

Adaptive Finite Element Methods for Local Volatility European Option Pricing

Alexandre Ern
CERMICS, Ecole nationale des ponts et chaussées
6 et 8 avenue Blaise Pascal
77455 Marne la Vallée cedex 2, France
ern@cermics.enpc.fr

Stéphane Villeneuve
Université d'Evry Val d'Essonne
Equipe d'Analyse et de Probabilité
Boulevard F.Mitterand
91 025 Evry cedex, France
svillene@maths.univ-evry.fr

Antonino Zanette
Dipartimento di Finanza dell'Impresa
e dei Mercati Finanziari
Università di Udine
via Tomadini 30/A, Udine, Italy
antonino.zanette@dfimf.uniud.it

February 5, 2003

Premia 5

1 Introduction

Over the last few years, significant progress has been made in the understanding of adaptive finite element approximation of partial differential equations (PDEs) based on a posteriori error estimation. For a recent review including residual error estimators, error estimators based on the solution of local problems and hierarchical basis error estimators, we refer to [13]. Among a posteriori error estimators, a promising approach appears to be the dual weighted residual (DWR) method. Its key advantage is that it allows to control the error by means of a user-specified functional output that may target quantities of interest. In the context of finance problems, this is particularly appealing for pricing problems where the practitioner needs to compute highly accurate option prices for specific values of the stock. Targeting quantities of interest may also be extremely useful in calibration problems where the volatility map is reconstructed from market prices. Another advantage of the DWR method is that error propagation through the computational domain is accounted for via the solution of a dual problem whose data is the density of the prescribed functional. From a financial viewpoint, this is particularly important for low volatility problems where the hyperbolic part of the PDE may dominate the elliptic terms.

The main concept in the DWR method is to introduce an auxiliary PDE problem, usually called the dual problem and written in terms of the formal adjoint of the PDE under consideration. The a posteriori error estimator may then be expressed in terms of various inner products involving the finite element residual of the numerical solution and quantities depending on the dual solution. Theoretical

results concerning the DWR method are presented in [5, 6, 2] for steady and unsteady problems. The DWR method may be conveniently implemented in the framework of an adaptive mesh refinement/derefinement procedure. To this purpose, the inner products in the error estimator are first localized into the space-time cells of the computational mesh. Local element bounds are then used to decide whether to refine (or derefine) the mesh locally. The efficiency of the DWR method for an extensive range of engineering problems is highlighted in [2].

The aim of this paper is to investigate the effectiveness of the DWR method in order to solve the partial differential equations associated with European option pricing in local volatility Black-Scholes models. In the Black-Scholes model, the price of a dividend-paying stock S_t follows the stochastic differential equation

$$\frac{dS_t}{S_t} = (r - \delta)dt + \sigma dB_t, \quad (1)$$

where the constant σ is the volatility of the stock. It is well-known that the price of a European call option has a closed-form solution. Nevertheless, since the volatility of the stock is not directly observable, practitioners often invert the closed-form solution in order to find the volatility σ (usually called *implied volatility*) that yields the best agreement with the market option price. It is well-known that the implied volatility varies with the strike and the time - *the smile effect*. Therefore, the model has to be extended in order to take this phenomenon into account. A type of model called *local volatility* considers that the volatility is a deterministic function of time and the underlying asset.

In this paper, we consider a market model of local volatility where the evolution of the stock-price is governed by the stochastic differential equation

$$\frac{dS_t}{S_t} = (r - \delta)dt + \sigma(t, S_t)dB_t, \quad (2)$$

where the interest rate r and the dividend rate δ are nonnegative constants and $(B_t)_{0 \leq t \leq T}$ is a standard Brownian motion. The volatility σ is a $C^{1,2}([0, T] \times \mathbb{R}_+)$ function and is assumed to be uniformly bounded, i.e. there exist two positive constants $\underline{\sigma}, \bar{\sigma}$ such that $\bar{\sigma} \geq \sigma(t, x) \geq \underline{\sigma} > 0$ for every $(t, x) \in [0, T] \times \mathbb{R}_+$.

Consider a derivative security with terminal payoff $\psi(S_T)$, where ψ is some continuous real function. In the absence of arbitrage, the price of the derivative is given by $P(t, S_t)$ where P solves the partial differential equation

$$\begin{cases} P_t + \mathcal{A}P = 0 & \text{on } (0, T] \times \mathbb{R}_+, \\ P(T, \cdot) = \psi & \text{on } \mathbb{R}_+, \end{cases} \quad (3)$$

with

$$\mathcal{A}P(t, x) = \hat{\sigma}(t, x)P_{xx}(t, x) + (r - \delta)xP_x(t, x) - rP(t, x), \quad (4)$$

and $\hat{\sigma}(t, x) = x^2 \frac{\sigma^2(t, x)}{2}$. In the context of PDEs, subscripts t and x refer to partial derivatives with respect to time and space respectively.

There are two problems in practice. One is the pricing problem which consists in computing option prices with reliable accuracy. Such problems are known to be difficult, especially near maturity. The second one is the calibration problem which focuses on the reconstruction of the volatility map from market prices. This paper will mainly focus on option pricing problems. For calibration problems, we refer to a recent paper [3] and references therein.

