

Principles of smooth and continuous fit in the determination of endogenous bankruptcy levels

A. E. Kyprianou · B. A. Surya

Received: 14 April 2006 / Accepted: 18 August 2006 /
Published online: 29 November 2006
© Springer-Verlag 2006

Abstract We revisit the previous work of Leland [J Finance 49:1213–1252, 1994], Leland and Toft [J Finance 51:987–1019, 1996] and Hilberink and Rogers [Finance Stoch 6:237–263, 2002] on optimal capital structure and show that the issue of determining an optimal endogenous bankruptcy level can be dealt with analytically and numerically when the underlying source of randomness is replaced by that of a general spectrally negative Lévy process. By working with the latter class of processes we bring to light a new phenomenon, namely that, depending on the nature of the small jumps, the optimal bankruptcy level may be determined by a principle of *continuous fit* as opposed to the usual *smooth fit*. Moreover, we are able to *prove* the optimality of the bankruptcy level according to the appropriate choice of fit.

Keywords Credit risk · Endogenous bankruptcy · Scale functions · Fluctuation identity · Continuous and smooth pasting principles · Wiener–Hopf factorization

JEL Classification C61

Mathematics Subject Classification (2000) 91B28 · 91B99 · 91B72

A. E. Kyprianou (✉)
Department of Mathematical Sciences, The University of Bath, Bath BA2 7AY, UK
e-mail: a.kyprianou@bath.ac.uk

B. A. Surya
Mathematical Institute, University of Utrecht, Budapestlaan 6, 3584 CD Utrecht,
The Netherlands
e-mail: surya@math.uu.nl

1 Introduction

We consider the following model for a firm based on the earlier work of Leland [12], Leland and Toft [11] and Hilberink and Rogers [8].

The firm is assumed to be partly financed by debt, whose maturity profile is kept constant through time, by the simultaneous issue of new debt and retirement of old debt. This debt is of equal seniority, and distributes a continuous stream of coupon payment to bondholders in a fixed amount. From this the firm also receives tax benefits which are also issued as a continuous stream at a fixed rate, provided the value of its assets is above a certain threshold. The bankruptcy level is determined endogenously by the shareholders to maximize the firm's equity value. Note that most of the authors mentioned above consider the case where the coupon is paid at a constant rate to the bondholder rather than proportionally to the value of the underlying asset, and the tax rebates are accordingly received at a constant rate, provided the value of the underlying asset is above a certain threshold.

In this paper we shall assume that the value of underlying assets of the firm is modelled using a general exponential spectrally negative Lévy process. This was also the case in Hilberink and Rogers [8]; however, it was necessary for them after a certain point in their calculations to work with the special case of a spectrally negative Lévy process taking the form of an independent sum of a linear Brownian motion and a compound Poisson process with negative jumps [cf. formula (3.21) on p. 245]. As advocated by Leland and Toft [11] and Hilberink and Rogers [8], the optimal bankruptcy level should be determined by applying a smooth-pasting condition. But for the special subclass of spectrally negative Lévy processes considered by Hilberink and Rogers [8], no rigorous proof was given to show that smooth pasting leads to the optimal choice of bankruptcy level; the authors relied instead on numerical observation. By working with a *completely general spectrally negative Lévy process* here, we not only show that an analytical treatment of the optimal bankruptcy level is possible, but we are able to show that the smooth-pasting condition is not always appropriate. We give an analytical *proof of the fact* that, depending on the path regularity of the underlying Lévy process, a principle of either smooth pasting or continuous pasting should be applied, accordingly as the underlying Lévy process has unbounded or bounded variation, respectively.

Among the class of spectrally negative Lévy processes, we consider the α -stable process with index $\alpha \in (0, 1) \cup (1, 2]$ for numerical examples. With the exception of the case $\alpha = 2$ which corresponds to linear Brownian motion, these are pure jump processes. Further, they have paths of *unbounded variation* when $\alpha \in (1, 2]$ and paths of bounded variation when $\alpha \in (0, 1)$. The numerical results for these processes give significant differences from the jump diffusion processes considered by Hilberink and Rogers [8].

In other recent work, Chen and Kou [4] consider the same model as we do here except that the underlying source of randomness is a Lévy process which is the independent sum of a linear Brownian motion and a compound Poisson process with two-sided exponential jumps. They also succeed in *proving* that

the optimal bankruptcy level is obtained by a principle of smooth pasting for the case considered there.

The paper is organized as follows. In Sect. 2 we present in more mathematical terms the basic models for the evolution of the value of the firm’s assets and the capital structures of the firm following Hilberink and Rogers [8]. Sections 3 and 4 discuss some notions of fluctuation theory of (general) Lévy processes, including a number of identities expressed in terms of scale functions, from which we are able to give analytic expressions for the value and debt of a firm. In Sect. 5 we discuss the computation of the optimal endogenous bankruptcy level. In Sect. 6 we illustrate the main results of Sect. 5 by means of numerical examples. Section 7 concludes this paper.

2 The capital structure of the firm

Let $X = (X_t, t \geq 0)$ be a real-valued stochastic process defined on a stochastic basis $(\Omega, \mathcal{F}, \mathbb{F}, \mathbb{P})$ where $\mathbb{F} = (\mathcal{F}_t)_{t \geq 0}$ is generated by the process X and satisfies the usual conditions of right-continuity and completeness. Assume further that X is càdlàg, $X_0 = 0$, and for $0 \leq s < t$ the random variable $X_t - X_s$ is independent of the σ -field \mathcal{F}_s and equal in distribution to X_{t-s} . The stochastic process X is then called a Lévy process for short. The law of the Lévy process started at $x \in \mathbb{R}$ will be denoted by \mathbb{P}_x . For convenience we write $\mathbb{P} = \mathbb{P}_0$ and we write \mathbb{E}_x for the expectation operator associated with \mathbb{P}_x and in the special case that $x = 0$ we write \mathbb{E} . From the definition of a Lévy process, it can be shown that

$$\mathbb{E}(e^{i\lambda X_t}) = e^{t\Psi(\lambda)} \quad \text{for } t \geq 0, \lambda \in \mathbb{R}, \tag{2.1}$$

where the *characteristic exponent* $\Psi(\lambda)$ of X is given by the Lévy–Khintchine formula

$$\Psi(\lambda) = \frac{1}{t} \log \mathbb{E}(e^{i\lambda X_t}) = i\mu\lambda - \frac{1}{2}\sigma^2\lambda^2 + \int_{\mathbb{R}} (e^{i\lambda y} - 1 - i\lambda y \mathbf{1}_{\{|y|<1\}}) \Pi(dy), \tag{2.2}$$

where μ and $\sigma \geq 0$ are real constants, and Π is a positive measure on $\mathbb{R} \setminus \{0\}$ which satisfies the integrability condition

$$\int_{\mathbb{R}} (1 \wedge y^2) \Pi(dy) < \infty. \tag{2.3}$$

Lévy processes form the basis of the model for the value of a firm that we now describe. Note that with some exceptions, most of what we say below is fundamentally the model described in Duffie and Lando [6], Hilberink and Rogers [8], and Leland and Toft [11].

To start with, let $V(t)$ denote the value of the firm’s assets at time t and assume that its dynamics are given by

$$V(t) = Ve^{X_t}. \tag{2.4}$$

We assume the existence of a default-free asset that pays a continuous interest rate $r > 0$. Further, it is assumed that under \mathbb{P} , the discounted value $e^{-(r-\delta)t}V(t)$ of the firm’s assets is a \mathbb{P} -martingale, that is to say that

$$\mathbb{E}(e^{-(r-\delta)t}V(t)) = V, \tag{2.5}$$

where $\delta > 0$ is the total payout rate to the firm’s investors (including both bond and equity holders).

