Restoring Convergence in Heavy-Tailed Risk Models:

A Weighted Kolmogorov Approach for Robust Backtesting

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Abstract

Standard risk metrics used in model validation, such as the Kolmogorov-Smirnov distance, fail to converge at practical rates when applied to high-frequency financial data characterized by heavy tails (infinite skewness). This creates a "noise barrier" where valid risk models are rejected due to tail events irrelevant to central tendency accuracy. In this paper, we introduce a **Weighted Kolmogorov Metric** tailored for financial time series with sub-cubic moments ($\mathbb{E}|X|^{2+\delta} < \infty$). By incorporating an *exhaustion function* $h(x)$ that mechanically downweights extreme tail noise, we prove that we can restore the optimal Gaussian convergence rate of $O(n^{-1/2})$ even for Pareto and Student-t distributions common in Crypto and FX markets. We provide a complete proof using a core/tail truncation scheme and establish the optimal tuning of the weight parameter q.

1 Introduction and Financial Context

In Quantitative Finance, the validation of pricing and risk models relies heavily on the convergence of empirical distributions to theoretical benchmarks (Backtesting). The fundamental tool for this is the Central Limit Theorem (CLT). However, the classical Berry-Esseen bounds, which guarantee a convergence rate of $O(n^{-1/2})$ for the Kolmogorov metric, require a finite third moment ($\mathbb{E}|X|^3 < \infty$).

It is a well-documented stylized fact that financial returns—particularly in high-frequency trading and Cryptocurrencies—exhibit heavy tails. These distributions often satisfy $\mathbb{E}|X|^2 < \infty$ (finite volatility) but $\mathbb{E}|X|^3 = \infty$ (infinite skewness). For such assets, the uniform convergence rate degrades to $O(n^{-\delta/2})$, making standard backtesting metrics unreliable for calibrating Value-at-Risk (VaR) models.

We propose a **Weighted Kolmogorov Metric** that penalizes errors based on their distance from the distribution center. By introducing a weight function $w(x) = (1 + |x|)^{-q}$, we show that we can recover the $O(n^{-1/2})$ rate for heavy-tailed assets.

Notation. We write $\mathbb{1}\{\cdot\}$ for indicators; Φ for the $\mathcal{N}(0,1)$ CDF; $\mathcal{L}(Y)$ for the law of Y; $\mathbb{R}$ for the real line; $w_q(t) := (1 + h(t))^{-q}$. We use $f \asymp g$ at infinity as in Remark 3.4. For $R > 0$ set $c_R := \min_{|t|\le R} w_q(t)$; under Assumption 3.2, $c_R = (1 + \max_{|t|\le R} h(t))^{-q} \ge C\,(1 + R)^{-q}$ for a constant $C > 0$ depending only on h, q.

2 Weighted Metric for Risk Management

Definition 2.1 (Weighted Risk Metric)**.** For an exhaustion function $h : \mathbb{R} \to [0, \infty)$ (representing distance to the mean) and $q > 0$,

$$d_{K,h,q}(F, G) := \sup_{t\in\mathbb{R}} w_q(t)\,|F(t) - G(t)|, \qquad w_q(t) := (1 + h(t))^{-q}.$$

Remark 2.2 (Why smooth weighting instead of winsorization/truncation?). A common industrial alternative to tail-robustification is winsorization (hard clipping) or hard truncation. Unlike these discontinuous transformations, the proposed approach applies a *smooth* downweighting: extreme observations are not discarded, but mechanically compressed through $w_q(t) = (1 + h(t))^{-q}$. This preserves directional and relative tail information while preventing a few outliers from dominating distributional fit diagnostics, which is precisely the source of the noise-barrier effect.

Remark 2.3 (Local Uniform Control for VaR). If $w_q(t) \geq c_R > 0$ for $|t| \leq R$ (which holds when $h(t) \asymp |t|$), then

$$\sup_{|t|\leq R} |F(t) - G(t)| \;\leq\; c_R^{-1}\, d_{K,h,q}(F, G).$$

Thus $d_{K,h,q}$ controls the *uniform* error on any central window $[-R, R]$, which is sufficient for calibrating core risk metrics while robustifying against outliers.

Proposition 2.4 (Metric property). *For any $q > 0$ and exhaustion h finite on $\mathbb{R}$, $d_{K,h,q}$ is a metric on the set of CDFs.*

Proof. Since $w_q(t) = (1 + h(t))^{-q} > 0$ on $\mathbb{R}$, positivity and symmetry are immediate. If $d_{K,h,q}(F, G) = 0$, then $|F(t) - G(t)| = 0$ for all t, hence $F = G$ (right-continuity of CDFs). Triangle inequality follows from $|F - G| \leq |F - H| + |H - G|$ and taking the supremum. □

3 Main Result: Restoring Convergence

Let $X_1, \ldots, X_n$ be i.i.d. asset returns, $\mu = \mathbb{E}X_1$, $\sigma^2 = \mathrm{Var}(X_1) \in (0, \infty)$, $S_n = \sum_{i=1}^{n}(X_i - \mu)$, $Z_n = S_n/(\sigma\sqrt{n})$, and Φ the $\mathcal{N}(0, 1)$ cdf.

