

# Conditional Expected Shortfall

## Nonparametric Estimation

Young-geun Kim  
ygeunkim.github.io

Statistics, SKKU

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[1] Z. Cai and X. Wang. “Nonparametric estimation of conditional VaR and expected shortfall”. In: *Journal of Econometrics* 147.1 (2008), pp. 120-130. ISSN: 0304-4076. DOI: 10.1016/j.jeconom.2008.09.005.

## Keywords

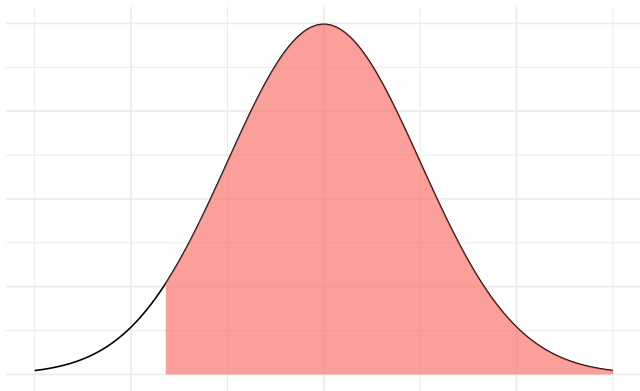
*Boundary effects, Empirical likelihood, Expected shortfall, Local linear estimation, Nonparametric smoothing, Value-at-risk, Weighted double kernel*

# Section 1

## Risk Measures

# Value at Risk

Given time horizon,



**Figure 1:** Loss Distribution - Can the financial institution still be in business after a catastrophic event?

## Two Viewpoints

Tsay (2010) says that

- Financial institution: Maximal loss of a financial position during a given time period for a given probability
  - Measure of loss under *normal* market conditions
- Regulatory committee: Minimal loss under *extraordinary* market circumstances

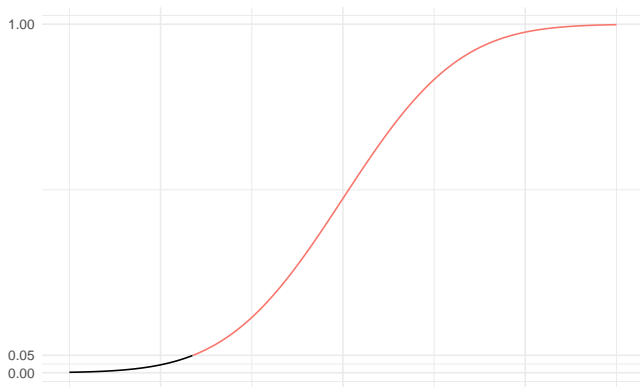
# Definition

- $p$ : **Right** tail probability
- $I$ : Time horizon
- $L(I)$ : loss function of the asset from  $t$  to  $t + I$
- $F_I$ : CDF of  $L(I)$

$$p = P[L(I) \geq VaR]$$

i.e. VaR can be computed by finding the  $p$ -th quantile.

# Quantile Loss



**Figure 2:** CDF of Loss

$$VaR = \inf \{x: F_l(x) \geq 1 - p\}$$



# Loss function and log Returns

Consider dollar  $\{P_t\}$ .

$$L(l) = P_{t+l} - P_t = R_{t+l} + \dots + R_{t+1}$$

where  $R_t = P_t - P_{t-1}$  is the return series.

- Loss occurs when the return  $R_t$  are *negative*
- Use *negative returns*

# log Returns

## Taylor expansion

For any  $x_0 > 0$ ,

$$\ln x \approx \ln x_0 + \frac{1}{x_0}(x - x_0)$$

Write  $x = x_2$ ,  $x_0 = x_1$ . Then

$$\ln \frac{x_2}{x_1} \approx \frac{x_2}{x_1} - 1 = \frac{x_2 - x_1}{x_1}$$

## Percentage change

- Log returns  $Y_t = \ln R_t$  correspond *approximately to percentage changes*
- Use *negative log returns*
- VaR by **Upper quantile of the distribution of log return**

# VaR using log Return

## log return

Cai and Wang (2008) used the following value in a real example part.

$$-100 Y_{t+1} = -100 \ln \frac{P_{t+1}}{P_t} \approx \text{percentage loss}$$

## Dollar amount of VaR

From  $t$  to  $t + 1$ ,

$$VaR = P_t \times VaR(-100 Y_{t+1})$$

# Subadditivity

- When two portfolios are merged, the risk measure should not be greater than the sum of each.
- VaR *underestimates* the actual loss.
- Thus, Expected shortfall

