Coupled Diffusions and Systemic Risk
“Systemic Risk Illustrated”

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HANDBOOK ON SYSTEMIC RISK

Editors: J.-P. Fouque and J. Langsam
Cambridge University Press (to appear in 2012)

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- 2012: Director nominated: Richard Berner will form a Financial Research Advisory Committee
Correlated Diffusions: Credit Risk

\[ X_{t}^{(i)}, i = 1, \ldots, N \] denote log-values

\[ dX_{t}^{(i)} = b_{t}^{(i)} dt + \sigma_{t}^{(i)} dW_{t}^{(i)} \quad i = 1, \ldots, N. \]

Three ingredients:

- Drifts \( b_{t}^{(i)} \)
- Volatilities \( \sigma_{t}^{(i)} \)
- Brownian motions \( W_{t}^{(i)} \)

Credit Risk (structural approach):

- Drifts imposed by risk neutrality
- Correlation is created between the BMs
- Joint distribution of hitting times is a problem!
- Correlation can also be created through stochastic volatilities

(Fouque-Wignall-Zhou 2008)
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Coupled Diffusions: Systemic Risk

$X_t^{(i)}, i = 1, \ldots, N$ denote log-monetary reserves of $N$ banks

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Assume independent Brownian motions $W_t^{(i)}, i = 1, \ldots, N$ and identical constant volatilities $\sigma_t^{(i)} = \sigma$
Coupled Diffusions: Systemic Risk

\( X^{(i)}_t, i = 1, \ldots, N \) denote log-monetary reserves of \( N \) banks

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\frac{dX^{(i)}_t}{dt} = b^{(i)}_t dt + \sigma^{(i)}_t dW^{(i)}_t \quad i = 1, \ldots, N.
\]

Assume independent Brownian motions \( W^{(i)}_t, i = 1, \ldots, N \) and identical constant volatilities \( \sigma^{(i)}_t = \sigma \)

Model borrowing and lending through the drifts:

\[
\frac{dX^{(i)}_t}{dt} = \frac{\alpha}{N} \sum_{j=1}^{N} (X^{(j)}_t - X^{(i)}_t) dt + \sigma dW^{(i)}_t , \quad i = 1, \ldots, N.
\]

The overall rate of borrowing and lending \( \alpha/N \) has been normalized by the number of banks and we assume \( \alpha > 0 \)
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The overall rate of borrowing and lending \( \alpha/N \) has been normalized by the number of banks and we assume \( \alpha > 0 \)

Denote the default level by \( D < 0 \) and simulate the system for various values of \( \alpha: 0, 1, 10, 100 \) with fixed \( \sigma = 1 \)
One realization of the trajectories of the coupled diffusions $X^{(i)}_t$ with $\alpha = 1$ (left plot) and trajectories of the independent Brownian motions ($\alpha = 0$) (right plot) using the same Gaussian increments. Solid horizontal line: default level $D = -0.7$.
One realization of the trajectories of the coupled diffusions $X_t^{(i)}$ with $\alpha = 10$ (left plot) and trajectories of the independent Brownian motions ($\alpha = 0$) (right plot) using the same Gaussian increments. Solid horizontal line: default level $D = -0.7$. 
One realization of the trajectories of the coupled diffusions $X_t^{(i)}$ with $\alpha = 100$ (left plot) and trajectories of the independent Brownian motions ($\alpha = 0$) (right plot) using the same Gaussian increments. Solid horizontal line: default level $D = -0.7$
These simulations “show” that STABILITY is created by increasing the rate $\alpha$ of borrowing and lending.
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Next, we compare the loss distributions for the coupled and independent cases. We compute these loss distributions by Monte Carlo method using $10^4$ simulations, and with the same parameters as previously.
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In the independent case, the loss distribution is Binomial($N, p$) with parameter $p$ given by

$$p = IP \left( \min_{0 \leq t \leq T} (\sigma W_t) \leq D \right)$$

$$= 2\Phi \left( \frac{D}{\sigma \sqrt{T}} \right),$$

where $\Phi$ denotes the $\mathcal{N}(0, 1)$-cdf, and we used the distribution of the minimum of a Brownian motion (see Karatzas-Shreve 2000 for instance). With our choice of parameters, we have $p \approx 0.5$. 
On the left, we show plots of the loss distribution for the coupled diffusions with $\alpha = 1$ (solid line) and for the independent Brownian motions (dashed line). The plots on the right show the corresponding tail probabilities.
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Mean-field Limit

