Two Price Valuation with Applications to Actuarial Problems

Ernst Eberlein

Department of Mathematical Stochastics
and
Center for Data Analysis and Modeling (FDM)
University of Freiburg

Joint work with Dilip Madan, Martijn Pistorius, Wim Schoutens, and Marc Yor

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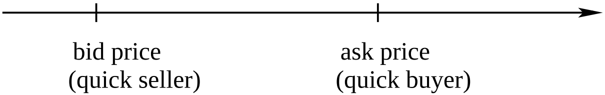
Law of one Price

In complete markets and for liquid assets

$$E^Q[X]$$

Reality however is incomplete and liquidity might be poor



Example for a Two Price Evaluation

Consider a public debt obligation (e.g. Greek government bond)

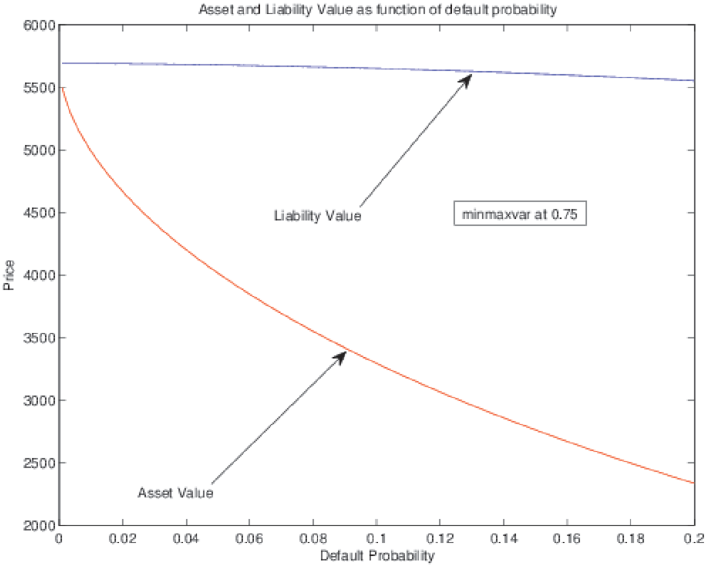
Possibility of default or other causes of illiquidity:
The lender (buyer) has to discount the value of the loan or bond
$\longrightarrow$ bid price

The borrower (issuer of debt) does not contemplate default:
For him the obligation is risk free $\longrightarrow$ ask price

At maturity: convergence of bid and ask

Consequences:
- Bid price will vary with the changes in the borrower's credit status
- Ask price will remain relatively steady

Further fact: Opponent of trade depends on the direction of the trade


Asset and Liability Value as function of default probability
6000
5500
5000
4500
4000
3500
3000
2500
2000
Price
0
0.02
0.04
0.06
0.08
0.1
0.12
0.14
0.16
0.18
0.2
Default Probability
Liability Value
minmaxvar at 0.75
Asset Value

Acceptability of Cashflows

Outcome (cashflow) of a risky position: X random variable

In complete and perfectly liquid markets: unique pricing kernel given by a probability measure Q

value of the position:	$E^Q[X]$
position is acceptable if:	$E^Q[X] \geq 0$
company's objective is:	maximize $E^Q[X]$

Real markets:

Instead of a unique probability measure Q we have to consider a set of probability measures (scenarios) $Q \in \mathcal{M}$

$$E^Q[X] \geq 0 \quad \text{for all } Q \in \mathcal{M} \qquad \text{or} \qquad \inf_{Q \in \mathcal{M}} E^Q[X] \geq 0$$

Coherent Risk Measures

Specification of $\mathcal{M}$ (test measures, generalized scenarios)

Axiomatic theory of risk measures: desirable properties

Monotonicity: $X \geq Y \Longrightarrow \varrho(X) \leq \varrho(Y)$

Cash invariance: $\varrho(X + c) = \varrho(X) - c$

Scale invariance: $\varrho(\lambda X) = \lambda \varrho(X), \quad \lambda \geq 0$

Subadditivity: $\varrho(X + Y) \leq \varrho(X) + \varrho(Y)$

Examples: Value at Risk (VaR)

Tail-VaR (expected shortfall)

General risk measure: $\varrho_m(X) = -\int_0^1 q_u(X) m(du)$

Any coherent risk measure has a representation

$$\varrho(X) = -\inf_{Q \in \mathcal{M}} E^Q[X]$$

Operationalization

Link between acceptability and concave distortions
(Cherny and Madan (2009))

