Numerical Stability of the Euler scheme for BSDEs

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joint work with
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Outline

Backward Sto. Diff. Eq. - Markovian Setting

- Decoupled Forward Backward SDE on $[0, T]$:

$$X_t = X_0 + \int_0^t b(X_s)\mathrm{d}s + \int_0^t \sigma(X_s)\mathrm{d}W_s$$
$$Y_t = g(X_T) + \int_t^T f(Y_s, Z_s)\mathrm{d}s - \int_t^T Z_s\mathrm{d}W_s$$

$\hookrightarrow$ b, σ, f and g are Lipschitz functions.

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- PDE representation: $Y_t = u(t, X_t)$, u solution to

$$-\partial_t u - \mathcal{L}_X u = f(u, \partial_x u\sigma) \quad \text{and} \quad u(T, .) = g\,.$$

If smoothness, $Z_t = \partial_x u(t, X_t)\sigma(t, X_t)\,.$

Non-linearity and finance

Example

The stock price is given by

$$X_t = X_0 + \int_0^t \mu X_s \mathrm{d}s + \int_0^t \sigma X_s \mathrm{d}W_s$$

The price of an european option with payoff g, assuming different rate for borrowing (R) and lending (r) is given by

$$Y_t = g(X_T) + \int_t^T (-rY_s + \frac{\mu - r}{\sigma} Z_s + (R-r)[Y_s - \frac{Z_s}{\sigma}]_-)\mathrm{d}s - \int_t^T Z_s \mathrm{d}W_s$$

$\hookrightarrow$ These are the dynamics of the value of the optimal hedging portfolio.

- Non-linearity coming from $f(y,z) = -ry + \frac{\mu - r}{\sigma} z + (R-r)[y - \frac{z}{\sigma}]_-$

Deriving the scheme

We are given an equidistant grid $\pi = \{0 = t_0 < ... < t_i < ... < t_n = T\}$, define $h = T/n$.

- Start with: $Y_{t_i} + \int_{t_i}^{t_{i+1}} Z_s \mathrm{d}W_s = Y_{t_{i+1}} + \int_{t_i}^{t_{i+1}} f(Y_s, Z_s)\mathrm{d}s \quad (1)$

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- *For the* Z*-part:*
  Multiply (1) by $\Delta W_i := W_{t_{i+1}} - W_{t_i}$, take conditional expectation:
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$$\hookrightarrow \quad Z_i := \mathbb{E}_{t_i}[H_i Y_{i+1}] \quad \text{with} \quad H_i := h^{-1}\Delta W_i\ .$$

Euler Scheme

- The Scheme: given the terminal condition $Y_n = g(X_n)$, the transition from step $i+1$ to i is

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- Goals: Understand the qualitative behaviour of the scheme in practice.

ODEs and BSDEs

- Things can go wrong already for ODEs: $y' = f(y)$ with $f(y) = -ay$, $a > 0$.

  Explicit Euler scheme satisfies: $y_n = (1 - ah)^n y_0$

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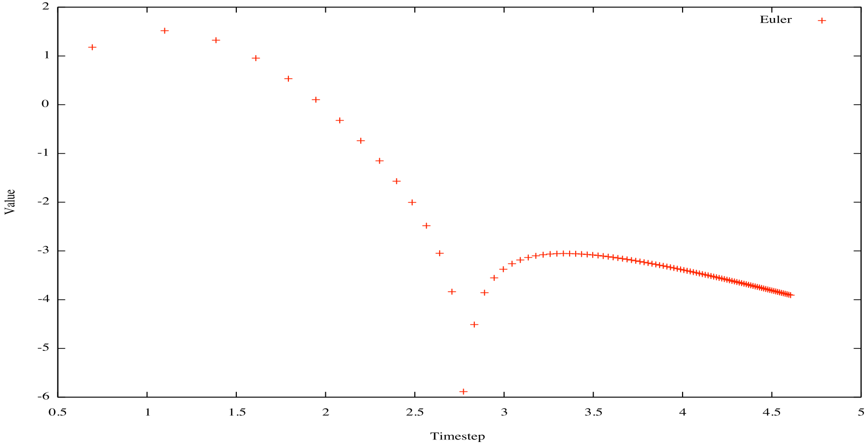
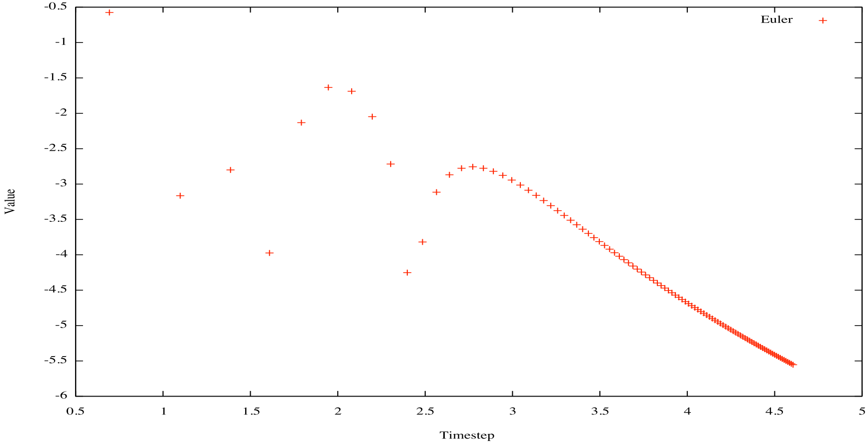
  $\bar{h} = \frac{2}{a}$ is a critical value.
- What happens in the 'pure' BSDEs setting?
  $\hookrightarrow$ We consider $f(Z) = bZ$ and $dim(Y) = dim(Z) = 1$.
  $\hookrightarrow$ The terminal condition is given by $\cos(\widehat{W}_T)$.
  $\hookrightarrow$ $\widehat{W}$ is a (recombining) trinomial tree for the brownian motion W.

