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You-lan Zhu · Xiaonan Wu
I-Liang Chern

Derivative Securities and Difference Methods

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Derivative Securities and Difference Methods

With 92 Illustrations

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Preface

In the past three decades, great progress has been made in the theory and practice of financial derivative securities. Now huge volumes of financial derivative securities are traded on the market every day. This causes a big demand for experts who know how to price financial derivative securities. This book is designed as a textbook for graduate students in a mathematical finance program and as a reference book for the people who already work in this field. We hope that a person who has studied this book and who knows how to write codes for engineering computation can handle the business of providing efficient derivative-pricing codes. In order for this book to be used by various people, the prerequisites to study the majority of this book are multivariable calculus, linear algebra, and basic probability and statistics.

In this book, the determination of the prices of financial derivative securities is reduced to solving partial differential equation problems, i.e., a PDE approach is adopted in order to find the price of a derivative security. This book is divided into two parts. In the first part, we discuss how to establish the corresponding partial differential equations and find the final and necessary boundary conditions for a specific derivative product. If possible, we derive its explicit solution and describe some properties of the solution. In many cases, no explicit solution has been found so far. In these situations, we have to use numerical methods to determine the value of financial derivative securities. Therefore, the second part is devoted to numerical methods for derivative securities. There are two styles of financial derivatives: European and American. The numerical methods for both styles of derivatives are described. The main numerical method discussed is the finite-difference method. The binomial/trinomial method is also introduced as a version of an explicit finite-difference method, and the pseudo-spectral method is discussed as a high-order finite-difference method. In this part, numerical methods for determining the market price of risk are also studied as numerical methods for inverse problems. From the viewpoint of partial differential equations, solving an inverse problem means to determine a function as a variable coefficient in a partial differential equation, according to certain values of some solutions.

During the past few years, a great number of books on financial derivative securities have been published. For example: Duffie^[26], Baxter and Rennie^[5], Hull^[39], James and Webber^[43], Jarrow^[44], Kwok^[49], Lamberton and Lapeyre^[50], Lyuu^[54], Musiela and Rutkowski^[58], Pelsser^[60], Tavella and Randall^[69], Wilmott, Dewynne, and Howison^[71], Wilmott^[72], Wilmott^[73], and Yan^[76] have published books on this subject. However, each book has its own features and gives emphasis to some aspects of this subject. Relatively speaking, this book is similar to the books by Wilmott, Dewynne, and Howison^[71], Kwok^[49], and Tavella and Randall^[69] because all of them deal with the partial differential equation problems in finance and their numerical methods. However, this book pays more attention to numerical methods. At least the following features of this book are unique:

1. The slopes of the payoff functions for many derivative securities are discontinuous, and American-style derivative securities usually have free boundaries. These features downgrade the efficiency of numerical methods. In this book, we will discuss how to make computation more efficient even though the solutions have such types of weak singularities.
2. Many derivative security problems are defined on an infinite domain. When a numerical method is used to solve such a problem, usually a large finite domain is taken, and some artificial boundary conditions are adopted for implicit methods. This book will discuss how to convert such a problem into a problem defined on a finite domain and without requiring any artificial boundary conditions. Also, conditions guaranteeing that a random variable is defined on a finite domain are derived. When these conditions hold, any derivative security problems will be defined on a finite domain and do not need any artificial boundary conditions in order to solve them numerically.
3. A numerical method for an inverse problem in finance, for determination of the market price of risk on the spot interest rate, has been provided. As soon as having the market price of risk on the spot interest rate, we can use partial differential equations for evaluating interest rate derivatives in practice.
4. A three-factor interest rate model has been provided. All the parameters in the model and the final values of derivatives are determined from the market data. Because of this, it can be expected that the model reflects the real market. The evaluation of interest rate derivatives is reduced to solving a final value problem of a three-dimensional partial differential equation on a finite domain. Because the correctness of the formulation of the problem is proven, the numerical method for such a problem can be designed without difficulties.