$\rightarrow$ Concave distortions

Assume acceptability is completely defined by the distribution function of the risk

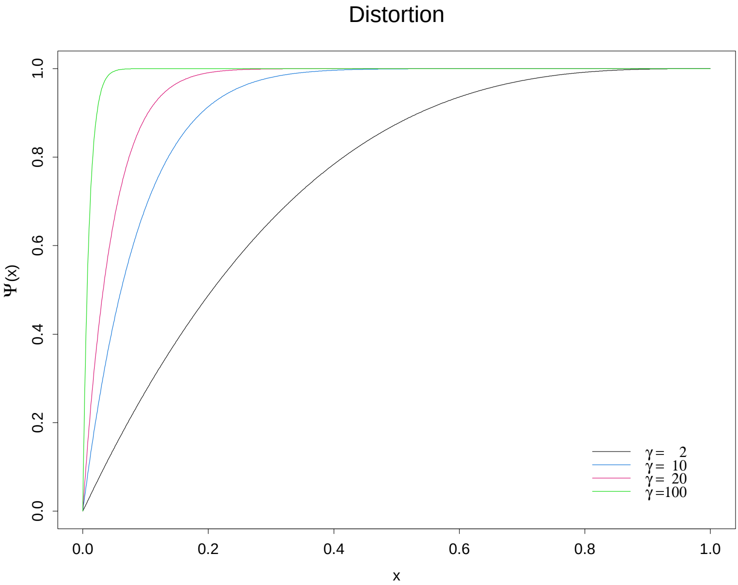
$\Psi(u)$: concave distribution function on $[0, 1]$

$\Rightarrow$ $\mathcal{M}$ the set of supporting measures is given by all measures Q with density $Z = \frac{dQ}{dP}$ s.t.

$$E^P[(Z-a)^+] \leq \sup_{u \in [0,1]} (\Psi(u) - ua) \quad \text{for all } a \geq 0$$

Acceptability of X with distribution function $F(x)$

$$\int_{-\infty}^{+\infty} x d\Psi(F(x)) \geq 0$$


Distortion
1.0
0.8
0.6
0.4
0.2
0.0
Ψ(x)
0.0
0.2
0.4
0.6
0.8
1.0
x
γ = 2
γ = 10
γ = 20
γ =100

Families of Distortions (1)

Consider families of distortions $(\Psi^{\gamma})_{\gamma \geq 0}$

γ stress level

Example: MIN VaR

$$\Psi^{\gamma}(x) = 1 - (1-x)^{1+\gamma} \qquad (0 \leq x \leq 1, \gamma \geq 0)$$

Statistical interpretation:

Let γ be an integer, then $\varrho_{\gamma}(X) = -E(Y)$ where

$$Y \overset{\text{law}}{=} \min\{X_1, \ldots, X_{\gamma+1}\}$$

and $X_1, \ldots, X_{\gamma+1}$ are independent draws of X

Families of Distortions (2)

Further examples: MAX VaR

$$\Psi^{\gamma}(x) = x^{\frac{1}{1+\gamma}} \quad (0 \leq x \leq 1, \gamma \geq 0)$$

Statistical interpretation: $\varrho_{\gamma}(X) = -E[Y]$

where Y is a random variable s.t.

$$\max\{Y_1, \ldots, Y_{\gamma+1}\} \stackrel{\text{law}}{=} X$$

and $Y_1, \ldots, Y_{\gamma+1}$ are independent draws of Y.

Combining MIN VaR and MAX VaR: MAX MIN VaR

$$\Psi^{\gamma}(x) = (1-(1-x)^{1+\gamma})^{\frac{1}{1+\gamma}} \qquad (0 \leq x \leq 1, \gamma \geq 0)$$

Interpretation: $\varrho_{\gamma}(X) = -E[Y]$ with Y s.t.

$$\max\{Y_1, \ldots, Y_{\gamma+1}\} \stackrel{\text{law}}{=} \min\{X_1, \ldots, X_{\gamma+1}\}$$

