Abstract. This paper considers an optimal life insurance purchase for a household subject to mortal-
ity risk. The household receives wage income continuously, which could be terminated by unexpected
premature loss of earning power. In order to hedge the risk of losing income stream, the household
enters a life insurance contract for the bereft members. The household may also invest their wealth
into a financial market. If insurance payment is made prior to the planned time horizon, the amount
shall be used for consumption and investment. Therefore, the problem is to determine an optimal insur-
ance/investment/consumption strategy in order to maximize the expected total discounted utility from
consumption and terminal wealth. To reflect a real-life situation better, we consider an incomplete market
where the household cannot trade insurance contracts continuously. We provide explicit solutions in a
fairly general setup.

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1. Introduction

We consider a household whose income stream relies on one particular member of the family. The
household has an incentive to buy a life insurance contract to mitigate mortality risk of the wage earner.
The investment time horizon of the household is $[0, T]$ where $T$ denotes the planned retirement time of
that person. That is, the household expects to receive wage income at rate $y(t)$ continuously until time
$T$, which could be terminated before time $T$ by some unexpected loss of earning power (e.g. death).
Accordingly, it is natural to assume that the household buys an insurance that terminates at time $T$. In
other words, the insurance coverage is effective until and upon time $T$. The mortality risk is modeled by
a first arrival of a certain Poisson process $N = \{N(t); t \geq 0\}$ with intensity process $\lambda = \{\lambda(t); t \geq 0\}$. We denote the random time of that event by $\tau$. The household buys $n$ shares of an insurance policy by
paying a lump-sum premium of $n \times p_0$ at time 0. We assume the premium per share, $p_0$ is determined
exogenously and $n$ is one of the decision variables. The insurance company pays insurance amount $X$
per share that depends on the time of Poisson arrival $\tau$. Therefore, if the household purchases $n$ shares,
the payment at $\tau \leq T$ is $n \times X(\tau)$.
Given the initial endowment at time 0, the household decides on the number of insurance contracts \( n \) and invests the rest of the money available into the financial market. In the case of \( \tau \leq T \), the household receives insurance money \( nX(\tau) \) and shall use the money for consumption and/or additional investment in the financial market. On the other hand, if \( \tau > T \), the insurance contract terminates and the insured person retires at \( T \). The household tries to maximize its utility for the entire time horizon \([0, T]\). See the next section for complete mathematical formulation. It should be emphasized here that the decision maker in our problem is the “household” (i.e. the whole family), not the insured person. Hence after time \( \tau \), consumption still continues.

Although the financial market (excluding insurance contracts) is assumed to be complete, the household’s inability to trade insurance contracts makes the whole model incomplete. We show, by using the convex duality method, that if a certain \( n \) solves the dual problem, that \( n \) also solves the original utility maximization problem. We then explicitly compute the corresponding consumption and wealth processes. Moreover, provided that insurance benefit is a linear function of \( n \), we find that for many popular utility functions, the household shall invest all the initial endowment either in the insurance contract or in the financial market, depending on the relationship between the insurance premium and the expected discount value of insurance benefit. This is natural because the financial market excluding insurance contracts is complete, if these two quantities are not equal, the household takes a full advantage of possible mispricing in the insurance contract. On the other hand, if these quantities are equal, the household does not have a clue as to how it should determine the optimal number of insurance contracts. In that case, we provide the optimal portfolio strategy for each \( n \). Hence this paper analyzes the household’s optimal behavior when the household faces the insurance contract and the financial market.

1.1. Literature review. We briefly discuss this paper’s position in the existing literature. While this paper considers insurance payment (at \( \tau \)) as a source of income to the bereft family members for the rest of the time horizon, previous treatments of insurance in the literature are in essence from insurers’ point of view. The main purpose is to calculate insurance premium of various contracts whose payment is exogenously given. For example, Albizzati and Geman [1] and Persson and Aase [21] examined option-like features contained in the insurance contracts. The fair premium of an equity-linked life insurance contract is calculated in Brennan and Schwartz [6] and Nielsen and Sandman [20], while Marceau and Gaillardetz [17] calculated the reserves in a stochastic mortality and interest rate model. See Bacinello [3]. See also Iwaki et al. [14] and Iwaki [13] for determining insurance premia in a multi-period economy and in a continuous-time economy, respectively.

In contrast, this paper discusses an optimal insurance purchase from the standpoint of households. The problem treated in this paper can be seen as an extension of the security allocation problem originally studied by Merton [18, 19]. In his model, only a riskless security and a risky security are considered and the problem is to obtain an optimal portfolio rule so as to maximize the expected utility from consumption. Since then, the model has been extended to various directions. Richard [22] included life insurance decisions in the Morton model. He assumed a specific diffusion for the risky asset and a complete market where the investor can trade life insurance contracts continuously. The investor in [22] maximizes the utility until uncertain time of death. Campbell [7] used a discrete-time model to derive the demand
function for life insurance. Babbel and Ohtsuka [2] extended to a multi-period model but did not include risky assets in the asset portfolio. Zhu [28], in one-period model, performed a comprehensive study of the insurance-investment-consumption problem and analyzed effects of parameters on individuals’ insurance purchase, consumption, and stock investment decisions by using two different individual groups: one with exponential utility and the other with power utility. Also, Bodie et al. [5] studied a life time model in which a “human capital” is considered, as in [22], to represent the present value of the total wage income to be obtained in the future. By including the human capital in their security allocation model, they succeeded in explaining the relationship between the age of an economic agent and his/her optimal investment strategy. See also He and Pagès [12], Svensson and Werner [24], and Karatzas and Shreve [15] as examples of such extensions.

Our current article contrasts with these papers in that we use a continuous-time framework with general utility functions and general underlying diffusions. Moreover, in order to make the model more realistic, we assume that the household cannot trade insurance contracts (unlike [22]) and incorporate the fact that the bereft family would use the money from the insurance contract to continue their consumption until the fixed time $T$. It should be noted that Cvitanic et al. [10] showed the existence of solutions for the investment-consumption problem with a random endowment in a general semimartingale model. Our current paper, though, has distinct merits in the sense that we obtain an explicit solution (which does not follow from the said paper) for a fairly general utility function and hence make economic implications much clearer. Moreover, while the random endowment in [10] is given exogenously, our random endowment (i.e., insurance money) here can be controlled by changing the number of shares of the insurance contract.

This paper is organized as follows. In the next section, we formulate our problem in a rigorous manner. We solve the problem in the following section and discuss possible extensions after we present our main results. We defer the detailed proofs to Appendix. Throughout this paper, all the random variables considered are bounded almost surely (a.s.) to avoid unnecessary technical difficulties. Equalities and inequalities for random variables hold in the sense of almost surely.

2. The Model

Let us consider a complete filtered probability space $(\Omega, \mathcal{F}, (\mathcal{F}_t)_{t \in \mathbb{R}_+}, \mathbb{P})$ that hosts a Brownian motion $B := \{B(t) : t \geq 0, B(0) = 0\}$ and a Poisson Process $N := \{N(t) : t > 0, N(0) = 0\}$. Let $\mathcal{F}^B_t := \sigma\{B(s); s \leq t\}, t \in [0, T]$. We denote the $\mathbb{P}$-augmentation of filtration by $\mathcal{F}^B := \{\mathcal{F}^B_t; t \in [0, T]\}$. The Brownian motion is the source of randomness other than the time $\tau$:

$$\tau := \inf\{t > 0; N(t) = 1\},$$

which denotes the time of the insured person’s loss of earning power (e.g., death). We assume that the intensity process $\lambda := \{\lambda(t); t \geq 0\}$ of the Poisson process $N$ is predictable with respect to $\mathcal{F}^B$. Let $\mathcal{F}^N_t := \sigma\{1_{\{\tau \leq s\}}; s \leq t\}$ where $1_E$ denotes the indicator function of event $E \in \mathcal{F}$ meaning that $1_E = 1$ if $E$ is true and $1_E = 0$ otherwise. The $\mathbb{P}$-augmentation of the filtration is denoted by $\mathcal{F}^N := \{\mathcal{F}^N_t; t \in [0, T]\}$. Clearly, $\tau$ is an $\mathcal{F}^N$-stopping time, but not an $\mathcal{F}^B$-stopping time. Now, let $\mathcal{F}_t := \mathcal{F}^B_t \vee \mathcal{F}^N_t, t \in [0, T]$ and its $\mathbb{P}$-augmentations $\mathbb{F} := \{\mathcal{F}_t; t \in [0, T]\}$. It is assumed that $\mathbb{F}$ satisfies the usual conditions regarding
right-continuity and completeness. The conditional expectation operator given $\mathcal{F}_t$ is denoted by $E_t$ with $E = E_0$.

Suppose that the current time is 0, and let $T > 0$ be the termination time of an insurance contract which is set to be the same as the retirement time. We consider a continuous-time economy in $[0, T]$ that consists of the insurance contract and a financial market. The financial market is assumed to be frictionless and perfectly competitive.\(^1\)

The household may receive cash flow from various sources of income. But for simplicity, we assume that it relies on one member’s income stream: $y = \{y(t); t \in [0, T]\}$ (called income process hereafter) which is given exogenously until time $T$. To hedge the risk of loss of income flow at time $\tau < T$, the household buys an insurance policy described as follows: Once the household buys $n$ shares of the policy by paying the insurance premium amounts $p_0 \times n$ at time 0, the insurance company makes an insurance payment in the amount of

\[(2.1) \quad n \times X(t) = n \times (1 + H(t))\]

at time $t = \tau \wedge T$. Here $H : [0, T] \mapsto \mathbb{R}_+$ is given exogenously, representing payment schedule until time $T$. In case $\tau > T$, the policy pays 1 dollar per share at time $T$. In order to avoid unnecessary complications, we assume that the schedule function satisfies the following assumption.

