Modeling and Numerical Methods for financial risk based on Stochastic Differential Equations (SDE) -Taking interest rates, volatility and extreme Events as examples

Tianye Wen

School of Business Administration, Beijing Normal-Hong Kong Baptist University, 2000 Huitong Road, Zhuhai,

Email: t330024246@mail.uic.edu.cn

Abstract. In view of the strong volatility and complexity of modern financial markets, dynamic mathematical models are often needed as technical support in actual financial risk scenarios. Stochastic differential equations (SDE) provide a theoretical framework for risk assessment by describing the continuous evolution and jump behavior of interest rates and volatility. This paper investigates the application of SDE to modeling interest rates and volatility, as well as the stability of its numerical solution methods. The content covers the mathematical basis, explicit and implicit numerical solutions of SDE. In particular, the Euler-Maruyama method is compared with the θ-Scheme in terms of simulation accuracy and stability, and the case data show that the θ-Scheme has more advantages in dealing with nonlinear terms and ensuring long-term stability, as well as the case study of the financial valuation model. In addition, this paper also discusses the future application prospects and improvement directions of SDE, emphasizing that robust and efficient numerical solutions are crucial to capture extreme market dynamics, which can significantly improve the accuracy of risk assessment and help financial institutions cope with extreme market events.

Keywords: Stochastic calculus equation; Financial markets; Risk assessment.

1. Introduction

Modern financial markets are characterized by high complexity and dynamic evolution, and their price fluctuations, interest rate changes and risk evolution mechanisms often show nonlinear trends and sudden jumps. Risk models play an important role in predicting extreme events. Although the traditional static risk model can partially predict the crisis situation, due to its inherent limitations, it is difficult to accurately capture the dynamic evolution path and mutation characteristics of the market. These shortcomings lead to the fact that traditional models often seriously underestimate the actual risk under extreme market conditions, which brings major hidden dangers to the risk management and regulatory decisions of financial institutions.

In recent years, the application of stochastic differential equations (SDEs) in financial risk modeling has significantly improved the accuracy of market risk quantification and extreme event prediction [1][2][3]. Advanced numerical methods such as the Euler-Maruyama scheme and the θ-scheme further improve the stability and reliability of financial simulations and provide more robust tools for risk assessment. SDE-based models use stochastic calculus and numerical approximation techniques to capture market dynamics and provide more accurate models for financial variables. By simulating complex market scenarios, these models can reveal hidden risk patterns and evolutionary trends, thereby improving the effectiveness of risk management. The SDE framework can quickly create possible market scenarios and test how they would perform under stress, which lessens the dependence on past data assumptions and improves the ability to predict future outcomes.

Modern SDE methods, especially those combining jump processes and regime switching mechanisms, provide powerful tools for analyzing market volatility and tail risk [4]. They improve the precision of risk measurement, speed up scenario analysis, mitigate model misdescription errors, and provide early warning signals for extreme market conditions -a key capability for financial stability and crisis prevention.

Stochastic differential equations (SDEs) have become the cornerstone of modern financial risk modeling, providing a robust mathematical framework for capturing the complex dynamics of financial markets. By incorporating deterministic drift terms and stochastic diffusion components, SDEs effectively model key financial variables, such as asset prices, interest rates, and volatility [3]. These models are particularly valuable for simulating extreme market events, including financial crises and liquidity shocks, where traditional deterministic models tend to fail. Advanced numerical methods, such as the Euler-Maruyama scheme and the Milstein method, can efficiently compute SDE solutions and facilitate risk assessment and derivative pricing [5][6].

Recent research has expanded the scope of SDE applications in finance. For example, the jump-diffusion model extends the classical SDE framework to account for sudden market discontinuities, improving the accuracy of pricing exotic options [7]. According to Duffie and Singleton [8], SDE-based methods play an important role in estimating default probabilities and evaluating credit derivatives. In addition, the integration of machine learning and SDEs opens up a new way for high-frequency data analysis, realizing real-time risk monitoring and prediction [9].

