Elimination of systemic risk in the financial system

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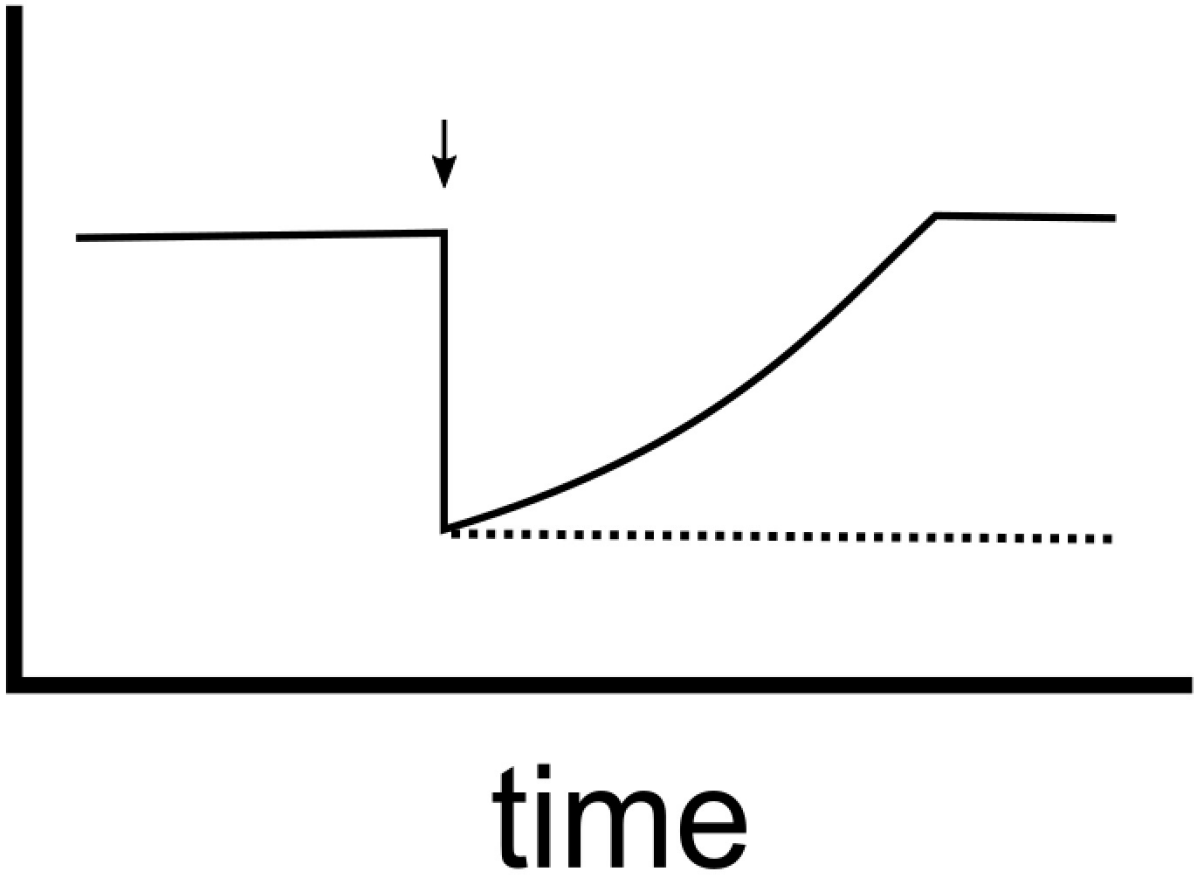
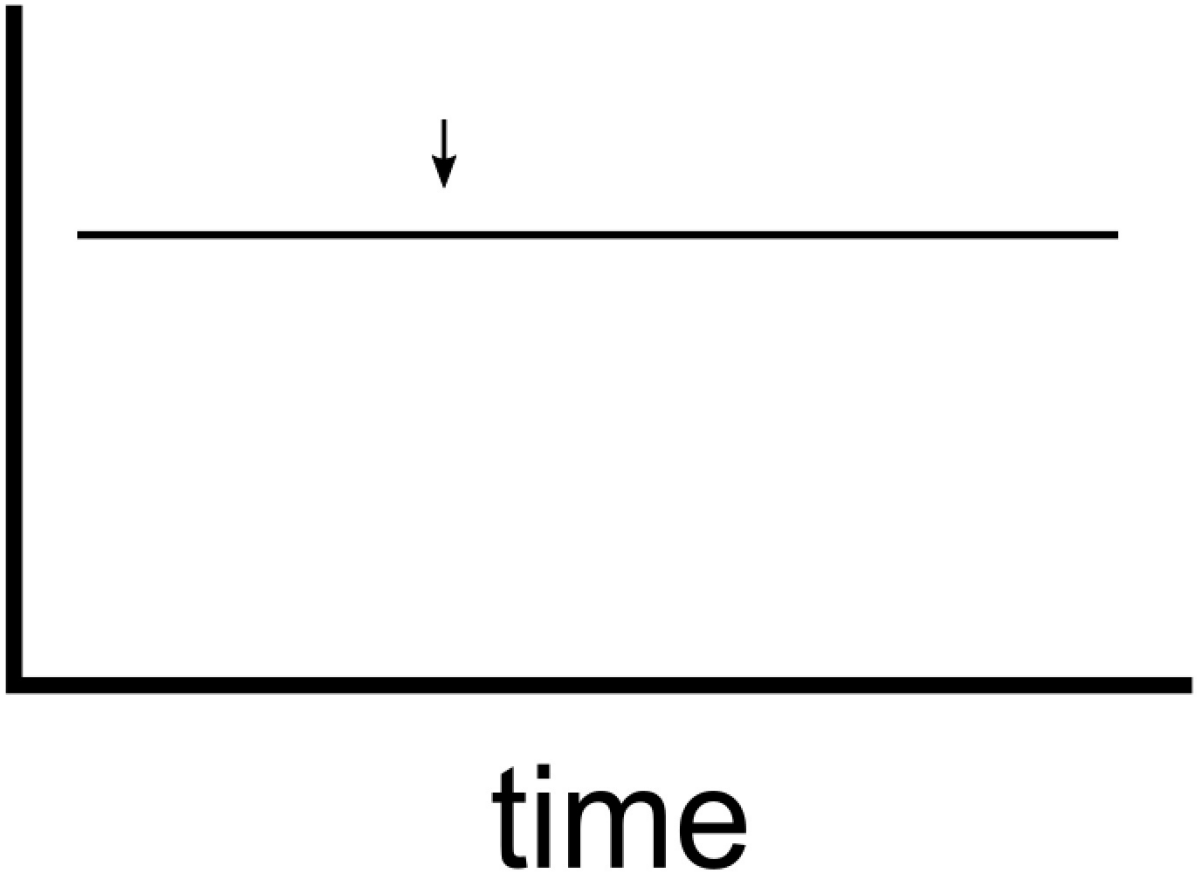
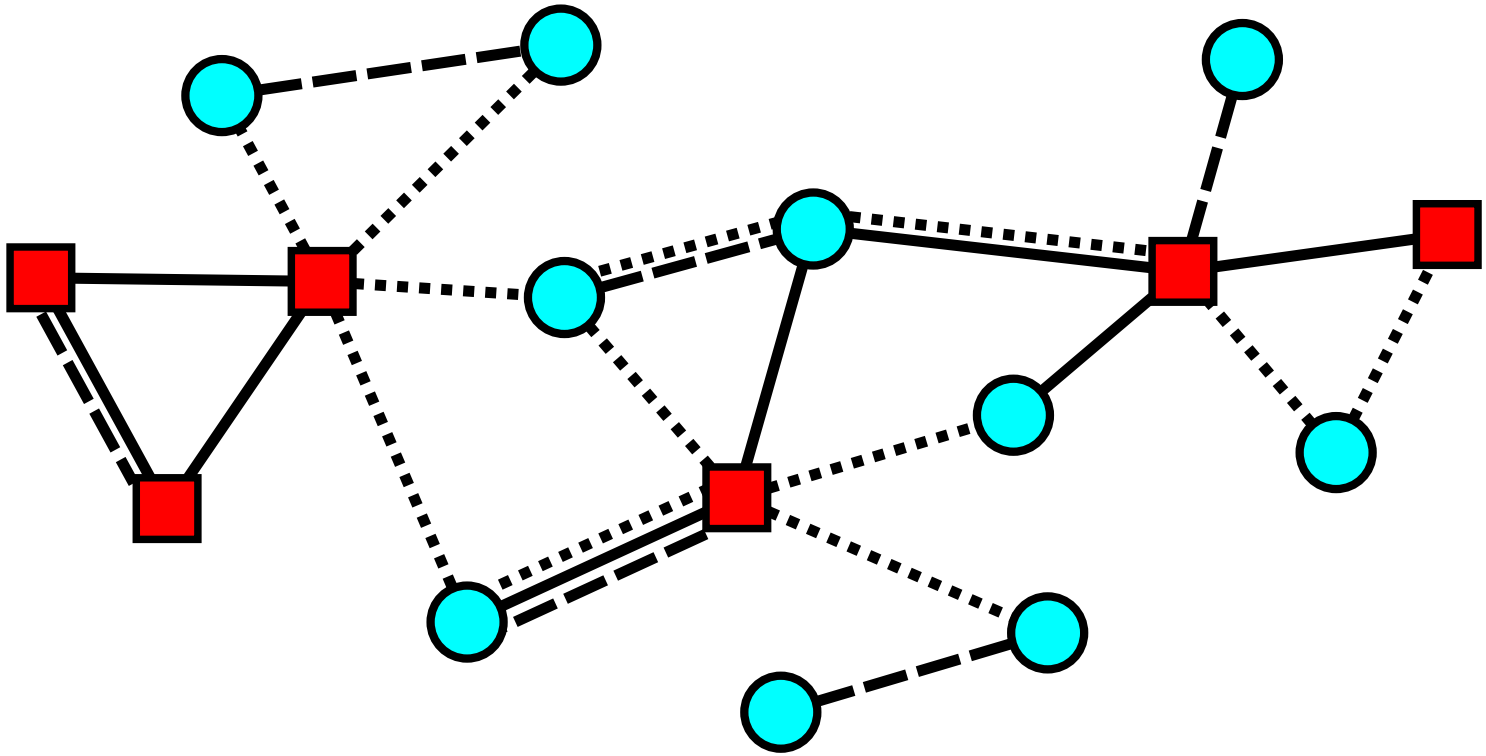
Resilience



Robustness



Complex systems collapse



- nodes i characterized by states, $\sigma_i^{\beta}(t)$
- links multiplex network, $M_{ij}^{\alpha}(t)$

Complex system=co-evolving multiplex network

$$\frac{d}{dt}\sigma_i^\alpha(t) \sim F\left(M_{ij}^\alpha(t), \sigma_j^\beta(t)\right)$$

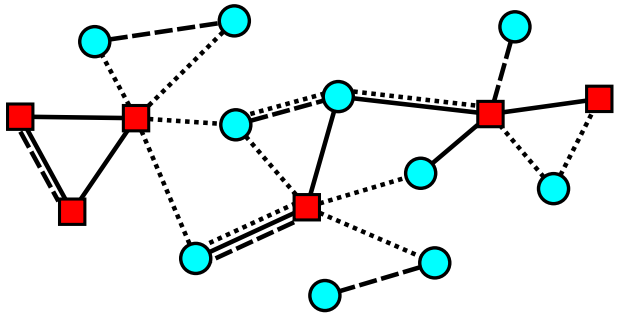
and

$$\frac{d}{dt}M_{ij}^\alpha(t) \sim G\left(M_{ij}^\alpha(t), \sigma_j^\beta(t)\right)$$

- states are observable (big data) – **reality**
- networks are observable (big data) – **invisible reality**
- context is there
- causality (determinism) is lost even without stochasticity

Complex system=co-evolving multiplex network

- algorithmic
- path dependent
- context dependent
- open-ended
- adaptive



Complex systems are intrinsically instable

statistics of complex systems is the **statistics of power laws**

- large number of large outliers – outliers are normal

$\rightarrow$ non-managable

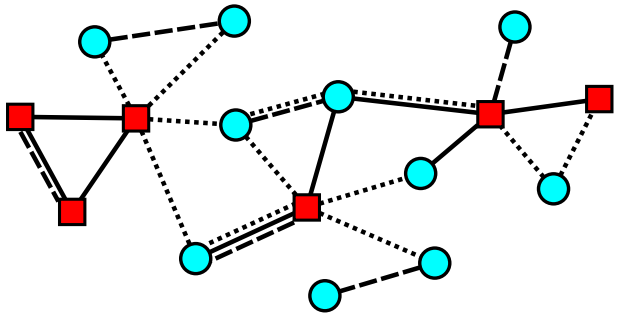
Example: Can we control systemic risk?

affects us most

understood the least of all risks

The three types of financial risk

- **economic risk:** investment in business idea does not pay off
- **credit-default risk:** you don't get back what you have lent
- **systemic risk:** system stops functioning due to local defaults and subsequent (global) cascading



