
Contents

Incomplete and Asymmetric Information in Asset Pricing Theory

<i>Kerry Back</i>	1
1 Filtering Theory	1
1.1 Kalman-Bucy Filter	3
1.2 Two-State Markov Chain	4
2 Incomplete Information	5
2.1 Seminal Work	5
2.2 Markov Chain Models of Production Economies	6
2.3 Markov Chain Models of Pure Exchange Economies	7
2.4 Heterogeneous Beliefs	11
3 Asymmetric Information	12
3.1 Anticipative Information	12
3.2 Rational Expectations Models	13
3.3 Kyle Model	16
3.4 Continuous-Time Kyle Model	18
3.5 Multiple Informed Traders in the Kyle Model	20
References	23

Modeling and Valuation of Credit Risk

<i>Tomasz R. Bielecki, Monique Jeanblanc, Marek Rutkowski</i>	27
1 Introduction	27
2 Structural Approach	29
2.1 Basic Assumptions	29
Defaultable Claims	29
Risk-Neutral Valuation Formula	31
Defaultable Zero-Coupon Bond	32
2.2 Classic Structural Models	34
Merton's Model	34
Black and Cox Model	37
2.3 Stochastic Interest Rates	43

2.4	Credit Spreads: A Case Study	45
2.5	Comments on Structural Models	46
3	Intensity-Based Approach	47
3.1	Hazard Function	47
	Hazard Function of a Random Time	48
	Associated Martingales	49
	Change of a Probability Measure	50
	Martingale Hazard Function	53
	Defaultable Bonds: Deterministic Intensity	53
3.2	Hazard Processes	55
	Hazard Process of a Random Time	56
	Valuation of Defaultable Claims	57
	Alternative Recovery Rules	59
	Defaultable Bonds: Stochastic Intensity	63
	Martingale Hazard Process	64
	Martingale Hypothesis	65
	Canonical Construction	67
	Kusuoka's Counter-Example	69
	Change of a Probability	70
	Statistical Probability	72
	Change of a Numeraire	74
	Preprice of a Defaultable Claim	77
	Credit Default Swaption	79
	A Practical Example	82
3.3	Martingale Approach	84
	Standing Assumptions	85
	Valuation of Defaultable Claims	85
	Martingale Approach under (H.1)	87
3.4	Further Developments	88
	Default-Adjusted Martingale Measure	88
	Hybrid Models	89
	Unified Approach	90
3.5	Comments on Intensity-Based Models	90
4	Dependent Defaults and Credit Migrations	91
4.1	Basket Credit Derivatives	92
	The i^{th} -to-Default Contingent Claims	92
	Case of Two Entities	93
4.2	Conditionally Independent Defaults	94
	Canonical Construction	94
	Independent Default Times	95
	Signed Intensities	96
	Valuation of FDC and LDC	96
	General Valuation Formula	97
	Default Swap of Basket Type	98

4.3 Copula-Based Approaches 99
 Direct Application 100
 Indirect Application 100
 Simplified Version 102

4.4 Jarrow and Yu Model 103
 Construction and Properties of the Model 103
 Bond Valuation 105

4.5 Extension of the Jarrow and Yu Model 106
 Kusuoka’s Construction 107
 Interpretation of Intensities 108
 Bond Valuation 108

4.6 Dependent Intensities of Credit Migrations 109
 Extension of Kusuoka’s Construction 109

4.7 Dynamics of Dependent Credit Ratings 112

4.8 Defaultable Term Structure 113
 Standing Assumptions 113
 Credit Migration Process 116
 Defaultable Term Structure 117
 Premia for Interest Rate and Credit Event Risks 119
 Defaultable Coupon Bond 120
 Examples of Credit Derivatives 121

4.9 Concluding Remarks 122

References 123

Stochastic Control with Application in Insurance

Christian Hipp 127

1 Preface 127

2 Introduction Into Insurance Risk 128
 2.1 The Lundberg Risk Model 128
 2.2 Alternatives 129
 2.3 Ruin Probability 129
 2.4 Asymptotic Behavior For Ruin Probabilities 131

