Chapter 15
Change of Numéraire and Forward Measures

In this chapter we introduce the notion of numéraire. This allows us to consider pricing under random discount rates using forward measures, with the pricing of exchange options (Margrabe formula) and foreign exchange options (Garman-Kohlagen formula) as main applications. A short introduction to the computation of self-financing hedging strategies under change of numéraire is also given in Section 15.5. The change of numéraire technique and associated forward measures will also be applied to the pricing of bonds and interest rate derivatives such as bond options in Chapter 18.

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15.1 Notion of Numéraire

A numéraire is any strictly positive \((F_t)_{t \in \mathbb{R}_+}\)-adapted stochastic process \((N_t)_{t \in \mathbb{R}_+}\) that can be taken as a unit of reference when pricing an asset or a claim.

In general, the price \(S_t\) of an asset, when quoted in terms of the numéraire \(N_t\), is given by

\[
\tilde{S}_t := \frac{S_t}{N_t}, \quad t \in \mathbb{R}_+.
\]

Deterministic numéraires transformations are easy to handle as a change of numéraire by a deterministic factor is a formal algebraic transformation that does not involve any risk. This can be the case for example when a currency is pegged to another currency, for example the exchange rate of the French
franc to the Euro was locked at €1 = FRF 6.55957 on 31 December 1998.

On the other hand, a random numéraire may involve new risks, and can allow for arbitrage opportunities.

Examples of numéraire processes \((N_t)_{t \in \mathbb{R}_+}\) include:

- **Money market account.**

  Given \((r_t)_{t \in \mathbb{R}_+}\) a possibly random, time-dependent and \((\mathcal{F}_t)_{t \in \mathbb{R}_+}\)-adapted risk-free interest rate process, let*

  \[ N_t := \exp \left( \int_0^t r_s ds \right). \]

  In this case,

  \[ \tilde{S}_t = \frac{S_t}{N_t} = e^{-\int_0^t r_s ds} S_t, \quad t \in \mathbb{R}_+, \]

  represents the discounted price of the asset at time 0.

- **Currency exchange rates.**

  In this case, \(N_t := R_t\) denotes the SGD/EUR (SGDEUR=X) exchange rate between a domestic currency (SGD) and a foreign currency (EUR), i.e. one unit of local currency (SGD) corresponds to \(R_t\) units in foreign currency (EUR). Let

  \[ \tilde{S}_t := \frac{S_t}{R_t}, \quad t \in \mathbb{R}_+, \]

  denote the price of a foreign (EUR) asset quoted in units of the local currency (SGD). For example, if \(R_t = 0.59\) and \(S_t = \€1\), then \(\tilde{S}_t = S_t/R_t = S_t/0.59 \approx \$1.7\), and \(1/R_t\) is the foreign EUR/SGD exchange rate.

- **Forward numéraire.**

  The price \(P(t,T)\) of a bond paying \(P(T,T) = \$1\) at maturity \(T\) can be taken as numéraire. In this case we have

  \[ N_t := P(t,T) = \mathbb{E}^* \left[ e^{-\int_t^T r_s ds} \mid \mathcal{F}_t \right], \quad 0 \leq t \leq T. \]

  Recall that

  \[ t \mapsto e^{-\int_0^t r_s ds} P(t,T) = \mathbb{E}^* \left[ e^{-\int_t^T r_s ds} \mid \mathcal{F}_t \right], \quad 0 \leq t \leq T, \]

  \* "Anyone who believes exponential growth can go on forever in a finite world is either a madman or an economist", Kenneth E. Boulding, Boulding (1973), page 248.
My foreign currency account $S_t$ grew by 5% this year.

Q: Did I achieve a positive return?
A:

(a) Scenario A.

My foreign currency account $S_t$ grew by 5% this year.
The foreign exchange rate dropped by 10%.

Q: Did I achieve a positive return?
A:

(b) Scenario B.

Fig. 15.1: Why change of numéraire?

is an $\mathcal{F}_t$-martingale.

- **Annuity numéraires.**

Processes of the form

$$N_t := \sum_{k=1}^{n} (T_k - T_{k-1}) P(t, T_k), \quad 0 \leq t \leq T_1,$$

where $P(t, T_1), P(t, T_2), \ldots, P(t, T_n)$ are bond prices with maturities $T_1 < T_2 < \cdots < T_n$ arranged according to a tenor structure.

- **Combinations of the above:** for example a foreign money market account $e^{\int_0^t r_s ds} R_t$, expressed in local (or domestic) units of currency, where $(r_t)_{t \in \mathbb{R}_+}$ represents a short-term interest rate on the foreign market.

When the numéraire is a random process, the pricing of a claim whose value has been transformed under change of numéraire, e.g. under a change of currency, has to take into account the risks existing on the foreign market.

In particular, in order to perform a fair pricing, one has to determine a probability measure (for example on the foreign market), under which the transformed (or forward, or deflated) process $\tilde{S}_t = S_t / N_t$ will be a martingale.

For example in case $N_t := e^{\int_0^t r_s ds}$ is the money market account, the risk-neutral probability measure $\mathbb{P}^*$ is a measure under which the discounted price process

$$\tilde{S}_t = \frac{S_t}{N_t} = e^{-\int_0^t r_s ds} S_t, \quad t \in \mathbb{R}_+,$$

is a martingale.
In the next section we will see that this property can be extended to any
kind of numéraire.

15.2 Change of Numéraire

In this section we review the pricing of options by a change of measure asso-
ciated to a numéraire \( N_t \), cf. e.g. Geman et al. (1995) and references therein.

Most of the results of this chapter rely on the following assumption, which
expresses absence of arbitrage. In the foreign exchange setting where \( N_t = R_t \), this condition states that the price of one unit of foreign currency is a
martingale when quoted and discounted in the domestic currency.

**Assumption (A)** Under the risk-neutral probability measure \( \mathbb{P}^* \), the
discounted numéraire

\[
t \mapsto M_t := e^{-\int_0^t r_s ds} N_t
\]

is an \( \mathcal{F}_t \)-martingale.

**Definition 15.1.** Given \( (N_t)_{t \in [0,T]} \) a numéraire process, the associated
forward measure \( \widehat{\mathbb{P}} \) is defined by

\[
\frac{d\widehat{\mathbb{P}}}{d\mathbb{P}^*} := \frac{M_T}{M_0} = e^{-\int_0^T r_s ds} \frac{N_T}{N_0}.
\]

(15.1)

Recall that from Section 7.3 the above Relation (15.1) rewrites as

\[
d\widehat{\mathbb{P}} = \frac{M_T}{M_0} d\mathbb{P}^* = e^{-\int_0^T r_s ds} \frac{N_T}{N_0} d\mathbb{P}^*,
\]

which is equivalent to stating that

\[
\int_{\Omega} X(\omega) d\widehat{\mathbb{P}}(\omega) = \int_{\Omega} e^{-\int_0^T r_s ds} \frac{N_T}{N_0} X d\mathbb{P}^*
\]

for any (bounded) random variable \( S \) or, under a different notation,

\[
\widehat{\mathbb{E}}[X] = \mathbb{E}^* \left[ e^{-\int_0^T r_s ds} \frac{N_T}{N_0} X \right],
\]

for all integrable \( \mathcal{F}_T \)-measurable random variables \( X \).
More generally, by (15.1) and the fact that the process
\[ t \mapsto M_t := e^{-\int_0^t r_s \, ds} N_t \]
is an \( \mathcal{F}_t \)-martingale under \( \mathbb{P}^* \) under Assumption (A), we find that
\[
\mathbb{E}^* \left[ \frac{d\hat{\mathbb{P}}}{d\mathbb{P}^*} \mid \mathcal{F}_t \right] = \mathbb{E}^* \left[ \frac{N_T}{N_0} e^{-\int_0^t r_s \, ds} \mid \mathcal{F}_t \right] = \frac{N_t}{N_0} e^{-\int_0^t r_s \, ds} = \frac{M_t}{M_0}, \tag{15.2}
\]
for all integrable random variable \( X \), which shows that
\[
\hat{\mathbb{E}}[X] = \mathbb{E}^* \left[ X e^{-\int_0^T r_s \, ds} \frac{N_T}{N_0} \right]
\]
\[
= \mathbb{E}^* \left[ X e^{-\int_0^t r_s \, ds} \mathbb{E}^* \left[ \frac{N_T}{N_0} e^{-\int_t^T r_s \, ds} \mid \mathcal{F}_t \right] \right]
\]
\[
= \mathbb{E}^* \left[ X e^{-\int_0^t r_s \, ds} \mathbb{E}^* \left[ \frac{N_T}{N_0} e^{-\int_t^T r_s \, ds} \mid \mathcal{F}_t \right] \right]
\]
\[
= \mathbb{E}^* \left[ X e^{-\int_0^t r_s \, ds} N_T N_0 \right], \tag{15.3}
\]
for all integrable random variable \( \hat{X} \), which shows that
\[
\hat{\mathbb{E}}[\hat{X} \mid \mathcal{F}_t] = \mathbb{E}^* \left[ \hat{X} e^{-\int_t^T r_s \, ds} \frac{N_T}{N_t} \mid \mathcal{F}_t \right],
\]
i.e. (15.3) holds. \qed
We note that in case the numéraire \( N_t = e^{\int_0^t r_s ds} \) is equal to the money market account we simply have \( \bar{P} = P^* \).

**Pricing using Change of Numéraire**

The change of numéraire technique is specially useful for pricing under random interest rates, in which case an expectation of the form

\[
IE^* \left[ e^{-\int_t^T r_s ds }C \mid \mathcal{F}_t \right]
\]

becomes a path integral, see e.g. Dash (2004) for a recent account of path integral methods in quantitative finance. The next proposition is the basic result of this section, it provides a way to price an option with arbitrary payoff \( C \) under a random discount factor \( e^{-\int_t^T r_s ds} \) by use of the forward measure. It will be applied in Chapter 18 to the pricing of bond options and caplets, cf. Propositions 18.1, 18.3 and 18.4 below.

**Proposition 15.3.** An option with integrable claim payoff \( C \in L^1(\Omega, \mathbb{P}^*, \mathcal{F}_T) \) is priced at time \( t \) as

\[
IE^* \left[ e^{-\int_t^T r_s ds }C \mid \mathcal{F}_t \right] = N_t \hat{E} \left[ \frac{C}{N_T} \mid \mathcal{F}_t \right], \quad 0 \leq t \leq T,
\]

provided that \( C/N_T \in L^1(\Omega, \hat{P}, \mathcal{F}_T) \).