**Assumption 2.1.** $H : [0, T] \mapsto \mathbb{R}_+$ is a nonincreasing continuous function with $H(T) = 0$.

Here we note that $H(T) = 0$ means that the insurance amount when $\tau$ occurs at time $T$ and the guaranteed insurance amount (which is unity) on the set $\{\tau(\omega) > T\}$ coincide.

Let $c = \{c(t); t \in [0, T]\}$ be the consumption process to be determined by the household. It is assumed that income and consumption processes are adapted to $\mathcal{F}$. In the financial market, there is a riskless security whose time $t$ price is denoted by $S_0(t)$. The riskless security evolves according to the differential equation;

\[
\frac{dS_0(t)}{S_0(t)} = r(t)dt, \quad t \in [0, T],
\]

where $r(t)$ is a positive, predictable process with respect to $\mathcal{F}^B$. The household can also invest their wealth into a risky security whose time $t$ price is denoted by $S_1(t)$. The risky security evolves according to the stochastic differential equation (abbreviated SDE);

\[(2.2) \quad \frac{dS_1(t)}{S_1(t)} = \mu(t)dt + \sigma(t)dB(t), \quad t \in [0, T],\]

where $\mu(t)$ and $\sigma(t)$ are progressively measurable processes with respect to $\mathcal{F}^B$.

Let $\pi(t)$ be the amount to be invested into the risky security at time $t$. The process $\pi = \{\pi(t); t \in [0, T]\}$ is referred to as a portfolio process. Now, given a portfolio process $\pi$, a consumption process $c$, the number

\(^1\)A financial market is said to be frictionless if the market has no transaction costs, no taxes, and no restrictions on short sales (such as margin requirements), and asset shares are divisible, while it is called perfectly competitive if each agent believes that he/she can buy and sell as many assets as desired without changing the market price.
of shares of the insurance policy \( n \) and an income process \( y \), the wealth process \( W = \{ W(t); t \in [0, T] \} \) is defined by

\[
W(t) := \begin{cases} 
W_0 - np_0 + \int_0^t (r(s)W(s) + y(s) - c(s))ds \\
+ \int_0^t \pi(s)[(\mu(s) - r(s))ds + \sigma(s)dB(s)] & \text{if } t \in [0, \tau \land T), \\
W(\tau -) + nX(\tau) + \int_\tau^t (r(s)W(s) - c(s))ds \\
+ \int_\tau^t \pi(s)[(\mu(s) - r(s))ds + \sigma(s)dB(s)] & \text{if } t \in [\tau \land T, T],
\end{cases}
\]

(2.3)

where \( W_0 \) is a given initial wealth which is assumed to be a positive constant.

In this paper, we assume that, given the intensity process \( \lambda \), the conditional survival probability of \( \tau \) is given by

\[
\mathbb{P}\{\tau > t|\lambda\} = \exp\left\{-\int_0^t \lambda(u)du\right\}, \quad t \in [0, T].
\]

(2.4)

That is, the intensity process \( \lambda \) plays the role of the hazard rate,

\[
\lambda(t) = \lim_{\Delta \downarrow 0} \frac{1}{\Delta} \mathbb{P}\{t < \tau \leq t + \Delta|\tau > t, \mathcal{F}_t^B\}.
\]

A Poisson process \( N \) driven by that (stochastic) intensity process is called a Cox process, which is also known as a doubly stochastic Poisson process. See, for example, Grandell [11] for details. In this case, we have \( \mathbb{P}\{\tau > t|\mathcal{F}_t^B\} = \mathbb{P}\{\tau > t|\mathcal{F}_t^B\} \) for \( t \leq T \). Note that, in this setting, the infinitesimal increments \( dB(t) \) and \( dN(t) \) are conditionally independent given \( \mathcal{F}_t^B \). Also, the process \( M_\lambda = \{ M_\lambda(t), t \in [0, T] \} \) defined by

\[
M_\lambda(t) := \int_0^t 1_{\{N(s-) = 0\}}[dN(s) - \lambda(s)ds]
\]

(2.5)

is an \( \mathcal{F} \)-martingale (i.e. the integral \( \int_0^t 1_{\{N(s-) = 0\}}\lambda(s)ds \) is the \( \mathcal{F} \)-compensator (see Yashin and Arjas [26])).

**Definition 2.1.** A consumption and wealth pair \((c, W)\) is called feasible if \( c(t) \geq 0 \), \( W(t) > -\infty \) for \( t \in [0, T], W(T) \geq 0 \) and it satisfies (2.3). We denote a class of feasible pairs \((c, W)\) by \( \mathcal{C} \).

Recall that the household consumes the wage income and, if any, insurance money to maximize the expected discounted utility from consumption \( c \) and terminal wealth \( W(T) \). Let \( U_1 : (0, \infty) \rightarrow \mathbb{R} \) be the utility function of the household from consumption, and let \( U_2 : (0, \infty) \rightarrow \mathbb{R} \) be the utility function of the household from the terminal wealth.

**Assumption 2.2.** We assume that our utility functions satisfy the following:

1. \( U_i (i = 1, 2) \) are strictly increasing, strictly concave and twice continuously differentiable with properties

\[
U_i'(\infty) := \lim_{x \rightarrow \infty} U_i'(x) = 0, \quad U_i'(0+) := \lim_{x\downarrow 0} U_i'(x) = \infty, \quad i = 1, 2.
\]

(2) For any \( c \in (0, \infty) \) there exist real numbers \( a \in (0, \infty) \) and \( b \in (0, \infty) \) satisfying \( aU_i'(c) \geq U_i'(bc) \).
Also, in order to represent time-preference of the household, we introduce a time-discount factor \( e^{-\int_0^t \rho(s)ds} \), \( t \in [0,T] \), where the process \( \rho = \{ \rho(t), t \in [0,T] \} \) is adapted to \( \mathbb{F} \). A natural problem for the household is as follows: Given the initial wealth \( W_0 \), the household decides how many insurance contracts to buy at time zero to protect from the risk of the Poisson event. The rest of the money \( W_0 - np_0 \) can be invested in the financial market. If \( \tau \leq T \), the household receives the insurance money \( nX(\tau) \) as in (2.1) and re-solves the optimal investment-consumption problem (2.7) by using the sum of the wealth at \( \tau \), \( W(\tau -) \) and the insurance money \( nX(\tau) \) as the “initial” wealth at \( \tau \). On the other hand, if \( \tau > T \), the problem reduces to an ordinary investment-consumption problem from time zero to \( T \). By keeping these possibilities in mind, the household decides on the number of insurance contract \( n \) at time zero along with the optimal consumption-investment pair to maximize the overall utility. Mathematically, it is stated as follows:

(MP): Given the discount process \( \rho \) and utility functions \( U_i(x), i = 1,2 \), find an optimal triplets consisting of consumption process, portfolio process and the number of shares of the insurance policy \((\hat{c}, \hat{w}, \hat{n})\) to solve the following maximization problem:

\[
\text{max} \mathbb{E} \left[ \int_0^{\tau \wedge T} e^{-\int_0^t \rho(s)ds} U_1(c(t)) dt + e^{-\int_0^{\tau \wedge T} \rho(s)ds} V(W(\tau \wedge T)) \right]
\]

with

\[
V(W(\tau \wedge T)) := \max \mathbb{E} \left[ \int_{\tau \wedge T}^T e^{-\int_{\tau \wedge T}^s \rho(s)ds} U_1(c(t)) dt + e^{-\int_{\tau \wedge T}^T \rho(s)ds} U_2(W(T)) \bigg| \mathcal{F}_{\tau \wedge T} \right],
\]

where the maximum is taken over the feasible consumption and wealth pairs, \((c, W) \in \mathcal{C}\) under the budget constraint (2.3).

In the next section, we shall solve the problem (MP) by applying the martingale approach in an incomplete market (see Karatzas and Shreve [15] and Kramkov and Schachermayer [16]).

3. Main Results

In order to apply the martingale approach, we need to specify a state price density process first. Let \( \mathcal{P} \) be a class of positive and predictable stochastic processes:

\[
\mathcal{P} = \left\{ \psi(t); \int_0^{\tau \wedge T} \psi(t) dt < \infty, t \in [0, \tau \wedge T] \right\}.
\]

For each \( \psi = \{ \psi(t); t \in [0, \tau \wedge T] \} \in \mathcal{P} \), the state price density process is given by

\[
\chi(t) := \beta(t) \chi^B(t) \chi^N(t),
\]

where

\[
\beta(t) := \exp \left\{ -\int_0^t \tau(s) ds \right\},
\]

\[
\chi^N(t) := \left( \frac{\psi(\tau)}{\lambda(\tau)} 1_{\{\tau \leq t\}} + 1_{\{\tau > t\}} \right) e^{\int_0^{\tau \wedge s} (\lambda(s) - \psi(s)) ds},
\]

\[
\chi^B(t) := \left( \frac{\psi(\tau)}{\lambda(\tau)} 1_{\{\tau \leq t\}} + 1_{\{\tau > t\}} \right) e^{\int_0^{\tau \wedge s} \rho(s) ds}.
\]
and
\[ \chi^B(t) := \exp \left\{ - \int_0^t \xi(s) dB(s) - \frac{1}{2} \int_0^t \xi^2(s) ds \right\}, \]
with
\[ \xi(t) := \frac{\mu(t) - r(t)}{\sigma(t)}, \quad t \in [0, T]. \]

Note that (3.1) and (3.3) say that the state price density process \( \chi \) is determined once the intensity process \( \psi \) is specified. Here and hereafter, we denote the conditional expectation operator given \( \mathcal{F}_t \) under the equivalent martingale measure \( Q \) by \( \mathbb{E}_t^Q \) with \( \mathbb{E}^Q = \mathbb{E}_0^Q \).

