

$$\delta(u) := \int_0^T u(t) \delta W(t) = \sum_{n=0}^{\infty} I_{n+1}(f_n)$$

$$D_t F = \sum_{n=1}^{\infty} n I_{n-1}(f_n(\cdot, t)), \quad t \in [0, T]$$

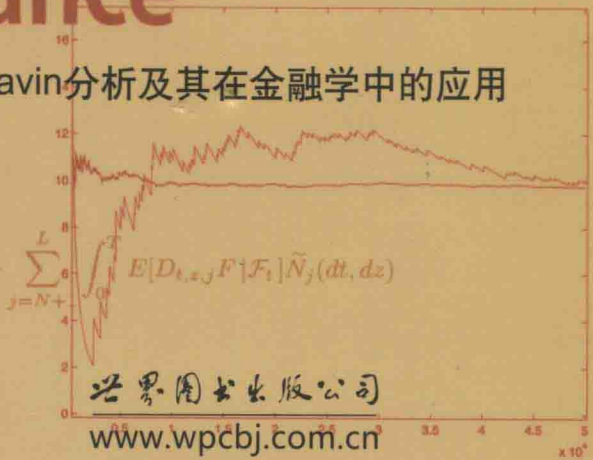
$$E\left[F \int_0^T u(t) \delta W(t)\right] = E\left[\int_0^T u(t) D_t F dt\right]$$

$$= \int_0^T D_t u(s) \delta W(s) + u(t)$$

Giulia Di Nunno  
Bernt Øksendal  
Frank Proske

# Malliavin Calculus for Lévy Processes with Applications to Finance

Lévy过程的Malliavin分析及其在金融学中的应用



$$F = E[F] + \sum_{j=1}^N \int_0^T E[D_{t,j} F | \mathcal{F}_t] dW_j(t) + \sum_{j=N+1}^L \int_0^T E[D_{t,j} F | \mathcal{F}_t] \tilde{N}_j(dt, dz)$$

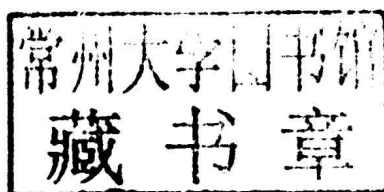


Springer

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Giulia Di Nunno · Bernt Øksendal  
Frank Proske

# Malliavin Calculus for Lévy Processes with Applications to Finance



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ISBN 978-3-540-78571-2 e-ISBN 978-3-540-78572-9  
DOI 10.1007/978-3-540-78572-9  
Springer Heidelberg Dordrecht London New York

Library of Congress Control Number: 2009934515

Mathematics Subject Classification (2000): 60H05, 60H07, 60H40, 91B28, 93E20, 60G51, 60G57

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Reprint from English language edition:

Malliavin Calculus for Lévy Processes with Applications to Finance

by Giulia Di Nunno, Bernt Øksendal, Frank Proske

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Universitext

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*To Christian. To my parents.*

G.D.N.

*To Eva.*

B.Ø.

*To Simone, Paulina and Siegfried.*

F.P.



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## Preface

There are already several excellent books on Malliavin calculus. However, most of them deal only with the theory of Malliavin calculus for Brownian motion, with [35] as an honorable exception. Moreover, most of them discuss only the application to regularity results for solutions of SDEs, as this was the original motivation when Paul Malliavin introduced the infinite-dimensional calculus in 1978 in [158]. In the recent years, Malliavin calculus has found many applications in stochastic control and within finance. At the same time, Lévy processes have become important in financial modeling. In view of this, we have seen the need for a book that deals with Malliavin calculus for Lévy processes in general, not just Brownian motion, and that presents some of the most important and recent applications to finance.

It is the purpose of this book to try to fill this need. In this monograph we present a general Malliavin calculus for Lévy processes, covering both the Brownian motion case and the pure jump martingale case via Poisson random measures, and also some combination of the two. We also present many of the recent applications to finance, including the following:

- The Clark–Ocone theorem and hedging formulae
- Minimal variance hedging in incomplete markets
- Sensitivity analysis results and efficient computation of the “greeks”
- Optimal portfolio with partial information
- Optimal portfolio in an anticipating environment
- Optimal consumption in a general information setting
- Insider trading

To be able to handle these applications, we develop a general theory of anticipative stochastic calculus for Lévy processes involving the Malliavin derivative, the Skorohod integral, the forward integral, which were originally introduced for the Brownian setting only. We dedicate some chapters to the generalization of our results to the white noise framework, which often turns out to be a suitable setting for the theory. Moreover, this enables us to prove



results that are general enough for the financial applications, for example, the generalized Clark–Ocone theorem.

