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Modeling Dependencies between rating categories and their effects on prediction in a credit risk portfolio

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Abstract

The internal-ratings based Basel II approach increases the need for the development of more realistic default probability models. In this paper we follow the approach taken in McNeil and Wendin (2006) by constructing generalized linear mixed models for estimating default probabilities from annual data on companies with different credit ratings. The models considered, in contrast to McNeil and Wendin (2006), allow parsimonious parametric models to capture simultaneously dependencies of the default probabilities on time and credit ratings. Macro-economic variables can also be included. Estimation of all model parameters are facilitated with a Bayesian approach using Markov Chain Monte Carlo methods. Special emphasis is given to the investigation of predictive capabilities of the models considered. In particular predictable model specifications are used. The empirical study using default data from Standard and Poor gives evidence that the correlation between credit ratings further apart decreases and is higher than the one induced by the autoregressive time dynamics.

Keywords and phrases: credit risk, default probability, asset correlation, generalized linear mixed models, Markov chain Monte Carlo, prediction
1 INTRODUCTION

The Basel II (2004) agreement allows financial institutions to choose an internal-ratings-based (IRB) approach to calculate the capital requirement for credit risk. McNeil, Frey, and Embrechts (2005) provide in Chapter 8 a survey of default probability models used in credit risk management. In particular threshold and Bernoulli mixture models are discussed. The risk weight formulas to be used in an IRB Basel II approach can be derived from a one-factor Gaussian threshold model with preassigned constant asset correlation (see for example Section 8.4.5 of McNeil et al. (2005)).

However, it has long been known that the value-at-risk and other risk indicators of a credit portfolio are sensitive to the accuracy of the estimation of default correlations. Since the data is scarce, it is a challenge to estimate the default correlations among the creditors correctly. In particular empirical studies have shown that credit default correlations vary over time (Nickell et al. 2000), rating classes and industry sectors (see Demey et al. (2004), Servigny and Renault (2003) and Gordy and Heitfield (2002)) and macro-economic variables (Bangia et al. 2002). This empirical evidence of varying default correlations is not reflected so far in the Basel II approach. McNeil and Wendin (2006) have utilized generalized linear mixed models (GLMM) to capture these dependencies. As McNeil et al. (2005) point out on page 403 a GLMM modeling approach allows for flexible models, which can incorporate macro-economic information as well as dynamic dependence structures. In contrast to standard industry credit risk models such as Credit Metrics or the KMV Model, in a GLMM model setup all model parameters are estimated jointly and no external data sources are needed for model parameters. In particular McNeil and Wendin (2006) studied Bernoulli mixture models with time dependent random effects. The time dynamic is modeled through a latent autoregressive component. For their analysis they used a Bayesian approach applying Markov Chain Monte Carlo (MCMC) techniques to facilitate parameter estimation and inference in a dynamic setting. This is a very powerful estimation method since estimation of all parameters is conducted in a single step and the dependence structure assumed allows to borrow strength for the fit of an area with scarce data from areas with more information. MCMC methods are summarized in Chib (2001) and discussed in detail in Gamerman (1997), while many examples are provided in Gilks, Richardson, and Spiegelhalter (1996). The empirical study presented in McNeil and Wendin (2006) using Standard & Poor’s data on US firms clearly demonstrated the usefulness and potential of their approach. In particular they investigated an unstructured model for modeling the dependency among default events on rating categories using a large number of parameters.

We would like to extend their work in two directions: Firstly, it would be interesting to see
whether one can use more parsimonious models to uncover the structure of this dependency on rating categories. For instance we would like to analyze whether the dependence on the rating categories is constant over all categories or whether the dependence decays for categories with their risk rating further apart. Secondly, for the application of such models for credit portfolio management it is vital to investigate the usefulness of these models for prediction.

For the first question we propose to model the joint dynamic over time and rating categories using a vector autoregressive latent component with different correlation structures of the error model. This allows us to model different correlation structures among the rating categories. The model fit of the considered models was assessed using the well established deviance information criterion (DIC) of Spiegelhalter et al. (2002) for models fitted by MCMC techniques in addition to graphical checks.

For the second question we consider models for prediction of one time period which allows information to be included up to the previous time period. For the macro-economic variables included in the models this means using a time shifted version of the variable. In order to compare the predictions we used the Brier-score (Brier 1950), conditional predictive ordinate (CPO) and standardized predictive residuals proposed by Gelfand (1996) and also utilized in McNeil and Wendin (2006). Finally we also investigated the information loss resulting from only using the macro-economic information available up to the previous year rather than the complete information.

To illustrate our approach we analyze annual data from Standard & Poor’s from 1981 to 2005. As in McNeil and Wendin (2006) we included the Chicago Fed National Activity Index (CFNAI) as a macro-economic variable to capture the cyclical component of the systematic risk due to common economic conditions. With regard to prediction our analysis suggests that the dependence induced by the rating classes decays for rating classes further apart rather than being constant over all rating classes. When considering predictions using a time shifted CFNAI the model with decaying dependencies shows the best predictive capability among the models investigated. The information loss from using this time shifted variable in contrast to the unshifted one was seen not to be severe in this data set.

2 Bayesian inference for binomial mixed regression

We start with a similar setup as McNeil and Wendin (2006), in particular we assume that there are $K$ different rating categories and $T$ periods under consideration. Let $m_{tk}$ the number of firms in category $k$ in time-period $t$ and $M_{tk}$ the number of defaults in category
in time-period $t$, $t = 1, 2, ..., T$, $k = 1, 2, \ldots, K$. One can then consider indicator variables $Y_{s,t,k}$ such that if in time-period $t$ the $s$th obligor of rating category $k$ defaults $Y_{s,t,k}$ takes value 1 and value 0 otherwise. We consider models of the form

$$\text{(2.1)} \quad M_{tk} | b_{tk} \sim \text{Bin}(m_{tk}, g(\mu_k - x_t' \beta - b_{tk})) \text{ independent},$$

where $b_t = (b_{t1}, \ldots, b_{tK})'$ represents the unobserved risk vector in time period $t$ and has a specified distribution, $\mu = (\mu_1, \ldots, \mu_K)$ and $\beta$ are fixed, unknown parameters, $x_t$ is a $p$ dimensional covariate vector representing observed macro-economic risk factors in time period $t$ and $g(\cdot)$ is a known link function for binomial data such as the logit or probit link. In our empirical study we will use the logit link. In the following, we will explore different distributions for $b_t, t = 1, \cdots, T$.