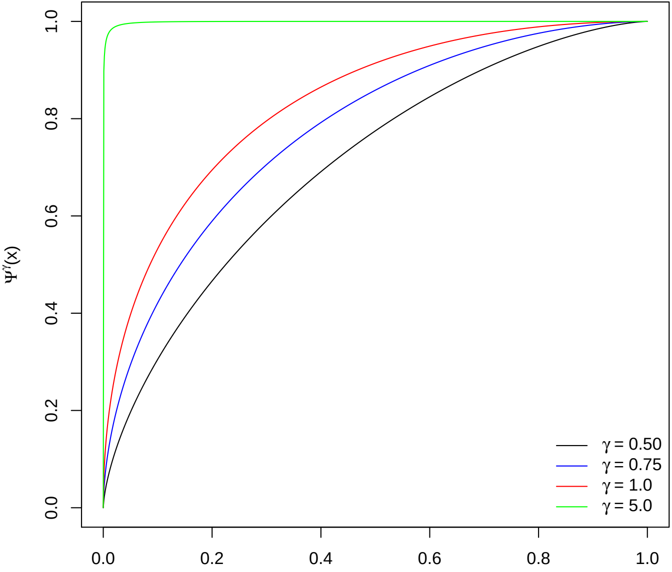
Families of Distortions (3)

Distortion used: MIN MAX VaR

$$\Psi^{\gamma}(x) = 1 - \left(1 - x^{\frac{1}{1+\gamma}}\right)^{1+\gamma} \qquad (0 \le x \le 1, \gamma \ge 0)$$

$\varrho_{\gamma}(X) = -E[Y]$ with Y s.t. $Y \overset{\text{law}}{=} \min\{Z_1, \ldots, Z_{\gamma+1}\}$,
$\max\{Z_1, \ldots, Z_{\gamma+1}\} \overset{\text{law}}{=} X$

Families of Distortions (4)



Marking Assets and Liabilities

Assets: Cash flow to be received $X \geq 0$

Largest value $b(X)$ s.t. $X - b(X)$ is acceptable

$$\Rightarrow \quad b(X) = \inf_{Q \in \mathcal{M}} E^Q[X]$$

Bid price or Lower price

Liabilities: Cash flow to be paid out $X \geq 0$

Smallest value $a(X)$ s.t. $a(X) - X$ is acceptable

$$\Rightarrow \quad a(X) = \sup_{Q \in \mathcal{M}} E^Q[X]$$

Ask price or Upper price

Directional Prices in a Two Price Economy

The goal is not to get a single risk neutral price which could be interpreted as a midpoint between bid and ask

Instead modeling two separate prices at which transactions occur
$\longrightarrow$ directional prices

Bid price: Minimal conservative valuation s.t. the expected outcome will safely exceed this price

Ask price: Maximal valuation s.t. the expected payout will fall below this price

$\longrightarrow$ specification of the set of valuation possibilities

Relating Bid and Ask Prices

Consider real-valued cashflows X, e.g. swaps

$$X = X^+ - X^-$$

$$\Rightarrow \qquad b(X) = b(X^+) - a(X^-)$$

$$\text{and} \qquad a(X) = a(X^+) - b(X^-)$$

Valuation as asset: X^+ is an asset and priced at the bid
X^- is a liability and priced at the ask

Valuation as liability: X^- is an asset and priced at the bid
X^+ is a liability and priced at the ask

Explicit Bid and Ask Pricing

Bid Price of a cash flow X: Acceptability of $X - b(X)$

$$b(X) = \int_{-\infty}^{\infty} x d\Psi(F_X(x))$$

Ask Price of a cash flow X: Acceptability of $a(X) - X$

$$a(X) = -\int_{-\infty}^{\infty} x d\Psi(1 - F_X(-x))$$

Examples: Calls and Puts

$$\begin{aligned}
bC(K,t) &= \int_K^{\infty} \big(1 - \Psi(F_{S_t}(x))\big) dx \\
aC(K,t) &= \int_K^{\infty} \Psi(1 - F_{S_t}(x)) dx \\
bP(K,t) &= \int_0^{K} \big(1 - \Psi(1 - F_{S_t}(x))\big) dx \\
aP(K,t) &= \int_0^{K} \Psi(F_{S_t}(x)) dx
\end{aligned}$$

