$V^j(t, b, y, s) = \sup_{\pi} \mathbb{E}_{t, b, y, s} \left[ 1 - e^{-\gamma \mathcal{W}^j(T)} \right] = 1 - e^{-\gamma \frac{b}{\delta(t, T)}} Q^j(t, y, s), \quad (5.26)$$

where

$$Q^j(t, y, s) = \inf_{\pi} \mathbb{E}_{t, y, s} \left[ e^{-\gamma \left[ - \int_t^T (1 + \theta_b) \frac{S_u}{\delta(u, T)} dL_u + \int_t^T (1 - \theta_s) \frac{S_u}{\delta(u, T)} dM_u \right]} \times H^j(Y_T^\pi, S_T) \right] \quad (5.27)$$

is our new minimization problem. The exponential term inside the expectation can be considered as a discount factor, and the second term  $H^j(y, s) = Q^j(T, y, s)$  is the terminal payoff:

- No option:

$$H^0(y, s) = e^{-\gamma c(y, s)}. \quad (5.28)$$

- Writer:

$$H^w(y, s) = e^{-\gamma [c(y, s) \mathbb{1}_{\{s(1+\theta_b) \leq K\}} + (c(y-1, s) + K) \mathbb{1}_{\{s(1+\theta_b) > K\}}]}. \quad (5.29)$$

- Buyer:

$$H^b(y, s) = e^{-\gamma [c(y, s) \mathbb{1}_{\{s(1+\theta_b) \leq K\}} + (c(y+1, s) - K) \mathbb{1}_{\{s(1+\theta_b) > K\}}]}. \quad (5.30)$$

Using conditions (5.13), (5.14) together with (5.26), we obtain the explicit formulas for the option prices:

$$p^w(t_0, y, s) = \frac{\delta(t_0, T)}{\gamma} \log \left( \frac{Q^w(t_0, y, s)}{Q^0(t_0, y, s)} \right), \quad (5.31)$$

$$p^b(t_0, y, s) = \frac{\delta(t_0, T)}{\gamma} \log \left( \frac{Q^0(t_0, y, s)}{Q^b(t_0, y, s)} \right). \quad (5.32)$$

Since  $Q^j(t, y, s)$  is independent on  $b$ , let us write  $Q^j(t, y, s) := 1 - V^j(t, 0, y, s)$ . It is convenient to pass to the log-variable  $x = \log(s)$ , such that

$$s \frac{\partial}{\partial s} = \frac{\partial}{\partial x}, \quad s^2 \frac{\partial^2}{\partial s^2} = \frac{\partial^2}{\partial x^2} - \frac{\partial}{\partial x}. \quad (5.33)$$

For  $j = 0, w, b$ , the HJB Eq. (5.21) becomes:

$$\begin{aligned} \min \left\{ \frac{\partial Q^j}{\partial t} + \left( \mu - \frac{1}{2} \sigma^2 \right) \frac{\partial Q^j}{\partial x} + \frac{1}{2} \sigma^2 \frac{\partial^2 Q^j}{\partial x^2} \right. \\ \left. + \int_{\mathbb{R}} \left[ Q^j(t, y, x+z) - Q^j(t, y, x) - (e^z - 1) \frac{\partial Q^j}{\partial x} \right] \nu(dz), \right. \\ \left. \frac{\partial Q^j}{\partial y} + (1 + \theta_b) e^x \frac{\gamma}{\delta(t, T)} Q^j, - \left( \frac{\partial Q^j}{\partial y} + (1 - \theta_s) e^x \frac{\gamma}{\delta(t, T)} Q^j \right) \right\} = 0. \end{aligned} \quad (5.34)$$

## 5.2 Existence of viscosity solution

The general fact that value functions of control problems can be characterized as viscosity solutions of certain partial differential equations is a direct consequence of the dynamic programming principle. For singular control problems, however, the classical approach of [Lions, 1983] fails because the state process may jump due to the singular control and it needs thus not stay in a small ball<sup>1</sup> for a small  $\Delta t$ . This problem can be circumvented by relying on the existence of the optimal control, as done in [Davis et al.,

<sup>1</sup>For processes of type (4.42) it is not possible to apply the theorem (4.1.1).

1993]. However, in our proof we will not assume the existence of the optimal control, which in this framework does not exist. We will assume that the **DPP** for the singular control problem (5.18), (5.20) holds, and that the value function is continuous. We refer to Sections 4 and 9 of [De Vallière et al., 2016] for the proofs of these statements.

In this section we prove that the value function (5.20), can be interpreted as the viscosity solution of the HJB equation (5.21). The proof follows the approach in [Framstad et al., 1999].

Let us call  $\tau_{\mathcal{S}}$  the first exit time from  $\mathcal{S}$ . Since the stock dynamics is stochastically continuous and (by definition) the control process  $\pi$  cannot be the cause of bankruptcy, we can exclude an immediate jump out of the solvency region, i.e.  $t_0 \neq \tau_{\mathcal{S}}$ .

We have to interpret the HJB equation (5.21) with boundary conditions (5.22) and (5.17) as a parabolic problem of the type (4.48). We use the dummy variable  $x = (b, y, s)$  to indicate a point in  $\mathbb{R}^2 \times \mathbb{R}^+$ . In order to satisfy the parabolic conditions we reformulate the HJB as

$$\begin{aligned} \min \left\{ - \left( \frac{\partial V}{\partial t} + rb \frac{\partial V}{\partial b} + \mu s \frac{\partial V}{\partial s} + \frac{1}{2} \sigma^2 s^2 \frac{\partial^2 V}{\partial s^2} \right. \right. \\ \left. \left. + \int_{\mathbb{R}} \left[ V(t, b, y, se^z) - V(t, b, y, s) - s(e^z - 1) \frac{\partial V}{\partial s} \right] \nu(dz) \right), \right. \\ \left. - \left( \frac{\partial V}{\partial y} - (1 + \theta_b)s \frac{\partial V}{\partial b} \right), + \left( \frac{\partial V}{\partial y} - (1 - \theta_s)s \frac{\partial V}{\partial b} \right) \right\} = 0. \end{aligned} \quad (5.35)$$

We indicate this function with  $F(t, x, V, D_t V, D_x V, D_{xx} V, \mathcal{I}(t, x, V)) = 0$  in the domain  $(t, x) \in [t_0, T) \times \mathcal{S}$ . To simplify the notation, let us introduce the integro-differential infinitesimal generator:

$$\begin{aligned} \mathcal{L}V(t, x) := - \left( \frac{\partial V}{\partial t}(t, x) + rb \frac{\partial V}{\partial b}(t, x) + \mu s \frac{\partial V}{\partial s}(t, x) + \frac{1}{2} \sigma^2 s^2 \frac{\partial^2 V}{\partial s^2}(t, x) \right) \\ - \int_{\mathbb{R}} \left[ V(t, b, y, se^z) - V(t, b, y, s) - s(e^z - 1) \frac{\partial V}{\partial s} \right] \nu(dz), \end{aligned}$$

such that the equation (5.35) has the form

$$\min \left\{ \mathcal{L}V(t, x), -(V_y - (1 + \theta_b)sV_b), V_y - (1 - \theta_s)sV_b \right\} = 0. \quad (5.36)$$

In order to prove that  $V(t, x)$  is a viscosity solution we need to verify both the subsolution and supersolution properties.

### 5.2.1 Subsolution

In this section we prove that the value function can be interpreted as a viscosity subsolution of the HJB equation associated to the maximization problem. We enunciate the following theorem:

**Theorem 5.2.1.** *The value function of the maximization problem (5.20), is a viscosity subsolution of the Eq. (5.36).*

*Proof.* Let us consider a test function  $\phi \in C^2([t_0, T] \times \mathbb{R}^2 \times \mathbb{R}^+) \cap \mathcal{C}_2([t_0, T] \times \mathbb{R}^2 \times \mathbb{R}^+)$  such that  $(\bar{t}, \bar{x}) \in [t_0, T] \times \mathcal{S}$  is a maximum point for  $V - \phi$ :

$$V(\bar{t}, \bar{x}) - \phi(\bar{t}, \bar{x}) \geq V(t, x) - \phi(t, x) \quad \forall (t, x) \in [t_0, T] \times \mathcal{S} \quad (5.37)$$

and we assume without loss of generality that:

$$V(\bar{t}, \bar{x}) = \phi(\bar{t}, \bar{x}) \quad (5.38)$$

so we can write:

$$V(t, x) \leq \phi(t, x) \quad (5.39)$$

We want to prove that

$$F(\bar{t}, \bar{x}, V(\bar{t}, \bar{x}), D_t \phi(\bar{t}, \bar{x}), D_x \phi(\bar{t}, \bar{x}), D_{xx} \phi(\bar{t}, \bar{x}), \mathcal{I}(\bar{t}, \bar{x}, \phi(\bar{t}, \bar{x}))) \leq 0$$

**Reductio ad absurdum:**

Let us assume that

$$F(\bar{t}, \bar{x}, V(\bar{t}, \bar{x}), D_t \phi(\bar{t}, \bar{x}), D_x \phi(\bar{t}, \bar{x}), D_{xx} \phi(\bar{t}, \bar{x}), \mathcal{I}(\bar{t}, \bar{x}, \phi(\bar{t}, \bar{x}))) > 0.$$

This means that all the terms inside the minimum in Eq. (5.36) are positive, i.e. exist  $\kappa > 0$  such that:

1.  $\mathcal{L}\phi(\bar{t}, \bar{x}) > \kappa$ ,
2.  $-\left(\frac{\partial \phi}{\partial y}(\bar{t}, \bar{x}) - (1 + \theta_b)\bar{s}\frac{\partial \phi}{\partial b}(\bar{t}, \bar{x})\right) > \kappa$ ,
3.  $\frac{\partial \phi}{\partial y}(\bar{t}, \bar{x}) - (1 - \theta_s)\bar{s}\frac{\partial \phi}{\partial b}(\bar{t}, \bar{x}) > \kappa$ .

Since the test function is smooth by definition, there exist a ball  $\mathcal{B}(\bar{x}, \rho) \subset \mathcal{S}$  where the three previous conditions are satisfied  $\forall x \in \mathcal{B}(\bar{x}, \rho)$ . We can define the exit time of the process  $\{X_t\}_{t \in [\bar{t}, T \wedge \tau_S]}$  from the ball  $\mathcal{B}(\bar{x}, \rho)$ :

$$\tau_\rho = \inf\{t \in [t_0, T] : X_t \notin \mathcal{B}(\bar{x}, \rho)\} \wedge N, \quad (5.40)$$

with  $N > 0$  fixed. Since  $\mathcal{B}(\bar{x}, \rho) \subset \mathcal{S}$  it follows that  $\tau_\rho \leq \tau_S$ .

In this proof, we will take advantage from the fact that transaction costs are linear. This means that any transaction can be split into two or more simultaneous smaller transactions. Therefore, the jump  $\Delta\pi_t > 0$  of the control can be divided into smaller jumps i.e.  $\Delta\pi_t = \sum_i c_i \Delta\pi_t$ , with  $c_i \geq 0$  and  $\sum_i c_i = 1$ . The coefficients  $c_i$  can be chosen such that after the action of each  $c_i \Delta\pi_t$  the state process is contained in an arbitrarily small closed ball.

Let us consider an admissible  $\epsilon$ -optimal control  $\{\pi_t^\epsilon\}_{t_0 \leq t \leq T}$ . To lighten the notation, in the following we suppress the apex  $\epsilon$ . At the point  $(\bar{t}, \bar{x})$ , for a  $\rho > 0$  there are two alternative cases:

**A:**  $\Delta\pi_t = 0$  for  $\bar{t} \leq t \leq \tau_\rho$ .

**B:**  $\Delta\pi_{t_k} > 0$  for some  $\bar{t} \leq t_k \leq \tau_\rho$ .

In this case we select a small enough  $\rho > 0$  such that  $\tau_\rho = \bar{t}$ .

The action of the control can be split in the following way. For a control jump at time  $\bar{t}$ , let us introduce

$$\begin{aligned} x_0 &= (b_0, y_0, s_0) = (\bar{b}, \bar{y}, \bar{s}) = \bar{x} \\ x_{i+1} &= x_i + \left( -(1 + \theta_b)\bar{s} c_i \Delta L_{\bar{t}} + (1 - \theta_s)\bar{s} c_i \Delta M_{\bar{t}}, c_i \Delta L_{\bar{t}} - c_i \Delta M_{\bar{t}}, 0 \right). \end{aligned}$$

For each  $x_i$ , we choose a ray  $\rho_i > 0$ . We can now define the coefficients  $c_i$  as:

$$c_i = \inf \left\{ c \in [0, 1] : \right. \quad (5.41)$$

$$\left. x_i + \left( -(1 + \theta_b)\bar{s} c \Delta L_{\bar{t}} + (1 - \theta_s)\bar{s} c \Delta M_{\bar{t}}, c \Delta L_{\bar{t}} - c \Delta M_{\bar{t}}, 0 \right) \notin \mathcal{B}(x_i, \rho_i) \right\}. \quad (5.42)$$

By the DPP (4.46), for every  $\epsilon > 0$ , there exists an  $\epsilon$ -optimal control  $\pi \in \Pi(\bar{t}, \bar{x})$  such that

$$V(\bar{t}, \bar{x}) \leq \mathbb{E}_{\bar{x}} \left[ V(\tau_\rho, X_{\tau_\rho}^\pi) \right] + \epsilon. \quad (5.43)$$

Using (5.38) and (5.39) we can write:

$$\phi(\bar{t}, \bar{x}) = V(\bar{t}, \bar{x}) \leq \mathbb{E}_{\bar{x}} [V(\tau_\rho, X_{\tau_\rho}^\pi)] + \epsilon \leq \mathbb{E}_{\bar{x}} [\phi(\tau_\rho, X_{\tau_\rho}^\pi)] + \epsilon.$$

In the following, in order to get a more readable notation, when necessary we indicate  $X_t$  with  $X(t)$ . The test function  $\phi$  is smooth enough to use the



generalized Itô formula.

$$\begin{aligned}
0 &\leq \mathbb{E}_{\bar{x}} \left[ \phi(\tau_\rho, X_{\tau_\rho}^\pi) - \phi(\bar{t}, \bar{x}) \right] + \epsilon \\
&= \mathbb{E}_{\bar{x}} \left[ \int_{\bar{t}}^{\tau_\rho} -\mathcal{L}\phi(t, X_t^\pi) dt \right. \\
&\quad + \int_{\bar{t}}^{\tau_\rho} \left( \frac{\partial \phi}{\partial y}(t, X_t^\pi) - (1 + \theta_b)S_{t-} \frac{\partial \phi}{\partial b}(t, X_t^\pi) \right) dL_t^c \\
&\quad - \int_{\bar{t}}^{\tau_\rho} \left( \frac{\partial \phi}{\partial y}(t, X_t^\pi) - (1 - \theta_s)S_{t-} \frac{\partial \phi}{\partial b}(t, X_t^\pi) \right) dM_t^c \\
&\quad + \sum_{\bar{t} \leq t_k \leq \tau_\rho} \left( \phi(t_k, B^\pi(t_k^-) - (1 + \theta_b)S(t_k^-) \Delta L_{t_k}, Y^\pi(t_k^-) + \Delta L_{t_k}, S(t_k)) \right. \\
&\quad \quad \left. - \phi(t_k, B^\pi(t_k^-), Y^\pi(t_k^-), S(t_k)) \right) \\
&\quad + \sum_{\bar{t} \leq t_k \leq \tau_\rho} \left( \phi(t_k, B^\pi(t_k^-) + (1 - \theta_s)S(t_k^-) \Delta M_{t_k}, Y^\pi(t_k^-) - \Delta M_{t_k}, S(t_k)) \right. \\
&\quad \quad \left. - \phi(t_k, B^\pi(t_k^-), Y^\pi(t_k^-), S(t_k)) \right) \Big] + \epsilon
\end{aligned} \tag{5.44}$$

where again  $t_k$  denotes the jump times of  $\{\pi_t\}_{t \in [\bar{t}, \tau_\rho]}$  and we indicate the continuous parts of  $\pi$  as

$$L_t^c = L_t - \sum_{\bar{t} \leq t_k \leq \tau_\rho} \Delta L_{t_k} \quad \text{and} \quad M_t^c = M_t - \sum_{\bar{t} \leq t_k \leq \tau_\rho} \Delta M_{t_k}. \tag{5.45}$$

**Case A:**  $\Delta\pi_t = 0$  for each  $\bar{t} \leq t \leq \tau_\rho$ . Equation (5.44) becomes:

$$\begin{aligned}
0 &\leq E_{\bar{x}} \left[ \int_{\bar{t}}^{\tau_\rho} -\mathcal{L}\phi(t, X_t^\pi) dt \right. \\
&\quad + \int_{\bar{t}}^{\tau_\rho} \left( \frac{\partial \phi}{\partial y}(t, X_t^\pi) - (1 + \theta_b)S_{t-} \frac{\partial \phi}{\partial b}(t, X_t^\pi) \right) dL_t^c \\
&\quad - \int_{\bar{t}}^{\tau_\rho} \left( \frac{\partial \phi}{\partial y}(t, X_t^\pi) - (1 - \theta_s)S_{t-} \frac{\partial \phi}{\partial b}(t, X_t^\pi) \right) dM_t^c \Big] + \epsilon \\
&< \underbrace{\left( -\kappa \mathbb{E}_{\bar{x}}[\tau_\rho - \bar{t}] - \kappa \mathbb{E}_{\bar{x}}[L_{\tau_\rho}^c - L_{\bar{t}}^c] - \kappa \mathbb{E}_{\bar{x}}[M_{\tau_\rho}^c - M_{\bar{t}}^c] \right)}_{<0} + \epsilon.
\end{aligned} \tag{5.46}$$

Since this must hold true for all  $\epsilon$ , when taking the limit  $\epsilon \rightarrow 0$  we get a contradiction.

