A Review of the Recent Advances Made in the Black-Scholes Models and Respective Solutions Methods

Yasir Hamad Al Saedi and Gurudeo Anand Tularam

1Department of Mathematics, Faculty of Science, Umm Al-Qura University, Makkah, KSA, Saudi Arabia
2Department of Mathematics and Statistics, Griffith Sciences (ENV), Environmental Futures Research Institute (EFRI), Griffith University, Brisbane, Australia

Abstract: The Black-Scholes model has been a major advance in finance over a period of time; this paper examines this model in some detail, in terms of the latest developments in both analytical and numerical solutions. The paper initially briefly examines historical aspects but quickly moves to a critical analysis of the works in the applications, solutions and implications for the efficiency and use of these. More specifically, this paper critically reviews the existing literature on the proposed exact as well as the numerical solutions to the Black-Scholes model. For this purpose, the exact solution literature on the Black-Scholes model includes speed based solutions and techniques based on valuation issues, time varying instruments and stochastic volatility. Similarly, the key numerical solutions include finite difference methods, the semi-discretization technique, Crank-Nicolson and the R3C scheme, the cubic spline wavelets and multi-wavelet bases method, the two-step backward differentiation formula in the temporal discretization and a High-Order Difference approximation with Identity Expansion (HODIE) scheme and fractional Black-Scholes model (TFBSM) along with Fourier analysis. This analysis reveals that transaction costs, high volatility, illiquid markets and large investor preferences are the key issues of today’s financial derivatives markets, especially after the Global Financial Crisis (GFC). These issues require non-linear solutions to the Black-Scholes models; therefore, Crank-Nicolson and the R3C scheme should be focused upon more by incorporating more and more real-life assumptions of current day trading.

Keywords: Black-Scholes Model, Numerical Solution, Analytical Solution, Option Pricing

Introduction

Black-Scholes (a pricing options equation) has been used over many years in financial markets particularly for various types of options including ‘exotic’ options. Financial markets are becoming complex but have some common issues, such as transaction costs, illiquid markets, large investors and risks from an unprotected portfolio. Such issues need to be incorporated whilst providing either an exact or a numerical solution to different types of options. Comparatively, recent studies have attempted to incorporate all of the relevant issues in attempts to provide a solution to the Black-Scholes model. This study briefly explains all of these developments in the Black-Scholes equation along with a historical perspective of the model. It also analyses the implications of the Black-Scholes model in different fields ranging from business (Corrado and Su, 1996) to construction projects (Barton and Lawryshyn, 2011).

This is followed by a detailed examination of exact solutions, with given additional conditions involved in the Black-Scholes questions. The introduction of nonlinearity in the Black-Scholes means that the solutions will require the use of numerical methods. Some key studies regarding the exact solutions and numerical methods are critically examined. Consequently, the first aim of this study is to explore briefly the historical perspective, implication and advancement of Black-Scholes in terms of exact and numerical solutions. The other aim is to provide a categorical analysis and a critical review of the Black-Scholes in terms of both exact and numerical solutions. A brief discussion and a summary followed by the main findings will conclude this paper.
Background of the Black-Scholes Model

It is noted that the Black-Scholes equations are still used a lot in the financial and investment world. This is because the derivative markets have become significantly important and continuing to grow. Therefore, the key concern for all finance professionals is to understand the mechanism and functioning of these markets. The proper understanding of fair prices of these derivatives can help mitigate the risks for financial professionals. The second key motivation to properly understand this mechanism is to avoid a crisis similar to the recent global financial crises (2007-2009) since it were the derivatives created for the residential mortgage in the USA that played a significant role in these crises (Hull et al., 2013).

The history of options markets goes back to the middle ages, when the futures were created in order to meet the need of merchants and farmers. Consider the position of a farmer in March who will harvest in June. Now, he is uncertain about the price of grains. The option market was developed to manage these kinds of risks. Later on, these trades were formalized through the trading boards, when the Chicago Board of Trade was established in 1848 in order to bring the merchants and farmers onto a single platform. It was not long after that this board opened the Chicago Board Option Exchange in 1973 (Hull et al., 2013). It was then that academicians and financial researchers started to focus on the valuation methods, such as the Black-Scholes equation to model the prices of the options.

Despite some estimation issues, as pointed out in Duan (1999; Yang, 2006; Harun and Hafizah, 2015), the Black-Scholes model has received considerable attention over past two decades-especially in underlying probability attributes of a European call option when written on a non-dividend stock. The Black-Scholes model estimates the probability of a European call option, which is frequently used in the investment decisions (see the work of Fischer Black, Myron Scholes and Robert Merton; they started publishing work related to the pricing of mainly European stock options). The focus was not on American options since the European one was much easier to deal with at the time.