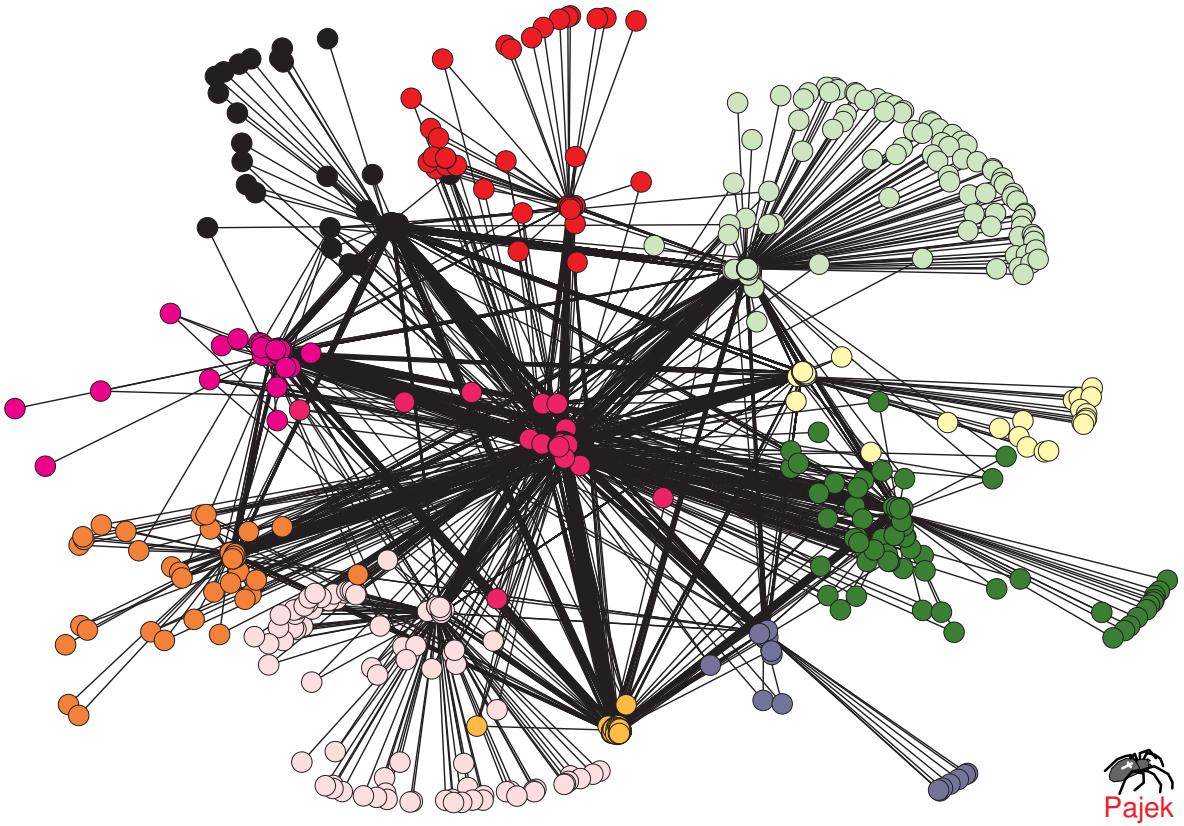
Systemic risk

- risk that significant fraction of financial network defaults
- systemic risk is **not** the same as credit-default risk
- banks care about credit-default risk
- banks have no means to manage systemic risk

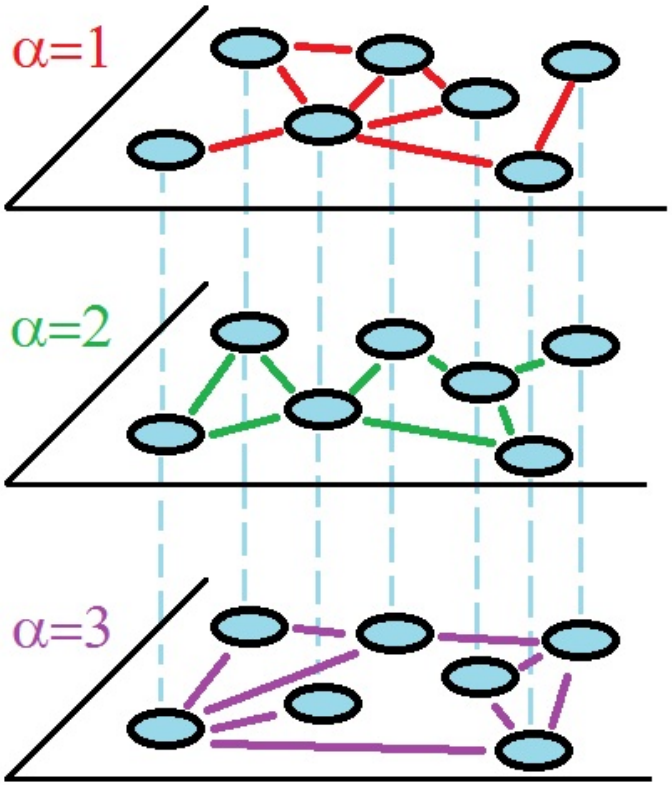
$\longrightarrow$ role of regulator: **manage systemic risk**
$\longrightarrow$ incentivise banks to think of SR

The 2 origins of systemic risk

- **synchronisation of behaviour**: herding, fire sales, margin calls, various amplification effects – may involve networks
- **networks of contracts**: this is what the financial system is


Pajek

Systemic risk is created on multiplex networks



layer 1: lending–borrowing loans

layer 2: derivative networks

layer 3: collateral networks

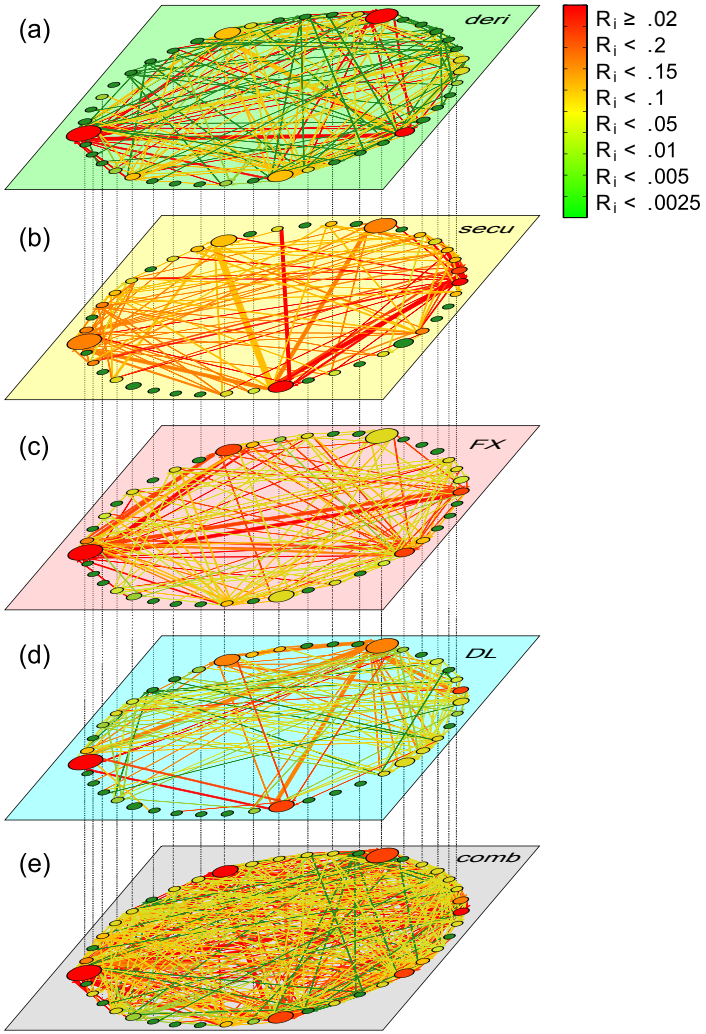
layer 4: securities networks

layer 5: cross-holdings

layer 6: overlapping pfolios

layer 7: liquidity: over-night loans

layer 8: FX transactions


(a)
deri
(b)
secu
(c)
FX
(d)
DL
(e)
comb
$R_i \geq .02$
$R_i < .2$
$R_i < .15$
$R_i < .1$
$R_i < .05$
$R_i < .01$
$R_i < .005$
$R_i < .0025$

Quantification of SR

Systemic risk – quantification

Wanted: systemic risk-value for every financial institution

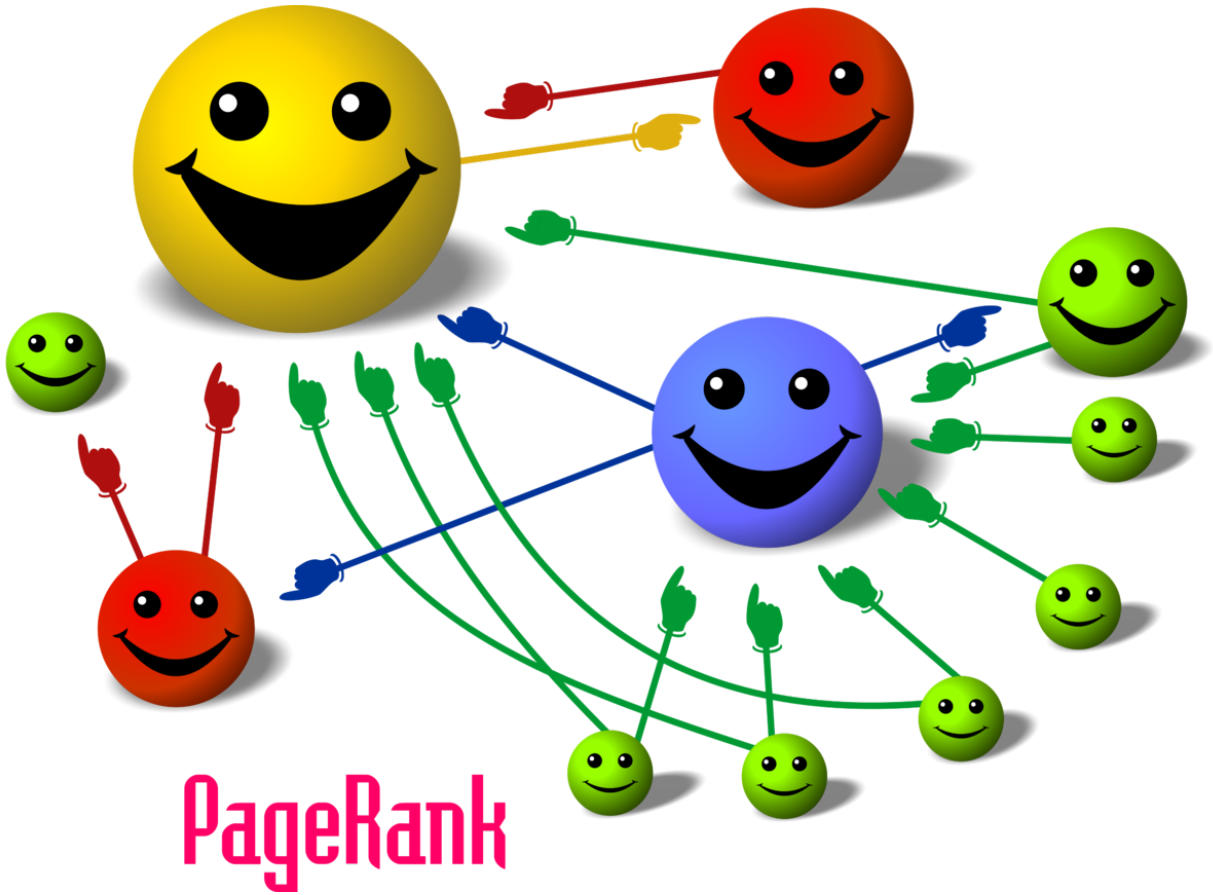
given: entire network

Google has similar problem: value for importance of web-pages

$\rightarrow$ page is important if many important pages point to it

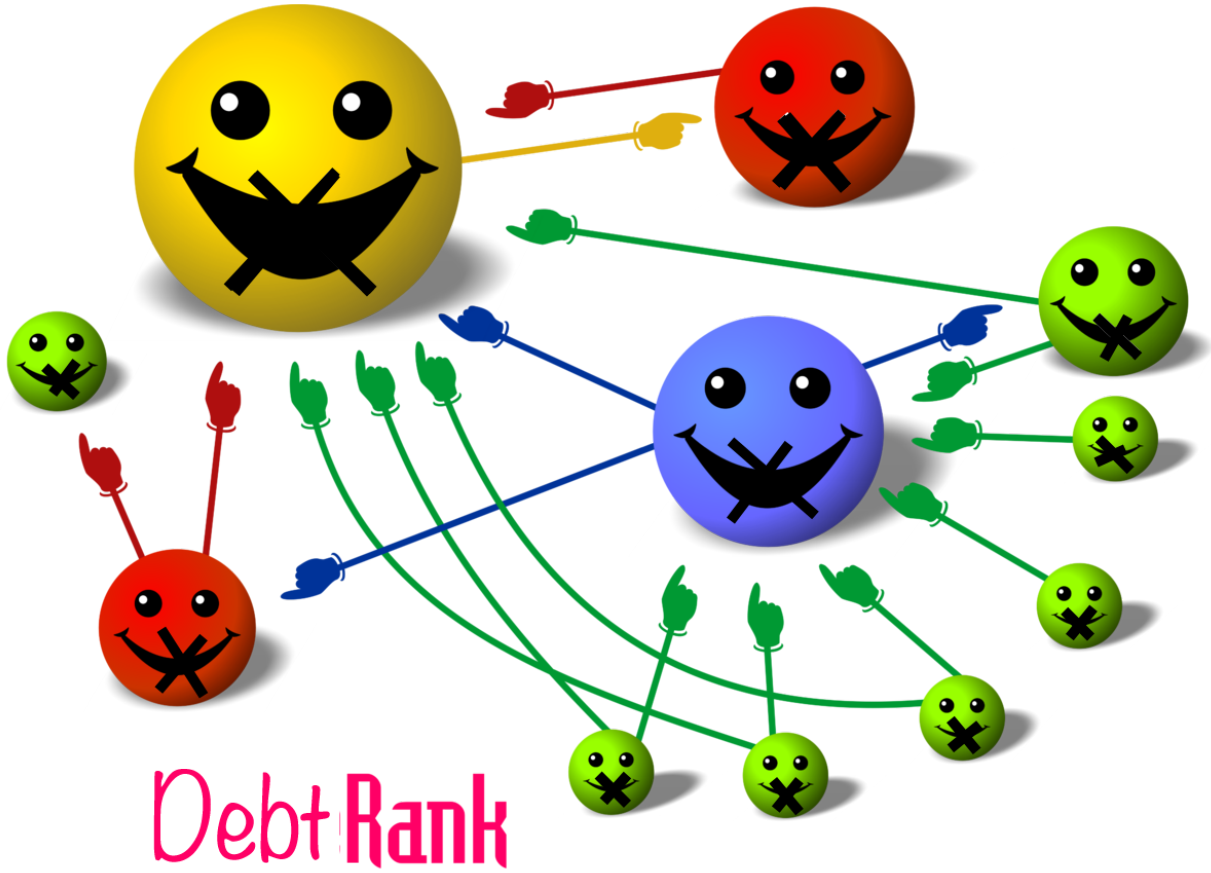
$\rightarrow$ number for importance $\rightarrow$ PageRank

page is **important** if many **important** pages point to it



source Wikipedia cc-license

institution system. risky if system. risky institutions lend to it



Systemic risk factor – DebtRank R

... is a "different Google" – adapted to context of systemic risk (S. Battiston et al. 2012)

superior to: eigenvector centrality, page-rank, Katz rank ...