The above model can be motivated as follows: Given $b_t$, the default indicators $Y_{s,t,k}$ are independent and take value 1 with probability $g(\mu_k - x_t' \beta - b_{tk})$ and value 0 otherwise. By defining

$$\text{(2.2)} \quad V_{s,t,k} = x_t' \beta + b_{tk} + \epsilon_{s,t,k}$$

where $\epsilon_{s,t,k} \sim g$ i.i.d. we can reformulate the model as follows: The $s$th obligor in rating category $k$ defaults in time period $t$ iff $V_{s,t,k} < \mu_k$. $V_{s,t,k}$ can be thought to represent the asset value of the $s$th obligor $s$ in rating category $k$ in time-period $t$ and $\mu_k$ can be thought of as the critical liability as laid out in (Merton 1974). The component $x_t' \beta$ represents the asset value attributable to the observed macro-economic market conditions, while $b_{tk}$ is the contribution of rating category $k$ in time period $t$. The idiosyncratic term $\epsilon_{s,t,k}$ captures the contributions which cannot be explained by global or rating category factors.

The implied asset correlation $\text{cor}(V_{s,t,k}, V_{r,\tau,l})$ is given by

$$\text{(2.3)} \quad \text{cor}(V_{s,t,k}, V_{r,\tau,l}) = \frac{\text{cov}(b_{t,k}, b_{r,l})}{\sqrt{\text{Var}(b_{t,k}) + \omega^2 \sqrt{\text{Var}(b_{t,k}) + \omega^2}}},$$

where $\text{Var}(\epsilon_{s,t,k}) = \omega^2$. For the logit link we have $\omega^2 = \frac{\pi^2}{3}$. We see that the distribution of $b_t, t = 1, \cdots, T$ can be used to capture different aspects of the default correlations. We discuss several such choices.

Our baseline model is

$$b_t = (b_{t1}, \cdots, b_{t})'$$

where $b_t \sim N(0, \sigma^2)$ i.i.d. (Model0)

Therefore the layout asset values $V_{s,t,k}$ and $V_{r,\tau,l}$ are independent for $t \neq \tau$. This assumption clearly is not realistic, because one surely would expect asset values in subsequent years to be correlated. Furthermore, the correlation of asset values of obligors in the same time-period always is $\frac{\text{Var}(b_{t,k})}{\text{Var}(b_{t,k}) + \omega^2}$, whether or not they are in the same rating category.
For the next model we assume asset value correlations are time-dependent but independent of the rating category. In particular we assume

\[ b_t = (b_1, \ldots, b_T)' \]

where

\[ b_t = \alpha b_{t-1} + \sigma \epsilon_t, \quad t = 1, 2, \ldots, T \quad \text{(Model 1)} \]

\[ b_0 = \sigma \epsilon_0 / \sqrt{1 - \alpha^2} \quad \text{with} \quad \epsilon_0, \epsilon_1, \ldots, \text{i.i.d.} \quad N(0,1) \]

This AR(1) time series for \( b_t \) has a \( \mathcal{N}(0, \sigma^2 / (1 - \alpha^2)) \) stationary distribution for \(|\alpha| < 1\).

This model was considered in McNeil and Wendin (2006). The asset values of obligors in subsequent years are now correlated with \( \text{cov}(b_{t-1}, b_t) = \sigma^2 / (1 + \alpha^2), \quad t = 1, 2, \ldots, T \), but correlations between asset values of obligors in the same time-period are still constant over rating categories.

The next two models allow for category dependent asset correlations. In Model 2 \( b_{tk} \) is assumed to be a first order vector autoregressive AR(1) time series with

\[ b_t = \alpha b_{t-1} + \epsilon_t, \quad t = 1, 2, \ldots, T \]

\[ b_0 = \epsilon_0 / \sqrt{1 - \alpha^2} \]

where \( \epsilon_0, \epsilon_1, \ldots \) are i.i.d. \( N(0, \Phi) \) with

\[ \Phi = \frac{\sigma^2}{1 - \rho^2} \begin{pmatrix} 1 & \rho & \ldots & \rho^{K-1} \\ \rho & 1 & \ldots & \rho^{K-2} \\ \vdots & \vdots & \ddots & \vdots \\ \rho^{K-1} & \rho^{K-2} & \ldots & 1 \end{pmatrix} \quad \text{(Model 2)} \]

Here \( N_n(\mu, \Sigma) \) denotes a \( n \)-dimensional normal distribution with mean vector \( \mu \) and covariance matrix \( \Sigma \). Model 2 introduces implied asset correlations

\[ \text{cor}(V_{s,t,k}, V_{r,t,l}) = \frac{\Phi_{k,l}(\alpha^{t-\tau} / (1 - \alpha^2)) / \sigma^2/((1 - \alpha^2)(1 - \rho^2)) + \omega^2}{\sigma^2/((1 - \alpha^2)(1 - \rho^2)) + \omega^2}. \]

Here the asset values of obligors in the same rating category are most strongly correlated and the asset values of obligors in similar rating categories are more closely correlated than those of obligors in disparate rating categories.

The final model considered is similar to Model 2, only the covariance matrix \( \Phi \) is replaced by

\[ \Phi = \frac{\sigma^2}{1 - \rho^2} \begin{pmatrix} 1 & \rho & \ldots & \rho \\ \rho & 1 & \ldots & \rho \\ \vdots & \vdots & \ddots & \vdots \\ \rho & \rho & \ldots & 1 \end{pmatrix} \quad \text{(Model 3)} \]
The implied asset correlations for Model3 are

\[
cor(V_{s,t,k}, V_{r,\tau,l}) = \frac{\Phi_{k,l}\alpha_{|t-\tau|}/(1-\alpha^2)}{\sigma^2/(1-\alpha^2) + \omega^2}
\]

where \(1(k \neq l)\) takes the value 1 if \(k \neq l\) and 0 otherwise. This model incorporates the assumption that asset values of obligors in the same rating category are more closely correlated than those of obligors in different rating categories but for obligors in different rating categories it does not make a difference whether or not their rating categories are similar.

To complete the model formulation for a Bayesian setup we have to specify the prior distributions. As in McNeil and Wendin (2006) we choose non-informative priors for the parameters and hyperparameters of our models. In all models we chose an ordered normal \(N_{K}(\boldsymbol{0}, \tau^2I)\) distribution as prior for \(\mu\) with \(\tau = 100\), i.e. we require \(\mu_1 > \mu_2 > \mu_3 > \mu_4 > \mu_5\) and the prior distribution then is \(N_{K}(\boldsymbol{0}, \tau^2I)\frac{1}{\mu_1 > \mu_2 > \mu_3 > \mu_4 > \mu_5}\).