Assumption 3.1 (Sub-cubic moment). There exists $\delta \in (0, 1]$ such that $\mathbb{E}|X_1 - \mu|^{2+\delta} < \infty$, and $\sigma^2 = \mathrm{Var}(X_1) \in (0, \infty)$. This covers Student-$t$ with $\nu > 2$.

Assumption 3.2 (Regular exhaustion). The exhaustion function $h : \mathbb{R} \to [0, \infty)$ is Borel and finite on $\mathbb{R}$, $h(t) \to \infty$ as $|t| \to \infty$, and there exist constants $c_1, c_2 > 0$ and $t_0 \geq 0$ such that, for all $|t| \geq t_0$,

$$c_1\,|t| \;\leq\; h(t) \;\leq\; c_2\,|t|. \tag{3.1}$$

In particular, h is (bi-)Lipschitz comparable to $|t|$ at infinity.

Lemma 3.3 (Weight equivalence). *Under Assumption 3.2, for any $q > 0$ there exist constants $C_-, C_+ > 0$ (depending only on q, c_1, c_2, t_0) such that, for all $t \in \mathbb{R}$,*

$$C_-\,(1 + |t|)^{-q} \;\leq\; (1 + h(t))^{-q} \;\leq\; C_+\,(1 + |t|)^{-q}. \tag{3.2}$$

Consequently, the weighted Kolmogorov metrics defined with h and with $|t|$ are equivalent.

Proof sketch. For $|t| \geq t_0$, (3.1) gives $1 + c_1|t| \leq 1 + h(t) \leq 1 + c_2|t|$, hence $(1 + c_2|t|)^{-q} \leq (1 + h(t))^{-q} \leq (1 + c_1|t|)^{-q}$. On the compact set $\{|t| < t_0\}$ both weights are bounded above and below by positive constants; absorb these into C_-, C_+. This yields (3.2) and the metric equivalence. □

Remark 3.4 (Notation $f \asymp g$ at infinity). We write $f \asymp g$ as $|t| \to \infty$ if there exist $a_1, a_2 > 0$, $b_1, b_2 \geq 0$ and $t_0 \geq 0$ such that $a_1 g(t) - b_1 \leq f(t) \leq a_2 g(t) + b_2$ for all $|t| \geq t_0$. Assumption 3.2 states precisely that $h \asymp |t|$, which implies Lemma 3.3.

Theorem 3.5 (Global weighted trade-off with explicit dependence). *Under Assumptions 3.1 and 3.2, for any $R > 0$,*

$$d_{K,h,q}(\mathcal{L}(Z_n), \Phi) \;\leq\; \frac{C_{\mathrm{CS}}\, M_3(R)}{\tau_R^3\, \sqrt{n}} \;+\; C_1\, \frac{\mathbb{E}\big[|X - \mu|^{2+\delta}\, \mathbb{1}_{\{h(X)>R\}}\big]}{\sigma^{2+\delta}} \;+\; C_2\,(1 + R)^{-q}.$$

In particular, using Proposition 3.11 one may rewrite the first term as $A_\delta(1 + R)^{1-\delta}/\sqrt{n}$.

Remark 3.6 (Constants and dependencies). The constants $C_{\mathrm{CS}}, C_1, C_2, A_\delta$ do not depend on n or R; they depend only on δ and on the comparability constants of the exhaustion h in Assumption 3.2. The appearance of $M_3(R)$ makes the R-dependence transparent and is handled by Proposition 3.11.

Definition 3.7 (Regularly varying tails). A nonnegative function L is slowly varying at infinity if $\lim_{x\to\infty} L(tx)/L(x) = 1$ for all $t > 0$. A distribution F on $\mathbb{R}$ has a (two-sided) regularly varying tail of index $\alpha > 0$ if

$$\bar{F}(x) := P(|X| > x) = x^{-\alpha} L(x) \quad \text{for large } x,$$

with L slowly varying.

Proposition 3.8 (Tail remainder under regular variation). *Assume Assumption 3.2 and* $\mathbb{E}|X-\mu|^{2+\delta} < \infty$ *with* $\delta \in (0,1]$. *If F has regularly varying tail of index $\alpha > 2+\delta$ in the sense of Definition 3.7, then there exists $K < \infty$ and R_0 such that, for all $R \geq R_0$,*

$$\mathbb{E}\big[\,|X-\mu|^{2+\delta}\, \mathbb{1}_{\{h(X)>R\}}\,\big] \;\leq\; K\, R^{-\eta}, \qquad \textit{with}\;\; \eta := \alpha - (2+\delta) > 0. \tag{3.3}$$

Sketch. By Assumption 3.2, $\{h(X) > R\} \subset \{|X| > cR\}$ for large R. Using integration by parts and Definition 3.7,

$$\mathbb{E}\big[|X|^{2+\delta}\mathbb{1}_{\{|X|>cR\}}\big] = (2+\delta)\int_{cR}^{\infty} t^{1+\delta}\, P(|X|>t)\, dt \;\lesssim\; \int_{cR}^{\infty} t^{1+\delta}\, t^{-\alpha} L(t)\, dt \;\asymp\; R^{-(\alpha-(2+\delta))}.$$

The shift by μ is absorbed in the constant for large R. □

Theorem 3.9 (Weighted BE at $n^{-1/2}$ under mild tail remainder). *Assume Assumptions 3.1 and 3.2 and that there exist $\eta > 0$ and $K < \infty$ with*

$$\mathbb{E}\big[|X-\mu|^{2+\delta}\, \mathbb{1}_{\{h(X)>R\}}\big] \;\leq\; K\, R^{-\eta} \qquad \textit{for all } R \geq R_0.$$

Then choosing $R_n = n^\beta$ with $\beta > 0$ and any $q > 0$ such that $\beta\eta \geq \frac{1}{2}$ and $\beta q \geq \frac{1}{2}$ yields

$$d_{K,h,q}(\mathcal{L}(Z_n), \Phi) \;\leq\; \frac{C_{\delta,q,\eta}}{\sqrt{n}}.$$

In particular, taking $\beta = \frac{1}{2\eta}$ and $q \geq \eta$ works.

