Stress testing of probability of default of individuals

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Abstract

This working paper introduces a model for stress testing of probability of default of individuals. The model rests on assumption that the individual defaults if his savings fall below zero. The probability of default is then described as a function of several macroeconomic indicators such as wages, unemployment and interest rates. Stress testing is carried out by applying exogenous stress scenarios for development of these indicators. The model implies that sensitivity of probability of default to the stress is mainly driven by Installment to Income Ratio and for mortgages also by loan maturity. Hence Installment to Income ratio is suggested as the appropriate tool to manage credit risk of retail portfolios.

Key words

banking; credit risk; stress testing; probability of default

1 Introduction

Complex credit risk management in financial institutions addresses three levels of credit risk: expected losses, unexpected losses, and extremal events. Expected losses, that are long-term average losses, are covered through proper credit risk pricing and profitability management. Possible unexpected losses, that are higher than long-term average losses, are covered by capital reserves up to certain level of severity. Extreme unexpected losses above the severity level shall be rare by definition and hence it is not efficient to keep reserves for them continuously. However, the institution should foresee impact of extreme events which could evolve from current situation and have a plan for each such event to mitigate its impact if it evolves. This task is supported by stress testing.

Stress testing is, in other words, investigation of impact of meaningfully defined scenarios of future development, extreme development in particular. In credit risk stress testing, impact of these scenarios is measured in terms of losses to be suffered on account of credit risk or in terms of change in credit risk parameters. This paper focuses on impact of adverse macroeconomic development on probability of default of individuals.

In line with [6], the background for Basel II model of unexpected losses, we consider two types of credit risk factors affecting probability of default: global (systemic) and individual (idiosyncratic). Individual factors are specific for each transaction and are averaged out on diversified portfolio. Global factors are common to all transactions in the portfolio and can be interpreted as the macroeconomic conditions. Hence the macroeconomic variables are in the center of our interest and are viewed as drivers of key individual factors such as income and level of savings.
In literature, impact of the macroeconomic environment on credit risk has been studied from two perspectives. A bottom-up approach is based on data of individual clients while a top-down approach relies on aggregate data. This paper adopts the bottom-up approach similarly as [2], who inspect stability of the credit risk models of the US households using the panel data set of credit cards. The top-down approach is more common in the literature since the aggregate data are more available. The time-series approach to modeling the arrears of UK individuals using the macroeconomic data is adopted by [7]. A latent-factor model is developed by [4], which is then applied to the Czech banking sector.

When modelling credit stress in the Czech Republic the following issues are faced regarding macroeconomic variables:

- The transitive economy has not experienced regular economic cycle. The economic downturn in nineties of the last century was driven by specific economic conditions that are not likely to repeat.
- In last ten years the economic conditions has been gradually improving.
- Retail banking business has been dynamically developing within relatively short time from almost zero to its contemporary complexity.

Moreover, the portfolio is usually closely controlled by the Risk Management and hence we will develop a theoretical macroeconomic model rather than any statistical model. A clear story behind the results is also an advantage of this approach so that it can better serve "as a diagnostic tool to improve the institution’s understanding of its risk profile". It is another important reason for stress testing as pointed out by [1].

The fundamental paper in the field of corporate default rate modelling and bond pricing is by [5]. This paper deals with modelling default rate of individual clients, which is not a topic frequently discussed in literature. We adopt the approach by [5] and modify it for the loans of individuals. [3] refer to "different sensitivities of corporations and households to the macroeconomic environment" which supports the need to build the model for individual clients differently.

[5] states that "on the maturity date, the firm must either pay the promised payment to the bondholders or else the current equity will be valueless." He concludes that the firm will default if the value of equity is lower than the promised payment. This conclusion is based on the assumption that "the firm cannot issue any new senior (or of equivalent rank) claims on the firm nor can it pay cash dividends or do share repurchase prior to the maturity date of the debt".

If we adopted this approach to the case of individuals, we would state that the client defaults if and only if the value of his property (incl. the net present value of his future income) is lower than the promised payment. However, assumption that the client cannot issue any claims on his property is not so realistic as it is in the case of firms. Hence, we will abstract of the client's property and focus solely on his income and savings.