Why?

- **economic value** in network that is affected by node's default
- capitalization/leverage of banks taken into account
- cycles taken into account: no multiple defaults

DebtRank

- recursive method
- corrects Katz rank for loops in the exposure network
- if i defaults and can not repay loans, j loses L_{ij}. If j has not enough capital to cover that loss $\rightarrow$ j defaults
- impact of bank i on neighbors $I_i = \sum_j W_{ij} v_j$

with $W_{ij} = \min\left[1, \frac{L_{ij}}{C_j}\right]$, ouststanding loans $L_i = \sum_j L_{ji}$, and $v_i = L_i / \sum_j L_j$

- impact on nodes at distance two and higher $\rightarrow$ recursive

$$I_i = \sum_j W_{ij} v_j + \beta \sum_j W_{ij} I_j,$$

If the network W_{ij} contains cycles the impact can exceed one
$\rightarrow$ DebtRank (S. Battiston et al. (2012))

- nodes have two state variables, $h_i(t) \in [0,1]$ and $s_i(t) \in \{Undistress, Distress, Inactive\}$
- Dynamics: $h_i(t) = \min\left[1, h_i(t-1) + \sum_{j|s_j(t-1)=D} W_{ji} h_j(t-1)\right]$

$$s_i(t) = \begin{cases} D & \text{if } h_i(t) > 0; s_i(t-1) \neq I \\ I & \text{if } s_i(t-1) = D \\ s_i(t-1) & \text{otherwise} \end{cases}$$

- DebtRank of set S_f (set of nodes in distress), is

$$R_S = \sum_j h_j(t) v_j - \sum_j h_j(1) v_j$$

Measures distress in the system, excluding initial distress. If S_f is a single node, DebtRank measures its systemic impact on the network.

- DebtRank of S_f containing only the single node i is

$$R_i = \sum_j h_j(t) v_j - h_i(1) v_i$$

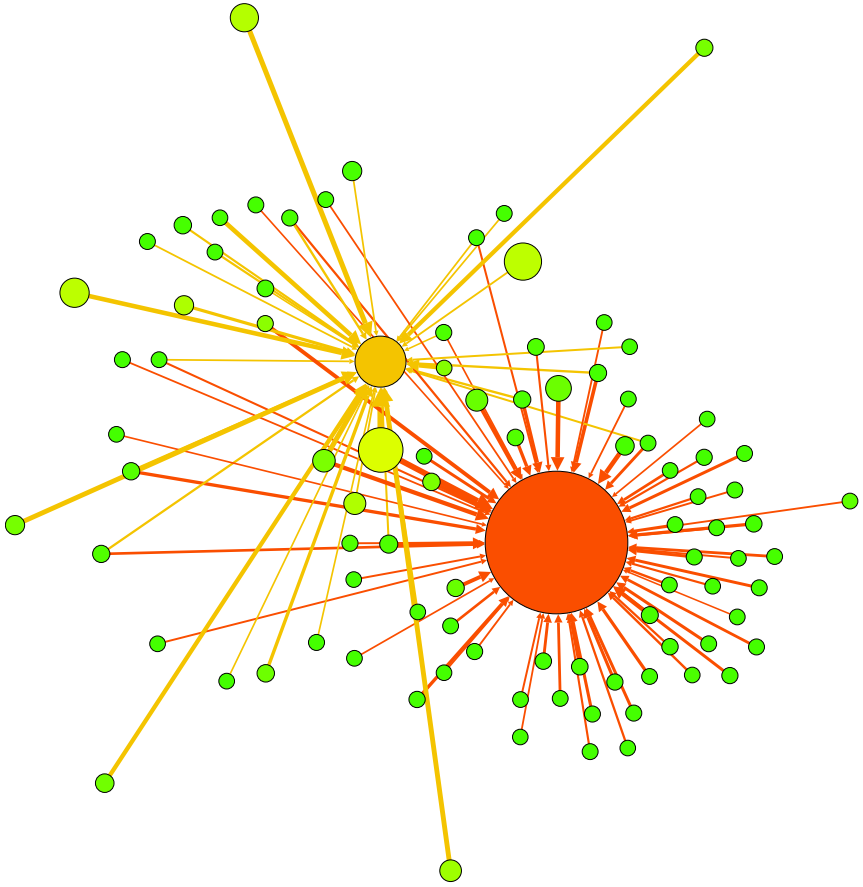
Systemic risk of nodes

Input: Network of contracts between banks

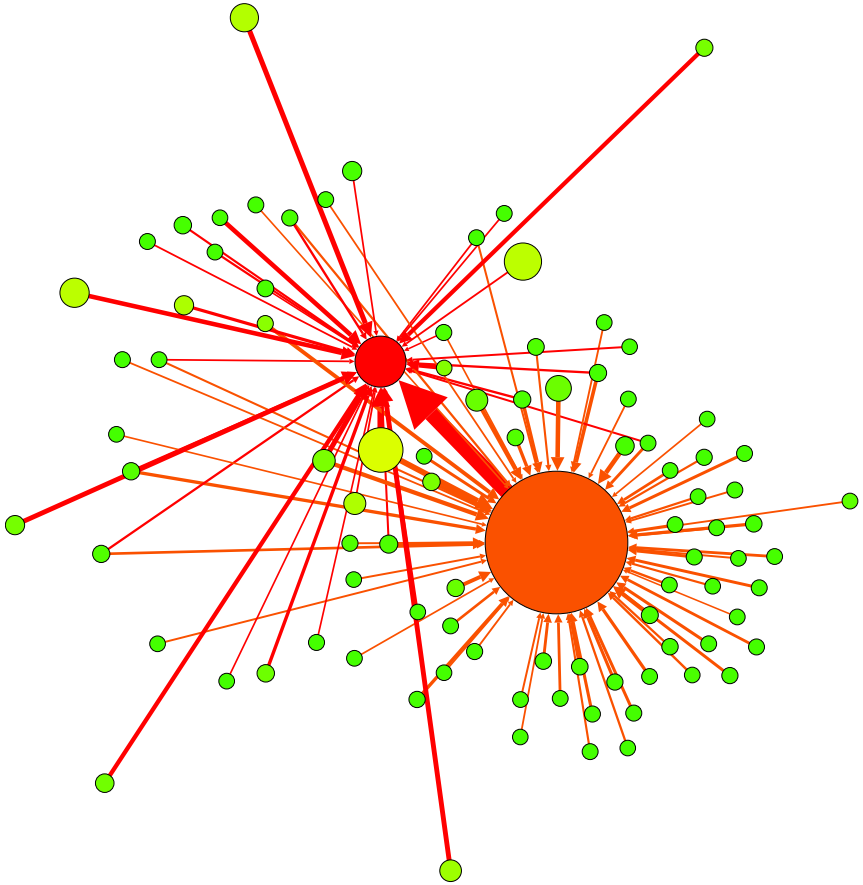
Compute = DebtRank; think of a complicated first eigenvector

Output: all banks i get damage value R_i (% of total damage)

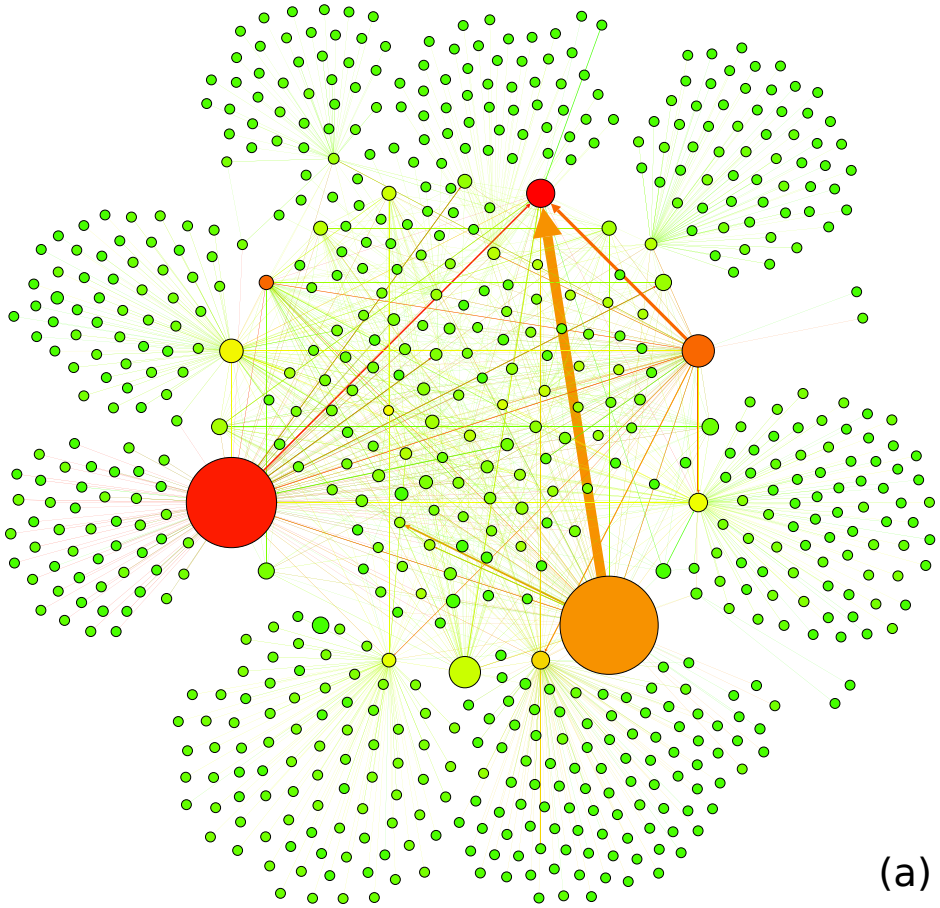
Systemic risk spreads by borrowing



Systemic risk spreads by borrowing



DebtRank Austria Sept 2009

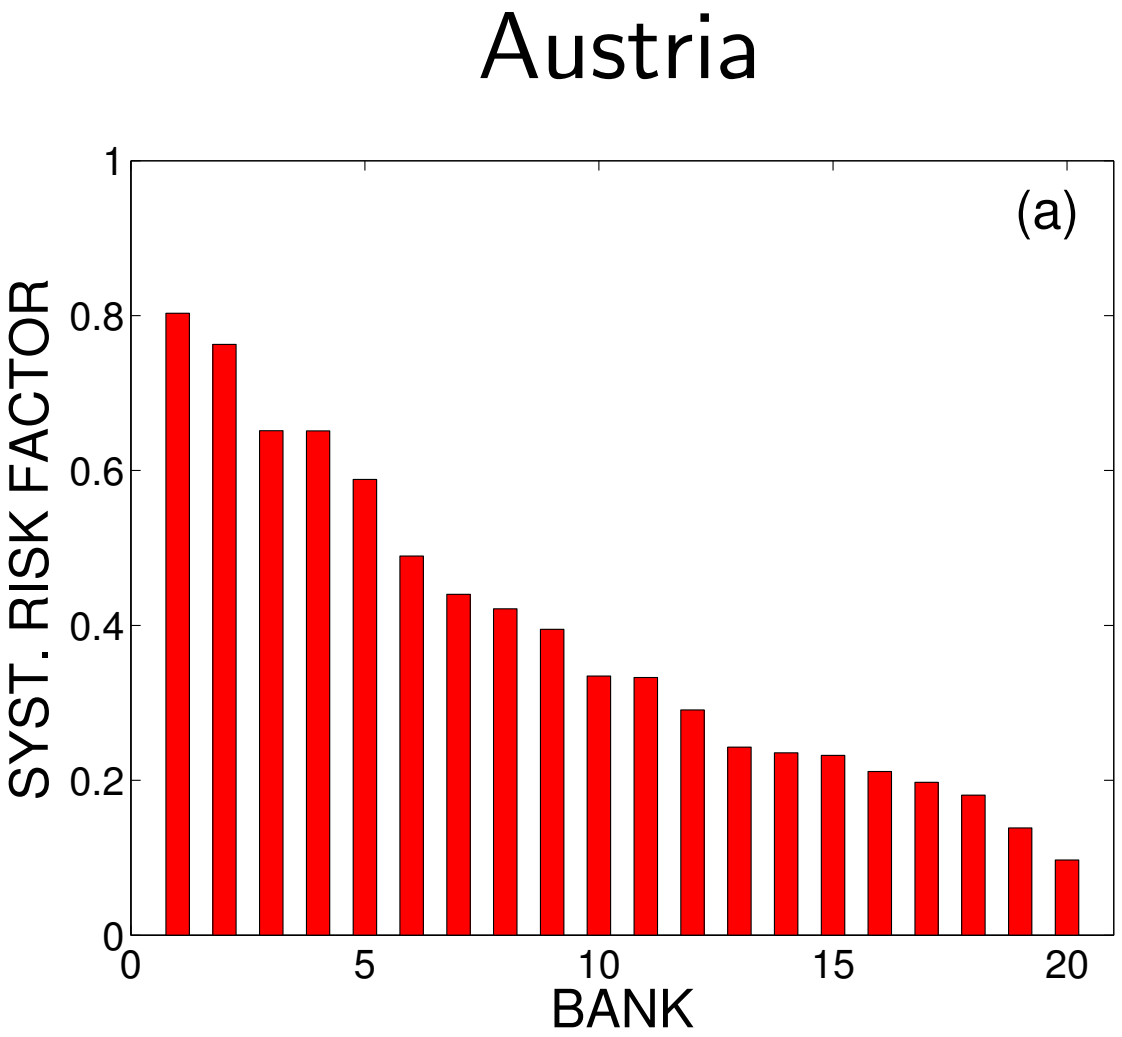


(a)