**Case B:** In this case we have  $\tau_\rho = \bar{t}$ .

Let us consider for simplicity  $\Delta\pi_{\bar{t}} = (\Delta L_{\bar{t}}, 0)$ . The case with  $\Delta\pi_{\bar{t}} = (0, \Delta M_{\bar{t}})$  is analogous.

We can split the trade and consider only the first action  $c_0 \Delta L_{\bar{t}}$  of the control, where  $c_0$  is defined in (5.41) with  $\rho_0 = \rho$ . After the control jump the state moves from  $x_0$  to  $x_1 \in \partial \mathcal{B}(x_0, \rho)$ .

Now we want to investigate the relation between  $\rho$  and  $\epsilon$ . Remember that  $\rho$  should be small enough in order to guarantee the immediate exit from the ball i.e.  $\bar{t} = \tau_\rho$ . The size of the initial jump  $\Delta L_{\bar{t}}$  however, depends on  $\epsilon$ . In general there are two possibilities:

1.  $\Delta L_{\bar{t}} \geq \epsilon$ .

If at the point  $(\bar{t}, \bar{x})$  the size of the control jump  $\Delta L_{\bar{t}}$  is bigger or equal than  $\epsilon$ , we can choose  $c_0$  such that

$$c_0 \Delta L_{\bar{t}} = \epsilon. \quad (5.47)$$

2.  $\Delta L_{\bar{t}} < \epsilon$ .

If  $0 < \Delta L_{\bar{t}} < \epsilon$  holds true for every  $\epsilon > 0$ , then for  $\epsilon \rightarrow 0$  it follows that  $\Delta L_{\bar{t}} \rightarrow 0$ , leading to the previous **case A**.

Let us consider the case of a control with a jump bigger than  $\epsilon$  i.e.  $\Delta L_{\bar{t}} \geq \epsilon$ . Thanks to the relation (5.47), when we take the limit  $\epsilon \rightarrow 0$  then  $c_0 \rightarrow 0$  as well, and consequently also the distance between  $x_0$  and  $x_1$  i.e.  $\rho \rightarrow 0$ .

It is convenient to rescale the parameter  $\epsilon$ :

$$c_0 \Delta L_{\bar{t}} = \epsilon = 2\tilde{\epsilon}/\kappa. \quad (5.48)$$

Using the DPP between the two states  $x_0$  and  $x_1$ , the equation (5.44) becomes:

$$\begin{aligned} 0 &\leq \phi(\bar{t}, x_1) - \phi(\bar{t}, x_0) + \tilde{\epsilon} \\ 0 &\leq \frac{\phi(\bar{t}, \bar{b} - (1 + \theta_b)\bar{s} \epsilon, \bar{y} + c_0 \Delta L_{\bar{t}}, \bar{s}) - \phi(\bar{t}, \bar{x})}{c_0 \Delta L_{\bar{t}}} + \frac{\tilde{\epsilon}}{c_0 \Delta L_{\bar{t}}} \\ &= \frac{\phi(\bar{t}, \bar{b} - (1 + \theta_b)\bar{s} \epsilon, \bar{y} + \epsilon, \bar{s}) - \phi(\bar{t}, \bar{x})}{\epsilon} + \frac{\kappa}{2} \\ &\stackrel{\epsilon \rightarrow 0}{=} \left( \frac{\partial \phi}{\partial y}(\bar{t}, \bar{x}) - (1 + \theta_b)\bar{s} \frac{\partial \phi}{\partial b}(\bar{t}, \bar{x}) \right) + \frac{\kappa}{2} \\ &< -\kappa + \frac{\kappa}{2} \end{aligned}$$

In the second line we expressed  $x_1$  in explicit form, and divided both sides by  $c_0 \Delta L_{\bar{t}}$ . In the third line we used (5.48) and took the limit for  $\epsilon \rightarrow 0$ .

We obtained a contradiction.  $\square$

### 5.2.2 Supersolution

Let us prove that the value function is a viscosity supersolution of the HJB equation (5.36).

**Theorem 5.2.2.** *The value function of the maximization problem (5.20), is a viscosity supersolution of the Eq. (5.36).*

*Proof.* Let us consider a test function  $\phi \in C^2([t_0, T] \times \mathbb{R}^2 \times \mathbb{R}^+) \cap \mathcal{C}_2([t_0, T] \times \mathbb{R}^2 \times \mathbb{R}^+)$  such that  $(\bar{t}, \bar{x}) \in [t_0, T] \times \mathcal{S}$  is a minimum point for  $V - \phi$ .

$$V(\bar{t}, \bar{x}) - \phi(\bar{t}, \bar{x}) \leq V(t, x) - \phi(t, x) \quad \forall (t, x) \in [t_0, T] \times \mathcal{S} \quad (5.49)$$

and we assume without loss of generality that:

$$V(\bar{t}, \bar{x}) = \phi(\bar{t}, \bar{x}) \quad (5.50)$$

so we can write:

$$V(t, x) \geq \phi(t, x) \quad (5.51)$$

We want to prove that

$$F(\bar{t}, \bar{x}, V(\bar{t}, \bar{x}), D_t \phi(\bar{t}, \bar{x}), D_x \phi(\bar{t}, \bar{x}), D_{xx} \phi(\bar{t}, \bar{x}), \mathcal{I}(\bar{x}, \phi(\bar{t}, \bar{x}))) \geq 0$$

that is analogous to prove that all the following terms are non-negative:

1.  $\mathcal{L}\phi(\bar{t}, \bar{x}) \geq 0$ ,
2.  $-\left(\frac{\partial \phi}{\partial y}(\bar{t}, \bar{x}) - (1 + \theta_b)\bar{s}\frac{\partial \phi}{\partial b}(\bar{t}, \bar{x})\right) \geq 0$ ,
3.  $\frac{\partial \phi}{\partial y}(\bar{t}, \bar{x}) - (1 - \theta_s)\bar{s}\frac{\partial \phi}{\partial b}(\bar{t}, \bar{x}) \geq 0$ .

By the DPP (4.45), for all  $\tau \in \mathcal{T}_{\bar{t}, \tau_S}$  and **for all**  $\pi \in \Pi(\bar{t}, \bar{x})$ , we can write:

$$V(\bar{t}, \bar{x}) \geq \mathbb{E}_{\bar{x}}[V(\tau, X_\tau^\pi)]. \quad (5.52)$$

Using (5.50) and (5.51) we can write:

$$\phi(\bar{t}, \bar{x}) = V(\bar{t}, \bar{x}) \geq \mathbb{E}_{\bar{x}}[V(\tau, X_\tau^\pi)] \geq \mathbb{E}_{\bar{x}}[\phi(\tau, X_\tau^\pi)]$$

The test function  $\phi$  is smooth enough to use the generalized Itô formula.

$$\begin{aligned}
0 &\geq \mathbb{E}_{\bar{x}} \left[ \phi(\tau, X_\tau^\pi) - \phi(\bar{t}, \bar{x}) \right] \\
&= \mathbb{E}_{\bar{x}} \left[ \int_{\bar{t}}^{\tau} -\mathcal{L}\phi(t, X_t^\pi) dt \right. \\
&\quad + \int_{\bar{t}}^{\tau} \left( \frac{\partial \phi}{\partial y}(t, X_t^\pi) - (1 + \theta_b) S_t - \frac{\partial \phi}{\partial b}(t, X_t^\pi) \right) dL_t^c \\
&\quad - \int_{\bar{t}}^{\tau} \left( \frac{\partial \phi}{\partial y}(t, X_t^\pi) - (1 - \theta_s) S_t - \frac{\partial \phi}{\partial b}(t, X_t^\pi) \right) dM_t^c \\
&\quad + \sum_{\bar{t} \leq t_k \leq \tau} \left( \phi(t_k, B^\pi(t_k^-) - (1 + \theta_b) S(t_k^-) \Delta L_{t_k}, Y^\pi(t_k^-) + \Delta L_{t_k}, S(t_k)) \right. \\
&\quad \quad \left. - \phi(t_k, B^\pi(t_k^-), Y^\pi(t_k^-), S(t_k)) \right) \\
&\quad + \sum_{\bar{t} \leq t_k \leq \tau} \left( \phi(t_k, B^\pi(t_k^-) + (1 - \theta_s) S(t_k^-) \Delta M_{t_k}, Y^\pi(t_k^-) - \Delta M_{t_k}, S(t_k)) \right. \\
&\quad \quad \left. - \phi(t_k, B^\pi(t_k^-), Y^\pi(t_k^-), S(t_k)) \right) \Big] \tag{5.54}
\end{aligned}$$

where, as in (5.44) the  $t_k$  denote the jump times of  $\{\pi_t\}_{t \in [\bar{t}, \tau]}$  and  $L^c, M^c$  indicate the continuous parts of  $\pi$ .

Now we can consider the two cases:

**A** There is a jump  $\Delta\pi_{\bar{t}} > 0$  at the initial time  $\bar{t}$ , and then the process is continuous i.e.  $\Delta\pi_t = 0$  for  $t \in (\bar{t}, \tau]$ . We consider the two cases  $\Delta L_{\bar{t}} = l > 0$  and  $\Delta M_{\bar{t}} = 0$  or  $\Delta L_{\bar{t}} = 0$  and  $\Delta M_{\bar{t}} = m > 0$ .

**B** The control  $\pi_t$  is constant for all  $t \in [\bar{t}, \tau]$ .

**Case A:** taking the limit  $\tau \rightarrow \bar{t}$  and writing  $\bar{x} = (\bar{b}, \bar{y}, \bar{s})$  we obtain the following expression

$$0 \geq \phi(\bar{t}, \bar{b} - (1 + \theta_b) \bar{s} l, \bar{y} + l, \bar{s}) - \phi(\bar{t}, \bar{b}, \bar{y}, \bar{s}),$$

and all the other terms go to zero.

The previous equation holds true for all  $l > 0$ , so we can take the limit  $l \rightarrow 0$  and get

$$\frac{\partial \phi}{\partial y}(\bar{t}, \bar{x}) - (1 + \theta_b) \bar{s} \frac{\partial \phi}{\partial b}(\bar{t}, \bar{x}) \leq 0,$$

and after multiplying by -1, we verify the second inequality.

$$-\left( \frac{\partial \phi}{\partial y}(\bar{t}, \bar{x}) - (1 + \theta_b) \bar{s} \frac{\partial \phi}{\partial b}(\bar{t}, \bar{x}) \right) \geq 0.$$

The third inequality can be obtained following the same steps but choosing  $\Delta M_{\bar{t}} = m > 0$  and  $\Delta L_{\bar{t}} = 0$ .

$$\frac{\partial \phi}{\partial y}(\bar{t}, \bar{x}) - (1 - \theta_s) \bar{s} \frac{\partial \phi}{\partial b}(\bar{t}, \bar{x}) \geq 0.$$

**Case B:** for a constant control the only surviving term in (5.44) is

$$\int_{\bar{t}}^{\tau} -\mathcal{L}\phi(t, X_t^{\pi}) dt \leq 0.$$

Let us divide by  $\tau - \bar{t}$ , send  $\tau \rightarrow \bar{t}$  and use the mean value theorem to get:

$$\mathcal{L}\phi(\bar{t}, \bar{x}) \geq 0.$$

This proves the first inequality. □

We conclude this chapter with the following main theorem:

**Theorem 5.2.3.** *The value function of the maximization problem (5.20), is a viscosity solution of the Eq. (5.36).*

The proof is a direct consequence of Theorems 5.2.1 and 5.2.2. Since the value function is both a viscosity subsolution and a supersolution, it is a viscosity solution.

### 5.3 Chapter conclusions

This chapter contains the main topic of the thesis i.e. a model for pricing options under proportional transaction costs and when the stock price follows an exponential Lévy process.

This model is an extension of the celebrated model of [Davis et al., 1993], that we recall in Section 5.1.1. This model can be identified in the category of singular stochastic problems presented in Chapter 4.

Following the framework of [De Vallière et al., 2016], we extend the DPZ model by replacing the geometric Brownian motion with an exponential Lévy process. Following the general singular control theory, we derive the associated HJB variational inequality. The complete equation (5.21) and the reduced equation (5.34) are the main equations of this thesis and are also presented in the paper [Cantarutti et al., 2018].

The end of the chapter is dedicated to the proof of existence of a viscosity solution of the HJB (5.21). Specifically, we prove that the value function of the problem satisfies the HJB in the viscosity sense.

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This chapter presents the numerical methods for solving the option pricing problems with transaction costs presented in Section 5.1.2. The optimization problems (5.20) and (5.27) are solved by using the Markov chain approximation method. The same approach has been used frequently in the literature in the case of diffusion processes, e.g. [Hodges and Neuberger,

1989], [Davis et al., 1993], [Damgaard, 1998], [Monoyios, 2004] and [Palczewsky et al., 2015]. We present results for the particular cases of diffusion process, Merton jump-diffusion and Variance Gamma process, although our scheme works for any Lévy process with finite variance. We show that our numerical scheme, applied to the problem (5.27), is monotone, consistent and stable, and that its solution converges to the viscosity solution of the HJB eq. (5.34). Further analysis, such as numerical convergence rate and time complexity of the algorithm are presented. In the Section 6.4 are presented numerical results obtained for the general problem (5.20) where also the default feature is considered. In the final Section 6.5 we apply the multinomial method introduced in Chapter 3 to the problem (5.27).

## 6.1 Markov chain approximation

In order to solve the problems (5.20) and (5.27) we use the Markov chain approximation method developed by [Kushner and Dupuis, 2001]. The numerical technique for singular controls has been originally developed in the article of [Kushner and Martins, 1991]. The portfolio dynamics (5.18) is approximated by a discrete state controlled Markov chain in discrete time. The method consists in creating a backward recursive dynamic programming algorithm, in order to compute the value function at time  $t$ , given its value at time  $t + \Delta t$ . [Kushner and Dupuis, 2001] prove that the value function obtained through the discrete dynamic programming algorithm converges to the value function of the original continuous time problem as  $\Delta t \rightarrow 0$ . Their proof uses a weak convergence in probability argument. Another approach to prove convergence has been introduced by [Barles and Souganidis, 1991]. It consider the convergence of the discrete value function to the viscosity solution of the original HJB equation. In the work of [Davis et al., 1993] the authors prove existence and uniqueness of the viscosity solution of the HJB Eq. (5.16) (diffusion case), and using the method developed by [Barles and Souganidis, 1991] prove that the value function obtained through the Markov chain approximation converges to it.

In this chapter we propose a discretization scheme and prove that it is monotone, consistent, stable, and its solution converges to the continuous viscosity solution of (5.34).