**Remark 3.1.** The following facts are well known. See for example Bellamy and Jeanblanc [4] and Yashin and Arjas [26].

1. The state price density process \( \chi = \{ \chi(t); t \in [0, T] \} \) is such a process that \( \chi(0) = 1, 0 < \chi(t) < \infty \), and for each \( t \in [0, T] \) and for any \( s > t, s \in [0, T] \),
\[ \mathbb{E}_t[\chi(s)S_j(s)] = \chi(t)S_j(t), \quad j = 0, 1, \]
i.e. each process \( \{ \chi(t)S_j(t), t \in [0, T] \}, j = 0, 1 \), is a martingale under \( P \).

2. The equivalent martingale measure \( Q \) is given by
\[ \frac{dQ}{dP} = \frac{\chi(T)}{\beta(T)}, \]

3. The process \( \psi \) represents the intensity process under the equivalent martingale measure \( Q \).

We solve the problem \((\text{MP})\) in two steps. First, for a given \( n \in \mathbb{R}_+ \), we solve the problem by applying the martingale methods for optimal portfolio selection problems in incomplete market. Second, we derive the value of \( n \) which maximizes the value function that is derived in the first step.

In the following, in order to make the dependence on \( \psi \in \mathcal{P} \) explicit, we denote the state price density by \( \chi^\psi(t) = \beta(t)\chi^B(t)\chi^N(t), t \in [0, T] \), where
\[ \chi^N(t) = \left( \frac{\psi(\tau)}{\lambda(\tau)} 1_{\{\tau \leq t\}} + 1_{\{\tau > t\}} \right) e^{-\int_0^{\tau \wedge \tau}(\psi(s) - \lambda(s)) ds}, \]
See also (3.3). Similarly, \( Q_\psi \) denotes the equivalent martingale measure associated with the state price density \( \chi^\psi \), that is given by \( dQ_\psi/dP = \chi^\psi(T)/\beta(T) \).

For a given consumption and wealth pair, \((c, W)\), the next result provides a necessary condition regarding its feasibility in the market.

**Lemma 3.1.** If a consumption and wealth pair \((c, W)\) is in \( C \) (as in Definition 2.1), then it satisfies the following inequalities.
\[ \left\{ \begin{array}{l} \mathbb{E}_0^Q \left[ \int_0^{\tau \wedge T} \beta(t)(c(t) - y(t)) \, dt + \beta(\tau \wedge T)(W(\tau \wedge T) - nX(\tau \wedge T)) \right] \leq W_0 - np_0, \\
\mathbb{E}_{\tau \wedge T}^Q \left[ \int_{\tau \wedge T}^T \beta(t)c(t) \, dt + \beta(T)W(T) \right] \leq \beta(\tau \wedge T)W(\tau \wedge T) \end{array} \right. \]
for each \( \psi \in \mathcal{P} \).
Proposition 3.1. The household’s optimal consumption/wealth process is given next:

\begin{equation}
\beta(t)W(t) = \begin{cases} 
W_0 - np_0 + \int_0^t \beta(s)(y(s) - c(s))ds + \int_0^t \beta(s)\sigma(s)\sigma(s)dB & \text{if } t \in [0, \tau \wedge T], \\
\beta(\tau)(W(\tau-) + nX(\tau)) - \int_0^\tau \beta(s)c(s)ds + \int_0^\tau \beta(s)\sigma(s)\sigma(s)d\tilde{B} & \text{if } t \in [\tau \wedge T, T],
\end{cases}
\end{equation}

where \(\tilde{B}(t) := B(t) + \int_0^t \xi(s)ds\) is a standard Brownian motion under \(Q_\psi\) for all \(\psi \in \mathcal{P}\). Now, on the set \(\{\tau < T\}\), in the first equation, set \(t = \tau-\) and note that \(W(\tau) = W(\tau-) + nX(\tau)\) and in the second equation, set \(t = T\). Then we obtain (3.8) after taking the expectation for this set \(\{\tau < T\}\). Similarly, on the set \(\{\tau \geq T\}\), in the first equation, we set \(t = T-\) and note that \(W(T) = W(T-) + nX(T)\) (recall Assumption 2.1). In the second equation, we set \(t = T\) (recall Assumption 2.1 again). On this set we also obtain (3.8) after taking the conditional expectation.

For each utility function \(U_i(x)\), \(i = 1, 2\) and each \((s, t)\) such that \(s \in [0, T]\) and \(t \in [s, T]\), we denote by \(I_s^{(i)}(x, t)\) the inverse function of \(\frac{d}{dx} \left[U_i(x)e^{-\int_0^s \rho(u)du}\right]\) with respect to \(x\). Similarly, for the function \(V(x)\) defined in (2.7), we denote by \(J(x)\) the inverse function of \(\frac{d}{dx} \left[V(x)e^{-\int_0^s \rho(u)du}\right]\) with respect to \(x\).

Under Assumption 2.2, for each \((s, t)\), the functions \(I_s^{(i)}(x, t)\) \((i = 1, 2)\) and \(J(x)\) exist, are continuous and strictly decreasing, and map \((0, \infty)\) onto itself. For each \(s, t,\) and \(i\), we define the Legendre transformation \(\tilde{u}_s(z, t)\) and \(\tilde{V}(z)\) by

\begin{align}
\tilde{u}_s^{(i)}(z, t) &= \sup_{c \geq 0} \left[e^{-\int_0^s \rho(u)du}U_i(c) - cz\right], \quad t \in [0, T], i = 1, 2, \\
\tilde{V}(z) &= \sup_{w \geq 0} \left[e^{-\int_0^{\tau \wedge T} \rho(s)ds}V(w) - zw\right].
\end{align}

Then we can be readily shown that \(I_s^{(i)}(0+, t) = \infty, I_s^{(i)}(\infty, t) = 0, J(0+, t) = \infty, J(\infty, t) = 0,\) and

\begin{align}
\tilde{u}_s^{(i)}(z, t) &= e^{-\int_0^s \rho(u)du}U_i(I_s^{(i)}(z, t)) - zI_s^{(i)}(z, t), \quad t \in [0, T], \quad i = 1, 2, \\
\tilde{V}(z) &= e^{-\int_0^{\tau \wedge T} \rho(s)ds}V(J(z)) - zJ(z).
\end{align}

Now, in order to solve the problem (MP), we consider the following dual optimization problem:

\begin{equation}
\text{(DP)} \quad \max_{n \in \mathbb{R}^+} \min_{(\zeta^{(n)}, \psi^{(n)}) \in \mathbb{R}^{++} \times \mathcal{P}} V_0 \left(\zeta^{(n)}, \psi^{(n)}\right),
\end{equation}

where

\begin{equation}
V_0(\zeta, \psi) = E\left[\int_0^{\tau \wedge T} \tilde{u}_0^{(1)}(\zeta \psi(t), t)dt + \tilde{V}(\zeta \psi(\tau \wedge T))
\right.
\begin{align}
&+ \zeta \left(W(0) - np_0 + \int_0^{\tau \wedge T} \chi(t)y(t)dt + \chi(\tau \wedge T)nx(\tau \wedge T)\right)\right].
\end{align}

The household’s optimal consumption/wealth process is given next:

Proposition 3.1. For a given \(w > 0\), let \(Z(w)\) be a solution of the equation:

\begin{equation}
w = E_{\tau \wedge T} \left[\int_0^{\tau \wedge T} \chi(\tau \wedge T, t)I_{\tau \wedge T}^{(1)}(Z(w)\chi(\tau \wedge T, t))dt + \chi(\tau \wedge T, T)I_{\tau \wedge T}^{(2)}(Z(w)\chi(\tau \wedge T, T))\right]
\end{equation}
where, by recalling (3.1),
\[ \chi(\tau \wedge T, t) = \frac{\beta(t)\chi(t)\beta(t)}{\beta(\tau \wedge T)\chi(\tau \wedge T)}, \quad t \in [\tau \wedge T]. \]