$f(Z) = bZ$, $b = 5$, $T = 1$



$f(Z) = bZ,\ b = 1,\ T = 10$


Euler
Value
Timestep
-0.5
-1
-1.5
-2
-2.5
-3
-3.5
-4
-4.5
-5
-5.5
-6
0.5
1
1.5
2
2.5
3
3.5
4
4.5
5

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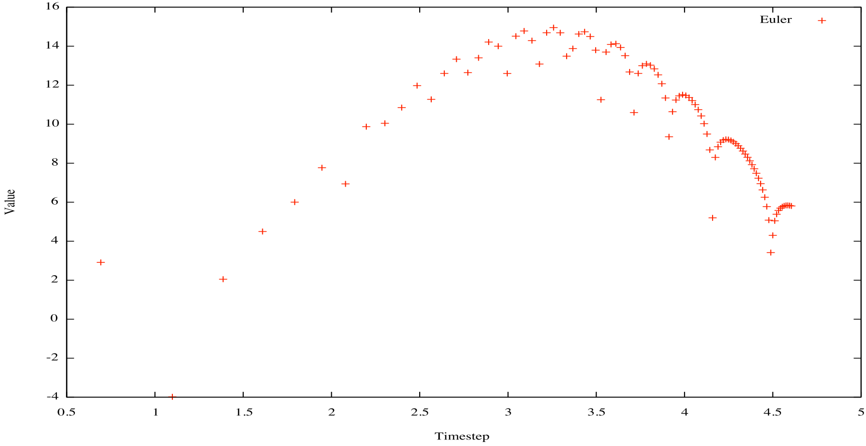
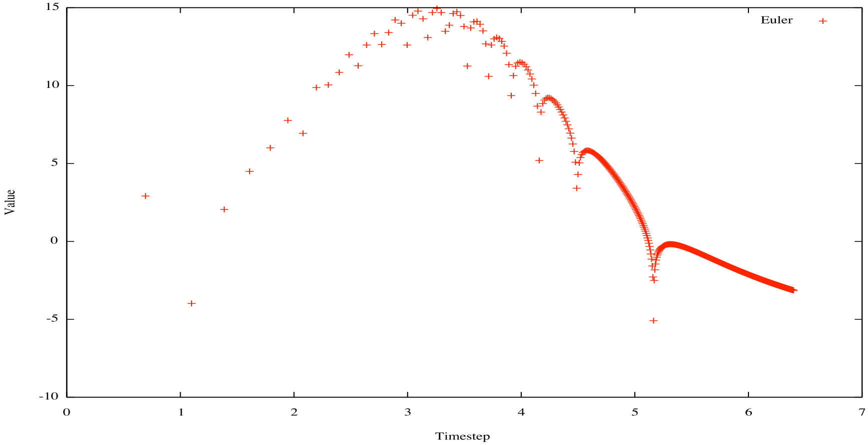


$f(Z) = bZ$, $b = 5$, $T = 10$, a lot of steps



Outline

Framework

We will discuss the two following schemes:

- BTZ-scheme 'Implicit' Euler:

$$Y_i := \mathbb{E}_{t_i}[Y_{i+1} + hf(Y_i, Z_i)]$$
$$Z_i := \mathbb{E}_{t_i}[H_i Y_{i+1}]$$

- 'Explicit' Euler:

$$Y_i := \mathbb{E}_{t_i}[Y_{i+1} + hf(Y_{i+1}, Z_i)]$$
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- $\mathbb{E}_{t_i}[H_i] = 0$, $\mathbb{E}_{t_i}\left[|H_i|^2\right] \leq \Lambda$, for some given $\Lambda > 0$.