The firm is assumed to be partly financed by debt, which is being constantly retired and reissued in the following way. In the time interval $(t, t + dt)$, the firm issues new debt with face value pdt , and maturity profile φ , where φ is non-negative and $\int_0^\infty \varphi(s)ds = 1$. Thus in the time interval $(t, t + dt)$ it issues debt with face value $p\varphi(s)dt ds$ maturing in the time interval $(t + s, t + s + ds)$. Therefore, at time 0 the face value of debt maturing in $(s, s + ds)$ is given by

$$\left(\int_{-\infty}^0 p\varphi(s - u)du \right) ds = pF(s)ds, \tag{2.6}$$

where $F(s) \equiv \int_s^\infty \varphi(u)du$ is the tail of the maturity profile. Taking $s = 0$ in (2.6), we see that the face value of debt maturing in $(0, ds)$ is pds , the same as face value of the newly issued debt. Thus the face value of all debt is constant, and equal to

$$P = p \int_0^\infty F(s)ds. \tag{2.7}$$

This is the same debt profile as in Hilberink and Rogers [8] and opposed to the paper of Leland and Toft [11] who take the Dirac delta-function at T which means that all new debt is always issued with a maturity of T . As in both of the above papers, however, we take $\varphi(t) = me^{-mt}$ for some positive m . This has the direct implication that $P = p/m$.

All debt is of equal seniority and attracts coupons of an amount ρP at time t until maturity, or until default if that occurs sooner, where $\rho > 0$. Default happens at the first time that the value of the firm’s assets falls to some level V_B or lower, i.e., at

$$\sigma_{V_B}^- = \inf\{t > 0 : V(t) < V_B\}. \tag{2.8}$$

As we shall show later, the value of V_B can be determined endogenously for a general class of Lévy processes. At default, a fraction η of the value of the firm’s assets is also assumed to be lost in reorganization.

Let us now consider a bond issued at time 0 with face value 1 and maturity t , which continuously pays a constant coupon flow at a fixed rate $\rho > 0$. Let $\frac{1}{P}$ be the fraction of the asset value $V(\sigma_{V_B}^-)$ which debt of maturity t receives in the event of bankruptcy. The value of the debt with maturity t is given by

$$d(V; V_B, t) = \mathbb{E} \left(\int_0^{t \wedge \sigma_{V_B}^-} \rho e^{-rs} ds \right) + \mathbb{E} \left(e^{-rt} : t < \sigma_{V_B}^- \right) + \frac{1}{P} (1 - \eta) \mathbb{E} \left(e^{-r\sigma_{V_B}^-} V(\sigma_{V_B}^-) : \sigma_{V_B}^- < t \right). \tag{2.9}$$

The first term on the right-hand side of (2.9) represents the expected discounted value of all coupon payments until time t or the default time $\sigma_{V_B}^-$, whichever is sooner. The second term represents the expected discounted value of the principal repayment, if this occurs before bankruptcy, and the final term must be the net present value of what is recovered upon bankruptcy, if this happens before maturity time t . Indeed, $V(\sigma_{V_B}^-)$ is the value of the firm’s asset when bankruptcy occurs and $(1 - \eta)V(\sigma_{V_B}^-)$ is the value of the remains after bankruptcy costs are deducted. Of this, the bondholder with face value 1 gets the fraction $\frac{1}{P}$, since his debt represents this fraction of the total debt outstanding. Notice that if the process X were continuous, then $V(\sigma_{V_B}^-)$ would simply be the bankruptcy level V_B ; but since we allow X to have possible jumps, $V(\sigma_{V_B}^-)$ can be below the bankruptcy level V_B .

Let $D(V; V_B)$ denote the total value of debt. The fraction of the firm’s asset value lost in bankruptcy is η . The remaining value $(1 - \eta)V(\sigma_{V_B}^-)$ is distributed to debt holders so that the sum of all fractional claims $\frac{1}{P}$ for debt of all outstanding maturities equals $(1 - \eta)$. We can now determine the total value at time 0 of all outstanding debt as

$$\begin{aligned} D(V; V_B) &= \int_0^\infty p e^{-mt} d(V; V_B, t) dt \\ &= \rho P \mathbb{E} \left(\int_0^{\sigma_{V_B}^-} e^{-(r+m)t} dt \right) + p \mathbb{E} \left(\int_0^{\sigma_{V_B}^-} e^{-(r+m)t} dt \right) \\ &\quad + (1 - \eta) \mathbb{E} \left(e^{-(r+m)\sigma_{V_B}^-} V(\sigma_{V_B}^-) \right) \\ &= \frac{(\rho + m)P}{r + m} \mathbb{E} \left(1 - e^{-(r+m)\sigma_{V_B}^-} \right) \\ &\quad + (1 - \eta) \mathbb{E} \left(e^{-(r+m)\sigma_{V_B}^-} V(\sigma_{V_B}^-) \right). \end{aligned} \tag{2.10}$$

We assume that there is a corporate tax rate $\tau > 0$ which depends on the value of the underlying risky asset in the following way. As introduced by Leland and Toft [11] (see also Hilberink and Rogers [8]), there exists a cutoff level V_T , whose effect is that the tax rebates are 0 while $V(t) < V_T$, and are $\tau \rho P dt$ when $V(t) \geq V_T$. Under this assumption, the value of the firm at time zero becomes

$$v(V; V_B) = V - \eta \mathbb{E} \left(e^{-r\sigma_{V_B}^-} V(\sigma_{V_B}^-) \right) + \tau \rho P \mathbb{E} \left(\int_0^{\sigma_{V_B}^-} e^{-rt} \mathbf{1}_{\{V(t) \geq V_T\}} dt \right). \tag{2.11}$$

In terms of (2.11) and (2.10), the value of the firm’s equity is given by

$$E(V; V_B) = v(V; V_B) - D(V; V_B). \tag{2.12}$$

The expressions for the expectations in (2.10) and (2.11) cannot be written in closed form in general, although this is possible in the Brownian motion case of Leland and Toft [11]. These difficulties can be circumvented by modeling the dynamics of the firm’s asset value by Lévy processes having downward jumps.

3 Lévy processes with no positive jumps

Now, let us return to the dynamics (2.4) for the value of the firm’s assets. We assume throughout the rest of this paper that X is a real-valued Lévy process having no positive jumps, that is, its Lévy measure Π is concentrated on $(-\infty, 0)$. This class of processes has a great interest from a theoretical point of view, because they are processes for which fluctuation theory can be developed to a fuller extent. As X will be chosen from this class in our financial model, we devote a little time in this section and the next to an overview of a number of relevant results from the above-mentioned fluctuation theory. Unless otherwise stated, all of what follows in this section can be extracted from the books of Bertoin [1] or Kyprianou [9].

The degenerate case when X is either the negative of a subordinator or a deterministic drift has no interest and will be excluded throughout. The Laplace exponent κ of X is given by

$$\mathbb{E}(e^{\lambda X_t}) = e^{t\kappa(\lambda)} \quad \text{for } \lambda, t \geq 0. \tag{3.1}$$

The function $\kappa : [0, \infty) \rightarrow (-\infty, \infty)$ is defined by

$$\kappa(\lambda) = \Psi(-i\lambda) = \mu\lambda + \frac{1}{2}\sigma^2\lambda^2 + \int_{(-\infty, 0)} (e^{\lambda x} - 1 - \lambda x \mathbf{1}_{\{x > -1\}}) \Pi(dx). \tag{3.2}$$

It is easily shown that κ is zero at the origin, tends to infinity at infinity and is strictly convex. We denote by $\Phi : [0, \infty) \rightarrow [0, \infty)$ the right-continuous inverse of $\kappa(\lambda)$, so that

$$\Phi(\alpha) = \sup\{p > 0 : \kappa(p) = \alpha\}$$

and

$$\kappa(\Phi(\lambda)) = \lambda \quad \text{for all } \lambda \geq 0.$$

Note that due to the convexity of κ , there exist at most two roots for a given α and precisely one root when $\alpha > 0$.

The class of spectrally negative Lévy processes is very rich. Among other things it allows for processes which have paths of both unbounded and bounded variation. The latter case occurs if and only if $\sigma = 0$ and $\int_{(-\infty,0)} |x|\Pi(dx) < \infty$. In that case one may rearrange (3.2) into the form

$$\kappa(\lambda) = c\lambda - \int_{(-\infty,0)} (1 - e^{\lambda x})\Pi(dx) \tag{3.3}$$

where necessarily $c > 0$. This reflects the fact that a spectrally negative Lévy process of bounded variation must be the difference of a linear drift and a pure jump subordinator. If further it is assumed that $\Pi(-\infty,0) < \infty$, then X is nothing more than the difference of a linear drift and a compound Poisson subordinator.