More specifically, Fischer was working on the stock warrant valuation models when Scholes became interested in his work and joined his research. Based on this, they developed their initial versions of the Black-Scholes equation. The initial version of Black and Scholes (Black and Scholes, 1973) was rejected twice, by: (i) Review of Economics and Statistics and (ii) Journal of Political Economy. Later on, this work was further developed by Merton (1973) and interestingly, the Merton paper was accepted earlier than the Black and Scholes (Black and Scholes, 1973). It seems that, on grounds of fairness, Robert Merton asked the journal editor to hold this publication until the acceptance and publication of Black and Scholes (Black and Scholes, 1973).

An acknowledge of the importance of the Black-Scholes model came in 1997, when Myron Scholes and Robert Merton were awarded the Nobel Prize in 1997. Fischer Black passed away on 30th August 1995; otherwise, he would undoubtedly also have been one of the recipients of the Nobel Prize. This model has now become one of the most important applications of Ito calculus in financial engineering. In this context, Wilmott et al. (1995) pointed out that the Black-Scholes or Black-Scholes-Merton model is the basic building block of the financial derivatives theory. Further, this model played a vital role in the growth and success of financial engineering. The above discussion raises an important question as to how Black, Scholes and Merton made their breakthrough.

Theoretical Justification of the Breakthrough

In terms of options discussed earlier, researchers have used various assumptions in order to calculate the expected payoff of the European options (Feltham, 1968). But in most instances, it was difficult to arrive at the correct discount rate, which is the key element in the calculation of the expected payoff of the European option, as elaborated in section 12.2 of Hull et al. (2013). In order to resolve this lingering issue, Black and Scholes used the capital asset pricing model to determine the association between the markets’ required return on the option and the required return on the stock.

This was a rather complicated issue since the underlying relationship was dependent upon: (i) The stock price and (ii) time. In this nexus, Merton’s approach was different, involving a riskless portfolio of the option and underlying stock. This riskless portfolio was based on the argument that the return on the portfolio over a short period of time must be equal to the risk-free return. This approach is more general when compared to Black and Scholes’ approach since it does not rely on the assumption of the capital asset pricing model in valuing stock options, namely, the Black-Scholes-Merton Model. This model helped, in the end, to turn around the guessing game of forward pricing of options into a mathematical science, which in turn further aided in the development of pricing more exotic options and many other different tools in financial engineering.

In addition to the assumptions mentioned, MacBeth and Merville (1979) stated some other key assumptions, namely, (i) the underlying stock pays no dividend, (ii) the risk-free rate remains constant over the period of an option, (iii) the market players can lend and borrow at the risk-free rate, (iv) the price of the stock one period ahead has a log-normal distribution with constant mean and variance and finally, (v) the number of shares in the stock outstanding remains the same.
Implications of the Black-Scholes Model

During the 1970s, after the publication of Black and Scholes (Black and Scholes, 1973), researchers focused on extracting some empirical evidences from the key financial markets, including insurance sector giants. For instance, MacBeth and Merville (1979) conducted a comparative analysis of the real market prices of call options with the prices predicted by Black and Scholes (Black and Scholes, 1973). These studies attracted researchers from other fields to use these models in the related price predictions. Years later, the Black-Scholes model has been widely used in different fields ranging from business (McGrath, 1997; 2004), customer relationship management (Maklan et al., 2005), assessment of bonds and derivatives (Singh, 2014) and management and evaluation of intangible assets (Park et al., 2012).

Along similar lines, Cutland et al. (1995) explored new horizons of implication of the Black-Scholes model, including ascertaining the value for the deposit insurance, loans for students, farm prices support, patents, pollution rights, policies for governments and drilling rights. Despite all this, the key relevant literature focuses on the stock markets in both equity and fixed income instruments (Geske et al., 1983; Rubinstein, 1983; Scott, 1987).

Comparatively recently, McKenzie, Gerace and Subedar (2007) tested the underlying probabilities attributed within the model in the Australian Stock Market. Applying qualitative regression and a maximum likelihood approach, the results of this study are in line with the Black-Scholes model. This study also includes alternative approaches such as jump-diffusion and implied volatility. Hong (2004) used the data from 1994 to 2003 from Malaysian stock markets and reported that the overall Black-Scholes model prices were significantly below the market prices; both market prices and the Black-Scholes model deviated in a certain systematic pattern. The Black-Scholes model can be applied as an investment strategy in the Malaysian stock market once the systematic pattern of deviation is clear for the specific investment. On similar lines, Mohanti and Priyan (2014) applied the Black-Scholes model and dynamic hedging strategy using daily closing prices of S&P CNX Nifty index options contracts from 1 April 2008 to 31 March 2012 in the Indian stock market. This study reported that the Indian index option market is efficient.