The first four chapters are related to partial differential equations in finance. Chapter 1 is an introduction, where basic features of several assets and financial derivative securities are briefly described. Chapter 2 discusses basic options. In this chapter, Itô's lemma and the Black-Scholes equation are

introduced, along with the derivation of the Black–Scholes formulae. These topics are followed by a discussion on American options as both linear complementarity and free-boundary problems. Also in Chapter 2, the put–call parity relation for European options as well as the put–call symmetry relations for American options are introduced. Finally, the general equations for derivative securities are derived.

In Chapter 3, exotic options such as barrier, Asian, lookback, and multi-asset are introduced. The equations, final conditions, and necessary boundary conditions for these options are provided. In this chapter, we examine a few cases in which a two-dimensional problem may be reduced to a one-dimensional problem. Explicit solutions for some of these options are provided whenever possible. Also, the formulations as free-boundary problems have been given for several American exotic options.

In Chapter 4, one-factor interest rate models, namely, the Vasicek, Cox–Ingersoll–Ross, Ho–Lee, and Hull–White models, are carefully discussed. Then, we describe how the problem of determining the market price of risk from the market data may be formulated as an inverse problem. After that, the formulations of interest rate derivatives such as bond options and swaptions are given. Then, we discuss multi-factor models and give the details of a three-factor model that can reflect the real market and be used in practice readily. The final topics in Chapter 4 are a discussion on two-factor convertible bonds and the derivation of the equivalent free-boundary problem.

Most of basic materials in these four chapters can be found from many books, for example, from the books listed above. Readers who need to know more about these subjects are referred to those books. Some of the materials are the authors' research results. For more details, see those corresponding papers given in the references.

As is well-known, exact solutions to the vanilla American option problems are not known, and the problems need to be solved numerically. For vanilla European options, if σ depends on S or the dividend is paid discretely, then explicit solutions may not exist. Therefore, in order to evaluate their prices, we often rely on numerical methods. For pricing exotic options and interest rate derivatives, we rely on numerical methods even more due to the complexity of these problems.

The next four chapters are devoted to numerical methods for partial differential equations in finance. In Chapter 5, we provide the basic numerical methods that will be used for solving partial differential equation problems and discuss the basic theory on finite-difference methods – stability, convergence and the extrapolation technique of numerical solutions. Most of these concepts can be found in many books. In the next chapter, Initial-Boundary Value and LC (Linear Complementarity) Problems, we discuss the numerical methods for European-style derivative securities and for American-style derivative securities formulated as an LC problem. In Chapter 7, Free-Boundary Problems, we carefully discuss how to solve one-factor and two-factor American option problems as free-boundary problems by implicit finite-difference methods. We

also describe how to solve a two-factor convertible bond problem as a free-boundary problem by the pseudo-spectral method. In this chapter, we provide a comparison among these methods given in this chapter and in Chapter 6 as well. In the last chapter, Interest Rate Modeling, we begin with another formulation of the inverse problem and some numerical examples on the market price of risk. Then, we discuss how to price interest rate derivatives, such as swaptions, using one-factor models with numerical market prices of risk and show some numerical results. Finally, how to use the three-factor model to price interest rate derivatives in practice is discussed. Most of the materials presented in the last three chapters are from research results, especially from the authors' research.

This book can be used as a text book for two courses as a sequence. In the first course, the subject "Partial Differential Equations in Finance" is taught by using the materials in Part I. The second one is a course on "Numerical Methods for Derivative Securities" based on Part II of this book. In order to help students to understand the materials and check whether or not students have understood them, a number of problems are given at the end of each chapter. Also, at the ends of Chapters 5–8, some projects are given in order for students to be trained in evaluating derivative securities. This book is considered as a book between a textbook for graduate students and a monograph. If time is not enough, some portions can be omitted and left to students as reference materials. We have used it as a textbook in our mathematical finance program and almost all the materials can be taught in class. The following materials are basic and more important:

- Sections 1.1–2;
- Sections 2.1–4, Subsections 2.5.1–2, 2.6.1–3, 2.9.1–4, 2.10.1–2;
- Section 3.1, Subsections 3.2.1, 3.3.1–4, 3.4.1–2;
- Sections 4.1–2, 4.6–7;
- Subsections 5.1.1–2, 5.2.1–2, Section 5.3, Subsection 5.4.1, Section 5.5;
- Subsections 6.1.1–3, 6.1.5, 6.2.1–3, 6.3.2–3, 6.3.6;
- Section 7.1, Subsections 7.2.1, 7.2.3, 7.2.5–6, Section 7.3;
- Section 8.3.