The paper is organized as follows. In Section 2, the finite element discretization with discontinuous in time and continuous in space functions is made concrete for European option problems with local volatility Black-Scholes models. The a posteriori error estimates are derived in Section 3. The adaptive mesh refinement algorithm including practical implementation is discussed in Section 4.

2 Discretization by space-time finite elements

We are interested in the numerical computation of the price function P . The numerical procedure consists in the following three steps:

- the parabolic problem (3) is localized to a bounded domain in space;
- the localized problem is written in weak form;
- an approximate solution is sought by means of a non-conforming Galerkin method involving discrete functions that are discontinuous in time and continuous in space.

In the sequel, it will be convenient to reverse the time variable and consider $u(t, \cdot) = P(T - t, \cdot)$.

2.1 Localization to a bounded domain

Consider the following approximation problem

$$\begin{cases} (u_a)_t - \mathcal{A}u_a = 0 \text{ on } (0, T] \times \Omega_a, \\ u_a(t, 1/a) = 0 \text{ and } u_a(t, a) = C_a(t), \\ u_a(0, \cdot) = \psi \text{ on } \Omega_a, \end{cases} \quad (5)$$

where $\Omega_a = (1/a, a)$ and $C_a(t)$ is an artificial boundary value imposed at $x = a$ and that may depend on time. The choice of a must answer two main purposes. First, the most probable values of S_T have to be contained in $(1/a, a)$. Second, a must be high enough to ensure the convergence of the approximated value u_a to the option value u . In order to impose relevant boundary conditions, it is necessary to understand the behavior of the solution at infinity and near zero. It is well-known that the convergence when we let the domain tend to $(0, +\infty)$ is governed by a phenomenon of large deviation type [1] and therefore the choice of Dirichlet boundary conditions leads to an exponential error. More precisely, we have the following lemma.

Lemma 1. *Suppose there exist constants c_1 and c_2 such that $\psi(x) \leq c_1 x$ for $x \in \mathbb{R}_+$, and $C_a(t) \leq c_2 a$ for $t \in (0, T)$. Then for every $a > 0$ and every $(t, x) \in (0, T) \times \Omega_a$, we have*

$$|u(t, x) - u_a(t, x)| \leq c_3 a \exp \left(- \frac{(\log(\frac{a}{x}) - (\frac{\bar{\sigma}^2}{2} + (r - \delta))(T - t))^2}{2\bar{\sigma}^2(T - t)} \right),$$

with $c_3 = \max(c_1, c_2)$.

It is worthwhile to point out that a high value for a induces substantial numerical costs. This drawback is in part circumvented by the adaptive method as we will see later. In our numerical experiments, we shall consider European call options with $\psi(x) = (x - K)_+$ and therefore take $C_a(t) = ae^{-\delta t} - Ke^{-rt}$.

2.2 Weak formulation

In order to write the localized problem (5) in weak form, we introduce the functional space

$$W(0, T; H_0^1(\Omega_a)) = \left\{ u \in L^2(0, T; H_0^1(\Omega_a)); u_t \in L^2(0, T; H^{-1}(\Omega_a)) \right\}.$$

Owing to the trace property $W(0, T; H_0^1(\Omega_a)) \subset C^0(0, T; L^2(\Omega_a))$ with continuous injection (see [11]), we have $u(t, \cdot) \in L^2(\Omega_a)$ for all $t \in [0, T]$. The weak formulation of (5) reads

$$\begin{cases} \text{find } u \in W(0, T; H_0^1(\Omega_a)) \text{ such that} \\ \int_0^T \langle u_t, v \rangle_{-1,1} dt + \int_0^T a(u, v) dt = \int_0^T (f, v)_{\Omega_a} dt, \quad \forall v \in W(0, T; H_0^1(\Omega_a)), \\ u(0, \cdot) = \psi \quad \text{in } L^2(\Omega_a), \end{cases} \quad (6)$$

where $\langle \cdot, \cdot \rangle_{-1,1}$ denotes the duality pairing between $H^{-1}(\Omega_a)$ and $H_0^1(\Omega_a)$ and $(\cdot, \cdot)_{\Omega_a}$ the inner product of $L^2(\Omega_a)$. Furthermore, the bilinear form $a(\cdot, \cdot)$ is given by

$$a(u, v) = (u_x, (\hat{\sigma}v)_x)_{\Omega_a} - (r - \delta)(xu_x, v)_{\Omega_a} + r(u, v)_{\Omega_a}.$$

Non-homogeneous Dirichlet boundary conditions at $x = a$ have been treated by introducing an appropriate right-hand side f in (6). f depends on t and x and without any loss of generality, one may choose $f \in C^\infty((0, T) \times \Omega_a)$.

The assumptions on σ ensure that the bilinear form a is strongly elliptic. Therefore, since the initial data ψ is in $H^1(\Omega_a)$ and the right-hand side f is smooth, problem (6) has a unique solution u which belongs to $C^1(0, T; H_0^1(\Omega_a))$ [11]. In the sequel, the duality pairing $\langle \cdot, \cdot \rangle_{-1,1}$ will thus be replaced by the $L^2(\Omega_a)$ inner product.

