Existence and Comparisons for BSDEs in general spaces

Samuel N. Cohen
(joint work with Robert J. Elliott)

University of Oxford (University of Adelaide)

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Outline

Classical BSDEs

Classically, a BSDE is an equation of the form

$$Y_t - \int_{]t,T]} F(\omega, u, Y_u, Z_u)du + \int_{]t,T]} Z_u dW_u = Q$$

where the solution pair (Y, Z) is adapted, Z is predictable and Q is some $\mathcal{F}_T$-measurable random variable.

- My interest is on generalising these equations to allow for different types of filtrations and randomness.
- Various generalisations of the filtration have been done (eg Jump processes, Markov chains)
- Various generalisations of this structure are possible (eg delay equations, general semimartingale decompositions)
- I seek to retain the structure, but work in a general filtration.

BSDEs in Discrete time

My recent work has considered BSDEs in discrete time, finite state systems

$$Y_t - \sum_{t \leq u < T} F(\omega, u, Y_u, Z_u) + \sum_{t \leq u < T} Z_u \Delta M_{u+1} = Q.$$

where M is a $\mathbb{R}^N$-valued martingale defining the filtration

- Existence and comparison results can be obtained for these equations
- These equations form a complete representation of time-consistent nonlinear expectations on $L^0(\mathcal{F}_T)$.
- *Is there a way to unite this discrete time theory with the classical one?*

BSDEs in general spaces

- Today we will consider BSDEs where both the martingale and driver terms can jump.
- This will include, as special cases, both the discrete time and continuous time theory of BSDEs
- Very few assumptions are needed on the underlying probability space.

Our first step is to state a general form of the Martingale representation theorem...

Theorem (Davis & Varaiya 1974)

Let $(\Omega, \mathcal{F}_T, \{\mathcal{F}_t\}_{t\in[0,T]}, \mathbb{P})$ *be a filtered probability space. Suppose* $L^2(\mathcal{F}_T)$ *is separable. Then there exists a sequence of martingales* $M^1, M^2 \ldots$ *such that any martingale N can be written as*

$$N_t = N_0 + \sum_{i=1}^{\infty} \int_{]0,t]} Z_u^i dM_u^i$$

for some predictable processes Z^i*, and*

$$\langle M^1 \rangle \succ \langle M^2 \rangle \succ \ldots$$

as measures on $\Omega \times [0, T]$*.*

i.e. $\langle M^i \rangle(A) = E[\int_{[0,T]} I_A d\langle M^i \rangle]$ for $A \subseteq \Omega \times [0, T]$.

We need an appropriate norm for $\{Z^i\}_{i\in\mathbb{N}}$ under which to consider continuity of the driver F.

Definition

Let μ be a fixed deterministic nonnegative Stieltjes measure on $[0, T]$. For each $i \in \mathbb{N}$, let

$$\langle M^i\rangle_t = m_t^{i,1} + m_t^{i,2}$$

where $m^{i,1}$ (resp. $m^{i,2}$) is absolutely continuous (resp. singular) with respect to $\mathbb{P} \times \mu$, as measures on $\mathcal{P}$.
Then define $\|\cdot\|_{M_t}$, the stochastic seminorm on infinite $\mathbb{R}^K$-valued sequences, by

$$\|(z^1, z^2, ...)\|^2_{M_t} = \sum_{i=1}^{\infty} \|z^i\|^2 \frac{dm_t^{i,1}}{d(\mathbb{P} \times \mu_t)}.$$

This norm has some useful properties:

- If $\mu_t = t$ and $M_t^i = W_t$, then $\frac{dm_t^{i,1}}{d(\mathbb{P}\times\mu_t)} = 1$, and so $\|\mathbf{z}\|_{M_t} \equiv \|\mathbf{z}\|_{\ell_2}$.
- If the filtration has finite multiplicity, then all but finitely many of the M_t^i are zero, and this all degenerates to the Euclidean norm.
- If
$$\sum_i \int Z_t^i dM_t^i = \sum_i \int \tilde{Z}_t^i dM_t^i,$$
then $\|\mathbf{Z}_t - \tilde{\mathbf{Z}}_t\|_{M_t} = 0$, μ-a.e.
- No matter our choice of μ,
$$\int_{]t,T]} E\left[\|\mathbf{Z}_u\|_{M_u}^2\right] d\mu \leq E\left[\sum_i \int_{]t,T]} \|Z_t^i\|^2 d\langle M^i\rangle_t\right]$$