This book is based on a series of courses that we have given in different years and to different audiences. The first one was given at the Norwegian School of Economics and Business Administration (NHH) in Bergen in 1996, at that time about Brownian motion only. Other courses were held later, every time including more updated material. In particular, we mention the courses given at the Department of Mathematics and at the Center of Mathematics for Applications (CMA) at the University of Oslo and also the intensive or compact courses presented at the University of Ulm in July 2006, at the University of Cape Town in December 2006, at the Indian Institute of Science (IIS) in Bangalore in January 2007, and at the Nanyang Technological University in Singapore in January 2008.

At all these occasions we met engaged students and attentive readers. We thank all of them for their active participation to the classes and their feedback. Our work has benefitted from the collaboration and useful comments from many people, including Fred Espen Benth, Maximilian Josef Butz, Delphine David, Inga Baadshaug Eide, Xavier Gabaix, Martin Groth, Yaozhong Hu, Asma Khedher, Paul Kettler, An Ta Thi Kieu, Jørgen Sjaastad, Thilo Meyer-Brandis, Farai Julius Mhlanga, Yeliz Yolcu Okur, Olivier Menoukeu Pamen, Ulrich Rieder, Goncalo Reiss, Steffen Sjursen, Alexander Sokol, Agnès Sulem, Olli Wallin, Diane Wilcox, Frank Wittmann, Mihail Zervos, Tusheng Zhang, and Xunyu Zhou. We thank them all for their help. Our special thanks go to Paul Malliavin for the inspiration and continuous encouragement he has given us throughout the time we have worked on this book. We also acknowledge with gratitude the technical support with computers of the Drift-IT at the Department of Mathematics at the University of Oslo.

Oslo,  
June 2008.

*Giulia Di Nunno*  
*Bernt Øksendal*  
*Frank Proske*

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# Contents

Introduction .....	1
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## Part I The Continuous Case: Brownian Motion

---

<b>1 The Wiener–Itô Chaos Expansion</b> .....	7
1.1 Iterated Itô Integrals .....	7
1.2 The Wiener–Itô Chaos Expansion .....	11
1.3 Exercises .....	16
<b>2 The Skorohod Integral</b> .....	19
2.1 The Skorohod Integral .....	19
2.2 Some Basic Properties of the Skorohod Integral .....	22
2.3 The Skorohod Integral as an Extension of the Itô Integral ....	23
2.4 Exercises .....	25
<b>3 Malliavin Derivative via Chaos Expansion</b> .....	27
3.1 The Malliavin Derivative .....	27
3.2 Computation and Properties of the Malliavin Derivative .....	29
3.2.1 Chain Rules for Malliavin Derivative .....	29
3.2.2 Malliavin Derivative and Conditional Expectation ....	30
3.3 Malliavin Derivative and Skorohod Integral .....	34
3.3.1 Skorohod Integral as Adjoint Operator to the Malliavin Derivative .....	34
3.3.2 An Integration by Parts Formula and Closability of the Skorohod Integral .....	36
3.3.3 A Fundamental Theorem of Calculus .....	37
3.4 Exercises .....	40
<b>4 Integral Representations and the Clark–Ocone Formula</b> ....	43
4.1 The Clark–Ocone Formula .....	43
4.2 The Clark–Ocone Formula under Change of Measure .....	45