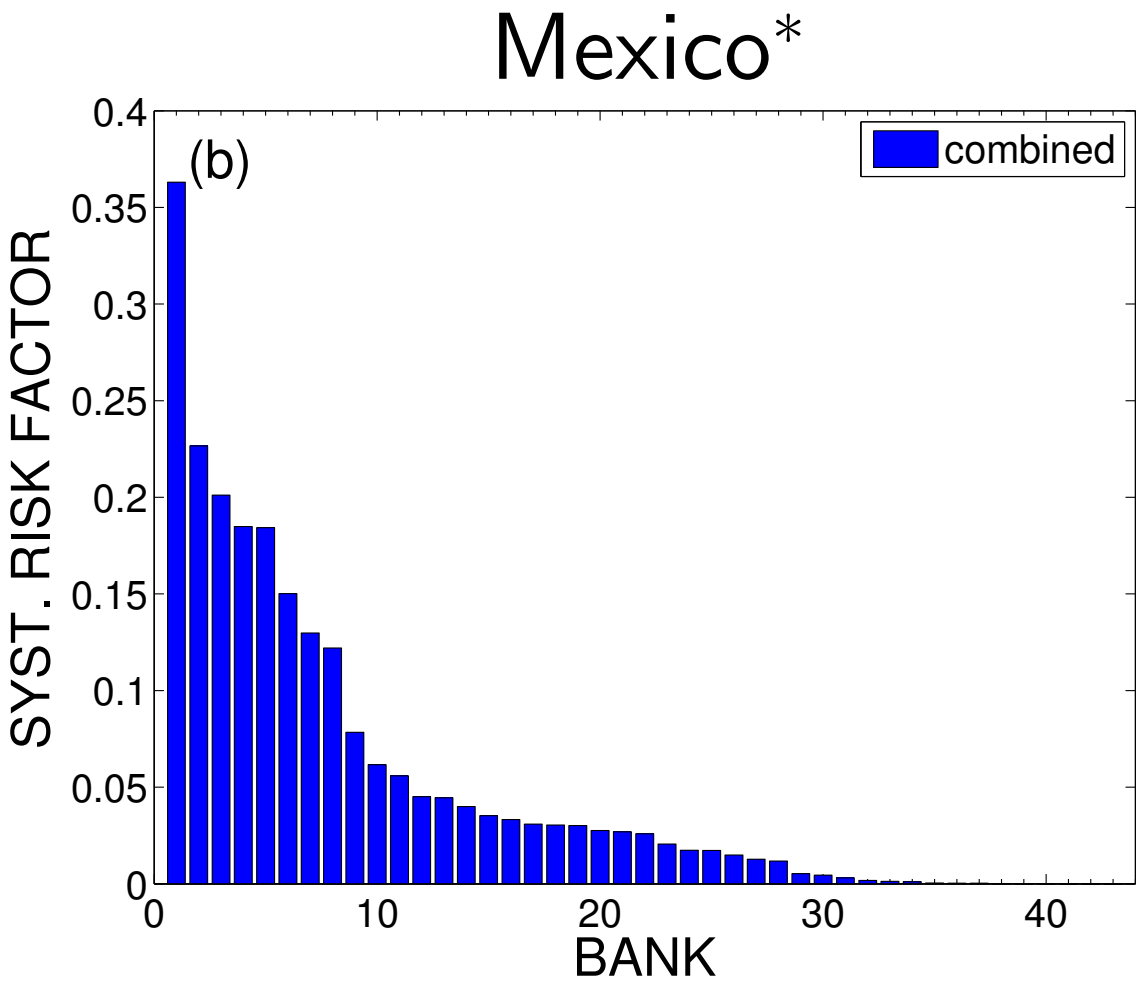
note: size is not proportional to systemic risk

note: core-periphery structure

Systemic risk profile



Systemic risk profile



*with Serafin Martinez-Jaramillo and his team at Banco de Mexico, 2014

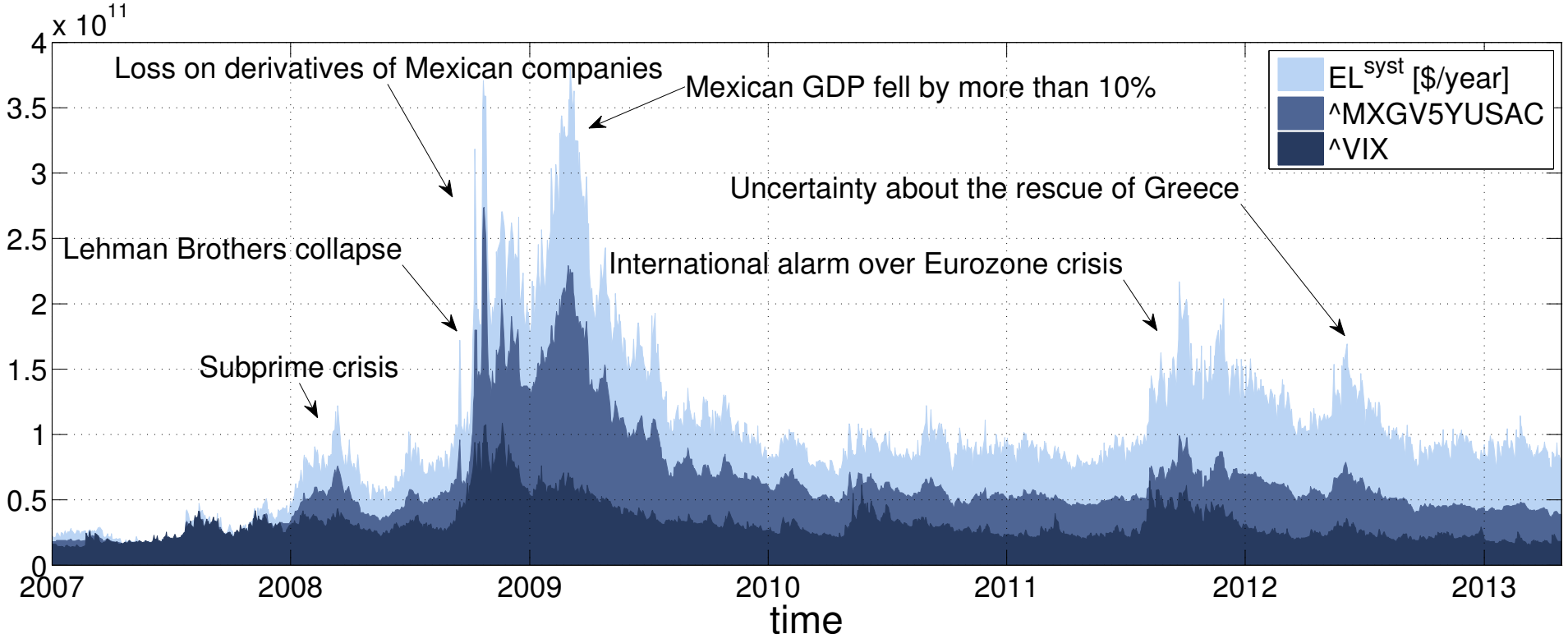
How big is the next financial crisis?

Expected systemic loss [Euro / Year]

Expected systemic loss $= \sum_i p_{\mathrm{default}}(\mathrm{i})$. DebtRank(i)

$$
\begin{aligned}
\mathrm{EL}^{\mathrm{syst}} &= V \sum_{S \in \mathcal{P}(B)} \prod_{i \in S} p_i \prod_{j \in B \setminus S} (1 - p_j)\,(R_S) \\
&\approx V \sum_{S \in \mathcal{P}(B)} \prod_{i \in S} p_i \prod_{j \in B \setminus S} (1 - p_j) \left(\sum_{i \in S} R_i \right) \\
&= V \sum_{i=1}^{b} \underbrace{\left(\sum_{J \in \mathcal{P}(B \setminus \{i\})} \prod_{j \in J} p_j \prod_{k \in B \setminus (J \cup \{i\})} (1 - p_k) \right)}_{=1} p_i \, R_i \\
&= V \sum_{i=1}^{b} p_i \, R_i
\end{aligned}
$$

Expected systemic loss index for Mexico*



*with Serafin Martinez-Jaramillo and team at Banco de Mexico, 2014

Expected systemic loss index

- expected losses per year within country in case of severe default and NO bailout

$\rightarrow$ rational decision on bailouts

- allows to compare countries
- allows to compare situation of country over time

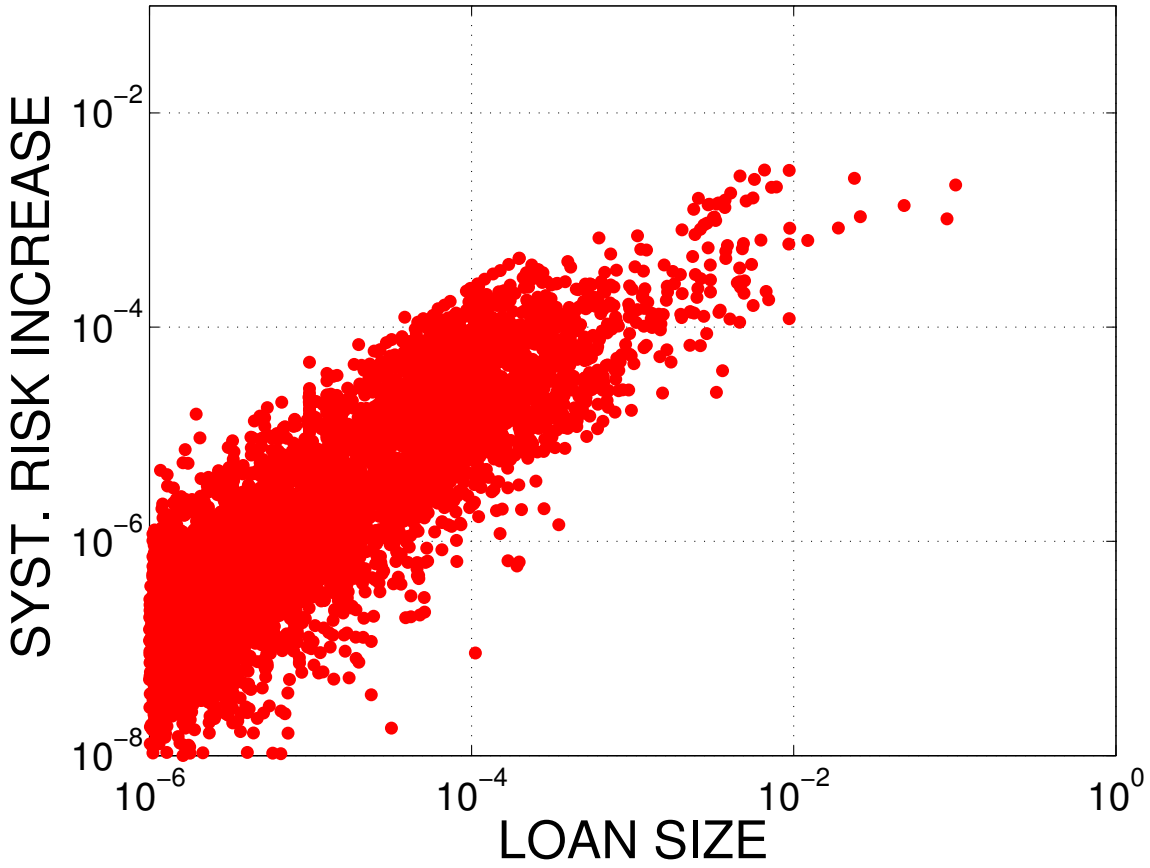
$\rightarrow$ are policy measures taking action in Spain? in Greece?

- note: **importance to to details !!!**

Observation

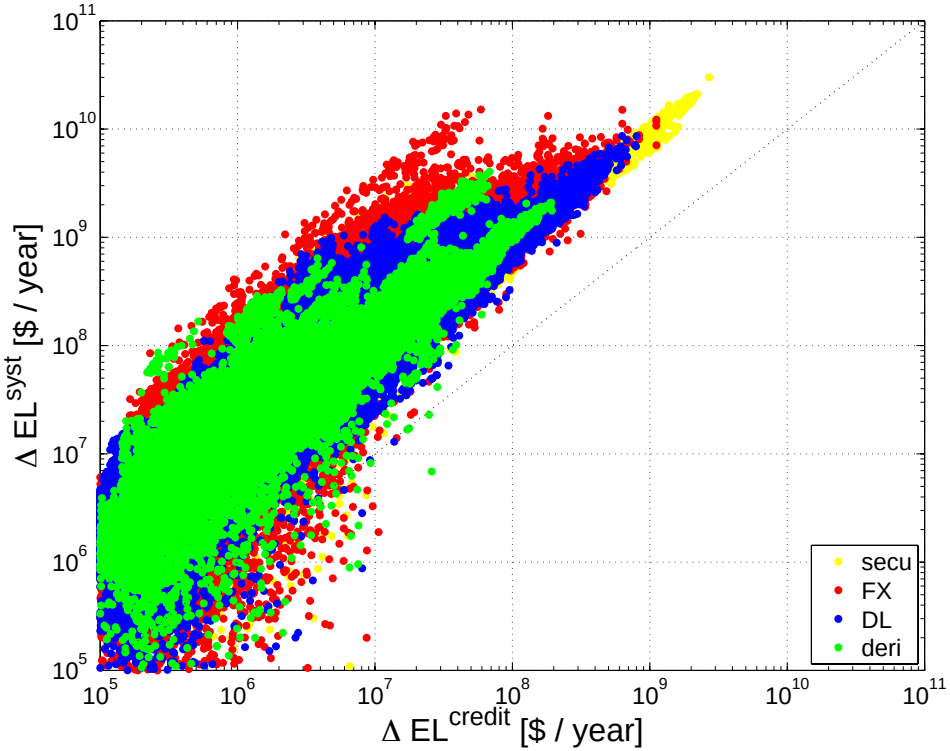
Systemic risk of a node changes with every transaction

Austria all interbank loans



note orders of magnitude !