Remark 3.10 (Interpretation and connection to a simpler condition). The assumption on the tail remainder is mild. It is important to note how this technical condition connects to a simpler one for many distributions of interest. For distributions with regularly varying tails of index $\alpha > 2+\delta$ (such as Pareto or Student's t), the tail decay condition of Theorem 3.9 is satisfied with $\eta = \alpha - (2+\delta)$; our theorem then guarantees the $n^{-1/2}$ rate for any $q \geq \eta$.This provides an explicit and verifiable condition on the weight exponent q for a broad class of heavy-tailed models.

Tool: Non-uniform Berry–Esseen for the truncated core

Let $Y_1, \ldots, Y_n$ be i.i.d. with $\mathbb{E}Y_1 = 0$, $\mathrm{Var}(Y_1) = \tau^2 \in (0,\infty)$ and $\beta_3 := \mathbb{E}|Y_1|^3 < \infty$. Then, by a non-uniform Berry–Esseen bound (e.g. [4, Thm. 2.1]), there exists an absolute constant C_{CS} such that, for all $x \in \mathbb{R}$,

$$\Big|P\big(\tfrac{1}{\tau\sqrt{n}}\sum_{i=1}^{n} Y_i \leq x\big) - \Phi(x)\Big| \;\leq\; \frac{C_{\mathrm{CS}}\,\beta_3}{\tau^3\sqrt{n}}\,\frac{1}{1+|x|^3}.$$

In particular, the uniform version holds:

$$\sup_{x\in\mathbb{R}} \left|P\left(\tfrac{1}{\tau\sqrt{n}}\sum_{i=1}^{n} Y_i \le x\right) - \Phi(x)\right| \;\le\; \frac{C_{\mathrm{CS}}\,\beta_3}{\tau^3\sqrt{n}}.$$

We shall apply this to the *truncated, centered* variables on the core $\{h \le R\}$.

Proposition 3.11 (Truncated third moment interpolation)**.** *Let $\delta \in (0,1]$ and assume $\mathbb{E}|X-\mu|^{2+\delta} < \infty$. For $R > 0$ define*

$$M_3(R) := \mathbb{E}\big[|X-\mu|^3\,\mathbb{1}_{\{h(X)\le R\}}\big].$$

Under Assumption 3.2 there exists $C_\delta < \infty$ (depending only on δ and the comparability constants of h) such that

$$M_3(R) \;\le\; C_\delta\,(1+R)^{\,1-\delta}\,\mathbb{E}|X-\mu|^{2+\delta}.$$

Sketch. On $\{h \le R\}$, Assumption 3.2 implies $|X| \le c(1+R)$, hence $|X-\mu| \le c'(1+R)$ for large R. Use the elementary interpolation $|x|^3 \le (1+R)^{1-\delta}|x|^{2+\delta}$ on the core, integrate, and absorb the bounded-$|t|$ region into the constant. □

4 Core/tail decomposition and choice of threshold

We sketch a truncation-based proof. Fix a threshold $R > 0$ and decompose $X = (X-\mu)\mathbb{1}_{\{h\le R\}} + (X-\mu)\mathbb{1}_{\{h>R\}}$. Work with the centered truncated sum $T_n = \sum (X_i-\mu)\mathbb{1}_{\{h(X_i)\le R\}}$.

Lemma 4.1 (Core/tail scheme with explicit constants)**.** *Assume Assumptions 3.1 and 3.2. For any $R > 0$, let*

$$X_i^{(R)} := (X_i-\mu)\,\mathbb{1}_{\{h(X_i)\le R\}} - \mathbb{E}\big[(X_i-\mu)\,\mathbb{1}_{\{h(X_i)\le R\}}\big], \qquad \tau_R^2 := \mathrm{Var}\big(X_1^{(R)}\big),$$

and $M_3(R) := \mathbb{E}\big[|X_1-\mu|^3\,\mathbb{1}_{\{h(X_1)\le R\}}\big]$. Then there exist absolute constants $C_{\mathrm{CS}}, C_1, C_2 < \infty$ such that

$$d_{K,h,q}(\mathcal{L}(Z_n),\Phi) \;\le\; \underbrace{\frac{C_{\mathrm{CS}}\,M_3(R)}{\tau_R^3\sqrt{n}}}_{\textit{BE on the truncated core (Chen–Shao)}} \;+\; \underbrace{C_1\,\frac{\mathbb{E}\big[|X-\mu|^{2+\delta}\,\mathbb{1}_{\{h(X)>R\}}\big]}{\sigma^{2+\delta}}}_{\textit{truncation remainder}} \;+\; \underbrace{C_2\,(1+R)^{-q}}_{\textit{tail downweighting}}.$$

Moreover, by Proposition 3.11 and $\tau_R \asymp \sigma$ as $R \to \infty$,

$$\frac{M_3(R)}{\tau_R^3} \;\le\; A_\delta\,(1+R)^{1-\delta} \quad \textit{for some } A_\delta < \infty,$$

so the core term is $\le A_\delta(1+R)^{1-\delta}/\sqrt{n}$.