The path variation for a spectrally negative Lévy process also dictates how the process moves away from its initial position. It can be shown that a general Lévy process has one of four types of behaviour in this respect which we shall now describe. Let

$$\sigma_0^+ = \inf\{t > 0 : X_t > 0\} \quad \text{and} \quad \sigma_0^- = \inf\{t > 0 : X_t < 0\}.$$

Then either

- (i) $\mathbb{P}(\sigma_0^+ = 0) = \mathbb{P}(\sigma_0^- = 0) = 1$,
- (ii) $\mathbb{P}(\sigma_0^+ = 0) = \mathbb{P}(\sigma_0^- > 0) = 1$,
- (iii) $\mathbb{P}(\sigma_0^+ > 0) = \mathbb{P}(\sigma_0^- = 0) = 1$, or
- (iv) $\mathbb{P}(\sigma_0^+ > 0) = \mathbb{P}(\sigma_0^- > 0) = 1$.

Note in particular that all probabilities are either zero or one (this follows by Blumenthal’s zero-one law). Case (iv) is only fulfilled by compound Poisson processes. It is well known that a spectrally negative Lévy process necessarily obeys case (i) when it has paths of unbounded variation and case (iii) when it has paths of bounded variation. To some extent, it is clear that when a spectrally negative process has a Gaussian component ($\sigma > 0$) then (i) must hold on account of the dominant behaviour of the latter. If however $\sigma = 0$, then the above conclusions tell us that when $\int_{(-1,0)} |x|\Pi(dx) = \infty$, the movement of X is volatile enough that the process visits both the upper and lower half-lines immediately. If on the other hand $\int_{(-1,0)} |x|\Pi(dx) < \infty$ then, taking (3.3) into account, the accumulation of negative jumps in the first moments of time is not sufficient to counterbalance the upward linear motion with rate c , thus bringing X immediately into the upper half-line for a strictly positive period of time.

When $\mathbb{P}(\sigma_0^+ = 0) = 1(=0)$ we say that 0 is regular (irregular) for $(0, \infty)$. When $\mathbb{P}(\sigma_0^- = 0) = 1(=0)$ we say that 0 is regular (irregular) for $(-\infty, 0)$.

4 Scale functions

As mentioned in the previous section, spectrally negative Lévy processes form a general class of Lévy processes that enjoy a degree of analytic tractability.

The purpose of this section is to give some exposure to explicit expressions for certain fluctuation identities which will be of use when considering the problem of determining the optimal endogenous bankruptcy level for the financial model described in Sect. 2.

The starting point is the so-called scale function which features invariably in almost all known identities (see [1] and [2] for the origin of this function).

Definition 4.1 (Scale function) *For a given spectrally negative Lévy process X with Laplace exponent κ , there exists for every $q \geq 0$ a function $W^{(q)} : \mathbb{R} \rightarrow [0, \infty)$ such that $W^{(q)}(x) = 0$ for all $x < 0$ and $W^{(q)}$ is differentiable on $[0, \infty)$, satisfying*

$$\int_0^{\infty} e^{-\lambda x} W^{(q)}(x) dx = \frac{1}{\kappa(\lambda) - q} \quad \text{for } \lambda > \Phi(q), \quad (4.1)$$

where $\Phi(q)$ was defined in the previous section. We write $W^{(0)} = W$ for short.

Smoothness properties of the scale functions $W^{(q)}$ are very closely related to the roughness of the underlying paths of the associated Lévy process. The following result, found in Lambert [10] and Chan and Kyprianou [3], gives necessary and sufficient conditions for the scale function on $(0, \infty)$ to belong to $C^1(0, \infty)$.

Theorem 4.2 *Suppose that X is a spectrally negative Lévy process. For each $q \geq 0$,*

- (i) *if X is of unbounded variation, then $W^{(q)}$ is continuously differentiable on $(0, \infty)$;*
- (ii) *if X is of bounded variation, then $W^{(q)}$ is continuously differentiable on $(0, \infty)$ if and only if Π has no atoms.*

In addition the behaviour of the scale function at the origin can also be established. In both lemmas below, recall that c is the drift appearing in the representation (3.3) of the Laplace exponent when X has bounded variation.

Lemma 4.3 *At the point zero, the value of the scale function $W^{(q)}(x)$ is determined for every $q \geq 0$ by*

$$W^{(q)}(0+) = \begin{cases} 1/c, & \text{when } X \text{ has bounded variation,} \\ 0, & \text{when } X \text{ has unbounded variation.} \end{cases}$$

Proof From (4.1) we have for $q \geq 0$ that

$$\int_{[0, \infty)} \lambda e^{-\lambda x} W^{(q)}(x) dx = \frac{\lambda}{\kappa(\lambda) - q} \quad \text{for } \lambda > \Phi(q). \quad (4.2)$$

When X has unbounded variation, a straightforward argument using the expression (3.2) shows that $\lim_{\lambda \uparrow \infty} \kappa(\lambda)/\lambda = \infty$. (In particular one can show that the integral in the expression for κ is of order λ^2 .) Hence by the continuity of $W^{(q)}$

it follows by taking limits as $\lambda \uparrow \infty$ in (4.2) that $W^{(q)}(0+) = 0$. On the other hand, when X is of bounded variation, then another straightforward argument shows that in fact $\lim_{\lambda \uparrow \infty} \kappa(\lambda)/\lambda = c$. \square

Lemma 4.4 *Following Theorem 4.2, we see for every $q \geq 0$ that*

$$\frac{dW^{(q)}}{dx}(0+) = \begin{cases} 2/\sigma^2, & \text{when } X \text{ has UBV and } \sigma \neq 0, \\ \infty, & \text{when } X \text{ has UBV with } \sigma = 0, \\ \infty, & \text{when } X \text{ has BV and } \Pi(-\infty, 0) = \infty, \\ (\Pi(-\infty, 0) + q)/c^2, & \text{when } X \text{ has BV and } \Pi(-\infty, 0) < \infty, \end{cases}$$

where UBV is short for unbounded variation and BV is short for bounded variation.

Proof Integrating (4.1) by parts and noting from Definition 4.1 and Theorem 4.2 that a right derivative at zero always exists, we have for each $q \geq 0$

$$\frac{dW^{(q)}}{dx}(0+) = \lim_{\lambda \uparrow \infty} \int_0^\infty \lambda e^{-\lambda x} \frac{dW^{(q)}(x)}{dx} dx = \lim_{\lambda \uparrow \infty} \frac{\lambda^2}{\kappa(\lambda) - q}.$$

In the spirit of the previous proof, it is easy to show when X has unbounded variation that $\lim_{\lambda \uparrow \infty} \kappa(\lambda)/\lambda^2 = \sigma^2/2$ (see also Bertoin [1]). This accounts for the first two cases. When X has bounded variation, a little more care is needed. Integrating again (4.1) by parts, taking care to note that $W^{(q)}(0+) = c^{-1}$, we have

$$\begin{aligned} & \frac{dW^{(q)}}{dx}(0+) \\ &= \lim_{\lambda \uparrow \infty} \frac{\lambda^2}{c\lambda - \lambda \int_0^\infty e^{-\lambda x} \Pi(-\infty, -x) dx - q} - \lambda W^{(q)}(0+) \\ &= \lim_{\lambda \uparrow \infty} \frac{\lambda^2 (1 - W^{(q)}(0+)c + W^{(q)}(0+) \int_0^\infty e^{-\lambda x} \Pi(-\infty, -x) dx) + q\lambda W^{(q)}(0+)}{c\lambda - \int_0^\infty \lambda e^{-\lambda x} \Pi(-\infty, -x) dx + q} \\ &= \lim_{\lambda \uparrow \infty} \frac{1 \int_0^\infty \lambda e^{-\lambda x} \Pi(-\infty, -x) dx + q}{c - \int_0^\infty e^{-\lambda x} \Pi(-\infty, -x) dx} \\ &= \frac{\Pi(-\infty, 0) + q}{c^2}. \end{aligned}$$

In particular, if $\Pi(-\infty, 0) = \infty$ then the right-hand side above is equal to ∞ , and if $\Pi(-\infty, 0) < \infty$, then $dW^{(q)}(0+)/dx$ is finite and equal to $(\Pi(-\infty, 0) + q)/c^2$. \square

It should be noted that the first of the last two lemmas is essentially not new but implicitly embedded in the literature for spectrally negative Lévy processes.