BSDEs in general spaces

Consider an equation of the form:

$$Y_t - \int_{]t,T]} F(\omega, u, Y_{u-}, \mathbf{Z}_u) d\mu + \sum_{i=1}^{\infty} \int_{]t,T]} Z_u^i dM_u^i = Q$$

where

- $Q \in L^2(\mathcal{F}_T)$,
- $Y \in \mathbb{R}^K$ is adapted and $\sup_{t\in[0,T]}\{\|Y_t\|^2\} < \infty$,
- $\mathbf{Z}_t \equiv (Z^1, Z^2, ...)$ is a sequence of predictable $\mathbb{R}^K$-valued processes such that $\mathbf{Z} \in \mathcal{H}_M^2$, that is

$$E\left[\sum_i \int_{]0,T]} \|Z_t^i\|^2 d\langle M^i\rangle_t\right] < \infty$$

BSDEs in general spaces

$$Y_t - \int_{]t,T]} F(\omega, u, Y_{u-}, \mathbf{Z}_u) d\mu + \sum_{i=1}^{\infty} \int_{]t,T]} Z^i_u dM^i_u = Q$$

Also,

- μ is a deterministic Stieltjes measure on $[0, T]$. For simplicity, assume μ is nonnegative.
- F is a progressively measurable function such that $F(\omega, t, 0, \mathbf{0})$ is μ-square-integrable.

Existence result

Theorem

Suppose F is firmly Lipschitz, that is, there exists a constant c and a map $c_{(\cdot)} : [0, T] \to [0, c]$ such that

$$\|F(\omega, t, y, \mathbf{z}) - F(\omega, t, y', \mathbf{z}')\|^2 \leq c_t \|y - y'\|^2 + c\|\mathbf{z} - \mathbf{z}'\|^2_{M_t}$$

and

$$c_t(\Delta\mu_t)^2 < 1.$$

Then the BSDE has a unique solution, (up to indistinguishability if $d\mu \succ dt$).

- As the discrete time BSDE can be embedded in continuous time, and the necessary and sufficient condition for existence in discrete time is that $y \mapsto y - F(\omega, t, y, z)$ is a bijection, the classical requirement of Lipschitz continuity is clearly insufficient.
- On the other hand, if μ is continuous, then these assumptions are simply classical Lipschitz continuity.
- By the use of the Radon-Nikodym theorem for measures on $\Omega \times [0, T]$, the requirement that μ is deterministic and nonnegative is somewhat flexible, as exceptions can be instead incorporated into F.

- From a mathematical perspective, this unites the theory of BSDEs in discrete and continuous time.
- From a modelling perspective, it allows us to build models without quasi-left-continuity.
  - For interest rate modelling, when central bank decisions are announced on certain dates.
  - For evaluating contracts where some counterparty decisions must be made on a certain date.
- Allowing these discontinuities is one step closer to a general semimartingale theory of BSDEs.

We now proceed to the proof of existence and uniqueness.