2.3 The non-conforming Galerkin method

A first approach that might be considered to discretize (6) is to combine finite difference schemes in time with a conforming finite element method in space. For a numerical analysis of associated schemes, we refer for instance to [7]. In this paper, we consider a different approach involving space-time finite elements [9, 5, 6]. More specifically, an approximate solution of (6) is sought by means of a non-conforming Galerkin method involving discrete functions that are discontinuous in time and continuous in space. The time interval $[0, T]$ is split into subintervals $I_n = (t_{n-1}, t_n]$ of length $k_n = t_n - t_{n-1}$, where $0 = t_0 < \dots < t_N = T$. We denote by $S_n = I_n \times \Omega_a$ the time slab associated with I_n . In each time slab S_n , we consider a mesh \mathcal{M}_n of the domain Ω_a consisting of $M_n + 1$ subintervals $K_i^n = (x_i^n, x_{i+1}^n)$ of length $h_i^n = x_i^n - x_{i-1}^n$ where $1/a = x_0^n < \dots < x_{M_n+1}^n = a$. The space-time mesh is illustrated in figure 1.

For an integer $p \geq 1$, we denote by $P_c^p(\mathcal{M}_n)$ the space of continuous functions in space that are polynomials of degree $\leq p$ on each subinterval K_i^n . In particular, we shall consider the space $P_c^1(\mathcal{M}_n)$ spanned by the functions $(\phi_i^n)_{1 \leq i \leq M_n}$ given by

$$\phi_i^n(x) = \begin{cases} \frac{x - x_{i-1}^n}{h_i^n} & \text{if } x_{i-1}^n \leq x \leq x_i^n, \\ \frac{x_{i+1}^n - x}{h_{i+1}^n} & \text{if } x_i^n \leq x \leq x_{i+1}^n, \\ 0 & \text{otherwise.} \end{cases}$$

For an integer $q \geq 0$, we define the space-time finite element space $P_{d/c}^{q,p}$ by

$$P_{d/c}^{q,p} = \left\{ v(t, x) = \sum_{n=1}^N \left(\sum_{l=0}^q v_l^n(x) \left(\frac{t - t_{n-1}}{k_n} \right)^l \right) 1_{I_n}(t) \text{ with } v_l^n \in P_c^p(\mathcal{M}_n) \right\}.$$

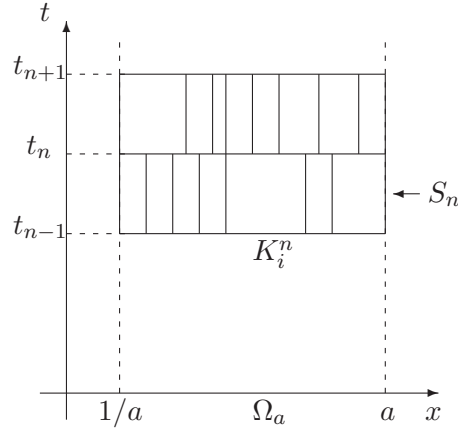


Figure 1: Space-time finite element mesh

Thus, on each cell $I_n \times K_i^n$, $v \in P_{d/c}^{q,p}$ is a polynomial of degree $\leq q$ in time whose coefficients are polynomials of degree $\leq p$ in space. Note that functions in $P_{d/c}^{q,p}$ are continuous in space but discontinuous in time. Therefore, $P_{d/c}^{q,p}$ is a non-conforming approximation space for $W(0, T; H_0^1(\Omega_a))$. For functions in $P_{d/c}^{q,p}$, the jumps occurring at each discrete time t_n ($n \geq 1$) are functions depending on the spatial variable x denoted by

$$\forall x \in \Omega_a, \quad [v]_n(x) = v_n^+(x) - v_n^-(x) = \lim_{s \rightarrow 0^+} v(t_n + s, x) - v(t_n, x),$$

and for $n = 0$, we adopt the convention that $[v]_0 = v_0^+$.

We may now write the discretization of (6) as follows

$$\begin{cases} \text{find } U \in P_{d/c}^{q,p} \text{ such that} \\ B(U, V) = F(V), \quad \forall V \in P_{d/c}^{q,p}, \end{cases} \quad (7)$$

with the bilinear form $B(\cdot, \cdot)$

$$B(v, w) = \sum_{n=1}^N \int_{I_n} \left\{ \left(\frac{\partial v}{\partial t}, w \right)_{\Omega_a} + a(v, w) \right\} dt + \sum_{n=1}^N ([v]_{n-1}, w_{n-1}^+)_{\Omega_a}, \quad (8)$$

and the linear form $F(\cdot)$

$$F(w) = \int_0^T (f, w)_{\Omega_a} dt + (i_0 \psi, w_0^+)_{\Omega_a}. \quad (9)$$

Here, $i_0 \psi$ is (for instance) the L^2 -projection of the terminal payoff function ψ onto the discrete space $P_c^p(\mathcal{M}_1)$. Since in general ψ is piecewise linear on the initial mesh \mathcal{M}_1 , we simply have $i_0 \psi = \psi$, an assumption that will be kept in the rest of this work. Notice that the initial condition $U(0, \cdot) = i_0 \psi$ is readily recovered from (7). We also point out that in the case $i_0 \psi = \psi$, the discrete problem (7) is consistent, i.e. the exact solution u of (6) also satisfies (7).