**Proof.** By Relation (15.3) in Lemma 15.2 we have

\[
\begin{align*}
IE^* \left[ e^{-\int_t^T r_s ds }C \mid \mathcal{F}_t \right] &= IE^* \left[ \frac{d\hat{P}|_{\mathcal{F}_t}}{d\mathbb{P}^*|_{\mathcal{F}_t}} \frac{N_t}{N_T} C \mid \mathcal{F}_t \right] \\
&= N_t IE^* \left[ \frac{d\hat{P}|_{\mathcal{F}_t}}{d\mathbb{P}^*|_{\mathcal{F}_t}} \frac{N_t}{N_T} C \mid \mathcal{F}_t \right] \\
&= N_t \int_\Omega \frac{d\hat{P}|_{\mathcal{F}_t}}{d\mathbb{P}^*|_{\mathcal{F}_t}} \frac{C}{N_T} d\mathbb{P}^*|_{\mathcal{F}_t} \\
&= N_t \int_\Omega \frac{C}{N_T} d\hat{P}|_{\mathcal{F}_t} \\
&= N_t \hat{E} \left[ \frac{C}{N_T} \mid \mathcal{F}_t \right], \quad 0 \leq t \leq T.
\end{align*}
\]

Equivalently we can write

\[
N_t \hat{E} \left[ \frac{C}{N_T} \mid \mathcal{F}_t \right] = N_t IE^* \left[ \frac{d\hat{P}|_{\mathcal{F}_t}}{d\mathbb{P}^*|_{\mathcal{F}_t}} \frac{C}{N_T} \mid \mathcal{F}_t \right]
\]
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\[ = \mathbb{E}^* \left[ e^{-\int_t^T r_s \, ds} C \mid \mathcal{F}_t \right], \quad 0 \leq t \leq T. \]

Each application of the formula (15.4) will require to:

a) pick a suitable numéraire \((N_t)_{t \in \mathbb{R}_+}\),

b) make sure that the ratio \(C / N_T\) takes a sufficiently simple form,

c) use the Girsanov theorem in order to determine the dynamics of asset prices under the new measure \(\hat{\mathbb{P}}\),

in order to allow for the computation of the expectation in the right-hand side of (15.4).

Next, we consider further examples of numéraires and associated examples of option prices.

Examples:

a) **Money market account.**

Take \(N_t := e^{\int_0^t r_s \, ds}\), where \((r_t)_{t \in \mathbb{R}_+}\) is a possibly random and time-dependent risk-free interest rate. In this case, Assumption (A) is clearly satisfied, we have \(\hat{\mathbb{P}} = \mathbb{P}^*\), and (15.4) simply reads

\[ \mathbb{E}^* \left[ e^{-\int_t^T r_s \, ds} C \mid \mathcal{F}_t \right] = \int_0^t r_s \, ds \mathbb{E}^* \left[ e^{-\int_0^T r_s \, ds} C \mid \mathcal{F}_t \right], \quad 0 \leq t \leq T, \]

which yields no particular information.

b) **Forward numéraire.**

Here, \(N_t := P(t, T)\) is the price \(P(t, T)\) of a bond maturing at time \(T\), \(0 \leq t \leq T\), and the discounted bond price process \(\left( e^{-\int_0^t r_s \, ds} P(t, T) \right)_{t \in [0, T]} \) is an \(\mathcal{F}_t\)-martingale under \(\mathbb{P}^*\), i.e. Assumption (A) is satisfied and \(N_t = P(t, T)\) can be taken as numéraire. In this case, (15.4) shows that a random claim payoff \(C\) can be priced as

\[ \mathbb{E}^* \left[ e^{-\int_t^T r_s \, ds} C \mid \mathcal{F}_t \right] = P(t, T) \tilde{\mathbb{E}} \left[ C \mid \mathcal{F}_t \right], \quad 0 \leq t \leq T, \quad (15.5) \]

since \(P(T, T) = 1\), where the forward measure \(\hat{\mathbb{P}}\) satisfies

\[ \frac{d\hat{\mathbb{P}}}{d\mathbb{P}^*} = e^{-\int_0^T r_s \, ds} \frac{P(T, T)}{P(0, T)} = \frac{e^{-\int_0^T r_s \, ds}}{P(0, T)} \quad (15.6) \]

by (15.1).
c) *Annuity numéraires.*

We take

\[ N_t := \sum_{k=1}^{n} (T_k - T_{k-1}) P(t, T_k) \]

where \( P(t, T_1), \ldots, P(t, T_n) \) are bond prices with maturities \( T_1 < T_2 < \cdots < T_n \). Here, (15.4) shows that a swaption on the cash flow \( P(T, T_n) - P(T, T_1) - \kappa N_T \) can be priced as

\[
\mathbb{E}^* \left[ e^{-\int_t^T r_s ds} (P(T, T_n) - P(T, T_1) - \kappa N_T)^+ \mid \mathcal{F}_t \right]
\]

\[ = N_t \mathbb{E} \left[ \left( \frac{P(T, T_n) - P(T, T_1)}{N_T} - \kappa \right)^+ \mid \mathcal{F}_t \right], \]

where \( (P(T, T_n) - P(T, T_1)) / N_T \) becomes a *swap rate*, cf. (17.17) in Proposition 17.8 and Section 18.5.

In the sequel, given \((X_t)_{t \in \mathbb{R}_+}\) an asset price process, we define the process of forward (or deflated) prices

\[ \hat{X}_t := \frac{X_t}{N_t}, \quad 0 \leq t \leq T, \quad (15.7) \]

which represents the values at times \( t \) of \( X_t \), expressed in units of the numéraire \( N_t \). It will be useful to determine the dynamics of \((\hat{X}_t)_{t \in \mathbb{R}_+}\) under the forward measure \( \hat{\mathbb{P}} \).

**Proposition 15.4.** Let \((X_t)_{t \in \mathbb{R}_+}\) denote a continuous \((\mathcal{F}_t)_{t \in \mathbb{R}_+}\)-adapted asset price process such that

\[ t \mapsto e^{-\int_0^t r_s ds} X_t, \quad t \in \mathbb{R}_+, \]

is a martingale under \( \mathbb{P}^* \). Then, under change of numéraire,

the deflated process \((\hat{X}_t)_{t \in [0,T]} = (X_t / N_t)_{t \in [0,T]}\) of forward prices is an \( \mathcal{F}_t\)-martingale under \( \hat{\mathbb{P}} \), provided that it is integrable under \( \hat{\mathbb{P}} \).

**Proof.** We need to show that

\[ \hat{\mathbb{E}} \left[ \frac{X_t}{N_t} \mid \mathcal{F}_s \right] = \frac{X_s}{N_s}, \quad 0 \leq s \leq t, \quad (15.8) \]

and we achieve this using a standard characterization of conditional expectation. Namely, for all bounded \( \mathcal{F}_s\)-measurable random variables \( G \) we note that under Assumption \( (\text{A}) \) we have
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\[ \hat{\mathbb{E}} \left[ G \frac{X_t}{N_t} \right] = \mathbb{E}^* \left[ G \frac{X_t}{N_t} \frac{d\hat{P}}{dP^*} \right] \]

\[ = \mathbb{E}^* \left[ \mathbb{E}^* \left[ G \frac{X_t}{N_t} \frac{d\hat{P}}{dP^*} \mid \mathcal{F}_t \right] \right] \]

\[ = \mathbb{E}^* \left[ G \frac{X_t}{N_t} \mathbb{E}^* \left[ \frac{d\hat{P}}{dP^*} \mid \mathcal{F}_t \right] \right] \]

\[ = \mathbb{E}^* \left[ G e^{-\int_0^t r_u du} \frac{X_t}{N_0} \right] \]

\[ = \mathbb{E}^* \left[ G e^{-\int_0^s r_u du} \frac{X_s}{N_0} \right] \]

\[ = \mathbb{E}^* \left[ G \frac{X_s}{N_s} \frac{d\hat{P}}{dP^*} \right] \]

\[ = \hat{\mathbb{E}} \left[ G \frac{X_s}{N_s} \right], \quad 0 \leq s \leq t, \]

because

\[ t \mapsto e^{-\int_0^t r_u ds} X_t \]

is an \( \mathcal{F}_t \)-martingale. Finally, the identity

\[ \hat{\mathbb{E}} [ G \hat{X}_t ] = \hat{\mathbb{E}} \left[ G \frac{X_t}{N_t} \right] = \hat{\mathbb{E}} \left[ G \frac{X_s}{N_s} \right] = \hat{\mathbb{E}} [ G \hat{X}_s ], \quad 0 \leq s \leq t, \]

for all bounded \( \mathcal{F}_s \)-measurable \( G \), implies (15.8). \( \square \)

Next we will rephrase Proposition 15.4 in Proposition 15.6 using the Girsanov Theorem, which is briefly recalled below.

**Girsanov Theorem**

Recall that, letting

\[ \Phi_t := \mathbb{E}^* \left[ \frac{d\hat{P}}{dP^*} \mid \mathcal{F}_t \right], \quad t \in [0, T], \quad (15.9) \]

\[ \Phi_t := \mathbb{E}^* \left[ \frac{d\hat{P}}{dP^*} \mid \mathcal{F}_t \right], \quad t \in [0, T], \quad (15.9) \]
and given \((W_t)_{t\in\mathbb{R}}\) a standard Brownian motion under \(\mathbb{P}^*\), the Girsanov Theorem* shows that the process \((\widehat{W}_t)_{t\in\mathbb{R}}\) defined by
\[
d\widehat{W}_t := dW_t - \frac{1}{\Phi_t} d\Phi_t \cdot dW_t, \quad t \in \mathbb{R}_+,
\]
is a standard Brownian motion under \(\widehat{\mathbb{P}}\) defined by the Girsanov density
\[
\Phi_T = \frac{d\widehat{\mathbb{P}}}{d\mathbb{P}^*}.
\]
In case the martingale \((\Phi_t)_{t\in[0,T]}\) takes the form
\[
\Phi_t = \exp \left( - \int_0^t \psi_s dW_s - \frac{1}{2} \int_0^t |\psi_s|^2 ds \right), \quad t \in \mathbb{R}_+,
\]
i.e.
\[
d\Phi_t = -\psi_t \Phi_t dW_t, \quad t \in \mathbb{R}_+,
\]
the Itô multiplication Table 4.1 shows that Relation (15.10) reads
\[
d\widehat{W}_t = dW_t - \frac{1}{\Phi_t} (-\psi_t \Phi_t dW_t) \cdot dW_t
= dW_t + \psi_t dt, \quad t \in \mathbb{R}_+,
\]
and shows that the shifted process \((\widehat{W}_t)_{t\in\mathbb{R}_+} = (W_t + \int_0^t \psi_s ds)_{t\in\mathbb{R}_+}\) is a standard Brownian motion under \(\widehat{\mathbb{P}}\), which is consistent with the Girsanov Theorem 7.4. The next result is another application of the Girsanov Theorem.