4.3	Application to Finance: Portfolio Selection .....	48
4.4	Application to Sensitivity Analysis and Computation of the “Greeks” in Finance .....	54
4.5	Exercises .....	60
<b>5</b>	<b>White Noise, the Wick Product, and Stochastic Integration .....</b>	<b>63</b>
5.1	White Noise Probability Space .....	63
5.2	The Wiener–Itô Chaos Expansion Revisited .....	65
5.3	The Wick Product and the Hermite Transform .....	70
5.3.1	Some Basic Properties of the Wick Product .....	72
5.3.2	Hermite Transform and Characterization Theorem for $(\mathcal{S})_{-1}$ .....	73
5.3.3	The Spaces $\mathcal{G}$ and $\mathcal{G}^*$ .....	77
5.3.4	The Wick Product in Terms of Iterated Itô Integrals ...	79
5.3.5	Wick Products and Skorohod Integration .....	80
5.4	Exercises .....	84
<b>6</b>	<b>The Hida–Malliavin Derivative on the Space <math>\Omega = \mathcal{S}'(\mathbb{R})</math> ....</b>	<b>87</b>
6.1	A New Definition of the Stochastic Gradient and a Generalized Chain Rule .....	87
6.2	Calculus of the Hida–Malliavin Derivative and Skorohod Integral .....	91
6.2.1	Wick Product vs. Ordinary Product .....	91
6.2.2	Closability of the Hida–Malliavin Derivative .....	92
6.2.3	Wick Chain Rule .....	93
6.2.4	Integration by Parts, Duality Formula, and Skorohod Isometry .....	95
6.3	Conditional Expectation on $(\mathcal{S})^*$ .....	97
6.4	Conditional Expectation on $\mathcal{G}^*$ .....	100
6.5	A Generalized Clark–Ocone Theorem .....	101
6.6	Exercises .....	109
<b>7</b>	<b>The Donsker Delta Function and Applications .....</b>	<b>111</b>
7.1	Motivation: An Application of the Donsker Delta Function to Hedging .....	111
7.2	The Donsker Delta Function .....	114
7.3	The Multidimensional Case .....	122
7.4	Exercises .....	129
<b>8</b>	<b>The Forward Integral and Applications .....</b>	<b>131</b>
8.1	A Motivating Example .....	131
8.2	The Forward Integral .....	134
8.3	Itô Formula for Forward Integrals .....	137

8.4	Relation Between the Forward Integral and the Skorohod Integral .....	140
8.5	Itô Formula for Skorohod Integrals .....	142
8.6	Application to Insider Trading Modeling .....	144
8.6.1	Markets with No Friction .....	144
8.6.2	Markets with Friction .....	149
8.7	Exercises .....	156

---

## Part II The Discontinuous Case: Pure Jump Lévy Processes

---

9	<b>A Short Introduction to Lévy Processes</b> .....	161
9.1	Basics on Lévy Processes .....	161
9.2	The Itô Formula .....	165
9.3	The Itô Representation Theorem for Pure Jump Lévy Processes .....	168
9.4	Application to Finance: Replicability .....	171
9.5	Exercises .....	173
10	<b>The Wiener–Itô Chaos Expansion</b> .....	177
10.1	Iterated Itô Integrals .....	177
10.2	The Wiener–Itô Chaos Expansion .....	178
10.3	Exercises .....	182
11	<b>Skorohod Integrals</b> .....	183
11.1	The Skorohod Integral .....	183
11.2	The Skorohod Integral as an Extension of the Itô Integral ...	184
11.3	Exercises .....	186
12	<b>The Malliavin Derivative</b> .....	187
12.1	Definition and Basic Properties .....	187
12.2	Chain Rules for Malliavin Derivative .....	190
12.3	Malliavin Derivative and Skorohod Integral .....	192
12.3.1	Skorohod Integral as Adjoint Operator to the Malliavin Derivative .....	192
12.3.2	Integration by Parts and Closability of the Skorohod Integral .....	192
12.3.3	Fundamental Theorem of Calculus .....	194
12.4	The Clark–Ocone Formula .....	196
12.5	A Combination of Gaussian and Pure Jump Lévy Noises ...	197
12.6	Application to Minimal Variance Hedging with Partial Information .....	200
12.7	Computation of “Greeks” in the Case of Jump Diffusions ...	206
12.7.1	The Barndorff–Nielsen and Shephard Model .....	207
12.7.2	Malliavin Weights for “Greeks” .....	209
12.8	Exercises .....	213