Continuous Time Theory

Underlying uncertainty given by a pure jump Lévy process $(X_t)_{0\leq t\leq T}$

Specified by: drift term α, Lévy measure $k(y)dy$ $(y \neq 0)$

Example: Variance gamma

$$k(y) = \frac{C}{|y|}(\exp(-G|y|)1_{\{y<0\}} + \exp(-M|y|)1_{\{y>0\}})$$

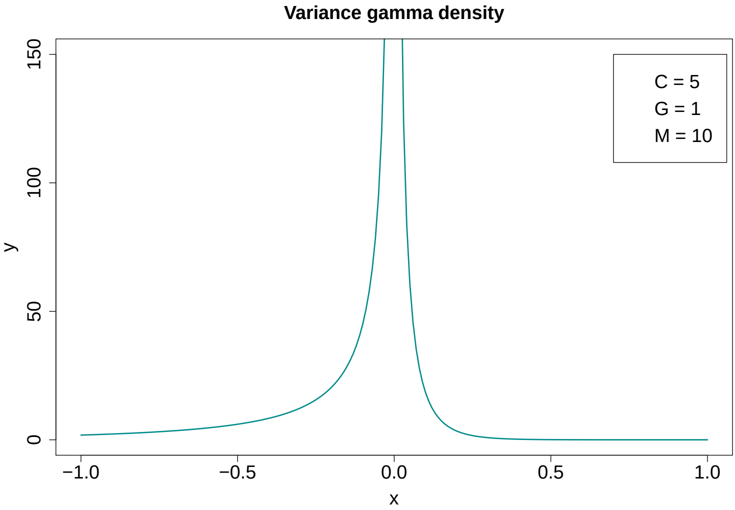
Note that

$$\int_{\mathbb{R}} y^2 k(y)dy < \infty$$

Infinitesimal generator $\mathcal{L}$ of the process

$$\mathcal{L}u(x) = \alpha \frac{\partial u}{\partial x}(x) + \int_{\mathbb{R}} \left(u(x+y) - u(x) - \frac{\partial u}{\partial x}(x)y \right) k(y)dy$$


GH Levy process with marginal densities
values of GH (-0.5,100,0,1,0.1) Levy process
100.6
100.4
100.2
100.0
99.8
0.0
0.5
1.0
1.5
2.0
t


Variance gamma density
C = 5
G = 1
M = 10
y
150
100
50
0
−1.0
−0.5
0.0
0.5
1.0
x

Valuation of Financial Contracts

Consider a claim which pays $\phi(X_t)$ at time t

Denote by $u(x,t)$ its time zero value when $X_0 = x$

$\Rightarrow \quad u(x,t) = E\left[e^{-rt}\phi(X_t) \mid X_0 = x\right]$

risk-neutral value
for constant interest rate r

$u(x,t)$ is at the same time the solution of the partial integro-differential equation (PIDE)

$$u_t = \mathcal{L}(u) - ru$$

with boundary condition $u(x,0) = \phi(x)$

$\mathcal{G}$-Expectations Using Distortions (1)

Remember: Higher weight on unfavorable states
Lower weight on favorable states

Integral part of the PIDE

$$\int_{\mathbb{R}} \underbrace{\frac{(u(x+y,t)-u(x,t)-u_x(x,t)y)\int_{\mathbb{R}} y^2 k(y)dy}{y^2}}_{=:Y_{x,t}} g(y)dy$$

where $g(y) = \dfrac{y^2 k(y)}{\int_{\mathbb{R}} y^2 k(y)dy}$

$\rightarrow$ g is a probability density

Define the distribution function

$$F_{Y_{x,t}}(v) = \int_{A(x,t,v)} g(y)dy$$

where $A(x,t,v) = \{y \mid Y_{x,t} \leq v\}$

$\mathcal{G}$-Expectations Using Distortions (2)

Integral part of the PIDE is now

$$\int_{\mathbb{R}} v dF_{Y_{x,t}}(v)$$

Distorted expectation

$$\int_{\mathbb{R}} v d\Psi(F_{Y_{x,t}}(v))$$

which by decomposition can be written as

$$-\int_{-\infty}^{0} \Psi(P^g(Y_{x,t} \leq v))dv + \int_{0}^{\infty} (1 - \Psi(P^g(Y_{x,t} \leq v)))dv$$

Define the new (distorted) operator

$$\mathcal{G}_{QV} u(x) = \alpha \frac{\partial u}{\partial x}(x) - \int_{-\infty}^{0} \Psi(P^g(Y_{x,t} \leq v))dv + \int_{0}^{\infty} (1 - \Psi(P^g(Y_{x,t} \leq 0)))dv$$