This brief review shows that Black-Scholes model has a number of different applications. In some cases, the results are in line with the model predictions, while in other cases; it seems there are some discrepancies. Nevertheless, the model has clearly the ability to examine various types of valuation of derivatives in different markets. Second, we note that financial derivatives are relatively less used in the electricity market and indeed in the Australian power market. This paper aims to provide a critical analysis of the advancement in the exact and numerical solutions to the Black-Scholes. Such an analysis of the latest advancements will allow researchers to choose more advanced analytical and technical methods of solutions for their research studies and model solutions.

The Black-Scholes Analytical Solution

During the last couple of years, different studies have provided solutions covering different quantitative aspects of the model. For instance, Shin and Kim (2016) focused on the Black-Scholes terminal value problem and provided its solution through the Laplace transform. This study claimed that the proposed method is simpler than the existing methods. In the early 1990s, Harper
(1994) applied the generalization technique in order to provide an exact solution for the Black-Scholes equation by reducing parabolic partial differential equations to canonical form. In this generalized form, the variables corresponding to the time appear to run backwards. These fluid mechanics can be applied in other financial derivative products where there are similar information-theoretic reasons behind the products.

Later, Forsyth et al. (1999) applied the finite element method under stochastic volatility to provide the exact solution of the Black-Scholes equation using the money-vanilla European option. In this approach, the outgoing waves are also correctly modelled whilst the boundary equations are discretised. For future research, this proposed technique can be applied on American options since the European option was used for the same time remaining until the expiry time.

In the early 2000s, the advanced financial engineering techniques become a part of financial products issued for the housing market. During this time, Jódar et al. (2005) considered the final-value problem and applied the Mellin transform to provide a new method of direct solution of Black-Scholes equation. This proposed method can be applied to the relevant option pricing models.

A year later, Rodrigo and Mamon (2006) incorporated the time varying factor into different aspects of options in order to provide the exact solution of an explicit formula for the price of an option on a dividend-paying equity. In this study, Rodrigo and Mamon (2006) used options of (i) dividend-paying equity and (ii) non-dividend paying equity. As output, this provides a simple derivation of the explicit formula of an option in time dependent parameters of the Black-Scholes partial differential equation. Thus, the pricing of other return-based equity instruments is possible through this mechanism.

Bohner and Zheng (2009) went further and applied the Adomian approximate decomposition technique to provide an exact solution to the equation. The authors suggested that the proposed technique be applied when studying some other problems in finance theory.

Comparatively recently, Edeki et al. (2015) modified the classical Differential Transformation Method (DTM) and used its modified version, Projected Differential Transformation Method (PDTM), to provide a faster exact solution to the Black-Scholes equation for European option valuation. A critical analysis reveals that this fast solution is efficient, reliable and better than the classical DTM. Additionally, it is recommended that both linear and nonlinear stochastic differential equations be encountered in the field of financial mathematics. For future research, this algorithm can be applied on the European put options. Table 1 summarizes the above discussion of the analytical techniques.

**Numerical Solutions to Black-Scholes**

Forsyth et al. (1999) used the finite element approach to the pricing of discrete lookbacks with stochastic volatility. Along similar lines, Tangman et al. (2008) considered High-Order Compact (HOC) schemes for quasilinear parabolic partial differential equations to discretise the Black-Scholes PDE for the numerical pricing of European and American options. Dremkova and Ehrhardt (2011) then presented compact finite difference schemes to solve nonlinear Black-Scholes equations for American options with a non-linear volatility function. Since a compact scheme cannot be applied on the American type options, the study used a fixed-domain transformation. Around the same time, Song and Wang (2013) applied symbolic calculation software to provide a numerical solution using the implicit scheme of the finite difference method. This study combined the time-fractional Black-Scholes equation with the conditions satisfied by the standard put options. Two years later, Uddin et al. (2015) presented the numerical result of semi-discrete and full-discrete schemes for European call option and put option by Finite Difference Method and Finite Element Method. In a recent study, Zhang et al. (2016) used the Tempered fractional derivative to price a European double-knock-out barrier option. This study analysed characteristics of the three fractional Black-Scholes models through comparison with the classical Black-Scholes model.