The variance \(\sigma^2\) was given an improper prior decaying as \(1/x\). This corresponds to the limiting case \(\sigma^2 \sim \text{InvGamma}(\eta, \nu)\) with \(\eta = 0\) and \(\nu = 0\), where \(\text{InvGamma}(\eta, \nu)\) denotes the inverse Gamma distribution with parameters \(\eta\) and \(\nu\). The coefficient \(\beta\) was given a \(N(0, \tau^2I)\) prior. In Model1, Model2 and Model3, \(\alpha\) was given a normal prior with mean 0 and standard deviation \(\frac{1}{4}\) truncated to the interval \((-1, 1)\). This informative prior was chosen to improve convergence of the Markov Chain and had little influence on the quality of the estimates. In Model2 and Model3 the parameter \(\rho\) was given a uniform prior on \((-1, 1)\).

We used an MCMC algorithm to simulate from the posterior distributions. Our algorithms update parameters one at a time. To simulate from univariate full conditional distributions, which are only known up to a constant, we apply apply the ARS (Adaptive Rejection Sampling) and ARMS-algorithms (Gilks (1992), Gilks (1996)). The former is intended for log-concave densities only, whereas the latter can be applied to a wide range of univariate densities. Only in one case this ARMS-algorithm was found not to work, and hence a Metropolis-sampling step had to be employed. For every model 10,000 iterations were used as a burn-in to give the sampler the opportunity to settle down to equilibrium. The estimates were based on the following 200,000 iterations. Every 40th iteration was used so that there was a sample of 5,000 simulations available for analysis. This subsampling frequency was chosen after having considered autocorrelation functions for the simulated values of the parameters.

For both prediction and estimation, we conducted our analyzes not only using covariate values from the current year, but also using covariate values from the previous year. This was done to realistically simulate the situation of predicting default probabilities for the coming year, when only covariate values of the current year are available.
3 Model comparison of fit and predictive power

To assess model fit the complete data was used to estimate the posterior distributions. This gives estimates of quantiles, median, mean and standard deviation for all parameters for all models. Credible intervals, which are the Bayesian equivalent to confidence intervals, are used to assess the significance of parameters.

The deviance information criterion (DIC) introduced by Spiegelhalter et al. (2002) is used to compare the fit of different models. For a probability model $p(y \mid \theta)$ with observed data $y = (y_1, y_2, \ldots, y_n)$ it is defined as $DIC := E[D(\theta \mid y)] + p_D$. The posterior mean deviance is defined as $D(\theta) = -2 \log(l(y \mid \theta))$ and corresponds to a Bayesian measure of fit or adequacy, while the effective number of parameters $p_D := E[D(\theta \mid y)] - D(E[\theta \mid y])$ is a measure of model complexity. In the case of a model with no random effects $p_D$ gives the number of parameters. Hence, this score considers both complexity and goodness of fit. When comparing models the model with smallest DIC is to be preferred.

Furthermore, seeing that in practical applications one is even more interested in the predictive quality of a model, we will consider this aspect carefully. To gain an idea of the predictive quality, we fitted the models using the data of all time periods but the last one and then computed the predictive distributions of the default probabilities for last time period. To assess the goodness of those predictions we will use the verification score introduced by Brier (1950). Let $p^{obs}_{tk}$ be the observed default probability in year $t$ and rating category $k$ and let $p_{tkr}$ the simulated value of the default probability in year $t$ and rating category $k$ from the $r^{th}$ iteration of the MCMC-process. Assume there are $R$ iterations. As our predictions were made for 2005, the corresponding Brier-score to measure the goodness of these predicted default probabilities is defined as

$$B = \frac{1}{R} \sum_{r=1}^{R} \sum_{k=1}^{K} (p^{2005kr}_{2005} - p^{obs}_{2005k})^2$$

Seeing that default probabilities vary strongly across rating categories, this Brier-score assigns greater weight to riskier rating categories than to less risky rating categories. In order to adjust for this we also considered a relative Brier-score, which is defined by

$$B_{Re} = \frac{1}{R} \sum_{r=1}^{R} \sum_{k=1}^{K} \left((p^{2005kr}_{2005}/p^{obs}_{2005k}) - 1\right)^2$$

A model with small (relative) Brier-score is to be preferred.

Further, we used the category-specific conditional predictive ordinate (CPO) for 2005, which for rating category $k$ is defined by

$$CPO^{2005,k} = p(N_{2005,k,obs} \mid \{N_{t,1,obs}, \ldots, N_{t,K,obs}\}, t \neq 2005).$$
$CPO_{2005,k}$ gives the conditional probability of observing $N_{2005,k,\text{obs}}$ given all observations up to year 2004 and for a good model one would expect it to be large. Note that \{CP0_{2005,k}, k = 1, ..., K\} can be estimated using the MCMC iterates.

Finally, we considered the univariate, standardized predictive residual $d_{2005,k}$ defined by

$$d_{2005,k} := \frac{N_{2005,k,\text{obs}} - E(N_{2005,k} | \{N_{t,1,\text{obs}}, ..., N_{t,K,\text{obs}}\}, t \neq 2005)}{\sqrt{\text{var}(N_{2005,k} | \{N_{t,1,\text{obs}}, ..., N_{t,K,\text{obs}}\}, t \neq 2005)}}.$$

Here, the model with small $|d_{2005,k}|$ would be preferred. The last score two scores were also considered in McNeil and Wendin (2006), which facilitates comparison of results. For details of these scores see Gelfand (1996). Again $d_{2005,k}$ can be estimated using the MCMC iterates.

## 4 An empirical study of S&P default data

### 4.1 Description of the data

The default data used is available from Standard and Poor’s CreditPro™ web site. It contains yearly default data from 1981 to 2005 in 7 rating categories: “CCC”, “B”, “BB”, “BBB”, “A”, “AA”, “AAA” ranked according to decreasing risk. Only categories CCC to A have been considered, because in categories AA and AAA defaults are too rare to allow for statistical inference. For simplicity we will number the rating categories 1, ..., 5. The average number of firms per rating category per year is 450.

There are significant numbers of firms that were rated at the beginning of a year but not at the end of a year, so that there is no information available on whether or not they defaulted. These firms have been excluded from the analysis.