and solve the (distorted) PIDE

$$u_t = \mathcal{G}_{QV}(u) - ru$$

Alternative $\mathcal{G}$-Expectation Approach

Truncation of the Lévy measure

$$\int_{\{|y|\geq\epsilon\}} \big(u(x+y,t)-u(x,t)-u_x(x,t)y\big)k(y)dy$$

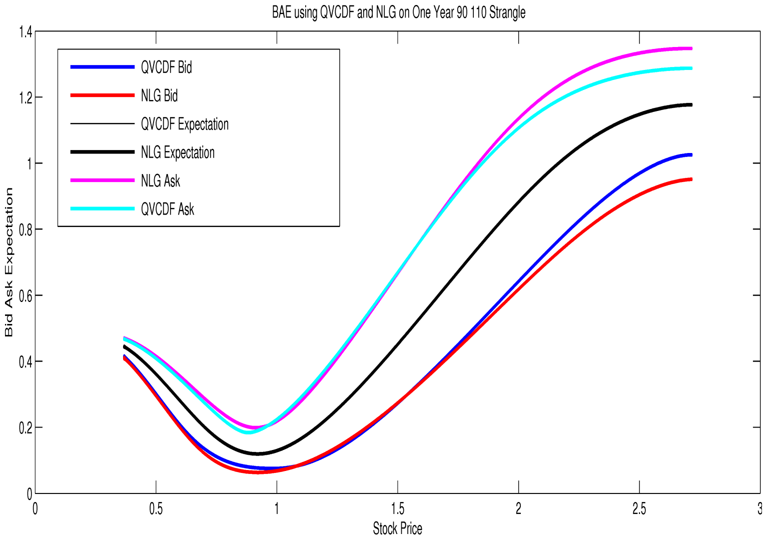
Definition of a probability density $h(y)$ via

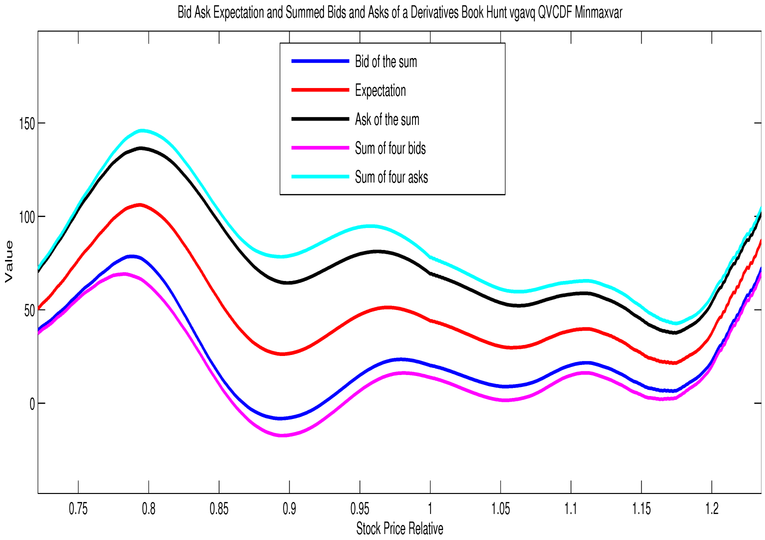
$$\int_{\{|y|\geq\epsilon\}} \underbrace{(u(x+y,t)-u(x,t)-u_x(x,t)y)\left(\int_{\{|y|\geq\epsilon\}} k(y)dy\right)}_{=:\tilde{Y}_{x,t}} h(y)dy$$

where $h(y) = \dfrac{k(y)}{\int_{\{|y|\geq\epsilon\}} k(y)dy} \mathbb{1}_{\{|y|\geq\epsilon\}}$

The distorted operator is now

$$\mathcal{G}_{NL}u(x) = \alpha\frac{\partial u}{\partial x}(x) - \int_{-\infty}^{0} \Psi(P^h(\tilde{Y}_{x,t}\leq v))dv + \int_0^\infty (1-\Psi(P^h(\tilde{Y}_{x,t}\leq v)))dv$$


BAE using QVCDF and NLG on One Year 90 110 Strangle
QVCDF Bid
NLG Bid
QVCDF Expectation
NLG Expectation
NLG Ask
QVCDF Ask
Bid Ask Expectation
Stock Price
0
0.2
0.4
0.6
0.8
1
1.2
1.4
0.5
1.5
2
2.5
3


Bid Ask Expectation and Summed Bids and Asks of a Derivatives Book Hunt vgavq QVCDF Minmaxvar
Bid of the sum
Expectation
Ask of the sum
Sum of four bids
Sum of four asks
Value
150
100
50
0
0.75
0.8
0.85
0.9
0.95
1
1.05
1.1
1.15
1.2
Stock Price Relative