Suppose that Assumptions 2.1 and 2.2 hold. Let \( n^* \) be a solution to (DP) satisfying
\[
\mathbb{E}_{T \wedge T} \left[ \int_{T \wedge T}^{T} \chi(\tau \wedge T, t)I_{T \wedge T}^{(1)}(J(\zeta \chi_{\psi^*}(\tau \wedge T)))\chi(\tau \wedge T, t)dt \right. \\
+ \chi(\tau \wedge T, T)I_{T \wedge T}^{(2)}(J(\zeta \chi_{\psi^*}(\tau \wedge T)))\chi(\tau \wedge T, T) \right] < \infty
\]
and
\[
\mathbb{E}_{Q^\psi^*} \left[ \int_{0}^{T \wedge T} \beta(t)I_{0}^{(1)}(\zeta \chi_{\psi^*}(t))dt + \beta(\tau \wedge T)J(\zeta \chi_{\psi^*}(\tau \wedge T)) \right] < \infty,
\]
where \((\zeta, \psi^*):=\arg\min V_0(\zeta^{(n^*)}, \psi^{(n^*)})\). Then, \( n^* \) agrees with an optimal share \( \hat{n} \) of the insurance policy in (MP) and an optimal consumption process \( \hat{c} \) and the corresponding wealth process \( \hat{W} \) are given, respectively, by
\[
\hat{c}(t) = \begin{cases} 
I_{0}^{(1)}(\zeta \chi_{\psi^*}(t)), & t \in [0, \tau \wedge T), \\
I_{T \wedge T}^{(2)}(J(\zeta \chi_{\psi^*}(t)))\chi(\tau \wedge T, t), & t \in [\tau \wedge T, T],
\end{cases}
\]
and
\[
\hat{W}(t) = \begin{cases} 
\frac{1}{\pi(\psi^*)}\mathbb{E}_{t}^{Q^\psi^*} \left[ \int_{T}^{T \wedge T} \beta(s)(\hat{c}(s) - y(s))ds + \beta(\tau \wedge T)(\hat{W}(\tau \wedge T) - n^*X(\tau \wedge T)) \right] & \text{if } t \in [0, \tau \wedge T), \\
\frac{1}{\pi(\psi^*)}\mathbb{E}_{t}^{Q^\psi^*} \left[ \int_{T}^{T \wedge T} \beta(s)\hat{c}(s)ds + \beta(T)\hat{W}(T) \right] & \text{if } t \in [\tau \wedge T, T],
\end{cases}
\]
with \( \hat{W}(\tau \wedge T) = J(\zeta \chi_{\psi^*}(\tau \wedge T)) \). Furthermore, \( \zeta^* \) satisfies
\[
\mathbb{E}_{Q^\psi^*} \left[ \int_{0}^{T \wedge T} \beta(t)I_{0}^{(1)}(\zeta \chi_{\psi^*}(t))dt + \beta(\tau \wedge T)\hat{W}(\tau \wedge T) \right] = W_0 - n^*p_0 + \mathbb{E}_{Q^\psi^*} \left[ \int_{0}^{T \wedge T} \beta(t)y(t)dt + n^*\beta(\tau \wedge T)X(\tau \wedge T) \right].
\]

**Proposition 3.2.** In addition to Assumptions 2.1 and 2.2, suppose that the functions \( I_{0}^{(1)}(\cdot, t), t \in [0, T] \), and \( J(\cdot) \) are convex. Then, the optimal solution \((\zeta^*, \psi^*)\) of the problem (DP) is given by \((\zeta^*, \lambda)\). Especially, \( \psi^* \) is uniquely given by \( \lambda \).

All the proofs are given in Appendix. In summary, we have obtained the following: If we assume that \( I_{0}^{(1)} \) and \( J \) are convex and that \( n^* \) solves the dual problem (DP) along with \((\zeta^*, \psi^*)\), then \( \zeta^* \) is represented by (3.18) and \( \psi^* \) matches the original intensity process \( \lambda \). Moreover, \( n^* \) is also the solution to the primal problem (MP), together with corresponding pair \((\hat{c}, \hat{W})\) that is given by (3.16) and (3.17), respectively. Note the additional convexity assumption on \( I_{0}^{(1)}(\cdot, t), t \in [0, T] \), and \( J(\cdot) \) is satisfied by popular utility functions including exponential, logarithmic, power, etc.

Now in the next proposition, we will show how the optimal \( \hat{n}(= n^*) \) looks like.
**Proposition 3.3.** Suppose that the assumptions of Proposition 3.2 hold. The optimal share \( \hat{n} \) is given as follows. If \( \mathbb{E}[\chi_\lambda(\tau \wedge T)X(\tau \wedge T)] > p_0 \) then \( \hat{n} = W_0/p_0 \). Otherwise, if \( \mathbb{E}[\chi_\lambda(\tau \wedge T)X(\tau \wedge T)] < p_0 \), then \( \hat{n} = 0 \), otherwise \( \hat{n} \) is indefinite.

This proposition states that if the money received from the insurance contract at time \( \tau \) is linear in \( n \), the household either spends all of the initial endowment in the insurance contract or buys no insurance, depending on \( \mathbb{E}[\chi_\lambda(\tau \wedge T)X(\tau \wedge T)] \gtrless p_0 \). That is, depending on whether the discounted expected benefit from the insurance contract is greater or less than the insurance premium. This makes sense since, for a utility function that satisfies the convexity assumption of \( I_0^{(1)}(\cdot, t), t \in [0, T] \), and \( J(\cdot) \), the household tries to take a full advantage of possible mispricing in the insurance contract. As pointed above, the convexity assumption is satisfied by popular utility functions, this result is quite general, provided that the household includes the insurance contract in their consumption-investment problem and attempts to maximize their utility on that basis. On the other hand, if the insurance premium is priced in such a way \( \mathbb{E}[\chi_\lambda(\tau \wedge T)X(\tau \wedge T)] = p_0 \) (for example, based on the law of large numbers (LLN)), the household does not have a clue as to how it should determine an optimal \( \hat{n} \). In this case, the following result can be of their help:

**Proposition 3.4.** Suppose that the assumptions of Proposition 3.2 hold. Provided that all parameters \( r, \mu, \sigma \) and \( \lambda \) are deterministic function of time \( t \in [0, T] \), then the optimal portfolio process \( \hat{\pi} = \{\hat{\pi}(t); t \in [0, T]\} \) is explicitly given by the following equations.

\[
\hat{\pi}(t) = -\zeta^*\chi(t)\mathbb{E}_t \left[ \int_t^{\tau \wedge T} \chi(t, u)^2 I_0^{(1)}(\zeta^*\chi(u))du + \chi(t, \tau \wedge T)^2 J'(\zeta^*\chi(\tau \wedge T)) \right] \frac{\xi(t)}{\sigma(t)}. \tag{3.19}
\]

Note that dependence on \( n \) is implicit through (3.18). The household can decide on the number of insurance contract, for example, by the absolute amount they would think necessary after the unexpected loss of the insured person. Given that \( n \), they hold on to the optimal consumption (3.16) and portfolio process (3.19) to maximize their utility.

Our framework can be discussed in other settings. First, the insurance benefit was computed as a linear function of \( n \) but we could assume a more general (non-linear) formula than in (2.1). In this case, the optimal number of insurance contract can be an interior point between \((0, W_0/p_0)\). Secondly, our insurance premium \( p_0 \) here is given exogenously and Proposition 3.3 discusses the relationship between \( p_0 \) and the expected payment at \( \tau \) whose form is basically LLN-based pricing. In this context, there exists an exceedingly increasing literature about pricing under distorted probabilities or Choquet pricing (see, for example, Wang et al. [25] and Young and Zariphopoulou [27]). In conjunction with these new pricing schemes our problem can be extended to an equilibrium analysis between the household and the insurer.
Appendix A. Proof of Theorem 3.1.

The proof here adapts the arguments in Cvitanić and Karatzas [9] and Cuoco [8]. Assume that \((\zeta^*, \psi^*)\) solves (DP) along with \(n^*\), and that

\[
J(\zeta^* \psi^* (\tau \wedge T)) = \mathbb{E}_{\tau \wedge T} \left[ \int_{\tau \wedge T}^{T} \chi(\tau \wedge T, t) I_{\tau \wedge T}^{(1)}(Z(J(\zeta^* \psi^* (\tau \wedge T)))) \chi(\tau \wedge T, t) dt \right.
\]

\[
+ \chi(\tau \wedge T, T) I_{\tau \wedge T}^{(2)}(Z(J(\zeta^* \psi^* (\tau \wedge T)))) \chi(\tau \wedge T, T), T) < \infty,
\]

(A.1) \[ \mathbb{E} \left[ \int_{0}^{\tau \wedge T} \chi \psi^* (t) I_{0}^{(1)}(\zeta^* \psi^* (t), t) dt + \chi^* (\tau \wedge T) J(\zeta^* \psi^* (\tau \wedge T)) \right] < \infty \]

holds. In order to prove that \((\hat{c}, \hat{W}(T))\) in (3.16) and (3.17) is optimal, we will proceed in two steps; first we will show that

(A.2) \[ \mathbb{E} \left[ \int_{0}^{\tau \wedge T} e^{-f_0^t \rho(s) ds} U_1(\hat{c}(t)) dt + e^{-f_0^{\tau \wedge T} \rho(t) dt} V(\hat{W}(\tau \wedge T)) \right] \geq \mathbb{E} \left[ \int_{0}^{\tau \wedge T} e^{-f_0^t \rho(s) ds} U_1(c(t)) dt + e^{-f_0^{\tau \wedge T} \rho(t) dt} V(W(\tau \wedge T)) \right] \]

and

(A.3) \[ V(\hat{W}(\tau \wedge T)) = \mathbb{E}_{\tau \wedge T} \left[ \int_{\tau \wedge T}^{T} e^{-f_0^t \rho(s) ds} U_1(\hat{c}(t)) dt + e^{-f_0^{\tau \wedge T} \rho(t) dt} U_2(\hat{W}(T)) \right] \]

\[ \geq \mathbb{E}_{\tau \wedge T} \left[ \int_{\tau \wedge T}^{T} e^{-f_0^t \rho(s) ds} U_1(c(t)) dt + e^{-f_0^{\tau \wedge T} \rho(t) dt} U_2(W(T)) \right] \]

hold for all \((c, W(T)) \in C\), and then that \((\hat{c}, \hat{W}(T)) \in C\).