Much earlier, Cortés et al. (2005) incorporated an important aspect of errors into the numerical solution. This study applied the Mellin transformation and proposed that the errors of composite Simpson’s rule or Euler’s method can be avoided whilst pricing the Black-Scholes equation in real-world financial derivatives. Company et al. (2006) also applied Mellin transform and a delta-defining sequence of the involved generalized Dirac delta function to provide a numerical solution of the modified Black-Scholes equation. Other studies on numerical solution literature considered different aspects. For instance, Company et al. (2008) applied the Semi-discretization technique to deal with the issues arising as a result of a nonlinear case of interest modelling option pricing with transaction costs.

The nonlinear Black-Scholes models are now gaining popularity because most of the realistic assumptions including transaction costs, high volatility, illiquid markets and large investor’s preferences can also be included. Ankudinova and Ehrhardt (2008) analysed that the Crank-Nicolson and the R3C scheme are the most accurate techniques to price the European call option. This study incorporated different volatility problems in stock price, option price and its derivatives.

Recently, the two-dimensional Black-Scholes equation was explored by Černá et al. (2016) using cubic spline wavelets and multi-wavelet bases. The proposed method suggests some key advantages, including (i) high-order accuracy, (ii) a small number of degrees of freedom and (iii) a relatively small number of iterations.
Rao (2016) applied the two-step backward differentiation formula in the temporal discretization and a High-Order Difference approximation with Identity Expansion (HODIE) scheme-concerned with the generalized Black-Scholes models for European call option. This study presents the case of the European call option. The solution noted second-order accuracy in time and third-order accuracy in space.

In a recent study, Zhang et al. (2016; Yang, 2006) applied fractional Black-Scholes model (TFBSM) along with Fourier analysis; this study extends different numerical solution literature on the price change of the underlying fractal transmission system. First, this study derives the fractional Black-Scholes model with an \( \alpha \)-order time fractional derivative by applying numerical simulation. Second, the proposed techniques and method are used to price different European options. The review of the above discussion on the numerical solution is categorized and presented chronologically in Table 2.

<table>
<thead>
<tr>
<th>Study</th>
<th>Methodology/Technique</th>
<th>Sample/Options/Markets</th>
<th>Context</th>
<th>Conclusion/Findings</th>
<th>Application/Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Harper et al. (1994)</td>
<td>Generalization</td>
<td>In this generalized form, the variables corresponding to the time appear to run backwards.</td>
<td>To provide an exact solution of the Black-Scholes equation, this study reduces parabolic partial differential equations to canonical form.</td>
<td>This study provides an exact solution of the Black-Scholes equation, elaborating the information-theoretic reasons where the time-variant variables of the Black-Scholes equation run backward.</td>
<td>This application from fluid mechanics can be applied in other financial derivative products where there are similar information-theoretic reasons behind the products.</td>
</tr>
<tr>
<td>Forsyth et al. (1999)</td>
<td>The finite element method is applied to provide this exact solution of the Black-Scholes equation</td>
<td>The money-vanilla European option is used for the analysis with the same time remaining until expiry.</td>
<td>This approach provides an exact solution of the Black-Scholes model considering the options under stochastic volatility.</td>
<td>Applying the finite element method, the limits where the Black-Scholes equation becomes first-order hyperbolic are handled correctly. Further, the outgoing waves are also correctly modelled whilst the boundary equations are discretised.</td>
<td>This is a good proposed technique to be applied on American options since the European option was used for the same time remaining until the expiry time.</td>
</tr>
<tr>
<td>Jódar et al. (2005)</td>
<td>Mellin transform</td>
<td>This study does not require any variable to provide an exact solution to the equation.</td>
<td>Options of dividend-paying equity as well as the non-dividend-paying equity</td>
<td>This study aims to provide a new method of direct solution using Mellin transform.</td>
<td>Considering the final-value problem, this study provides an exact solution of the Black-Scholes model.</td>
</tr>
<tr>
<td>Rodrigo and Mamon (2006)</td>
<td>Time-varying parameters</td>
<td>This study incorporates the time-varying factor in different aspects of options in order to provide the exact formula for the price of an option on a dividend-paying equity.</td>
<td></td>
<td>This study provides a simple derivation of the explicit formula of an option in time-dependent parameters of the Black-Scholes partial differential equation.</td>
<td>The pricing of other return-based equity instruments is possible through applying this proposed technique.</td>
</tr>
<tr>
<td>Bohner and Zheng (2009)</td>
<td>The Adomian approximate decomposition technique is applied in this study.</td>
<td>This analytical solution does not require any variable to provide an exact solution to the Equation.</td>
<td>The objective of this study is to present a theoretical analysis of the Black-Scholes equation in a given terminal condition.</td>
<td>This study provides the analytical solution of the using Black-Scholes equation the Adomian approximate decomposition technique.</td>
<td>The proposed technique is suggested for application in studying some other problems in finance theory.</td>
</tr>
<tr>
<td>Edeki et al. (2015)</td>
<td>The Projected Differential Transformation Method (PDTM), a modification of classical Differential Transformation Method (DTM)</td>
<td>Applied on the Black-Scholes equation for European option valuation</td>
<td>This study aims to apply PDTM on the Black-Scholes equation for European option valuation for a faster exact solution.</td>
<td>The results of this study indicate that the proposed method is efficient, reliable and better than the classical DTM. Furthermore, it is recommended that both linear and nonlinear stochastic differential equations be encountered in the field of financial mathematics.</td>
<td>The same algorithm is expected to be applied on the European put options.</td>
</tr>
<tr>
<td>Shin and Kim (2016)</td>
<td>Laplace transform</td>
<td>In order to provide the solution to the Black-Scholes terminal value problem, this study does not require any variable.</td>
<td>The aim of this study is to check the solution of the Black-Scholes terminal value problem since this problem is closely related to the put and call options of the stock market.</td>
<td>Applying a proposed simpler method than the existing, Laplace transform, this study provides the exact solution to the terminal value problem of Black-Scholes.</td>
<td>Looking at the application of the Euler-Cauchy equation, this proposed method can be applied to model any other derivative products.</td>
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### Table 2: Numerical solutions to Black-Scholes