Remarks

The analysis covers various types of schemes:

- Theoretical ones given in the introduction and $H_i := \frac{1}{h}(W_{t_{i+1}} - W_{t_i})$.
- Numerical scheme using trees e.g.
  (i) Trinomial:

$$\mathbb{P}(H_i = \pm\frac{3}{\sqrt{h}}) = \frac{1}{6}\,,\ \mathbb{P}(H_i = 0) = \frac{2}{3}.$$

  (ii) Binomial:

$$\mathbb{P}(H_i = \pm\frac{1}{\sqrt{h}}) = \frac{1}{2}.$$

$\hookrightarrow$ H_i is bounded.

Assumptions

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and

$$yf(y,0) \leq -l^Y |y|^2 \quad \textbf{(Mon)}$$

where L^Y, l^Y are non-negative real numbers.

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where L^Y, l^Y are non-negative real numbers.

- We also assume that f is Lipschitz continuous in z (uniformly) i.e.

$$|f(y,z) - f(y,z')| \le L^Z |z - z'| \,. \quad \textbf{(Lip z)}$$

Behaviour of the true solution

In our setting (Lip z + monotone y), if

- in the multidimensional case (for Y): $(L^Z)^2 \leq 2l^Y$, $\|\xi\|_\infty < \infty$
- in the one-dimensional case (for Y): simply $\|\xi\|_\infty < \infty$

then

$$|Y_t| \leq \|\xi\|_\infty .$$

(remark: for all T.)

Some Definitions

Let ξ be a bounded terminal condition (random).

- Numerical stability: We say that the scheme is numerically stable if there exists $h^* > 0$, such that for all $h \leq h^*$

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$\hookrightarrow$ In practice, we could expect 2 regimes for the scheme:

- $h < \bar{h}$: scheme returns a 'reasonable' value
- $h > \bar{h}$: scheme is unstable

Strict monotony ($l^Y > 0$) and one dimensional Y

Theorem

Assume that

$$1 - h^* \frac{|L^Y|^2}{2l^Y} - L^Z h^* \max_i |H_i| \geq 0 \tag{1}$$

then the scheme is numerically stable for the Y part.

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$\hookrightarrow$ Scheme based on binomial tree, Linear case: $f(y,z) = -ay + bz$.
the condition reads

$$\sqrt{h} \leq \sqrt{\left(\frac{b}{a}\right)^2 + \frac{2}{a}} - \frac{b}{a} > 0 \,.$$

Strict monotony ($l^Y > 0$) and multidimensional Y

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Assume that

$$1 - \frac{\left(L^Y \sqrt{h^*} + L^Z \sqrt{\Lambda}\right)^2}{2l^Y} \geq 0 \tag{2}$$

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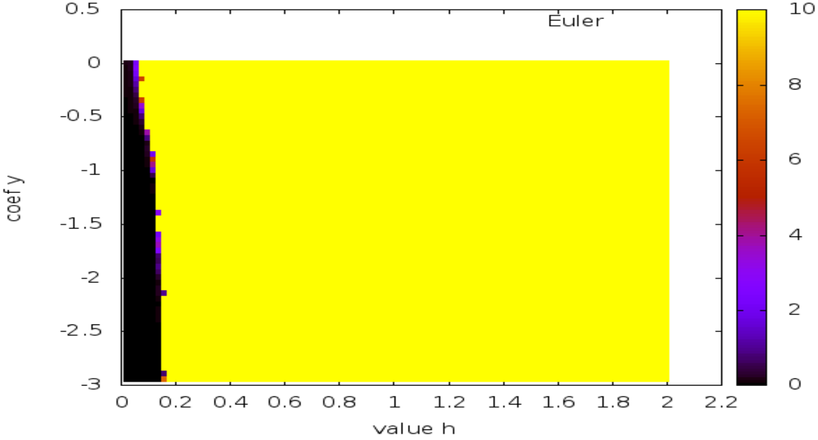
More restrictive condition.

Numerical illustration $f(y,z) = -ay + bz$, $b = 5$

Yellow = unstable, correct Y_0 value $\simeq 0$.