Step 1 (optimality). By Assumption 2.1-(b), there exists \(a, b \in (0, \infty)\) such that for each \(i = 1, 2\),

\[
a U_i'(I_s^{(i)}(z, t)) \geq b U_i'(b I_s^{(i)}(z, t)) \quad t \in [s, T], \quad s \in [0, T].
\]

Applying \(I_s^{(i)}(\cdot, t)\) to both sides and iterating, show that for all \(a \in (0, \infty)\) there exists a \(b \in (0, \infty)\) such that

\[ I_s^{(i)}(az, t) \leq b I_s^{(i)}(z, t), \quad (z, t) \in (0, \infty) \times [s, T], \quad s \in [0, T]. \]

Hence (A.1) implies

(A.4) \[ \mathbb{E} \left[ \int_{0}^{\tau \wedge T} \chi \psi^* (t) I_{0}^{(1)}(\zeta_1 \chi \psi^* (t), t) dt + \chi^* (\tau \wedge T) J(\zeta_2 \chi \psi^* (\tau \wedge T)) \right] < \infty \]

for all \(\zeta_i \in (0, \infty), i = 1, 2\).
By the optimality of $\zeta^*$, we have

\[(A.5) \quad 0 = \lim_{\epsilon \to 0} \frac{V_0(\zeta^* + \epsilon, \psi^*) - V_0(\zeta^*, \psi^*)}{\epsilon} \]

\[= \mathbb{E} \left[ \int_0^{\tau \wedge T} \lim_{\epsilon \to 0} \frac{\tilde{u}_1((\zeta^* + \epsilon)\chi_{\psi^*}(t), t) - \tilde{u}_1(\zeta^*\chi_{\psi^*}(t), t)}{\epsilon} \, dt \right. \]

\[+ \lim_{\epsilon \to 0} \frac{\tilde{V}((\zeta^* + \epsilon)\chi_{\psi^*}(\tau \wedge T), \tau \wedge T) - \tilde{V}(\zeta^*\chi_{\psi^*}(\tau \wedge T), \tau \wedge T)}{\epsilon} \]

\[+ W_0 - np_0 + \int_0^{\tau \wedge T} \chi_{\psi^*}(t) \gamma(t) \, dt + n\chi(\tau \wedge T)X(\tau \wedge T) \bigg] \]

\[= W_0 - np_0 - \mathbb{E} \left[ \int_0^{\tau \wedge T} \chi_{\psi^*}(t) (\hat{c}(t) - \gamma(t)) \, dt + \chi_{\psi^*}(\tau \wedge T)(\hat{W}(\tau \wedge T) - nX(\tau \wedge T)) \right], \]

where the second equality follows the dominated convergence theorem, using (A.4) and the fact that

\[\left| \frac{\tilde{u}_0^{(1)}((\zeta^* + \epsilon)\chi_{\psi^*}(t), t) - \tilde{u}_0^{(1)}(\zeta^*\chi_{\psi^*}(t), t)}{\epsilon} \right| \leq \frac{\tilde{u}_0^{(1)}((\zeta^* - |\epsilon|)\chi_{\psi^*}(t), t) - \tilde{u}_0^{(1)}(\zeta^*\chi_{\psi^*}(t), t)}{|\epsilon|} \]

\[\leq \chi_{\psi^*}(t)I_0^{(1)}((\zeta^* - |\epsilon|)\chi_{\psi^*}(t), t) \]

\[\leq \chi_{\psi^*}(t)I_0^{(1)} \left( \frac{\zeta^*}{2} \chi_{\psi^*}(t), t \right), \]

and that

\[\left| \frac{\tilde{V}((\zeta^* + \epsilon)\chi_{\psi^*}(t), \tau \wedge T) - \tilde{V}(\zeta^*\chi_{\psi^*}(\tau \wedge T), \tau \wedge T)}{\epsilon} \right| \leq \frac{\tilde{V}((\zeta^* - |\epsilon|)\chi_{\psi^*}(\tau \wedge T), \tau \wedge T) - \tilde{u}_1(\zeta^*\chi_{\psi^*}(\tau \wedge T), \tau \wedge T)}{|\epsilon|} \]

\[\leq \chi_{\psi^*}(t)J((\zeta^* - |\epsilon|)\chi_{\psi^*}(\tau \wedge T), \tau \wedge T) \]

\[\leq \chi_{\psi^*}(t)J \left( \frac{\zeta^*}{2} \chi_{\psi^*}(\tau \wedge T), \tau \wedge T \right), \quad \forall \epsilon \leq \frac{\zeta^*}{2}, \]

(because both $\tilde{u}_0^{(1)}(\cdot, t)$ and $\tilde{V}(\cdot, \tau \wedge T)$ are decreasing and convex,

\[\frac{\partial}{\partial z} \tilde{u}_0^{(1)}(z, t) = -I_0^{(i)}(z, t), \quad \frac{\partial}{\partial z} \tilde{V}(z, \tau \wedge T) = -J(z, \tau \wedge T), \]

and both $I_0^{(i)}(\cdot, t)$ and $J(\cdot, \tau \wedge T)$ are decreasing). Since by concavity

\[e^{-\int_0^{\tau \wedge T} \rho(s) \, ds} U_1(t_0^{(1)}(z, t)) - e^{-\int_0^{\tau \wedge T} \rho(s) \, ds} U_1(c) \geq z[I_0^{(1)}(z, t) - c] \]

\[e^{-\int_0^{\tau \wedge T} \rho(s) \, ds} V(J(z)) - e^{-\int_0^{\tau \wedge T} \rho(s) \, ds} V(c) \geq z[J(z) - c] \quad \forall c > 0, \ z > 0, \]
it then, by evaluating the previous inequality at \( z = \zeta^* \chi_{\psi^*}(t) \) and using the definition of \( \hat{c} \) and \( \hat{W}(\tau \wedge T) \) in (3.16) and (3.17), follows from (3.8) and (A.5)

\[
\begin{align*}
&\mathbb{E} \left[ \int_{0}^{\tau \wedge T} e^{-\int_{0}^{s} \rho(s)ds} U_1(\hat{c}(t))dt + e^{-\int_{0}^{\tau \wedge T} \rho(t)dt} V(\hat{W}(\tau \wedge T)) \right] \\
&\quad - \mathbb{E} \left[ \int_{0}^{\tau \wedge T} e^{-\int_{0}^{s} \rho(s)ds} U_1(c(t))dt + e^{-\int_{0}^{\tau \wedge T} \rho(t)dt} V(W(\tau \wedge T)) \right] \\
&\geq \zeta^* \mathbb{E} \left[ \int_{0}^{\tau \wedge T} \chi_{\psi^*}(t)(\hat{c}(t) - c(t))dt + \chi_{\psi^*}(\tau \wedge T)(\hat{W}(\tau \wedge T) - W(\tau \wedge T)) \right] \geq 0.
\end{align*}
\]

Furthermore, we can easily confirm that (A.3) holds since (3.12), (3.15) and that \( \hat{W}(\tau \wedge T) = J(\zeta^* \chi_{\psi^*}(\tau \wedge T)) \). Hence, \((\hat{c}, \hat{W}(\tau \wedge T))\) must be optimal provided it is in \( \mathcal{C} \).

**Step 2 (feasibility).** We are only left to show that there exists an admissible portfolio process \( \hat{\pi} \) financing \((\hat{c}, \hat{W}(T))\). For any \( n \in \mathbb{R}_+ \), define a process \( \tilde{W} = \{\tilde{W}(t); \ t \in [0, \tau \wedge T]\} \) by

\[
\tilde{W}(t) := \begin{cases} 
\tilde{W}(t-) + nX(t) & \text{if } t = \tau \wedge T, \\
\tilde{W}(t-) & \text{if } t \in (0, \tau \wedge T),
\end{cases}
\]

where

\[
\tilde{W}(t-) := \chi_{\psi^*}(t-)^{-1} \mathbb{E}^Q_{t-} \left[ \int_{t}^{\tau \wedge T} \chi_{\psi^*}(s)(\hat{c}(s) - y(s))ds + \chi_{\psi^*}(\tau \wedge T)(\hat{W}(\tau \wedge T) - nX(\tau \wedge T)) \right].
\]

Clearly, \( \tilde{W}(\tau \wedge T) = \hat{W}(\tau \wedge T) \), and \( \tilde{W} \) is bounded below (because of boundedness of \( y \) and \( X \) by the ground assumption). Also, it follows from the martingale representation theorem that there exists a process \( \{(\theta_1(t), \theta_2(t)); \ t \in [0, \tau \wedge T]\} \) with \( \int_{0}^{\tau \wedge T} |\theta_1(t)^2 + \theta_2(t)| \ dt < \infty \) such that,

\[
\begin{align*}
\beta(t)\tilde{W}(t-) + \int_{0}^{t} \beta(s)(\hat{c}(s) - y(s))ds \\
&= \tilde{W}(0) + \int_{0}^{t} \theta_1(s)d\hat{B}(s) + \int_{0}^{t} \theta_2(s)(dN(s) - \psi^*(s)ds), \quad t \in (0, \tau \wedge T].
\end{align*}
\]

From (A.6) and the definition of \( \tilde{W} \), if \( t \in (0, \tau \wedge T) \),

\[
\begin{align*}
d(\beta(t)\tilde{W}(t)) = -\beta(t)(\hat{c}(t) - y(t))dt + \theta_1(t)d\hat{B}(t) + \theta_2(t)(dN(t) - \psi^*(t)dt).
\end{align*}
\]

Define a portfolio process \( \pi = \{\pi(t); \ t \in [0, \tau \wedge T]\} \) by

\[
\pi(t) = \frac{\theta_1(t)}{\beta(t)\sigma(t)}.
\]
Introduce the ratio
\[
W(t) = \frac{\hat{W}(t)}{W(0)} + \int_0^t \left( r(s)\hat{W}(s) + y(s) - \hat{c}(s) \right) ds
\]
\[
+ \int_0^t \beta(s)^{-1} \theta_1(s) dB(s) + \int_0^t \beta(s)^{-1} \theta_2(s)(dN(s) - \psi^*(s)ds) + nX(t)1_{\{t = \tau \wedge T\}}
\]
\[
= \hat{W}(0) + \int_0^t \left( r(s)\hat{W}(s) + y(s) - \hat{c}(s) \right) ds
\]
\[
+ \int_0^t \beta(s)^{-1} \theta_2(s)(dN(s) - \psi^*(s)ds)
\]
A comparison with (2.3) then reveals that only if we verify that \( \theta_2(t) = 0 \) for all \( t \in [0, \tau \wedge T] \) with \( \hat{W}(t) = \hat{W}(t) \), the proof will be completed.