# VaR and Expected Loss

- VaR: Quantile loss of the loss distribution
- ES: Expected value of loss function if the *VaR is exceeded*

$$ES := E [L(I) \mid L(I) \geq VaR]$$

# Conditional information

- $\{X_t: t = 1, \dots, n\}$
- Exogenous variable: economic, market variables
- or *past observed returns* e.g.  $\{Y_{t-1}\}$

# Conditional VaR

- Stationary log-return  $\{Y_t: t = 1, \dots, n\}$
- Conditional information  $\{X_t: t = 1, \dots, n\}$
- Conditional VaR (CVaR)

$$\nu_p(x) = S^{-1}(p | x)$$

where

- $S(y | x) := 1 - F(y | x)$
- $F$ : conditional CDF of  $Y_t$  given  $X_t = x$ .

# Conditional Expected Shortfall

$$\begin{aligned}
 \mu_p(x) &= E[Y_t \mid Y_t \geq \nu_p(x), X_t = x] \\
 &= \frac{1}{P(Y_t \geq \nu_p(x) \mid X_t = x)} \int_{\nu_p(x)}^{\infty} y f(y \mid x) dy \\
 &= \frac{1}{p} \int_{\nu_p(x)}^{\infty} y f(y \mid x) dy
 \end{aligned}$$



## Section 2

# Nonparametric Estimation

# Goal

## Risk measures

- CVaR:  $\hat{\nu}_p(x)$
- CES:  $\hat{\mu}_p(x)$

# Workflow of Estimation

## Plugging-in Method

$$\hat{\mu}_p(x) = \frac{1}{p} \int_{\hat{\nu}_p(x)}^{\infty} y \hat{f}(y | x) dy$$

## What to estimate

- Conditional PDF:  $\hat{f}(y | x)$
- CVaR:  $\hat{\nu}_p(x) = \hat{S}^{-1}(p | x)$  by inverting the conditional CDF

# Weighted Double Kernel Local Linear

## Section 3

# Simulation

# AR(1)-GARCH(1, 0)

$$\begin{cases} X_t = Y_{t-1} \\ Y_t = 0.01 + 0.62X_t + \sigma_t\epsilon_t \\ \sigma_t^2 = 0.15 + 0.65\sigma_{t-1}^2 \\ \epsilon_t \sim N(0, 1) \end{cases}$$

# True conditional distribution

Since  $\epsilon_t \sim N(0, 1)$ ,

$$\sigma_t \epsilon_t \sim N(0, \sigma_t^2)$$

$$Y_t \mid X_t \sim N(0.01 + 0.62X_t, \sigma_t^2)$$

# True CES

- For each  $X_t$ , `pnorm(x, mean, sd)` gives the conditional cdf value.
- Inverting  $S(y | x) = 1 - F(y | x)$  gives  $\nu_p(x)$ .

$$\nu_p(x) = S^{-1}(p | x)$$

- Plugging-in method gives  $\mu_p(x)$ .

$$\mu_p(x) = \frac{1}{p} \int_{\nu_p(x)}^{\infty} y f(y | x) dy$$



# Goal of MC Simulation

- Compute the error between the true  $\mu_p(x)$  and  $\hat{\mu}_p(x)$
- Is the estimator of Cai and Wang (2008) good?

# Process

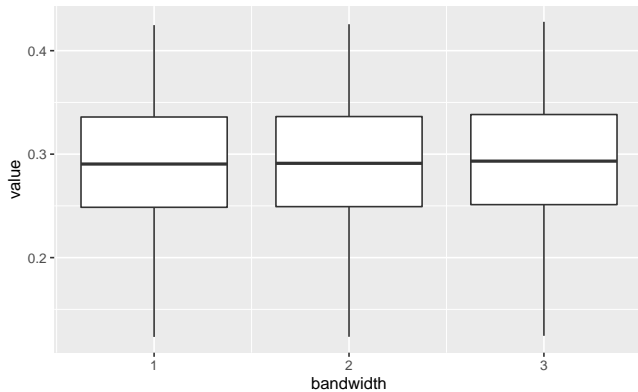
Monte Carlo Samples:

- 1 For fixed  $x_t$  (pre-determined grid points)
- 2 Generate GARCH(1, 0):  $(\sigma_t, \epsilon_t)$
- 3 Generate  $Y_t$  using AR(1) for each  $X_t = Y_{t-1}$
- 4 AR(1):  $Y_t = 0.01 + 0.62Y_{t-1} + \sigma_t\epsilon_t$

# Monte Carlo Samples

```
#>      sigma      garch  mc      xt      yt
#> 1: 0.655 -0.41011  s1 0.005 -0.397
#> 2: 0.655  0.12022  s1 0.010  0.136
#> 3: 0.655 -0.54705  s1 0.015 -0.528
#> 4: 0.655  1.04436  s1 0.020  1.067
#> 5: 0.655  0.21571  s1 0.025  0.241
#> ---
#> 1996: 0.655 -0.00527 s20 0.480  0.302
#> 1997: 0.655  0.67677 s20 0.485  0.987
#> 1998: 0.655 -0.52315 s20 0.490 -0.209
#> 1999: 0.655  0.65742 s20 0.495  0.974
#> 2000: 0.655 -0.20423 s20 0.500  0.116
```

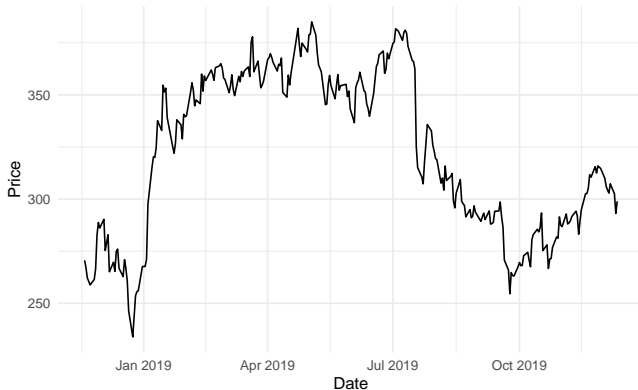
## MC



# Section 4

## Data Analysis

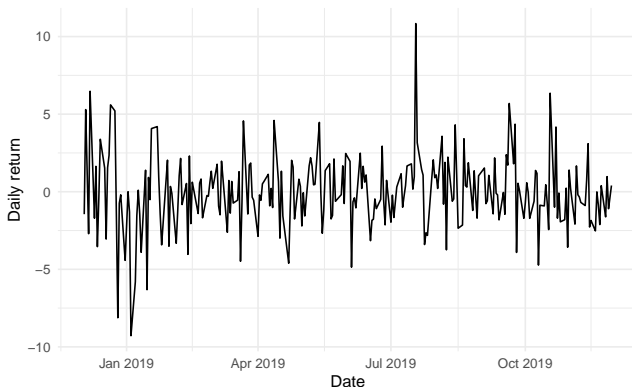
# Netflix Stock



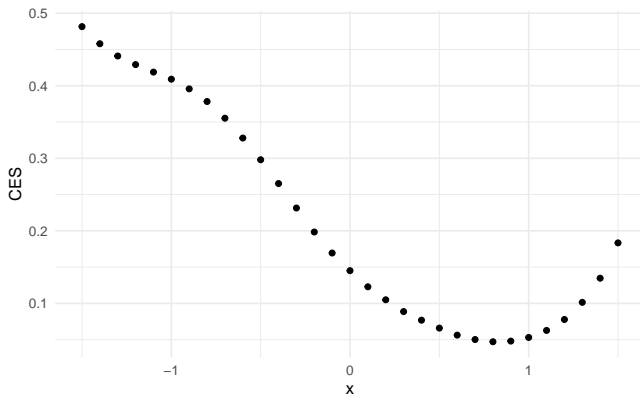
# Daily Return

As mentioned, Cai and Wang (2008) used daily return defined by

$$y_t := -100 \ln \frac{P_t}{P_{t-1}}$$



# CES for DJI





# Interpretation

Following Cai and Wang (2008),

- Risk tends to be lower when *lagged log loss* is close to the empirical average
- Netflix stock price is more likely to fall *if there were a positive return* within the last day than if there was a same amount of negative return.

## References

- Cai, Zongwu, and Xian Wang. 2008. "Nonparametric estimation of conditional VaR and expected shortfall." *Journal of Econometrics* 147 (1): 120–30. <https://doi.org/10.1016/j.jeconom.2008.09.005>.
- Tsay, Ruey S. 2010. *Analysis of Financial Time Series*. John Wiley & Sons.