Mexican data



$\Delta EL^{\text{syst}} > \Delta EL^{\text{credit}} \rightarrow$ defaults **do not only affect lenders** but involves third parties

systemic risk is an externality

Management of systemic risk

- systemic risk is a network property

$\rightarrow$ manage systemic risk: **re-structure financial networks** such that cascading failure becomes unlikely / impossible

systemic risk management

=

re-structure networks

Systemic risk elimination

- systemic risk spreads by borrowing from risky agents
- how risky is a transaction? $\rightarrow$ increase of expected syst. loss
- ergo: restrict transactions with high systemic risk

$\rightarrow$ **tax those transactions** that increase systemic risk

Systemic risk tax

- tax transactions according to their systemic risk contribution

$\rightarrow$ agents look for deals with agents with low systemic risk
$\rightarrow$ liability networks re-arrange $\rightarrow$ eliminate cascading

no-one should pay the tax – tax serves as incentive to re-structure networks

- size of tax = expected systemic loss of transaction (government is neutral)

- if system is risk free: no tax

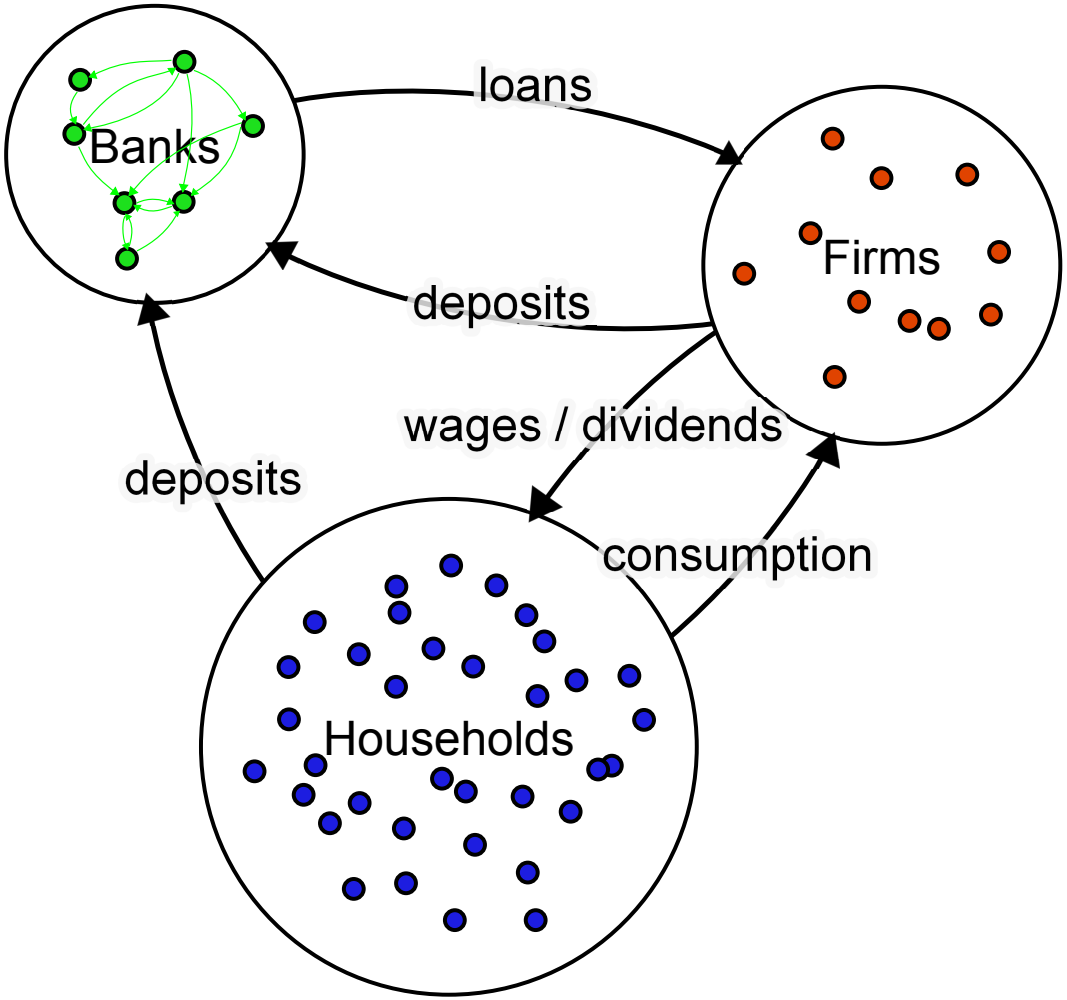
- **credit volume MUST not be reduced by tax**

Self-stabilisation of systemic risk tax

- those who can not lend become systemically safer
- those who are safe can lend and become unsafer
- $\rightarrow$ new equilibrium where systemic risk is distributed evenly across the network (cascading minimal)

$\rightarrow$ self-organized critical

To test efficacy of tax: Crisis Macro-Financial Simulator (schematic)



The agents

- **firms:** ask bank for loans: random size, maturity τ, $r^{\mathrm{f-loan}}$

$\rightarrow$ firms sell products to households: realise profit/loss

$\rightarrow$ if surplus $\rightarrow$ deposit it bank accounts, for $r^{\mathrm{f-deposit}}$

$\rightarrow$ firms are bankrupt if insolvent, or capital is below threshold

$\rightarrow$ if firm is bankrupt, bank writes off outstanding loans

- **banks** try to provide firm-loans. If they do not have enough

$\rightarrow$ approach other banks for interbank loan at interest rate r^{ib}

$\rightarrow$ bankrupt if insolvent or equity capital below zero

$\rightarrow$ bankruptcy may trigger other bank defaults

- **households** single aggregated agent: receives cash from firms (through firm-loans) and re-distributes it randomly in banks (household deposits, r^{h}), and among other firms (consumption)

For comparison: implement Tobin-like tax

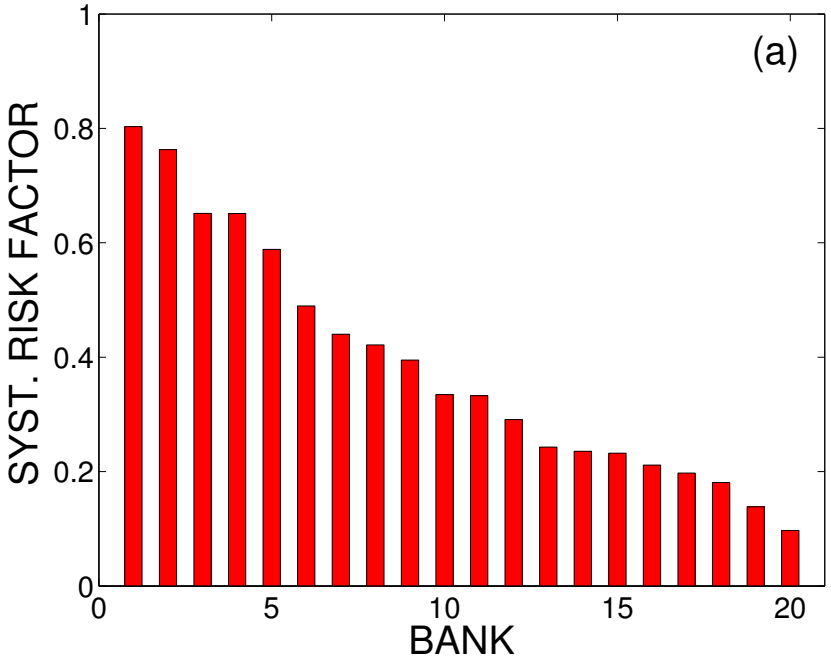
- tax all transactions regardless of their risk contribution
- 0.2% of transaction ($\sim$ 5% of interest rate)

Comparison of three schemes

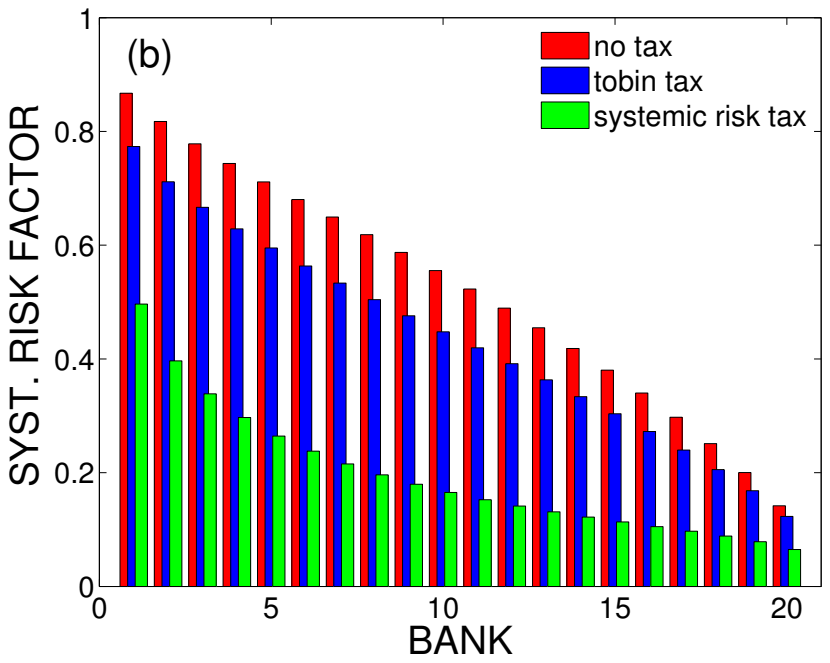
- No systemic risk management
- Systemic Risk Tax (SRT)
- Tobin-like tax