Perpetuities

The discounted variance gamma model

$\gamma_p(t)$, $\gamma_n(t)$ two independent standard gamma processes

Driving process

$$X(t) = \int_0^t b_p e^{-rs} d\gamma_p(c_p s) - \int_0^t b_n e^{-rs} d\gamma_n(c_n s)$$

$b_p, c_p, b_n, c_n > 0$ scale and shape parameters of the undiscounted gamma processes

Discounted stock price

$$M(t) = \exp(X(t) + \omega(t))$$

where $\exp(\omega(t)) = (E[\exp(X(t))])^{-1}$

$\rightarrow$ uniformly integrable martingale with a well-defined limit

$$M(\infty) = \exp(X(\infty) + \omega(\infty))$$

Valuation of Perpetuities

Consider now a claim promising at infinity $F(M(\infty))$ where the payout is expressed in time zero dollars (F 'nice' function)

Value of the claim at time t

$$w_F(t) = E[F(M(\infty)) \mid \mathcal{F}_t]$$

$\rightarrow$ martingale

Observe now that

$$\begin{aligned} X(\infty) &= X(t) + \int_t^\infty b_p e^{-ru} d\gamma_p(c_p u) - \int_t^\infty b_n e^{-ru} d\gamma_n(c_n u) \\ &\stackrel{(d)}{=} X(t) + e^{-rt} Y \end{aligned}$$

for an independent random variable $Y \sim X(\infty)$

$\Rightarrow$
$$w_F(t) = H(X(t), e^{-rt})$$

Bid and Ask Prices (1)

Martingale condition on $w_F(t)$ (write $v = e^{-rt}$)

$$-rvH_v + \int_{-\infty}^{-\infty} (H(X+y,v) - H(X,v))k(y,v)dy = 0$$

PIDE with boundary condition

$$H(X,0) = F(\exp(X(\infty) + \omega(\infty)))$$

where

$$k(y,v) = \frac{c_p}{y} \exp\left(-\frac{y}{b_p v}\right) \mathbb{1}_{\{y>0\}} + \frac{c_n}{|y|} \exp\left(-\frac{|y|}{b_n v}\right) \mathbb{1}_{\{y<0\}}$$

Bid and Ask Prices (2)

Rewrite the PIDE

$$rvH_v = \int_{-\infty}^{+\infty} \frac{(H(X+y,v) - H(X,v)) \int_{-\infty}^{+\infty} y^2 k(y,v)dy}{y^2} dF_{QV}(y)$$

where

$$F_{QV}(a) = \frac{1}{\int_{-\infty}^{+\infty} y^2 k(y,v)dy} \int_{-\infty}^{a} y^2 k(y,v)dy$$

Bid price is the solution of the distorted PIDE

$$rvH_v = \int_{-\infty}^{+\infty} \frac{(H(X+y,v) - H(X,v)) \int_{-\infty}^{+\infty} y^2 k(y,v)dy}{y^2} d\Psi^{\gamma}(F_{QV}(y))$$