The Chicago Fed National Activity Index (CFNAI), which is published monthly, was used as a macro-economic indicator and its yearly average was used as the covariable. The CFNAI is based on data from the following broad categories: production and income; employment, unemployment and hours; personal consumption and housing; sales, orders and inventories and is thought to give a gauge on current and future economic activity and inflation.
4.2 Results

4.2.1 Estimation and model fit

Table 1 summarizes the posterior distributions of all parameters for all models considered. One can see very clearly that $\beta$ is significantly $\neq 0$, i.e. the CFNAI index is able to explain part of the inhomogeneity of default rates over time. This is illustrated by Figure 1, where one can see the fitted ($t < 2005$), respectively predicted ($t = 2005$) default probabilities from Model2, the observed default probabilities and (scaled) CFNAI index in the same graph. One can observe that the CFNAI index and the default probabilities behave very similarly over time. One can also see that for Model1, Model2 and Model3 the correlation parameter $\alpha$ for the time structure is significant, i.e. the time-dependency of the unobserved risk helps to explain observed default probabilities. Moreover, in Model2 and Model3 correlation parameter $\rho$ for the dependence between rating categories is distinct from 0 and higher than $\alpha$, which indicates that the new correlation structures of Model2 and Model3 improve the fit. Further, the time correlation measured by $\alpha$ is lower than the correlation between induced by the dependency between the categories as measured by $\rho$.

Table 2 shows DIC scores using the unshifted CFNAI index and the shifted CFNAI index. For the unshifted and the shifted CFNAI index one can see that Model2 and Model3 have significantly lower DIC scores than Model0 and Model1, thus indicating a better fit when a dependency on the rating category is allowed. Since the DIC scores are the lowest for Model3, we see a slight preference in model fit for an equidistant correlation structure among the rating categories. The DIC values for Model0 and Model1 are quite similar for each of the two CFNAI specifications, which implies that the sole introduction of an unobserved autoregressive risk component does not improve the fit over the base model by much. One can see that the DIC-scores are consistently higher when using the shifted CFNAI index than when using the unshifted CFNAI index. This could be expected, because one would expect this year’s CFNAI to give more relevant information than last year’s CFNAI. However, the DIC scores using the shifted CFNAI are in the range of those using the unshifted CFNAI, which indicates, that using the shifted CFNAI one still obtains an acceptable model fit.

In Figure 2 one can see the observed default rates, the posterior fitted default probabilities for 1981-2004 and the predicted default probabilities for 2005. These probabilities are shown for all models and all rating categories. For instance, concentrating on rating
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</table>

Table 1: Posterior mean estimates with estimated standard errors and 10%, 50%, and 90% estimated quantiles of the posterior distribution based on complete data 1981–2005 with unshifted CFNAI index.
Table 2: DIC score to assess model fit for the considered models. Models are fitted with data 1981-2005 using unshifted CFNAI (top) and shifted CFNAI (bottom)

category B and the year 1990 one can see that whereas for Model0 and Model1 the observed default probability is not in the fitted 80% credible interval it is in this interval for Model2 and Model3. One can also see that the fitted expected default probability 1990 is clearly closer to observed default probability 1990 for Model2 and Model3. This again illustrates the improved fit of Model2 and Model3.

From a model fit perspective Model3 is slightly preferable over Model2. This result has to be critically examined by checking the predictive capabilities of the models, since this is the primary interest of the data analyst.

4.2.2 Analysis of predictive distributions

Figure 3 and the top part of Table 3 summarize the predictive distributions for 2005 obtained for the different models using the unshifted CFNAI index. In general the point predictions such as the mode, mean and median of the predictive distribution are higher than the observed values. Further, the predictive distributions are skewed with a long right tail, so that mean and median are to the right of the mode of the distribution. Comparing the distributions obtained for rating category BBB one can see in Figure 3 that the mode of the distribution is closest to the observed default probability for Model2. The same effect can be observed in the upper part of Table 3.
<table>
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<tr>
<th>Rating</th>
<th>Observed</th>
<th>Model0</th>
<th>5%</th>
<th>50%</th>
<th>Mean(Stdv)</th>
<th>Mode</th>
<th>95%</th>
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<td></td>
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<td>CCC</td>
<td>0.11</td>
<td>Model0</td>
<td>0.14</td>
<td>0.26</td>
<td>0.27(0.092)</td>
<td>0.24</td>
<td>0.43</td>
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<td>Model1</td>
<td>0.12</td>
<td>0.23</td>
<td>0.24(0.085)</td>
<td>0.21</td>
<td>0.39</td>
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<td></td>
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<td>0.11</td>
<td>0.21</td>
<td>0.22(0.084)</td>
<td>0.20</td>
<td>0.38</td>
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<td>Model3</td>
<td>0.11</td>
<td>0.21</td>
<td>0.23(0.085)</td>
<td>0.19</td>
<td>0.39</td>
</tr>
<tr>
<td>B</td>
<td>0.019</td>
<td>Model0</td>
<td>0.022</td>
<td>0.046</td>
<td>0.051(0.025)</td>
<td>0.041</td>
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<td></td>
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<td>0.018</td>
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<td>0.043(0.021)</td>
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<td>0.034</td>
<td>0.038(0.020)</td>
<td>0.026</td>
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<td>0.00024</td>
<td>0.00031(0.0003)</td>
<td>0.00016</td>
<td>0.00077</td>
</tr>
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</table>

Table 3: Predicted default probabilities in 2005 with estimated standard errors and estimated quantiles of the predicted default distribution using the unshifted (top) and shifted CFNAI index (bottom)
The lower part of Table 3 shows the predicted default probabilities for 2005 but this time the shifted CFNAI index was used. As one would expect, using this less informative covariate, one obtains slightly larger standard deviations and larger 90% credible intervals. However, the modal values are closer to the observed values than in the upper part of Table 3. This probably is due to the fact that the CFNAI mainly is an indicator for future economic activity and therefore also is highly relevant for the coming year.

Figure 4 compares fit and prediction obtained for rating category B for all models using the shifted CFNAI and the unshifted CFNAI. The left panels of Figure 4 give the fitted ($t \neq 2005$) and the predicted ($t = 2005$) default probabilities, while the right panels of Figure 4 compare the predicted densities for 2005. Clearly the base model Model0 gives the worst predictions, while the predictions in Model1 are better than Model0 for both the unshifted and shifted CFNAI specifications. However the predictive distribution of Model2 is the most concentrated predictive distribution with mode closest to the observed value.