In this work we model the stock dynamics with a general exponential Lévy process. For practical computations we need to specify which Lévy process we are using, and this is equivalent to choose a Lévy triplet. Since every Lévy process satisfies the Markov property, we are allowed to use the Markov chain approximation approach. A possible way to construct the Markov chain is to discretize the infinitesimal generator by using an explicit finite difference method (see for instance [Kushner and Dupuis, 2001] or [Fleming and Soner, 2005]). This is straightforward for Lévy processes

of jump-diffusion type with finite jump activity. But for Lévy processes with infinite jump activity, it is not straightforward to obtain the transition probabilities from the discretization of the generator. A common procedure is to approximate the small jumps with a Brownian motion, as explained in Section 2.2.3, in order to remove the singularity of the Lévy measure near the origin.

In the next section we focus our attention on the simplified problem (5.27).

### 6.1.1 The discrete model

Thanks to the variable reduction introduced in the previous section, the optimization problem (5.27) only depends on two state variables. The portfolio dynamics (5.18) has the simpler form (using  $X_t = \log S_t$ ):

$$\begin{cases} dY_t^\pi &= dL_t - dM_t \\ dX_t &= \left( \mu - \frac{1}{2}\sigma^2 - \int_{\mathbb{R}} (e^z - 1 - z)\nu(dz) \right) dt + \sigma dW_t + \int_{\mathbb{R}} z \tilde{N}(dt, dz). \end{cases} \quad (6.1)$$

where the SDE for the log-variable corresponds to (2.25) with  $\mu$  defined in (1.54). If the process has finite activity  $\lambda := \int_{\mathbb{R}} \nu(dz)$ , thanks to assumption **EM** (in Section 1.1.4), we can define with an abuse of notation<sup>1</sup>  $m := \int_{\mathbb{R}} (e^z - 1)\nu(dz)$  and  $\lambda\alpha := \int_{\mathbb{R}} z\nu(dz)$  such that the SDE of  $\{X_t\}_{t \in [t_0, T]}$  can be written as

$$dX_t = \left( \mu - \frac{1}{2}\sigma^2 - m + \lambda\alpha \right) dt + \sigma dW_t + \int_{\mathbb{R}} z \tilde{N}(dt, dz). \quad (6.2)$$

If the process has infinite activity  $\lambda = \int_{\mathbb{R}} \nu(dz) = \infty$ , we can approximate the “small jumps” martingale component by a Brownian motion, following the arguments in Section 2.2.3, and get the equation

$$dX_t = \left( \mu - \frac{1}{2}(\sigma^2 + \sigma_\epsilon^2) - \omega_\epsilon + \lambda_\epsilon \theta_\epsilon \right) dt + (\sigma + \sigma_\epsilon) dW_t + \int_{|z| \geq \epsilon} z \tilde{N}(dt, dz), \quad (6.3)$$

with parameters defined in (2.42).

Now we can discretize the time and space to create a Markov chain approximation of the portfolio process (6.1). For  $n = 0, 1, \dots, N \in \mathbb{N}$ , we define the discrete time step  $\Delta t := \frac{T-t_0}{N}$  such that  $t_n = t_0 + n\Delta t$ . We assume that the controls  $(L_u, M_u)$  are constant for  $u \in [t_n, t_{n+1})$ , and allow for a possible variation at  $t_n$  for each  $n$ .

From now on, we indicate with  $X_n$  the value of  $X_t$  at  $t_n$  and with  $Y_n$  the value of  $Y_t$  at the time  $t_n^-$  immediately before the possible transaction.

Let us define the set  $\Sigma_x := \{-K_1 h_x, \dots, -h_x, 0, h_x, \dots, +K_2 h_x\}$ , where  $h_x > 0$  is the discrete log-return step. The values  $K_1, K_2 \in \mathbb{N}$  can be

<sup>1</sup>We have already defined  $m$  in (1.77) and  $\alpha$  in (1.56) for the Merton model. We extend this notation for any Lévy measure with finite activity.



different to capture the possible asymmetry in the jump sizes. Its dimension is  $\bar{L} = \#(\Sigma_x) = K_1 + K_2 + 1$ . Let us define also the set  $\Sigma_y := \{-K_3 h_y, \dots, -h_y, 0, h_y, \dots, +K_4 h_y\}$ , where  $h_y > 0$  is the discrete shares step and  $K_3, K_4 \in \mathbb{N}$ . Its dimension is  $\bar{M} = \#(\Sigma_y) = K_3 + K_4 + 1$ .

The discretized version of the SDE (6.1) is:

$$\begin{cases} \Delta Y_n &= \Delta L_n - \Delta M_n \\ \Delta X_n &= \hat{\mu} \Delta t + \hat{\sigma} \Delta W_n + \Delta \tilde{J}_n = \Delta \Xi_n + \Delta \tilde{J}_n, \end{cases} \quad (6.4)$$

where  $\Delta X_n := X_{n+1} - X_n \in \Sigma_x$ ,  $\hat{\mu} \in \mathbb{R}$  and  $\hat{\sigma} > 0$ . The term  $\Delta \Xi_n := \hat{\mu} \Delta t + \hat{\sigma} \Delta W_n$  takes values in  $\{-h_x, 0, h_x\}^2$  and satisfies  $\mathbb{E}[\Delta \Xi_n] = \hat{\mu} \Delta t$  and  $\mathbb{E}[(\Delta \Xi_n)^2] = \hat{\sigma} \Delta t$ , at first order in  $\Delta t$ . The term  $\Delta \tilde{J}_n$  is the discrete version of the compensated Poisson jump term, and satisfies  $\mathbb{E}[\Delta \tilde{J}_n] = 0$  and  $\mathbb{E}[(\Delta \tilde{J}_n)^2] = \tilde{\sigma} \Delta t$ , at first order in  $\Delta t$ , with  $\tilde{\sigma} > 0$ . When the continuous time jump term is  $\int_{\mathbb{R}} z \tilde{N}(dt, dz)$ , the corresponding discrete version  $\Delta \tilde{J}_n$  can assume all the values in  $\Sigma_x$ . If instead the integral has a truncation term  $\epsilon$ , i.e.  $\int_{|z| \geq \epsilon} z \tilde{N}(dt, dz)$ , we can define the subset  $\Sigma_x^\epsilon := \Sigma_x \setminus \{-h_x, 0, h_x\}$ , such that  $\Delta \tilde{J}_n \in \Sigma_x^\epsilon$ .

The Markov chain  $\{X_n\}_{n \in \mathbb{N}}$  has the shape of a recombining multinomial tree, where each node has  $\bar{L}$  branches. The number of nodes at time  $n$  is  $n(\bar{L} - 1) + 1$ . We derive the transition probabilities by an explicit discretization of the infinitesimal generator (see Section 6.2.2). Following [Kushner and Dupuis, 2001], the process  $\{X_n\}_{n \in \mathbb{N}}$  has to satisfy the following two conditions in order to be admissible:

1. the transition probabilities have the representation:

$$p^X(X_n, X_{n+1}) = (1 - \lambda \Delta t) p^D(X_n, X_{n+1}) + (\lambda \Delta t) p^J(X_n, X_{n+1}) \quad (6.5)$$

where  $\lambda > 0$ , and  $p^D, p^J$  are respectively the diffusion and jump transition probabilities (see Section 6.2.1).

2. (*local consistency*) The moments of the discrete increments match those of the continuous increments, at first order in  $\Delta t$ :

$$\mathbb{E}_n[\Delta X_n] = \mathbb{E}_t[\Delta X_t], \quad \mathbb{E}_n[(\Delta X_n)^2] = \mathbb{E}_t[(\Delta X_t)^2]. \quad (6.6)$$

The process  $\{Y_n\}_{n \in \mathbb{N}}$  assumes values in  $\Sigma_y$  and  $\Delta L_n, \Delta M_n$  are non-negative multiples of  $h_y$ . The two increments  $\Delta L_n := L(t_n) - L(t_n^-)$  and  $\Delta M_n := M(t_n) - M(t_n^-)$  can occur instantaneously at time  $t_n$ . They cannot assume values different from 0 at the same time, and must satisfy the condition  $Y_{n+1} = Y_n + \Delta Y_n \in \Sigma_y$ <sup>3</sup> for all  $n$ .

<sup>2</sup>A common alternative is to consider a binomial discretization with  $\Delta \Xi \in \{-h_x, h_x\}$ , as in [Davis et al., 1993].

<sup>3</sup>The values attainable by  $\Delta L_n$  and  $\Delta M_n$  depend on the current value of  $Y_n \in \Sigma_y$ . For instance, if  $Y_n = -K_3 h_y$ , then  $\Delta L_n \in \{0, h_y, \dots, (\bar{M} - 1) h_y\}$  and  $\Delta M_n \in \{0\}$ .

### 6.1.2 Discrete dynamic programming algorithm

We can formulate a discrete backward algorithm by applying the dynamic programming principle to (5.27) on the discrete nodes of the chain  $\{(Y_n, X_n)\}_n$ :

$$\begin{aligned} Q^j(t_n, Y_n, X_n) = & \min \left\{ \mathbb{E}_n \left[ Q(t_{n+1}, Y_n, X_n + \Delta X_n) \right], \right. \\ & \min_{\Delta L_n} \exp \left( \frac{\gamma}{\delta(t_n, T)} (1 + \theta_b) e^{X_n} \Delta L_n \right) \mathbb{E}_n \left[ Q^j(t_{n+1}, Y_n + \Delta L_n, X_n + \Delta X_n) \right], \\ & \left. \min_{\Delta M_n} \exp \left( \frac{-\gamma}{\delta(t_n, T)} (1 - \theta_s) e^{X_n} \Delta M_n \right) \mathbb{E}_n \left[ Q^j(t_{n+1}, Y_n - \Delta M_n, X_n + \Delta X_n) \right] \right\}. \end{aligned} \quad (6.7)$$

The variations of  $\{Y_t\}_{t \in [t_0, T]}$  are instantaneous at  $t_n$  for each  $n$ , while the process  $\{X_t\}_{t \in [t_0, T]}$  changes in the interval  $[t_n, t_{n+1}]$  according to its Lévy dynamics. This feature suggests to introduce a numerical scheme based on two steps: an evolution step and a control step.

From now on we drop the superscript  $j$  from  $Q^j$ . We introduce the discretization parameter  $\rho = (\Delta t, h_x, h_y)$  and indicate the discretized value function with  $Q^\rho$ . For a fixed  $\rho$ , we adopt the common short notation  $Q_{j,i}^n := Q^\rho(t_n, y_j, x_i)$ .

We set the initial value  $x_i = X_{n=0}$  for  $i = 0$ . At time  $n$ , the index  $i$  assumes values in  $\{-nK_1, -nK_1 + 1, \dots, nK_2 - 1, nK_2\}$  and  $j$  assumes values in  $\{-K_3, -K_3 + 1, \dots, K_4 - 1, K_4\}$ .

We can define the auxiliary functions:

$$\begin{aligned} F(x_i, l, t_n) &:= e^{\left( \frac{\gamma}{\delta(t_n, T)} (1 + \theta_b) e^{x_i} l h_y \right)} \\ G(x_i, m, t_n) &:= e^{\left( -\frac{\gamma}{\delta(t_n, T)} (1 - \theta_s) e^{x_i} m h_y \right)}, \end{aligned} \quad (6.8)$$

such that  $l \in \{0, \dots, K_4 - j\}$  and  $m \in \{0, \dots, K_3 + j\}$  for each fixed  $j$ .

---

**Algorithm 1** Backward algorithm

---

**Input:**  $r, (b, \sigma, \nu), X_0, K, T, \theta_b, \theta_s, \gamma, N, \bar{L}, \bar{M}$ ,

**Output:**  $Q^j(t_0, y, X_0)$  for  $j = 0, w, b$

- 1: Create the lattice for (6.4) with appropriate discrete steps  $\Delta t, h_y, h_x$ .
  - 2: Create the vector of probabilities  $p_k$  as defined in 6.19.
  - 3: Use (5.28) or (5.29) or (5.30) to initialize a  $\bar{M} \times (N(\bar{L} - 1) + 1)$  grid for  $Q_{j,i}^N$ .
  - 4: **for**  $n = N-1$  **to**  $0$  **do**
  - 5:    $W_{j,i} = \sum_{k=-K_1}^{K_2} p_k Q_{j,i+k}^{n+1}$
  - 6:    $Q_{j,i}^n = \min \left\{ W_{j,i}, \min_l F(x_i, l, t_n) W_{j+l,i}, \min_m G(x_i, m, t_n) W_{j-m,i} \right\}$
  - 7: **end for**
-

The computational complexity of the Algorithm [1] is

$$\mathcal{O}\left((N+1)\left[\frac{N(\bar{L}-1)}{2}+1\right]\times\bar{M}\times\bar{M}\right).$$

The first factor comes from the loop over all the nodes of the tree i.e.  $\sum_{n=0}^N n(\bar{L}-1)+1$ . The second factor,  $\bar{M}$ , comes from the loop over all the values  $y_j$ , and the third factor,  $\bar{M}$ , comes from the minimum search.

For a simple diffusion process the number of branches is fixed to  $\bar{L}=3$ , but for processes with jumps it is proportional to  $\sqrt{N}$ . The standard deviation of every Lévy process satisfying the finite second moment assumption grows as the square root of time. Therefore the size of a space step  $h_x \propto \sqrt{\mathbb{E}[\Delta X^2]} \propto \sqrt{\Delta t} \propto \frac{1}{\sqrt{N}}$ . Let us consider for instance the integral term in Eq. (6.2) or (6.3). For computational reasons we have to reduce the region of integration to the bounded domain  $[-B_1, B_2]$ , with  $B_1, B_2 > 0$  (see Section 6.2.2). The number of branches to cover this region is  $\bar{L} = \frac{B_1+B_2}{h_x} \propto \sqrt{N}$ .

In order to have a more accurate result, it is better to choose  $h_y \propto h_x$  and consequently  $\bar{M} \propto N$ . In this way, the number  $h_y$  of shares to buy or sell is more sensitive to the resolution  $h_x$  in the log-price tree. If we set  $\bar{L} = \sqrt{N}$  and  $\bar{M} = N$  we have total computational complexity  $\mathcal{O}(N^{4.5})$ . For a fixed  $\bar{L}$ , the total complexity is reduced to  $\mathcal{O}(N^4)$ .

## 6.2 Properties of the Markov chain

We explained in the Section 6.1.1 that the Markov chain approximation of a continuous time jump-diffusion process has to satisfy two properties. This section makes a summary of the key concepts and refers to [Kushner and Dupuis, 2001] for detailed definitions and proofs of convergence.

### 6.2.1 Transition probabilities

Let us indicate the transition probabilities of  $\{X_n\}_{n \in \mathbb{N}}$  as:

$$p(x_i, x_j) := \mathbb{P}(X_{n+1} = x_j | X_n = x_i). \quad (6.9)$$

The number of jumps of a jump-diffusion process is Poisson distributed  $N_t \sim \text{Po}(\lambda t)$ , with  $\lambda > 0$ , i.e.

$$\mathbb{P}(N_t = n) = e^{-\lambda t} \frac{(\lambda t)^n}{n!}. \quad (6.10)$$

For a small  $\Delta t$ , we can compute the first order approximated probabilities:

$$\bullet \mathbb{P}(N_{t+\Delta t} - N_t = 0) \stackrel{d}{=} \mathbb{P}(N_{\Delta t} = 0) = e^{-\lambda \Delta t} \approx 1 - \lambda \Delta t,$$

- $\mathbb{P}(N_{\Delta t} = 1) = e^{-\lambda\Delta t}(\lambda\Delta t) \approx \lambda\Delta t$ ,
- $\mathbb{P}(N_{\Delta t} > 0) = 1 - \mathbb{P}(N_{\Delta t} = 0) \approx \lambda\Delta t$ .

Let us consider the discrete dynamics of  $\{X_n\}_{n \in \mathbb{N}}$  in Eq. (6.4). We assume that in a small time step  $\Delta t$  the process jumps exactly once ( $N_{\Delta t} = 1$ ), or does not jump at all ( $N_{\Delta t} = 0$ ). The two possible mutually exclusive events are:

- **Diffusion.** The transition probability is  $p^D(x_i, x_i + \Delta \Xi)$  and  $\Delta \Xi \in \{-h_x, 0, h_x\}$ .  $p^D(x_i, x_{i+k}) = 0$  for  $k \notin \{-1, 0, +1\}$ .
- **Jumps.** The transition probability is  $p^J(x_i, x_i + \Delta \tilde{J})$ . The random variable  $\Delta \tilde{J}$  takes values in  $\Sigma_x$  (or  $\Sigma_x^c$ ).