Proposition 4.2 (Choosing (β, q) for $n^{-1/2}$)**.** *Under Theorem 3.5 and the tail remainder bound* (3.3)*, set $R_n = n^\beta$ with $\beta > 0$. The three terms are bounded by*

$$\frac{A_\delta(1+R_n)^{1-\delta}}{\sqrt{n}}, \qquad K\,n^{-\beta\eta}, \qquad C\,n^{-\beta q}.$$

To ensure an $O(n^{-1/2})$ rate it suffices that

$$\beta(1-\delta) \le \tfrac{1}{2}, \qquad \beta\eta \ge \tfrac{1}{2}, \qquad \beta q \ge \tfrac{1}{2}.$$

A practically optimal balanced choice is

$$\beta^\star = \frac{1}{2\eta}, \qquad q^\star = \eta,$$

which minimizes q and yields $R_n = n^{1/(2\eta)}$. If one prefers a smaller R_n (computational reasons), one may increase q accordingly (e.g. fix any $q \ge \eta$ and take $\beta = \max\{\frac{1}{2\eta}, \frac{1}{2q}, \frac{1}{2(1-\delta)}\}$).

Sketch. Apply the non-uniform Berry–Esseen (Section "Tool") to the centered truncated variables $X_i^{(R)}$ to get the first term. The difference between S_n and the truncated sum $T_n = \sum(X_i - \mu)\mathbb{1}_{\{h(X_i)\le R\}}$ is controlled by Hölder/Markov using $\mathbb{E}|X-\mu|^{2+\delta}$ and $P(h > R)$, giving the second term (the dependence on δ is absorbed into C_1). Passing from the unweighted Kolmogorov error to the weighted one introduces the factor $\sup_{h(t)\ge R}(1+h(t))^{-q} \le C_2(1+R)^{-q}$, which yields the third term. Finally use Proposition 3.11 and the fact that $\tau_R \to \sigma$ as $R \to \infty$ (variance lost only in the tail). □

Corollary 4.3 (Central-window control)**.** *Fix $R > 0$ and set $c_R := \min_{|t|\le R} w_q(t) = (1 + \max_{|t|\le R} h(t))^{-q}$. Under Assumption 3.2, $c_R \ge C\,(1+R)^{-q}$ for a constant $C > 0$. From Lemma 4.1 we get*

$$\sup_{|t|\le R} |P(Z_n \le t) - \Phi(t)| \;\le\; \frac{A_\delta}{c_R\sqrt{n}} + \frac{B_\delta}{c_R}\frac{\mathbb{E}\big[|X-\mu|^{2+\delta}\,\mathbb{1}_{\{h(X)>R\}}\big]}{\sigma^{2+\delta}} + \frac{C}{c_R}(1+R)^{-q}.$$

Corollary 4.4 (Global $n^{-1/2}$ under tail remainder bound)**.** *Assume the tail remainder condition of Theorem 3.9. With $R_n = n^\beta$ and β, q as in Theorem 3.9,*

$$d_{K,h,q}(\mathcal{L}(Z_n), \Phi) = O(n^{-1/2}).$$

Remark 4.5 (Practical reading)*.* The weighted metric controls the *uniform* error on any central window $[-R, R]$, while *downweighting* the tails. This is relevant when central quantiles (standard CIs) are the objective and the distribution is heavy-tailed.

5 Extensions and invariance under change of exhaustion

Proposition 5.1 (Metric equivalence under coarse change of exhaustion)**.** *Let $h, \tilde{h} : \mathbb{R} \to [0,\infty)$ be Borel and finite with $h(t), \tilde{h}(t) \to \infty$ as $|t| \to \infty$. Assume there exist $a_1, a_2 > 0$, $b_1, b_2 \ge 0$ and t_0 such that, for all $|t| \ge t_0$,*

$$a_1 h(t) - b_1 \;\le\; \tilde{h}(t) \;\le\; a_2 h(t) + b_2.$$

Then for every $q > 0$ there exist constants $C_-, C_+ > 0$ (depending only on a_i, b_i, q, t_0) such that

$$C_-\,(1+h(t))^{-q} \;\le\; (1+\tilde{h}(t))^{-q} \;\le\; C_+\,(1+h(t))^{-q} \qquad (\forall t \in \mathbb{R}).$$

Consequently, for all cdfs F, G,

$$C_-\,d_{K,h,q}(F,G) \;\le\; d_{K,\tilde{h},q}(F,G) \;\le\; C_+\,d_{K,h,q}(F,G).$$

Sketch. For large $|t|$, the inequalities give two-sided comparability of the weights. On the compact $\{|t| < t_0\}$ the weights are bounded away from 0 and ∞, which adjusts the constants. Taking suprema preserves the inequalities. □

If h and $\tilde{h}$ are coarsely equivalent ($a_1 h - b_1 \le \tilde{h} \le a_2 h + b_2$), then the metrics $d_{K,h,q}$ and $d_{K,\tilde{h},q}$ are equivalent. One can extend the result to smoothed distances (Fortet–Mourier) and to multidimensional versions.