Definition (Stieltjes-Doleans-Dade Exponentials)

For any cadlag function of finite variation ν, let

$$\mathfrak{E}(\nu; t) = e^{\nu_t} \prod_{0 \leq s \leq t} (1 + \Delta\nu_s) e^{-\Delta\nu_s}.$$

and if $\Delta\nu_s < 1$ a.s.

$$\tilde{\nu}_t = \nu_t + \sum_{0 \leq s \leq t} \frac{(\Delta\nu_s)^2}{1 - \Delta\nu_s} \qquad \text{and} \qquad \mathfrak{E}(-\nu; t) = \mathfrak{E}(\tilde{\nu}; t)^{-1}.$$

Lemma (Backwards Grönwall inequality with jumps)

For semimartingales u, w, a finite-variation process ν with $\Delta\nu_s < 1$ a.s., if

$$du_t \geq -u_t d\nu_t + dw_t$$

then

$$d(u_t \mathfrak{E}(\tilde{\nu}; t)) \geq (1 - \Delta\nu_t)^{-1} \mathfrak{E}(\tilde{\nu}; t-) dw_t.$$

Lemma (Bound on BSDE solutions)

Let Y be a solution to a BSDE with firm Lipschitz driver, and let $Z \in \mathcal{H}^2_M$. Then $E[\sup_{t\in[0,T]}\{\|Y_t\|^2\}] < \infty$ if and only if

$$\int_{]0,T]} E[\|Y_{t-}\|^2] d\mu < \infty.$$

Lemma (BSDEs, no dependence on $Y, \mathbf{Z}$)

Let $F : \Omega \times [0, T] \to \mathbb{R}^K$. Then a BSDE with driver F has a solution.

Proof.

Simple application of martingale representation theorem. $\square$

Bound on solutions

Assume $\mu_T \leq 1$ and $c_t\Delta\mu_t < 1$. We have the following bound:

Lemma

For two BSDEs with solutions Y, Y', etc. let $\delta Y := Y - Y'$, $\delta \mathbf{Z} := \mathbf{Z} - \mathbf{Z}'$, $\quad \delta_2 f_t = F(\omega, t, Y'_{t-}, \mathbf{Z}'_t) - F'(\omega, t, Y'_{t-}, \mathbf{Z}'_t)$. For meas. $x, w : [0, T] \to [0, \infty]$ with $\Delta\mu_t \leq x_t^{-1}$, any $A \in \mathcal{B}([0, T])$,

$$\begin{aligned}\int_A dE[\|\delta Y_t\|^2] \geq - \int_A E[\|\delta Y_t\|^2] d\upsilon_t - \int_A E[\|\delta_2 f_t\|^2](1 - \Delta\upsilon_t) d\pi_t \\ + E\left[\sum_i \int_A \|\delta {Z^i}_t\|^2 (1 - \Delta\upsilon_t) d\rho^i_t\right].\end{aligned}$$

$$\begin{aligned}d\upsilon_t &= [(x_t^{-1} - \Delta\mu_t)(1 + w_t)c_t + x_t] d\mu_t \\ d\pi_t &= [(x_t^{-1} - \Delta\mu_t)(1 + w_t^{-1})](1 - \Delta\upsilon_t)^{-1} d\mu_t \\ d\rho^i_t &= [1 - (x_t^{-1} - \Delta\mu_t)(1 + w_t)c](1 - \Delta\upsilon_t)^{-1} d\langle M^i\rangle_t\end{aligned}$$

Sketch proof of existence theorem

- Under the assumption $\mu_T \leq 1$, and $c_t(\Delta\mu_t) < 1$,
  - Note that as $c_t(\Delta\mu_t)$ is summable and strictly bounded by 1, it is bounded by $1 - \epsilon$
  - Use Picard iteration on Z, (easy, convergence in equivalent norm at rate $1/2$)
  - Then iterate on Y, (harder, convergence rate $1 - \epsilon^2/8$)
- Use a measure-change argument to separate $[0, T]$ into a finite sequence of pieces of size < 1, use backward induction to establish result.
  - This also relaxes to assuming $c_t(\Delta\mu_t)^2 < 1$.

Comparison results

With our existence theory, we now wish to be able to compare solutions to BSDEs.

- As our martingales can jump, we need to be careful.
- A comparison result is closely related to a nonlinear no-arbitrage result, so similar language may be helpful.

For simplicity, we shall consider the scalar case only.