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One dimensional Y, possibly $l^Y = 0$

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$$h^* \leq \frac{1}{b^2} .$$

Sketch of proof

- Recall the scheme: $Y_i := \mathbb{E}_{t_i}[Y_{i+1} + hf(Z_i)]$ and $Z_i := \mathbb{E}_{t_i}[H_i Y_{i+1}]$

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- If $(1 + h\gamma_i H_i) \geq 0$,

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$$(1 + h\gamma_i H_i) \geq 0 \Longleftrightarrow 1 - \sqrt{h}|b| \geq 0.$$

- Comparison Theorem in this case.

Financial application

- Consider the model with two different interest rates and the following 'plausible' parameters:

$$r = 0.03,\ R = 0.06,\ \sigma = 0.4.$$

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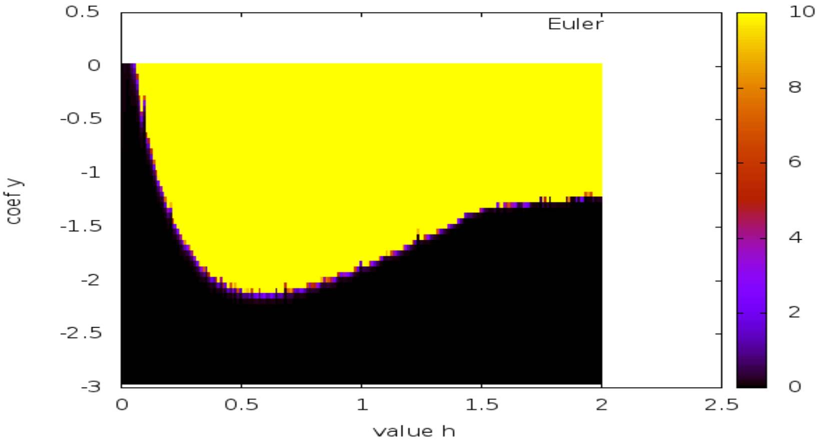
- Consider the model with two different interest rates and the following 'plausible' parameters:

$$r = 0.03, \; R = 0.06, \; \sigma = 0.4.$$

- then (for binomial tree), we get
  - Implicit scheme: A-stable!
  - Semi explicit scheme: $\bar{h} \geq 12$.

No worries, at least for $d = 1$...

Numerical illustration $-ay + bz$, $b = 5$



Outline

Von Neumann Stability Analysis: $f(y,z) = -ay + bz$

- $dim(Y) = 1$, Scheme given by *time discretization* only (i.e. $H_i = h^{-1}(W_{t_{i+1}} - W_{t_i})$ unbounded!).

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- $dim(Y) = 1$, Scheme given by *time discretization* only (i.e. $H_i = h^{-1}(W_{t_{i+1}} - W_{t_i})$ unbounded!).
- Definition: Scheme is 'VN stable' if for all $k \in \mathbb{R}$,

$$|Y_0| \leq 1 \quad \text{when} \quad \xi := e^{\mathbf{i}kW_T}$$

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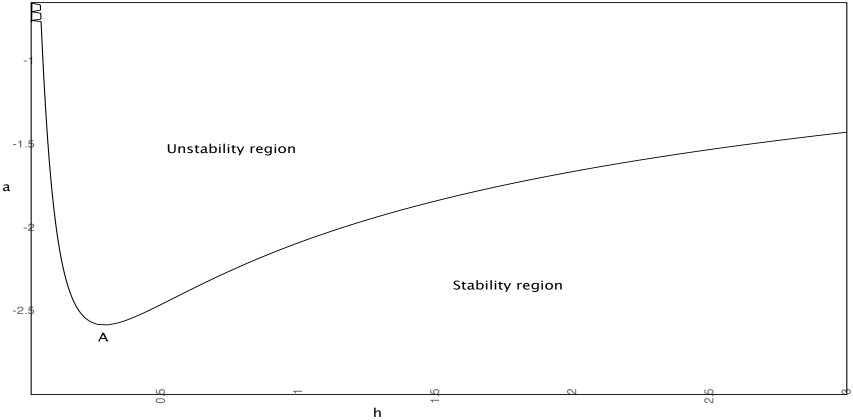
VN stability region - Implicit Scheme - b=5



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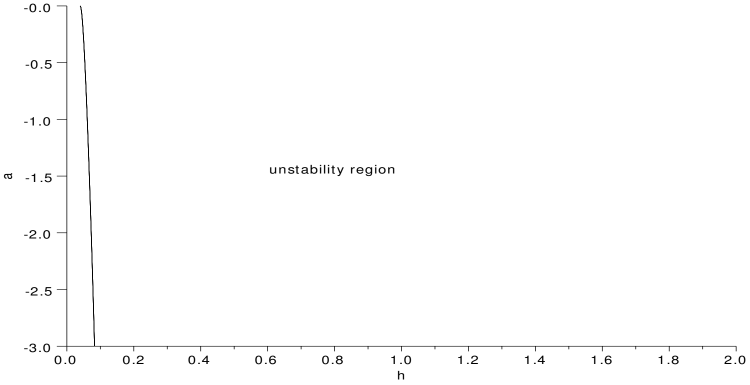

