



# Weak convergence of Markov-modulated diffusion processes with rapid switching



Gang Huang\*, Michel Mandjes, Peter Spreij

Korteweg–de Vries Institute for Mathematics, University of Amsterdam, Science Park 904, 1098 XH Amsterdam, The Netherlands

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## ABSTRACT

In this paper, we study the weak convergence of a sequence of Markov-modulated diffusion processes when the modulating Markov chain is ergodic and rapidly switching. We prove, in particular, its tightness property based on Aldous' tightness criterion.

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## 1. Introduction

The Markov-modulated diffusion process is defined as a two-component Markov process  $\{X_t, M_t\}_{t \geq 0}$  on the space  $\mathbb{S} \times \mathbb{R}$ , where  $\mathbb{S} := \{1, \dots, d\}$ , for some  $d \in \mathbb{N}$ .  $X_t$  is a finite-state Markov chain with transition rate matrix  $Q$ , and  $M_t$  is an  $X_t$ -modulated diffusion process. Such processes have been intensively studied in the literature. They have proven to be particularly useful in finance, as they are able to capture various relevant phenomena; see for instance the option pricing models of Yao et al. (2006) and Jobert and Rogers (2006) (where the focus is on Markov-modulated geometric Brownian motions), and the term structure model of Elliott and Siu (2009) (focusing on Markov-modulated versions of the Ornstein–Uhlenbeck and Cox–Ingersoll–Ross types). This kind of models allows the volatility and rate of returns to be random, and it turns out that parameters can be relatively easily calibrated on real data (where it is noted that this becomes harder when the modulating Markov chain has a large number of states, requiring sophisticated numerical methods).

There is also a large body of literature devoted to asymptotic behaviors of Markov-modulated (diffusion) processes. For example, Yin and Zhou (2004) and Nguyen and Yin (2010) studied the weak convergence of Markov-modulated random sequences where the modulating Markov chains and the modulated sequences are both discrete-time processes. Their continuous-time interpolations under time scaling are proved to converge weakly to switching diffusion processes. The result was applied to construct asymptotically optimal portfolios for discrete-time models of Markowitz's mean–variance portfolio selection problem in Zhou and Yin (2003) and Yin and Zhou (2004).

In this paper we consider the Markov-modulated diffusion process from another point of view, namely that we study its limiting behavior when the modulating Markov chain is rapidly switching and ergodic. We speed up the process  $X_t$  by a factor  $n$ , and consider the resulting system as  $n \rightarrow \infty$ . In more concrete terms, it means that we replace the transition rate matrix  $Q$  by  $nQ$ , and we denote by  $X_t^n$  the sequence of rapidly switching Markov chains. We let  $\pi$  be the ergodic distribution corresponding to  $X_t$ , and hence also to  $X_t^n$  for every  $n \in \mathbb{N}$ . Each process  $M_t^n$  is defined on a probability space  $(\Omega^n, \mathcal{F}^n, \mathbb{P}^n =$

\* Corresponding author.

E-mail addresses: [g.huang@uva.nl](mailto:g.huang@uva.nl) (G. Huang), [m.r.h.mandjes@uva.nl](mailto:m.r.h.mandjes@uva.nl) (M. Mandjes), [spreij@uva.nl](mailto:spreij@uva.nl) (P. Spreij).

$\{\mathcal{F}_t^n\}_{t \geq 0, \mathbb{P}^n}$ ) through the stochastic differential equation

$$M_t^n = m_0 + \int_0^t b(X_s^n, M_s^n) ds + \int_0^t \sigma(X_s^n, M_s^n) dB_s^n, \quad X_0^n = x_0, \tag{1}$$

with  $x_0 \in \mathbb{S}$  and  $B^n$  a Brownian motion. Processes with rapid switching have been studied in great detail by Skorokhod (1989), where it is noted that the analysis covers models that are more general than the one introduced above. In particular, Theorem 2.8 in Skorokhod (1989) implies that, as  $n \rightarrow \infty$ , the sequence of the Markov-modulated diffusion processes  $\{M_t^n\}_{t \in [0, T]}$  converges, in terms of finite-dimensional distributions, to a (non-modulated) diffusion process  $\{\hat{M}_t\}_{t \in [0, T]}$  whose coefficients are obtained by averaging the coefficients of  $M_t^n$  with respect to the ergodic distribution  $\pi$ .

The main result in this paper is a proof of the tightness of  $\{M_t^n\}_{t \in [0, T]}$ . That, combined with convergence of finite-dimensional distributions, implies the weak convergence of  $\{M_t^n\}_{t \in [0, T]}$  to  $\{\hat{M}_t\}_{t \in [0, T]}$ . In our proof, Aldous' tightness criterion in Aldous (1978) is the main ingredient, in combination with a technique which is used to prove the exponential tightness of two scaled diffusions in Liptser (1996).