By conditioning on the values of  $N_{\Delta t}$ , the total transition probability is

$$\begin{aligned} p(x_i, x_j) &= p^D(x_i, x_j) \mathbb{P}(N_{\Delta t} = 0) + p^J(x_i, x_j) \mathbb{P}(N_{\Delta t} = 1) \\ &= (1 - \lambda\Delta t) p^D(x_i, x_j) + (\lambda\Delta t) p^J(x_i, x_j). \end{aligned} \quad (6.11)$$

The request of a positive probability impose a restriction on the time step size  $\Delta t \leq \frac{1}{\lambda}$ . In this section we showed that the transition probability of  $\{X_n\}_{n \in \mathbb{N}}$  is a convex combination of  $p^D$  and  $p^J$ , as required by the property (6.5). We refer to Chapter 5.6 of [Kushner and Dupuis, 2001] for more details.

### 6.2.2 Infinitesimal generator discretization and local consistency

In this section we provide an explicit form for the transition probabilities. This can be achieved by discretizing the infinitesimal generator of the process  $\{X_t\}_{t \in [t_0, T]}$  in (6.1), which corresponds to the first term inside the “min” in the HJB equation (5.34). In the following steps we consider only the finite activity case, but the same idea works for an infinite activity process approximated by a jump-diffusion. In fact, the only difference between (6.2) and (6.3) is the truncation in the integral.

In this section we drop the variable  $y_j$  from  $Q(t_n, y_j, x_i)$ , because we are interested only in the uncontrolled log-price dynamics. Let us assume for convenience that  $Q$  is smooth enough, the derivatives are discretized by the finite differences:

- Backward approximation in time:  $\frac{\partial Q}{\partial t} \approx \frac{Q_i^{n+1} - Q_i^n}{\Delta t}$ .
- Central approximation in space:  $\frac{\partial Q}{\partial x} \approx \frac{Q_{i+1}^{n+1} - Q_{i-1}^{n+1}}{2h_x}$ .
- Second order in space:  $\frac{\partial^2 Q}{\partial x^2} \approx \frac{Q_{i+1}^{n+1} + Q_{i-1}^{n+1} - 2Q_i^{n+1}}{h_x^2}$ .

The integral terms in (5.34) are truncated and restricted to the domain  $[-B_1, B_2] = [(-K_1 - 1/2)h_x, (K_2 + 1/2)h_x]$ <sup>4</sup>. The discretization is obtained by approximating with Riemann sums (see [Cont and Voltchkova, 2005a]):

$$\int_{-B_1}^{B_2} Q(t_{n+1}, y_j, x_i + z) \nu(dz) \approx \sum_{k=-K_1}^{K_2} \nu_k Q_{i+k}^{n+1}, \quad (6.12)$$

where

$$\nu_k = \int_{(k-\frac{1}{2})h_x}^{(k+\frac{1}{2})h_x} \nu(z) dz, \quad \text{for } -K_1 \leq k \leq K_2. \quad (6.13)$$

We define the discrete version of  $\hat{m} := \int_{-B_1}^{B_2} (e^z - 1) \nu(dz)$ ,  $\hat{\lambda} := \int_{-B_1}^{B_2} \nu(dz)$  and  $\hat{\alpha} := \frac{1}{\hat{\lambda}} \int_{-B_1}^{B_2} z \nu(dz)$ :

$$\hat{m} \approx \sum_{k=-K_1}^{K_2} (e^{kh_x} - 1) \nu_k, \quad \hat{\lambda} \approx \sum_{k=-K_1}^{K_2} \nu_k, \quad \hat{\alpha} \approx \frac{h_x}{\hat{\lambda}} \sum_{k=-K_1}^{K_2} k \nu_k. \quad (6.14)$$

The jump transition probabilities can be defined as:

$$p_k^J := \frac{\nu_k}{\hat{\lambda}}. \quad (6.15)$$

The discretized equation becomes:

$$\begin{aligned} & \frac{Q_i^{n+1} - Q_i^n}{\Delta t} + (\mu - \frac{1}{2}\sigma^2 - \hat{m}) \frac{Q_{i+1}^{n+1} - Q_{i-1}^{n+1}}{2h_x} \\ & + \frac{1}{2}\sigma^2 \frac{Q_{i+1}^{n+1} + Q_{i-1}^{n+1} - 2Q_i^{n+1}}{h_x^2} + \sum_{k=-K_1}^{K_2} \nu_k Q_{i+k}^{n+1} - \hat{\lambda} Q_i^n = 0. \end{aligned} \quad (6.16)$$

Rearranging the terms we get:

$$\begin{aligned} (1 + \hat{\lambda}\Delta t) Q_i^n &= p_{-1}^D Q_{i-1}^{n+1} + p_0^D Q_i^{n+1} + p_{+1}^D Q_{i+1}^{n+1} \\ &+ (\hat{\lambda}\Delta t) \sum_{k=-K_1}^{K_2} p_k^J Q_{i+k}^{n+1}. \end{aligned}$$

where we defined:

$$\begin{aligned} p_{-1}^D &:= \left( -(\mu - \frac{1}{2}\sigma^2 - \hat{m}) \frac{\Delta t}{2h_x} + \frac{1}{2}\sigma^2 \frac{\Delta t}{h_x^2} \right) \geq 0 \\ p_0^D &:= \left( 1 - \sigma^2 \frac{\Delta t}{h_x^2} \right) \geq 0 \\ p_{+1}^D &:= \left( (\mu - \frac{1}{2}\sigma^2 - \hat{m}) \frac{\Delta t}{2h_x} + \frac{1}{2}\sigma^2 \frac{\Delta t}{h_x^2} \right) \geq 0 \end{aligned} \quad (6.17)$$

---

<sup>4</sup>If the integral has a truncation parameter as in (2.44), we choose  $\epsilon = 1.5h_x$  and the restricted domain becomes  $[-B_1, -\epsilon] \cup [\epsilon, B_2] = [(-K_1 - 1/2)h_x, -3/2h_x] \cup [3/2h_x, (K_2 + 1/2)h_x]$ .

and  $p_k^D := 0$  for  $k \notin \{-1, 0, +1\}$ . From  $p_0^D$  we obtain an important restriction on the time step size:  $\Delta t \leq \frac{h_x^2}{\sigma^2}$ , while the condition obtained from  $p_{-1}^D$  and  $p_{+1}^D$  i.e.  $h_x \leq \frac{\sigma^2}{|\mu - \frac{1}{2}\sigma^2 - \hat{m}|}$  is easily satisfied. If we bring the term  $(1 + \hat{\lambda}\Delta t)$  on the right hand side and use the first order Taylor approximation  $(1 + \hat{\lambda}\Delta t)^{-1} \approx 1 - \hat{\lambda}\Delta t$ , we obtain:

$$\begin{aligned} Q_i^n &\approx (1 - \hat{\lambda}\Delta t) \sum_{k=-1}^1 p_k^D Q_{i+k}^{n+1} + (\hat{\lambda}\Delta t) \sum_{k=-K_1}^{K_2} p_k^J Q_{i+k}^{n+1} \\ &= \sum_{k=-K_1}^{K_2} p_k Q_{i+k}^{n+1} \end{aligned} \quad (6.18)$$

where

$$p_k = (1 - \hat{\lambda}\Delta t)p_k^D + (\hat{\lambda}\Delta t)p_k^J \quad (6.19)$$

is the total transition probability, written in the form (6.5). It is straightforward to check that  $\sum_k p_k = 1$ . Let us check that also the *local consistency* conditions (6.6) are satisfied at first order in  $\Delta t$ :

$$\begin{aligned} \mathbb{E}[\Delta X_n] &= (1 - \hat{\lambda}\Delta t) \sum_{k=-1}^1 p_k^D k h_x + (\hat{\lambda}\Delta t) \sum_{k=-K_1}^{K_2} p_k^J k h_x \\ &= (1 - \hat{\lambda}\Delta t) \left( \mu - \frac{1}{2}\sigma^2 - \hat{m} \right) \Delta t + (\hat{\lambda}\Delta t) \hat{\alpha} \\ &\approx \left( \mu - \frac{1}{2}\sigma^2 - \hat{m} + \hat{\lambda}\hat{\alpha} \right) \Delta t, \\ \mathbb{E}[\Delta X_n]^2 &= (1 - \hat{\lambda}\Delta t) \sum_{k=-1}^1 p_k^D (k h_x)^2 + (\hat{\lambda}\Delta t) \sum_{k=-K_1}^{K_2} p_k^J (k h_x)^2 \\ &= (1 - \hat{\lambda}\Delta t) \sigma^2 \Delta t + (\hat{\lambda}\Delta t) \hat{\eta}^2 \\ &\approx (\sigma^2 + \hat{\lambda}\hat{\eta}^2) \Delta t. \end{aligned}$$

We introduced  $\hat{\eta}^2 := \frac{1}{\hat{\lambda}} \int_{-B_1}^{B_2} z^2 \nu(dz) \approx \frac{h_x^2}{\hat{\lambda}} \sum_{k=-K_1}^{K_2} k^2 \nu_k$ , and indicate  $\eta^2 := \frac{1}{\lambda} \int_{\mathbb{R}} z^2 \nu(dz) = \frac{1}{\lambda} \mathbb{E}[|\int_{\mathbb{R}} z \tilde{N}(dt, dz)|^2]$ . The discrete moments match the continuous moments when  $h_x \rightarrow 0$  and  $K_1, K_2 \rightarrow \infty$  such that  $\hat{\lambda} \rightarrow \lambda$ ,  $\hat{\alpha} \rightarrow \alpha$  and  $\hat{\eta} \rightarrow \eta$ .

### 6.2.3 Convergence of the numerical scheme

In Section 6.1.2 we introduced the discretization parameter  $\rho = (\Delta t, h_x, h_y)$  and the discretized value function  $Q^\rho$ . For a fixed  $\rho$ , we indicate  $Q_{j,i}^n := Q^\rho(t_n, y_j, x_i)$ .

Using the functions in (6.8), let us define the numerical scheme corresponding to the Algorithm [1]:

**Scheme 1.** Let us define a two steps numerical scheme  $\mathbb{S}$  such that

$$\mathbb{S}(\rho, (t_n, y_j, x_i), Q^\rho(t_n, y_j, x_i), [Q^\rho]_{t_n, y_j, x_i}) = 0, \quad (6.20)$$

where  $[Q^\rho]_{t_n, y_j, x_i}$  indicates all the values of  $Q^\rho$  not in  $(t_n, y_j, x_i)$ .

$$\text{step 1: } Q_{j,i}^n = \sum_{k=-K_1}^{K_2} p_k Q_{j,i+k}^{n+1} \quad \text{for all } j, i$$

$$\text{step 2: } \mathbb{S} = Q_{j,i}^n - \min \left\{ Q_{j,i}^n, \min_l F(x_i, l, t_n) Q_{j+l,i}^n, \min_m G(x_i, m, t_n) Q_{j-m,i}^n \right\}$$

Let us indicate the Eq. (5.34) by:

$$F(x, Q(x), DQ(x), D^2Q(x), \mathcal{I}(x, Q)) = 0, \quad (6.21)$$

where  $x := (t, y, x)$ .

**Theorem 6.2.1.** The scheme [1] (with transition probabilities  $p_k$  defined in 6.19) is monotone, stable and consistent.

Let us prove the three properties separately.

With the square brackets around  $[\varepsilon_{j,i}^n]$ , we indicate all the possible values  $\varepsilon_{j',i'}^{n'}$  such that  $(n', j', i') \neq (n, j, i)$ . The scheme is **monotone** i.e. for all  $[\varepsilon_{j,i}^n] \geq 0$ , then  $\mathbb{S}(\rho, (n, j, i), Q_{j,i}^n, [Q_{j,i}^n] + [\varepsilon_{j,i}^n]) \leq \mathbb{S}(\rho, (n, j, i), Q_{j,i}^n, [Q_{j,i}^n])$ .

*Proof.* Let us write the scheme [1] as

$$\mathbb{S} = Q_{j,i}^n - \min \left\{ \sum_{k=-K_1}^{K_2} p_k Q_{j,i+k}^{n+1}, \min_l F(x_i, l, t_n) Q_{j+l,i}^n, \min_m G(x_i, m, t_n) Q_{j-m,i}^n \right\}$$

Since  $F(x_i, l, t_n) > 0$ ,  $G(x_i, m, t_n) > 0$  for all  $x_i, l, m, n$ , and  $p_k > 0$  for all  $k$ , the scheme  $\mathbb{S}$  is a decreasing function of  $[Q_{j,i}^n]$ .  $\square$

The scheme is **stable** i.e. for any  $\rho > 0$  there exists a bounded solution  $Q^\rho$ , with bound independent of  $\rho$ . This is equivalent to prove that  $\|Q^n\|_\infty \leq C$ , for any  $0 \leq n \leq N$  and for  $C$  independent on  $\rho$ .

*Proof.* The terminal conditions (5.28), (5.29), (5.30) are positive bounded functions in a bounded domain. Therefore we can write  $0 \leq Q_{j,i}^N \leq C$  for all  $i, j$ , and  $C$  does not depend on  $\rho$ . Since all the coefficients are positive, it follows that the scheme is *sign preserving* i.e.  $Q_{j,i}^n \geq 0$  for all  $n$ . We can write:

$$\begin{aligned} Q_{j,i}^n &= \min \left\{ \sum_{k=-K_1}^{K_2} p_k Q_{j,i+k}^{n+1}, \min_l F(x_i, l, t_n) Q_{j+l,i}^n, \min_m G(x_i, m, t_n) Q_{j-m,i}^n \right\} \\ &\leq \sum_{k=-K_1}^{K_2} p_k Q_{j,i+k}^{n+1} \leq \|Q^{n+1}\|_\infty. \end{aligned}$$

This holds for all  $i, j$ , then  $\|Q^n\|_\infty \leq \|Q^{n+1}\|_\infty$ . Iterating we obtain:

$$\|Q^n\|_\infty \leq \|Q^N\|_\infty \leq C.$$

□

The scheme is **consistent** i.e. for any smooth function  $\phi$

$$\mathbb{S}(\rho, \mathbf{x}_\rho, \phi^\rho(\mathbf{x}_\rho), [\phi^\rho]_{\mathbf{x}_\rho}) \xrightarrow[\substack{\rho \rightarrow 0 \\ \mathbf{x}_\rho \rightarrow \mathbf{x}}]{\quad} F(\mathbf{x}, \phi(\mathbf{x}), D\phi(\mathbf{x}), D^2\phi(\mathbf{x}), I(\mathbf{x}, \phi)).$$

with  $\mathbf{x}_\rho := (t_n, y_j, x_i)$ .