Rewrite the dynamics as:

\[
\begin{align*}
  dX_t^{(i)} &= \frac{\alpha}{N} \sum_{j=1}^{N} (X_t^{(j)} - X_t^{(i)}) \, dt + \sigma dW_t^{(i)} \\
  &= \alpha \left[ \left( \frac{1}{N} \sum_{j=1}^{N} X_t^{(j)} \right) - X_t^{(i)} \right] \, dt + \sigma dW_t^{(i)}.
\end{align*}
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\]

The processes \(X^{(i)}\)'s are “OU”s mean-reverting to the ensemble average which satisfies

\[
d\left( \frac{1}{N} \sum_{i=1}^{N} X^{(i)}_t \right) = d\left( \frac{\sigma}{N} \sum_{i=1}^{N} W^{(i)}_t \right).
\]
Assuming for instance that $x_0^{(i)} = 0$, $i = 1, \ldots, N$, we obtain

$$\frac{1}{N} \sum_{i=1}^{N} X_t^{(i)} = \frac{\sigma}{N} \sum_{i=1}^{N} W_t^{(i)},$$

and consequently

$$dX_t^{(i)} = \alpha \left[ \left( \frac{\sigma}{N} \sum_{j=1}^{N} W_t^{(j)} \right) - X_t^{(i)} \right] dt + \sigma dW_t^{(i)}.$$
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Note that the ensemble average is distributed as a Brownian motion with diffusion coefficient \( \sigma/\sqrt{N} \).
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Note that the ensemble average is distributed as a Brownian motion with diffusion coefficient $\sigma/\sqrt{N}$.

In the limit $N \to \infty$, the strong law of large numbers gives

$$\frac{1}{N} \sum_{j=1}^{N} W_t^{(j)} \to 0 \quad a.s.,$$

and therefore, the processes $X^{(i)}$'s converge to independent OU processes with long-run mean zero.
In fact, $X_t^{(i)}$ is given explicitly by

$$X_t^{(i)} = \frac{\sigma}{N} \sum_{j=1}^N W_t^{(j)} + \sigma e^{-\alpha t} \int_0^t e^{\alpha s} dW_s^{(i)} - \frac{\sigma}{N} \sum_{j=1}^N \left( e^{-\alpha t} \int_0^t e^{\alpha s} dW_s^{(j)} \right),$$

and therefore, $X_t^{(i)}$ converges to $\sigma e^{-\alpha t} \int_0^t e^{\alpha s} dW_s^{(i)}$ which are independent OU processes.

This is a simple example of a **mean-field limit** and propagation of chaos studied in general by Sznitman (1991).
Large Deviation

We focus on the event where the ensemble average reaches the default level. The probability of this event is small (as \(N\) becomes large), and is given by the theory of Large Deviation.
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In our simple example, this probability can be computed explicitly as follows:

\[
\mathbb{P} \left( \min_{0 \leq t \leq T} \left( \frac{\sigma}{N} \sum_{i=1}^{N} W_t^{(i)} \right) \leq D \right) = \mathbb{P} \left( \min_{0 \leq t \leq T} \tilde{W}_t \leq \frac{D \sqrt{N}}{\sigma} \right) = 2\Phi \left( \frac{D \sqrt{N}}{\sigma \sqrt{T}} \right),
\]

where \( \tilde{W} \) is a standard Brownian motion.
Systemic Risk

Using classical equivalent for the Gaussian cumulative distribution function, we obtain

\[ \lim_{N \to \infty} - \frac{1}{N} \log P \left( \min_{0 \leq t \leq T} \left( \sum_{i=1}^{N} W^{(i)}_t \right) \leq D \right) = \frac{D^2}{2\sigma^2 T}. \]
Systemic Risk

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$$\lim_{N \to \infty} -\frac{1}{N} \log \mathbb{P} \left( \min_{0 \leq t \leq T} \left( \frac{\sigma}{N} \sum_{i=1}^{N} W_{t}^{(i)} \right) \leq D \right) = \frac{D^2}{2\sigma^2 T}.$$ 

For a large number of banks, the probability that the ensemble average reaches the default barrier is of order $\exp \left( -\frac{D^2 N}{2\sigma^2 T} \right)$.
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For a large number of banks, the probability that the ensemble average reaches the default barrier is of order \(\exp\left(-\frac{D^{2}N}{2\sigma^{2}T}\right)\)