Model results: Systemic risk profile

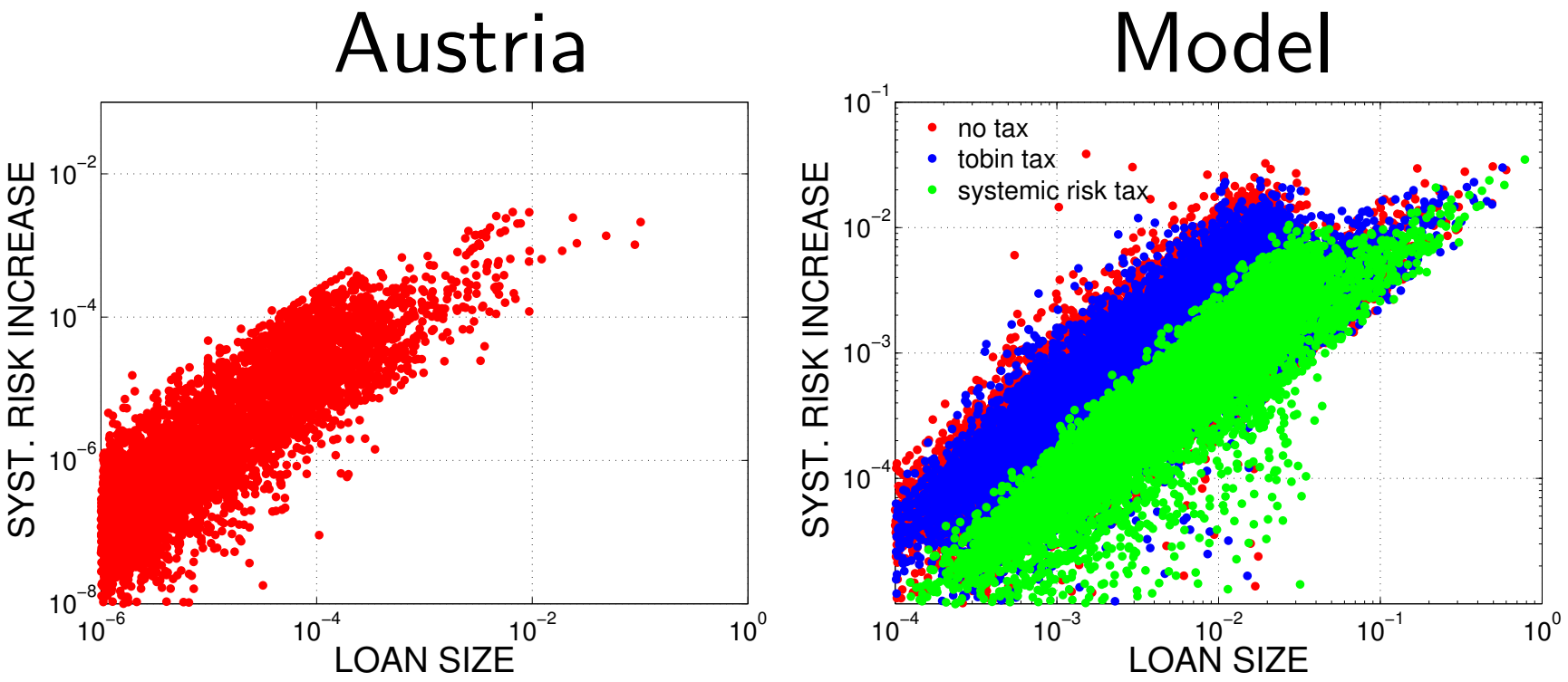
Austria



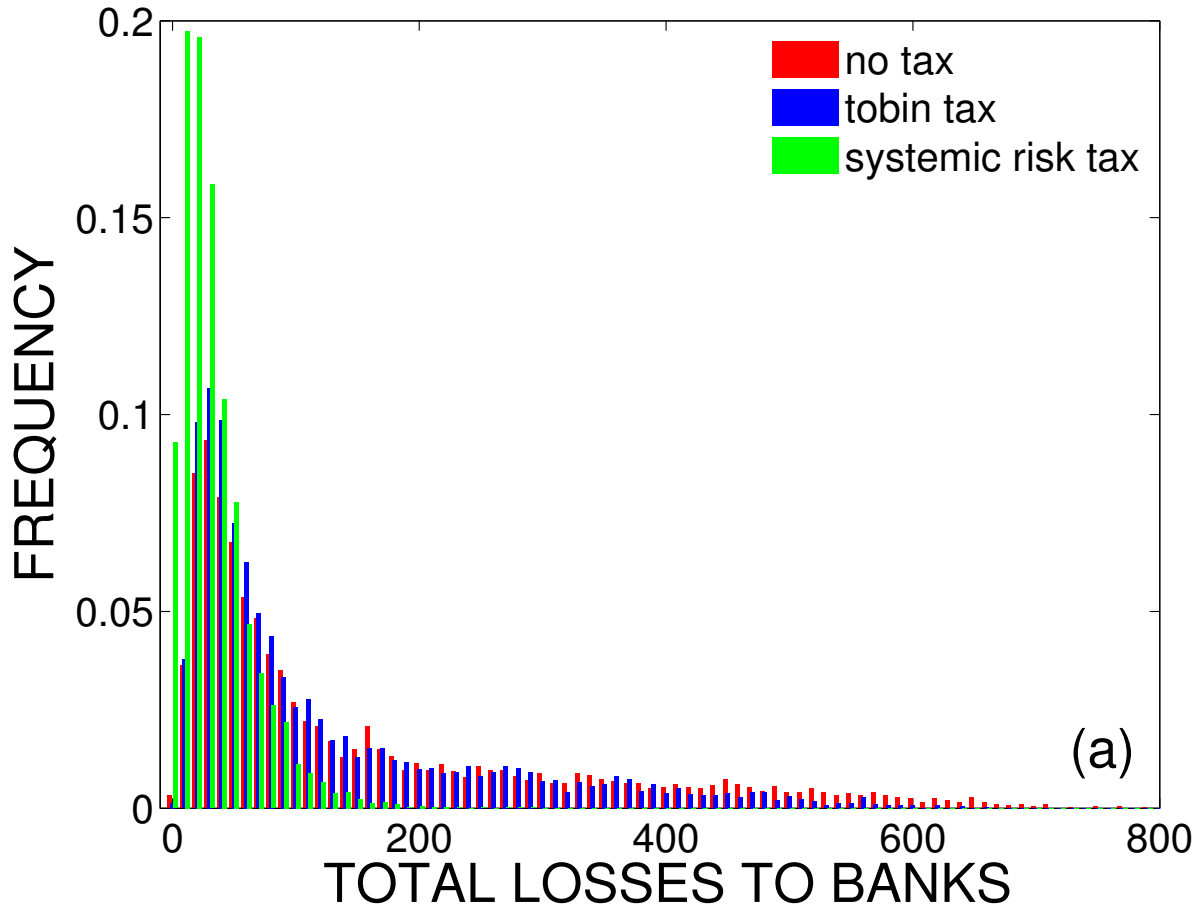
Model



Model results: Systemic risk of individual loans

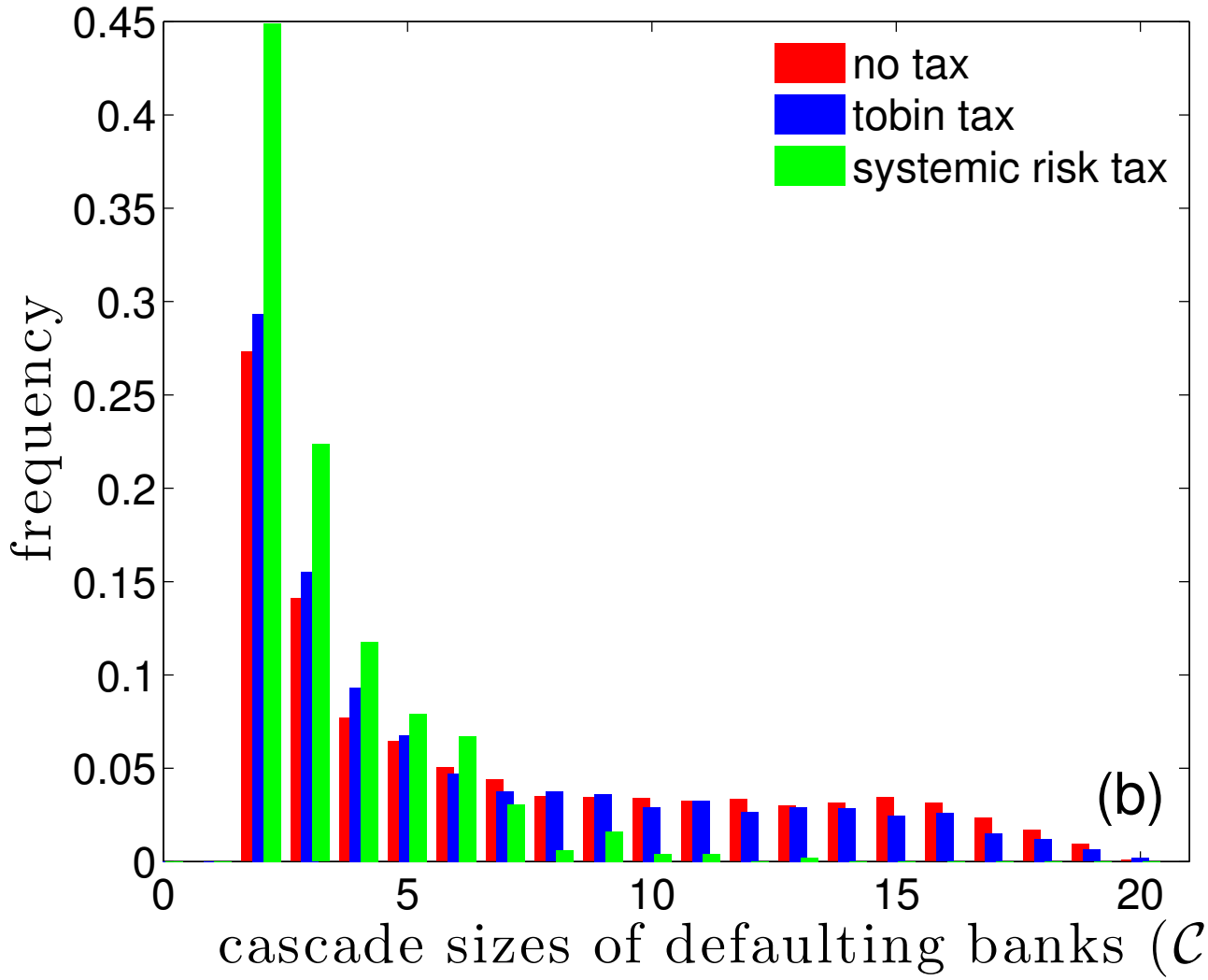


Model results: Distribution of losses

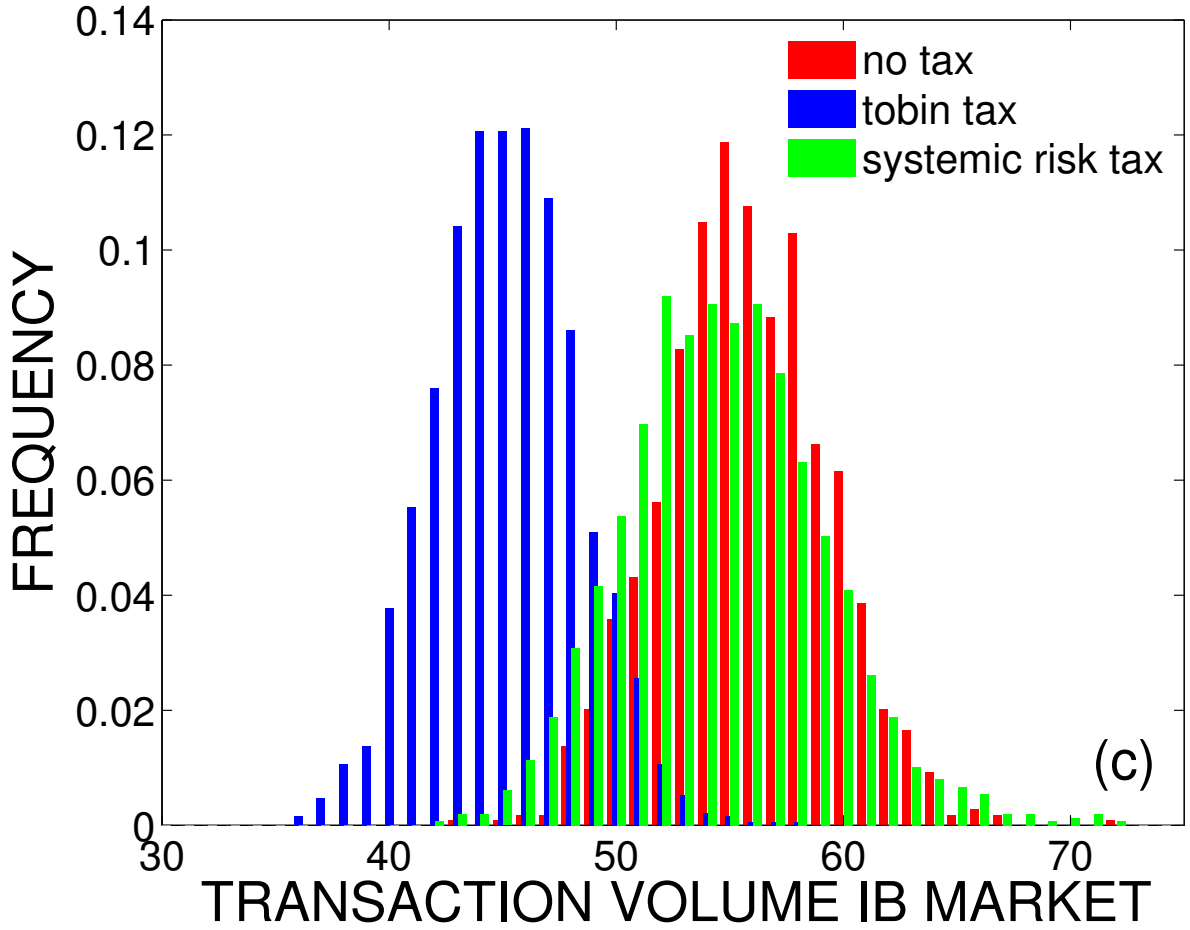


SRT eliminates systemic risk. How?

Model results: Cascading is suppressed



Model results: Credit volume



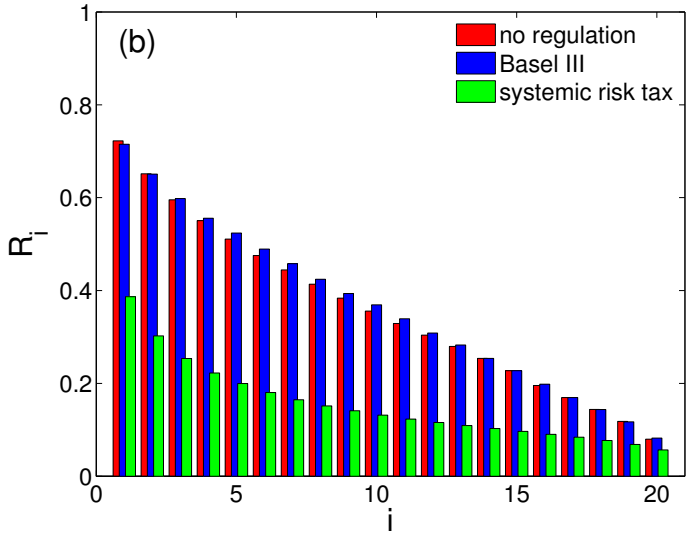
Tobin tax reduces risk by reducing credit volume

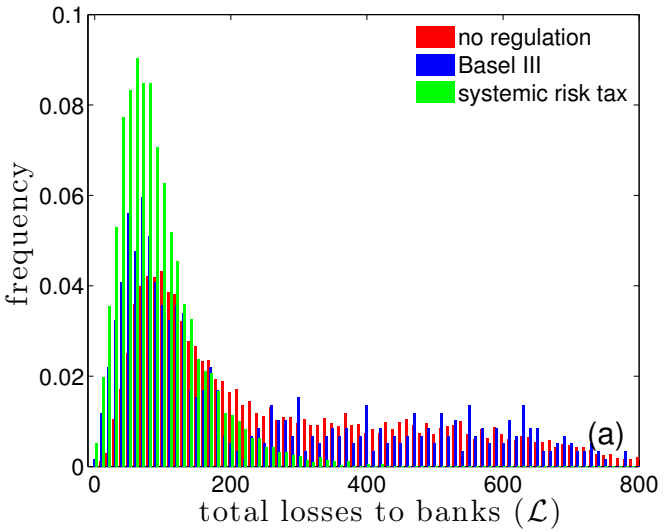
Mathematical proof:

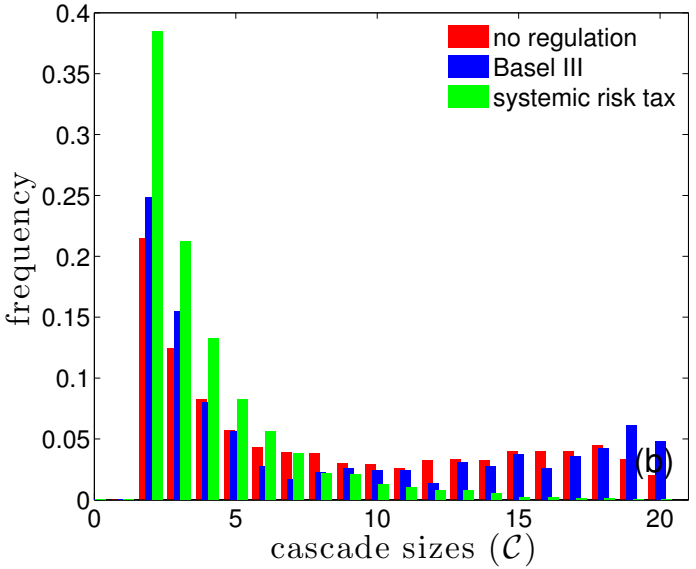
SR-free equilibrium under SRT exists

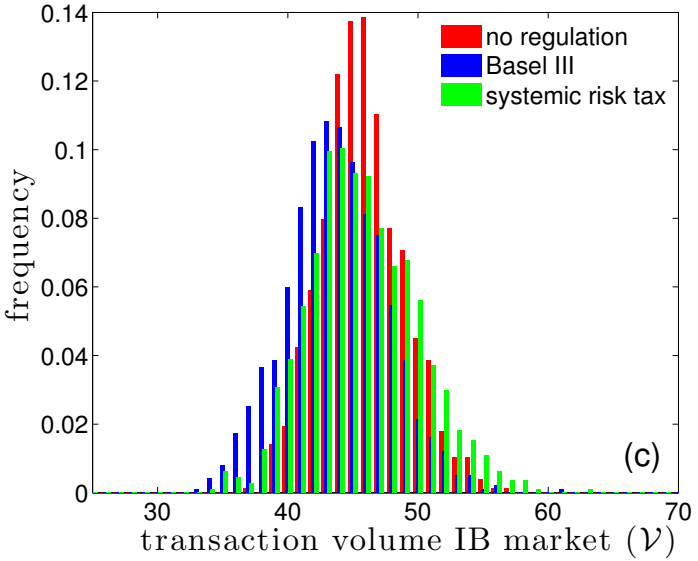
Basel III does not reduce SR

Basel III does not reduce SR !