The upper part of Table 4 shows Brier-scores and relative Brier-scores for all models using the unshifted and the shifted CFNAI index. Since in rating-category A the observed default probability is 0, we chose to divide by $10^{-4}$ instead, which is approximately the order of magnitude of the predictive default probabilities. Brier-scores using the shifted CFNAI index are higher for all models but they are still in the range of Brier-scores using the unshifted CFNAI. That means that while using the shifted CFNAI rather than the unshifted CFNAI impairs the predictive strength of our models, the predictions obtained using the shifted CFNAI still are reasonably good. These scores again support that Model2 has the best predictive qualities, closely followed by Model3. The same effects can also be observed in Table 5. In the top and bottom part Model2 scores best for all rating categories and for shifted and unshifted CFNAI. Moreover, in the bottom part one can see that scores using the non-shifted CFNAI are very close to the scores obtained using the shifted CFNAI. This illustrates again that using the shifted CFNAI does not impair predictions by much.

Judging from the results on the predictive distributions one would clearly prefer Model2 over Model3.

5 Summary and discussion

We have extended the Bernoulli mixture models considered in McNeil and Wendin (2006) by explicitly modeling the correlation structure between rating category and time period
and studied their model fit and predictive capability. In contrast to McNeil and Wendin (2006) we put special emphasis on model prediction, which we believe is the primary focus of the data analyst. In particular for the investigation of the predictive ability of a model we used predictable model specifications. Further we utilized the Brier-score and a standardized predictive residual. The results of our empirical study showed that the model extensions are useful both for model fit and prediction. In particular, the data provides evidence that the correlation effect between rating categories is decreasing when rating categories are further apart despite a rather limited data base and it is larger than the correlation effect induced by the time dynamics.

For a larger data set with longer time history, one can extend the model to include dynamic model components for exogenous variables reflecting macro-economic information. In this context models as considered and fitted in Czado and Song (2006) can be utilized. In addition one could also consider different time dynamics such as general ARMA or stochastic volatility models. Further additional fixed grouping variables such as industry sectors to allow for more homogeneous groups can be easily included.

With regard to the Bayesian approach external data sources can be easily incorporated transforming this information into proper prior information. For example if one expects the time correlation parameter $\rho$ to be close to a value $\rho_0$, one can use for example a normal prior for $\rho$ with mean value $\rho_0$ truncated to the interval $(-1, 1)$.

Because of the requirements for an IRB based approach, it is to be expected that larger internal data bases over longer time horizons will become available, where the model extensions discussed above will be feasible and expected to improve the default probability predictions. Finally, we like to note that models for default probabilities are only one com-

<table>
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<th>Index not shifted</th>
<th>Brier-score</th>
<th>Relative Brier-score</th>
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<tbody>
<tr>
<td>Model0</td>
<td>0.037</td>
<td>54</td>
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<tr>
<td>Model1</td>
<td>0.025</td>
<td>36</td>
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<tr>
<td>Model2</td>
<td>0.022</td>
<td>28</td>
</tr>
<tr>
<td>Model3</td>
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<td>30</td>
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<table>
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<th>Brier-score</th>
<th>Relative Brier-score</th>
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<td>86</td>
</tr>
<tr>
<td>Model1</td>
<td>0.032</td>
<td>51</td>
</tr>
<tr>
<td>Model2</td>
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<td>37</td>
</tr>
<tr>
<td>Model3</td>
<td>0.027</td>
<td>41</td>
</tr>
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</table>

Table 4: Brier-scores for 2005 using 1981-2004 data with unshifted CFNAI and shifted CFNAI index
| Index not shifted | $|d_{2005,CCC}|$ | $|d_{2005,B}|$ | $|d_{2005,BB}|$ | $|d_{2005,BBB}|$ | $|d_{2005,A}|$ |
|------------------|----------------|----------------|----------------|----------------|----------------|
| Model0           | 3.66           | 3.96           | 2.33           | 1.27           | 0.63           |
| Model1           | 3.00           | 3.15           | 2.00           | 1.05           | 0.58           |
| Model2           | 2.75           | 2.57           | 1.76           | 0.89           | 0.55           |
| Model3           | 2.79           | 2.69           | 1.85           | 0.94           | 0.56           |
| Index shifted    | $|d_{2005,CCC}|$ | $|d_{2005,B}|$ | $|d_{2005,BB}|$ | $|d_{2005,BBB}|$ | $|d_{2005,A}|$ |
| Model0           | 4.00           | 4.36           | 2.51           | 1.38           | 0.67           |
| Model1           | 3.08           | 3.25           | 2.06           | 1.08           | 0.59           |
| Model2           | 2.71           | 2.47           | 1.74           | 0.85           | 0.55           |
| Model3           | 2.83           | 2.72           | 1.87           | 0.94           | 0.57           |
| Index not shifted | $CPO_{2005,CCC}$ | $CPO_{2005,B}$ | $CPO_{2005,BB}$ | $CPO_{2005,BBB}$ | $CPO_{2005,A}$ |
| Model0           | 0.011          | 0.009          | 0.032          | 0.148          | 0.667          |
| Model1           | 0.018          | 0.015          | 0.049          | 0.186          | 0.710          |
| Model2           | 0.023          | 0.023          | 0.071          | 0.216          | 0.729          |
| Model3           | 0.022          | 0.022          | 0.063          | 0.207          | 0.725          |
| Index shifted    | $CPO_{2005,CCC}$ | $CPO_{2005,B}$ | $CPO_{2005,BB}$ | $CPO_{2005,BBB}$ | $CPO_{2005,A}$ |
| Model0           | 0.012          | 0.010          | 0.034          | 0.137          | 0.640          |
| Model1           | 0.022          | 0.018          | 0.058          | 0.185          | 0.698          |
| Model2           | 0.027          | 0.025          | 0.081          | 0.220          | 0.730          |
| Model3           | 0.025          | 0.023          | 0.070          | 0.207          | 0.719          |

Table 5: Top Part: Absolute predictive residuals $|d_{2005,k}|$ for $k = 1, \ldots, K$ using 1981-2004 data with unshifted CFNAI and shifted CFNAI Bottom Part: Conditional predictive ordinates $CPO_{2005,k}$ for $k = 1, \ldots, K$ using 1981-2004 data with unshifted CFNAI and shifted CFNAI
ponent for credit risk management in addition to models for loss after default. Therefore more realistic joint models which can be fitted and assessed by a Bayesian approach are to be envisioned.