<table>
<thead>
<tr>
<th>Study</th>
<th>Methodology/Technique</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Cortés et al. (2005)</td>
<td>Mellin transform</td>
<td>Black-Scholes for pricing stock options</td>
<td>Along with providing numerical solutions, this research also focuses on incorporating the errors of previous proposed numerical solutions.</td>
<td>Considering the final value problem, this paper provides a new method to solve the Black-Scholes equation.</td>
<td>The errors of composite Simpson’s rule or Euler’s method can be avoided whilst pricing the Black-Scholes equation in real-world financial Derivatives.</td>
</tr>
<tr>
<td>Company et al. (2006)</td>
<td>This study applied two key techniques: (i) the delta-defining sequence of the involved generalized Dirac delta function and (ii) the Mellin transform.</td>
<td>Stock options with discrete dividend payments</td>
<td>This study attempts to provide a numerical solution of the modified Black-Scholes equation in order to model the stock option valuation with discrete dividend payments.</td>
<td>This study obtained an integral formula for the required numerical solution.</td>
<td>In addition to a numerical solution, this study also provides the numerical quadrature approximations along with some illustrative examples.</td>
</tr>
<tr>
<td>Company et al. (2008)</td>
<td>Semi-discretization technique</td>
<td>Focusing on the options with high transaction costs like vanilla call option</td>
<td>The objective of this study was to deal with the issues arising as a result of nonlinear case of interest modelling option pricing with transaction costs.</td>
<td>This study provides the numerical solution of the Black-Scholes option pricing partial differential equations applying the semi-discretization technique.</td>
<td>The proposed method is applicable on other forms, such as the standard put option.</td>
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<tr>
<td>Tangman et al. (2008)</td>
<td>Fourth-Order Compact Finite Difference (FOCFD)</td>
<td>European and American options, where the results validate the accurate numerical solution for European options only</td>
<td>This study applies the High-Order Compact (HOC) schemes to discretise Black-Scholes PDE in order to get numerical pricing of European as well as American options. For this purpose, quasilinear parabolic partial differential equations are used.</td>
<td>This study concludes that a HOC scheme with grid stretching (in association with asset price dimension) provides an accurate numerical solution in case of European options under stochastic volatility.</td>
<td>Considering the results of this study, coarse meshes can be used to obtain high accuracy in case of high-frequency data in option markets such as the American and European options.</td>
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<tr>
<td>Ankudinova and Ehrhardt (2008)</td>
<td>Crank-Nicolson and the R3C scheme are the most accurate techniques to price the European call option.</td>
<td>Both of the options including American and European with a volatility considering different facts: (i) Stock price, (ii) time, (iii) option price and (iv) derivatives</td>
<td>As a result of some realistic assumptions, including transaction costs, high volatility, illiquid markets and large investor’s preferences, nonlinear Black-Scholes models are gaining popularity.</td>
<td>This study presents different numerical discretization schemes for European options for various volatility models consisting of (i) the Leland model, (ii) the Barles and Soner model and (iii) the Risk adjusted pricing methodology mode.</td>
<td>Following the results of this study, the generalized forms of Numerov-type and Crandall-Douglas scheme can be applied for the numerical solution of nonlinear Black-Scholes equations.</td>
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<tr>
<td>Dremkova and Ehrhardt (2011)</td>
<td>This study applies FOCFD using a fixed-domain Transformation proposed by Sevcovic.</td>
<td>Standard options generally known as plain vanilla options of American type since a closed-form solution to non-linear Black-Scholes equation does not exist; resultantly, solved numerically</td>
<td>This study addresses some of the issues in classical Black-Scholes model assumptions as a result of (i) transaction costs, (ii) illiquid markets, (iii) large investors and (iv) risks from an unprotected portfolio. As a result of these issues, the model faces nonlinear, possibly degenerate, parabolic diffusion issues.</td>
<td>This study indicates that compact methods are the better option for efficient modelling of American options applying the fixed-domain transformation technique.</td>
<td>These results motivate the implementation of the discrete artificial boundary condition in this framework.</td>
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<tr>
<td>Song and Wang (2013)</td>
<td>Finite difference method</td>
<td>European and American put options</td>
<td>Based on the time-fractional Black-Scholes equation, the aim of this study is to provide the numerical solution to the standard put options using symbolic calculation software.</td>
<td>The successful numerical solution provided in this study indicates that the finite difference method in this framework is effective with less computational work inorder to solve the fractional partial differential equation.</td>
<td>This fractional model can be applied to model the price of other financial derivatives, including swaps, warrants and so on.</td>
</tr>
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Table 2. Continue