**Proposition 15.5.** The process \((\widehat{W}_t)_{t\in\mathbb{R}_+}\) defined by
\[
d\widehat{W}_t := dW_t - \frac{1}{N_t} dN_t \cdot dW_t, \quad t \in \mathbb{R}_+,
\]
is a standard Brownian motion under \(\widehat{\mathbb{P}}\).

**Proof.** Relation (15.2) shows that \(\Phi_t\) defined in (15.9) satisfies
\[
\Phi_t = \mathbb{E}^* \left\{ \frac{d\widehat{\mathbb{P}}}{d\mathbb{P}^*} \bigg| \mathcal{F}_t \right\}
= \mathbb{E}^* \left\{ \frac{N_T}{N_0} e^{-\int_0^T r_s ds} \bigg| \mathcal{F}_t \right\}
\]
* See e.g. Theorem III-35 page 132 of Protter (2004).
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\[ \frac{N_t}{N_0} e^{-\int_0^t r_s ds}, \quad 0 \leq t \leq T, \]
hence

\[ d\Phi_t = d \left( \frac{N_t}{N_0} e^{-\int_0^t r_s ds} \right) = -\Phi_t r_t dt + e^{-\int_0^t r_s ds} d\left( \frac{N_t}{N_0} \right) = -\Phi_t r_t dt + \frac{\Phi_t}{N_t} dN_t, \]

which, by (15.10), yields

\[ d \tilde{W}_t = dW_t - \frac{1}{\Phi_t} d\Phi_t \cdot dW_t = dW_t - \frac{1}{\Phi_t} \left( -\Phi_t r_t dt + \frac{\Phi_t}{N_t} dN_t \right) \cdot dW_t = dW_t - \frac{1}{N_t} dN_t \cdot dW_t, \]

which is (15.11), from Relation (15.10) and the Itô multiplication Table 4.1. □

The next proposition confirms the statement of Proposition 15.4, and in addition it determines the precise dynamics of \((\hat{X}_t)_{t \in \mathbb{R}_+}\) under \(\hat{\mathcal{P}}\). See Exercise 15.1 for another calculation based on geometric Brownian motion, and Exercise 15.9 for an extension to correlated Brownian motions. As a consequence, we have the next proposition.

**Proposition 15.6.** Assume that \((X_t)_{t \in \mathbb{R}_+}\) and \((N_t)_{t \in \mathbb{R}_+}\) satisfy the stochastic differential equations

\[ dX_t = r_t X_t dt + \sigma^X_t X_t dW_t, \quad \text{and} \quad dN_t = r_t N_t dt + \sigma^N_t N_t dW_t, \quad (15.12) \]

where \((\sigma^X_t)_{t \in \mathbb{R}_+}\) and \((\sigma^N_t)_{t \in \mathbb{R}_+}\) are \((\mathcal{F}_t)_{t \in \mathbb{R}_+}\)-adapted volatility processes. Then we have

\[ d\hat{X}_t = (\sigma^X_t - \sigma^N_t) \hat{X}_t d\tilde{W}_t, \quad (15.13) \]

hence \((\hat{X}_t)_{t \in [0,T]}\) is given by the driftless geometric Brownian motion

\[ \hat{X}_t = \hat{X}_0 e^{(\sigma^X_t - \sigma^N_t) \tilde{W}_t - (\sigma^X_t - \sigma^N_t)^2/2}, \quad 0 \leq t \leq T. \]

**Proof.** First we note that by (15.11) and (15.12),

\[ d\tilde{W}_t = dW_t - \frac{1}{N_t} dN_t \cdot dW_t = dW_t - \sigma^N_t dt, \quad t \in \mathbb{R}_+, \]
is a standard Brownian motion under \(\hat{\mathbb{P}}\). Next, by Itô’s calculus and the Itô multiplication Table 4.1 and (15.12) we have

\[
d\left(\frac{1}{N_t}\right) = -\frac{1}{N_t^2} dN_t + \frac{1}{N_t^3} (dN_t)^2
\]

\[
= -\frac{1}{N_t^2} (r_t N_t dt + \sigma_t^N dW_t) + \frac{\sigma_t^N}{N_t} \, dt
\]

\[
= -\frac{1}{N_t^2} (r_t N_t dt + \sigma_t^N N_t (d\hat{W}_t + \sigma_t^N \, dt)) + \frac{\sigma_t^N}{N_t} \, dt
\]

\[
= -\frac{1}{N_t} (r_t dt + \sigma_t^N d\hat{W}_t),
\]

hence

\[
d\hat{X}_t = d\left(\frac{X_t}{N_t}\right)
\]

\[
= \frac{dX_t}{N_t} + X_t d\left(\frac{1}{N_t}\right) + dX_t \cdot d\left(\frac{1}{N_t}\right)
\]

\[
= \frac{1}{N_t} (r_t X_t dt + \sigma_t^X X_t dW_t) - \frac{X_t}{N_t} \left(r_t dt + \sigma_t^N dW_t - |\sigma_t^N|^2 dt\right)
\]

\[
- \frac{1}{N_t} (r_t X_t dt + \sigma_t^X X_t dW_t) \cdot \left(r_t dt + \sigma_t^N dW_t - |\sigma_t^N|^2 dt\right)
\]

\[
= \frac{1}{N_t} (r_t X_t dt + \sigma_t^X X_t dW_t) - \frac{X_t}{N_t} (r_t dt + \sigma_t^N dW_t)
\]

\[
+ \frac{X_t}{N_t} |\sigma_t^N|^2 dt - \frac{X_t}{N_t} \sigma_t^X \sigma_t^N dt
\]

\[
= \frac{X_t}{N_t} \sigma_t^X dW_t - \frac{X_t}{N_t} \sigma_t^N dW_t - \frac{X_t}{N_t} \sigma_t^X \sigma_t^N dt + X_t |\sigma_t^N|^2 dt
\]

\[
= \frac{X_t}{N_t} \left(\sigma_t^X dW_t - \sigma_t^N dW_t - \sigma_t^X \sigma_t^N dt + |\sigma_t^N|^2 dt\right)
\]

\[
= \hat{X}_t (\sigma_t^X - \sigma_t^N) dW_t - \hat{X}_t (\sigma_t^X - \sigma_t^N) \sigma_t^N dt
\]

\[
= \hat{X}_t (\sigma_t^X - \sigma_t^N) d\hat{W}_t,
\]

since \(d\hat{W}_t = dW_t - \sigma_t^N dt\), \(t \in \mathbb{R}_+\). 

We end this section with some comments on inverse changes of measure.

### Inverse Changes of Measure

In the next proposition we compute conditional inverse density \(d\mathbb{P}^*/d\hat{\mathbb{P}}\).

**Proposition 15.7.** We have

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\[
\tilde{E} \left[ \frac{dP^*}{dP} \mid \mathcal{F}_t \right] = \frac{N_0}{N_t} \exp \left( \int_0^t r_s ds \right) \quad 0 \leq t \leq T, \quad (15.15)
\]

and the process

\[
t \mapsto \frac{N_0}{N_t} \exp \left( \int_0^t r_s ds \right), \quad 0 \leq t \leq T,
\]

is an \( \mathcal{F}_t \)-martingale under \( \tilde{P} \).

Proof. For all bounded and \( \mathcal{F}_t \)-measurable random variables \( F \) we have,

\[
\tilde{E} \left[ F \frac{dP^*}{dP} \right] = \mathbb{E}^* [F]
\]

\[
= \mathbb{E}^* \left[ F \frac{N_t}{N_t} \right]
\]

\[
= \mathbb{E}^* \left[ F \frac{N_T}{N_t} \exp \left( - \int_t^T r_s ds \right) \right]
\]

\[
= \tilde{E} \left[ F \frac{N_0}{N_t} \exp \left( \int_0^t r_s ds \right) \right].
\]

\[\square\]

By (15.14) we also have

\[
d \left( \frac{1}{N_t} \exp \left( \int_0^t r_s ds \right) \right) = - \frac{1}{N_t} \exp \left( \int_0^t r_s ds \right) \sigma^N_t \, d\tilde{W}_t,
\]

which recovers the second part of Proposition 15.7, i.e. the martingale property of

\[
t \mapsto \frac{1}{N_t} \exp \left( \int_0^t r_s ds \right)
\]

under \( \tilde{P} \).

15.3 Foreign Exchange

Currency exchange is a typical application of change of numéraire that illustrate the principle of absence of arbitrage.

Let \( R_t \) denote the foreign exchange rate, i.e. \( R_t \) is the (possibly fractional) quantity of local currency that correspond to one unit of foreign currency.

Consider an investor that intends to exploit an “overseas investment opportunity” by
a) at time 0, changing one unit of local currency into \(1/R_0\) units of foreign currency,
b) investing \(1/R_0\) on the foreign market at the rate \(r^f\), which will yield the amount \(e^{tr^f}/R_0\) at time \(t\),
c) changing back \(e^{tr^f}/R_0\) into a quantity \(e^{tr^f}R_t/R_0 = N_t/R_0\) of his local currency.

In other words, the foreign money market account \(e^{tr^f}\) is valued \(e^{tr^f}R_t\) on the local (or domestic) market, and its discounted value on the local market is

\[ e^{-tr+tr^f}R_t, \quad t \in \mathbb{R}_+. \]

The outcome of this investment will be obtained by a martingale comparison of \(e^{tr^f}R_t/R_0\) to the amount \(e^{rt}\) that could have been obtained by investing on the local market.

Taking

\[ N_t := e^{tr^f}R_t, \quad t \in \mathbb{R}_+, \quad (15.16) \]

as numéraire, absence of arbitrage is expressed by Assumption (A), which states that the discounted numéraire process

\[ t \mapsto e^{-rt}N_t = e^{-t(r-r^f)}R_t \]

is an \(\mathcal{F}_t\)-martingale under \(\mathbb{P}^*\).