References


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APPENDIX A: Conditional distributions

In this section, we will denote by $[\cdot]$ unconditional densities and by $[\cdot|\cdot]$ conditional densities. Further we collect the observed data $M_{tk}$ and $m_{tk}$ for $t = 1, \cdots, T; k = 1, \cdots, K$ into the vector $M$ and $m$, respectively. The complete risk vector is denoted by $b = (b_1, \cdots, b_T)$. Finally we make repeated use of the following fact also used in McNeil and Wædin (2006):

If $Z = (Z_1, Z_2, ..., Z_m) \sim N_m(\mu, \Psi)$ where $X$ denotes the inverse of $\Psi$, then

\[(A.1) \quad Z_r | Z_{-r} \sim N\left(\tilde{\mu}, \tilde{\sigma}^2\right) \text{ with } \tilde{\mu} = \mu_r + \frac{1}{X_{rr}} \sum_{s=1, s \neq r}^{K} X_{sr} (\mu_s - Z_s) \text{ and } \tilde{\sigma}^2 = \frac{1}{X_{rr}} \]

**Model1**

The joint density is given by

$$[M, m, b, \mu, \sigma, \beta, \alpha] = \prod_{t=1}^{T} \prod_{k=1}^{K} \left[M_{tk} | m_{tk}, b_t, \mu_k, \beta\right] [b | \sigma, \alpha] [\mu] [\beta | \alpha],$$

where $[M_{tk} | m_{tk}, b_t, \mu_k, \beta] \propto g(\mu_k - x_i \beta - b_t)^{M_{tk}} (1 - g(\mu_k - x_i \beta - b_t))^{m_{tk} - M_{tk}}$. Now, the complete risk vector $b = (b_1, b_2, ..., b_T)^T$ is multivariate normal with covariance matrix $\Sigma$ given by $\Sigma_{st} = \text{cov}(b_s, b_t) = \sigma^2 \alpha_1^{s-t}, s, t \in \{1, 2, ..., T\}$. Its inverse is tridiagonal

\[
\Sigma^{-1} = \frac{1}{\sigma^2} \begin{pmatrix}
1 & -\alpha & & & \\
-\alpha & 1 + \alpha^2 & -\alpha & & \\
& -\alpha & 1 + \alpha^2 & -\alpha & \\
& & \ddots & \ddots & \ddots \\
& & & -\alpha & 1 + \alpha^2 -\alpha \\
& & & & -\alpha & 1 \\
\end{pmatrix}
\]

Moreover, $\det(\Sigma^{-1}) = \sigma^{-2T} (1 - \alpha^2)$. It then follows that the full conditional of $\alpha$ is

\[(A.2) \quad [\alpha | \sigma, \beta, \mu, b, m, M] \propto \sqrt{\det(\Sigma^{-1})} \exp\left\{-\frac{1}{2} b^T \Sigma^{-1} b\right\} [\alpha] \]

\[\propto \sqrt{1 - \alpha^2} \exp\left\{-\frac{1}{2} \sigma^{-2} (C_1(b) \alpha^2 - C_2(b) \alpha)\right\} [\alpha] \]

where $C_1(b) = \sum_{t=2}^{T-1} b_t^2$ and $C_2(b) = 2 \sum_{t=2}^{T} b_t b_{t-1}$. The posterior density of $\sigma$ is given by

$$[\sigma^2 | \alpha, \beta, \mu, b, m, M] \propto [b | \sigma, \alpha] [\sigma] \propto \sigma^{-T} \exp\left\{-C_3(b) \sigma^{-2}\right\} [\sigma]$$
where \( C_3(b) = \frac{1}{2} \left( \sum_{t=1}^{T} b_t^2 + \alpha^2 \sum_{t=2}^{T-1} b_t^2 - 2\alpha \sum_{t=2}^{T} b_t b_{t-1} \right) \). But now, if \( \sigma^2 \) has an \( \text{Inv}\Gamma(\eta, \nu) \) prior then

\[
[\sigma^2 | \alpha, \beta, \mu, b, m, M] \sim \text{Inv}\Gamma(\eta + T/2, \nu + C_3(b, \alpha)).
\]

The risk vector \( b | \alpha, \sigma \) is multivariate normal and for \( b_{-t} = (b_1, b_2, ..., b_{t-1}, b_{t+1}, ..., b_T) \), \( t = 1, 2, \ldots, T \)

\[
[b_t | b_{-t}, \alpha, \sigma] \sim \begin{cases} 
N(\alpha b_2, \sigma^2) & t = 1 \\
N(\alpha b_{T-1}, \sigma^2) & t = T \\
N\left(\frac{\alpha}{1+\alpha^2} (b_{t-1} + b_{t+1}), \frac{\sigma^2}{1+\alpha^2}\right) & \text{otherwise}
\end{cases}
\]

The full conditional density then is

\[
[b_t | b_{-t}, \alpha, \sigma, m, M] \propto \prod_{k=1}^{K} [M_{tk} | m_{tk}, b_t, \mu_k] [b_t | b_{-t}, \alpha, \sigma]
\]

where \( [M_{tk} | m_{tk}, b_t, \mu_k, \beta] \propto g(\mu_k - x_t \beta - b_t)^{M_{tk}} (1 - g(\mu_k - x_t \beta - b_t))^{m_{tk} - M_{tk}} \). The full conditional density of \( \beta \) is given by

\[
[\beta | \alpha, \sigma, \mu, b, m, M] \propto \prod_{t=1}^{T} \prod_{k=1}^{K} [M_{tk} | m_{tk}, b_t, \mu_k, \beta] [\beta].
\]

The corresponding full conditionals for Model0 can easily be obtained by setting \( \alpha = 0 \).