*Proof.* Now we look at the following cases, corresponding to each minimum value in the scheme [1]:

1) For some  $l > 0$ , it holds

$$\begin{aligned} 0 &= e^{\left(\frac{\gamma}{\delta(t_n, T)}(1+\theta_b)e^{x_i}lh_y\right)} \phi(t_n, y_j + lh_y, x_i) - \phi(t_n, y_j, x_i) \\ &= \left(1 + \frac{\gamma(1+\theta_b)e^{x_i}}{\delta(t_n, T)}lh_y + \mathcal{O}(h_y)\right) \left(\phi(t_n, y_j, x_i) + \frac{\partial \phi}{\partial y}\bigg|_{y_j} lh_y + \mathcal{O}(h_y)\right) - \phi(t_n, y_j, x_i) \\ &= \frac{\partial \phi}{\partial y}(t_n, y_j, x_i) + \frac{\gamma}{\delta(t_n, T)}(1+\theta_b)e^{x_i} \phi(t_n, y_j, x_i) + \mathcal{O}(h_y). \end{aligned}$$

2) For some  $m > 0$ , an analogous computation leads to

$$-\frac{\partial \phi}{\partial y}(t_n, y_j, x_i) - \frac{\gamma}{\delta(t_n, T)}(1-\theta_s)e^{x_i} \phi(t_n, y_j, x_i) + \mathcal{O}(h_y) = 0.$$

3) When  $\sum_{k=-K_1}^{K_2} p_k \phi(t_{n+1}, y_j, x_{i+k}) - \phi(t_n, y_j, x_i) = 0$  let us consider the expression (6.19), and expand  $p^D$  (6.17) and  $p^J$  (6.15):

$$\begin{aligned} &(1 - \sigma^2 \frac{\Delta t}{h_x^2}) \left( \phi + \frac{\partial \phi}{\partial t}\bigg|_{t_n} \Delta t + \mathcal{O}(\Delta t^2) \right) - \hat{\lambda} \Delta t \phi(t_{n+1}, y_j, x_i) - \phi(t_n, y_j, x_i) \\ &+ \left( (\mu - \frac{1}{2}\sigma^2 - \hat{m}) \frac{\Delta t}{2h_x} + \frac{1}{2}\sigma^2 \frac{\Delta t}{h_x^2} + \mathcal{O}(\Delta t^2) \right) \left( \phi + \frac{\partial \phi}{\partial x}\bigg|_{x_i} h_x + \frac{1}{2} \frac{\partial^2 \phi}{\partial x^2} h_x^2 + \mathcal{O}(h_x^3) \right) \\ &+ \left( -(\mu - \frac{1}{2}\sigma^2 - \hat{m}) \frac{\Delta t}{2h_x} + \frac{1}{2}\sigma^2 \frac{\Delta t}{h_x^2} + \mathcal{O}(\Delta t^2) \right) \left( \phi - \frac{\partial \phi}{\partial x}\bigg|_{x_i} h_x + \frac{1}{2} \frac{\partial^2 \phi}{\partial x^2} h_x^2 + \mathcal{O}(h_x^3) \right) \\ &+ \hat{\lambda} \Delta t \sum_{k=-K_1}^{K_2} \frac{\nu_k}{\hat{\lambda}} \phi(t_{n+1}, y_j, x_{i+k}) = 0. \end{aligned}$$

Let us replace all the terms at  $t_{n+1}$  by using the first order Taylor approximation  $\phi(t_{n+1}, \cdot, \cdot) = \phi(t_n, \cdot, \cdot) + \frac{\partial \phi}{\partial t}\bigg|_{t_n} \Delta t + \mathcal{O}(\Delta t^2)$ . The two terms in  $\hat{\lambda}$



can be rewritten as  $\Delta t \sum_{k=-K_1}^{K_2} \nu_k (\phi(t_n, y_j, x_{i+k}) - \phi(t_n, y_j, x_i))$ . Using the approximation (6.12) and (6.13) we obtain

$$\begin{aligned} & \frac{\partial \phi}{\partial t} + (\mu - \frac{1}{2}\sigma^2 - \hat{m}) \frac{\partial \phi}{\partial x} + \frac{1}{2}\sigma^2 \frac{\partial^2 \phi}{\partial x^2} \\ & + \int_{-B_1}^{B_2} (\phi(t_n, y_j, x_i + z) - \phi(t_n, y_j, x_i)) \nu(z) dz + \mathcal{O}(\Delta t) + \mathcal{O}(h_x) = 0. \end{aligned}$$

When sending  $\rho \rightarrow 0$ ,  $x_\rho \rightarrow x$  and  $B_1, B_2 \rightarrow \infty$  we obtain the desired result for all 1) 2) and 3).  $\square$

**Theorem 6.2.2.** *The solution  $Q^\rho$  of (6.20) converges uniformly to the unique viscosity solution of (5.34).*

The proof follows closely [Barles and Souganidis, 1991].

*Proof.* We only prove the subsolution case, since the arguments for the supersolution are identical. Let  $\bar{x}$  the strict global maximum of  $Q - \phi$  for some  $\phi \in C^{1,1,2} \cap C_2$ , and such that  $Q(\bar{x}) = \phi(\bar{x})$ . Then there exist sequences  $\rho_n$  and  $x_n$  such that for  $n \rightarrow \infty$ :

$\rho_n \rightarrow 0$ ,  $x_n \rightarrow \bar{x}$ ,  $Q^{\rho_n}(x_n) \rightarrow Q(\bar{x})$  and  $x_n$  is a global maximum of  $Q^{\rho_n}(\cdot) - \phi(\cdot)$ . Let us define  $\xi_n := Q^{\rho_n}(x_n) - \phi(x_n)$ , such that  $\xi_n \rightarrow 0$  when  $n \rightarrow \infty$ . For any  $x$  it holds  $Q^{\rho_n}(x) \leq \phi(x) + \xi_n$ . Let us consider the scheme [1]:

$$\begin{aligned} 0 &= \mathbb{S}(\rho_n, x_n, Q^{\rho_n}(x_n), [Q^{\rho_n}]_{x_n}) \\ &\geq \mathbb{S}(\rho_n, x_n, \phi(x_n) + \xi_n, [\phi + \xi_n]_{x_n}), \end{aligned}$$

where we used the monotonicity property. By sending  $n \rightarrow \infty$  and thanks to the consistency property, we obtain:

$$F(\bar{x}, \phi(\bar{x}), D\phi(\bar{x}), D^2\phi(\bar{x}), I(\bar{x}, \phi)) \leq 0.$$

$\square$

### 6.3 Numerical results

In this section we implement the Algorithm [1] described in Section 6.1.2 and calculate the prices of European call options for the writer and the buyer. The prices are computed under the assumption that the stock log-price follows three different Lévy processes: a Brownian motion, a Merton jump-diffusion and a Variance Gamma, with parameters in Table 6.1.

We compute the option prices using the standard *martingale pricing theory* presented in Chapter 2. In the Table 6.2 we show the *at the money* values obtained with the closed formula and by solving the respective PIDE (see Table 2.4). The PIDE prices are obtained by solving the equations (2.34), (2.36) and (2.40). Of course, the parameter  $\mu$  has not been used to

| Details           |     |     | Diffusion parameters |          |                |          |
|-------------------|-----|-----|----------------------|----------|----------------|----------|
| $K$               | $T$ | $r$ | $\mu$                | $\sigma$ | $\gamma$       |          |
| 15                | 1   | 0.1 | 0.1                  | 0.25     | 0.001          |          |
| Merton parameters |     |     |                      |          |                |          |
|                   |     |     | $\mu$                | $\sigma$ | $\alpha$       | $\xi$    |
|                   |     |     | 0.1                  | 0.25     | 0              | 0.5      |
| VG parameters     |     |     |                      |          |                |          |
|                   |     |     | $\mu$                | $\theta$ | $\bar{\sigma}$ | $\kappa$ |
|                   |     |     | 0.1                  | -0.1     | 0.2            | 0.1      |

Table 6.1: Option details and parameters for diffusion, Merton and VG processes.

| Diffusion price |        | Merton price   |        | VG price       |        |
|-----------------|--------|----------------|--------|----------------|--------|
| Closed formula  | PDE    | Closed formula | PIDE   | Closed formula | PIDE   |
| 2.2463          | 2.2463 | 3.4776         | 3.4775 | 1.9870         | 1.9871 |

Table 6.2: At the money prices with  $S_0 = K = 15$  with parameters in Tab. 6.1.

compute the prices in Tab. 6.2. In Section (6.3.5), we prove with a numerical experiment that even in the model with transaction costs, the drift  $\mu$  does not play an important role for the option price. In the following analysis, we consider the PIDE prices as our benchmarks for comparisons. In all the computations we use equal transaction costs for buying and selling,  $\theta_b = \theta_s$ .

In Fig. 6.1 we show that model prices replicate the PIDE prices for zero transaction costs and small values of  $\gamma$ . The values of  $\gamma$  in the Table 6.1, are chosen very small<sup>5</sup> for this purpose. An intuitive argument to justify this choice is that for  $\gamma \rightarrow 0$ , the utility function can be approximated by a linear utility  $\mathcal{U}(w) = 1 - e^{-\gamma w} \approx \gamma w$  and the investor can be considered risk neutral. A rigorous argument can be found in [Barles and Soner, 1998], where the authors use asymptotic analysis for small values of  $\theta_b$ ,  $\theta_s$  and  $\gamma$  to derive a nonlinear PDE for the option price. For zero transaction costs this equation corresponds to the Black-Scholes PDE. Their argument can be extended also to PIDEs.

<sup>5</sup> In Chapter 5 of [Grinold and Kahn, 1999] are presented some common values for the risk aversion coefficient:  $\gamma = 0.3$ ,  $\gamma = 0.2$  and  $\gamma = 0.1$  for high, medium and low level of risk aversion respectively.

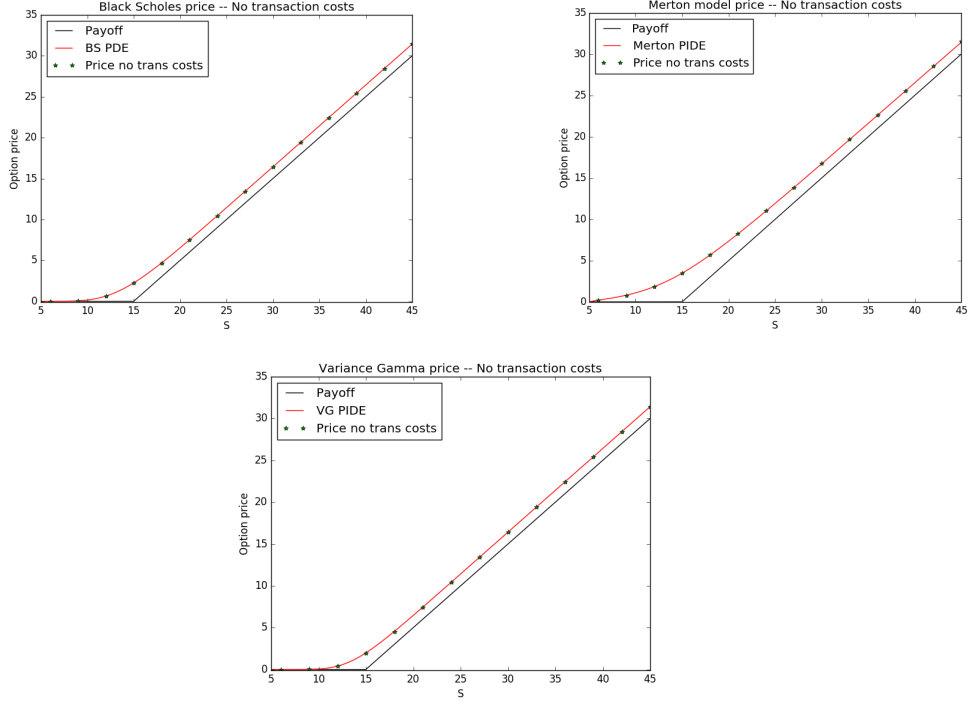


Figure 6.1: Writer prices with zero transaction costs for diffusion (top-left), Merton (top-right) and VG (bottom) process. Parameters are in the Table 6.1.

### 6.3.1 Diffusion results

In the Figure 6.2 we show the diffusion writer and buyer prices with different transaction costs. We can see that a higher transaction cost corresponds to a higher writer price, while a lower transaction cost corresponds to a lower buyer price. In fact, the writer and buyer prices are respectively increasing and decreasing functions of the transaction cost, as already verified in [Clewlow and Hodges, 1997]. The prices Figures 6.2, are calculated with  $N = 1500$  time steps and  $\bar{M} = N$ . In the Table 6.3 we show ATM option prices for different values of  $N$ , with  $\theta_s = \theta_b = 0$  and different risk aversion coefficients. For  $\gamma = 0.0001$  and  $N = 3500$  the price is identical, up to the fourth decimal digit, to the original Black-Scholes price in Table 6.2. Using the values in the Table 6.3 it is possible to perform a *numerical convergence analysis* (see Section 6.3.4). We also present the execution times, from which we can estimate the asymptotic *time complexity* of the algorithm. In Section (6.1.2) we estimated a complexity of  $\mathcal{O}(N^4)$ . From the Table 6.3, we obtain the exponent  $\frac{\log(1291.3/910.8)}{\log(3500/3200)} = 3.9$ , which is very close to the predicted value. The algorithm is written in Matlab using vectorized operations, and

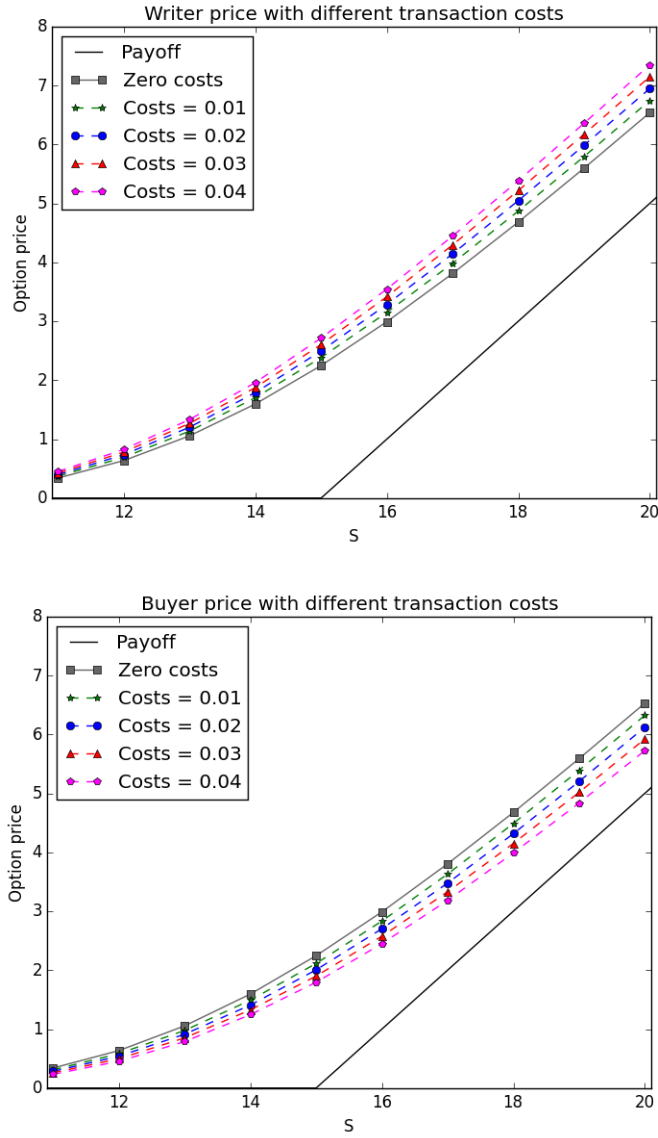


Figure 6.2: Writer and buyer prices for different levels of transaction costs. The continuous line is the solution of the Black-Scholes PDE.

runs on an Intel i7 (7th Gen) with Linux.

### 6.3.2 Merton results

In the Figure 6.3 we show the writer and buyer prices for the Merton process, with parameters in Tab. 6.1. An interesting feature of the multinomial tree construction for jump-diffusion processes is that  $\bar{L} \propto \sqrt{N}$ . The integral

| Convergence table |                   |                  |                 |                  |
|-------------------|-------------------|------------------|-----------------|------------------|
| $N = \bar{M}$     | $\gamma = 0.0001$ | $\gamma = 0.001$ | $\gamma = 0.01$ | Execution time   |
| 50                | 2.241214          | 2.241764         | 2.247311        | $0.01 \pm 0.004$ |
| 100               | 2.249142          | 2.249506         | 2.253159        | $0.02 \pm 0.005$ |
| 200               | 2.245422          | 2.245676         | 2.248216        | $0.11 \pm 0.02$  |
| 400               | 2.246784          | 2.246959         | 2.248717        | $0.85 \pm 0.04$  |
| 800               | 2.246288          | 2.246271         | 2.247635        | $8.63 \pm 0.1$   |
| 1600              | 2.246576          | 2.246662         | 2.247515        | $82.44 \pm 2.71$ |
| 3200              | 2.246412          | 2.246471         | 2.247068        | $910.8 \pm 10.5$ |
| 3500              | 2.246366          | 2.246423         | 2.246993        | $1291.3 \pm 13$  |

Table 6.3: Convergence table for ATM diffusion prices with zero transaction costs.

domain is restricted to the bounded domain  $[-B_1, B_2]$  with length  $B_1 + B_2 = \bar{L} h_x$ . We choose the size of a space step  $h_x = \sqrt{\mathbb{E}[\Delta X^2]} = \sigma_X \sqrt{\Delta t}$  and  $\sigma_X^2 = \sigma^2 + \tilde{\sigma}_J^2$  with  $\tilde{\sigma}_J^2 = \int_{-B_1}^{B_2} z^2 \nu(dz)$ . However, the size of the Poisson jumps does not scale with  $\Delta t$ . So the number  $\bar{L}$  has to be chosen big enough in order to have  $L h_x \geq B_1 + B_2$ .