Next, we find a characterization of this arbitrage condition under the parameters of the model, and for this we will model foreign exchange rates \(R_t\) according to a geometric Brownian motion (15.17).‡

**Proposition 15.8.** Assume that the foreign exchange rate \(R_t\) satisfies a stochastic differential equation of the form

\[ dR_t = \mu R_t dt + \sigma R_t dW_t, \quad (15.17) \]

* For illustration purposes only. This is not an advertisement.
‡ Major currencies have started floating against each other since 1973, following the end of the system of fixed exchanged rates agreed upon at the Bretton Woods Conference, July 1-22, 1944.
where \((W_t)_{t \in \mathbb{R}^+}\) is a standard Brownian motion under \(\mathbb{P}^*\). Under the absence of arbitrage Assumption (A) for the numéraire (15.16), we have

\[
\mu = r - r^f, \quad (15.18)
\]

hence the exchange rate process satisfies

\[
dR_t = (r - r^f)R_t dt + \sigma R_t dW_t. \quad (15.19)
\]

under \(\mathbb{P}^*\).

Proof. The equation (15.17) has solution

\[
R_t = R_0 e^{\mu t + \sigma W_t - \sigma^2 t/2}, \quad t \in \mathbb{R}^+,
\]

hence the discounted value of the foreign money market account \(e^{tr^f}\) on the local market is

\[
e^{-tr + tr^f}R_t = R_0 e^{(r^f - r + \mu) t + \sigma W_t - \sigma^2 t/2}, \quad t \in \mathbb{R}^+.
\]

Under the absence of arbitrage Assumption (A), the process \(e^{-(r-r^f)t}R_t = e^{-tr}N_t\) should be an \(\mathcal{F}_t\)-martingale under \(\mathbb{P}^*\), and this holds provided that \(r^f - r + \mu = 0\), which yields (15.18) and (15.19).

As a consequence of Proposition 15.8, under absence of arbitrage a local investor who buys a unit of foreign currency in the hope of a higher return \(r^f \gg r\) will have to face a lower (or even more negative) drift

\[
\mu = r - r^f << 0
\]

in his exchange rate \(R_t\). The drift \(\mu = r - r^f\) is also called the cost of carrying the foreign currency.

The local money market account \(X_t := e^{rt}\) is valued \(e^{rt}/R_t\) on the foreign market, and its discounted value on the foreign market is

\[
t \mapsto \frac{e^{(r-r^f)t}}{R_t} = \frac{X_t}{N_t} = \frac{1}{R_0} e^{(r^f - r + \mu) t + \sigma W_t - \sigma^2 t/2},
\]

where

\[
d\widehat{W}_t = dW_t - \frac{1}{N_t} dN_t \cdot dW_t.
\]
\[ dW_t - \frac{1}{R_t} dR_t \cdot dW_t = dW_t - \sigma dt, \quad t \in \mathbb{R}_+, \]
is a standard Brownian motion under \( \hat{P} \) by (15.11). Under absence of arbitrage \( e^{-(r-r^f)t} R_t \) is an \( \mathcal{F}_t \)-martingale under \( P^* \) and (15.20) is an \( \mathcal{F}_t \)-martingale under \( \hat{P} \) by Proposition 15.4, which recovers (15.18).

**Proposition 15.9.** Under the absence of arbitrage condition (15.18), the inverse exchange rate \( 1/R_t \) satisfies

\[ d \left( \frac{1}{R_t} \right) = \frac{r^f - r}{R_t} dt - \frac{\sigma}{R_t} d\hat{W}_t, \quad (15.21) \]

under \( \hat{P} \), where \((R_t)_{t \in \mathbb{R}_+} \) is given by (15.19).

**Proof.** By (15.18), the exchange rate \( 1/R_t \) is written by Itô’s calculus as

\[
\begin{align*}
\frac{1}{R_t} & = \frac{1}{R_t} (\mu R_t dt + \sigma R_t dW_t) + \frac{1}{R_t^3} \sigma^2 R_t^2 dt \\
& = \left( \frac{1}{R_t} \right) \left( \mu - \sigma^2 \right) dt - \frac{\sigma}{R_t} dW_t \\
& = \left( \frac{1}{R_t} \right) \left( r^f - r \right) dt - \frac{\sigma}{R_t} d\hat{W}_t,
\end{align*}
\]

where \((\hat{W}_t)_{t \in \mathbb{R}_+} \) is a standard Brownian motion under \( \hat{P} \). \( \square \)

Consequently, under absence of arbitrage, a foreign investor who buys a unit of the local currency in the hope of a higher return \( r >> r^f \) will have to face a lower (or even more negative) drift \(-\mu = r^f - r\) in his exchange rate \( 1/R_t \) as written in (15.21) under \( \hat{P} \).

**Foreign exchange options**

We now price a foreign exchange option with payoff \((R_T - \kappa)^+\) under \( P^* \) on the exchange rate \( R_T \) by the Black-Scholes formula as in the next proposition, also known as the Garman-Kohlhagen Garman and Kohlhagen (1983) formula.

**Proposition 15.10.** (Garman-Kohlagen formula). Consider an exchange rate process \((R_t)_{t \in \mathbb{R}_+} \) given by (15.19). The price of the foreign exchange call option on \( R_T \) with maturity \( T \) and strike price \( \kappa \) is given by
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\[
\begin{align*}
\left. e^{-(T-t)r} \mathbb{E}^* \left[ (R_T - \kappa)^+ | R_t \right] \right| = e^{-(T-t)r} R_t \Phi_+(t, R_t) - \kappa e^{-(T-t)r} \Phi_-(t, R_t) \\
(15.22)
\end{align*}
\]

0 ≤ t ≤ T, where

\[
\Phi_+(t, x) = \Phi \left( \frac{\log(x/\kappa) + (T-t)(r - r^f + \sigma^2/2)}{\sigma\sqrt{T-t}} \right),
\]

and

\[
\Phi_-(t, x) = \Phi \left( \frac{\log(x/\kappa) + (T-t)(r - r^f - \sigma^2/2)}{\sigma\sqrt{T-t}} \right).
\]

Proof. As a consequence of (15.19), we find the numéraire dynamics

\[
\begin{align*}
n_N(t) &= d(e^{tr^f} R_t) \\
&= r^f e^{tr^f} R_t dt + e^{tr^f} dR_t \\
&= r e^{tr^f} R_t dt + \sigma e^{tr^f} R_t dW_t \\
&= r N_t dt + \sigma N_t dW_t.
\end{align*}
\]

Hence, a standard application of the Black-Scholes formula yields

\[
\begin{align*}
&= e^{-(T-t)r} \mathbb{E}^* \left[ (R_T - \kappa)^+ | R_t \right] = e^{-(T-t)r} \mathbb{E}^* \left[ (e^{-Tr^f} N_T - \kappa)^+ | R_t \right] \\
&= e^{-(T-t)r} \mathbb{E}^* \left[ (N_T - \kappa e^{Tr^f})^+ | R_t \right] \\
&= e^{-Tr^f} \left( N_t \Phi \left( \frac{\log(N_t e^{-Tr^f}/\kappa) + (r + \sigma^2/2)(T-t)}{\sigma\sqrt{T-t}} \right) \\
&- \kappa e^{Tr^f} (T-t) r \Phi \left( \frac{\log(N_t e^{-Tr^f}/\kappa) + (r - \sigma^2/2)(T-t)}{\sigma\sqrt{T-t}} \right) \right) \\
&= e^{-Tr^f} \left( N_t \Phi \left( \frac{\log(R_t/\kappa) + (T-t)(r - r^f + \sigma^2/2)}{\sigma\sqrt{T-t}} \right) \\
&- \kappa e^{Tr^f} (T-t) r \Phi \left( \frac{\log(R_t/\kappa) + (T-t)(r - r^f - \sigma^2/2)}{\sigma\sqrt{T-t}} \right) \right) \\
&= e^{-(T-t)r} R_t \Phi_+(t, R_t) - \kappa e^{-(T-t)r} \Phi_-(t, R_t).
\end{align*}
\]

\[
\Box
\]

Similarly, from (15.21) rewritten as

\[
\begin{align*}
d \left( \frac{e^{rt}}{R_t} \right) &= r^f \frac{e^{rt}}{R_t} dt - \sigma \frac{e^{rt}}{R_t} d\hat{W}_t,
\end{align*}
\]

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https://www.ntu.edu.sg/home/nprivault/indext.html
a foreign exchange put option with payoff \((1/\kappa - 1/R_T)^+\) can be priced under \(\widehat{P}\) in a Black-Scholes model by taking \(e^{rt}/R_t\) as underlying asset price, \(r^f\) as risk-free interest rate, and \(-\sigma\) as volatility parameter. In this framework, the Black-Scholes formula (6.9) yields

\[
e^{-(T-t)r^f} \mathbb{E}\left[\left(\frac{1}{\kappa} - \frac{1}{R_T}\right)^+ \mid R_t\right] = e^{-(T-t)r^f} e^{-rT} \mathbb{E}\left[\left(\frac{e^{rT}}{\kappa} - \frac{e^{rT}}{R_T}\right)^+ \mid R_t\right] = \frac{1}{\kappa} e^{-(T-t)r^f} \Phi_-(t, \frac{1}{R_t}) - \frac{e^{-(T-t)r^f}}{R_t} \Phi_+(t, \frac{1}{R_t}),
\]

which is the symmetric of (15.22) by exchanging \(R_t\) with \(1/R_t\), and \(r^f\) with \(r\), where

\[
\Phi_+(t, x) = \Phi\left(-\frac{\log(\kappa x) + (T-t)(r^f - r + \sigma^2/2)}{\sigma \sqrt{T-t}}\right),
\]

and

\[
\Phi_-(t, x) = \Phi\left(-\frac{\log(\kappa x) + (T-t)(r^f - r - \sigma^2/2)}{\sigma \sqrt{T-t}}\right).
\]

**Call/put duality for foreign exchange options**

Let \(N_t = e^{tr^f} R_t\), where \(R_t\) is an exchange rate with respect to a foreign currency and \(r^f\) is the foreign market interest rate.

**Proposition 15.11.** The foreign exchange call and put options on the local and foreign markets are linked by the call/put duality relation

\[
\frac{1}{\kappa R_t} e^{-(T-t)r^f} \mathbb{E}^*\left[(R_T - \kappa)^+ \mid R_t\right] = \frac{e^{-(T-t)r^f}}{\kappa} \mathbb{E}\left[\left(\frac{1}{\kappa} - \frac{1}{R_T}\right)^+ \mid R_t\right],
\]

between a put option with strike price \(1/\kappa\) and a (possibly fractional) quantity \(1/(\kappa R_t)\) of call option(s) with strike price \(\kappa\).