In order to make the notation in the sequel not unnecessarily heavy, we drop the dependence on  $n$  everywhere where it does not lead to confusion, e.g. we simply use  $\mathbb{P}$  for probability,  $\mathbb{E}$  for expectation and  $B$  for Brownian motion.

### 2. Main result

We first introduce some additional notation. For an arbitrary stochastic process  $H_t$ , we denote  $H_t^* := \sup_{s \leq t} |H_s|$ . For  $T \geq 0$ , let  $C[0, T]$  denote the space of real-valued continuous functions on  $[0, T]$  equipped with the uniform topology; also,  $D[0, \infty)$  is the space of càdlàg functions on  $[0, \infty)$ , equipped with Skorokhod's  $J_1$ -topology. We then impose some assumptions on the coefficients of (1).

(A.1) Local Lipschitz continuity: for any  $r < \infty$ , there is a positive constant  $K_r$  such that

$$|b(i, x) - b(i, y)| + |\sigma(i, x) - \sigma(i, y)| \leq K_r |x - y|, \quad \forall i \in \mathbb{S}, |x|, |y| \leq r.$$

(A.2) Linear growth: there exists a positive constant  $C$  such that

$$|b(i, x)| + |\sigma(i, x)| \leq C(1 + |x|), \quad \forall i \in \mathbb{S}, x \in \mathbb{R}.$$

(A.3)  $X_t^n$  is ergodic with the ergodic distribution  $\pi = (\pi_1, \dots, \pi_d)$  for every  $n \in \mathbb{N}$ .

Assumptions (A.1) and (A.2) guarantee a unique strong solution  $(X_t^n, M_t^n)$  of (1), and the following estimate for fixed  $T > 0$  and  $n \in \mathbb{N}$ :

$$\mathbb{E}(M_t^{n*})^\gamma \leq K(T, \gamma) < \infty, \quad \forall \gamma > 0; \tag{2}$$

cf. Yin and Zhu (2010). The following result is our main result, stating the weak convergence of the solution of the Markov-modulated stochastic differential equation to that of a non-modulated stochastic differential equation.

**Theorem 2.1.** *If Assumptions (A.1)–(A.3) hold, then as  $n \rightarrow \infty$ ,  $M_t^n$  converges weakly in  $C[0, T]$  to  $\hat{M}_t$ , which is the solution of the stochastic differential equation*

$$\hat{M}_t = m_0 + \int_0^t \hat{b}(\hat{M}_s) ds + \int_0^t \hat{\sigma}(\hat{M}_s) dB_s,$$

where

$$\hat{b}(x) := \sum_{i=1}^d b(i, x)\pi_i, \quad \hat{\sigma}(x) := \left( \sum_{i=1}^d \sigma^2(i, x)\pi_i \right)^{1/2}.$$

Proofs of this type of weak convergence results typically consist of two parts: (i) proving that all the finite-dimensional convergence of  $\{M_t^n\}_{t \in [0, T]}$  to  $\{\hat{M}_t\}_{t \in [0, T]}$ , and (ii) proving the tightness of  $M_t^n$  in  $C[0, T]$ . As mentioned in the introduction, the first part is a consequence of Theorem 2.8 in Skorokhod (1989); its proof is based on the method of generators. It is noted that, confusingly, in Skorokhod (1989) the term convergence in distribution is to be understood as finite-dimensional convergence; see p. 77 of Skorokhod (1989). Our contribution, as given in the next section, is the proof of the tightness part.

### 3. Proof of tightness

The proof of tightness relies on the following theorem, to which we refer as Aldous' tightness criterion, see Aldous (1978), Liptser and Shirayev (1989, Theorem 6.3.1).

Let  $H^n = \{H_t^n\}_{t \geq 0}$  be a sequence in  $D[0, \infty)$  defined on some stochastic basis, in particular we assume that each  $H^n$  is adapted to a filtration  $\mathbb{F}^n$ . Let, for  $T > 0$ ,  $\Gamma_T(\mathbb{F}^n)$  denote the family of stopping times adapted to  $\mathbb{F}^n$  taking values in  $[0, T]$ .

**Theorem 3.1.** *Let  $H^n = \{H_t^n\}_{t \geq 0}$  be a sequence in  $D[0, \infty)$  defined on a stochastic basis  $(\Omega, \mathcal{F}, \mathbb{F}^n, \mathbb{P})$ . If (i) for all  $T > 0$ ,*

$$\lim_{K \rightarrow \infty} \limsup_{n \rightarrow \infty} \mathbb{P} \left( \sup_{t \leq T} |H_t^n| \geq K \right) = 0,$$

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