The paper is organized as follows: Section 2 introduces the underlying dynamic model of client's income and savings. In section 3, the default is defined and sensitivity of probability of default to changes of macroeconomic variables is investigated. Section 4 deals with issues concerning implementation of the model. In section 5, an example of results of the model is presented. Section 6 concludes.

2 Model of Income and Savings

In this section, we will develop a dynamic model of individual's income and savings. The model will be used later for computation and stress of PD.
The following notation will be used throughout the paper: Macro variables are denoted by capital letters while the variables concerned with an individual client or a loan are denoted in lowercase.

The nominal income $i_t$ is divided between the consumption $c_t$, sum of all annuity payments $a_t$, and deposit $s_t - s_{t-1}(1 + r_{t-1}^s)$,

$$i_t = c_t + a_t + [s_t - s_{t-1}(1 + r_{t-1}^s)]$$ (1)

where $s_t$ is the amount of savings and $r_{t-1}^s$ is an interest rate on savings per one interest period. To simplify formulae, refer to savings accrued in time $t$ as

$$s_t^* ≡ s_{t-1}(1 + r_{t-1}^s)$$ (2)

We conservatively assume that each client who is borrowing money has zero available savings in the time of loan granting, i.e. $s_0 = 0$. If the client has savings at the time of loan granting he will spend them and borrow only the rest of the money needed.

Let consumption $c_t$ depend linearly on disposable income plus savings coming from the previous period, namely,

$$c_t = γ^* P_t + γ^* [s_t^* + i_t - a_t - γ^* P_t]$$ (3)

where $γ^*$ is the client's minimum level of real consumption and it is assumed to be constant over time, $P_t$ is a price level in time $t$. Hence, $γ^* P_t$ is the client's minimum nominal consumption.

The coefficient $γ ∈ [0,1]$ is a marginal propensity to consumption. When the client's income (or savings coming from the previous period) increases by 1 CZK his nominal consumption increases by $γ$ CZK.

Dynamics of savings can be described using (1) and (3) as

$$s_t = (1 - γ^*)[s_{t-1}(1 + r_{t-1}^s) + i_t - a_t - γ^* P_t]$$ (4)

Variables $a_t$ and $P_t$ are given exogenously, dynamics of income $i_t$ is specified hereunder.

Denote $I_0$ the equilibrium client's income in time 0 and $I_t$ the nominal per capita income in the economy in time $t$. Assume that $\ln (i_t/I_t)$ is the AR(1) process with intercept. The intercept term is given by the ratio of the client's equilibrium income to the per capita income in the economy. This ratio is assumed to be constant over time.

Hence, we can write the income equation as

$$\ln \frac{i_t}{I_t} = α\ln \frac{I_t}{I_0} + (1 - α)\ln \frac{i_{t-1}}{I_{t-1}} + ε_t$$ (5)

where $0 < α < 1$ is an autoregression coefficient, and assume that $ε_t$ has a distribution with zero mean.

### 3 Probability of Default

#### 3.1 Definition of Default

For the sake of definition of default assume that the client cannot borrow additional money or restructure the debt. Hence default occurs when client's income plus savings coming from the previous period do not cover the installments plus minimum consumption, i.e. $s_t^* + i_t < a_t + γ^* P_t$.

By equation (4), this is equivalent to the condition when the current volume of savings falls to negative values, $s_t < 0$.

Let us define the default formally. Let $D_t$ be the random event that the client is in default in time $t$. Then
3.2 Sensitivity Analysis

We will determine the transaction-specific factors affecting sensitivity of PD to the stress of macroeconomic conditions. It will allow identifying potentially risky parts of retail portfolios.

When performing the sensitivity analysis, we will start with a given (typically expected) PD in time $t$ under the given loan parameters and macroeconomic conditions in time $t$ and $t−1$. We will inspect change of PD caused by a change (stress) in macroeconomic conditions in time $t$ having all the parameters in time $t−1$ constant. The variables concerned with the changed conditions will be marked by a prime, e.g. $P_t'$, while the original variables remain denoted in the simple way, e.g. $P_t$.