<b>13 Lévy White Noise and Stochastic Distributions</b>	215
13.1 The White Noise Probability Space	215
13.2 An Alternative Chaos Expansion and the White Noise	216
13.3 The Wick Product	221
13.3.1 Definition and Properties	221
13.3.2 Wick Product and Skorohod Integral	224
13.3.3 Wick Product vs. Ordinary Product	227
13.3.4 Lévy–Hermite Transform	228
13.4 Spaces of Smooth and Generalized Random Variables: $\mathcal{G}$ and $\mathcal{G}^*$	229
13.5 The Malliavin Derivative on $\mathcal{G}^*$	230
13.6 A Generalization of the Clark–Ocone Theorem	232
13.7 A Combination of Gaussian and Pure Jump Lévy Noises in the White Noise Setting	237
13.8 Generalized Chain Rules for the Malliavin Derivative	239
13.9 Exercises	242
<b>14 The Donsker Delta Function of a Lévy Process and Applications</b>	243
14.1 The Donsker Delta Function of a Pure Jump Lévy Process	244
14.2 An Explicit Formula for the Donsker Delta Function	244
14.3 Chaos Expansion of Local Time for Lévy Processes	249
14.4 Application to Hedging in Incomplete Markets	255
14.5 A Sensitivity Result for Jump Diffusions	258
14.5.1 A Representation Theorem for Functions of a Class of Jump Diffusions	258
14.5.2 Application: Computation of the “Greeks”	263
14.6 Exercises	265
<b>15 The Forward Integral</b>	267
15.1 Definition of Forward Integral and its Relation with the Skorohod Integral	267
15.2 Itô Formula for Forward and Skorohod Integrals	270
15.3 Exercises	274
<b>16 Applications to Stochastic Control: Partial and Inside Information</b>	275
16.1 The Importance of Information in Portfolio Optimization	275
16.2 Optimal Portfolio Problem under Partial Information	276
16.2.1 Formalization of the Optimization Problem: General Utility Function	277
16.2.2 Characterization of an Optimal Portfolio Under Partial Information	278
16.2.3 Examples	285
16.3 Optimal Portfolio under Partial Information in an Anticipating Environment	289

16.3.1	The Continuous Case: Logarithmic Utility . . . . .	291
16.3.2	The Pure Jump Case: Logarithmic Utility . . . . .	296
16.4	A Universal Optimal Consumption Rate for an Insider . . . . .	300
16.4.1	Formalization of a General Optimal Consumption Problem . . . . .	302
16.4.2	Characterization of an Optimal Consumption Rate . . . . .	304
16.4.3	Optimal Consumption and Portfolio . . . . .	307
16.5	Optimal Portfolio Problem under Inside Information . . . . .	310
16.5.1	Formalization of the Optimization Problem: General Utility Function . . . . .	310
16.5.2	Characterization of an Optimal Portfolio under Inside Information . . . . .	314
16.5.3	Examples: General Utility and Enlargement of Filtration . . . . .	317
16.6	Optimal Portfolio Problem under Inside Information: Logarithmic Utility . . . . .	322
16.6.1	The Pure Jump Case . . . . .	322
16.6.2	A Mixed Market Case . . . . .	325
16.6.3	Examples: Enlargement of Filtration . . . . .	327
16.7	Exercises . . . . .	334
<b>17</b>	<b>Regularity of Solutions of SDEs Driven by Lévy Processes . . . . .</b>	<b>337</b>
17.1	The Pure Jump Case . . . . .	337
17.2	The General Case . . . . .	341
17.3	Exercises . . . . .	343
<b>18</b>	<b>Absolute Continuity of Probability Laws . . . . .</b>	<b>345</b>
18.1	Existence of Densities . . . . .	345
18.2	Smooth Densities of Solutions to SDE's Driven by Lévy Processes . . . . .	349
18.3	Exercises . . . . .	351
<b>Appendix A:</b>	<b>Malliavin Calculus on the Wiener Space . . . . .</b>	<b>353</b>
A.1	Preliminary Basic Concepts . . . . .	353
A.2	Wiener Space, Cameron–Martin Space, and Stochastic Derivative . . . . .	357
A.3	Malliavin Derivative via Chaos Expansions . . . . .	363
<b>Solutions</b>	<b>. . . . .</b>	<b>367</b>
<b>References</b>	<b>. . . . .</b>	<b>399</b>
<b>Notation and Symbols</b>	<b>. . . . .</b>	<b>411</b>
<b>Index</b>	<b>. . . . .</b>	<b>415</b>



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# Introduction

The mathematical theory now known as *Malliavin calculus* was first introduced by Paul Malliavin in [158] as an infinite-dimensional integration by parts technique. The purpose of this calculus was to prove the results about the smoothness of densities of solutions of stochastic differential equations driven by Brownian motion. For several years this was the only known application. Therefore, since this theory was considered quite complicated by many, Malliavin calculus remained a relatively unknown theory also among mathematicians for some time. Many mathematicians simply considered the theory as too difficult when compared with the results it produced. Moreover, to a large extent, these results could also be obtained by using Hörmander's earlier theory on hypoelliptic operators. See also, for example, [20, 114, 225, 230].