From a computational viewpoint, we shall focus on linear interpolation in space ($p = 1$) and either constant or linear interpolation in time ($q = 0$ or $q = 1$). For $1 \leq n \leq N$, let A_n be the discrete operator acting on $P_c^1(\mathcal{M}_n)$ such that $(A_n U, V)_{\Omega_a} = a(U, V)$ for $(U, V) \in P_c^1(\mathcal{M}_n)$ and let π_n be the L^2 -projection operator onto $P_c^1(\mathcal{M}_n)$.

- for $q = 0$, set $U_n = U|_{I_n} \in P_c^1(\mathcal{M}_n)$ for $n \geq 1$. System (7) may then be recast into the form

$$U_n - \pi_n U_{n-1} + k_n A_n U_n = \int_{I_n} \pi_n f dt, \quad n \geq 1, \quad (10)$$

with initial condition $U_0 = i_0 \psi$. For each time step, (10) is thus equivalent to the resolution of a backward Euler scheme.

- for $q = 1$, set $U_n = U_n^0 + \left(\frac{t - t_{n-1}}{k_n}\right) U_n^1$ for $n \geq 1$ with U_n^0 and $U_n^1 \in P_c^1(\mathcal{M}_n)$. System (7) then reduces to the following system of equations

$$\begin{cases} (I + k_n A_n) U_n^0 + (I + \frac{k_n}{2} A_n) U_n^1 = \pi_n U_{n-1}^- + \int_{I_n} \pi_n f dt, \\ \frac{k_n}{2} A_n U_n^0 + (\frac{I}{2} + \frac{k_n}{3} A_n) U_n^1 = \int_{I_n} (t - t_{n-1}) \pi_n f dt, \end{cases} \quad n \geq 1, \quad (11)$$

with initial condition $U_0^- = i_0 \psi$.

Let u be the solution of the continuous problem (6) and U be the solution of the discrete problem (7) for $p = 1$ and $q = 0$ or 1 . Then, under reasonable assumptions on the time steps and the regularity of the exact solution u , a priori error estimates show that the error $\max_{t \in [0, T]} \|u - U\|_{L^2(\Omega_a)}$ is of order 2 in space and $q + 1$ in time (see [5] for details). In the sequel, method (10) will be termed the dG(0) method and method (11) the dG(1) method.

3 A posteriori error analysis

In this section we briefly present the mathematical analysis of the a posteriori error estimator that will serve as the basis for the adaptive mesh refinement algorithm described in Section 4.

3.1 Output functionals of financial interest

Let $e = u - U$ be the error. Given two functionals $\theta_1 := \theta_1(t, x)$ for $(t, x) \in (0, T) \times \Omega_a$ and $\theta_2 := \theta_2(x)$ for $x \in \Omega_a$, our goal is to control the θ -error measure given by

$$\Theta(e) := \int_0^T (\theta_1, e)_{\Omega_a} dt + (\theta_2, e(T, \cdot))_{\Omega_a}. \quad (12)$$

The functionals θ_1 and θ_2 are user-specified functionals designed to target quantities of financial interest.

For instance, in the rather simple situation of an option pricing problem at a given strike value K , high demands on accuracy do not concern $e(t, x)$ for $(t, x) \in (0, T) \times \Omega_a$ but only $e(T, x)$ for $x \in \omega$ where ω is a small neighborhood of K . Therefore, an appropriate θ -error measure may be obtained by taking $\theta_1 = 0$ and

$$\theta_2(x) = \frac{1}{\|\sqrt{\psi} e(T, \cdot)\|_{L^2(\Omega_a)}} \psi(x) e(T, x),$$

where $\psi := \psi(x)$ is a function chosen by the user with support in ω . The θ -error measure simply reads

$$\Theta(e) = \|\sqrt{\psi} e(T, \cdot)\|_{L^2(\Omega_a)}.$$

Possible choices for ψ are a Gaussian with narrow band centered at $x = K$ or $\psi = 1_\omega$, in which case $\Theta(e) = \|e(T, \cdot)\|_{L^2(\omega)}$.

As a second example, consider a calibration problem where a volatility map is recovered from market data assimilation by minimizing some appropriate difference between model predictions and observed market prices. Assume for instance that we can observe market put option prices for three dates of maturity $t_1 < t_2 < T$ and strike prices living in an open set $\omega \subset \Omega_a$. The symmetry between call option and put option prices implies that it is equivalent to observe call option prices with fixed strike price K for initial value varying in ω . In order to recover the parameter of the model (such as volatility) from market data, we need to compute very accurately the implied option prices only in the neighborhood of the relevant strike price and dates of maturity. Hence, we may choose a control of the following L^2 norms of e

$$\Theta(e) = \|e\|_{L^2((t_1, t_2) \times \omega)} + \|e(T, \cdot)\|_{L^2(\omega)},$$

which corresponds to

$$\theta_1(t, x) = \frac{1}{\|e\|_{L^2((t_1, t_2) \times \omega)}} e(t, x) \mathbf{1}_{(t_1, t_2) \times \omega} \quad \text{and} \quad \theta_2(x) = \frac{1}{\|e(T, \cdot)\|_{L^2(\omega)}} e(T, x) \mathbf{1}_\omega.$$