Due to the complexity of the Laplace exponent κ , the scale functions $W^{(q)}$ are not available in explicit form in general. We give some examples in the Appendix, however, which are of relevance to the numerical study at the end

of this paper. It turns out all the same that we have sufficient analytical information regarding these ‘special’ functions in order to achieve our main goal of establishing an optimal choice of V_B via the imposition of an appropriate pasting condition.

4.1 Fluctuation identities for spectrally negative Lévy processes

Recall our notation

$$\sigma_0^- = \inf\{t > 0 : X_t < 0\} \tag{4.3}$$

for the first time that the Lévy process X goes below the level 0. Under the model described in Sect. 2, it is possible to write the equity (2.12) in terms of this stopping time. Via a number of fluctuation identities for spectrally negative processes this then allows us to write the equity in terms of scale functions. We devote this section to doing precisely this and we begin with quoting the necessary fluctuation identities. These come in the form of two lemmas. The first is due to Bertoin [2] and the second is due to Emery [7].

Lemma 4.5 *Denote by \mathbf{e}_q an independent exponential random variable with mean q^{-1} . We have for every $x, y > 0$ and $q > 0$ that*

$$q^{-1} \mathbb{P}_x(X_{\mathbf{e}_q} \in dy, \mathbf{e}_q < \sigma_0^-) = \left(e^{-\Phi(q)y} W^{(q)}(x) - \mathbf{1}_{\{x \geq y\}} W^{(q)}(x - y) \right) dy. \tag{4.4}$$

Lemma 4.6 *For all $q, \beta, x \geq 0$, the joint Laplace transform under \mathbb{P} of the stopping time σ_{-x}^- and its overshoot $X_{\sigma_{-x}^-}$ is given by*

$$\begin{aligned} \mathbb{E}_x \left(e^{-q\sigma_0^- + \beta X_{\sigma_0^-}} \right) &= e^{\beta x} - \frac{(\kappa(\beta) - q)}{(\beta - \Phi(q))} W^{(q)}(x) \\ &\quad - (\kappa(\beta) - q) \int_0^x e^{\beta(x-y)} W^{(q)}(y) dy. \end{aligned} \tag{4.5}$$

Throughout the rest of this paper, we define

$$\begin{aligned} \gamma(x; q, \beta) &= \mathbb{E} \left(1 - e^{-q\sigma_{-x}^- + \beta X_{\sigma_{-x}^-}} \right), \\ g(x; q, b) &= \mathbb{E} \left(\int_0^{\sigma_{-x}^-} e^{-qt} \mathbf{1}_{\{X_t \geq b-x\}} dt \right). \end{aligned}$$

Writing $x = \log(V/V_B)$ and reconsidering (2.10), the total value of the debt can be re-expressed as

$$\begin{aligned} D(V; V_B) &= \frac{(\rho + m)P}{m + r} \mathbb{E}_x \left(1 - e^{-(m+r)\sigma_0^-} \right) + (1 - \eta) V_B \mathbb{E}_x \left(e^{-(r+m)\sigma_0^- + X_{\sigma_0^-}} \right) \\ &= \frac{(\rho + m)P}{m + r} \gamma(x; m + r, 0) + (1 - \eta) V (1 - \gamma(x; m + r, 1)). \end{aligned} \tag{4.6}$$

The value of the firm can be re-expressed as

$$\begin{aligned} v(V; V_B) &= V_B e^x + \tau \rho P \mathbb{E}_x \left(\int_0^{\sigma_0^-} e^{-rt} \mathbf{1}_{\{X_t \geq b\}} dt \right) - \eta V_B \mathbb{E}_x \left(e^{-r\sigma_0^- + X_{\sigma_0^-}} \right) \\ &= V(1 - \eta) + \tau \rho P g(x; r, b) + \eta V \gamma(x; r, 1), \end{aligned} \tag{4.7}$$

where $b = \log \frac{V_T}{V_B}$.

Following the expression in (4.5) one can easily deduce an explicit expression for the function γ in terms of the scale function $W^{(q)}$.

Lemma 4.7 For $x \in \mathbb{R}, q \geq 0$ and $\beta \geq 0$,

$$\gamma(x; q, \beta) = \frac{(\kappa(\beta) - q)}{(\beta - \Phi(q))} e^{-\beta x} W^{(q)}(x) + (\kappa(\beta) - q) \int_0^x e^{-\beta y} W^{(q)}(y) dy.$$

Using the resolvent density (4.4), the expression for g , a function that appears in the expression for the value of the firm, can also be deduced explicitly in terms of the scale function $W^{(q)}$. This will be of use in the next section. The following lemma gives the expression of g .

Lemma 4.8 For $x \in \mathbb{R}, q \geq 0$ and $b \in \mathbb{R}$,

$$g(x; q, b) = \frac{e^{-\Phi(q)(b \vee 0)}}{\Phi(q)} W^{(q)}(x) - \int_0^{x - (b \vee 0)} W^{(q)}(y) dy. \tag{4.8}$$

Proof Using (4.4) of Lemma 4.5, we see that

$$\begin{aligned} \mathbb{E}_x \left(\int_0^{\sigma_0^-} e^{-qt} \mathbf{1}_{\{X_t \geq b\}} dt \right) &= q^{-1} \mathbb{P}_x \left(X_{\mathbf{e}_q} \geq b, \mathbf{e}_q < \sigma_0^- \right) \\ &= \int_{b \vee 0}^{\infty} \left(e^{-\Phi(q)y} W^{(q)}(x) - \mathbf{1}_{\{x \geq y\}} W^{(q)}(x - y) \right) dy \\ &= \int_{b \vee 0}^{\infty} e^{-\Phi(q)y} W^{(q)}(x) dy - \int_{b \vee 0}^{\infty} \mathbf{1}_{\{x \geq y\}} W^{(q)}(x - y) dy \\ &= \frac{e^{-\Phi(q)(b \vee 0)}}{\Phi(q)} W^{(q)}(x) - \int_0^{x - (b \vee 0)} W^{(q)}(y) dy, \end{aligned}$$

where the last equality was obtained after changing variables in the integral. The required identity is proved. \square

To conclude this section, we may now write an explicit expression for the firm’s equity values in terms of the scale function $W^{(q)}(x)$, namely

$$E(V; V_B) = V \left(\eta \gamma(x; r, 1) + (1 - \eta) \gamma(x; m + r, 1) \right) - \frac{(m + \rho)P}{m + r} \gamma(x; m + r, 0) + \tau \rho P g(x; r, b) \tag{4.9}$$

where $x = \log(V/V_B)$ and $b = \log(V_T/V_B)$.

We now move on to determining an optimal bankruptcy level V_B .

5 Determining the bankruptcy level V_B

The expression for E in (4.9) gives the firm’s equity value as a function of the firm’s initial asset value V and the chosen bankruptcy-triggering asset level V_B . In determining the bankruptcy level V_B , the idea is to fix V and maximize E with respect to V_B subject to the limited liability constraint that the equity value $E(V; V_B)$ must always be uniformly non-negative for $V \geq V_B$. We refer to Leland [12], Leland and Toft [11], Hilberink and Rogers [8], and the literature therein for a more detailed discussion of the underlying economics.

The main claim of this paper is that, observing this constraint, the bankruptcy level V_B is determined in the following way.