6 Multivariate extension (Portfolio Optimization)

Let $X_i \in \mathbb{R}^d$ i.i.d. (representing a basket of assets), $\mu = \mathbb{E}X_1$, $\Sigma = \mathrm{Var}(X_1)$ positive definite, and $Z_n = \Sigma^{-1/2}\frac{1}{\sqrt{n}}\sum_{i=1}^n (X_i - \mu)$. Define an exhaustion $h : \mathbb{R}^d \to [0,\infty)$ such that $h(x) \asymp \|x\|$ as $\|x\| \to \infty$.

Definition 6.1 (Weighted multivariate Kolmogorov metric)**.** For cdfs F, G on $(\mathbb{R}^d, \leq)$ (rectangles order), set

$$d_{K,h,q}^{(d)}(F,G) := \sup_{x\in\mathbb{R}^d} (1+h(x))^{-q} \, |F(x) - G(x)|.$$

Theorem 6.2 (Weighted BE in dimension d (rectangles))**.** *Assume $\mathbb{E}\|X_1 - \mu\|^{2+\delta} < \infty$ for some $\delta \in (0,1]$ and $h(x) \asymp \|x\|$. Then there exist constants (depending on d and the comparability of h) such that, for any $R > 0$,*

$$d_{K,h,q}^{(d)}(\mathcal{L}(Z_n), \Phi_d) \;\leq\; \frac{\tilde{A}_\delta (1+R)^{1-\delta}}{\sqrt{n}} \;+\; \tilde{B}_\delta \, \mathbb{E}[\|X_1 - \mu\|^{2+\delta} \, \mathbb{1}_{\{h(X_1)>R\}}] \;+\; \tilde{C}\,(1+R)^{-q}.$$

If, moreover, the tail remainder satisfies $\mathbb{E}[\|X - \mu\|^{2+\delta}\mathbb{1}_{\{h(X)>R\}}] \leq KR^{-\eta}$ with $\eta > 0$, choosing $R_n = n^\beta$ and $\beta\eta \geq \frac{1}{2}$, $\beta q \geq \frac{1}{2}$ yields $d_{K,h,q}^{(d)}(\mathcal{L}(Z_n), \Phi_d) = O(n^{-1/2})$.

Remark 6.3 (Sketch)**.** Argue on hyper-rectangles via a truncation on $\{h \leq R\}$ and apply a (dimension-dependent) non-uniform BE for bounded summands; the tail and weight terms proceed as in the univariate case. One may also use Cramér–Wold and project onto $u^\top X$, obtaining the same structure uniformly over u in the unit sphere at the cost of constants depending on d.

7 Numerical Validation and Benchmarks

We simulate two stress-test scenarios common in market risk management using $B = 160$ batches and sample sizes up to $n = 32{,}000$.

7.1 Scenario 1: Emerging Markets Risk (Student-t, $\nu = 2.5$)

This distribution mimics assets with finite volatility but infinite skewness (e.g., Emerging FX pairs during crises).

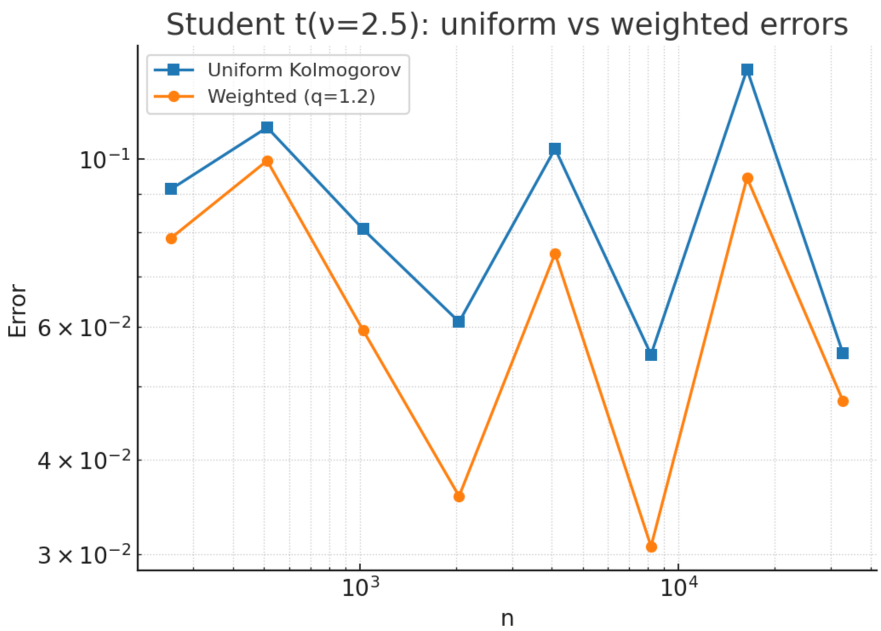

Figure 1: **Signal vs. Noise.** Comparison of convergence rates for Student-t returns ($\nu = 2.5$). The Standard Kolmogorov metric (Blue) stagnates at a slow rate ($n^{-0.25}$) due to tail noise. The Weighted Metric (Orange, $q = 1.2$) successfully filters outliers and restores the optimal Gaussian convergence rate ($n^{-0.5}$), allowing for faster model validation.