We bring this short discussion on output functionals to a close by noticing that the functionals θ_1 and θ_2 must depend on e in order to control the error in some norm. As a result, they are not known a priori and in a numerical implementation, this dependence must be relaxed by means of an iterative technique. More details shall be given in Section 4. An alternative approach is to consider functionals θ_1 and θ_2 independent of e . For example, in the calibration problem, one may choose $\theta_1(t, x) = \mathbf{1}_{(t_1, t_2) \times \omega}$ and $\theta_2(x) = \mathbf{1}_\omega$ yielding

$$\Theta(e) = \int_{t_1}^{t_2} \int_\omega e(t, x) dt dx + \int_\omega e(T, x) dx.$$

In this case, the method controls the error in a semi-norm only. It may still be accurate for problems where the error e does not change sign.

3.2 Error representation by duality

The a posteriori error estimator with respect to the θ -error measure given by (12) is obtained by using duality arguments. The dual problem associated with (θ_1, θ_2) reads

$$\begin{cases} \text{find } z \in W(0, T; H_0^1(\Omega_a)) \text{ such that} \\ - \int_0^T \langle z_t, v \rangle_{-1,1} dt + \int_0^T a(v, z) dt = \int_0^T (\theta_1, v)_{\Omega_a} dt, \quad \forall v \in W(0, T; H_0^1(\Omega_a)), \\ z(T, \cdot) = \theta_2 \quad \text{in } L^2(\Omega_a). \end{cases} \quad (13)$$

The a posteriori error analysis will be performed under the assumptions that $\theta_1 \in H^1(0, T; H^2(\Omega_a))$ and $\theta_2 \in H^2(\Omega_a)$. In this case, L^p regularity results for evolution problems (see for instance [11, 4]) imply that the dual problem (13) has a unique solution z which belongs to $H^2(0, T; H^2(\Omega_a) \cap H_0^1(\Omega_a))$. As before, duality pairing will be replaced by $L^2(\Omega_a)$ inner product.

Proposition 1. *The θ -error measure satisfies $\Theta(e) = B(e, z)$.*

Using the consistency of the variational problem (7) and Galerkin orthogonality property, we eliminate the exact solution u from the above error representation.

Proposition 2. Let U be the discrete solution satisfying (7), let z be the unique solution of (13) and let Z be an arbitrary test function in $P_{d/c}^{q,p}$ such that $(z - Z)_0^+ = 0$. Then, we have the error representation

$$\Theta(e) = \sum_{n=1}^N \left\{ \int_{I_n} (f - U_t, z - Z)_{\Omega_a} dt - \int_{I_n} a(U, z - Z) dt - ([U]_{n-1}, (z - Z)_{n-1}^+)_{\Omega_a} \right\}. \quad (14)$$

3.3 Localization of the error estimator

Our goal is to localize the θ -error measure given by (14) to the space-time cells $I_n \times K_i^n$. The contribution associated with each space-time cell may then be used for the purpose of refinement or derefinement as discussed in Section 4.

Let us first introduce some notation. For functions f depending on time and/or space, we denote by $\|f\|_{I_n \times K_i^n}$, $\|f\|_{K_i^n}$ and $\|f\|_{I_n}$ the L^2 norms taken over the corresponding subscript and we use a similar notation for L^2 scalar products. For $x \in \partial K_i^n$ and $t \in I_n$, let

$$[U_x](t) := \lim_{s \rightarrow 0^+} \{U_x(t, x_i + s) - U_x(t, x_i - s)\},$$

be the jump at x of the first derivative of U . We also introduce the computable residual $R(U) = f - \mathcal{A}U - U_t$ where \mathcal{A} is the differential operator given by (4).

Proposition 3. Keeping the assumptions of proposition 2, we have

$$\Theta(e) = \sum_{n=1}^N \sum_{i=0}^{M_n} \left\{ (R(U), z - Z)_{I_n \times K_i^n} - \frac{1}{2}([\hat{\sigma}U_x], z - Z)_{I_n \times \partial K_i^n} - ([U]_{n-1}, (z - Z)_{n-1}^+)_{K_i^n} \right\}. \quad (15)$$

In order to use numerically the a posteriori estimate for the θ -error measure derived in proposition 3, we have to approximate the interpolation error $z - Z$ by higher order derivatives of the dual solution z . The numerical approximation of these derivatives is discussed in Section 4.