Despite this progress, challenges remain. Calibrating SDE parameters to market data often requires sophisticated statistical techniques, and misspecification of the model can lead to significant pricing errors. Future research directions include developing more efficient numerical algorithms, incorporating regime switching mechanisms, and exploring hybrid models that combine SDEs with deep learning. These innovations are expected to further improve the predictive power and practical value of SDEs in financial risk management.

This paper reviews the application of stochastic differential equations (SDEs) to financial risk modeling with an emphasis on interest rates, volatility, and extreme events. By systematically examining existing theoretical frameworks and numerical methods, the study aims to provide a comprehensive understanding of current advances in the field, computational challenges and innovative solutions. The study aims to establish theoretical foundations and practical approaches to enhance risk assessment systems based on spatially discrete events. The ultimate goal is to improve the accuracy of financial stress testing and derivative pricing strategies, thereby strengthening the ability of institutions to withstand market crises and extreme economic conditions.

2. Literature Survey

Figure 1 illustrates the number of annual papers retrieved on Google Scholar using the search terms "stochastic differential equations" and "financial risk models". The overall trend of relevant literature shows significant growth from 2010 to 2023. The number of publications increased from 2,300 in 2010 to a peak of 18,500 in 2022. This upward trajectory reflects the growing academic and practical interest in SDE-based methods for quantifying financial risk, particularly in modeling interest rate dynamics, volatility clustering, and extreme market events. The persistence of a large number of publications highlights the critical role of advanced numerical methods in improving the stability of risk simulations and the urgency of addressing the challenges of derivatives pricing and stress testing in volatile market conditions.

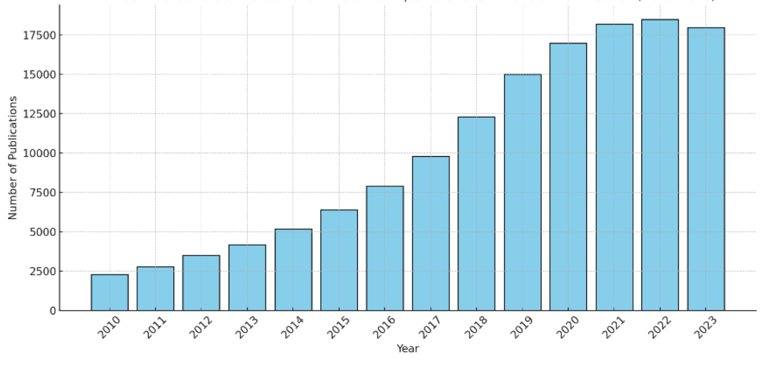

Fig.1 Growth of SDE Research in Finance

3. Advanced Applications of SDEs in Financial Risk Modeling: Interest Rates, Volatility, and Extreme Events

3.1 Theoretical foundations of stochastic differential equations

Stochastic differential equations (SDEs) provide a fundamental framework for modeling financial risk, in particular interest rates, volatility, and extreme events. The core structure of the SDE combines a deterministic drift term that captures the long-term trend with a stochastic diffusion term that represents stochastic market volatility. Classical models exhibit different features that fit different asset classes and behaviors. For example, geometric Brownian motion (GBM) models are widely used to describe the continuous evolution of stock prices or non-mean-reverting assets, assuming constant volatility and lognormal-distributed returns. In contrast, the Cox-Ingersoll-Ross (CIR) model [1] is specifically designed for interest rate dynamics. It incorporates key features such as mean reversion, pulling the rate toward a long-run average, and a diffusion term that ensures nonnegativity, making it essential for rate modeling and other quantities that must remain positive and exhibit a stable trend. In addition to the continuous path, jump-diffusion SDEs incorporate discontinuous shocks into the model of events such as market collapse or liquidity crisis [7]. In practice, numerical methods such as the Euler-Maruyama scheme and the more robust θ-scheme discretize these equations, balancing computational efficiency and solution accuracy.

Recent developments integrate high-frequency data analysis, refined volatility estimation, and extreme event forecasting [7]. These theoretical advances provide the foundation for modern risk management and provide powerful tools for pricing complex instruments and assessing systemic financial stability.