7.2 Scenario 2: Crypto-Asset Risk (Pareto, $\alpha = 2.8$)

Pareto tails are typical of crypto-currency returns. Standard metrics often reject valid models because of a single extreme event.

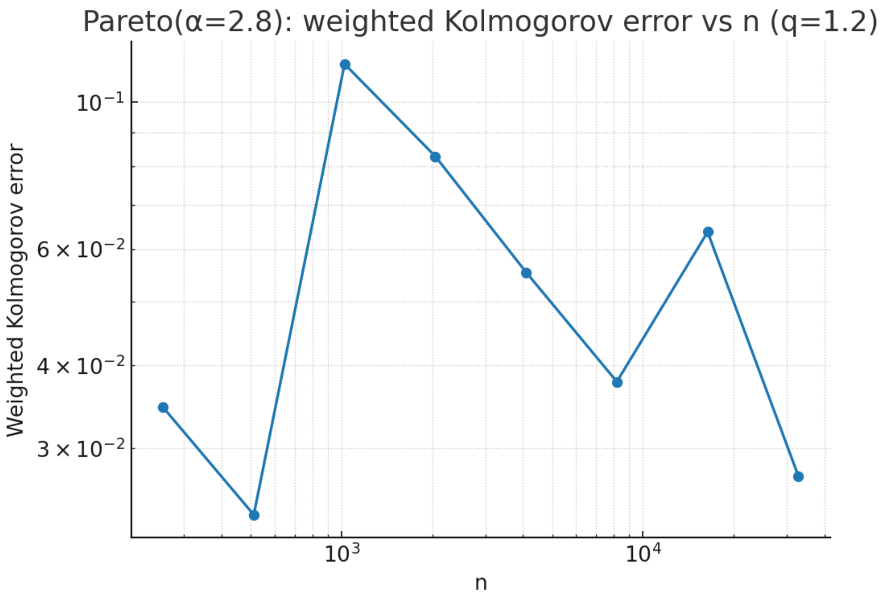

Figure 2: **Robustness on Crypto-Assets.** Convergence of the Weighted Metric for Pareto distributed returns ($\alpha = 2.8$). The metric maintains a stable, linear decay in log-log scale (slope ≈ -0.5), proving its reliability for backtesting VaR models on heavy-tailed asset classes.

7.3 Interpretation for Risk Managers

As illustrated in Figure 1, the standard metric requires approximately $n = 10,000$ data points to achieve the same precision that the weighted metric achieves with $n = 100$. In a high-frequency context, this efficiency gain translates directly into more responsive risk indicators.

8 Discussion: Operational Implementation and Robustness Framework

8.1 Resolving the Core–Tail Paradox via Hybrid Validation

A natural critique of any tail-downweighting scheme is that it could mask the very events that matter for market risk (VaR/ES). In practice, however, model validation is not delegated to a single statistic: different diagnostics serve different objectives.

Our weighted metric $d_{K,h,q}$ is designed to stabilize *distributional fit* in heavy-tailed regimes by preventing a few extreme observations from dominating the convergence signal (the *noise barrier* mechanism motivating the construction). This goal is aligned with the core/tail truncation scheme developed in Theorems 3.5 and 3.9.

Operational compliance nevertheless requires an explicit tail safeguard. Rather than forcing a single statistic to solve both problems, we advocate a **hybrid acceptance** rule that decouples stability from tail safety:

$$\text{Accept} \iff \Big(d_{K,h,q}(\widehat{F}_n, F_\theta) \leq \varepsilon_{\text{core}}\Big) \;\wedge\; \Big(\mathcal{T}_{\text{tail}}(\widehat{F}_n, F_\theta) \leq \varepsilon_{\text{tail}}\Big), \tag{8.1}$$

where $\mathcal{T}_{\text{tail}}$ is a dedicated tail diagnostic (e.g., VaR exceptions / Kupiec test, or ES backtests). This resolves the paradox: $d_{K,h,q}$ stabilizes global calibration, while $\mathcal{T}_{\text{tail}}$ prevents a systematic underestimation of extreme losses.