For this purpose, fix an arbitrary \( \psi = \{\psi(t); t \in [0, \tau \wedge T]\} \in P \) and define stochastic processes \( \kappa \) and \( \bar{\kappa} \) by, respectively,
\[
(\text{A.9}) \quad \kappa(t) := \int_0^t \frac{\psi^*(s) - \psi(s)}{\psi^*(s)}(dN(s) - \psi^*(s)ds),
\]
and
\[
\bar{\kappa}(t) := \int_0^t (\psi^*(s) - \psi(s)) ds, \quad t \in [0, \tau \wedge T],
\]
as well as the sequence of stopping times
\[
\tau_m := \inf \left\{ t \in [0, \tau \wedge T]: |\kappa(t)| + |\bar{\kappa}(t)| + \left| \frac{\psi^*(t) - \psi(t)}{\psi^*(t)} \right| \geq m \right\}, \quad m = 1, 2, \ldots.
\]
Then \( \tau_m \uparrow \tau \wedge T \). Also, letting
\[
\psi_{\epsilon,m}(t) := \psi^*(t) + \epsilon (\psi(t) - \psi^*(t))1_{\{t \leq \tau_m\}}
\]
for \( \epsilon \in (0, \frac{1}{m}) \) with some \( l > 1 \). Clearly \( \int_0^{\tau \wedge T} \psi_{\epsilon,m}(t) dt < \infty \) a.s. Hence \( \psi_{\epsilon,m} = \{\psi_{\epsilon,m}(t); t \in [0, \tau \wedge T]\} \) belongs to \( P \). Therefore, as in (3.7), we can define \( \chi_{\psi_{\epsilon,m}} \) and consider
\[
0 \leq \frac{1}{\epsilon \zeta^*} [V_0(\zeta^*, \psi_{\epsilon,m}) - V_0(\zeta^*, \psi^*)] = \mathbb{E}[Y_m^*],
\]
where
\[
\epsilon \zeta^* \cdot Y_m^* := \int_0^{\tau \wedge T} [\tilde{u}^{(1)}_0(\zeta^* \chi_{c,m}(t), t) - \tilde{u}^{(1)}_0(\zeta^* \psi^*(t), t)] dt + \tilde{V}(\zeta^* \chi_{c,m}(\tau \wedge T)) - \tilde{V}(\zeta^* \psi^*(\tau \wedge T))
\]
\[
+ \zeta^* \int_0^{\tau \wedge T} [\chi_{c,m}(t) - \chi_{\psi^*}(t)] y(t) dt + \epsilon [\chi_{c,m}(\tau \wedge T) - \chi_{\psi^*}(\tau \wedge T)] nX(\tau \wedge T).
\]
Introduce the ratio
\[
K^* (t) := \frac{\chi_{c,m}(t)}{\chi_{\psi^*}} = \exp \left\{ \int_0^t \ln \left( \frac{\psi_{\epsilon,m}(s)}{\psi^*} \right) dN(s) - \int_0^t (\psi_{\epsilon,m}(s) - \psi^*(s)) ds \right\}
\]
\[
e^{\epsilon \bar{\kappa}(t \wedge \tau_m)} (1 - \epsilon (\kappa(t \wedge \tau_m) + \bar{\kappa}(t \wedge \tau_m))), \quad t \in [0, \tau \wedge T].
\]
We have then
\[
0 < e^{-\frac{1}{l}} \left( 1 - 1 \ell \right) \leq e^{-\epsilon m}(1 - \epsilon m) \leq R'(t) \leq e^{\epsilon m}(1 + \epsilon m) \leq e^{\frac{1}{l}} \left( 1 + 1 \ell \right),
\]
as well as the upper bounds for the random variable \(Y_m^\epsilon\):
\[
Y_m^\epsilon \leq Q_m := \int_0^{\tau_m} \chi_{\psi^*}(t) \frac{1 - R'(t)}{\epsilon} I_0^{(1)}(\zeta^* e^{-\epsilon s}(1 - \epsilon n(t))\chi_{\psi^*}(t), t) dt \\
+ \int_0^{\tau_m} \chi_{\psi^*}(\tau \wedge T) \frac{1 - R'(\tau \wedge T)}{\epsilon} \int (\zeta^* e^{-\epsilon n(s)}(1 - \epsilon n(s))\chi_{\psi^*}(\tau \wedge T) \\
- \int_0^{\tau_m} \chi_{\psi^*}(t) \frac{1 - R'(t)}{\epsilon} y(t) dt - \chi_{\psi^*}(\tau \wedge T) \frac{1 - R'(\tau \wedge T)}{\epsilon} nX(\tau \wedge T),
\]
where \(\text{sgn}(t) = 1\) if \(1 - R'(t) \geq 0\) and \(-1\) if \(1 - R'(t) < 0\). We have used the mean-value theorem applying to \(I_0^{(1)}(y, t) = -\frac{\partial}{\partial y} I_0^{(1)}(y, t), J(y) = -\frac{\partial}{\partial y} J(y)\) with end points \(\chi_{\epsilon, n}(t)\) and \(\chi_{\psi^*}(t)\) and the fact both \(I_0^{(1)}(y, t)\) and \(J(y)\) are decreasing in \(y\) for all \(t \in [0, \tau \wedge T]\). Since the random variable \(Y_m\) is integrable, then by Fatou’s lemma, we obtain
\[
0 \leq \lim_{\epsilon \downarrow 0} \text{E}[Y_m^\epsilon] \leq \text{E}[\lim_{\epsilon \downarrow 0} Y_m^\epsilon] \leq \text{E}[\lim_{\epsilon \downarrow 0} Q_m^\epsilon]
\]
We used the definition of \(\hat{W}(t)\) (3.17) in the third equality. On the other hand, using (A.6)-(A.9) with \(\hat{W} = \hat{W}\) and Itô’s lemma shows that
\[
\beta(\tau \wedge \tau_m)\kappa(\tau \wedge \tau_m)\hat{W}(\tau \wedge \tau_m) + \int_0^{\tau \wedge \tau_m} \beta(s)\kappa(s)(\hat{c}(s) - y(s))ds
\]
\[
= \int_0^{\tau \wedge \tau_m} \beta(s)\hat{W}(s) \frac{\psi^*(s) - \psi^*(s)}{\psi^*(s)} [dN(s) - \psi^*(s)ds] + \int_0^{\tau \wedge \tau_m} \beta(s)\kappa(s)\theta_2(s)[dN(s) - \psi^*(s)ds]
\]
\[
+ \int_0^{\tau \wedge \tau_m} \beta(s)\kappa(s)\pi(s)\sigma(s)d\tilde{B}(s) + \int_0^{\tau \wedge \tau_m} \beta(s)\theta_2(s)\frac{\psi^*(s) - \psi^*(s)}{\psi^*(s)}dN(s).
\]
Therefore we have

\[
\mathbb{E} \left[ \int_0^{\tau \wedge \tau_m} \chi_{\psi^*}(s)\kappa(s)(\hat{c}(s) - y(s))ds + \chi_{\psi^*}(\tau \wedge \tau_m)\tilde{W}(\tau \wedge \tau_m) \right] = \mathbb{E} \left[ \int_0^{\tau \wedge \tau_m} \chi_{\psi^*}(s)\theta_2(s)(\psi^*(s) - \psi(s))ds \right].
\]

Substituting (A.10) into (A.10) gives

\[
0 \leq \lim_{\epsilon \to 0} \frac{V_0(\zeta^*, \psi_{\epsilon, m}) - V_0(\zeta^*, \psi^*)}{\zeta^* \epsilon} \leq \mathbb{E} \left[ \int_0^{\tau \wedge \tau_m} \chi_{\psi^*}(s)\theta_2(s)(\psi^*(s) - \psi(s))ds \right].
\]

Taking \( \psi = \psi^* + \eta \) with \( \eta \in \mathcal{P} \), it follows that

\[
\mathbb{E} \left[ \int_0^{\tau \wedge \tau_m} \chi_{\psi^*}(s)\theta_2(s)\eta(s)ds \right] \leq 0.
\]