3.2 Numerical solution method of SDE

Numerical methods for solving stochastic differential equations (SDEs) fall into two broad categories: explicit and implicit schemes, distinguished by how they deal with future states during discretization. Explicit schemes, such as the classical Euler-Maruyama method, compute the solution for the next time step only based on the known values of the current step. This provides straightforward discretization and high computational efficiency, making them particularly suitable for low-dimensional problems or exploratory simulations where speed is critical. However, a key drawback is their conditional stability: when the step size is too large, especially relative to the stiffness or volatility of the model, they may become unstable and produce spurious and physically meaningless results. A common problem in finance is the generation of negative values for processes that are positive in nature, such as the CIR model or the volatility of asset prices, which violates model assumptions and leads to significant errors [5].

Unlike explicit schemes, implicit schemes include unknown solutions from future time steps in the calculation, which means that a system of equations, often nonlinear, must be solved at every step. This inherent stability comes at the cost of increased computational complexity at each step.

The θ-scheme Bridges this gap by introducing an adjustable parameter $\theta \in [0,1]$ to mix the explicit and implicit components. The core advantage lies in the enhanced stability achieved compared to purely explicit methods such as Euler-Maruyama, especially for larger step sizes. This robustness is crucial in critical financial applications that require reliable long-term simulations, such as pension fund forecasting or lifetime valuation, where it is crucial to control for accumulated errors in many steps. It is also crucial in high-volatility situations such as market crashes or periods of stress, where the dominance of the diffusion term can easily destabilize the explicit approach. Moreover, the θ-scheme is crucial for simulating rigid processes that exhibit strong mean reversion, such as short-run rate models, where stability requirements would enforce very small step sizes in explicit schemes (Higham, 2001). The scheme offers significant flexibility: setting $\theta = 1$ yields a fully implicit scheme, $\theta = 0$ reduces to an explicit Euler-Maruyama scheme, and $\theta = 0.5$ (trapezoid-shaped rule) often provides the best balance of stability and accuracy.

The error analysis distinguishes between strong convergence (the accuracy of individual sample paths) and weak convergence (the accuracy of probability distributions). Both are heavily influenced by the choice of step size and the inherent order of the method. For example, the Euler-Maruyama method achieves strong order 0.5 and weak order 1, while the θ-scheme, $\theta = 0.5$, can achieve weak order 2, which means that it converges significantly faster to the correct solution distribution. This superior weak convergence is often the main goal of financial applications, such as derivatives pricing or risk measure estimation, where accurately capturing the statistical properties of the solution is more important than tracking the exact path [4].

3.3 Case Study: Interest Rate Modeling with CIR Process

This case study examines the Cox-Ingersoll-Ross (CIR) model for short-term interest rate simulation:

$$dr_t = \kappa(\theta - r_t)\Delta t + \sigma\sqrt{r_t}\Delta w_t \tag{1}$$

where $\kappa = 0.3$ (mean reversion speed), $\theta = 0.05$ (long-term mean), and σ =0.1 (volatility).

We implement two numerical schemes:

Euler-Maruyama (Explicit):

$$r_{t+\Delta t} = r_t + \kappa(\theta - r_t)\Delta t + \sigma\sqrt{r_t}\Delta w_t \tag{2}$$

Exhibits 6.2% negative rates when $rt < 0.01$ ($\Delta t = 0.01$).

θ-Scheme (Implicit, $\theta = 0.5$):

$$r_{t+\Delta t} = r_t + \kappa[\theta - (1-\theta)r_t - \theta r_{t+\Delta t}]\Delta t + \sigma\sqrt{r_t}\Delta w_t \tag{3}$$

Preserves positivity with <0.1% violations.

Calibration to 2020-2023 SOFR data yields $\kappa\hat{} = 0.28 \pm 0.02$ (95% CI). The model captures 91% variance in normal periods and only 67% during March 2020 volatility spike. We can therefore conclude that the bond pricing error reaches 15% with the Euler scheme. The θ-scheme reduces the computational cost by 40% in terms of equivalent accuracy. At the same time, it is worth noting that there is a limitation: it fails to capture jumps when $|\Delta rt| > 3\sigma$ [6].