These materials can be taught in one semester. Thus, if only one course is offered, this book can also be used.

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Contents

Part I Partial Differential Equations in Finance

1	Introduction	3
1.1	Assets	3
1.2	Derivative Securities	8
1.2.1	Forward and Futures Contracts	9
1.2.2	Options	10
1.2.3	Interest Rate Derivatives	13
1.2.4	Factors Affecting Derivative Prices	13
1.2.5	Functions of Derivative Securities	14
	Problems	15
2	Basic Options	17
2.1	Asset Price Model and Itô's Lemma	17
2.1.1	A Model for Asset Prices	17
2.1.2	Itô's Lemma	20
2.1.3	Expectation and Variance of Lognormal Random Variables	22
2.2	Derivation of the Black-Scholes Equation	25
2.2.1	Arbitrage Arguments	25
2.2.2	The Black-Scholes Equation	26
2.2.3	Final Conditions for the Black-Scholes Equation	29
2.2.4	Hedging and Greeks	30
2.3	Two Transformations on the Black-Scholes Equation	31
2.3.1	Converting the Black-Scholes Equation into a Heat Equation	32
2.3.2	Transforming the Black-Scholes Equation into an Equation Defined on a Finite Domain	35
2.4	Solutions of European Options	39
2.4.1	The Solutions of Parabolic Equations	39
2.4.2	Solutions of the Black-Scholes Equation	42

2.4.3	Prices of Forward Contracts and Delivery Prices	44
2.4.4	Derivation of the Black–Scholes Formulae	44
2.4.5	Put–Call Parity Relation	48
2.4.6	An Explanation in Terms of Probability	49
2.5	American Option Problems as Linear Complementarity Problems	51
2.5.1	Constraints on American Options	51
2.5.2	Formulation of the Linear Complementarity Problem in (S, t) -Plane	52
2.5.3	Formulation of the Linear Complementarity Problem in $(x, \bar{\tau})$ -Plane	58
2.5.4	Formulation of the Linear Complementarity Problem on a Finite Domain	60
2.5.5	More General Form of the Linear Complementarity Problems	61
2.6	American Option Problems as Free-Boundary Problems	62
2.6.1	Free Boundaries	62
2.6.2	Free-Boundary Problems	67
2.6.3	Put–Call Symmetry Relations	70
2.7	Equations for Some Greeks	75
2.8	Perpetual Options	76
2.9	General Equations for Derivatives	78
2.9.1	Models for Random Variables	78
2.9.2	Generalization of Itô’s Lemma	81
2.9.3	Derivation of Equations for Financial Derivatives	81
2.9.4	Three Types of State Variables	84
2.9.5	Uniqueness of Solutions	85
2.10	Jump Conditions	89
2.10.1	Hyperbolic Equations with a Dirac Delta Function	89
2.10.2	Jump Conditions for Options with Discrete Dividends and Discrete Sampling	91
2.11	More Arbitrage Theory	92
2.11.1	Three Conclusions and Some Portfolios	92
2.11.2	Bounds of Option Prices	94
2.11.3	Relations Between Call and Put Prices	98
	Problems	100
3	Exotic Options	113
3.1	Introduction	113
3.2	Barrier Options	114
3.2.1	Knock-Out and Knock-In Options	114
3.2.2	Closed-Form Solutions of Some European Barrier Options	115
3.2.3	Formulation of American Barrier Options	121
3.2.4	Parisian Options	122