(A.11) leads to a stronger statement:

\[
\theta_2(t)\eta(t) \leq 0, \quad t \in [0, \tau \wedge T].
\]

Indeed, suppose that, for some \( t \in [0, \tau \wedge T] \), the set \( E = \{ \omega \in \Omega; \theta_2(t)\eta(t) > 0 \} \) had positive probability for some \( \eta \in \mathcal{P} \) such that \( \psi^* + \eta \in \mathcal{P} \). Then by selecting \( \eta' = \eta 1_E \), we have \( \eta' \in \mathcal{P} \), \( \psi^* + \eta' \in \mathcal{P} \), and

\[
\mathbb{E} \left[ \int_0^{\tau \wedge \tau_m} \chi_{\psi^*}(s)\theta_2(s)\eta'(s)ds \right] > 0,
\]

contradicting (A.11). From Theorem 13.1 of Rockafellar [23] and (A.12), we can conclude that \( \theta_2(t) = 0 \), \( t \in [0, \tau \wedge T] \).

\[\Box\]

APPENDIX B. PROOF OF PROPOSITION 3.2

We first show that if a solution \((\zeta^*, \psi^*)\) exists, then this solution is unique with respect to \( \psi^* \). Let \( \hat{\psi} \) be any other intensity process that minimizes \( V_0(\zeta, \psi) \) for a given \( \zeta \), and let

\[
M := \min_{\psi \in \mathcal{P}} V_0(\zeta, \psi)
\]

\[
= \mathbb{E} \left[ \int_0^{\tau \wedge T} \hat{u}^{(1)}_0(\zeta \chi_\psi(t), t)dt + \hat{V}(\zeta \chi_\psi(\tau \wedge T)) \right] + \zeta \left( W_0 - np_0 + \mathbb{E} \left[ \int_0^{\tau \wedge T} y(t)\chi_\psi(t)dt + n\chi_\psi(\tau \wedge T)X(\tau \wedge T) \right] \right).
\]

Since we can readily show that \( \hat{V}(y) \) and \( \hat{u}^{(1)}_0(y, t) \), \( t \in [0, T] \), are convex in \( y \),

\[
M \geq \mathbb{E} \left[ \int_0^{\tau \wedge T} \hat{u}^{(1)}_0(\eta \zeta \chi_\psi(t) + (1 - \eta)\hat{\psi}(t), t)dt + \hat{V}(\eta \zeta \chi_\psi(\tau \wedge T) + (1 - \eta)\hat{\psi}(\tau \wedge T)) \right] + \zeta \left( W_0 - np_0 + \mathbb{E} \left[ \int_0^{\tau \wedge T} y(t) \left( \eta \chi_\psi(t) + (1 - \eta)\hat{\psi}(t) \right)dt + n(\eta \chi_\psi(\tau \wedge T) + (1 - \eta)\hat{\psi}(\tau \wedge T))X(\tau \wedge T) \right] \right), \quad \eta \in [0, 1].
\]
Thus and

Then, by using the definition of \((B.3)\) we have

\[
G' ( \eta ) = - \zeta \mathbb{E} \left[ \int_{0}^{\tau \wedge T} I_{0}^{(1)} ( \eta \zeta \psi^{\ast} (t) + (1 - \eta) \zeta \chi_{\psi^{\ast}} (t), \chi_{\psi^{\ast}} (t) - \chi_{\psi} (t) ) dt \right.
\]

\[
+ J ( \eta \zeta \psi^{\ast} ( \tau \wedge T ) + (1 - \eta) \zeta \chi_{\psi^{\ast}} ( \tau \wedge T ) ) \left( \chi_{\psi^{\ast}} ( \tau \wedge T ) - \chi_{\psi} ( \tau \wedge T ) \right)
\]

\[
- \int_{0}^{\tau \wedge T} y(t)\chi_{\psi^{\ast}} (t) - \chi_{\psi} (t) dt - nX ( \tau \wedge T ) ( \chi_{\psi^{\ast}} ( \tau \wedge T ) - \chi_{\psi} ( \tau \wedge T ) ) \right]
\]

and

\[
G'' ( \eta ) = - \zeta^2 \mathbb{E} \left[ \int_{0}^{\tau \wedge T} I_{0}^{(1)} ( \eta \zeta \psi^{\ast} (t) + (1 - \eta) \zeta \chi_{\psi^{\ast}} (t), \chi_{\psi^{\ast}} (t) - \chi_{\psi} (t) )^2 dt \right.
\]

\[
+ J' ( \eta \zeta \psi^{\ast} ( \tau \wedge T ) + (1 - \eta) \zeta \chi_{\psi^{\ast}} ( \tau \wedge T ) ) ( \chi_{\psi^{\ast}} ( \tau \wedge T ) - \chi_{\psi} ( \tau \wedge T ) )^2 \right] \geq 0.
\]

Thus \(G(\eta)\) is a convex function of \(\eta\). If \(\psi^{\ast}\) is a solution of the original problem, then \(G(\eta)\) achieves its minimum at \(\eta = 1\). This is possible if and only if \(G'(1) \leq 0\). Explicitly, \(\psi^{\ast}\) is a solution if and only if, for every other \(\psi\) that satisfies

\[
\mathbb{E} \left[ \int_{0}^{\tau \wedge T} I_{0}^{(1)} ( \zeta \chi_{\psi} (t), \chi_{\psi} (t) ) dt + J ( \zeta \chi_{\psi} ( \tau \wedge T ) ) \chi_{\psi} ( \tau \wedge T ) \right]
\]

\[
\leq \mathbb{E} \left[ \int_{0}^{\tau \wedge T} y(t)\chi_{\psi} (t) dt + n\chi_{\psi} ( \tau \wedge T ) X ( \tau \wedge T ) \right] + W_0 - np_0,
\]

we have

\[
(B.4) \quad \mathbb{E} \left[ \int_{0}^{\tau \wedge T} I_{0}^{(1)} ( \zeta \chi_{\psi}^{\ast} (t), \chi_{\psi}^{\ast} (t) ) dt + J ( \zeta \chi_{\psi}^{\ast} ( \tau \wedge T ) ) \chi_{\psi}^{\ast} ( \tau \wedge T ) - \int_{0}^{\tau \wedge T} y(t)\chi_{\psi}^{\ast} (t) dt - n\chi_{\psi}^{\ast} ( \tau \wedge T ) X ( \tau \wedge T ) \right]
\]

\[
\geq \mathbb{E} \left[ \int_{0}^{\tau \wedge T} I_{0}^{(1)} ( \zeta \chi_{\psi}^{\ast} (t), \chi_{\psi}^{\ast} (t) ) dt + J ( \zeta \chi_{\psi}^{\ast} ( \tau \wedge T ) ) \chi_{\psi}^{\ast} ( \tau \wedge T ) - \int_{0}^{\tau \wedge T} y(t)\chi_{\psi}^{\ast} (t) dt - n\chi_{\psi}^{\ast} ( \tau \wedge T ) X ( \tau \wedge T ) \right].
\]
Since $E[\varphi(t)] = 1$ for each $t \in [0, T]$, if $P(\{\varphi(t) > 1\}) > 0$, then $P(\{\varphi(t) < 1\}) > 0$. Accordingly, for any intensity process $\psi$, since $\zeta > 0$, $\chi_\psi > 0$ a.s., and that $\tau_0^{(1)}$ and $J$ are convex, we have

\begin{equation}
\mathbb{E} \left[ \int_0^{\tau \land T} I_0^{(1)}(\zeta \chi_\psi(t), t) \chi_\psi(t) dt + J(\zeta \chi_\psi(\tau \land T)) \chi_\psi(\tau \land T) - \int_0^{\tau \land T} y(t) \chi_\psi(t) dt - n \chi_\psi(\tau \land T) X(\tau \land T) \right]
\geq \mathbb{E} \left[ \int_0^{\tau \land T} I_0^{(1)}(\zeta \chi_\lambda(t), t) \chi_\lambda(t) dt + J(\zeta \chi_\lambda(\tau \land T)) \chi_\lambda(\tau \land T) - \int_0^{\tau \land T} y(t) \chi_\lambda(t) dt - n \chi_\lambda(\tau \land T) X(\tau \land T) \right].
\end{equation}

So that, if we choose a $\zeta$ so that it satisfies

\begin{equation}
\mathbb{E} \left[ \int_0^{\tau \land T} I_0^{(1)}(\zeta \chi_\lambda(t), t) \chi_\lambda(t) dt + J(\zeta \chi_\lambda(\tau \land T)) \chi_\lambda(\tau \land T) - \int_0^{\tau \land T} y(t) \chi_\lambda(t) dt - n \chi_\lambda(\tau \land T) X(\tau \land T) \right] = W_0 - np_0,
\end{equation}

then we have

\begin{equation}
\mathbb{E} \left[ \int_0^{\tau \land T} I_0^{(1)}(\zeta \chi_\lambda(t), t) \chi_\lambda(t) dt + J(\zeta \chi_\lambda(\tau \land T)) \chi_\lambda(\tau \land T) - \int_0^{\tau \land T} y(t) \chi_\lambda(t) dt - n \chi_\lambda(\tau \land T) X(\tau \land T) \right] \geq \mathbb{E} \left[ \int_0^{\tau \land T} I_0^{(1)}(\zeta \chi_\lambda(t), t) \chi_\lambda(t) dt + J(\zeta \chi_\lambda(\tau \land T)) \chi_\lambda(\tau \land T) - \int_0^{\tau \land T} y(t) \chi_\lambda(t) dt - n \chi_\lambda(\tau \land T) X(\tau \land T) \right]
\end{equation}

holds by (B.4), replacing its LHS by $\lambda$. If we compare (B.7) with (B.4), $\lambda$ must be $\psi^*$ and this argument completes the proof. Finally, we note that there exists a unique $\zeta$ satisfying (B.6) since we have

\[ \lim_{x \to \infty} U'_i(x) = 0, \quad \lim_{x \to 0+} U'_i(x) = \infty, \quad U''_i(x) < 0, \quad i = 1, 2, \quad x > 0, \]

and

\[ V'(x) = Z(x), \quad V''(x) = Z'(x) < 0, \quad x > 0, \]

from Assumption 2.2 and the definition of $U_i$, $i = 1, 2$, and $V$. \hfill \Box