In general, for a fixed  $h_x$ , the interval  $[-B_1, B_2]$  should be chosen as big as possible. In practice, the choice of the truncation depends on the shape of the Lévy measure. The Figures 6.4, 6.5 show two examples with  $[-B_1, B_2] = [\sqrt{\lambda}\xi, \sqrt{\lambda}\xi]$  and  $[-B_1, B_2] = [-3\sqrt{\lambda}\xi, 3\sqrt{\lambda}\xi]$  respectively. These choices correspond to  $\bar{L} = 17$  and  $\bar{L} = 52$ . For the Merton Lévy measure (a scaled Normal distribution), a good choice is  $[-B_1, B_2] = [-3\sigma_J, 3\sigma_J]$ , where  $\sigma_J^2 = \int_{\mathbb{R}} z^2 \nu(dz) = \lambda(\alpha^2 + \xi^2)$  is the variance of the jump component of the Merton process. The length of the interval is  $\bar{L} h_x = 6\sigma_J$ . It is well known that the integral over this region is about the 99.74% of the total area. Using this interval and the parameters in Tab. 6.1 we obtain the relation  $\bar{L} \geq 5.86\sqrt{N}$ . In the calculation of the Merton prices in Fig. 6.3, we used a discretization with  $N = \bar{M} = 100$ , and  $\bar{L} = 81$ , with a good balance between small computational time and small price error.

The convergence Tab. 6.4 shows different Merton prices for different values of  $N$  and  $\bar{L}$ . Looking at the table from left to right, for each fixed  $N$  it is possible to note how the truncation error decreases when  $\bar{L}$  increases.

In Table 6.5 we show several prices with increasing values of  $N$  and  $\bar{L}$ . We choose  $\bar{L}$  big enough, such that the truncation error can be ignored. Given the high computational complexity of the algorithm, it is difficult to present prices with bigger values of  $N, \bar{L}$ . For larger values of  $N$  and smaller  $\gamma$ , we expect a convergence to the Merton price in Tab. 6.2. The computational complexity in this case is expected to be  $\mathcal{O}(N^{4.5})$ . From the Table 6.5 we get the exponent equal to  $\frac{\log(1106.0/585.7)}{\log(200/175)} = 4.76$ . Considering

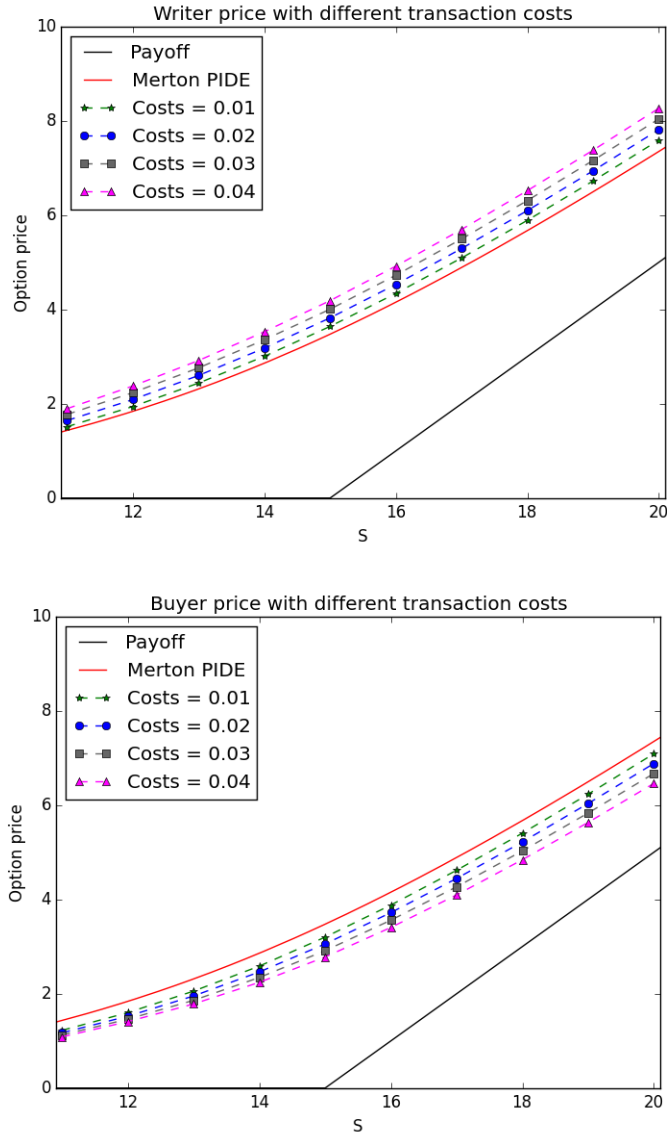


Figure 6.3: Writer and buyer prices for different transaction costs. The continuous line is the solution of the Merton PIDE.

the errors, the results is not so different from the predicted value.

### 6.3.3 VG results

In the Figure 6.6 we show how the writer and buyer prices for the VG process change for several level of transaction costs (parameters in Tab. 6.1). In these computations we used  $N = \bar{M} = 150$  and  $\bar{L} = 43$ , such that

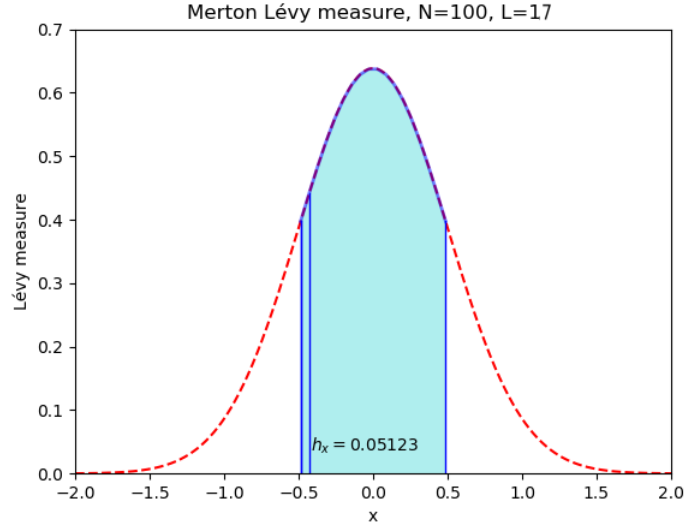


Figure 6.4: Merton Lévy measure computed using parameters in Tab. 6.1,  $N = 100$  and  $\bar{L} = 17$ . The domain  $[-B_1, B_2] = [-\sqrt{\lambda\xi}, \sqrt{\lambda\xi}]$  has length  $\bar{L}h_x \approx 2\sqrt{\lambda\xi}$ .

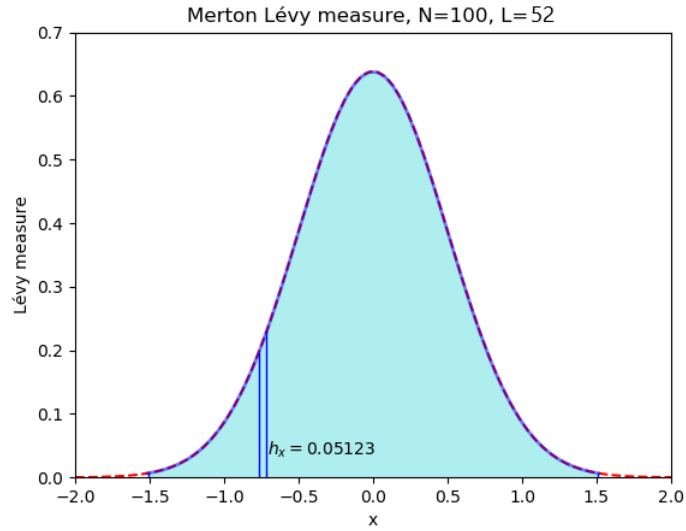


Figure 6.5: Merton Lévy measure computed using parameters in Tab. 6.1,  $N = 100$  and  $\bar{L} = 52$ . The domain  $[-B_1, B_2] = [-3\sqrt{\lambda\xi}, 3\sqrt{\lambda\xi}]$  has length  $\bar{L}h_x \approx 6\sqrt{\lambda\xi}$ .

the program can run in a reasonable computational time. The integration

| Truncation error table |                |                |                |                 |                 |
|------------------------|----------------|----------------|----------------|-----------------|-----------------|
| $N$                    | $\bar{L} = 51$ | $\bar{L} = 71$ | $\bar{L} = 91$ | $\bar{L} = 101$ | $\bar{L} = 111$ |
| 50                     | 3.481318       | 3.481616       | 3.481617       | 3.481617        | 3.481617        |
| 100                    | 3.468774       | 3.478806       | 3.479141       | 3.479146        | 3.479146        |
| 150                    | 3.439090       | 3.474403       | 3.477574       | 3.477714        | 3.477742        |
| 200                    | 3.399442       | 3.466338       | 3.476439       | 3.477234        | 3.477457        |

Table 6.4: Truncation error for ATM Merton prices with zero transaction costs.

| Convergence table |           |          |                   |
|-------------------|-----------|----------|-------------------|
| $N = \bar{M}$     | $\bar{L}$ | Price    | Execution time    |
| 50                | 61        | 3.481600 | $2.20 \pm 0.08$   |
| 75                | 75        | 3.479980 | $15.15 \pm 0.07$  |
| 100               | 91        | 3.479141 | $63.04 \pm 0.49$  |
| 125               | 97        | 3.478254 | $148.4 \pm 1.16$  |
| 150               | 105       | 3.477731 | $315.3 \pm 5.58$  |
| 175               | 113       | 3.477610 | $585.7 \pm 10.57$ |
| 200               | 121       | 3.477513 | $1106.0 \pm 12.2$ |

Table 6.5: Convergence table for ATM Merton prices with zero transaction costs.

region in 2.44 is restricted to  $[-B_1, -\epsilon] \cup [\epsilon, B_2]$  with  $\epsilon = 1.5h_x$ . The choice of  $B_1$  and  $B_2$  depends on the shape of the Lévy measure. In Fig. 6.7 and 6.8 we show two examples for the VG Lévy measure (using parameters in Table 6.1) with  $N = 150$ ,  $h_x = 0.0165$  and  $N = 1000$ ,  $h_x = 0.0064$ . The two Lévy measures are normalized, such that the integral on the region  $[-\infty, -\epsilon] \cup [\epsilon, +\infty]$  is equal to one. The area underlying the functions on  $[-B_1, -\epsilon] \cup [\epsilon, B_2]$  is highlighted for clarity. For  $\bar{L} = 43$ , we can see that in both cases it is possible to cover a very high percentage of the initial unrestricted region. We can conclude that, unlike the Merton measure, we do not need a big truncation interval. Given the space step  $h_X = \sigma_X \sqrt{\Delta t}$ , with  $\sigma_X^2 = \hat{\sigma}_J^2 + \sigma_\epsilon^2$  and  $\hat{\sigma}_J^2 = \int_{[-B_1, -\epsilon] \cup [\epsilon, B_2]} z^2 \nu(dz)$ , it is enough to consider a region at least as big as the standard deviation of the unrestricted jump process<sup>6</sup> i.e.  $h_X \bar{L} \geq \sigma_J$ , where  $\sigma_J^2 = \int_{[-\infty, -\epsilon] \cup [\epsilon, \infty]} z^2 \nu(dz)$ . Putting all together, the relation becomes  $\bar{L} \geq \frac{\sigma_J}{\sigma_X} \sqrt{N}$ , and replacing the values  $\sigma_X = 0.2024$  and  $\sigma_J = 0.1916$  we get  $\bar{L} \geq 0.94\sqrt{N}$ .

In the Table 6.6 we present several option prices computed with differ-

<sup>6</sup>For small values of  $\epsilon$  the value of  $\sigma_\epsilon^2$  is negligible. In this case it is possible to use the expression for the variance of the VG process and write  $\sigma_X^2 = \bar{\sigma}^2 + \theta^2 \kappa$ .



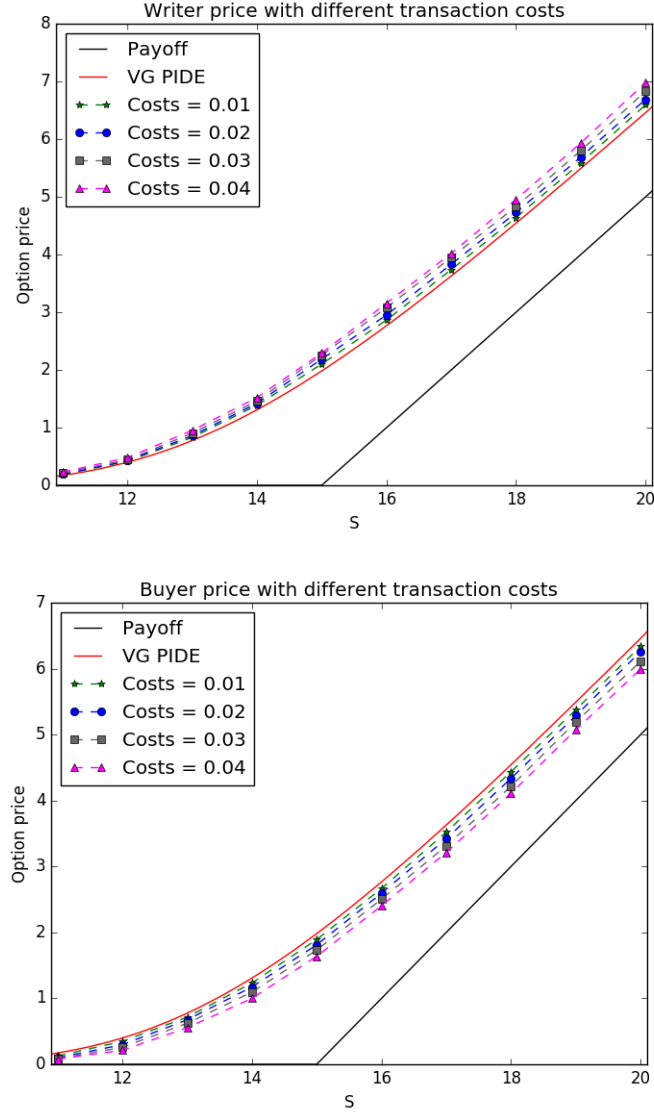


Figure 6.6: Writer and buyer prices for different transaction costs. The continuous line is the solution of the VG PIDE.

ent values of  $N$ , but with fixed  $\bar{L}$ . In the case of the VG process it is more difficult to analyze the convergence results. This is due to the approximation (6.3) introduced to replace the infinite activity jump component with a Brownian motion. All the parameters in (2.42) depend on  $\epsilon$ , and consequently on  $N$ . Within our discretization ( $N = 150$ ), we have  $\sigma_\epsilon = 0.0654$ ,  $\lambda_\epsilon = 10.01$ . With the parameters under consideration, we obtain an ATM price for zero transaction costs of 1.9821, which is very close to the PIDE

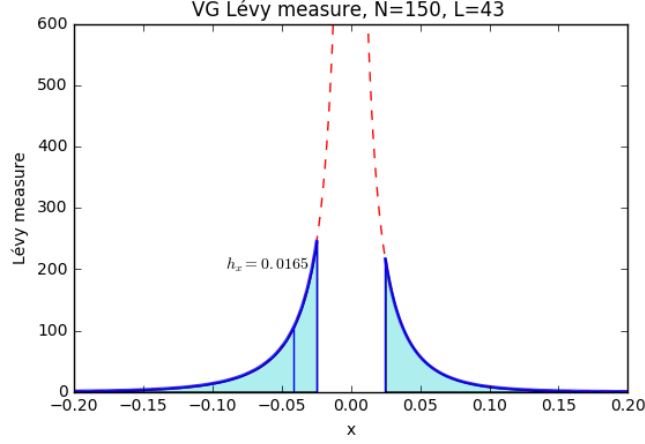


Figure 6.7: VG Lévy measure computed using parameters in Tab. 6.1,  $N = 150$  and  $\bar{L} = 43$ . The domain  $[-B_1, -\epsilon] \cup [\epsilon, B_2]$  has length  $(\bar{L} - 3)h_x$ . The highlighted area is 99.9% of the total area.