Proposition 4. Assume $\theta_1 \in H^1(0, T; H^2(\Omega_a))$ and $\theta_2 \in H^2(\Omega_a)$. There exists a constant $c > 0$ independent of the space-time mesh such that: (i) For the $dG(0)$ finite element method applied to the generalized Black-Scholes problem (5), we have the a posteriori estimate

$$|\Theta(e)| \leq c \sum_{n=1}^N \sum_{i=0}^{M_n} \left\{ \rho_1^{i,n} (\omega_{1,k}^{i,n} + \omega_{1,h}^{i,n}) + \rho_2^{i,n} \omega_{2,k}^{i,n} + \rho_3^{i,n} (\omega_{3,k}^{i,n} + \omega_{3,h}^{i,n}) \right\},$$

with

$$\begin{aligned} \rho_1^{i,n} &= \|R(U)\|_{I_n \times K_i^n}, \quad \omega_{1,k}^{i,n} = k_n \|z_t\|_{I_n \times K_i^n}, \quad \omega_{1,h}^{i,n} = (h_i^n)^2 \|z_{xx}\|_{I_n \times K_i^n}, \\ \rho_2^{i,n} &= (h_i^n)^{-\frac{1}{2}} \|\hat{\sigma}[U_x]\|_{I_n \times \partial K_i^n}, \quad \omega_{2,k}^{i,n} = k_n (\|z_t\|_{I_n \times K_i^n} + h_i^n \|z_{tx}\|_{I_n \times K_i^n}), \\ \rho_3^{i,n} &= k_n^{-\frac{1}{2}} \|[U]_{n-1}\|_{K_i^n}, \quad \omega_{3,k}^{i,n} = k_n \|z_t\|_{I_n \times K_i^n}, \quad \omega_{3,h}^{i,n} = (h_i^n)^2 \|z_{xx}\|_{I_n \times K_i^n}. \end{aligned}$$

(ii) For the $dG(1)$ finite element method applied to the generalized Black-Scholes problem (5), we have the a posteriori estimate

$$|\Theta(e)| \leq c \sum_{n=1}^N \sum_{i=0}^{M_n} \left\{ \rho_1^{i,n} (\omega_{1,k}^{i,n} + \omega_{1,h}^{i,n}) + \rho_2^{i,n} \omega_{2,k}^{i,n} + \rho_1^{3,n} (\omega_{3,k}^{i,n} + \omega_{3,h}^{i,n}) \right\},$$

with

$$\begin{aligned}\rho_1^{i,n} &= \|R(U)\|_{I_n \times K_i^n}, \quad \omega_{1,k}^{i,n} = k_n^2 \|z_{tt}\|_{I_n \times K_i^n}, \quad \omega_{1,h}^{i,n} = (h_i^n)^2 \|z_{xx}\|_{I_n \times K_i^n}, \\ \rho_2^{i,n} &= (h_i^n)^{-\frac{1}{2}} \|\hat{\sigma}[U_x]\|_{I_n \times \partial K_i^n}, \quad \omega_{2,k}^{i,n} = k_n^2 (\|z_{tt}\|_{I_n \times K_i^n} + h_i^n \|z_{ttx}\|_{I_n \times K_i^n}), \\ \rho_3^{i,n} &= k_n^{-\frac{1}{2}} \|[U]_{n-1}\|_{K_i^n}, \quad \omega_{3,k}^{i,n} = k_n^2 \|z_{tt}\|_{I_n \times K_i^n}, \quad \omega_{3,h}^{i,n} = (h_i^n)^2 \{\|z_{xx}(t_{n-1})\|_{I_n \times K_i^n} + k_n \|z_{txx}\|_{I_n \times K_i^n}\}.\end{aligned}$$

Remark 1. The quantities ρ are residuals depending on the finite element solution U and the quantities ω are weights depending on the dual solution z . The dual solution brings information where the numerical error is generated. Thus, it enables to account for error propagation in space and time. For instance, a small residual but a large weight at a given cell $I_n \times K_i^n$ indicate that this cell may actually contribute significantly to error generation.

Remark 2. The assumptions on the error control functions θ_1 and θ_2 ensure that all the weights are well defined. From a theoretical viewpoint, these assumptions may be slightly relaxed. From a practical viewpoint, it is interesting to consider error control functions that are proportional to the error $e = u - U$. In this case, the best regularity for θ_1 and θ_2 can only be $\theta_1 \in L^2(0, T; H^1(\Omega_a))$ and $\theta_2 \in H^1(\Omega_a)$. This approach will be illustrated numerically in Section 5.

Remark 3. When σ is constant in time, we have $([\hat{\sigma}U_x], z - P_n z)_{I_n \times \partial K_i^n} = 0$ by definition of the orthogonal L^2 -projection operator. Therefore, we may take $\rho_2^{i,n} = 0$. This remark applies to both $dG(0)$ and $dG(1)$ cases.

Remark 4. The exact value of the interpolation constant c arising in the estimates of proposition 4 is given in the proof above and one generally has $c \leq 1$. In our numerical experiments, we will simply take $c = 1$.

4 Adaptive mesh refinement

In this section we present an adaptive mesh refinement/derefinement algorithm based on the a posteriori error estimate derived in the previous section. Particular emphasis is laid upon practical implementation aspects.