<table>
<thead>
<tr>
<th>Uddin et al. (2015)</th>
<th>This study applies the Finite Element Method (FEM) followed by the weighted average method, where different weights are used for numerical approximations. European call and put options</th>
<th>This study attempts to solve European call and put options and apply different numerical and analytical methods.</th>
<th>This study presents numerical results of the semi as well as full discrete schemes by (i) the Finite Difference Method and (ii) the Finite Element Method in order to model the European call and put option pricing.</th>
<th>The linear algebra solvers can be applied to different forms of options to verify the solvers.</th>
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<tr>
<td>Černá et al. (2016)</td>
<td>For all types of options</td>
<td>The objective of this paper is to provide numerical solutions for the two-dimensional Black-Scholes equation.</td>
<td>By providing a numerical solution through cubic spline wavelets, this study concludes that this proposed method is suggested due to some key advantages, including (i) high-order accuracy, (ii) a small number of degrees of freedom and (iii) a relatively small number of iterations.</td>
<td>This method can be applied to a wide range financial derivatives for the computation of their market value at a given time.</td>
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<tr>
<td>Zhang et al. (2016)</td>
<td>This technique is applied to price a European double-knock-out barrier option. Further, a comparative analysis is conducted on the characteristics of the three fractional Black-Scholes models and classical Black-Scholes model.</td>
<td>Large movements and jumps over the small time steps are the important characteristics of the dynamic process of stock price changes over the last couple of years. In order to capture these dynamics, the Finite Moment Log Stable (FMLS), KoBoL and CGMY models are considered the most popular modelling framework. This study provides a numerical solution of these models.</td>
<td>The findings of experimental data indicate that experimental results are in line with the theoretical analysis.</td>
<td>Based on these results, the numerical techniques can be applied in related fractional models for pricing different options.</td>
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<tr>
<td>Rao (2016)</td>
<td>The numerical method used in this study is based on the two-step backward differentiation formula in the temporal discretization and a High-Order Difference approximation with Identity Expansion (HODIE) scheme. European call option</td>
<td>This numerical solution is more concerned with the generalized Black-Scholes models for the European call option.</td>
<td>This study presents a high -order numerical method in order to provide the numerical solution of the generalized Black-Scholes models especially for the case of the European call option. Additionally, this solution gives second-order accuracy in time and third-order accuracy in space.</td>
<td>Since these numerical experiments are conducted in order to support theoretical aspects of the financial derivatives, these numerical solutions can be extended to the European put option.</td>
</tr>
<tr>
<td>Zhang et al. (2016)</td>
<td>A special case of European options</td>
<td>This research extends different numerical solution literature on the price change of the underlying fractal transmission system.</td>
<td>This research is two-fold. First, it derives the fractional Black-Scholes model with an α-order time fractional derivative applying numerical simulation. Second, the proposed techniques are used to price different European options.</td>
<td>These numerical techniques are expected to apply in other similar fractional models to price European options.</td>
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Discussion of Analytical Solutions