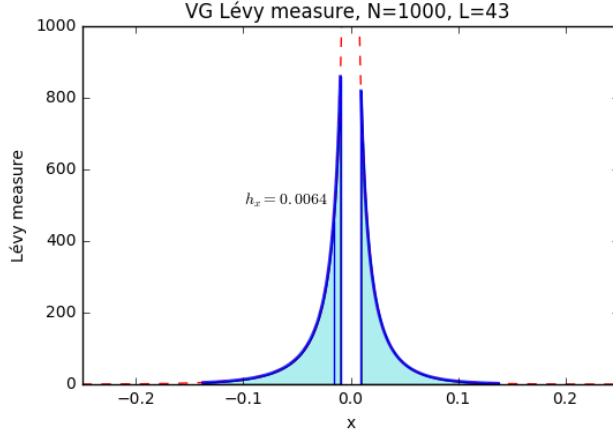


Figure 6.8: VG Lévy measure computed using parameters in Tab. 6.1,  $N = 1000$  and  $\bar{L} = 43$ . The domain  $[-B_1, -\epsilon] \cup [\epsilon, B_2]$  has length  $(\bar{L} - 3)h_x$ . The highlighted area is 98.9% of the total area.

price in Tab. 6.2.

The convergence rate of the VG PIDE is quite low and this is reflected in our algorithm. We refer to [Cont and Voltchkova, 2005a] for a detailed error analysis. In order to solve the PIDE (using an implicit-explicit scheme) we constructed a grid with 13000 space steps of size  $\delta x = 0.0004$  and 7000 time steps, and obtained the price in Tab 6.2, with an approximated activity  $\lambda_\epsilon = 75$ . Consequently, we expect to have good convergence results in our algorithm when  $N \sim 10^4$ . All the presented prices (Figures 6.6) have thus a

truncation error, which is adjusted by an accurate choice of the value of  $\gamma$ .

| Convergence table |                    |          |                  |
|-------------------|--------------------|----------|------------------|
| $N = \bar{M}$     | $\lambda_\epsilon$ | Price    | Execution time   |
| 50                | 4.73               | 1.910934 | $3.63 \pm 0.16$  |
| 100               | 7.82               | 1.957806 | $26.54 \pm 0.26$ |
| 150               | 10.01              | 1.982078 | $82.51 \pm 0.20$ |
| 200               | 11.73              | 1.996180 | $185.2 \pm 0.81$ |
| 250               | 13.14              | 2.004719 | $350.3 \pm 4.5$  |
| 300               | 14.35              | 2.008536 | $654.2 \pm 7.3$  |
| 350               | 15.40              | 2.009436 | $1236 \pm 12$    |

Table 6.6: Convergence of ATM VG prices with  $\bar{L} = 43$ , zero transaction costs.

From Tab. 6.6 we can estimate the time complexity of this algorithm. The exponent is  $\frac{\log(1236.0/654.2)}{\log(350/300)} = 4.12$ , indeed very close to the theoretical  $\mathcal{O}(N^4)$ .

### 6.3.4 Numerical convergence analysis

In this section we want to analyze the convergence properties of the Algorithm [1] considering the prices presented in Tables 6.3, 6.5 and 6.6.

Let us first consider the prices in Table 6.3, which are plotted in Figure 6.9. We can see that for higher values of  $\gamma$ , not only the price increases, but the oscillations of the log-error increases as well. Let us assume the limit price  $V^*$  is represented by the price at  $N = 3500$ . For computational reasons, i.e. the very high computational time, it was not possible to consider higher values. Following the arguments in Section 2.2.4, let us define the log-error  $\log_2(\varepsilon_N)$  with  $\varepsilon_N = |V^N - V^*|$ . Then we consider  $n = 0, 1, \dots, 6$  such that  $N = 50 \cdot 2^n$ . In Figure 6.10 we plot the log-error for each value of  $n$ . For  $\gamma = 0.0001$  and  $\gamma = 0.001$ , even if the line is not straight, it is possible to recognize a linear behavior. In these cases it is possible to estimate the rate of convergence (the slope of the line is about  $-1$  i.e. linear convergence). For  $\gamma = 0.01$ , given the irregular shape, it is hard to understand the functional behavior. The value at  $n = 0$  can be excluded because it is probably an outlier originated by the rough grid resolution. In general, given the nonlinear nature of the optimization problem, we expect a nonlinear behavior of the convergence functional form.

This is confirmed by the Pictures 6.11 and 6.12, containing the prices obtained for the jump-diffusion Merton process in Table 6.5, and the VG process in Table 6.6. The shape is more regular (here the number of steps  $N$  is much smaller), but it is not a linear function. The algorithm converges

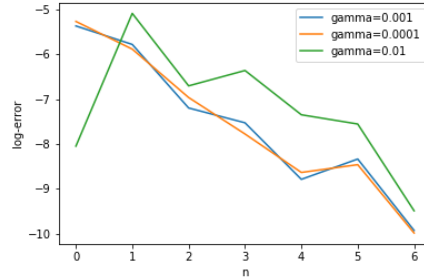
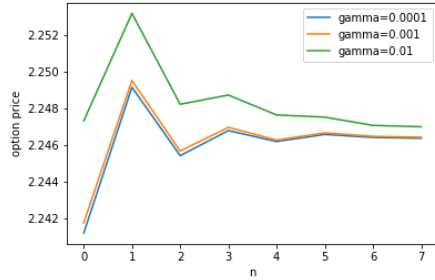


Figure 6.9: Prices in table 6.3 as function of  $n = \log_2(N/50)$ .

Figure 6.10: Plot of the log-errors as function of  $n = \log_2(N/50)$ .

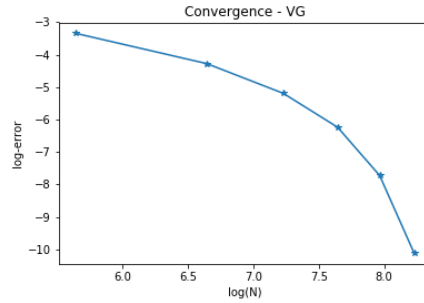
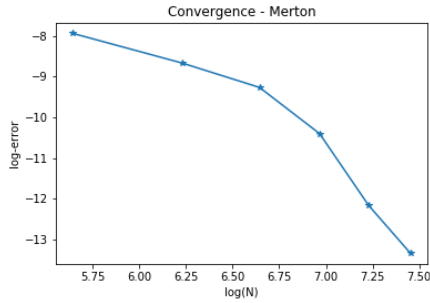


Figure 6.11: Plot of the log-errors as function of  $n = \log_2(N/50)$ , for Merton prices in 6.5

Figure 6.12: Plot of the log-errors as function of  $n = \log_2(N/50)$ , for VG prices in 6.6

faster for higher values of  $N$ .

### 6.3.5 Properties of the model

In this section we want to analyze the properties of the model and how the option price depends on the level of transaction costs  $\theta_b$ ,  $\theta_s$ , the risk aversion parameter  $\gamma$  and the drift  $\mu$ . In this numerical experiment, we use the Merton model with parameters of Tab. 6.1. In Tab. 6.7 we show the writer ATM option values for different transaction costs.

In Fig. 6.13 we can see better how the price for the writer is affected by the change of the transaction costs. The picture shows prices for different values of risk coefficient. The risk profile of the investor also plays an important role. As already shown in [Hodges and Neuberger, 1989], the writer price is an increasing function of the risk aversion coefficient. Figure 6.14 confirms their results.

In all the previous computations we always used the drift term  $\mu$  equal

|               | cost = 0 | cost = 0.01 | cost = 0.02 | cost = 0.03 | cost = 0.04 |
|---------------|----------|-------------|-------------|-------------|-------------|
| <b>Merton</b> | 3.4771   | 3.6400      | 3.8212      | 4.0054      | 4.1864      |
| <b>VG</b>     | 1.9821   | 2.0921      | 2.1870      | 2.2568      | 2.3131      |

Table 6.7: Merton and VG writer prices for different transaction costs, with parameters as in Tab. (6.1).

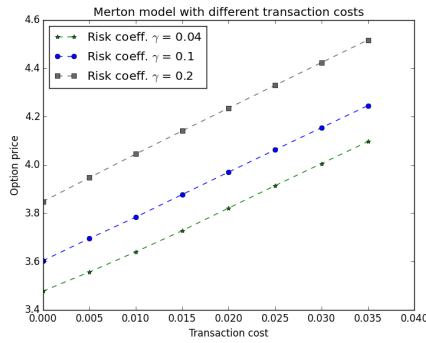


Figure 6.13: Merton option prices for the writer as function of the transaction cost, with different values of  $\gamma$ .

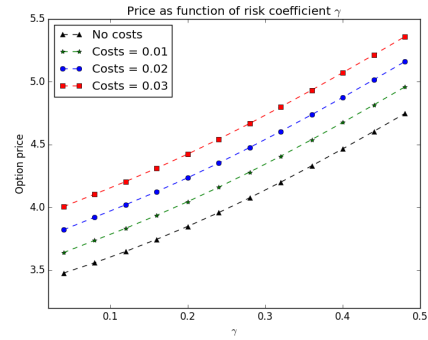


Figure 6.14: Merton option prices for the writer as function of  $\gamma$ , with different values of transaction costs.

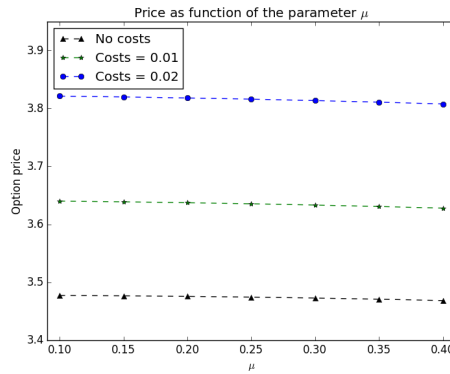


Figure 6.15: Merton option prices for the writer as function of  $\mu$ , with different values of transaction costs.

to the risk free interest rate  $r$ . This is the choice made in [Hodges and Neuberger, 1989], following the common rule of the standard no-arbitrage theory. The option price has to be independent of the expected return of the underlying asset. As we can see in Fig. 6.15, the numerical experiment shows that also in this model, the option prices do not depend on the drift  $\mu$ .

## 6.4 Solution of the 4-dimensional problem

This section focuses on the original HJB equation 5.21, where no variables reduction is considered. A few authors have already presented some results for the diffusion case, using different approaches. In [Palczewsky et al., 2015] the authors propose a method to improve the performances of the Markov chain approximation method for the diffusion case. In [Wang and Li, 2014] the author propose a penalty method for the diffusion case of the 4 dimensional HJB equation, but the numerical results they present are not very clear.

If we want to solve the problem (5.20), we have to deal with a three dimensional state. In the variable reduction Section 5.1.3 we assumed a high value of credit availability  $C$ , such that the default probability can be ignored. Here we do not ignore the default case, and compute option prices for an investor with low credit availability. We work with the original problem (5.20) and derive a discrete time dynamic programming equation as done for (6.7).

Let us indicate with  $B_n := B(t_n^-)$  the value of cash immediately before the possible transaction. Let us define  $\Sigma_b := \{-K_5 h_b, \dots, -h_b, 0, h_b, \dots, +K_6 h_b\}$ , where  $h_b > 0$  is the discrete cash step and  $K_5, K_6 \in \mathbb{N}$ . Its dimension is  $\bar{B} = \#(\Sigma_b) = K_5 + K_6 + 1$ . The discretized SDE for the cash account process  $\{B_t\}_{t \in [t_0, T]}$  in (5.18), with solution (5.25), is:

$$B_{n+1} = e^{r\Delta t} \left( B_n - (1 + \theta_b) e^{X_n} \Delta L_n + (1 - \theta_s) e^{X_n} \Delta M_n \right) \quad (6.22)$$

Let us derive the backward algorithm for computing the value function using the DPP, as we did for (6.7). We obtain the discrete DPE:

$$\begin{aligned} V(t_n, B_n, Y_n, X_n) = \max & \left\{ \mathbb{E}_n \left[ V(t_{n+1}, e^{r\Delta t} B_n, Y_n, X_n + \Delta X_n) \right], \right. \\ & \max_{\Delta L_n} \mathbb{E}_n \left[ V(t_{n+1}, e^{r\Delta t} (B_n - e^{X_n} (1 + \sigma_b) \Delta L_n), Y_n + \Delta L_n, X_n + \Delta X_n) \right], \\ & \left. \max_{\Delta M_n} \mathbb{E}_n \left[ V(t_{n+1}, e^{r\Delta t} (B_n + e^{X_n} (1 - \sigma_s) \Delta M_n), Y_n - \Delta M_n, X_n + \Delta X_n) \right] \right\}, \end{aligned} \quad (6.23)$$

where all the expectations are conditioned on the current state  $(B_n, Y_n, X_n)$ . We use the notation  $V(t_n, b_h, y_j, x_i) = V_{h,j,i}^n$ .

Following the arguments in Section 6.1.2, the computational complexity is

$$\mathcal{O} \left( (N+1) \left[ \frac{N(\bar{L}-1)}{2} + 1 \right] \times \bar{M} \times \bar{B} \times \min\{\bar{M}, \bar{B}\} \right).$$

The term  $\min\{\bar{M}, \bar{B}\}$  is the computational complexity of the minimum search. It is performed for each  $(t_n, b_h, y_j, x_i)$  such that of all  $l, m \in \mathbb{N}$ :

$$y_j + l h_y \in \Sigma_y \bigcap (b_h - e^{x_i} (1 + \sigma_b) l h_y) \geq -K_5 h_b$$

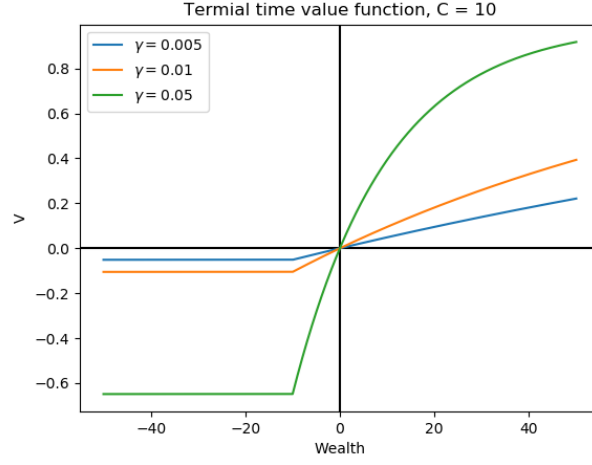


Figure 6.16: Terminal time value functions with  $\mathcal{U}(w) = -C$  for  $w < -C$ .

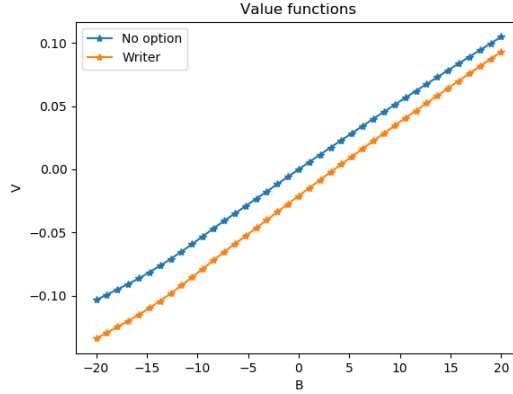


Figure 6.17: Value function for the writer and value function with no option at time  $t_0$  with  $Y_0 = 0$  and  $S_0 = 15$ . Parameters in Tab. 6.1 and  $\theta_b = \theta_s = 0$ . The option price at  $B_0 = 0$  is  $p^w = 3.48303858$ .

and

$$y_j - mh_y \in \Sigma_y \bigcap (b_h + e^{x_i}(1 - \sigma_s)mh_y) \leq K_6 h_b.$$

If we set  $\bar{L} = \sqrt{N}$  and  $\bar{B} = \bar{M} = N$  we have total computational complexity  $\mathcal{O}(N^{5.5})$ .

In the following analysis of the problem (5.20), we assume that  $\mathcal{U}(w) = -C$  for  $w < -C$  and  $\beta = r$ . In Figure (6.16) it is possible to see the shape of the value function at terminal time for different values of  $\gamma$ . In the points  $(b, y, x)$  such that  $\mathcal{W}(b, y, x) = -C$  the function is not differentiable, and this may create some instabilities in the numerical computations.