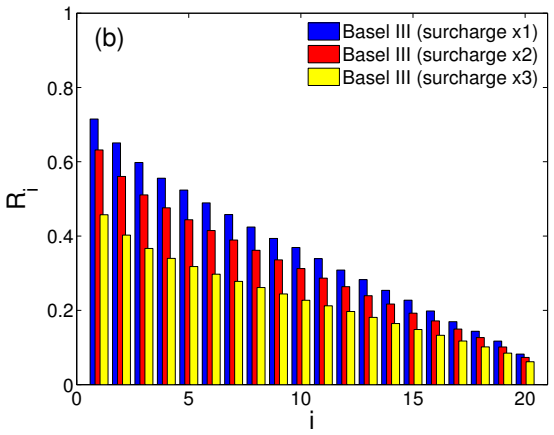


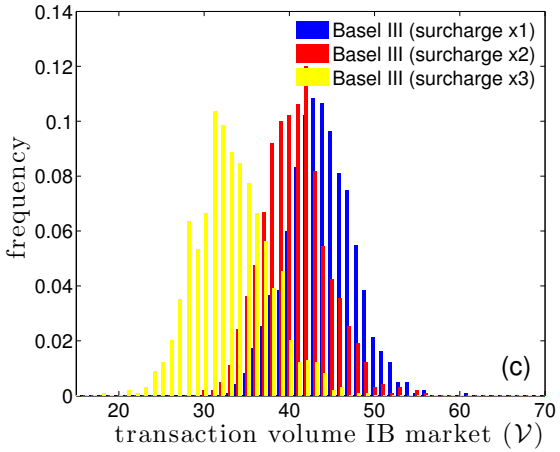


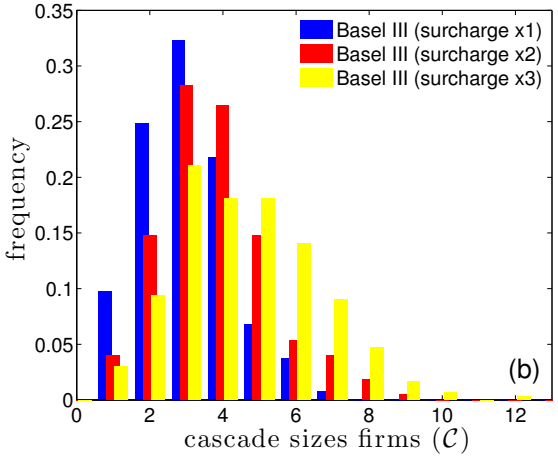




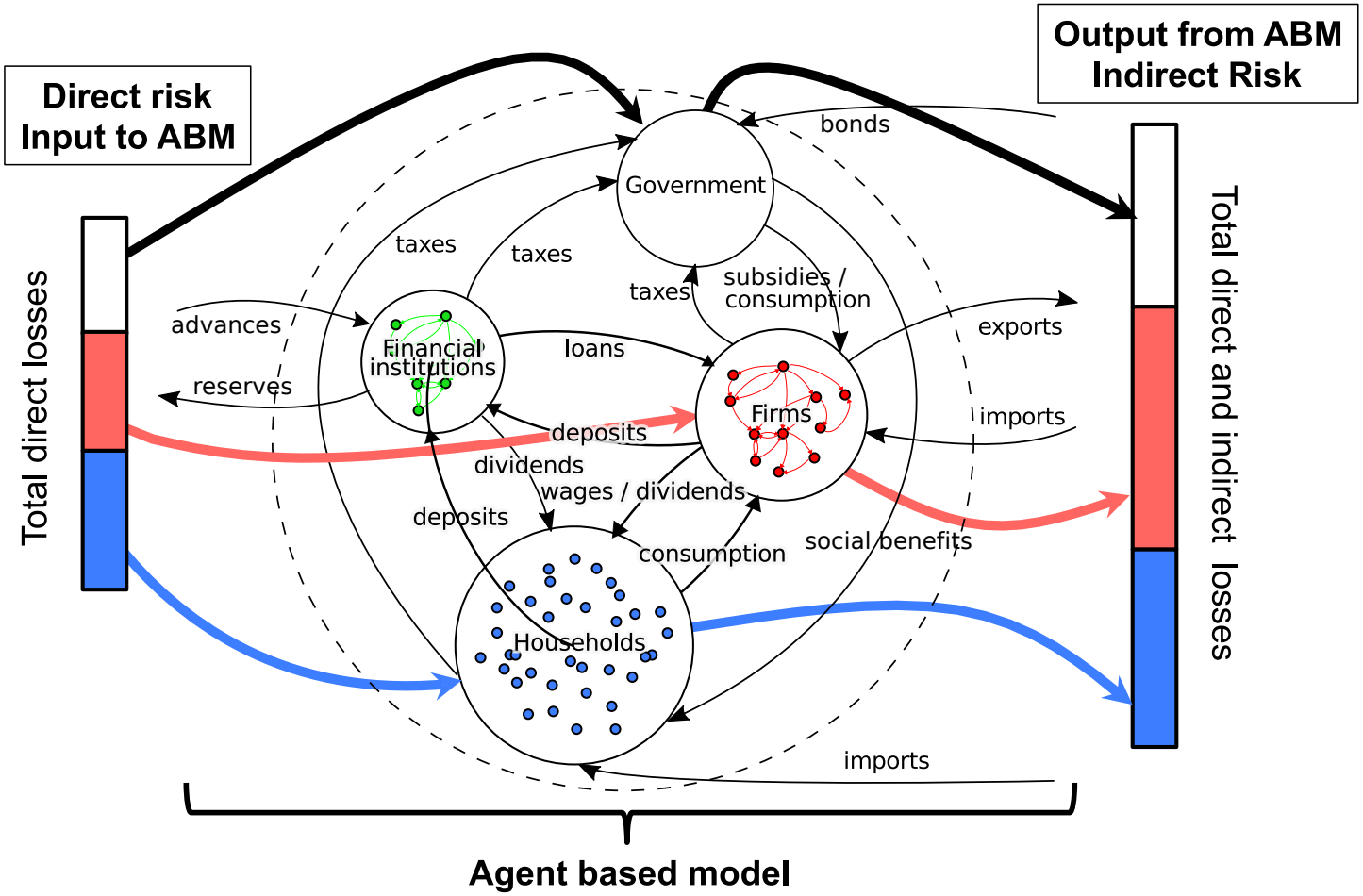
Basel III works under tremendous costs





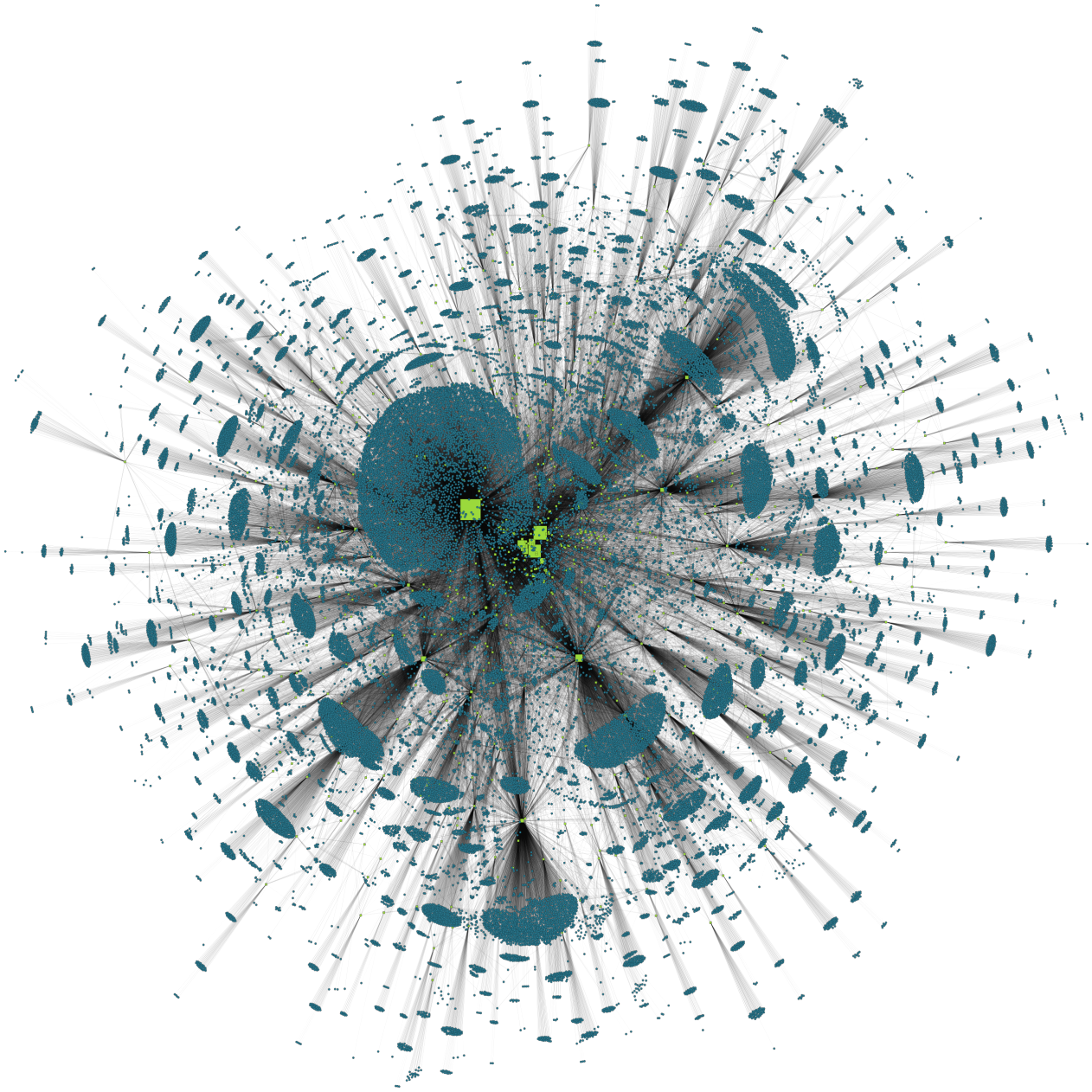


1:1 ABMs

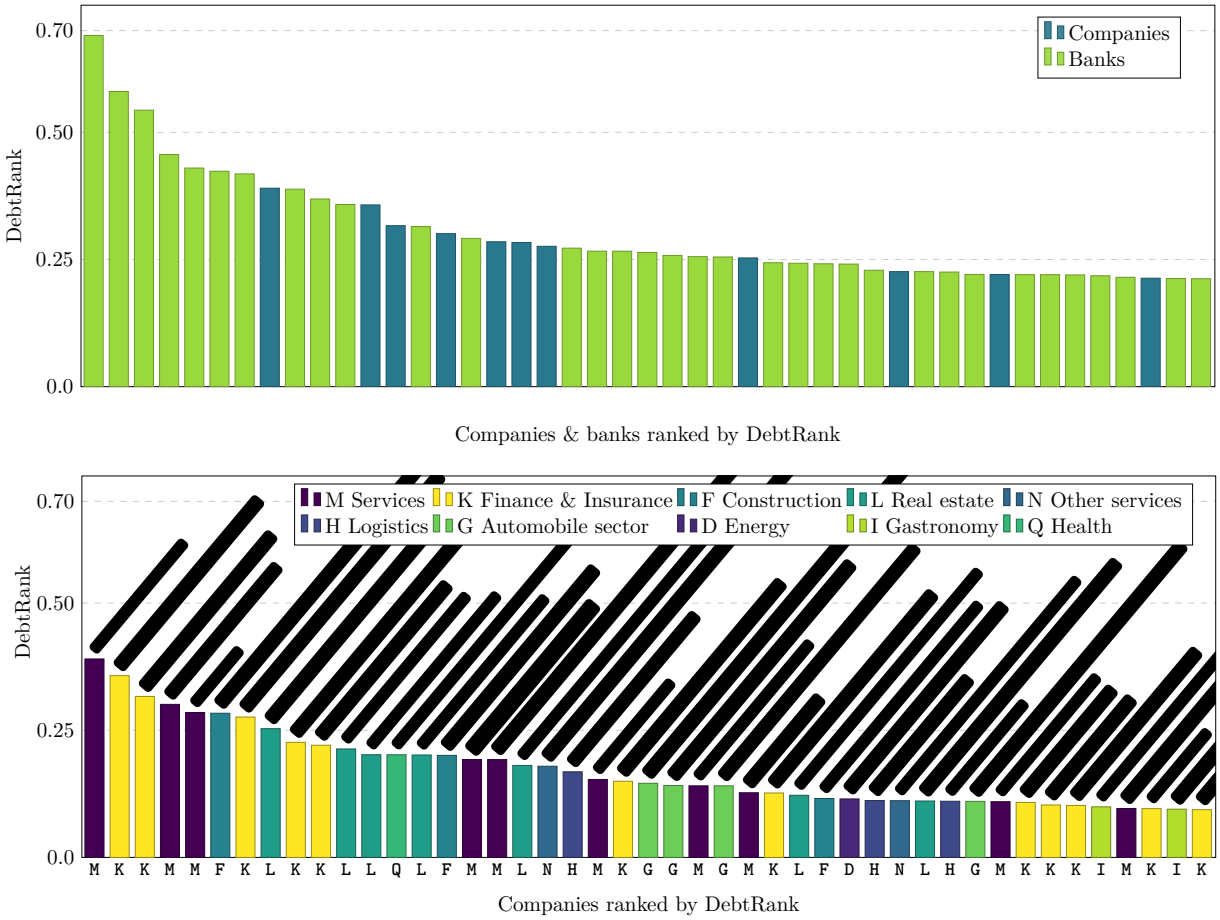

Direct risk
Input to ABM
Output from ABM
Indirect Risk
Total direct losses
Total direct and indirect losses
Government
bonds
taxes
taxes
taxes
subsidies /
consumption
advances
reserves
Financial
institutions
loans
exports
imports
Firms
deposits
dividends
wages / dividends
deposits
consumption
social benefits
Households
imports
Agent based model