**Proof.** By application of change of numéraire from Proposition 15.3 and (15.4) we have

\[
\frac{1}{e^{tr^f} R_T} (R_T - \kappa)^+ \mid R_t = \frac{1}{N_t} e^{-(T-t)r^f} \mathbb{E}^*\left[(R_T - \kappa)^+ \mid R_t\right],
\]

hence

\[
e^{-(T-t)r^f} \mathbb{E}\left[\left(\frac{1}{\kappa} - \frac{1}{R_T}\right)^+ \mid R_t\right] = e^{-(T-t)r^f} \mathbb{E}\left[\frac{1}{\kappa R_T} (R_T - \kappa)^+ \mid R_t\right].
\]
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\[
\begin{align*}
&= \frac{1}{\kappa} e^{tr} \mathbb{E} \left[ \frac{1}{e^{Tr} R_T} (R_T - \kappa)^+ | R_t \right] \\
&= \frac{1}{\kappa N_t} e^{tr-(T-t)r} \mathbb{E}^* \left[ (R_T - \kappa)^+ | R_t \right] \\
&= \frac{1}{\kappa R_t} e^{-(T-t)r} \mathbb{E}^* \left[ (R_T - \kappa)^+ | R_t \right].
\end{align*}
\]

\[\square\]

In the Black-Scholes case, the duality (15.24) can be directly checked by verifying that (15.23) coincides with

\[
\begin{align*}
\frac{1}{\kappa R_t} e^{-(T-t)r} \mathbb{E}^* \left[ (R_T - \kappa)^+ | R_t \right] \\
&= \frac{1}{\kappa R_t} e^{-(T-t)r} e^{-Tr} \mathbb{E}^* \left[ (e^{Tr} R_T - \kappa e^{Tr})^+ | R_t \right] \\
&= \frac{1}{\kappa R_t} e^{-(T-t)r} e^{-Tr} \mathbb{E}^* \left[ (N_T - \kappa e^{Tr})^+ | R_t \right] \\
&= \frac{1}{\kappa R_t} \left( e^{-(T-t)r} R_t \Phi_+ (t, R_t) - \kappa e^{-(T-t)r} \Phi_- (t, R_t) \right) \\
&= \frac{1}{\kappa} e^{-(T-t)r} \Phi_+ (t, R_t) - \frac{e^{-(T-t)r}}{R_t} \Phi_- (t, R_t) \\
&= \frac{1}{\kappa} e^{-(T-t)r} \left( t, \frac{1}{R_t} \right) - \frac{e^{-(T-t)r}}{R_t} \Phi_+ \left( t, \frac{1}{R_t} \right),
\end{align*}
\]

where

\[
\Phi_+ (t, x) := \Phi \left( \frac{\log (x/\kappa) + (T-t)(r - r^f + \sigma^2/2)}{\sigma \sqrt{T-t}} \right),
\]

and

\[
\Phi_- (t, x) := \Phi \left( \frac{\log (x/\kappa) + (T-t)(r - r^f - \sigma^2/2)}{\sigma \sqrt{T-t}} \right).
\]
Buy back guarantee

The put option priced

\[ e^{-(T-t)r} \mathbb{E}^* \left[ \left( \frac{1}{\kappa} - \frac{1}{R_T} \right)^+ | R_t \right] = \frac{1}{\kappa} e^{-(T-t)r} \Phi_- \left( t, \frac{1}{R_t} \right) - \frac{e^{-(T-t)r}}{R_t} \Phi_+ \left( t, \frac{1}{R_t} \right) \]

on the foreign market corresponds to a buy back guarantee in currency exchange. In the case of an option at the money with \( \kappa = R_t \) with \( r = r^f \simeq 0 \) we find

\[ \mathbb{E} \left[ \left( \frac{1}{R_t} - \frac{1}{R_T} \right)^+ | R_t \right] = \frac{1}{R_t} \times \left( \Phi \left( \frac{\sigma \sqrt{T-t}}{2} \right) - \Phi \left( -\frac{\sigma \sqrt{T-t}}{2} \right) \right) = \frac{1}{R_t} \times \left( 2\Phi \left( \frac{\sigma \sqrt{T-t}}{2} \right) - 1 \right). \]

For example, if \( T - t = 30 \) days, \( \sigma = 10\% \), and \( R_t \) denotes the USD/EUR (USDEUR=X) exchange rate from a local currency (USD) and a foreign currency (EUR), i.e. one unit of local currency (USD) corresponds to \( R_t = 1/1.23 \) units of foreign currency (EUR) we find

\[ \mathbb{E} \left[ \left( \frac{1}{R_t} - \frac{1}{R_T} \right)^+ | R_t \right] = 1.23 \left( 2\Phi \left( 0.505813 \right) - 1 \right) = 1.23(2 \times 0.505813 - 1) = 0.01429986 \]

Table 15.1: Local vs foreign markets.
per USD, or €$0.011626 per EUR. Based on an actual option price of €4.5, this would result into an average amount of $4.5/0.011626 \approx 387$ exchanged at counters.

15.4 Pricing Exchange Options

Based on Proposition 15.4, we model the process $\hat{X}_t$ of forward prices as a continuous martingale under $\hat{P}$, written as

$$d\hat{X}_t = \hat{\sigma}_t d\hat{W}_t, \quad t \in \mathbb{R}_+,$$

where $(\hat{W}_t)_{t \in \mathbb{R}_+}$ is a standard Brownian motion under $\hat{P}$ and $(\hat{\sigma}_t)_{t \in \mathbb{R}_+}$ is an $(\mathcal{F}_t)_{t \in \mathbb{R}_+}$-adapted process. More precisely, we assume that $(\hat{X}_t)_{t \in \mathbb{R}_+}$ has the dynamics

$$d\hat{X}_t = \hat{\sigma}_t(\hat{X}_t) d\hat{W}_t,$$

where the function $x \mapsto \hat{\sigma}_t(x)$ is uniformly Lipschitz in $t \in \mathbb{R}_+$. The Markov property of the diffusion process $(\hat{X}_t)_{t \in \mathbb{R}_+}$, cf. Theorem V-6-32 of Protter (2004), shows that when $\hat{g}$ is a deterministic payoff function, the conditional expectation $\hat{E}[\hat{g}(\hat{X}_T) \mid \mathcal{F}_t]$ can be written using a (measurable) function $\hat{C}(t, x)$ of $t$ and $\hat{X}_t$, as

$$\hat{E}[\hat{g}(\hat{X}_T) \mid \mathcal{F}_t] = \hat{C}(t, \hat{X}_t), \quad 0 \leq t \leq T.$$

Consequently, a vanilla option with claim payoff $C := N_T \hat{g}(\hat{X}_T)$ can be priced as

$$\mathbb{E}^* \left[ e^{-\int_0^T r_s ds} N_T \hat{g}(\hat{X}_T) \mid \mathcal{F}_t \right] = N_t \hat{E}[\hat{g}(\hat{X}_T) \mid \mathcal{F}_t] = N_t \hat{C}(t, \hat{X}_t), \quad 0 \leq t \leq T. \quad (15.27)$$

In the next Proposition 15.12 we state the Margrabe (1978) formula for the pricing of exchange options by the zero interest rate Black-Scholes formula. It will be applied in particular in Proposition 18.3 below for the pricing of bond options. Here, $(N_t)_{t \in \mathbb{R}_+}$ denotes any numéraire process satisfying Assumption (A).

**Proposition 15.12.** (Margrabe formula). Assume that $\hat{\sigma}_t(\hat{X}_t) = \hat{\sigma}(t)\hat{X}_t$, i.e. the martingale $(\hat{X}_t)_{t \in [0,T]}$ is a (driftless) geometric Brownian motion under $\hat{P}$ with deterministic volatility $(\hat{\sigma}(t))_{t \in [0,T]}$. Then we have
\[ t \in [0, T], \text{ where} \]
\[ \Phi_+^0 (t, x) = \Phi \left( \frac{\log (x / \kappa)}{v(t, T)} + \frac{v(t, T)}{2} \right), \quad \Phi_-^0 (t, x) = \Phi \left( \frac{\log (x / \kappa)}{v(t, T)} - \frac{v(t, T)}{2} \right), \]
\[ (15.29) \]
and \( v^2 (t, T) = \int_t^T \tilde{\sigma}^2 (s) ds. \)

**Proof.** Taking \( g(x) := (x - \kappa)^+ \) in (15.27), the call option with payoff
\[ (X_T - \kappa N_T)^+ = N_T (\tilde{X}_T - \kappa)^+ \]
\[ = N_T \left( \tilde{X}_t \exp \left( \int_t^T \tilde{\sigma} (t) d\tilde{W}_t - \frac{1}{2} \int_t^T |\tilde{\sigma} (t)|^2 dt \right) - \kappa \right)^+, \]
and floating strike price \( \kappa N_T \) is priced by (15.27) as
\[ \mathbb{E}^* \left[ e^{-\int_t^T r_s ds} (X_T - \kappa N_T)^+ \mid \mathcal{F}_t \right] = \mathbb{E}^* \left[ e^{-\int_t^T r_s ds} N_T (\tilde{X}_T - \kappa)^+ \mid \mathcal{F}_t \right] \]
\[ = N_t \mathbb{E} [(\tilde{X}_T - \kappa)^+ \mid \mathcal{F}_t] \]
\[ = N_t \tilde{C}(t, \tilde{X}_t), \]
where the function \( \tilde{C}(t, \tilde{X}_t) \) is given by the Black-Scholes formula
\[ \tilde{C}(t, x) = x \Phi_+^0 (t, x) - \kappa \Phi_-^0 (t, x), \]
with zero interest rate, since \( (\tilde{X}_t)_{t \in [0, T]} \) is a driftless geometric Brownian motion which is an \( \mathcal{F}_t \)-martingale under \( \tilde{\mathbb{P}} \), and \( \tilde{X}_T \) is a lognormal random variable with variance coefficient \( v^2 (t, T) = \int_t^T \tilde{\sigma}^2 (s) ds. \) Hence we have
\[ \mathbb{E}^* \left[ e^{-\int_t^T r_s ds} (X_T - \kappa N_T)^+ \mid \mathcal{F}_t \right] = N_t \tilde{C}(t, \tilde{X}_t) \]
\[ = N_t \tilde{X}_t \Phi_+^0 (t, \tilde{X}_t) - \kappa N_t \Phi_-^0 (t, \tilde{X}_t), \]
t \in \mathbb{R}_+. \]

In particular, from Proposition 15.6 and (15.13), we can take \( \tilde{\sigma} (t) = \sigma_t^X - \sigma_t^N \) when \( (\sigma_t^X)_{t \in \mathbb{R}_+} \) and \( (\sigma_t^N)_{t \in \mathbb{R}_+} \) are deterministic.