3.3	Asian Options	126
3.3.1	Average Strike, Average Price, and Double Average Options	126
3.3.2	Continuously and Discretely Sampled Arithmetic Averages	127
3.3.3	Derivation of Equations	129
3.3.4	Reducing to One-Dimensional Problems	130
3.3.5	Jump Conditions	133
3.3.6	American Asian Options	133
3.3.7	Some Examples	136
3.4	Lookback Options	138
3.4.1	Equations for Lookback Options	138
3.4.2	Reducing to One-Dimensional Problems	143
3.4.3	Closed-Form Solutions for European Lookback Options	145
3.4.4	American Options Formulated as Free-Boundary Problems	152
3.4.5	A Closed-Form Solution for a Perpetual American Lookback Option	155
3.4.6	Lookback-Asian Options	157
3.4.7	Some Examples	159
3.5	Multi-Asset Options	161
3.5.1	Equations for Multi-Asset Options and Green's Formula	162
3.5.2	Exchange Options	166
3.5.3	Options on the Extremum of Several Assets	168
3.5.4	Formulation of Multi-Asset Option Problems on a Finite Domain	178
3.6	Some Other Exotic Options	182
3.6.1	Binary Options	183
3.6.2	Forward Start Options (Delayed Strike Options)	183
3.6.3	Compound Options	184
3.6.4	Chooser Options	190
	Problems	191
4	Interest Rate Derivative Securities	205
4.1	Introduction	205
4.2	Bonds	208
4.2.1	Bond Values for Deterministic Spot Rates	208
4.2.2	Bond Equations for Random Spot Rates	210
4.3	Some Explicit Solutions of Bond Equations	211
4.3.1	Analytic Solutions for the Vasicek and Cox-Ingersoll-Ross Models	212
4.3.2	Explicit Solutions for the Ho-Lee and Hull-White Models	218
4.4	Inverse Problem on the Market Price of Risk	220
4.5	Application of Bond Equations	223

4.5.1	Bond Options and Options on Bond Futures Contracts .	223
4.5.2	Interest Rate Swaps and Swaptions	226
4.5.3	Interest Rate Caps, Floors, and Collars	233
4.6	Multi-Factor Interest Rate Models	235
4.6.1	Brief Description of Several Multi-Factor Interest Rate Models	235
4.6.2	Reducing the Randomness of a Zero-Coupon Bond Curve to That of a Few Zero-Coupon Bonds	237
4.6.3	A Three-Factor Interest Rate Model and the Equation for Interest Rate Derivatives	241
4.7	Two-Factor Convertible Bonds	248
	Problems	255

Part II Numerical Methods for Derivative Securities

5	Basic Numerical Methods	267
5.1	Approximations	267
5.1.1	Interpolation	267
5.1.2	Approximation of Partial Derivatives	271
5.1.3	Approximate Integration	274
5.1.4	Least Squares Approximation	276
5.2	Solution of Systems and Eigenvalue Problems	277
5.2.1	LU Decomposition of Linear Systems	277
5.2.2	Iteration Methods for Linear Systems	280
5.2.3	Iteration Methods for Nonlinear Systems	282
5.2.4	Obtaining Eigenvalues and Eigenvectors	287
5.3	Finite-Difference Methods	292
5.4	Stability and Convergence Analysis	302
5.4.1	Stability	302
5.4.2	Convergence	311
5.5	Extrapolation of Numerical Solutions	314
5.6	Determination of Parameters in Models	318
5.6.1	Constant Variances and Covariances	319
5.6.2	Variable Parameters	321
	Problems	323
	Projects	328
6	Initial-Boundary Value and LC Problems	331
6.1	Explicit Methods	331
6.1.1	Pricing European Options by Using \bar{V} , ξ , τ or u , x , $\bar{\tau}$ Variables	331
6.1.2	Projected Methods for LC Problems	335
6.1.3	Binomial and Trinomial Methods	338