3 Possible Control Variables and Stochastic Control 132
 3.1 Possible Control Variables 132
 Investment, One Risky Asset 132
 Investment, Two or More Risky Assets 133
 Proportional Reinsurance 134
 Unlimited XL Reinsurance 134
 XL-Reinsurance 135
 Premium Control 135
 Control of New Business 135

3.2 Stochastic Control 136
 Objective Functions 136
 Infinitesimal Generators 137
 Hamilton-Jacobi-Bellman Equations 139

Verification Argument	141
Steps for Solution	143
4 Optimal Investment for Insurers	143
4.1 HJB and its Handy Form	143
4.2 Existence of a Solution	145
4.3 Exponential Claim Sizes	145
4.4 Two or More Risky Assets	147
5 Optimal Reinsurance and Optimal New Business	148
5.1 Optimal Proportional Reinsurance	150
5.2 Optimal Unlimited XL Reinsurance	151
5.3 Optimal XL Reinsurance	152
5.4 Optimal New Business	153
6 Asymptotic Behavior for Value Function and Strategies	154
6.1 Optimal Investment: Exponential Claims	154
6.2 Optimal Investment: Small Claims	154
6.3 Optimal Investment: Large Claims	155
6.4 Optimal Reinsurance	156
7 A Control Problem with Constraint: Dividends and Ruin	157
7.1 A Simple Insurance Model with Dividend Payments	157
7.2 Modified HJB Equation	158
7.3 Numerical Example and Conjectures	159
7.4 Earlier and Further Work	161
8 Conclusions	162
References	163

Nonlinear Expectations, Nonlinear Evaluations and Risk Measures

<i>Shige Peng</i>	165
1 Introduction	165
1.1 Searching the Mechanism of Evaluations of Risky Assets	165
1.2 Axiomatic Assumptions for Evaluations of Derivatives	166
General Situations: \mathcal{F}_t^X -Consistent Nonlinear Evaluations	166
\mathcal{F}_t^X -Consistent Nonlinear Expectations	167
1.3 Organization of the Lecture	168
2 Brownian Filtration Consistent Evaluations and Expectations	169
2.1 Main Notations and Definitions	169
2.2 \mathcal{F}_t -Consistent Nonlinear Expectations	171
2.3 \mathcal{F}_t -Consistent Nonlinear Evaluations	173
3 Backward Stochastic Differential Equations: g -Evaluations and g -Expectations	176
3.1 BSDE: Existence, Uniqueness and Basic Estimates	176
3.2 1-Dimensional BSDE	182
Comparison Theorem	183
Backward Stochastic Monotone Semigroups and g -Evaluations	186
Example: Black-Scholes Evaluations	188

g -Expectations 189

Upcrossing Inequality of \mathcal{E}^g -Supermartingales and Optional
Sampling Inequality 193

3.3 A Monotonic Limit Theorem of BSDE 199

3.4 g -Martingales and (Nonlinear) g -Supermartingale
Decomposition Theorem 201

4 Finding the Mechanism: Is an \mathcal{F} -Expectation a g -Expectation? 204

4.1 \mathcal{E}^μ -Dominated \mathcal{F} -Expectations 204

4.2 \mathcal{F}_t -Consistent Martingales 207

4.3 BSDE under \mathcal{F}_t -Consistent Nonlinear Expectations 210

4.4 Decomposition Theorem for \mathcal{E} -Supermartingales 213

4.5 Representation Theorem
of an \mathcal{F} -Expectation by a g -Expectation 216

4.6 How to Test and Find g ? 219

4.7 A General Situation: \mathcal{F}_t -Evaluation Representation Theorem .. 220

5 Dynamic Risk Measures 221

6 Numerical Solution of BSDEs: Euler's Approximation 222

7 Appendix 224

7.1 Martingale Representation Theorem 224

7.2 A Monotonic Limit Theorem of Itô's Processes 226

7.3 Optional Stopping Theorem for \mathcal{E}^g -Supermartingale 232

References 238

References on BSDE and Nonlinear Expectations 240

Utility Maximisation in Incomplete Markets

Walter Schachermayer 255

1 Problem Setting 255

2 Models on Finite Probability Spaces 259

2.1 Utility Maximization 266

The complete Case (Arrow) 266

The Incomplete Case 272

3 The General Case 277

3.1 The Reasonable Asymptotic Elasticity Condition 277

3.2 Existence Theorems 281

References 289