**Examples:**

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a) When the short rate process \((r(t))_{t \in [0,T]}\) is a deterministic function of time and \(N_t = e^{-\int_t^T r(s) \, ds}, 0 \leq t \leq T\), we have \(\hat{P} = P^*\) and Proposition 15.12 yields Merton’s Merton (1973) “zero interest rate” version of the Black-Scholes formula

\[
e^{-\int_t^T r(s) \, ds} \mathbb{E}^* \left[ (X_T - \kappa)^+ \mid F_t \right] = X_t \Phi_+^0 \left( t, e^{\int_t^T r(s) \, ds} X_t \right) - \kappa e^{-\int_t^T r(s) \, ds} \Phi_-^0 \left( t, e^{\int_t^T r(s) \, ds} X_t \right),
\]

where \(\Phi_+^0\) and \(\Phi_-^0\) are defined in (15.29) and \((X_t)_{t \in \mathbb{R}}\) satisfies the equation

\[
\frac{dX_t}{X_t} = r(t) \, dt + \sigma(t) \, dW_t, \quad \text{i.e.} \quad \frac{d\hat{X}_t}{\hat{X}_t} = \tilde{\sigma}(t) \, dW_t, \quad 0 \leq t \leq T.
\]

b) In the case of pricing under a forward numéraire, i.e. when \((N_t)_{t \in [0,T]} = (P(t,T))_{t \in [0,T]}\), we get

\[
\mathbb{E}^* \left[ e^{-\int_t^T r_s \, ds} (X_T - \kappa)^+ \mid F_t \right] = X_t \Phi_+^0 \left( t, \hat{X}_t \right) - \kappa P(t,T) \Phi_-^0 \left( t, \hat{X}_t \right),
\]

\(0 \leq t \leq T\), since \(P(T,T) = 1\). In particular, when \(X_t = P(t,S)\) the above formula allows us to price a bond call option on \(P(T,S)\) as

\[
\mathbb{E}^* \left[ e^{-\int_t^T r_s \, ds} (P(T,S) - \kappa)^+ \mid F_t \right] = P(t,S) \Phi_+^0 \left( t, \hat{X}_t \right) - \kappa P(t,T) \Phi_-^0 \left( t, \hat{X}_t \right),
\]

\(0 \leq t \leq T\), provided that the martingale \(\hat{X}_t = P(t,S)/P(t,T)\) under \(\hat{P}\) is given by a geometric Brownian motion, cf. Section 18.2.

15.5 Hedging by Change of Numéraire

In this section we reconsider and extend the Black-Scholes self-financing hedging strategies found in (7.32)-(7.33) and Proposition 7.13 of Chapter 7. For this, we use the stochastic integral representation of the forward claim payoffs and change of numéraire in order to compute self-financing portfolio strategies. Our hedging portfolios will be built on the assets \((X_t, N_t)\), not on \(X_t\) and the money market account \(B_t = e^{\int_0^t r_s \, ds}\), extending the classical hedging portfolios that are available in from the Black-Scholes formula, using a technique from Jamshidian (1996), cf. also Privault and Teng (2012).

Consider a claim with random payoff \(C\), typically an interest rate derivative, cf. Chapter 18. Assume that the forward claim payoff \(C/N_T \in L^2(\Omega)\) has the stochastic integral representation

\[
\mathbb{E}^* \left[ e^{-\int_t^T r_s \, ds} \mathbb{E}^* \left[ \frac{C}{N_T} \mid F_t \right] \mid F_t \right] = \mathbb{E}^* \left[ e^{-\int_t^T r_s \, ds} \mathbb{E}^* \left[ \frac{C}{N_T} \mid F_t \right] \mid F_t \right] = \mathbb{E}^* \left[ e^{-\int_t^T r_s \, ds} \mathbb{E}^* \left[ \frac{C}{N_T} \mid F_t \right] \mid F_t \right]
\]
\( \tilde{C} := \frac{C}{N_T} = \mathbb{E} \left[ \frac{C}{N_T} \right] + \int_0^T \tilde{\phi}_t d\tilde{X}_t, \)  

(15.30)

where \((\tilde{X}_t)_{t \in [0,T]}\) is given by (15.25) and \((\tilde{\phi}_t)_{t \in [0,T]}\) is a square-integrable adapted process under \( \hat{\mathbb{P}} \), from which it follows that the forward claim price

\[
\tilde{V}_t := \frac{V_t}{N_t} = \frac{1}{N_t} \mathbb{E}^* \left[ e^{-\int_0^T r_s ds} C \bigg| \mathcal{F}_t \right] = \mathbb{E} \left[ \frac{C}{N_T} \bigg| \mathcal{F}_t \right], \quad 0 \leq t \leq T,
\]

is an \( \mathcal{F}_t \)-martingale under \( \hat{\mathbb{P}} \), that can be decomposed as

\[
\tilde{V}_t = \mathbb{E} \left[ \tilde{C} \bigg| \mathcal{F}_t \right] = \mathbb{E} \left[ \frac{C}{N_T} \bigg| \mathcal{F}_t \right] + \int_0^t \tilde{\phi}_s d\tilde{X}_s, \quad 0 \leq t \leq T. \tag{15.31}
\]

The next proposition extends the argument of Jamshidian (1996) to the general framework of pricing using change of numéraire. Note that this result differs from the standard formula that uses the money market account \( B_t = e^{\int_0^t r_s ds} \) for hedging instead of \( N_t \), cf. e.g. Geman et al. (1995) pages 453-454. The notion of self-financing portfolio is similar to that of Definition 5.8.

**Proposition 15.13.** Letting \( \hat{\eta}_t := \tilde{V}_t - \tilde{X}_t \tilde{\phi}_t \), with \( \tilde{\phi}_t \) defined in (15.31), \( 0 \leq t \leq T \), the portfolio allocation \((\tilde{\phi}_t, \hat{\eta}_t)_{t \in [0,T]}\) with value

\[
V_t = \tilde{\phi}_t X_t + \hat{\eta}_t N_t, \quad 0 \leq t \leq T,
\]

is self-financing in the sense that

\[
dV_t = \tilde{\phi}_t dX_t + \hat{\eta}_t dN_t,
\]

and it hedges the claim payoff \( C \), i.e.

\[
V_t = \tilde{\phi}_t X_t + \hat{\eta}_t N_t = \mathbb{E}^* \left[ e^{-\int_0^T r_s ds} C \bigg| \mathcal{F}_t \right], \quad 0 \leq t \leq T. \tag{15.32}
\]

**Proof.** In order to check that the portfolio allocation \((\tilde{\phi}_t, \hat{\eta}_t)_{t \in [0,T]}\) hedges the claim payoff \( C \) it suffices to check that (15.32) holds since by (15.4) the price \( V_t \) at time \( t \in [0, T] \) of the hedging portfolio satisfies

\[
V_t = N_t \tilde{V}_t = \mathbb{E}^* \left[ e^{-\int_0^T r_s ds} C \bigg| \mathcal{F}_t \right], \quad 0 \leq t \leq T.
\]

Next, we show that the portfolio allocation \((\tilde{\phi}_t, \hat{\eta}_t)_{t \in [0,T]}\) is self-financing. By *numéraire invariance*, cf. e.g. page 184 of Protter (2001), we have, using the relation \( d\tilde{V}_t = \tilde{\phi}_t d\tilde{X}_t \) from (15.31),

\[
dV_t = d(N_t \tilde{V}_t)
\]
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\[ V_t dN_t + N_t d\tilde{V}_t + dN_t \cdot d\tilde{V}_t \]
\[ = \tilde{V}_t dN_t + N_t \tilde{\phi}_t d\tilde{X}_t + \tilde{\phi}_t dN_t \cdot d\tilde{X}_t \]
\[ = \tilde{\phi}_t \tilde{X}_t dN_t + N_t \tilde{\phi}_t d\tilde{X}_t + \tilde{\phi}_t dN_t \cdot d\tilde{X}_t + (\tilde{V}_t - \tilde{\phi}_t \tilde{X}_t) dN_t \]
\[ = \tilde{\phi}_t (N_t \tilde{X}_t) + \tilde{\eta}_t dN_t \]
\[ = \tilde{\phi}_t dX_t + \tilde{\eta}_t dN_t. \]

\[ \square \]

We now consider an application to the forward Delta hedging of European-type options with payoff
\[ C = N_T \tilde{g}(\tilde{X}_T) \] where \( \tilde{g} : \mathbb{R} \rightarrow \mathbb{R} \) and \( \tilde{X}_t \) has the Markov property as in (15.26), where \( \sigma : \mathbb{R}_+ \times \mathbb{R} \) is a deterministic function. Assuming that the function \( \tilde{C}(t, x) \) defined by
\[ \tilde{V}_t := \tilde{E}[\tilde{g}(\tilde{X}_T) | \mathcal{F}_t] = \tilde{C}(t, \tilde{X}_t) \]
is \( C^2 \) on \( \mathbb{R}_+ \), we have the following corollary of Proposition 15.13, which extends the Black-Scholes Delta hedging technique to the general change of numéraire setup.