Ask price: Negative of the bid price of the negative cash flow

Implementation Details

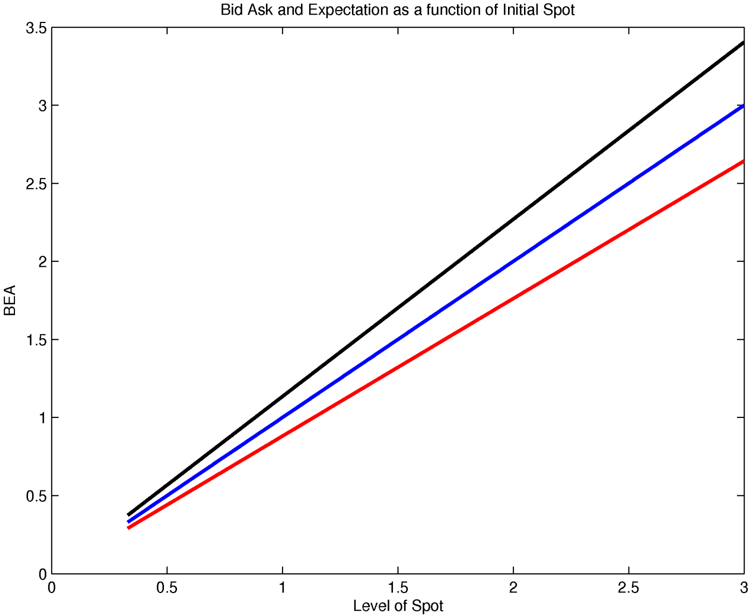
Risk neutral parameters from S & P 500

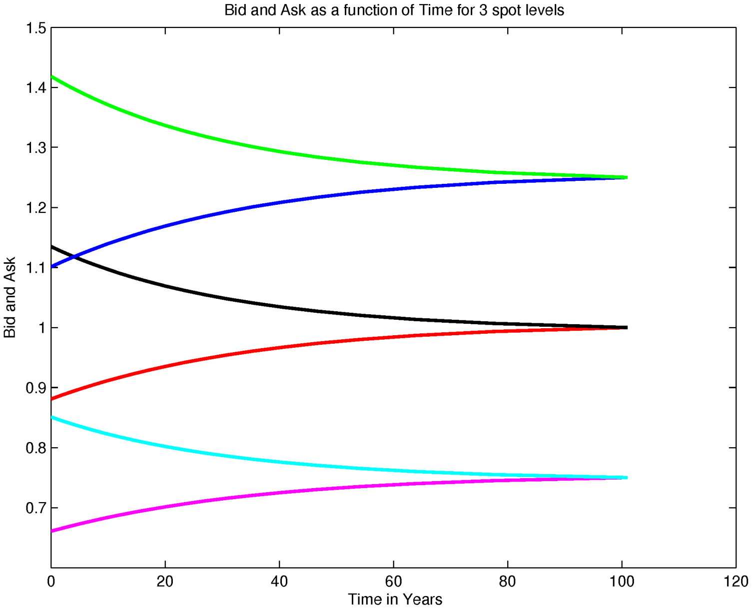
$$r = 0.02966 \qquad b_p = 0.0145 \qquad c_p = 48.4215$$

$$b_n = 0.5707 \qquad c_n = 0.3493$$

Actually solved for a PIDE in $M(t)$:

$$G(M(v), v) = M(v) \exp\Big(\omega(\infty) - \omega\Big(-\frac{\ln v}{r}\Big)\Big)\phi_Y(-iv)$$


Bid Ask and Expectation as a function of Initial Spot
BEA
Level of Spot
0
0.5
1
1.5
2
2.5
3
3.5


Bid and Ask as a function of Time for 3 spot levels
Bid and Ask
Time in Years
1.5
1.4
1.3
1.2
1.1
1
0.9
0.8
0.7
0
20
40
60
80
100
120

Two Price Valuation of Insurance Losses (1)

Cumulated loss process $L(t)$: e.g. compound Poisson (arrival rate λ)

Loss sizes are iid γ-distributed (scale and shape parameters ζ and κ)

Consider the value process in time zero dollars

$$V(t) = E_t\Big[\int_0^\infty e^{-rs} dL(s)\Big]$$

Let $X(t)$ be the discounted losses to date

$$X(t) = \int_0^t e^{-rs} dL(s)$$

Rewrite

$$\int_0^\infty e^{-rs} dL(s) \;=\; X(t) + e^{-rt}\int_t^\infty e^{-r(s-t)} dL(s) \stackrel{(d)}{=} X(t) + e^{-rt}Y$$

where Y is an independent copy of $\int_0^\infty e^{-rs} dL(s)$

$\Rightarrow$
$$V(t) = H(X(t), e^{-rt})$$

Two Price Valuation of Insurance Losses (2)

Applying Itô's formula and using the martingale condition (where we replace t by $v = e^{-rt}$)

$$rvH_v = \int_0^\infty (H(x+w,v) - H(X,v))k(w,v)dw$$

where $k(w,v)$ is related to the Lévy system for $X(t)$

$$k(w,v) = \frac{\lambda}{\Gamma(\kappa)}\left(\frac{\zeta}{v}\right)^{\kappa} w^{\kappa-1}\exp\left(-\frac{\zeta}{v}w\right)$$

Risk neutral price is the solution of this PIDE

Bid price is the solution of the distorted PIDE

How to distort a measure integral?