Balanced drivers

Definition

Let F be such that for any square-integrable Y, any $\mathbf{Z}, \mathbf{Z}' \in \mathcal{H}^2_M$,

$$- \int_{]0,t]} [F(\omega, u, Y_{u-}, \mathbf{Z}_u) - F(\omega, u, Y_{u-}, \mathbf{Z}'_u)] d\mu_u \\ + \sum_i \int_{]0,t]} [(Z)^i_u - (Z')^i_u] dM^i_u$$

has an equivalent martingale measure. Then F shall be called *balanced*.

Classically, this can be shown through a Girsanov transformation.

Comparison Theorem

Theorem

Let $(Y, \mathbf{Z})$ and $(Y', \mathbf{Z}')$ be the solutions to two BSDEs with drivers F, F' and terminal conditions Q, Q'. Then if

- $Q \geq Q'$ *a.s.*
- $F(\omega, t, Y'_{t-}, Z'_t) \geq F'(\omega, t, Y'_{t-}, Z'_t)$ $\mu \times \mathbb{P}$-*a.s. and*
- *F is balanced*

It follows that $Y_t \geq Y'_t$ for all t. The strict comparison also applies.

Sketch proof

Omit ω, t for clarity. Decompose $Y - Y'$ into the differences based on

- $Q - Q'$ (nonnegative),
- $F(Y', \mathbf{Z}') - F'(Y', \mathbf{Z}')$ (nonnegative),
- $F(Y', \mathbf{Z}) - F(Y', \mathbf{Z}')$ (equivalent martingale measure),
- $F(Y, \mathbf{Z}) - F(Y', \mathbf{Z})$ (remainder).

By assumption and the existence of a martingale measure $\tilde{\mathbb{P}}$, this implies

$$Y_t - Y'_t - E_{\tilde{\mathbb{P}}}\left[\int_{]t,T]} F(Y_{u-}, \mathbf{Z}_u) - F(Y'_{u-}, \mathbf{Z}_u) d\mu \middle| \mathcal{F}_t\right] \geq 0$$

Lipschitz continuity and a growth bound yields the result.

- These conditions are the natural extension of the requirements in discrete time, which can be shown to be (loosely) necessary for the general result to hold.
- As the comparison theorem is the non-linear version of a no-Arbitrage result, it is natural to think of it in terms of equivalent-martingale-measures.
- This also indicates that, perhaps with generalisation to local- or σ-martingales, it may be the most general condition to use.
- The various classical examples of the comparison theorem can all be seen to be special cases of this requirement.

Nonlinear Expectations

We can now construct examples of nonlinear expectations in these general probability spaces.

Theorem

Let F be a firmly Lipschitz driver. Define $\mathcal{E}_t(Q) = Y_t$, where Y is the solution to the BSDE with driver F, terminal value Q. Then

- $\mathcal{E}_s(\mathcal{E}_t(Q)) = \mathcal{E}_s(Q)$ *for all* $t \geq s$.
- $I_A\mathcal{E}_t(I_A Q) = I_A\mathcal{E}_t(Q)$ *for all* $A \in \mathcal{F}_t$.
- *If F is balanced, then $Q \geq Q'$ a.s. implies $\mathcal{E}_t(Q) \geq \mathcal{E}_t(Q')$.*
- *If $F(\omega, t, y, \mathbf{0}) = 0$ then $\mathcal{E}_t(Q) = Q$ for all $Q \in L^2(\mathcal{F}_t)$.*
- *If F is independent of y, then $\mathcal{E}_t(Q + q) = \mathcal{E}_t(Q) + q$ for all $q \in L^2(\mathcal{F}_t)$.*
- *If F is balanced and concave, then $\mathcal{E}$ is concave.*

Conclusions

We have presented a theory of BSDEs in general probability spaces

- Our only assumption is that $L^2(\mathcal{F}_T)$ is separable.
- This unites the discrete and continuous theories of BSDEs.
- We have conditions for existence of unique solutions of BSDEs in this context, based on Lipschitz continuity.
- We have a version of the comparison theorem for this situation.
- This allows modelling of various situations with less continuity than classically required.