VN Stability - Empirical Scheme - Analysis, $f(y,z) = bz$

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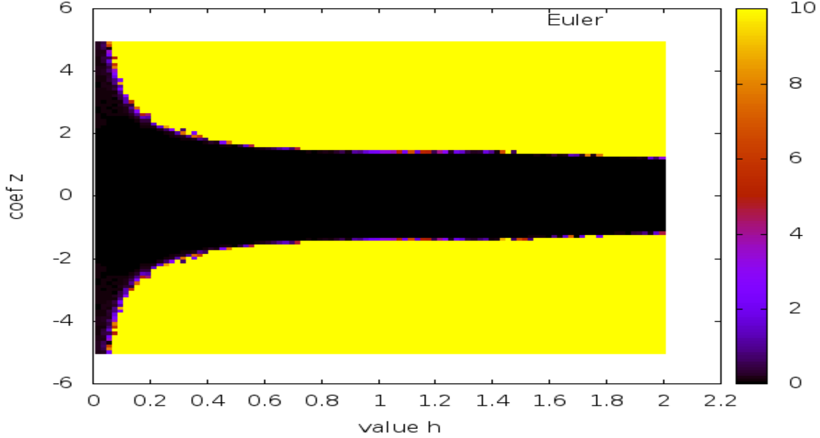
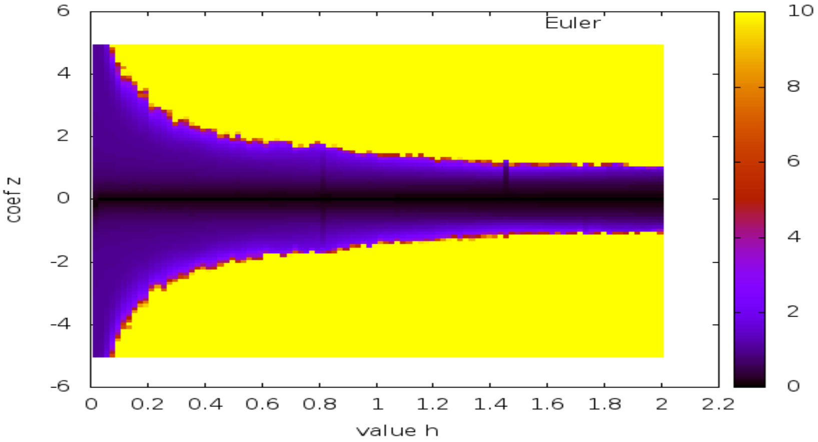
- Remark: observe that the dimension of b (so W) impacts the stability of the scheme.

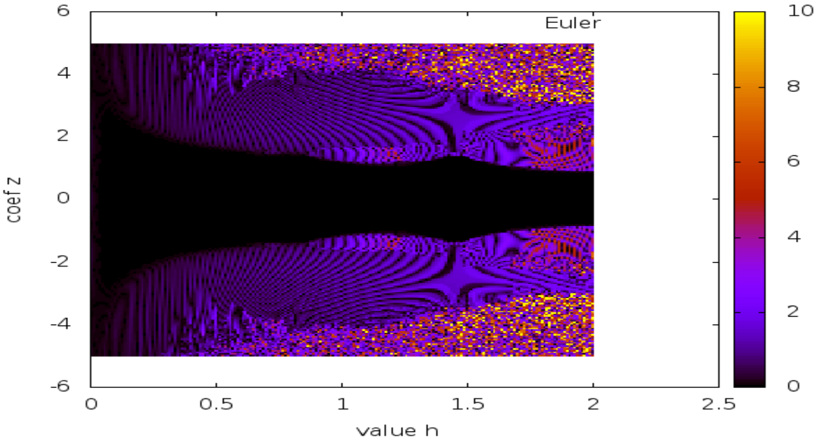
Numerical illustration $f(z) = bz$



Numerical illustration $f(z) = b|z|$



Numerical illustration $f(z) = sin(bz)$



Conclusion

- Above results hold true for US options.
- Convergent method for BSDEs with unbounded terminal time?
- Numerical stability condition for other schemes?
- Numerical experiments to run with other methods to compute conditional expectations, in greater dimension.

$f(z) = atan(bz)$