1:1 data-driven ABM of Austria

- 10 million households
- 200.000 companies (70.000 balance sheet histories)
- 1.000 banks
- 1000s of government agents



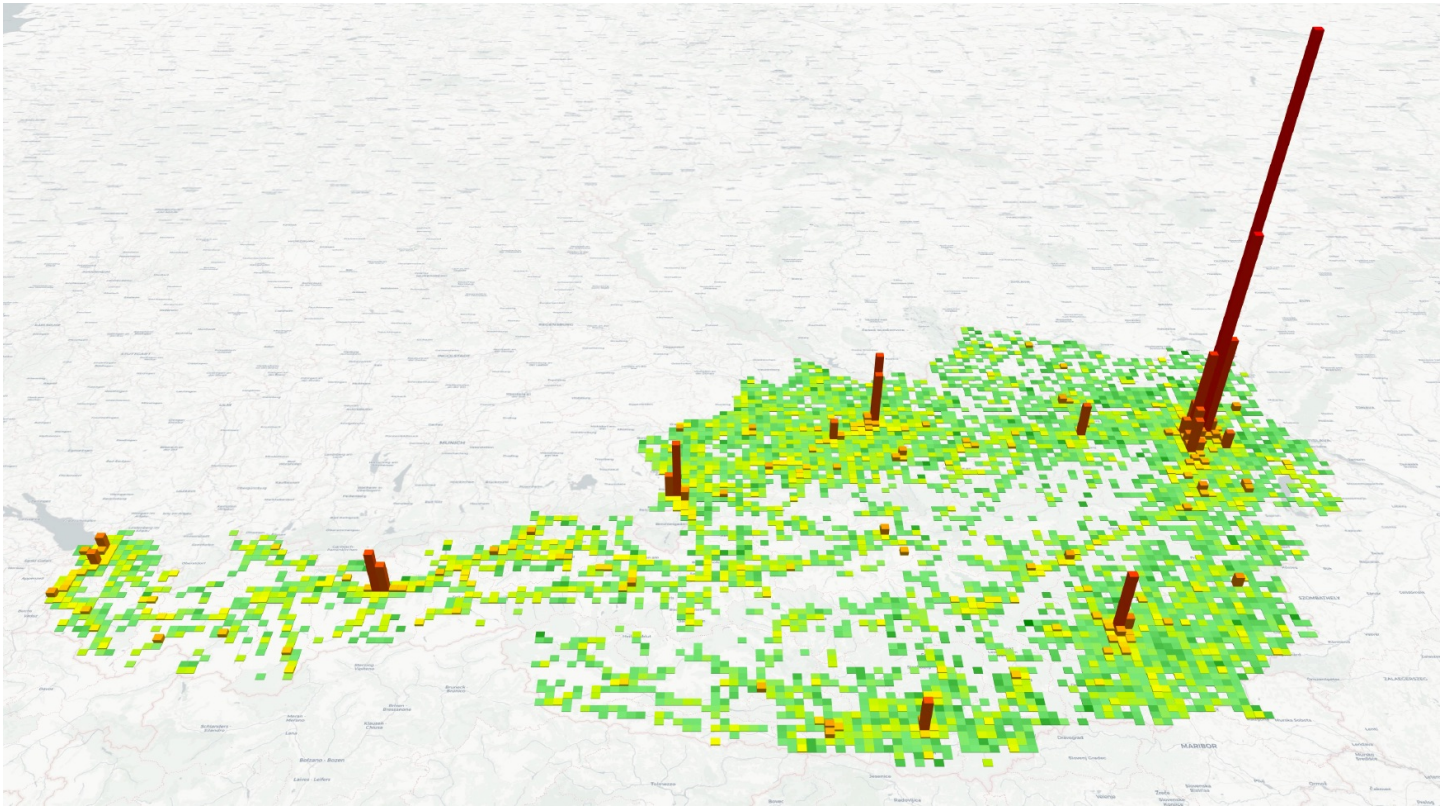
SR of companies



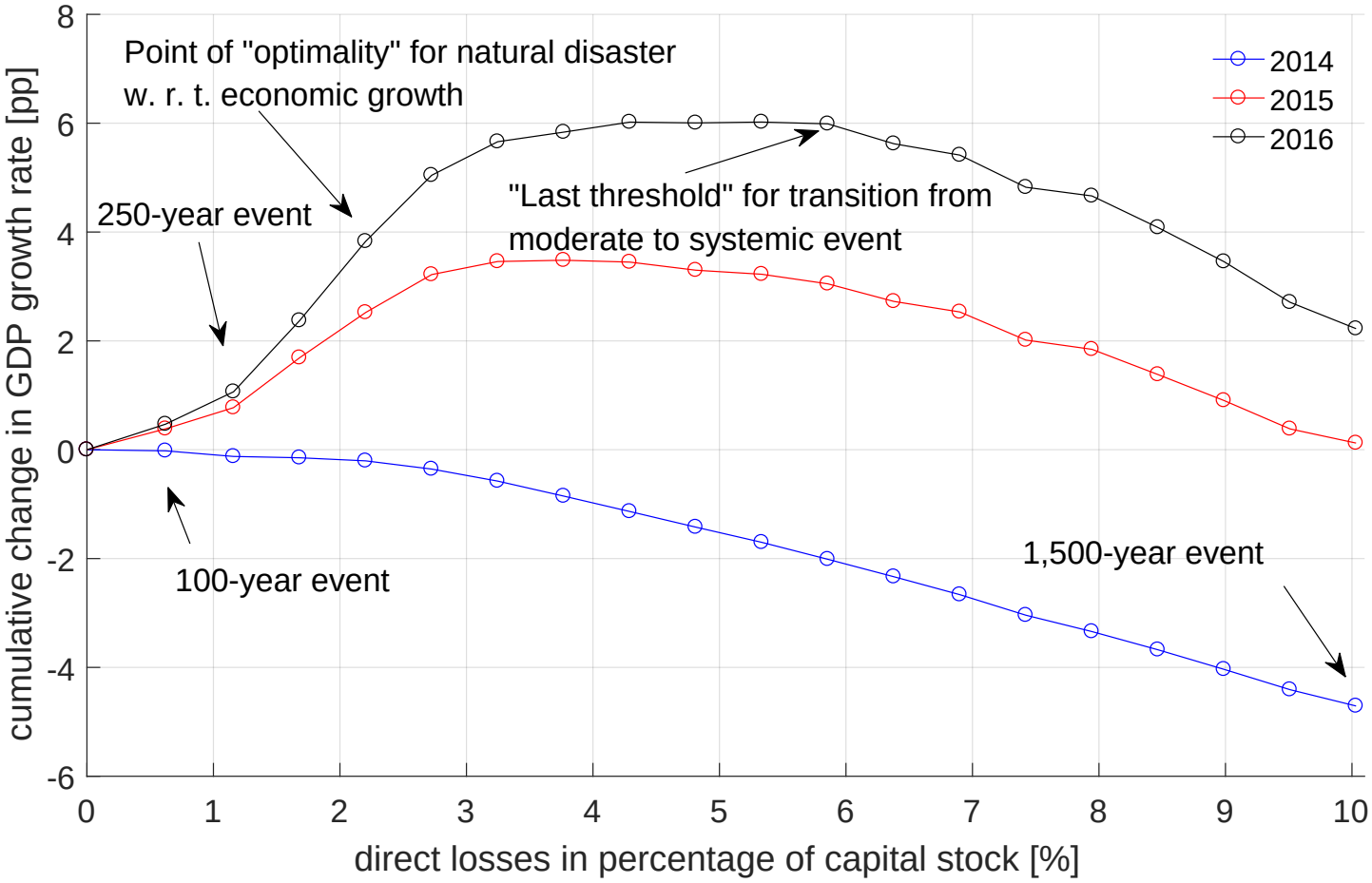
Message

more than half of the total financial SR comes from companies

1:1 ABMs in combination with external shocks



Optimal shock size?



Conclusions

- economies can be described without aggregation
- systemic risk is a network property – endogenously created
- can be measured for each institution / transaction: DebtRank
- can be eliminated by SRT; networks don't allow for cascading
- SRT should **not be payed!** – evasion re-structures networks
- SRT does not reduce credit volume; re-ordering transactions
- SR requires a multi-level network framework
- SR tax is technically feasible
- data driven ABMs can be used to **quantify** resilience

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Alternatives to systemic risk tax

- Mandatory CDS

- Markose: taxes banks – not transactions – according to eigenvalue centrality

Problem 1 eigenvector is not economically reasonable number

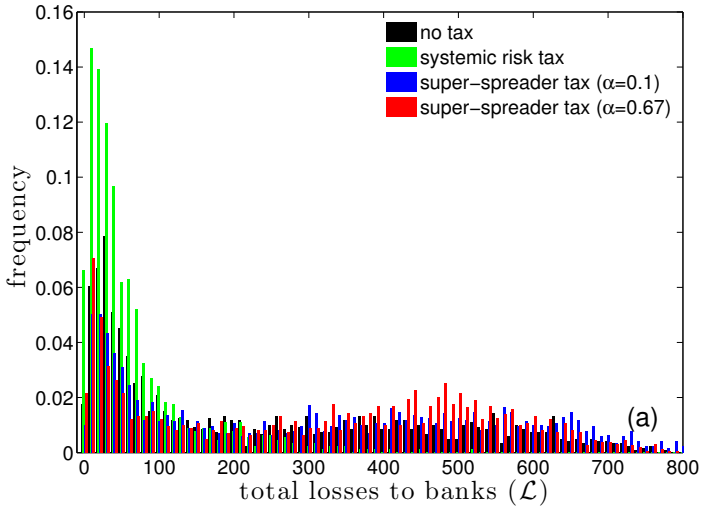
Problem 2 blind to cycles in contract networks

Problem 3 absurd size (up to 30% of capital)

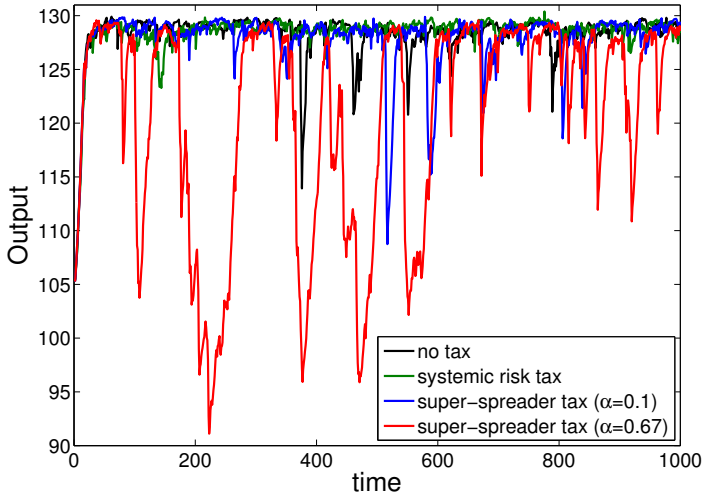
- Tax size: misses small SR institutions, SR improvement at tremendous economic cost

Markose proposal in macro-financial ABM

Losses



Output (GDP)



	No tax	SRT	SST (α=0.1)	SST (α=0.67)
Output	128.458 ± 1.792	128.382 ± 2.038	127.506 ± 3.278	**106.877 ± 20.706**
Unemployment	0.0017 ± 0.0102	0.0020 ± 0.0121	0.0059 ± 0.0204	**0.1520 ± 0.1533**
Credits (firms)	128.174 ± 18.990	121.435 ± 17.303	120.193 ± 19.397	**87.943 ± 29.958**
Interest (firms)	0.0238 ± 0.0015	0.0243 ± 0.0016	0.0241 ± 0.0017	**0.0248 ± 0.0023**

Statistical measures

- CoVAR: descriptive – not predictive!
- SES, SRISK: related to leverage and size
- DIP: market based – markets do not see NW-based SR

pro data publicly available, easy to implement

contra 'conditional' hard to define without knowledge of networks, descriptive, non-predictive