**Corollary 15.14.** Letting \( \tilde{\eta}_t = \tilde{C}(t, \tilde{X}_t) - \tilde{X}_t \frac{\partial \tilde{C}}{\partial x}(t, \tilde{X}_t), 0 \leq t \leq T, \) the portfolio allocation \( \left( \frac{\partial \tilde{C}}{\partial x}(t, \tilde{X}_t), \tilde{\eta}_t \right) \) with value
\[ V_t = \tilde{\eta}_t N_t + X_t \frac{\partial \tilde{C}}{\partial x}(t, \tilde{X}_t), \quad t \in \mathbb{R}_+, \]
is self-financing and hedges the claim payoff \( C = N_T \tilde{g}(\tilde{X}_T). \)

**Proof.** This result follows directly from Proposition 15.13 by noting that by Itô’s formula, and the martingale property of \( \tilde{V}_t \) under \( \tilde{P} \) the stochastic integral representation (15.31) is given by
\[ \tilde{V}_T = \tilde{C} \]
\[ = \tilde{g}(\tilde{X}_T) \]
\[ = \tilde{C}(0, \tilde{X}_0) + \int_0^T \frac{\partial \tilde{C}}{\partial t}(t, \tilde{X}_t) dt + \int_0^T \frac{\partial \tilde{C}}{\partial x}(t, \tilde{X}_t) d\tilde{X}_t \]
\[ + \frac{1}{2} \int_0^T \frac{\partial^2 \tilde{C}}{\partial x^2}(t, \tilde{X}_t) |\tilde{\sigma}_t|^2 dt \]
\[ = \tilde{C}(0, \tilde{X}_0) + \int_0^T \frac{\partial \tilde{C}}{\partial x}(t, \tilde{X}_t) d\tilde{X}_t \]
\[ = \tilde{E} \left[ \frac{C}{N_T} \right] + \int_0^T \tilde{\phi}_t d\tilde{X}_t, \quad 0 \leq t \leq T, \]
hence
\[
\hat{\phi}_t = \frac{\partial \hat{C}}{\partial x}(t, \hat{X}_t), \quad 0 \leq t \leq T.
\]

In the case of an exchange option with payoff function
\[
C = (X_T - \kappa N_T)^+ = N_T(\hat{X}_T - \kappa)^+
\]
on the geometric Brownian motion \((\hat{X}_t)_{t \in [0,T]}\) under \(\hat{P}\) with
\[
\hat{\sigma}_t(\hat{X}_t) = \hat{\sigma}(t)\hat{X}_t,
\]
where \((\hat{\sigma}(t))_{t \in [0,T]}\) is a deterministic volatility function of time, we have the following corollary on the hedging of exchange options based on the Margrabe formula (15.28).

**Corollary 15.15.** The decomposition
\[
\mathbb{E}^* \left[ e^{-\int_t^T r_s ds} (X_T - \kappa N_T)^+ \middle| \mathcal{F}_t \right] = X_t \Phi^0_+ (t, \hat{X}_t) - \kappa N_t \Phi^0_- (t, \hat{X}_t)
\]
yields a self-financing portfolio allocation \((\Phi^0_+ (t, \hat{X}_t), -\kappa \Phi^0_- (t, \hat{X}_t))_{t \in [0,T]}\) in the assets \((X_t, N_t)\), that hedges the claim payoff \(C = (X_T - \kappa N_T)^+\).

**Proof.** We apply Corollary 15.14 and the relation
\[
\frac{\partial \hat{C}}{\partial x}(t, x) = \Phi^0_+ (t, x), \quad x \in \mathbb{R},
\]
for the function \(\hat{C}(t, x) = x \Phi^0_+ (t, x) - \kappa \Phi^0_- (t, x)\), cf. Relation (6.12) in Proposition 6.3.

Note that the Delta hedging method requires the computation of the function \(\hat{C}(t, x)\) and that of the associated finite differences, and may not apply to path-dependent claims.

**Examples:**

a) When the short rate process \((r(t))_{t \in [0,T]}\) is a deterministic function of time and \(N_t = e^{\int_t^T r(s) ds}\), Corollary 15.15 yields the usual Black-Scholes hedging strategy
\[
\left( \Phi^0_+ (t, \hat{X}_t), -\kappa e^{\int_t^T r(s) ds} \Phi^0_- (t, X_t) \right)_{t \in [0,T]}
\]

\[
= \left( \Phi^0_+ (t, e^{\int_t^T r(s) ds} \hat{X}_t), -\kappa e^{\int_t^T r(s) ds} \Phi^0_- (t, e^{\int_t^T r(s) ds} X_t) \right)_{t \in [0,T]},
\]

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https://www.ntu.edu.sg/home/nprivault/index.html
in the assets $(X_t, \exp_t^0 r(s) ds)$, that hedges the claim payoff $C = (X_T - \kappa)^+$, with

$$\Phi_+(t, x) := \Phi \left( \frac{\log(x/\kappa) + \left( \int_t^T r(s) ds + (T-t)\sigma^2/2 \right)}{\sigma \sqrt{T-t}} \right),$$

and

$$\Phi_-(t, x) := \Phi \left( \frac{\log(x/\kappa) + \left( \int_t^T r(s) ds - (T-t)\sigma^2/2 \right)}{\sigma \sqrt{T-t}} \right).$$

b) In case $N_t = P(t, T)$ and $X_t = P(t, S)$, $0 \leq t \leq T < S$, Corollary 15.15 shows that when $(\tilde{X}_t)_{t \in [0, T]}$ is modeled as the geometric Brownian motion (15.33) under $\widehat{P}$, the bond call option with payoff $(P(T, S) - \kappa)^+$ can be hedged as

$$E^* \left[ e^{-\int_t^T r(s) ds} (P(T, S) - \kappa)^+ \mid F_t \right] = P(t, S) \Phi_+(t, \tilde{X}_t) - \kappa P(t, T) \Phi_-(t, \tilde{X}_t)$$

by the self-financing portfolio allocation

$$(\Phi_+(t, \tilde{X}_t), -\kappa \Phi_-(t, \tilde{X}_t))_{t \in [0, T]}$$

in the assets $(P(t, S), P(t, T))$, i.e. one needs to hold the quantity $\Phi_+(t, \tilde{X}_t)$ of the bond maturing at time $S$, and to short a quantity $\kappa \Phi_-(t, \tilde{X}_t)$ of the bond maturing at time $T$.

**Exercises**

Exercise 15.1 Let $(B_t)_{t \in \mathbb{R}_+}$ be a standard Brownian motion started at 0 under the risk-neutral probability measure $\mathbb{P}^*$. Consider a numéraire $(N_t)_{t \in \mathbb{R}_+}$ given by

$$N_t := N_0 \exp^{\eta B_t - \eta^2 t/2}, \quad t \in \mathbb{R}_+,$$

and a risky asset $(X_t)_{t \in \mathbb{R}_+}$ given by

$$X_t := X_0 \exp^{\sigma B_t - \sigma^2 t/2}, \quad t \in \mathbb{R}_+,$$

in a market with risk-free interest rate $r = 0$. Let $\widehat{P}$ denote the forward measure relative to the numéraire $(N_t)_{t \in \mathbb{R}_+}$, under which the process $\tilde{X}_t := X_t/N_t$ of forward prices is known to be a martingale.

a) Using the Itô formula, compute
\[ d\tilde{X}_t = d\left( \frac{X_t}{N_t} \right) = \frac{X_0}{N_0} d\left( e^{(\sigma-\eta)B_t-(\sigma^2-\eta^2)t/2} \right). \]

b) Explain why the exchange option price \( \mathbb{E}^*[(X_T - \lambda N_T)^+] \) at time 0 has the Black-Scholes form

\[
\mathbb{E}^*[(X_T - \lambda N_T)^+] = X_0 \Phi \left( \frac{\log(\tilde{X}_0/\lambda)}{\tilde{\sigma}\sqrt{T}} + \frac{\tilde{\sigma}\sqrt{T}}{2} \right) - \lambda N_0 \Phi \left( \frac{\log(\tilde{X}_0/\lambda)}{\tilde{\sigma}\sqrt{T}} - \frac{\tilde{\sigma}\sqrt{T}}{2} \right).
\]

Hints:

(i) Use the change of numéraire identity

\[
\mathbb{E}^*[(X_T - \lambda N_T)^+] = N_0 \mathbb{E}^\lambda[(\tilde{X}_T - \lambda)^+].
\]

(ii) The forward price \( \tilde{X}_t \) is a martingale under the forward measure \( \mathbb{P} \) relative to the numéraire \( (N_t)_{t \in \mathbb{R}_+} \).

c) Give the value of \( \tilde{\sigma} \) in terms of \( \sigma \) and \( \eta \).

Exercise 15.2 Let \( (B_t^{(1)})_{t \in \mathbb{R}_+} \) and \( (B_t^{(2)})_{t \in \mathbb{R}_+} \) be correlated standard Brownian motions started at 0 under the risk-neutral probability measure \( \mathbb{P}^* \), with correlation \( \text{Corr}(B_s^{(1)}, B_t^{(2)}) = \rho \min(s, t) \), \( \text{i.e.} \ dB_t^{(1)} \cdot dB_t^{(2)} = \rho dt \). Consider two asset prices \( (S_t^{(1)})_{t \in \mathbb{R}_+} \) and \( (S_t^{(2)})_{t \in \mathbb{R}_+} \) given by the geometric Brownian motions

\[
S_t^{(1)} := S_0^{(1)} e^{rt + \sigma B_t^{(1)} - \sigma^2 t/2}, \quad \text{and} \quad S_t^{(2)} := S_0^{(2)} e^{rt + \eta B_t^{(2)} - \eta^2 t/2}, \quad t \in \mathbb{R}_+.
\]

Let \( \mathbb{P}_2 \) denote the forward measure with numéraire \( (N_t)_{t \in \mathbb{R}_+} := (S_t^{(2)})_{t \in \mathbb{R}_+} \) and density

\[
\frac{d\mathbb{P}_2}{d\mathbb{P}^*} = e^{-rT} \frac{S_T^{(2)}}{S_0^{(2)}} = e^{\eta B_T^{(2)} - \eta^2 T/2}.
\]

a) Using the Girsanov Theorem 15.5, determine the shifts \( \hat{B}_t^{(1)}_{t \in \mathbb{R}_+} \) and \( \hat{B}_t^{(2)}_{t \in \mathbb{R}_+} \) of \( (B_t^{(1)})_{t \in \mathbb{R}_+} \) and \( (B_t^{(2)})_{t \in \mathbb{R}_+} \) which are standard Brownian motions under \( \mathbb{P}_2 \).

b) Using the Itô formula, compute

\[
d\hat{S}_t^{(1)} = d\left( \frac{S_t^{(1)}}{S_t^{(2)}} \right).
\]
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\[
= \frac{S_0^{(1)}}{S_0^{(2)}} d\left( e^{\sigma B^{(1)}_t - \eta B^{(2)}_t} - (\sigma^2 - \eta^2)t/2 \right),
\]

and write the answer in terms of the martingales \( d\tilde{B}^{(1)}_t \) and \( d\tilde{B}^{(2)}_t \).

c) Using change of numéraire, explain why the exchange option price

\[
e^{-rT} \mathbb{E}^* \left[ (S_T^{(1)} - \lambda S_T^{(2)})^+ \right]
\]

at time 0 has the Black-Scholes form

\[
e^{-rT} \mathbb{E}^* \left[ (S_T^{(1)} - \lambda S_T^{(2)})^+ \right] = S_0^{(1)} \Phi \left( \frac{\log \left( S_0^{(1)}/\lambda \right) + \hat{\sigma} \sqrt{T}}{\hat{\sigma} \sqrt{T}} - \frac{\hat{\sigma} \sqrt{T}}{2} \right)
\]

\[\quad -\lambda S_0^{(2)} \Phi \left( \frac{\log \left( \hat{S}_0^{(1)}/\lambda \right)}{\hat{\sigma} \sqrt{T}} - \frac{\hat{\sigma} \sqrt{T}}{2} \right).\]

d) Give the value of \( \hat{\sigma} \) in terms of \( \sigma \) and \( \eta \).