This was the situation until 1984, when Ocone in [173] obtained an explicit interpretation of the Clark representation formula [46, 47] in terms of the Malliavin derivative. This remarkable result later became known as the *Clark–Ocone formula*. Sometimes also called *Clark–Haussmann–Ocone formula* in view of the contribution of Haussmann in 1979, see [98]. In 1991, Ocone and Karatzas [174] applied this result to finance. They proved that the Clark–Ocone formula can be used to obtain explicit formulae for replicating portfolios of contingent claims in complete markets.

Since then, new literature helped to distribute these results to a wider audience, both among mathematicians and researchers in finance. See, for example, the monographs [53, 161, 169, 212, 216] and the introductory lecture notes [178]; see also [206].

The next breakthrough came in 1999, when Fournié et al. [81] obtained numerically tractable formulae for the computation of the so-called *greeks* in finance, also known as *parameters of sensitivity*. In the recent years, many new applications of the Malliavin calculus have been found, including partial information optimal control, insider trading and, more generally, anticipative stochastic calculus.

At the same time Malliavin calculus was extended from the original setting of Brownian motion to more general Lévy processes. This extensions were at



first motivated by and tailored to the original application within the study of smoothness of densities (see e.g. [12, 35, 37, 38, 44, 141, 142, 143, 163, 189, 190, 218, 219]) and then developed largely targeting the applications to finance, where Lévy processes based models are now widely used (see, e.g., [25, 29, 64, 69, 148, 171, 181]). Within this last direction, some extension to random fields of Lévy type has also been developed, see, for example, [61, 62]. Other extension of Malliavin calculus within quantum probability have also appeared, see, for example, [84, 85].

One way of interpreting the Malliavin derivative of a given random variable  $F = F(\omega)$ ,  $\omega \in \Omega$ , on the given probability space  $(\Omega, \mathcal{F}, P)$  is to regard it as a derivative with respect to the random parameter  $\omega$ . For this to make sense, one needs some mathematical structure on the space  $\Omega$ . In the original approach used by Malliavin, for the Brownian motion case,  $\Omega$  is represented as the *Wiener space*  $C_0([0, T])$  of continuous functions  $\omega : [0, T] \rightarrow \mathbb{R}$  with  $\omega(0) = 0$ , equipped with the uniform topology. In this book we prefer to use the representation of Hida [99], namely to represent  $\Omega$  as the *space  $S'$  of tempered distributions*  $\omega : \mathcal{S} \rightarrow \mathbb{R}$ , where  $\mathcal{S}$  is the Schwartz space of rapidly decreasing smooth functions on  $\mathbb{R}$  (see Chap. 5). The corresponding probability measure  $P$  is constructed by means of the Bochner–Minlos theorem. This is a classical setting of white noise theory. This approach has the advantage that the Malliavin derivative  $D_t F$  of a random variable  $F : S' \rightarrow \mathbb{R}$  can simply be regarded as a *stochastic gradient*.

In fact, if  $\gamma$  is deterministic and in  $L^2(\mathbb{R})$  (note that  $L^2(\mathbb{R}) \subset S'$ ), we define the *directional derivative of  $F$  in the direction  $\gamma$* ,  $D_\gamma F$ , as follows:

$$D_\gamma F(\omega) = \lim_{\varepsilon \rightarrow 0} \frac{F(\omega + \varepsilon \gamma) - F(\omega)}{\varepsilon}, \quad \omega \in S',$$

if the limit exists in  $L^2(P)$ . If there exists a process  $\Psi(\omega, t) : \Omega \times \mathbb{R} \rightarrow \mathbb{R}$  such that

$$D_\gamma F(\omega) = \int_{\mathbb{R}} \Psi(\omega, t) \gamma(t) dt, \quad \omega \in S'$$

for all  $\gamma \in L^2(\mathbb{R})$ , then we say that  $F$  is *Malliavin–Hida differentiable* and we define

$$D_t F(\omega) := \Psi(\omega, t), \quad \omega \in S'$$

as the *Malliavin–(Hida) derivative* (or *stochastic gradient*) of  $F$  at  $t$ .

This gives a simple and intuitive interpretation of the Malliavin derivative in the Brownian motion case. Moreover, some of the basic properties of calculus such as *chain rule* follow easily from this definition. See Chap. 6.

Alternatively, the Malliavin derivative can also be introduced by means of the *Wiener–Itô chaos expansion* [120]:

$$F = \sum_{n=0}^{\infty} I_n(f_n)$$