Measure Distortions (1)

Consider a possibly infinite measure μ with tails of finite measure and

$$m = \int_{-\infty}^{+\infty} v(y)\mu(dy) < \infty$$

Rewrite this as

$$m = -\int_{-\infty}^{0} \mu(v(y) \leq x)dx + \int_{0}^{\infty} \mu(v(y) > x)dx$$

Distorted measure integrals

$$\mathfrak{m} = -\int_{-\infty}^{0} \Gamma_{+}(\mu(v(y) \leq x))dx + \int_{0}^{\infty} \Gamma_{-}(\mu(v(y) > x))dx$$

for functions $\Gamma_{+}, \Gamma_{-} : \mathbb{R}_{+} \to \mathbb{R}_{+}$

$\Gamma_{\pm}(0) = 0$, monotone increasing, resp. concave and convex, bounded below and above by the identity function

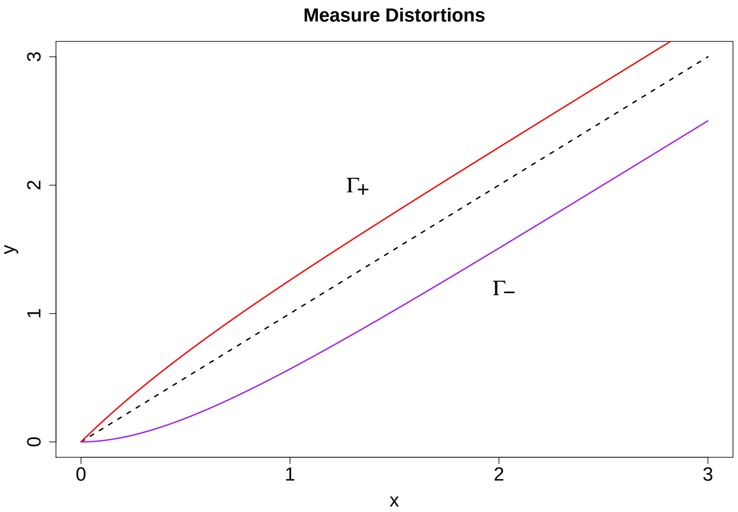
Measure Distortions (2)

Natural Candidates:

$$\Gamma_+(x) = x + \alpha(1 - e^{-cx})^{-\frac{1}{1+\gamma_+}}$$

$$\Gamma_-(x) = x - \frac{\beta}{c}(1 - e^{-c(1+\gamma_-)x})$$

(Γ_+ derived from maxvar, Γ_- from minvar)


Measure Distortions
3
2
1
0
y
0
1
2
3
x
Γ+
Γ−

Bid Price for the Discounted Cumulated Loss Process

Distorted measure integral for positive variables

$$\mathfrak{m} = \int_0^\infty \Gamma_-(\mu(\chi > x))dx$$

Rewrite this as (integration by parts)

$$\mathfrak{m} = -\int_0^\infty x d\Gamma_-(\mu(\chi > x))$$

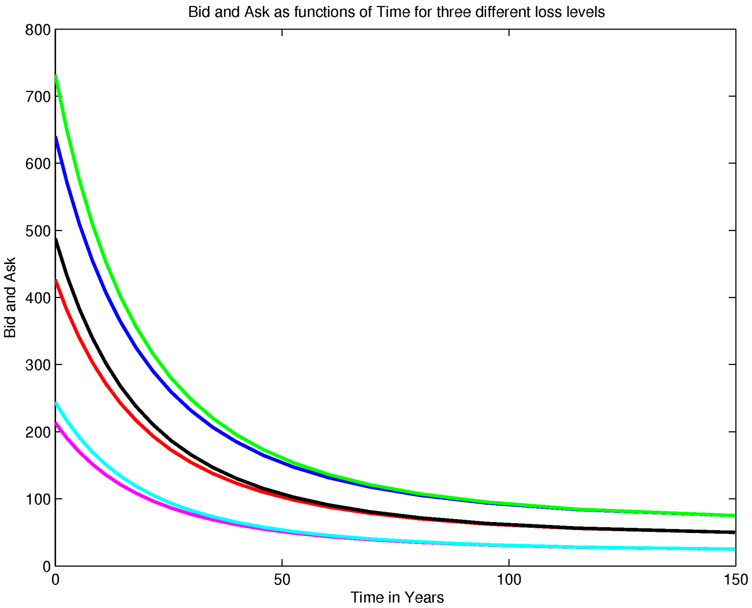
Now choose $\chi(y) = H(X + y, v) - H(X, v), \qquad \mu(dy) = k(y, v)dy$

Bid price is the solution of

$$rvH_v = -\int_0^\infty x d\Gamma_-(\mu(\chi > x))$$

For the ask price one has to consider the integral

$$rvH_v = -\int_0^\infty x d\Gamma_+(\mu(\chi > x))$$


Bid and Ask as functions of Time for three different loss levels
Bid and Ask
Time in Years
0
100
200
300
400
500
600
700
800
0
50
100
150

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