Theorem 5.1 *If the spectrally negative Lévy process X has unbounded variation, so that 0 is regular for the lower half-line $(-\infty, 0)$, then the bankruptcy-triggering asset level V_B satisfies the condition of smooth pasting; that is to say that V_B is chosen to satisfy*

$$\frac{\partial E}{\partial V}(V_{B+}; V_B) = 0. \tag{5.1}$$

However, if the spectrally negative Lévy process X has bounded variation, so that 0 is irregular for the lower half-line $(-\infty, 0)$, then V_B satisfies the condition of continuous pasting; that is to say that V_B is chosen to satisfy

$$E(V_{B+}; V_B) = 0. \tag{5.2}$$

In both cases, it follows that V_B is the unique solution to the equation

$$x = \frac{\frac{(m+\rho)P}{\Phi(m+r)} - \frac{\tau\rho P}{\Phi(r)} \left(\left(\frac{x}{V_T} \right) \wedge 1 \right)^{\Phi(r)}}{\left(\eta \frac{(r-\kappa(1))}{\Phi(r)-1} + (1 - \eta) \frac{(m+r-\kappa(1))}{\Phi(m+r)-1} \right)}. \tag{5.3}$$

Before moving to the proof of this theorem, note that

$$f(x) = x - \frac{\frac{(m+\rho)P}{\Phi(m+r)} - \frac{\tau\rho P}{\Phi(r)} \left(\left(\frac{x}{V_T} \right) \wedge 1 \right)^{\Phi(r)}}{\left(\eta \frac{(r-\kappa(1))}{\Phi(r)-1} + (1 - \eta) \frac{(m+r-\kappa(1))}{\Phi(m+r)-1} \right)}$$

is continuous, strictly increasing in x , $f(0+) < 0$ and $f(\infty) = \infty$ so that there is a unique solution to the equation $f(x) = 0$ which we denote by V_B^* . The equation (5.3) naturally agrees with the equation for determining the optimal V_B in Hilberink and Rogers [8] who considered the case of a linear Brownian motion plus an independent spectrally negative compound Poisson process.

In fact Hilberink and Rogers [8] show that smooth pasting leads to the Eq. (5.3) for V_B by using the Wiener–Hopf factorization where, in principle, they are working with a general spectrally negative Lévy process. However, close inspection of their calculations shows that they are implicitly assuming that X has a Gaussian component. Specifically this is because of the assumed asymptotic behaviour of their functions $\varphi(x, \lambda)$ and $\gamma(x, \theta, \lambda)$ as $x \downarrow 0$ in the text following (3.16) on p. 244. One sees that this assumed asymptotic behaviour is equivalent to the assumption that the scale function $W^{(\lambda)}$ is zero with a finite derivative at the origin which in turn implies the presence of a Gaussian component.

We also note that in Chen and Kou [4], where the underlying Lévy process takes the form of an independent sum of a linear Brownian motion and a compound Poisson process with two-sided exponential jumps, it was proved that the optimal bankruptcy level follows as a consequence of the smooth-pasting condition. Their result is consistent with the above theorem in the sense that, for the Lévy process considered there, 0 is regular for $(-\infty, 0)$ on account of the presence of the Gaussian term.

We now move to the proof of Theorem 5.1. Without further elaboration, we shall make use of a number of facts and notions from the theory of spectrally negative Lévy processes which are well documented in the literature. We refer to Chap. 8 of Kyprianou [9] for a recent review in which all of the used concepts are addressed.

Proof of Theorem 5.1 We split the proof into two: the cases that X has paths of unbounded and bounded variation.

1. First we assume that X has paths of unbounded variation. Since the scale function $W^{(q)}(x)$ is continuous and equal to zero at $x = 0$, it is easy to check that the continuous-pasting condition (5.2) is always satisfied for any bankruptcy level $V_B > 0$. We look instead at choosing V_B^* by the criterion (5.1).

Assume temporarily that $\sigma > 0$. By differentiating the firm’s equity value E with respect to V , we see after a rather long calculation that

$$\frac{\partial E}{\partial V}(V_{B+}; V_B) = \frac{2}{\sigma^2 V_B} \left(\eta \frac{(r - \kappa(1))}{(\Phi(r) - 1)} + (1 - \eta) \frac{(m + r - \kappa(1))}{(\Phi(m + r) - 1)} \right) f(V_B).$$

From the remarks following the statement of Theorem 5.1 we can now see that

$$\frac{\partial E}{\partial V}(V_{B+}; V_B) > (<) 0 \quad \text{for } V_B > (<) V_B^* \quad \text{and} \quad \frac{\partial E}{\partial V}(V_{B+}^*, V_B^*) = 0.$$

In the case that $\sigma = 0$ one may similarly check with the help of the second case in the conclusion of Lemma 4.4 that if V_B is chosen strictly greater than V_B^* then in fact $\frac{\partial E}{\partial V}(V_{B+}; V_B) = \infty$ and similarly if V_B is chosen strictly less than

V_B^* then $\frac{\partial E}{\partial V}(V_B+; V_B) = -\infty$. When $V_B = V_B^*$ it conveniently turns out that $\frac{\partial E}{\partial V}(V_B+; V_B) = 0$.

Taking account of the limited liability constraint that the equity curve must be uniformly non-negative for all $V \geq V_B$, the calculations lead to the conclusion that the bankruptcy level V_B must be at least as big as V_B^* , i.e., $V_B \geq V_B^*$. We should now like to prove that V_B^* is the optimal bankruptcy level. We do this by showing that for each fixed $V > V_B^*$, the function $V_B \mapsto E(V; V_B)$ is monotone decreasing in V_B . To this end, we note that it can be shown after some algebra that for each fixed $V > V_B^*$ and $V_B \in [V_B^*, V]$,

$$\begin{aligned} \frac{\partial E}{\partial V_B}(V; V_B) &= -\eta \frac{(r - \kappa(1))}{(\Phi(r) - 1)} \left\{ \Theta^{(r)}(x) - \Theta^{(r+m)}(x) \right\} \\ &\quad - \frac{\tau \rho P e^{-\Phi(r)(b \vee 0)}}{\Phi(r) V_B} \left\{ \Theta^{(r)}(x) - \Theta^{(r+m)}(x) \right\} \\ &\quad - \frac{\Theta^{(r+m)}(x)}{V_B} \left\{ \eta \frac{(r - \kappa(1))}{(\Phi(r) - 1)} \right. \\ &\quad \left. + (1 - \eta) \frac{(m + r - \kappa(1))}{(\Phi(m + r) - 1)} \right\} f(V_B) \end{aligned} \tag{5.4}$$

where $\Theta^{(q)}(x) := W^{(q)'}(x) - \Phi(q)W^{(q)}(x)$ and $x = \log(V/V_B)$. Note that in computing this derivative it is worth reminding oneself that

$$\frac{\partial \gamma}{\partial V_B}(x; q, \beta) = -\frac{1}{V_B} \frac{\partial \gamma}{\partial x}(x; q, \beta) = -\frac{1}{V_B} \frac{(q - \kappa(\beta))}{(\Phi(q) - \beta)} e^{-\beta x} \Theta^{(q)}(x),$$

and that

$$\frac{\partial g}{\partial V_B}(x; q, b) = -\frac{1}{V_B} \frac{\partial g}{\partial x}(x; q, b) - \frac{1}{V_B} \frac{\partial g}{\partial b}(x; q, b) = -\frac{e^{-\Phi(q)(b \vee 0)}}{V_B \Phi(q)} \Theta^{(q)}(x),$$

where special care should be taken in the derivatives of g accordingly with the sign of the value b .

Our objective now is to show that each of the three terms on the right-hand side of (5.4) is non-positive.

By a stroke of good fortune, it turns out that the q -resolvent measure of the descending ladder height process $\widehat{H} = \{\widehat{H}_t : t \geq 0\}$ of X can be identified via

$$\mathbb{E} \left(\int_0^\infty e^{-qt} \mathbf{1}_{\{\widehat{H}_t \in A\}} dt \right) = k \int_A \Theta^{(q)}(y) dy,$$

where $q \geq 0, k > 0$ is a meaningless constant (determined by the normalization of local time at the minimum to generate the descending ladder height process \widehat{H}) and A is a Borel set in $[0, \infty)$; see for example Pistorius [13]. It is immediately obvious from this relation, in particular on account of the arbitrary choice of A , that $\Theta^{(q)}(x)$ is non-negative and for each fixed $x \geq 0$ is also monotone decreasing in q .

The latter fact implies that the first two terms on the right-hand side of (5.4) are non-positive. The monotonicity of f also implies that the third expression is non-positive. In conclusion we see that for each fixed $V \geq V_B^*$,

$$\frac{\partial E}{\partial V_B}(V; V_B) < 0$$

when $V_B \in [V_B^*, V]$, thus justifying the claim that V_B^* is optimal.