Since

\[
\frac{1}{N} \sum_{i=1}^{N} X_{t}^{(i)} = \frac{\sigma}{N} \sum_{i=1}^{N} W_{t}^{(i)},
\]

we identify

\[
\left\{ \min_{0 \leq t \leq T} \left( \frac{\sigma}{N} \sum_{i=1}^{N} X_{t}^{(i)} \right) \leq D \right\}
\]

as a **systemic event**

Observe that this event does not depend on \(\alpha > 0\)
The probability

$$\exp \left( -\frac{D^2 N}{2\sigma^2 T} \right)$$

of a systemic event does not depend on $\alpha > 0$, in other words:

“Increasing stability by increasing the rate of borrowing and lending does not prevent a systemic event where a large number of banks default”

In fact, once in this event, increasing $\alpha$ creates even more defaults by “flocking to default”. This is illustrated in the simulation with $\alpha = 100$ where the probability of systemic risk is roughly 3%.
One realization of the trajectories of the coupled diffusions $X_t^{(i)}$ with $\alpha = 100$ (left plot) and trajectories of the independent Brownian motions ($\alpha = 0$) (right plot) using the same Gaussian increments. Solid horizontal line: default level $D = -0.7$.

The probability of a systemic event is roughly $3\%$. 
So far:

We proposed a simple toy model of coupled diffusions to represent **lending and borrowing** between banks. We show that, as expected, this activity **stabilizes** the system in the sense that it decreases the number of defaults. Indeed, and naively, banks in difficulty can be “saved” by borrowing from others. In fact, the model illustrates the fact that stability increases as the rate of borrowing and lending increases.

However, there is a small probability, computed explicitly in our model, that the average of the ensemble reaches the default level. Combined with the “flocking” behavior **“everybody follows everybody”**, this leads to a **systemic event** where almost all default, in particular when the rate of borrowing and lending is large.
Related Papers

• *Diversification in Financial Networks may Increase Systemic Risk*
  by J. Garnier, G. Papanicolaou, and T.-W. Yang

• *Stability in a model of inter-bank lending*
  by J.-P. Fouque and T. Ichiba (Submitted).
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**On Credit Risk:**


So far we have seen that:

“Lending and borrowing improves stability but also contributes to systemic risk”

But how about if the banks compete?

• Can we find an equilibrium in which the previous analysis can still be performed?
• Can we find and characterize a Nash equilibrium?

What follows is a work in progress with René Carmona.
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Mean Field Game

Denoting $\overline{X}_t = \frac{1}{N} \sum_{i}^{N} X_t^i$, the dynamics is

$$dX_t^i = \left[ a(\overline{X}_t - X_t^i) + \alpha_t^i \right] dt + \sigma dW_t^i, \quad i = 1, \cdots, N$$

where $\alpha_t^i$ is the control of bank $i$, and they minimize

$$J^i(\alpha^1, \cdots, \alpha^N) = \mathbb{E} \left\{ \int_{0}^{T} \left[ \frac{1}{2q} (\alpha_t^i)^2 - \alpha_t^i (\overline{X}_t - X_t^i) \right] dt \right\}$$

This is an example of Mean Field Game (MFG) studied extensively by P.L. Lions and collaborators (see also the recent work of R. Carmona and F. Delarue).
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This is an example of **Mean Field Game (MFG)** studied extensively by P.L. Lions and collaborators (see also the recent work of R. Carmona and F. Delarue).

The regulator can choose the parameter $q > 0$ controlling the cost of borrowing and lending to the system. If $X^i_t$ is small (relative to the empirical mean $\overline{X}_t$) then bank $i$ will want to borrow that is $\alpha^i_t > 0$. If $X^i_t$ is large then bank $i$ will want to lend that is $\alpha^i_t < 0$. 