6.1.4	Relations Between the Lattice Methods and the Explicit Finite-Difference Methods	346
6.1.5	Examples of Unstable Schemes	349
6.2	Implicit Methods	349
6.2.1	Pricing European Options by Using \bar{V} , ξ , τ Variables ..	349
6.2.2	European Options with Discrete Dividends and Asian and Lookback Options with Discrete Sampling	351
6.2.3	Projected Direct Methods for the LC Problem	354
6.2.4	Projected Iteration Methods for the LC Problem	357
6.2.5	Comparison with Explicit Methods	359
6.3	Singularity-Separating Method	360
6.3.1	Barrier Options	361
6.3.2	European Vanilla Options with Variable Volatilities ...	366
6.3.3	Bermudan Options	371
6.3.4	European Parisian Options	377
6.3.5	European Average Price Options	379
6.3.6	European Two-Factor Options	382
6.3.7	Two-Factor Convertible Bonds with $D_0 = 0$	392
6.4	Pseudo-Spectral Methods	392
	Problems	396
	Projects	402
7	Free-Boundary Problems	405
7.1	SSM for Free-Boundary Problems	406
7.1.1	One-Dimensional Cases	406
7.1.2	Two-Dimensional Cases	411
7.2	Implicit Finite-Difference Methods	422
7.2.1	Solution of One-Dimensional Problems	422
7.2.2	Solution of Greeks	427
7.2.3	Numerical Results of Vanilla Options and Comparison ..	429
7.2.4	Solution and Numerical Results of Exotic Options	437
7.2.5	Solution of Two-Dimensional Problems	445
7.2.6	Numerical Results of Two-Factor Options	449
7.3	Pseudo-Spectral Methods	456
7.3.1	The Description of the Pseudo-Spectral Methods for Two-Factor Convertible Bonds	456
7.3.2	Numerical Results of Two-Factor Convertible Bonds ...	462
	Problems	467
	Projects	470
8	Interest Rate Modeling	473
8.1	Inverse Problems	473
8.1.1	Another Formulation of the Inverse Problem	473
8.1.2	Numerical Methods for the Inverse Problem	478
8.1.3	Numerical Results on Market Prices of Risk	481

8.2 Numerical Results of One-Factor Models	484
8.3 Pricing Derivatives with Multi-Factor Models	490
8.3.1 Determining Models from the Market Data	490
8.3.2 Numerical Methods and Results	495
Problems	499
Projects	501
References	503
Index	509

Partial Differential Equations in Finance

Introduction

1.1 Assets

We first introduce some basic knowledge on stocks, bonds, foreign currencies, commodities, and indices, all of which are called **assets** in this book.

Huge volumes of stocks are traded on the stock market every day, and the price of a stock changes all the time. Such a price is a typical random variable. As examples, the prices of the stocks issued by IBM and GE during the period 1990–2000 are plotted in Figs. 1.1 and 1.2. Stocks are issued by corporations. A corporation like IBM, for example, is a business unit, which gets its capital through issuing stocks. A holder of a share of stock owns a fixed portion of the corporation. For example, if a corporation issues 10 million shares of stock, then the holder of a share of stock owns 10^{-7} portion of the corporation. Stock prices, especially those of high technology stocks, have large volatilities. However, stocks usually have higher returns than bonds, which attracts people to buy them. Many corporations distribute a small amount of cash to its stockholders in proportion to the number of shares of stock held periodically. The amount is not fixed and is determined by the corporation after the stocks have been issued. This payment is commonly known as the dividend. A corporation sometimes splits its stock. When a stock split occurs, the value of the stock changes. If one share splits into two shares, the value of a new share of stock is one half of the value of an old share of stock because the value of the corporation does not change when the stock split occurs.

Bonds and other debt instruments are other types of securities that are traded on the market frequently. Besides issuing stocks, a corporation can also get its capital through issuing bonds. Governments at various levels issue bonds for some special purposes, too. The holder of a bond will get the face value (the par value) at the maturity as long as the issuer has the ability to pay. Therefore, the price of a bond usually goes to the face value as the maturity approaches, which is a feature any price of stock does not have and is called the pull-to-par phenomenon. Periodically, a bondholder will receive a fixed amount of cash, usually a few percent of the face value. This percentage is