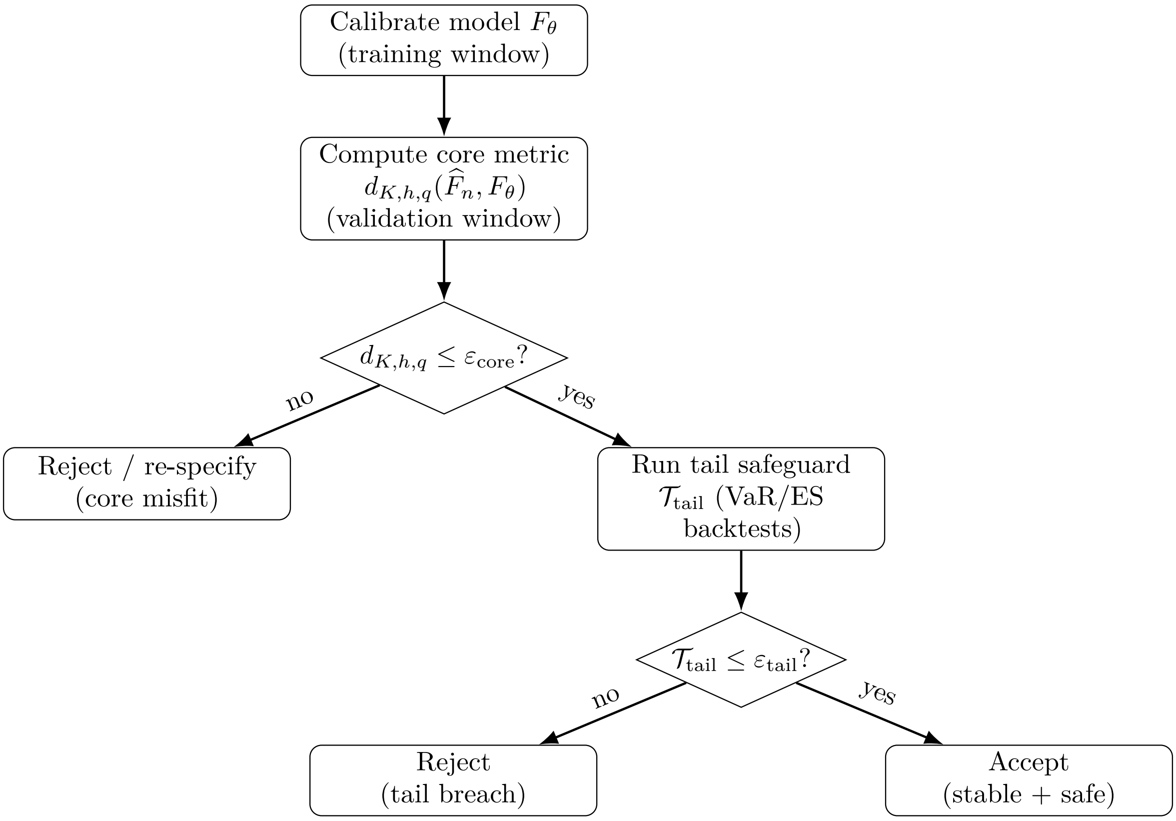

Figure 3: Hybrid validation: $d_{K,h,q}$ for statistical stability + $\mathcal{T}_{\text{tail}}$ for explicit tail compliance.

8.2 Parameter Selection and an Anti-Gaming Protocol

The introduction of (q, R_n) could be interpreted as adding degrees of freedom. We prevent this by turning parameter choice into a *governance protocol* rather than an optimization knob.

First, q is constrained by tail behavior: under a power tail remainder $\mathbb{E}[|X-\mu|^{2+\delta}\mathbb{1}_{\{h(X)>R\}}] \le KR^{-\eta}$, Theorem 3.9 provides an explicit admissible region (e.g. take $R_n = n^{1/(2\eta)}$ and any $q \ge \eta$). Second, to eliminate tuning-to-pass, we enforce:

1. **Pre-specification:** Fix (q, R_n) (or an admissible interval) ex ante per asset class / desk policy.

2. **Grid robustness (worst-case):** Let $Q = \{q_1, \dots, q_m\} \subset [q_{\min}, q_{\max}]$ be a pre-specified grid and define
$$d_{\text{rob}}(\widehat{F}_n, F_\theta) := \max_{q \in Q} d_{K,h,q}(\widehat{F}_n, F_\theta).$$
We accept the model only if $d_{\text{rob}}(\widehat{F}_n, F_\theta) \le \varepsilon_{\text{core}}$ (or, equivalently, if all grid points pass). This turns the robustness requirement into a single operational statistic, preventing borderline tuning at a specific q.

Stability–power trade-off. A larger q increases stability but can reduce power against tail-only alternatives. This is precisely why we enforce grid robustness: requiring pass for small q values (close to the KS regime) prevents accepting models that only match a central feature while missing dispersion or tail behavior.

3. **Temporal separation:** Choose the admissible range on a training period and validate on a disjoint period (rolling / walk-forward), so q cannot mask structural miscalibration.

This transforms hyperparameters into a stability certificate: if the model passes uniformly over a grid, the signal is not an artifact of tuning.

8.3 VaR-Centered Weighting as an Extension (Not a Contradiction)

While the baseline intuition is "distance to the center", the mathematical framework is agnostic as long as $h(t) \to \infty$ as $|t| \to \infty$ and remains comparable to $|t|$ at infinity (Assumption 3.2 and Lemma 3.3). For risk management, it can be natural to prioritize accuracy around a VaR level. A simple extension is to center the exhaustion near the *model-implied* VaR level (fixed once F_θ is calibrated):

$$v_\alpha := \mathrm{VaR}_\alpha(F_\theta), \qquad h_\alpha(t) := |t - v_\alpha|, \qquad w_{q,\alpha}(t) := (1 + h_\alpha(t))^{-q}.$$

Since $h_\alpha(t) \asymp |t|$ as $|t| \to \infty$, the weight remains equivalent to $(1 + |t|)^{-q}$, so the heavy-tail stabilization mechanism and the $O(n^{-1/2})$ guarantees remain aligned with the main assumptions.

Remark 8.1 (Robust centering for heavy tails). The baseline intuition "distance to the center" should not be read as "distance to the mean" in all regimes. When tails are extremely heavy, the sample mean may be unstable and can propagate noise into the weight anchor. In such cases, we recommend centering h using a robust location functional (e.g. the median or a fixed quantile), which fits naturally into the framework and is consistent with the VaR-centered construction above.