4.1 The algorithm

Given a tolerance `tol`, our goal is to construct adaptively a computational mesh on which the discrete solution U achieves the accuracy requirement

$$|\Theta(u - U)| \leq \text{tol}.$$

To this purpose, we first notice that the a posteriori error estimator obtained in proposition 4 allows to separate the contribution due to space and time discretization. More precisely, for a time slab S_n , let us define

$$\eta_k^n = \sum_{i=0}^{M_n} \eta_k^{i,n} \quad \text{where} \quad \eta_k^{i,n} = \sum_{j=1}^3 \rho_j^{i,n} \omega_{j,k}^{i,n},$$

and

$$\eta_h^n = \sum_{i=0}^{M_n} \eta_h^{i,n} \quad \text{where} \quad \eta_h^{i,n} = \rho_1^{i,n} \omega_{1,h}^{i,n} + \rho_3^{i,n} \omega_{3,h}^{i,n}.$$

The global time and space contribution are respectively defined as

$$\eta_k = \sum_{n=1}^N \eta_k^n, \quad \eta_h = \sum_{n=1}^N \eta_h^n.$$

Error control will be achieved by imposing that both η_h and η_k be lower than $\frac{\text{tol}}{2}$. Other choices modifying the balance between space and time contributions might be considered as well.

The iterative algorithm by which the space-time mesh is adaptively modified reads as follows. We use the notation $\Gamma = \cup_{n=1}^N I_n \times \mathcal{M}_n$ for a given space-time mesh and denote by Γ_i the mesh at iteration i of the adaptive algorithm. In addition, the parameter ε denotes a derefinement threshold with $0 < \varepsilon < 1$.

1. Construct an initial space-time mesh Γ_0 . Γ_0 may typically be a rather coarse, uniform, tensor-product mesh. Set $j = 0$;
 2. Compute discrete solution U_j of primal problem (5) on space-time mesh Γ_j . Compute residuals $\rho_j^{i,n}$ for $j = 1, 2, 3$;
 3. Compute error $e_j = u - U_j$ and evaluate error control functions θ_1 and θ_2 ;
 4. Solve dual problem (13) and compute weights $\omega_{j,k}^{i,n}$ and $\omega_{j,h}^{i,n}$ for $j = 1, 2, 3$;
 5. Compute error estimators η_h^n and η_k^n . If $|\Theta(e_j)| \leq \text{tol}$ then STOP, else construct a new mesh Γ_{j+1} using the following refinement/derefinement procedure:
 - 5.a Space loop: let $M = \sum_{n=1}^N M_n$ be the total numbers of elements. If $\eta_h^{i,n} \geq \frac{\text{tol}}{2M}$, we refine by halving the cell K_i^n while if $\eta_h^{i,n} \leq (1 - \varepsilon) \frac{\text{tol}}{2M}$ for two consecutive indices i and $i + 1$, we derefine by assembling the cells K_i^n and K_{i+1}^n ;
 - 5.b Time loop: if $\eta_k^n \geq \frac{\text{tol}}{2N}$, we refine by halving the time interval I_n while if $\eta_k^n \leq (1 - \varepsilon) \frac{\text{tol}}{2N}$ for two consecutive indices n and $n + 1$, we derefine by assembling the time intervals I_n and I_{n+1} ;
- Set $j := j + 1$ and return to step 2.

The above algorithm thus consists in a sequence of forward/backward sweeps where a primal problem and a dual problem are sequentially solved on a given space-time mesh which is then adaptively modified. An alternative approach developed for instance in [10] is based on L^∞ estimates in time and cubic Hermite polynomial interpolation in space and allows to implement a single forward time-marching algorithm where slabs are iteratively refined one after the other.

4.2 Practical implementation

The adaptive algorithm described in the previous section needs several modifications to be useful in practice.

4.2.1 Approximate data for dual problem

For European options with constant volatility, closed formulas are available to evaluate the exact solution u and therefore the error $e_j = u - U_j$. However, in the financially interesting case where local volatility is considered, closed formulas are no longer available and the data for the dual problem needs to be estimated.

A simple procedure is to use a relaxation method in which $e \simeq U_j - U_{j-1}$. This approximation may be partly justified under a saturation assumption of the form

$$\|e_j\| \leq \beta \|e_{j-1}\|,$$

for some $0 < \beta < 1$ independent of j . This assumption yields

$$\frac{1-\beta}{\beta} \|e_j\| \leq \|U_j - U_{j-1}\| \leq (1 + \beta) \|e_{j-1}\|,$$

showing that the estimate $\|U_j - U_{j-1}\|$ is asymptotically equivalent to the error.

With this modification, the first three steps of the adaptive algorithm are modified as follows:

1. Construct an initial space-time mesh Γ_0 and a second space-time mesh Γ_1 by global refinement of Γ_0 in space and time. Compute discrete solution U_0 of primal problem (5) on initial space-time mesh Γ_0 . Set $j = 1$;
2. Compute discrete solution U_j of primal problem (5) on space-time mesh Γ_j . Compute residuals $\rho_j^{i,n}$ for $j = 1, 2, 3$;
3. Approximate error $e_j \simeq U_j - U_{j-1}$ and evaluate error control functions θ_1 and θ_2 .