**Algorithm 2** Backward algorithm**Input:**  $r, (b, \sigma, \nu), X_0, K, T, \theta_b, \theta_s, \gamma, N, \bar{L}, \bar{M}, \bar{B}$ .**Output:**  $V^j(t_0, b, y, X_0)$  for  $j = 0, w, b$ 

- 1: Create the lattice for (6.4) and (6.22) with appropriate discrete steps  $\Delta t, h_y, h_x, h_b$ .
- 2: Create the vector of probabilities  $p_k$  as defined in 6.19.
- 3: Use (5.17) to initialize a  $\bar{B} \times \bar{M} \times (N(\bar{L} - 1) + 1)$  grid for  $V_{h,j,i}^N$ .
- 4: **for**  $n = N-1$  **to** 0 **do**
- 5:    $W_{h,j,i} = \sum_{k=-K_1}^{K_2} p_k V_{h,j,i+k}^{n+1}$
- 6:   Interpolate the value of  $W$  in the points:
  - $W_1(n, h, j, i)$  at  $(t_n, e^{r\Delta t}b_h, y_j, x_i)$ .
  - $W_2(n, h, j, i, l)$  at  $(t_n, e^{r\Delta t}(b_h - e^{x_i}(1 + \sigma_b)lh_y), y_j + lh_y, x_i)$  for each  $l$ .
  - $W_3(n, h, j, i, m)$  at  $(t_n, e^{r\Delta t}(b_h + e^{x_i}(1 - \sigma_s)mh_y), y_j - mh_y, x_i)$  for each  $m$ .
- 7:    $V_{h,j,i}^n = \max \left\{ W_1(n, h, j, i), \max_l W_2(n, h, j, i, l), \max_m W_3(n, h, j, i, m) \right\}$
- 8: **end for**

We present numerical solutions for a Merton process with values in Table 6.1. The cash vector is chosen such that  $-20 \leq B_0 \leq 20$ , and consider values of  $N = \bar{M} = \bar{B} = 25$  and  $\bar{L} = 11$ , but even with these small values, the algorithm takes about 2 hours to run. The algorithm is written in Python and runs on a Linux machine with a i7 processor.

In the Figure 6.17 we computed the value functions and the option prices for  $C = 5000$ . The value functions are smooth and, as expected, the option price (defined in (5.13)) corresponding to the horizontal distance between the value functions, is not affected too much by the initial wealth. The high value of the credit availability  $C$  has to be intended as a low default probability. Under this setting, this problem corresponds to the reduced problem with 3 variables (where the probability of default is ignored). As expected, also the numerical results reproduce the results in Section 6.3. The option price at  $B_0 = 0$  is  $p^w = 3.48303858$ , which is very close to the corresponding value in table 6.7.

A different story happens when we choose a small credit availability. For example  $C = 10$ .

In Figure 6.18 we can see that the two value functions have the same value for  $B_0 < -C$ , because in this region the value function corresponds to the boundary conditions (remember that we are considering  $Y_0 = 0$ ). For higher values of  $B_0$ , the influence of the boundary conditions decreases and the value functions look like those in Figure 6.17.

It is important to stress that the grid resolution we used in these examples is quite low. Although we this algorithm is able to replicate quite well the results obtained in the previous sections, given its high complexity



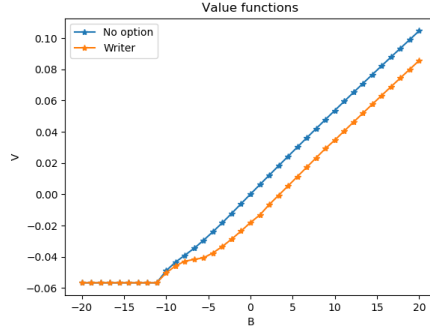


Figure 6.18: Writer and no option value functions at  $t_0$  with  $C = 10$ ,  $Y_0 = 0$  and  $S_0 = 15$ .

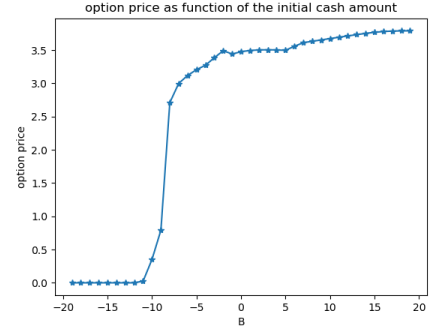


Figure 6.19: Option price as function of  $B_0$  at  $t_0$  with  $C = 10$ ,  $Y_0 = 0$  and  $S_0 = 15$ .

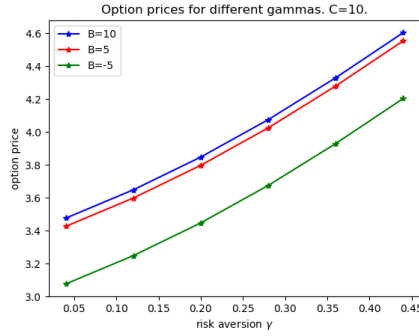


Figure 6.20: Option price as function of risk aversion, for several values of initial  $B_0$ . We set  $C = 10$ ,  $Y_0 = 0$  and  $S_0 = 15$ .

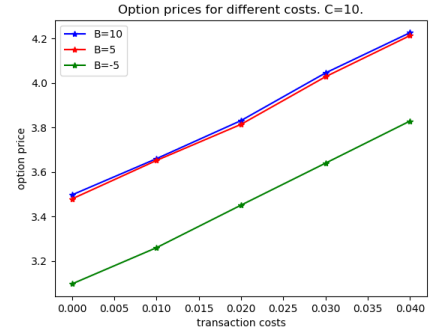


Figure 6.21: Option price as function of transaction costs, for several values of initial  $B_0$ . We set  $C = 10$ ,  $Y_0 = 0$  and  $S_0 = 15$ .

is not possible to study the convergence properties. Furthermore, the value function is highly non-linear. In the algorithm we used a linear interpolation to obtain the missing points in the grid, and this may create further errors when the discretization steps are large.

We conclude this section by testing the model properties as we did in Section 6.3.5. In Figures 6.20 and 6.21 we present several values of option prices as function of the risk aversion and transaction costs respectively. We can see that the value of  $B_0$  does not affect the shape of the curve, but only its height. As we saw in Figures 6.13 and 6.14, the option price is an increasing function of the risk aversion and of the transaction costs.

| Convergence table |               |
|-------------------|---------------|
| $N = \bar{M}$     | Price         |
| 50                | 1.96121076540 |
| 100               | 1.96889900730 |
| 200               | 1.97154200723 |
| 400               | 1.97288296067 |
| 800               | 1.97354995910 |
| 1000              | 1.97368292970 |
| 1600              | 1.97388226442 |
| 2000              | 1.97394872091 |

Table 6.8: Convergence table for ATM VG prices with parameters in Tab. 6.1, calculated with the multinomial method.

## 6.5 Multinomial method applied to the reduced problem

In Section 6.1 we have seen that a possible technique to construct the Markov chain approximation is to discretize the infinitesimal generator using an explicit finite difference scheme. For Lévy processes with infinite activity, however, this technique cannot be used directly because of the singularity of the Lévy measure. In Section 2.2.3 we explained how to approximate the original process by a jump-diffusion process. The associated infinitesimal generator can be discretized using the same approach developed for jump-diffusion generators in Section 6.2.2.

In this section, instead, we use the multinomial approximation method presented in Chapter 3. With this method the total computational complexity is reduced because the number of branches is kept fixed. Although the method still relies on an approximation (the VG process is approximated by a general jump process with only the first four moments corresponding to the moments of the original VG process), the number of branches is fixed to  $\bar{L} = 5$ , and therefore the computational complexity is reduced by a factor  $\sqrt{\bar{N}}$ . Recall that the complexity of the Algorithm [1] is

$$\mathcal{O}\left((N+1)\left[\frac{N(\bar{L}-1)}{2}+1\right]\times\bar{M}\times\bar{M}\right).$$

Assuming  $\bar{M} = N$  and  $\bar{L} = 5$ , the computational time is reduced to  $\mathcal{O}(N^4)$ .

In the numerical computations we used the VG parameters in Table 6.1. The discretization scheme is implemented according to the method proposed in Chapter 3 i.e. the space step has size given by Eq. (3.9) and the transition probabilities are obtained by (3.10). In Table 6.8 we reported prices for different values of  $N$ . Using these prices, in Figure 6.22

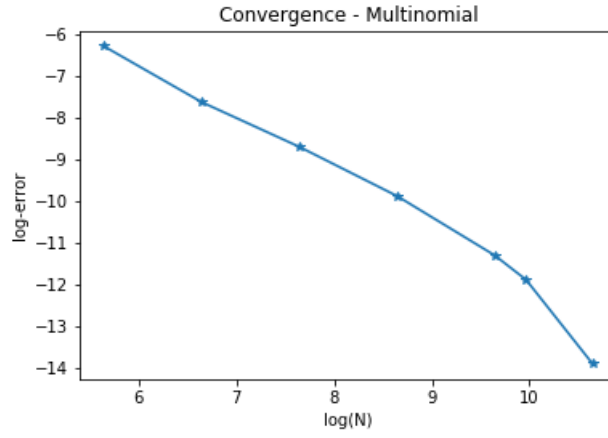


Figure 6.22: Multinomial VG writer and buyer prices for different transaction costs.

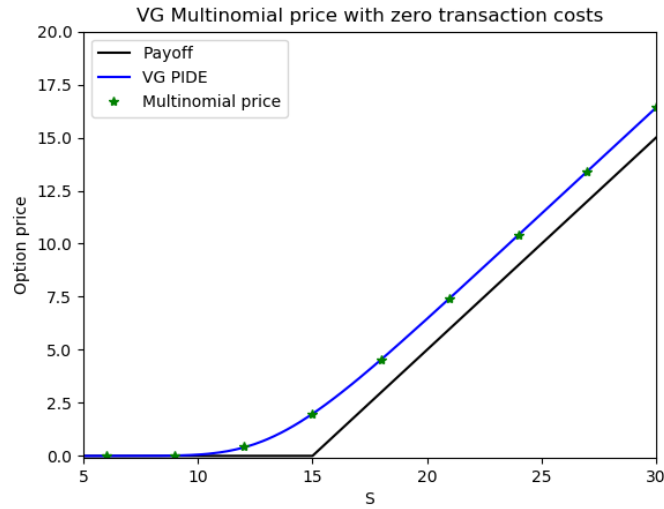


Figure 6.23: Comparison of multinomial VG prices with zero transaction costs and the solution of the VG PIDE (continuous line).

we plot the log-error as a function of the logarithm of  $N$ . We can see that there is a linear relation  $\log_2(\varepsilon) \sim p \log_2(N)$  between them, with a rate of convergence  $p$  which is about  $p \approx 1.6$ . In Figures 6.23 and 6.24 we present numerical results obtained using the multinomial method for different levels of transaction costs.

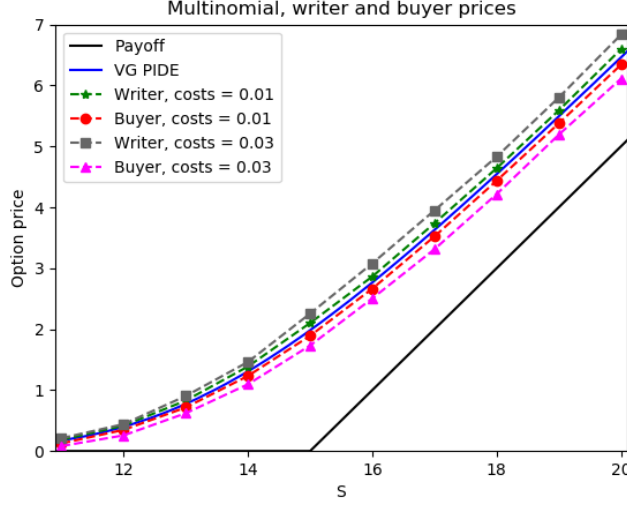


Figure 6.24: Multinomial VG writer and buyer prices for different levels of transaction costs.

## 6.6 Chapter conclusions

In Chapter 5 we derived the general HJB equation of the model, Eq. (5.21), which is an equation with three state variables and a time variable. After that, we decided to simplify the problem by reducing the number of variables, and we obtained the simpler HJB Eq. (5.34).

The objective of Chapter 6 is to present numerical solutions of these optimization problems. The chapter starts with the description of the Markov chain approximation approach, and presents the discretization of the continuous time problem.

We proposed a numerical scheme and proved that it is monotone, stable and consistent. We also proved that the solution of the proposed scheme converges to the viscosity solution of the HJB equation (5.34).

Numerical results for the equation (5.34) are obtained for the particular cases of diffusion, Merton jump-diffusion and Variance Gamma processes, although any Lévy process satisfying the conditions **EM** can be used. The transition probabilities in the Markov chain approximation are obtained by explicit finite difference discretization of the infinitesimal generator of the process. The Brownian motion and the Merton process can be discretized directly, while the VG process needs to be approximated to remove the infinite activity jump component. Due to this approximation, the Algorithm [1] has slower convergence when applied to the VG dynamics. Using numerical experiments, we confirmed some features of the model such as the sensitivity of the price with respect to transaction costs, the risk aversion and the drift

parameters.

We also developed the Algorithm [2] to solve the maximization problem (5.20) associated to the HJB Eq. (5.21) and presented numerical results that consider the case of default.

We conclude the Chapter 6 by discussing how option prices can be computed under the VG model using the multinomial approach, where the transition probabilities are obtained from the approximation introduced in Chapter 3.

## Conclusions

The main objective of this thesis is to develop a new model for pricing options in presence of proportional transaction costs. We propose a model that is a generalization of the model first introduced by [Hodges and Neuberger, 1989] and then formalized by [Davis et al., 1993]. The main difference with previous works in the literature is that we are considering a stock dynamics following a generic exponential Lévy process. Another new feature introduced in our model is the possibility of default for the investor's portfolio. These new features have already been introduced in articles concerning portfolio selection problems e.g. [De Vallière et al., 2016], but to our knowledge are completely new in the area of option pricing under transaction costs. Following the framework of [De Vallière et al., 2016], we present an optimal singular control problem and derive the associated Hamilton-Jacobi-Bellman equation. In the thesis the option price is defined as the *indifference price*, whose definition is based on the *expected utility maximization* concept. One of the main theoretical contributions of the thesis is the proof of the existence of a viscosity solution for this HJB equation.

Since the general maximization problem (5.20) is quite complex and its numerical solution is computationally expensive, we considered also the special case of an investor with a very large *credit availability* i.e. the possibility of default is ignored. Under this assumption it is possible to reduce the number of variables of the problem. We then obtained the simplified problem (5.27), with the associated HJB equation (5.34). We proposed a numerical scheme and proved that it is a monotone, stable and consistent scheme. Moreover, we proved that its solution converges to the viscosity solution of the HJB equation (5.34). This is another important theoretical contribution

of the thesis.

Numerical solutions are provided for both the HJB equations (5.34) and (5.21). More emphasis was given to (5.34) where we presented several numerical results for different Lévy processes and we provided convergence and time complexity analysis. Numerical examples are provided for three different Lévy processes: the Brownian motion, the Merton jump-diffusion and the Variance Gamma processes. We compared the results of our model with the prices obtained with the martingale pricing theory. We verified that for small risk aversion and for zero transaction costs, our model is able to replicate those prices with good precision.

The main numerical approach used in the thesis is the *Markov chain approximation* method. We explain how to construct the approximated Markov chain from the discretization of the infinitesimal generator of the continuous time process. We showed that the Brownian motion and the Merton process can be discretized directly, while the VG process needs to be approximated to remove the infinite activity jump component. We also present results obtained with the multinomial method of [Yamada and Primbs, 2001] for the Variance Gamma process. In this case, there is no need to discretize the infinitesimal generator in order to construct the Markov chain approximation, and the computational complexity of the method is smaller.

To conclude, we want to mention some possible future improvements in this area of research. An interesting direction can be the development of a more efficient numerical method for the HJB equations (5.34), and in particular for (5.21), which has a huge time complexity. There are several approaches in the literature to solve variational inequalities, such as the policy iteration method of [Forsyth and Huang, 2012b], or the penalty method of [Forsyth and Huang, 2012a], [Wang and Li, 2014]. We argue that an implicit/explicit (IMEX), with the possible help of the Fast-Fourier-Transform for evaluating the integral term (as in [Andersen and Andreasen, 2000] for instance) can increase the efficiency of the numerical method. Also, using a non-uniform grid as in [Haentjens, 2013], can help to improve the efficiency and reduce the computational cost for both the differential and the integral part.

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