The exact solution literature provided in Table 1 addresses a couple of real-word phenomena of the financial markets. Considering these phenomena, this literature can be categorized into the following:

\[
\frac{\partial V}{\partial t} = \frac{\partial^2 V}{\partial x^2} + (k - 1) \frac{\partial V}{\partial x} - kv(x, h + 1) \\
= \frac{1}{h} \left[ \frac{\partial^2 V}{\partial x^2} \right]_{h}^{h+1} + (k - 1) \frac{\partial V}{\partial x} - klV(x, h) \tag{1}
\]

ii. Valuation issues-based techniques using which Shin and Kim (2016) addressed the terminal value problem of the Black-Scholes model by using the Laplace transformation:
\[
u^2 \mathcal{F}(v) - uv(x, 0) - v_x(x, 0) \\
+ \frac{1}{2} \sigma^2 u^2 \mathcal{F}(v_x, t) + ru \mathcal{F}(v_x, t) - r \mathcal{F}(v) = 0 \tag{2}
\]

Jódar et al. (2005) applied the Mellin transformation to solve the final-value problem:
\[
\frac{\partial C}{\partial t} = \frac{1}{2} \sigma^2 S \frac{\partial^2 C}{\partial S^2} + rS \frac{\partial C}{\partial S} - rC(S, t) \\
= \frac{1}{2 \pi i} \int e^{-p(x + ir)} + \frac{\sigma^2}{2} S^2 (\alpha + ir)(\alpha + 1 + ir) \left( S^2 - rS(\alpha + 1)S^{-1} - r \right) \times f(\alpha + ir) e^{-r(u+1)(\alpha+ir) dt} = 0 \tag{3}
\]

iii. A time-varying instrument-based technique using which Rodrigo and Mamon (2006) used time-varying parameters for the options of dividend paying equity as well as the non-dividend paying equity:
\[
V(x, t) = \frac{K}{\sigma} \exp \left[ -\int r(u) - \frac{\sigma^2}{2} \sigma(u) du \right] V^-(s, t), \\
S^- = \frac{K}{\sigma} \exp \left[ -\int r(u) \sigma(u) + D(u) - r(u) du \right] s, \\
t^- = -\frac{1}{\sigma^4} \int \sigma(u) \sigma(u)^T du + t^- \tag{4}
\]

iv. A stochastic volatility-based technique with which Forsyth et al. (1999) applied the finite element method to provide this exact solution of the Black-Scholes equation:
\[
U_i = \frac{\nu^2}{2} U_{ss} + \rho \sigma v \nu U_{sv} + \frac{\nu^2}{2} U_{vv} \\
+ \rho \sigma v \nu U_{sv} + \left( K (\theta - v) - \lambda v \right) U_{v} - r U \\
\]

All of these proposed techniques provide analytical and/or quasi-exact solutions by incorporating different issues of financial derivatives. Therefore, these techniques have their importance for the applicability purpose.

### Discussion on Numeric Solutions

The nature of the conditions used in the valuation methods make models such as Black-Scholes a nonlinear one and they then require numerical approaches to reach satisfactory solutions. Some of the aspects that influence the nature of the model are: Transaction costs, illiquid markets, large investors, risks from an unprotected portfolio, weights allocation methods along with the long movements and jumps over the small time steps are the common problem in the financial derivatives markets. All of these issues are incorporated into different studies (Dremkova and Ehrhardt, 2011; Song and Wang, 2013; Tangman et al., 2008; Uddin et al., 2015; Zhang et al., 2016), all of which attempted to provide the numerical solution to the Black-Scholes model using finite difference methods. Other proposed techniques in numerical solution approaches are as follows:

i. Semi-discretization technique (Company et al., 2008):
\[
U_t - \frac{S^2}{2} \sigma^2 U_{ss} - rS U_s + rU = 0 \quad 0 < S < \infty, 0 < t \leq T \\
\tau = T - t \\
U(S, 0) = \max(0, S - E) \\
U(0, \tau) = 0, \lim_{\tau \to 0^+} \frac{U(S, \tau, t) - E}{\tau} = 1 \tag{6}
\]

ii. Crank-Nicolson and the R3C scheme-the most accurate techniques to provide a solution to the nonlinear Black-Scholes models (Ankudinova and Ehrhardt, 2008):
\[
D_x [U_t + DU_{x}^{-1}] + D_x [U_t + DU_{x}^{-1}] + D_x [U_t + DU_{x}^{-1}] + D_x [U_t + DU_{x}^{-1}] + D_x [U_t + DU_{x}^{-1}] + D_x [U_t + DU_{x}^{-1}] \\
\leq \left( 1 + s^2 \right) \left[ \left( a + B_1 \right) D_x [U_t] + \left( a + B_2 \right) D_x [U_t] \right] \\
+ \left( 1 + s^2 \right) \left[ \left( a + B_1 \right) D_x [U_t] + \left( a + B_2 \right) D_x [U_t] \right] \\
+ D_x [U_t] + D_x [U_t] \tag{7}
\]

iii. The cubic spline wavelets and multi-wavelet bases method to provide a solution for the two-dimensional Black-Scholes equation (Čermá et al., 2016):
\[
\mathcal{E}_{ss}(V) = \frac{\nu^2}{2} U_{ss} + \rho \sigma v \nu U_{sv} + \frac{\nu^2}{2} U_{vv} \\
+ \rho \sigma v \nu U_{sv} + \left( K (\theta - v) - \lambda v \right) U_{v} - r U \\
\]