Estimated scale (studentization). In practice σ is estimated (often with slow convergence under heavy tails). The weighting reduces the influence of regions where scale misspecification is most visible (far tails), so the signal-to-noise ratio remains improved relative to uniform metrics. Robust scale estimators (e.g. MAD-type) can further stabilize deployment.

8.4 Critical Values and p-values in Production (Parametric Bootstrap)

A practical deployment question is how to translate an observed value (e.g. $d_{K,h,q} = 0.03$) into an accept/reject decision. Unlike the standard Kolmogorov–Smirnov statistic, the critical values of $d_{K,h,q}$ are not universal: they depend on the weighting scheme (through h, q) and, in general, on the null model F_θ.[1]

In production, we recommend computing thresholds and p-values via a *parametric bootstrap* under H_0: simulate B i.i.d. samples of size n from the fitted model F_θ, compute the bootstrap statistics $d^{*(b)} := d_{K,h,q}(\widehat{F}_n^{*(b)}, F_\theta)$, and set the $(1-\alpha)$ critical value to the empirical quantile

$$c_{1-\alpha} := \inf\Big\{x : \frac{1}{B}\sum_{b=1}^{B} \mathbb{1}\{d^{*(b)} \le x\} \ge 1 - \alpha\Big\}.$$

The model passes the core test at level α if $d_{K,h,q}(\widehat{F}_n, F_\theta) \le c_{1-\alpha}$, and an approximate p-value is given by $\widehat{p} = \frac{1}{B}\sum_{b=1}^{B} \mathbb{1}\{d^{*(b)} \ge d_{K,h,q}(\widehat{F}_n, F_\theta)\}$. This matches the hybrid governance view: statistical stability is assessed with calibrated (model-aware) critical values, while tail compliance is enforced separately via $\mathcal{T}_{\mathrm{tail}}$.

[1] In high-throughput settings (e.g. validating thousands of strategies), bootstrap critical values can be precomputed offline (or cached) on a grid of (θ, q) configurations, since they depend on the model parameters which typically evolve at a slower pace than intraday market data.

8.5 On Benchmarking in Heavy-Tailed Regimes

Finally, we stress that tail-amplifying goodness-of-fit tests are not the right “opponent” in this regime. For instance, Anderson–Darling-type statistics upweight the tails via factors that explode as $F(t) \to 0$ or 1, which can turn rare tail observations into dominant noise under heavy tails. A fair benchmark should therefore compare (i) uniform KS, (ii) $d_{K,h,q}$ (stability objective), and (iii) the hybrid procedure (8.1), which matches how risk desks and regulators validate models in practice.

Here, $\mathcal{T}_{\text{tail}}$ denotes a standard tail backtesting functional (e.g., Kupiec unconditional coverage / Christoffersen independence for VaR, or an Expected Shortfall backtest), evaluated on the same validation window.

9 Conclusion and Operational Implications

The divergence between theoretical assumptions (Gaussianity) and market reality (Heavy Tails) creates a significant blind spot in modern risk management. Standard uniform metrics like Kolmogorov–Smirnov can become dominated by a few extreme tail events, whereas in crypto-currency and high-frequency FX markets, these events often define the survival of the fund.

By introducing the **Exhaustion Framework** and the weighted metric $d_{K,h,q}$, we provide a bridge between rigorous probability theory and practical trading constraints. Our findings have three immediate operational implications for Quantitative Research desks:

1. **Regulatory Compliance (FRTB):** The regulatory shift towards Expected Shortfall (ES) under FRTB requires a precise understanding of tail dynamics. Our weighted metric offers a more stable calibration tool for internal models, reducing the penalty for "false positive" backtesting breaches caused by single outliers that do not reflect structural model failure.

2. **Algorithmic Regime Detection:** Standard metrics are sluggish to react to structural market changes due to their uniform sensitivity. The weighted metric, by filtering out tail noise, provides a cleaner signal for regime-switching algorithms, allowing strategies to adapt faster to volatility clusters without being triggered by momentary liquidity gaps.

3. **Data Efficiency:** As demonstrated in Section 7, achieving statistical significance with $n = 100$ points (versus $n = 10,000$ for standard metrics) allows risk managers to use shorter rolling windows. This makes risk indicators significantly more responsive to recent market history, a critical edge in high-frequency environments.

Limitations and future work (dependence). Our theoretical results are derived under an i.i.d. assumption. In real markets, returns exhibit serial dependence and volatility clustering (e.g. GARCH-type effects). While the weighted construction is expected to remain practically robust, extending the convergence guarantees to dependent processes (e.g. mixing sequences, martingale differences, or GARCH models) is an important direction for future research.

Future work on copulas targets the dependence structure separately from marginals, complementing Section 6 which concerns joint distributional convergence in $\mathbb{R}^d$.

We conclude that the weighted Kolmogorov framework is not merely a theoretical refinement, but a necessary evolution for risk modeling in non-Gaussian environments. Future work will focus on extending this framework to multivariate copulas for portfolio correlation stress-testing.

Availability. The reference implementation, including the optimized Python library and reproduction scripts, is open-sourced to foster industry adoption:

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