**Model2**

Model2 has the joint distribution

\[ (A.3) \quad [M, m, b, \mu, \sigma, \alpha, \beta, \rho] = \prod_{t=1}^{T} \prod_{k=1}^{K} [M_{tk} | m_{tk}, b_t, \mu_k, \beta] [b | \sigma, \alpha \rho] [\mu] [\sigma] [\alpha] [\beta] [\rho], \]

The risk vector \( b \) is again multivariate normal with zero mean vector and \( \text{cov} (b_{sk}, b_{tl}) = \Phi_{kl} \frac{\alpha^{t-s}}{1-\alpha^2}, s, t \in \{1, 2, \ldots, T\}, k, l \in \{1, 2, \ldots, K\} \) so that the covariance matrix has inverse

\[ (A.4) \quad \Sigma^{-1} = \frac{1}{\sigma^2} \begin{pmatrix}
\Lambda & -\alpha \Lambda \\
-\alpha \Lambda & \Lambda (1 + \alpha^2) & -\alpha \Lambda \\
-\alpha \Lambda & \Lambda (1 + \alpha^2) & -\alpha \Lambda \\
& & \ddots & \ddots & \ddots \\
-\alpha \Lambda & \Lambda (1 + \alpha^2) & -\alpha \Lambda \\
-\alpha \Lambda & \Lambda (1 + \alpha^2) & -\alpha \Lambda
\end{pmatrix} \]
is the inverse of $\Phi/\sigma^2$. This gives that \( \det (\Sigma^{-1}) = \det (\Lambda)^T (1 - \alpha^2) \sigma^{-2TK} = \sigma^{-2TK} (1 - \rho^2)^T (1 - \alpha^2) \). Now, \( b \) is again multivariate normal and it follows from (A.1) that

\[
\begin{pmatrix}
1 & -\rho \\
-\rho & 1 + \rho^2 & -\rho \\
-\rho & 1 + \rho^2 & -\rho \\
\vdots & \ddots & \ddots \\
-\rho & 1 + \rho^2 & -\rho \\
-\rho & 1 \\
\end{pmatrix}
\]

is the inverse of $\Phi/\sigma^2$. This gives that \( \det (\Sigma^{-1}) = \det (\Lambda)^T (1 - \alpha^2) \sigma^{-2TK} = \sigma^{-2TK} (1 - \rho^2)^T (1 - \alpha^2) \). Now, \( b \) is again multivariate normal and it follows from (A.1) that

\[
[A.5] \quad [b_t | b_{-t}, \alpha, \beta, \sigma, \rho] \sim \begin{cases} 
N(\alpha b_2, \Phi) & t = 1 \\
N(\alpha b_{T-1}, \Phi) & t = T \\
N\left( \frac{\alpha}{1 + \alpha^2} (b_{t-1} + b_{t+1}), \frac{1}{1 + \alpha^2} \Phi \right) & \text{otherwise}
\end{cases}
\]

Again using A.1 gives that if \( t = 1 \)

\[
[b_{tk} | b_{-tk}, \alpha, \beta, \rho, \sigma] \sim \begin{cases} 
N(\alpha b_{2,k} - \rho (\alpha b_{2,k+1} - b_{1,k+1}), \sigma^2) & k = 1 \\
N(\alpha b_{2,k} - \rho (\alpha b_{2,k-1} - b_{1,k-1}), \sigma^2) & k = K \\
N\left( \frac{\alpha}{1 + \rho^2} (\alpha b_{2,k-1} - b_{1,k-1} + \alpha b_{2,k+1} - b_{1,k+1}), \frac{\sigma^2}{1 + \rho^2} \right) & \text{otherwise}
\end{cases}
\]

If \( t = T \)

\[
[b_{tk} | b_{-tk}, \alpha, \beta, \rho, \sigma] \sim \begin{cases} 
N(\alpha b_{T-1,k} - \rho (\alpha b_{T-1,k+1} - b_{T,k+1}), \sigma^2) & k = 1 \\
N(\alpha b_{T-1,k} - \rho (\alpha b_{T-1,k-1} - b_{T,k-1}), \sigma^2) & k = K \\
N\left( \frac{\alpha}{1 + \rho^2} (\alpha b_{T-1,k-1} - b_{T,k-1} + \alpha b_{T-1,k+1} - b_{T,k+1}), \frac{\sigma^2}{1 + \rho^2} \right) & \text{otherwise}
\end{cases}
\]

For \( 1 < t < T \)

\[
[b_{tk} | b_{-tk}, \alpha, \beta, \rho, \sigma] \sim \begin{cases} 
N \left( \frac{\alpha}{1 + \alpha^2} (b_{t-1,k} + b_{t+1,k}) - \rho \left( \frac{\alpha}{1 + \alpha^2} (b_{t-1,k+1} + b_{t+1,k+1} - b_{t,k+1}) \right), \frac{\sigma^2}{1 + \alpha^2} \right) & k = 1 \\
N \left( \frac{\alpha}{1 + \alpha^2} (b_{t-1,k} + b_{t+1,k}) - \rho \left( \frac{\alpha}{1 + \alpha^2} (b_{t-1,k-1} + b_{t+1,k-1} - b_{t,k-1}) \right), \frac{\sigma^2}{1 + \alpha^2} \right) & k = K \\
N \left( \frac{\alpha}{1 + \alpha^2} (b_{t-1,k} + b_{t+1,k}) - \frac{\rho}{1 + \rho^2} \left[ \frac{\alpha}{1 + \alpha^2} (b_{t-1,k+1} + b_{t+1,k+1} - b_{t,k+1}) \right], \frac{\sigma^2}{1 + \alpha^2} \right) & \text{otherwise}
\end{cases}
\]

Then \( [b_{tk} | b_{-tk}, \alpha, \beta, \rho, \sigma, m, M] \propto [b_{tk} | b_{-tk}, \alpha, \rho, \sigma, ] [N_{tk} | n_{tk}, b_{tk}, \mu_k, \beta] \). The full condi-
tional distribution of \( \rho \) is given by

\[
\begin{align*}
[\rho | \alpha, \sigma, \beta, m, M, b] & \propto [b | \sigma, \rho, \alpha] [\rho] \\
& \propto \sqrt{\text{det}(\Sigma^{-1})} \exp \left\{ -\frac{1}{2} b^{T} \Sigma^{-1} b \right\} [\sigma] \\
& \propto \sqrt{(1 - \rho^2)^T} \exp \left\{ -\frac{1}{2} \sigma^{-2} \left( S_1 (b, \alpha) \rho + S_2 (b, \alpha) \rho^2 \right) \right\}
\end{align*}
\]

Now, if \( c_i(u, v) \) denotes the coefficient of \( \rho^i \) in \( u^{T} \Lambda v \), then here \( c_1(u, v) = -\left( \sum_{k=2}^{K} u_k v_{k-1} + u_{k-1} v_k \right) \) and \( c_2(u, v) = \sum_{k=2}^{K} u_k v_k \). Then for \( i = 1, 2 \)

(A.6) \quad S_i (b, \alpha) = \sum_{t=2}^{T-1} \left( c_i(b_t, b_t) \left( 1 + \alpha^2 \right) + c_i(b_t, b_1) + c_i(b_T, b_T) - 2 \alpha \sum_{t=2}^{T} c_i(b_t, b_t) \right)