4.2.2 Discrete dual problem

Several approaches have been investigated in the literature to solve approximately the dual problem. One of such approaches consists in using higher-order interpolation to estimate the dual solution z (see for instance [12] and [2]). This approach usually yields sharp bounds for the θ -error measure but is not straightforward to implement since it generally needs some restrictions on the used meshes. For instance, it is convenient to utilize meshes that are organized patch-wise with local hierarchical refinement. An alternative approach, which yields looser bounds for the θ -error measure but is easier to implement, is to discretize the dual problem on the same mesh and with the same polynomial interpolation as the primal problem. This second approach has been selected hereafter. Our numerical experiments show that for the finance problems under consideration, this choice yields nearly optimal convergence rates.

The discrete dual problem reads

$$\begin{cases} \text{find } Z \in P_{d/c}^{q,p} \text{ such that} \\ B(V, Z) = \Theta(V), \quad \forall V \in P_{d/c}^{q,p}, \end{cases} \quad (16)$$

with Θ defined in (12).

4.2.3 Computing the weights

Whenever possible, integrals are evaluated analytically or are approximated by 4-point Gaussian quadrature. In order to estimate the weights involving high order derivatives (z_{xx} , z_{tt} , z_{txx} and z_{ttx}) from the discrete dual solution Z , we use the following approximations:

- the second order derivative in space is approximated by

$$\left(\frac{1}{2} ((Z_{xx}^2(t_n, x_i) + Z_{xx}^2(t_n, x_{i-1})) \times \text{mes}(I_n \times k_i^n)) \right)^{\frac{1}{2}},$$

with $Z_{xx}(t_n, x_i)$ computed from

$$\frac{2}{h_i + h_{i+1}} \left(\frac{Z(t_n, x_{i+1}) - Z(t_n, x_i)}{h_{i+1}} - \frac{Z(t_n, x_i) - Z(t_n, x_{i-1})}{h_i} \right).$$

- the second order derivative in time is approximated by

$$\left(\frac{1}{2} (Z_{tt}^2(t_n, x_i) + Z_{tt}^2(t_n, x_{i-1})) \times \text{mes}(I_n \times K_i^n) \right)^{\frac{1}{2}},$$

with $Z_{tt}(t_n, x_i)$ computed from

$$\frac{2}{k_n + k_{n+1}} (P_n Z_t(t_{n+1}, x_i) - Z_t(t_n, x_i)),$$

and $Z_t(t_n, x_i)$ is directly recovered from the local, linear-in-time expression for Z .

- for the third order derivatives z_{txx} and z_{ttx} , the previous quadratures are used with Z replaced by Z_t and Z_x respectively.

References

- [1] Barles, G., Daher C. and Romano M. (1995) Convergence of numerical schemes for problems arising in finance theory, *Math. Models and Meth. in Applied Science* 5, 125-143. [3](#)
- [2] Becker, R. and Rannacher, R. (2001) An optimal control approach to a posteriori error estimation in finite element methods, *Acta Numerica* 10, 1-102. [2](#), [11](#)
- [3] Berestycki, H., Busca J. and Florent I. (2002) Asymptotics and calibration of local volatility models, *Quantitative Finance* 2, 61-69. [2](#)
- [4] Coulhon, T. and Lamberton, D. (1987) Régularité L^p pour les équations d'évolution, *Publications mathématiques de l'université Paris VII* 26, 155-165. [7](#)
- [5] Eriksson, K. and Johnson C. (1991): Adaptive finite element methods for parabolic problem: A linear model problem, *SIAM Journal of Numerical Analysis* 28, 43-77. [2](#), [4](#), [6](#)
- [6] Eriksson, K., Estep, D., Hansbo, P. and Johnson C. (1995) Introduction to adaptive methods for differential equations. In: Iserles, A. (ed.), *Acta numerica*, 105-158. [2](#), [4](#)
- [7] Ern, A. and Guermond, J.-L. (2002) *Éléments finis : théorie, applications, mise en œuvre*, Collection Mathématiques & Applications, Vol 36, Springer, Heidelberg. [4](#)
- [8] Hartmann, R. (1998) A posteriori Fehlerschätzung und adaptive Schrittweiten und Ortsgittersteuerung bei Galerkin-Verfahren für die Wärmelleitungsgleichung. Diplomarbeit, Universität Heidelberg.

- [9] Johnson, C. (1987) *Numerical Solution of Partial Differential Equations by the Finite Element Method*, Cambridge University Press, Cambridge. 4
- [10] Jackson, N. and Süli, E. (1997) Adaptive finite element solutions of 1D European option pricing problems, *Technical report NA/97-05, Oxford University Computing Laboratory*. 10
- [11] Pazy, A. (1983) *Semigroups of linear operators and applications to partial differential equations*, Applied Mathematical Sciences, Springer-Verlag, New York. 4, 7
- [12] Süli, E. and Houston, P. (2002) Adaptive Finite Element Approximation of Hyperbolic Problems; in *T. Barth and H. Deconinck, editors: Error Estimation and Adaptive Discretization Methods in Computational Fluid Dynamics. Lecture Notes in Computational Science and Engineering 25*, Springer-Verlag, 269-344 11
- [13] Verfürth, R. (1996) *A review of a posteriori error estimation and adaptive mesh-refinement techniques*, Wiley, Chichester. 1
- [14] Verfürth, R. (1998) A posteriori error estimators for convection-diffusion equations, *Numer. Math.* 80, 641-663.