**APPENDIX C. PROOF OF PROPOSITION 3.3**

For each $n \in \mathbb{R}_+$, let $\hat{V}_0(n)$ be defined by

\[ \hat{V}_0(n) = \min_{\zeta^{(n)} \in \mathbb{R}_+} V_0(\zeta^{(n)}, \lambda). \]

Then, we can readily show that

\[ \hat{V}_0(n) = \mathbb{E} \left[ \int_0^{\tau \land T} \hat{u}_0^{(1)}(\hat{\zeta}^{(n)} \chi_\lambda(t), t) dt + \hat{V}_{\tau \land T}(\hat{\zeta}^{(n)} \chi_\lambda(\tau \land T)) \right] + \hat{\zeta}^{(n)} \left( W(0) - np_0 + \int_0^{\tau \land T} \chi_\lambda(t) y(t) dt + \chi_\lambda(\tau \land T) n X(\tau \land T) \right). \]
Here, noting that, from (3.18),
\[
E\left[\int_0^{\tau \wedge T} \chi_\lambda(t) f_t^{(1)} \left(\tilde{\zeta}^{(n)} \chi_\lambda(t), t\right) dt + \chi_\lambda(\tau \wedge T) \hat{W}(\tau \wedge T)\right] = W_0 - np_0 + E\left[\int_0^{\tau \wedge T} \chi_\lambda(t)y(t) dt + n\chi_\lambda(\tau \wedge T)X(\tau \wedge T)\right]
\]
(C.1)
holds, we obtain
\[
\hat{V}_0'(n) := \frac{d\hat{V}_0(n)}{dn} = \tilde{\zeta}^{(n)} (E[\chi_\lambda(\tau \wedge T)X(\tau \wedge T)] - p_0).
\]
(C.2)
Since \(\hat{V}_0'(n) > 0\), (C.2) immediately leads to the result.

\section*{Appendix D. Proof of Proposition 3.4}

First, we define some notations as follows.

(D.1) \(P_t(\tau \in ds) = \lambda(s)e^{-\int_t^s \lambda(v)dv}ds\), \(P_t(\tau > u) = e^{-\int_t^u \lambda(v)dv}\),

(D.2) \(E_t(u, z) := e^{\alpha_t(u) + \gamma_t(u)z}\),

(D.3) \(\alpha_t(u) := -\int_t^u r(s)ds - \frac{1}{2}\int_t^u \xi(s)^2 ds\),

(D.4) \(\gamma_t(u) := \left(\int_t^u \xi(s)^2 ds\right)^{\frac{1}{2}}\).

We note that if \(Z \sim N(0, 1)\), that is, if \(Z\) is a random variable that follows the standard normal distribution, a process \(\{E_t(u, Z); u \in [t, T]\}\) has an identical distribution with that of the state price density process \(\{\chi(u); u \in [t, T]\}\) conditioned by \(\mathcal{F}_t\).

Now, we consider the value of the household’s wealth \(\hat{W}\) at time \(t\). If \(\tau \geq t\), then

(D.5) \(\hat{W}(t) = \begin{cases} 
\hat{W}(t-) + nX(t) & \text{if } \tau = t, \\
\hat{W}(t-) & \text{if } \tau > t.
\end{cases}\)

On the other, considering total net value at time \(t\) of optimal future consumption of the household, if \(\tau = t\),

(D.6) \(\hat{W}(t) = J(\zeta^* \chi(t)),\)

otherwise, if \(\tau > t\),

(D.7) \(\hat{W}(t) = (TC)_t - (TY)_t - (TX)_t,\)

where

(D.8) \((TC)_t := \mathbb{E}_t \left[\int_t^{\tau \wedge T} E_t(u, Z) f_t^{(1)}(\zeta^* \chi(t)E_t(u, Z), u)du + E_t(\tau \wedge T, Z)J(\zeta^* \chi(t)E_t(\tau \wedge T, Z))\right],\)

(D.9) \((TY)_t := \mathbb{E}_t \left[\int_t^{T} E_t(u, Z)y(u)1_{\{\tau > u\}}du\right] = \int_t^{T} y(u)e^{-\int_t^u (r(s) + \lambda(s))ds}du,\)
and

\[
\begin{align*}
(D.10) \quad (TX)_t & := n \mathbb{E}_t \left[ \mathcal{E}_t(\tau \wedge T, Z)X(\tau \wedge T) \right] \\
& = nx \mathbb{E}_t \left[ \int_t^T \mathcal{E}_t(s, Z)(1 + H(s))P_t(\tau \in ds) + \mathcal{E}_t(T, Z)P_t(\tau > T) \right] \\
& = nx \left( \int_t^T (1 + H(s))\lambda(s)e^{-\int_t^s (r(u)+\lambda(u))du}ds + e^{-\int_t^T (r(s)+\lambda(s))ds} \right).
\end{align*}
\]

Here, we note that \((TY)_t\) denotes time \(t\) value of the household’s income to be gained in the future and that \((TX)_t\) denotes time \(t\) value of the money from insurance paid if \(\tau\) occurs before time \(T\).

Therefore, from (D.5) and (D.7), if \(\tau \geq t\),

\[
\begin{align*}
d\hat{W}(t) &= d\hat{W}(t-) + nX(t)dN(t) \\
&= d(TC)_{t-} - d(TY)_{t-} - d(TX)_{t-} + nX(t)dN(t).
\end{align*}
\]

Next, we derive differential, \(d(TC)_{t-}, d(TY)_{t-}\) and \(d(TX)_{t-}\), explicitly. Since

\[
(D.11) \quad (TC)_{t-} = \int_t^T \int_{-\infty}^\infty \left( \int_s^t \mathcal{E}_t(u, z)I_0^1(\zeta^* \chi(t)\mathcal{E}_t(u, z), u)du + \mathcal{E}_t(s, z)J(\zeta^* \chi(t)\mathcal{E}_t(s, z)) \right) d\Phi(z)P_t(\tau \in ds)
\]

\[
+ \int_{-\infty}^\infty \left( \int_t^T \mathcal{E}_t(u, z)I_0^1(\zeta^* \chi(t)\mathcal{E}_t(u, z), u)du + \mathcal{E}_t(T, z)J(\zeta^* \chi(t)\mathcal{E}_t(T, z)) \right) d\Phi(z)P_t(\tau > T),
\]

where \(\Phi(z)\) is the c.d.f. of the standard normal distribution. Note that the last equation holds by Fubini’s theorem. A straightforward but long algebra leads to

\[
(D.12) \quad d(TC)_{t-} = -I_0^1(\zeta^* \chi(t), t)dt + (TC)_{t-}r(t)dt
\]

\[
- \zeta^* \chi(t)\mathbb{E}_t \left[ \int_t^{\tau \wedge T} \mathcal{E}_t(u, Z)I_0^1(\zeta^* \chi(t)\mathcal{E}_t(u, Z), u)du \\
+ \mathcal{E}_t(\tau \wedge T, Z)J(\zeta^* \chi(t)\mathcal{E}_t(\tau \wedge T, Z)) \right] (\xi(t)^2dt + \xi(t)dB(t))
\]

\[- (J(\zeta^* \chi(t)) - (TC)_{t-}) \lambda(t)dt.
\]

Similarly, from (D.10) and (D.9), we can readily confirm that

\[
(D.13) \quad d(TX)_{t-} = -nx(1 + H(t))\lambda(t)dt + (TX)_{t-}(r(t) + \lambda(t))dt
\]

\[
= (TX)_{t-}r(t)dt - (nX(t) - (TX)_{t-})\lambda(t)dt,
\]

and

\[
(D.14) \quad d(TY)_{t-} = (TY)_{t-}(r(t) + \lambda(t))dt - y(t)dt,
\]
hold. Therefore, from (D.11), (D.13), (D.14) and (D.15), we obtain
\[
\begin{align*}
\hat{W}(t) &= (TC)_{t-} - d(TX)_{t-} - d(TY)_{t-} + nX(t)dN(t) \\
&= y(t)dt + \hat{c}(t)dt + \hat{W}(t-)(r(t)dt + \hat{n}(t)((\mu(t) - r(t))dt + \sigma(t)dB(t)) \\
&= y(t)dt + \hat{c}(t)dt + \hat{W}(t-)(r(t)dt + \hat{n}(t)((\mu(t) - r(t))dt + \sigma(t)dB(t)) \\
&= -[J(\xi^* \chi(t)) - nX_t - \hat{W}(t-)]d(t) + nX(t)dN(t).
\end{align*}
\]

From (D.5), since \(J(\xi^* \chi(t)) = \hat{W}(t-) + nX(t)\), we can conclude that the proposition holds.

References


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