2. Now consider the case that X has paths of bounded variation. In that case the arguments above do not apply due to the fact that, for any given choice of V_B , $0 = E(V_{B-}; V_B)$ is not necessarily equal to $E(V_{B+}, V_B)$. To see this, one can show with the help of Lemma 4.3 that

$$E(V_{B+}; V_B) = \frac{f(V_B)}{c} \left(\eta \frac{(r - \kappa(1))}{(\Phi(r) - 1)} + (1 - \eta) \frac{(m + r - \kappa(1))}{(\Phi(m + r) - 1)} \right).$$

The monotonicity of f in V_B now implies that

$$E(V_{B+}, V_B) > (<) 0 \quad \text{for} \quad V_B > (<) V_B^* \quad \text{and} \quad E(V_B^+, V_B^*) = 0. \tag{5.5}$$

The constraint of non-negativity of the equity curve thus implies that we must choose $V_B \geq V_B^*$. Exactly the same analysis of the partial derivative $\frac{\partial E}{\partial V_B}(V; V_B)$ as for the unbounded variation case shows that in fact V_B^* must be optimal as $E(V; V_B)$ is decreasing in V_B for each fixed V . □

6 Numerical examples

We illustrate our result from the previous section by means of numerical examples. Our main objective is to show that the bankruptcy level V_B^* is the one that maximizes the equity value $E(V; V_B)$. For our numerical examples, we pay attention to two cases. Firstly, we assume that the underlying dynamics of X is generated by α -stable processes with Laplace exponent

$$\kappa(\theta) = K\theta - \theta^\alpha \quad \text{and} \quad \kappa(\theta) = K\theta^\alpha,$$

respectively. For the first (second) Laplace exponent, we choose $\alpha = 0.5$ ($\alpha = 1.75$). Secondly, we consider *jump diffusion processes* where the jump component of X is contributed by a compound Poisson process having independent downward jumps with exponential $\exp(c)$ distribution occurring at *Poissonian* times with rate a , i.e., X has Laplace exponent

$$\kappa(\theta) = \nu\theta + \frac{1}{2}\sigma^2\theta^2 - \frac{a\theta}{c + \theta}, \tag{6.1}$$

where $\nu \in \mathbb{R}$. This special case of spectrally negative Lévy process was considered in [8]. For all computations, we fix some values of parameters: we set $r = 7.5\%$, $\delta = 7\%$, $\eta = 50\%$ and $\tau = 35\%$, $\sigma = 0.2$, $a = 0.5$, $c = 9$, which are the values used in [8, 11, 12]. We shall also assume as in [8, 11] that $V_T = \rho P / \delta$. The linear drift coefficient ν in the Laplace exponent κ is chosen to respect the martingale condition

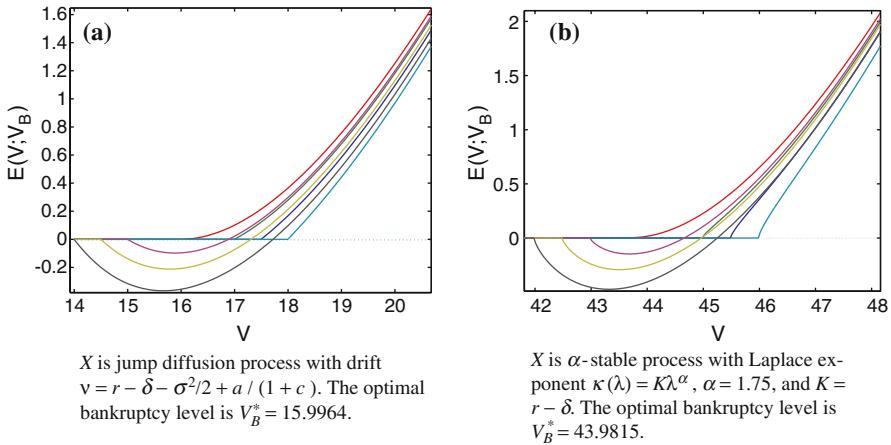


Fig. 1 Various shapes of equity curves $V \mapsto E(V; V_B)$ for different values of bankruptcy level V_B for unbounded variation X . The curve with zero gradient (smooth pasting) at $V = V_B$ (horizontal axis) corresponds to $V_B = V_B^*$; those with negative (positive) gradient correspond to $V_B < (>)V_B^*$

$$\mathbb{E}\left(e^{-(r-\delta)t}V(t)\right) = V,$$

which determines v .

Since our modeling for capital structures of a firm depends on the bankruptcy level V_B , we need to do the following in order to get one point on the curves (for the firm’s (equity) values and debt values). Once a firm has been set up, the face value of the debt P and the coupon rate ρ are calculated for a fixed $m > 0$ in such a way that the equation (5.3) for the bankruptcy level V_B holds,

$$D(V, V_B) = P \quad \text{and} \quad L = \frac{P}{v(V, V_B)},$$

for some positive constant *leverage* L running from 5 to 95% in steps of 5%. The firm’s value $v(V; V_B)$ and the total debt outstanding value $D(V; V_B)$ at time zero are defined in (2.11) and (2.10), respectively. The numerical results for the equity curves $E(V; V_B)$ are reported in Figs. 1 and 2.

We present the numerical outcomes in Fig. 1 for the case where the underlying dynamics X of the firm asset has paths of unbounded variation. The first picture is for the case where X is a jump diffusion process and the other is for an α -stable process with $\alpha = 1.75$. The latter process is a process of pure jumps with no Gaussian component. We see that all the curves of the equity value $E(V; V_B)$ are equal to zero for all $V \leq V_B$. The curves with negative (positive) gradients at $V = V_B$ correspond to bankruptcy levels $V_B < (>)V_B^*$. The only curve which has zero gradient (smooth pasting) at $V = V_B$ corresponds to the one with the bankruptcy level $V_B = V_B^*$. In addition, while X has no Gaussian component we observe also that there are infinite gradient at $V = V_B$ for $V_B \neq V_B^*$ for the equity curves.

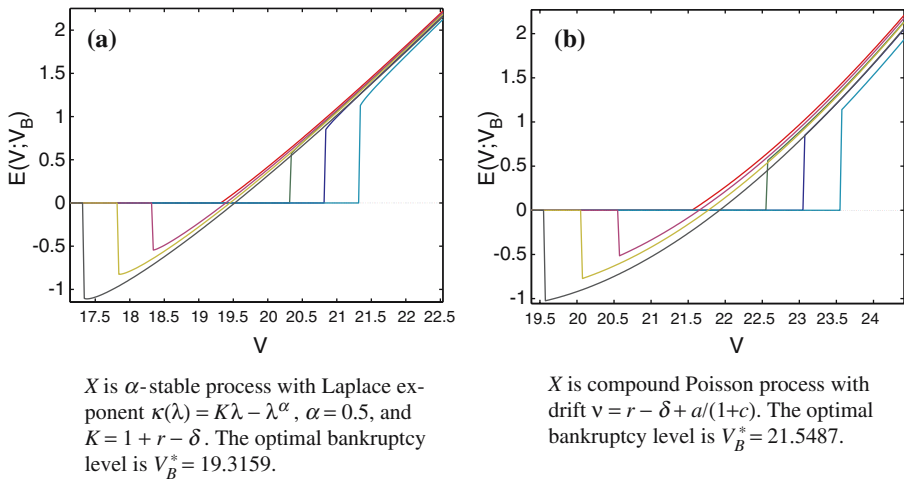


Fig. 2 Various shapes of equity curves $V \mapsto E(V; V_B)$ for different values of bankruptcy level V_B for bounded variation X . The curve with zero value (continuous pasting) at $V = V_B$ (horizontal axis) corresponds to $V_B = V_B^*$; those with negative (positive) jumps correspond to $V_B < (>)V_B^*$

For the case where X has paths of bounded variation, the numerical outcomes are presented in Fig. 2. We see that all the curves of the equity value $E(V; V_B)$ have zero values for all $V < V_B$. From the picture we observe that at the bankruptcy level $V_B < (>)V_B^*$, the equity curves $E(V; V_B)$ exhibit negative (positive) jumps. The only curve which has no jumps (continuous pasting) at $V = V_B$ corresponds to the one with the bankruptcy level $V_B = V_B^*$.