Where \( v \in H_0^1(\Omega), a(u, v) = \langle \mathcal{E}_{ss}(u), v \rangle \)
iv. A two-step backward-differentiation formula in the temporal discretization and a HODIE scheme (Rao, 2016):

\[ Lu(x,t) = \frac{\partial u}{\partial t} - a_t(x,t) \frac{\partial^2 u}{\partial x^2} - a_s(x,t) \frac{\partial u}{\partial x} \]

(9)

v. A TFBSM along with Fourier analysis (Zhang et al., 2016):

\[ \frac{\partial^3 C(S,t)}{\partial \sigma^3} + \frac{1}{2} \sigma^2 \frac{\partial^2 C(S,t)}{\partial S^2} + (r - D) \frac{\partial C(S,t)}{\partial S} - r C(S,t) = 0, \]

(10)

\[ (S_t, x_t, r_t) = (0, 0), \]

\[ C(B_r, t) = r(t), C(B_r, t) = q(t) \]

\[ C(S, T) = v(S) \]

It has been noted that the transaction costs, high volatility, illiquid markets and large investor’s preferences are some key issues in today’s financial derivatives markets, especially after the event of GFC. These inclusions require the solving of a nonlinear solution to the Black-Scholes models. It is recommended therefore that the Crank-Nicolson and the R3C scheme be focused on more because they can accommodate more and more real life assumptions of current-day trading (Ankudinova and Ehrhardt, 2008).

Conclusion

This paper critically analyse the recent advances made in the Black-Scholes model and solution methods. The authors examine the historical aspects, various applications, analytical and numerical solutions and efficiency and use of the same. The historical perspective and implication section of this study reveals that the Black-Scholes model is able to examine various types of valuations of derivatives in different markets. Many researchers have attempted to obtain the solution of the Black-Scholes model analytically or numerically, thereby adopting and using various direct and iterative methods, respectively. In the literature on the Black-Scholes model, exact solutions come in the form of speed-based solutions and techniques based on valuation issues, time-varying instruments and stochastic volatility. All of these proposed techniques provide analytical and/or quasi-exact solutions by incorporating different issues of financial derivatives. Therefore, these techniques have advanced their importance in the applicability as well as purpose. The numerical solutions include finite-difference methods, semi-discretization technique, Crank-Nicolson method, the R3C scheme, cubic spline wavelets and multi-wavelet bases method, the two-step backward differentiation formula in the temporal discretization and a High-Order Difference approximation with Identity Expansion (HODIE) scheme, fractional Black-Scholes model (TFBSM) using a Fourier analysis. The main findings show that transaction costs, high volatility, illiquid markets and large investor preferences are key issues of today’s financial derivatives markets-especially after the Global Financial Crisis (GFC). Complexity issues require non-linear solutions to the Black-Scholes model; therefore, the Crank-Nicolson method and the R3C ought to be focused on more by incorporating more real-life assumptions of current day trading. Moreover, the Finite difference methods are by far the simplest, except when mesh adaptively is required; in which case it is rather difficult to control the numerical error. It is noted that the FEM performs better with respect to the convergence than the explicit FDM particularly when small number of time points is used. The FEM converges to the solution when the explicit scheme of FDM diverges.

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Author’s Contributions

All the authors contributed equally to writing the manuscript and they had an equal say in reviewing and approving the final version.

Ethics

This article is original and contains unpublished material. The corresponding author confirms that all of the other authors have read and approved the manuscript and there are no ethical issues involved.

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**Abbreviations**

- **DTM** = Differential Transformation Method
- **FBi-CGSTAB** = Fast Bi-Conjugate Gradient Stabilized Method
- **FEM** = Finite Element Method
- **FMLS** = Finite Moment Log Stable
- **FOCFD** = Fourth-Order Compact Finite Difference
- **GFC** = Global Financial Crisis
- **HOC** = High-Order Compact
- **HODIE** = High-Order Difference approximation with Identity Expansion
- **PDTM** = Projected Differential Transformation Method
- **TFBSM** = Fractional Black-Scholes Model