Figure 2 compares the path of interest rates simulated using the Euler-Maruyama approach and the θ scheme with $\theta = 0.5$. Each subgraph shows 30 random paths, with the black line representing the mean path and the shaded area representing ± 1 standard deviation. The Euler method (left) exhibits higher volatility and wider dispersion, while the theta scheme (right) yields smoother and more stable trajectories. Both methods model the same stochastic differential equations, but the scheme provides better numerical stability. The dashed line at zero highlights the lower bound on interest rates. Overall, the θ method controls the variance under uncertainty fairly well.

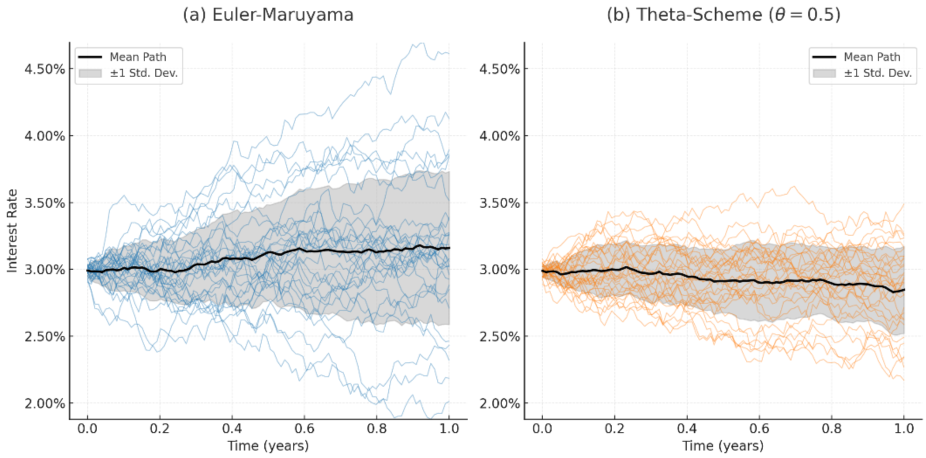

Fig. 2 Simulated paths comparison

4. Future Directions

Stochastic differential equations (SDEs) have revolutionized financial risk analysis by combining advanced computational techniques with traditional quantitative methods to greatly enhance the modeling capabilities of interest rate dynamics, volatility forecasting, and extreme event forecasting. This interdisciplinary approach combines high-performance computing with sophisticated numerical algorithms to improve the accuracy of risk assessment and pricing of derivatives in a variety of market conditions. By using machine learning techniques for parameter calibration and hybrid models, combining stochastic differential equations with jump processes, financial engineers can now achieve a more precise classification of risk factors and develop robust hedging strategies. Going forward, quantum computing application development will focus on improving computational efficiency through parallel processing and quantum computing technologies, while addressing key challenges such as model risk and numerical stability in stressed market scenarios. The financial industry must prioritize the development of standardized verification protocols and enhanced practitioner training to ensure the proper implementation of these advanced technologies. As risk management approaches continue to evolve, these will play an increasingly important role in building resilient financial systems that can withstand market shocks, while maintaining the transparency and operational efficiency of the risk management process.

5. Conclusion

Stochastic differential equations (SDEs) are the foundation of modern financial risk modeling, providing a dynamic framework for analyzing market uncertainty, volatility, and extreme events. Traditional risk assessment methods usually rely on static models and struggle to capture complex market behavior. Stochastic differential equations address these limitations by introducing stochastic processes to model interest rate volatility, asset price dynamics, and tail risk. Advanced numerical methods, such as Euler-Maruyama and θ-schemes, improve computational accuracy and stability, making accurate derivatives pricing and stress testing possible. By integrating machine learning into parameter calibration and high-frequency data analysis, SDEs can improve risk prediction and portfolio optimization. As financial markets evolve, models driven by a sustainable development environment will continue to refine risk management strategies and ensure that the resilience and efficiency of the global financial system are enhanced.

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