It is seen from the two figures that the equity curve associated with $V_B = V_B^*$ seems to dominate the other curves, even without the constraint of positive equity. This is to say that the bankruptcy level V_B^* is indeed the optimal level of bankruptcy at which the firm’s equity value is maximized. This conclusion concerning the optimality of the bankruptcy level V_B^* is illustrated in Figs. 3 and 4 from which we see that V_B^* is the only bankruptcy value at which for a fixed initial value V of the firm’s asset, the firm’s equity value $E(V; V_B)$ is optimal. These numerical findings confirm our theoretical results given in Sect. 5.

7 Conclusion and remarks

We have built on the work of Leland [12], Leland and Toft [11] and Hilberink and Rogers [8] by showing that one may push the model considered by these authors fully into the case that the underlying source of randomness is a spectrally negative Lévy process. We have done this by giving an analytical treatment using scale functions. This has led to the discovery that the optimal default level is not always achieved by a smooth-pasting condition, but instead continuous pasting is sufficient according to the path regularity of the underlying Lévy

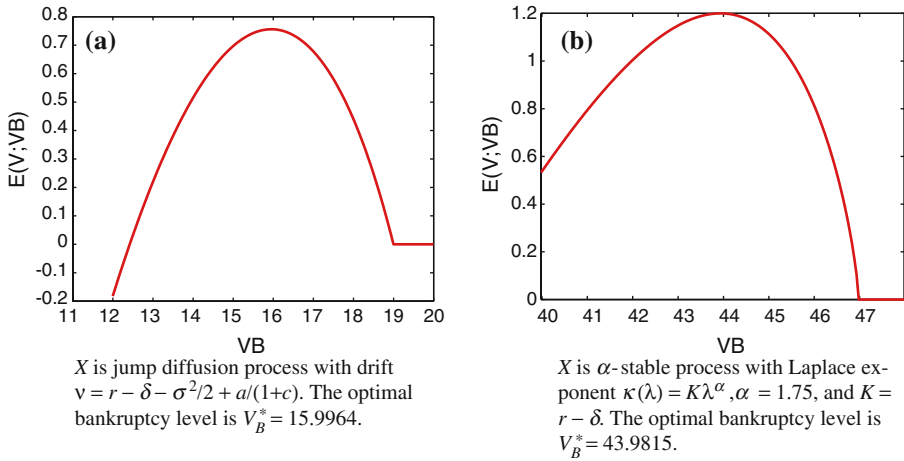


Fig. 3 The shape of the equity curves $V_B \mapsto E(V; V_B)$ for a fixed initial value V of the firm’s asset for X having paths of unbounded variation

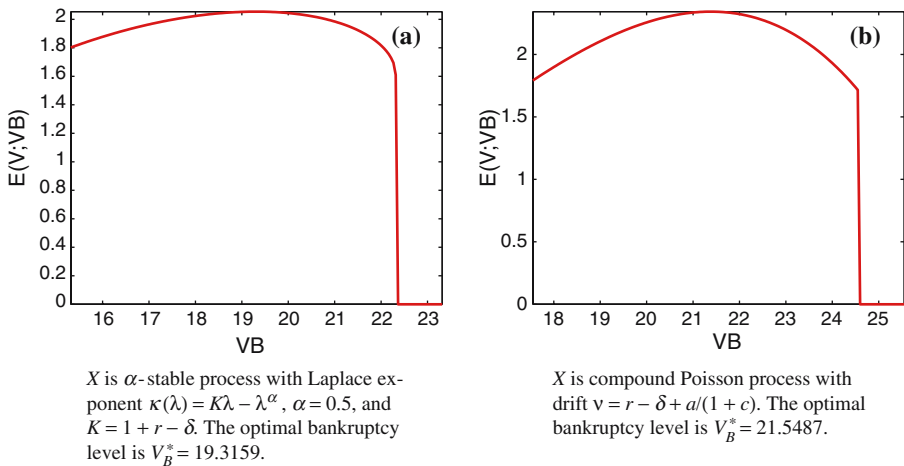


Fig. 4 The shape of the equity curves $V_B \mapsto E(V; V_B)$ for a fixed initial value V of the firm’s asset for X having paths of bounded variation

process. Moreover, our justification for the pasting principles goes further than numerical observation and we give a formal proof of this fact.

Appendix

Numerical inversion of the Laplace transform (4.1) can always be used to compute the scale function numerically. We refer to Choudhury et al. [5] for a general discussion on numerical inversion of Laplace transforms and to Surya [14] for a specific description of the case at hand. For some spectrally negative Lévy

processes, the scale functions $W^{(q)}$ are available explicitly. We consider four such examples below.

Example 7.1 Standard Brownian motion. Taking $\kappa(\lambda) = \lambda^2/2$, it is a straightforward exercise to show that the scale function is given by

$$W^{(q)}(x) = \sqrt{\frac{2}{q}} \sinh(x\sqrt{2q}).$$

Example 7.2 Spectrally negative α -stable process. In this case X has (up to a multiplicative constant which we take as equal to 1) Laplace exponent $\kappa(\lambda) = \lambda^\alpha$ with $\alpha \in (1, 2)$. Due to [2], it is known that the scale function $W^{(q)}$ satisfies

$$\int_{[0, \infty)} e^{-\lambda x} W^{(q)}(x) dx = \frac{1}{\lambda^\alpha - q} \quad \text{for } \lambda > q^{1/\alpha},$$

from which one can deduce that

$$W^{(q)}(x) = \alpha x^{\alpha-1} E'_\alpha(qx^\alpha) \quad \text{for } x \geq 0,$$

where $E_\alpha(\cdot)$ is the Mittag-Leffler function of parameter α defined as

$$E_\alpha(y) = \sum_{n=0}^\infty \frac{y^n}{\Gamma(1 + \alpha n)}, \quad y \in \mathbb{R}.$$

Example 7.3 Spectrally negative Lévy process of bounded variation drifting to infinity. Suppose that $X_t = ct - S_t$ where $\{S_t : t \geq 0\}$ is a subordinator with Lévy measure Π having no atoms and $\mathbb{E}(X_1) > 0$ so that $\mathbb{P}(\lim_{t \uparrow \infty} X_t = \infty) = 1$. It can be shown that the scale function $W(x)$ satisfies

$$\int_{[0, \infty)} e^{-\lambda x} W(x) dx = \frac{1}{c - \int_{(0, \infty)} e^{-\lambda x} \Pi(x, \infty) dx},$$

from which we can deduce that

$$W(x) = \frac{1}{c} \sum_{n \geq 0} v^{*n}(x),$$

where v^{*n} denotes the n th convolution power of $v(x) = c^{-1} \Pi(x, \infty)$ with $v^{*0}(x)$ being understood as $\delta_0(x)$.

Example 7.4 Compound Poisson process with rate β and exponential jumps with parameter $\mu > 0$. From the previous example one may deduce further that when $c\mu - \beta > 0$, the scale function is given by

$$W(x) = \frac{1}{c} \left(1 + \frac{\beta}{c\mu - \beta} (1 - e^{-(\mu - c^{-1}\beta)x}) \right).$$