The full conditional distribution of \( \alpha \) can be determined as in A.2

\[
[\alpha | \sigma, \beta, \rho, \mu, b, m, M] \propto \sqrt{\text{det}(\Sigma^{-1})} \exp \left\{ -\frac{1}{2} b^{T} \Sigma^{-1} b \right\} [\alpha] \\
\propto \sqrt{\text{det}(\Sigma^{-1})} \exp \left\{ -\frac{1}{2} \sigma^{-2} \left( C_1 (b, \Lambda) \alpha^2 - C_2 (b, \Lambda) \alpha \right) \right\} [\alpha]
\]

where \( C_1 (b, \Lambda) = \sum_{t=2}^{T-1} b_t^{T} \Lambda b_t \) and \( C_2 (b) = \sum_{t=2}^{T} b_t^{T} \Lambda b_{t-1} + b_{t-1}^{T} \Lambda b_t \). The posterior density of \( \sigma^2 \) is given by

\[
[\sigma^2 | \alpha, \beta, \rho, \mu, b, m, M] \propto [b | \sigma, \rho, \alpha] [\sigma] \propto \sqrt{\text{det}(\Sigma)} \exp \left\{ -\frac{1}{2} b^{T} \Sigma^{-1} b \right\} [\sigma] \\
\propto \sigma^{-TK} \exp \left\{ -C_3 (b, \Lambda) \sigma^{-2} \right\} [\sigma]
\]

where \( C_3 (b, \Lambda, \alpha) = \frac{1}{2} \left( \sum_{t=1}^{T} b_t^{T} \Lambda b_t + \alpha^2 \sum_{t=2}^{T-1} b_t^{T} \Lambda b_t - \alpha \sum_{t=2}^{T} b_t^{T} \Lambda b_{t-1} + b_{t-1}^{T} \Lambda b_t \right) \).

Then, if \( \sigma^2 \) has an \( \text{Inv}\Gamma(\eta, \nu) \) prior

\[
[\sigma^2 | \alpha, \beta, \rho, \mu, b, m, M] \sim \text{Inv}\Gamma(\eta + TK/2, \nu + C_3 (b, \Lambda, \alpha))
\]

The posterior densities for \( \beta \) and \( \mu \) can be found similarly to those in Model1.

**Model3**

Model3 again has joint density (A.3). Here, the covariance matrix has inverse as in (A.4) where \( \Lambda \) is the inverse of \( \Phi^{-\frac{1}{2}} \Phi^2 \) with \( \Phi \) defined in (2.6) i.e

(A.7) \quad \Lambda = \frac{1 + 3 \rho}{1 + 3 \rho - 4 \rho^2} \begin{pmatrix} 1 & \lambda & \lambda & \lambda \\ \lambda & 1 & \lambda & \lambda \\ \lambda & \lambda & 1 & \lambda \\ \lambda & \lambda & \lambda & 1 \end{pmatrix} \quad \text{with} \quad \lambda = \frac{-\rho}{1 + 3 \rho}.

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This then gives

\[
det (\Sigma^{-1}) = \det (\Lambda)^T (1 - \alpha^2) \sigma^{-2TK} = \left( (1 - \lambda)^4 (1 + 4\lambda) \left( \frac{1 + 3\rho}{1 + 3\rho - 4\rho^2} \right)^K \right)^T \sigma^{-2TK} (1 - \alpha^2).
\]

(A.5) and (A.1) hold exactly as for Model2 and with \( \Lambda \) as above \([b_{tk} | b_{-tk}, \alpha, \beta, \rho, \sigma] \) can be determined. For \( t = 1 \)

\[
[b_{tk} | b_{-tk}, \alpha, \beta, \rho, \sigma] \sim N \left( \alpha b_{2,k} + \lambda \sum_{s \neq k} (\alpha b_{2,s} - b_{1,s}), \frac{1 + 3\rho - 4\rho^2}{1 + 3\rho} \sigma^2 \right).
\]

For \( t = T \)

\[
[b_{tk} | b_{-tk}, \alpha, \beta, \rho, \sigma] \sim N \left( \alpha b_{T-1,k} + \lambda \sum_{s \neq k} (\alpha b_{T-1,s} - b_{T,s}), \frac{1 + 3\rho - 4\rho^2}{1 + 3\rho} \sigma^2 \right).
\]

For \( 1 < t < T \)

\[
[b_{tk} | b_{-tk}, \alpha, \beta, \rho, \sigma] \sim N \left( \frac{\alpha}{1 + \alpha^2} (b_{t-1,k} + b_{t+1,k}) + \lambda \sum_{s \neq k} \left( \frac{\alpha}{1 + \alpha^2} (b_{t-1,s} + b_{t+1,s}) - b_{t,s} \right), \sigma^2 \frac{1 + 3\rho - 4\rho^2}{1 + 3\rho} \right).
\]

The full conditional density of \( \rho \) is determined by

\[
|\rho|, \sigma, \alpha, \beta, \nu, \mu \propto \frac{1}{\sigma^2} \exp \left\{ \frac{1}{2} \frac{1}{1 + 3\rho - 4\rho^2} S_1 (b, \alpha) - S_2 (b, \alpha) \right\}
\]

Now, if \( c_i (u, v) \) this time denotes the coefficient of \( \lambda_i \) in \( u^T \frac{1 + 3\rho - 4\rho^2}{1 + 3\rho} \nu \) for \( \Lambda \) defined in (A.7) then here \( c_1 (u, v) = \sum_k u_kv_k \) and \( c_2 (u, v) = \sum_{k \neq l} u_kv_l \). Then for \( i = 1, 2 \) \( S_i \) is again defined by (A.6). Since the full conditional distributions of \( \alpha, \beta, \sigma \) and \( \mu \) do not depend on the actual form of \( \Lambda \) these full conditional distributions are the same as in Model2.
Figure 1: Fitted and predicted default probabilities (solid) in Model 2 with unshifted CFNAI index (dashed)
Figure 2: Estimated posterior mean default probabilities for $t = 1981, \ldots, 2004$ and predicted default probability for 2005 (solid line) with 80% credible intervals (dotted lines) and observed default probabilities (o) using the unshifted CFNAI index.
Figure 3: Predictive densities for 2005 in the different rating categories using unshifted CFNAI index. The vertical dashed red line indicates the observed default probability in 2005 and the blue vertical dashed lines show the 90% credible interval.
Figure 4: Left panels: fitted \((t \neq 2005)\) and predicted \((t = 2005)\) default probabilities for different covariate specifications, Right panels: Predictive default densities for rating category B in 2005.