MFG Problem

1. Fix \((m_t)_{t \geq 0}\) (to be the deterministic limit of \(\overline{X}_t\) as \(N \to \infty\))
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2. Solve the control problem

\[
\inf_{\alpha=(\alpha_t) \in A} \mathbb{E} \left\{ \int_0^T \left[ \frac{1}{2}(\alpha_t)^2 - q\alpha_t(m_t - X_t) \right] dt \right\}
\]

subject to: \(dX_t = [a(m_t - X_t) + \alpha_t] dt + \sigma dW_t\)
MFG Problem

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subject to: \( dX_t = [a(m_t - X_t) + \alpha_t] dt + \sigma dW_t \)

3. Find \( m_t \) so that \( \mathbb{E} X_t = m_t \) for all \( t \).
MFG Problem

1. Fix \((m_t)_{t \geq 0}\) (to be the deterministic limit of \(\overline{X}_t\) as \(N \to \infty\))

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\inf_{\alpha = (\alpha_t) \in \mathcal{A}} \mathbb{I} \mathbb{E} \left\{ \int_0^T \left[ \frac{1}{2} (\alpha_t)^2 - q \alpha_t (m_t - X_t) \right] dt \right\}
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3. Find \(m_t\) so that \(\mathbb{I} \mathbb{E} X_t = m_t\) for all \(t\).

**Hamiltonian:**

\[
H(t, x, y, \alpha) = [a(m_t - x) + \alpha] y + \frac{1}{2} \alpha^2 - q \alpha (m_t - x)
\]

\[
\frac{\partial H}{\partial \alpha} = 0 \quad \rightarrow \hat{\alpha} = q(m_t - x) - y
\]
Adjoint Equations

\[ dX_t = [(a + q)(m_t - X_t) - Y_t] dt + \sigma dW_t, \quad X_0 = 0 \]
\[ dY_t = -\frac{\partial H}{\partial x} dt + Z_t dW_t \]
\[ = -[-(a + q)Y_t + q^2(m_t - X_t)] dt + Z_t dW_t, \quad Y_T = 0. \]

One easily checks that \( m_t = \mathbb{E}X_t = 0 \).
Adjoint Equations

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    dY_t &= -\frac{\partial H}{\partial x} dt + Z_t dW_t \\
    &= - \left[-(a + q)Y_t + q^2(m_t - X_t)\right] dt + Z_t dW_t, \quad Y_T = 0.
\end{align*}
\]

One easily checks that \( m_t = IE X_t = 0 \).

**Ansatz:** \( Y_t = \eta_t X_t + \chi_t \) with \( \eta_t \) and \( \chi_t \) deterministic.

**Solution:**

\[
\begin{align*}
    \chi'_t &= (a + q + \eta_t)\chi_t, \quad \chi_T = 0 \quad \text{gives} \quad \chi_t = 0 \\
    \eta'_t &= \eta_t^2 + 2(a + q)\eta_t + q^2, \quad \eta_T = 0 \quad \text{gives:} \\
    \eta_t &= \frac{q^2 e^{2(a+q+\theta)(T-t)} - q^2}{[\theta - 2(a + q + \theta)] e^{2(a+q+\theta)(T-t)} - \theta} \\
    \theta &= -(a + q) \pm \sqrt{(a + q)^2 - q^2}
\end{align*}
\]
Equilibrium

As $N \to \infty$, banks become independent,

$\hat{\alpha} = q(0 - x) - y = -(q + \eta)x$, and they follow the dynamics

$$dX_t = -[a + q + \eta_t]X_t dt + \sigma dW_t$$
Equilibrium

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Assuming that $N$ is **large but finite** and that
$\alpha^i_t = q(\overline{X}_t - X^i_t) - \eta_t X^i_t$ then

$$dX^i_t = [(a + q)(\overline{X}_t - X^i_t) - \eta_t X^i_t] dt + \sigma dW^i_t$$

and therefore

$$d\overline{X}_t = -\eta_t \overline{X}_t dt + \frac{\sigma}{\sqrt{N}} d\overline{W}_t$$

where $\overline{W}_t = \frac{1}{\sqrt{N}} \sum_{1}^{N} dW^i_t$.

Note that $\eta_t < 0$, and therefore $(\overline{X}_t)$ is a repulsive OU.
GAME 2, ETA of t, \( a = 10 \quad q = 1 \quad p = 0.0263 \)
One sample of $X_{\text{bar}}(t)$ -- black dots -- & $X_i(t)$ for $i=1,\ldots,10$ -- colors --, $a=10$ $q=1$
One sample of $X_{\bar{t}}$ -- black dots -- & $X_{i}(t)$ for $i=1,\ldots,10$ -- colors --, $a=100$, $q=1$
One sample of $X_{\text{bar}}(t)$ -- black dots -- & $X_i(t)$ for $i=1,...,10$ -- colors --, $a=100$ $q=10$