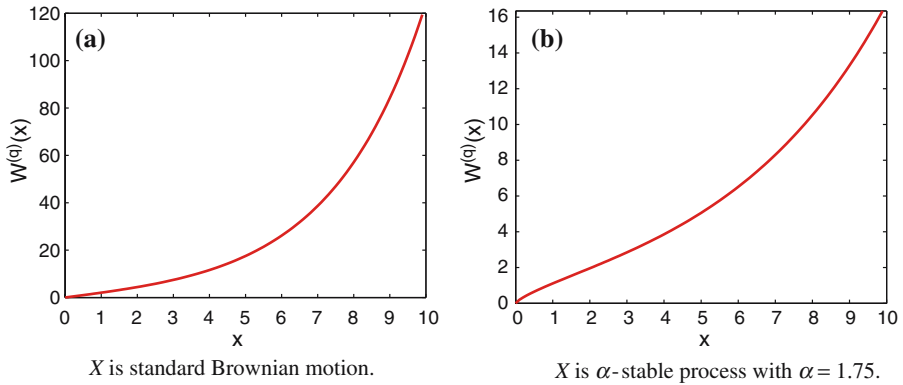


Fig. 5 The shapes of $W^{(q)}(x)$, $q = 0.075$, for unbounded variation X

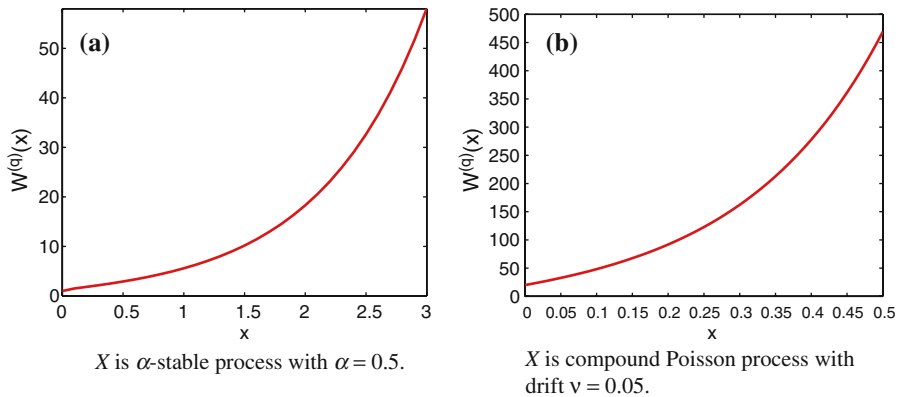


Fig. 6 The shapes of $W^{(q)}(x)$, $q = 0.075$, for bounded variation X

The scale function $W^{(q)}$ can be determined by the formula

$$W^{(q)}(x) = e^{\Phi(q)x} W_{\Phi(q)}(x)$$

where $W_{\Phi(q)}(x)$ plays the role of $W(x)$ when X is taken under the measure $\mathbb{P}^{\Phi(q)}$ defined by

$$\frac{d\mathbb{P}^{\Phi(q)}}{d\mathbb{P}} \Big|_{\mathcal{F}_t} = e^{\Phi(q)X_t - qt}.$$

(Note that it is known that under the latter change of measure, $(X, \mathbb{P}^{\Phi(q)})$ is still a spectrally negative Lévy process.)

Various numerical plots of the scale function $W^{(q)}$ and its derivative $\frac{d}{dx} W^{(q)}$ can be found in Figs. 5, 6, 7 and 8 for each of the above examples when $q > 0$. Note that in each case the asymptotic behaviour is that of an exponential function. This is not surprising since for $\lambda > 0$ and $V^{(q)}(x) = e^{-\Phi(q)x} W^{(q)}(x)$,

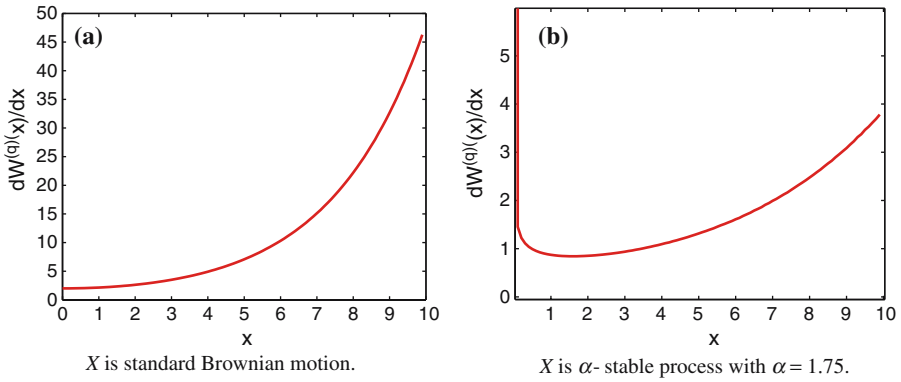


Fig. 7 The shapes of $\frac{d}{dx} W^{(q)}(x)$, $q = 0.075$, for unbounded variation X

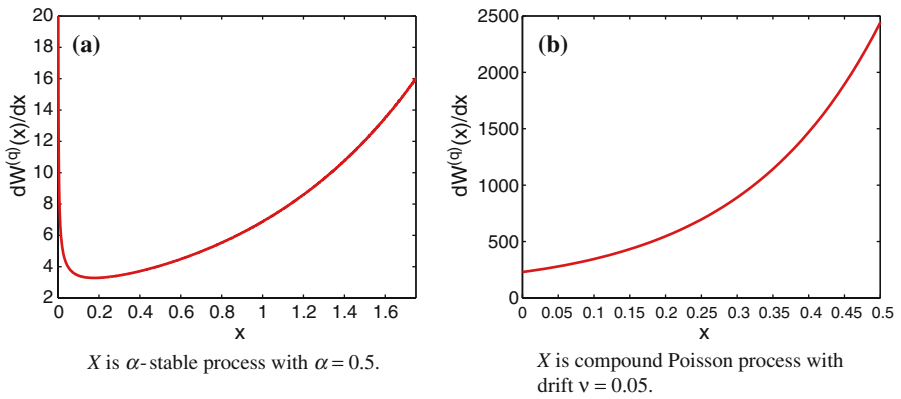


Fig. 8 The shapes of $\frac{d}{dx} W^{(q)}(x)$, $q = 0.075$, for bounded variation X

$$\int_0^\infty e^{-\lambda x} V^{(q)}(dx) = \frac{\lambda}{\kappa(\lambda + \Phi(q)) - q},$$

and hence by taking limits as $\lambda \downarrow 0$ on the right-hand side to obtain $1/\kappa'(\Phi(q))$, it follows from an application of the standard Tauberian theorem that

$$W^{(q)}(x) \sim \frac{e^{\Phi(q)x}}{\kappa'(\Phi(q))} \text{ as } x \rightarrow \infty.$$

Acknowledgments We are grateful to David Hobson and Martijn Pistorius for a number of very useful comments. We are also grateful to a number of anonymous referees for comments on an earlier draft of this paper.

References

1. Bertoin, J.: *Lévy Processes*. Cambridge University Press, Cambridge (1996)
2. Bertoin, J.: Exponential decay and ergodicity of completely asymmetric Lévy processes in a finite interval. *Ann. Appl. Probab.* **7**, 156–169 (1997)
3. Chan, T., Kyprianou, A.E.: Smoothness of scale functions for spectrally negative Lévy processes. (preprint, 2005). <http://www.maths.bath.ac.uk/~ak257/levyc2version11.pdf>
4. Chen, N., Kou, S.: Credit spreads, optimal capital structure, and implied volatility with endogenous default and jump risk (preprint, 2005). <http://www.newton.cam.ac.uk/pre-prints/NI05031.pdf>
5. Choudhury, G.L., Lucantoni, D.M., Whitt, W.: Multidimensional transform inversion with applications to the transient M/G/1 queue. *Ann. Appl. Probab.* **4**, 719–740 (1994)
6. Duffie, D., Lando, D.: Term structure of credit spreads with incomplete accounting information. *Econometrica* **69**, 633–664 (2001)
7. Emery, D.J. Exit problem for a spectrally positive process. *Adv. Appl. Probab.* **5**, 498–520 (1973)
8. Hilberink, B., Rogers, L.C.G.: Optimal capital structure and endogenous default. *Finance Stoch.* **6**, 237–263 (2002)
9. Kyprianou, A.E.: *Introductory Lectures on Fluctuations of Lévy Processes with Applications*. Springer, Berlin Heidelberg New York (2006)
10. Lambert, A.: Completely asymmetric Lévy processes confined in a finite interval. *Ann. Inst. Henri Poincaré* **36**, 251–274 (2000)
11. Leland, H.E., Toft, K.B.: Optimal capital structure, endogeneous bankruptcy, and the term structure of credit spreads. *J. Finance* **51**, 987–1019 (1996)
12. Leland, H.E.: Corporate debt value, bond covenants, and optimal capital structure with default risk. *J. Finance* **49**, 1213–1252 (1994)
13. Pistorius, M.R.: An excursion theoretical approach to some boundary crossing problems and the Skorokhod embedding for reflected Lévy processes. In: *Séminaire de Probabilités*. Springer, Berlin Heidelberg New York (to appear, 2006)
14. Surya, B.A.: Evaluating scale functions of spectrally negative Lévy processes (preprint, 2006)