Exercise 15.3  Consider two zero-coupon bond prices of the form \( P(t, T) = F(t, r_t) \) and \( P(t, S) = G(t, r_t) \), where \( (r_t)_{t \in \mathbb{R}_+} \) is a short-term interest rate process. Taking \( N_t := P(t, T) \) as a numéraire defining the forward measure \( \hat{\mathbb{P}} \), compute the dynamics of \( (P(t, S))_{t \in [0, T]} \) under \( \hat{\mathbb{P}} \) using a standard Brownian motion \( (\hat{W}_t)_{t \in [0, T]} \) under \( \hat{\mathbb{P}} \).

Exercise 15.4  Forward contract. Using a change of numéraire argument for the numéraire \( N_t := P(t, T), t \in [0, T] \), compute the price at time \( t \in [0, T] \) of a forward (or future) contract with payoff \( P(T, S) - K \) in a bond market with short-term interest rate \( (r_t)_{t \in \mathbb{R}_+} \). How would you hedge this forward contract?

Exercise 15.5  (Question 2.7 page 17 of Downes et al. (2008)). Consider a price process \( (S_t)_{t \in \mathbb{R}_+} \) given by \( dS_t = rS_t dt + \sigma S_t dB_t \) under the risk-neutral measure \( \mathbb{P}^* \). Using change of numéraire and a forward measure, price the option with payoff

\[
(S_T(S_T - K))^+ = \max(S_T(S_T - K), 0)
\]
at time \( t \in [0, T] \) from the Black-Scholes formula.

Exercise 15.6  Bond options. Consider two bonds with maturities \( T \) and \( S \), with prices \( P(t, T) \) and \( P(t, S) \) given by

\[\circ\]
\[ \frac{dP(t, T)}{P(t, T)} = r_t dt + \zeta^T_t dW_t, \]

and
\[ \frac{dP(t, S)}{P(t, S)} = r_t dt + \zeta^S_t dW_t, \]

where \((\zeta^T(s))_{s \in [0, T]}\) and \((\zeta^S(s))_{s \in [0, S]}\) are deterministic volatility functions of time.

a) Show, using Itô’s formula, that
\[
d \left( \frac{P(t, S)}{P(t, T)} \right) = \frac{P(t, S)}{P(t, T)} (\zeta^S(t) - \zeta^T(t)) d\tilde{W}_t,
\]

where \((\tilde{W}_t)_{t \in \mathbb{R}_+}\) is a standard Brownian motion under \(\tilde{P}\).

b) Show that
\[
P(T, S) = \frac{P(t, S)}{P(t, T)} \exp \left( \int_t^T (\zeta^S(s) - \zeta^T(s)) d\tilde{W}_s - \frac{1}{2} \int_t^T |\zeta^S(s) - \zeta^T(s)|^2 ds \right).
\]

Let \(\tilde{P}\) denote the forward measure associated to the numéraire
\[
N_t := P(t, T), \quad 0 \leq t \leq T.
\]

c) Show that for all \(S, T > 0\) the price at time \(t\)
\[
\mathbb{E}^* \left[ e^{-\int_t^T r_s ds} (P(T, S) - \kappa)^+ \big| \mathcal{F}_t \right]
\]
of a bond call option on \(P(T, S)\) with payoff \((P(T, S) - \kappa)^+\) is equal to
\[
\mathbb{E}^* \left[ e^{-\int_t^T r_s ds} (P(T, S) - \kappa)^+ \big| \mathcal{F}_t \right] = P(t, S) \Phi \left( \frac{v}{2} + \frac{1}{v} \log \frac{P(t, S)}{\kappa P(t, T)} \right) - \kappa P(t, T) \Phi \left( -\frac{v}{2} + \frac{1}{v} \log \frac{P(t, S)}{\kappa P(t, T)} \right),
\]

where
\[
v^2 = \int_t^T |\zeta^S(s) - \zeta^T(s)|^2 ds.
\]
d) Compute the self-financing hedging strategy that hedges the bond option using a portfolio based on the assets \(P(t, T)\) and \(P(t, S)\).

Exercise 15.7 Consider two risky assets \(S_1\) and \(S_2\) modeled by the geometric Brownian motions
\[
S_1(t) = e^{\sigma_1 W_t + \mu t} \quad \text{and} \quad S_2(t) = e^{\sigma_2 W_t + \mu t}, \quad t \in \mathbb{R}_+,
\]

where \(\sigma_1, \sigma_2, \mu\) are constants.
where \((W_t)_{t \in \mathbb{R}_+}\) is a standard Brownian motion under \(\mathbb{P}\).

a) Find a condition on \(r, \mu\) and \(\sigma_2\) so that the discounted price process \(e^{-rt}S_2(t)\) is a martingale under \(\mathbb{P}\).

b) Assume that \(r - \mu = \sigma_2^2/2\), and let
\[
X_t = e^{(\sigma_2^2 - \sigma_1^2)t/2}S_1(t), \quad t \in \mathbb{R}_+.
\]

Show that the discounted process \(e^{-rt}X_t\) is a martingale under \(\mathbb{P}\).

c) Taking \(N_t = S_2(t)\) as numéraire, show that the forward process \(\hat{X}(t) = X_t/N_t\) is a martingale under the forward measure \(\hat{\mathbb{P}}\) defined by
\[
\frac{d\hat{\mathbb{P}}}{d\mathbb{P}} = e^{-rT}N_T/N_0.
\]

Recall that
\[
\hat{W}_t := W_t - \sigma_2 t
\]
is a standard Brownian motion under \(\hat{\mathbb{P}}\).

d) Using the relation
\[
e^{-rT} \mathbb{E}^*[(S_1(T) - S_2(T))^+] = N_0 \mathbb{E}^*[(S_1(T) - S_2(T))^+/N_T],
\]
compute the price
\[
e^{-rT} \mathbb{E}^*[(S_1(T) - S_2(T))^+]
\]
of the exchange option on the assets \(S_1\) and \(S_2\).

Exercise 15.8: Compute the price \(e^{-(T-t)r} \mathbb{E}^*[1_{\{R_T \geq \kappa\}} \mid R_t]\) at time \(t \in [0, T]\) of a cash-or-nothing “binary” foreign exchange call option with maturity \(T\) and strike price \(\kappa\) on the foreign exchange rate process \((R_t)_{t \in \mathbb{R}_+}\) given by
\[
dR_t = (r - r^f)R_t dt + \sigma R_t dW_t.
\]

Hint: We have the relation
\[
\mathbb{P}^*(xe^{X+\mu} \geq \kappa) = \Phi\left(\frac{\mu - \log(\kappa/x)}{\sqrt{\text{Var}[X]}}\right)
\]
for \(X \simeq \mathcal{N}(0, \text{Var}[X])\) a centered Gaussian random variable.

Exercise 15.9: Extension of Proposition 15.6 to correlated Brownian motions. Assume that \((S_t)_{t \in \mathbb{R}_+}\) and \((N_t)_{t \in \mathbb{R}_+}\) satisfy the stochastic differential equations
\[
dS_t = r_s S_t dt + \sigma^S S_t dW^S_t, \quad \text{and} \quad dN_t = \eta_t N_t dt + \sigma^N N_t dW^N_t,
\]
where \((W^S_t)_{t \in \mathbb{R}_+}\) and \((W^N_t)_{t \in \mathbb{R}_+}\) have the correlation

\[ dW^S_t \cdot dW^N_t = \rho dt, \]

where \(\rho \in [-1, 1]\).

a) Show that \((W^N_t)_{t \in \mathbb{R}_+}\) can be written as

\[ W^N_t = \rho W^S_t + \sqrt{1 - \rho^2} W_t, \quad t \in \mathbb{R}_+, \]

where \((W_t)_{t \in \mathbb{R}_+}\) is a standard Brownian motion under \(\mathbb{P}^*\), independent of \((W^S_t)_{t \in \mathbb{R}_+}\).

b) Letting \(X_t = S_t / N_t\), show that \(dX_t\) can be written as

\[ dX_t = (r_t - \eta_t + (\sigma^N_t)^2 - \rho \sigma^N_t \sigma^S_t) X_t dt + \tilde{\sigma}_t X_t dW^X_t, \]

where \((W^X_t)_{t \in \mathbb{R}_+}\) is a standard Brownian motion under \(\mathbb{P}^*\) and \(\tilde{\sigma}_t\) is to be computed.

Exercise 15.10 Quanto options (Exercise 9.5 in Shreve (2004)). Consider an asset priced \(S_t\) at time \(t\), with

\[ dS_t = r S_t dt + \sigma S_t dW^S_t, \]

and an exchange rate \((R_t)_{t \in \mathbb{R}_+}\) given by

\[ dR_t = (r - r^f) R_t dt + \sigma R_t dW^R_t, \]

from (15.18) in Proposition 15.8, where \((W^R_t)_{t \in \mathbb{R}_+}\) is written as

\[ W^R_t = \rho W^S_t + \sqrt{1 - \rho^2} W_t, \quad t \in \mathbb{R}_+, \]

where \((W_t)_{t \in \mathbb{R}_+}\) is a standard Brownian motion under \(\mathbb{P}^*\), independent of \((W^S_t)_{t \in \mathbb{R}_+}\), i.e. we have

\[ dW^R_t \cdot dW^S_t = \rho dt, \]

where \(\rho\) is a correlation coefficient.

a) Let

\[ a = r - r^f + \rho \sigma R \sigma S - (\sigma^R)^2 \]

and \(X_t = e^{a t} S_t / R_t, t \in \mathbb{R}_+\), and show by Exercise 15.9 that \(dX_t\) can be written as

\[ dX_t = r X_t dt + \tilde{\sigma} X_t dW^X_t, \]

where \((W^X_t)_{t \in \mathbb{R}_+}\) is a standard Brownian motion under \(\mathbb{P}^*\) and \(\tilde{\sigma}\) is to be determined.

b) Compute the price
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\[ e^{-(T-t)r} \mathbb{E}^* \left[ \left( \frac{S_T}{R_T} - \kappa \right)^+ \mid \mathcal{F}_t \right] \]

of the quanto option at time \( t \in [0, T] \).