Denote

$$p_t = P[D_t]$$

For expectation of $\ln i_t$ given by (5) we have conditionally on information prior to $t$:

$$\ln i_t = E_{t−1} [\ln i_t] = \alpha \ln \frac{I_t}{I_0} + (1− \alpha) \ln \frac{i_{t−1}}{I_{t−1}} + \ln I_t.$$  

(9)

Since values of variables from time $t−1$ are known in time $t$ and $I_t$ is exogenous, all the variables involved in equation (9) are deterministic and therefore

$$\frac{\hat{i}_t}{\hat{i}_t'} = \frac{I_t}{I_t'}.$$  

(10)

Definition of default (6), model specification (4) and (5), and equation (9) imply that

$$p_t = P[s_t < 0] = F\left[\gamma^* P_t + a_t - s_t^* \right].$$  

(11)

where $F$ is the CDF of $\exp(\varepsilon_t)$.

Assume that $p_t > 0$. When $F$ is continuous, we can uniquely define $F^{-1}[p_t]$ and express the consumption level under zero disposable income as

$$\gamma^* = \frac{i_t F^{-1}[p_t] - a_t + s_t^*}{P_t}.$$  

(12)

It is assumed to be positive, which is equivalent to the condition

$$p_t > F\left[\frac{a_t - s_t^*}{i_t} \right].$$  

(13)

Using the stressed values (marked by prime) we obtain an equation analogous to (11):

$$p_t' = F\left[\gamma^* P_t' + a_t' - s_t' \right].$$  

(14)
After substitution of equation (12) into (14) and due to (10),

\[ p_t' = F \left[ \frac{I_t / P_t}{I_t' / P_t'} \left( F^{-1} \left[ p_t \right] + \frac{a_t}{\hat{i}_t} \left( \frac{a_t'}{a_t} \cdot \frac{P_t}{P_t'} - 1 \right) \right) - \frac{s_t^*}{\hat{i}_t} \left( \frac{P_t}{P_t'} - 1 \right) \right] \]

(15)

The ratio \( a_t / \hat{i}_t \) will be called Installment to Income Ratio (IIR), \( s_t^* / \hat{i}_t \) referred to as the Savings to Income Ratio (SIR) in the next paragraphs.

Discussion of the theoretical findings derived can be found in section 5.1.

### 4 Model Implementation

This part of the paper deals with issues concerning calibration of the theoretical models established heretofore. Tentative scenarios of future development of the Czech economy are given exogenously and referred to in section 4.1. Section 4.2 discusses relationship between the loan interest rate and interest rate in the economy. Distribution of income change is selected in section 4.3.

**4.1 Stress Testing Scenarios**

Trajectories for development of the economy are exogenous to our model. Several tentative scenarios are provided, covering beside the expected development the following unfavorable types of evolution: recession and growing interest rates.

Expected scenario is the point prediction of macroeconomic development. Recession will negatively affect incomes, i.e. wages decline and unemployment increases. Scenario with growth of interest rates is crucial for mortgage loans stress testing.

**4.2 Interest Rates**

For the loans that are assumed to be re-fixed in the future, the new loan nominal interest rate per one period \( r_t \) must be computed. Denote \( R_t \) interest rate per one period in the economy. For simplicity, we will assume a constant additive gross margin. Hence if the loan is re-fixed in time \( t > 0 \), its new interest rate will be \( r_t = r_0 - R_0 + R_t \), where \( R_t \) is a nominal interest rate in the economy in time \( t \).

**4.3 Distribution of Income Change**

Loans can be paid off from various sources of income, such as wage, rent, interests, dividends etc. However, wage strongly prevails for most clients and hence we will focus on this source of income in our analysis.

Income should reflect also the possibility of being unemployed. When losing a job the client receives social aid from the state. Other sources of income in such situation may be: withdrawal of savings, work in the grey economy or help of client's family or friends. We will assume that possible unemployment is already incorporated in the process of income.

In equation (5), \( \varepsilon_t \) is assumed to have a distribution with zero mean. Here tentatively assume that \( \varepsilon_t / \sigma \) has a Student distribution with \( d > 1 \) degrees of freedom, its CDF will be denoted \( G \). (Note that mean of the Student distribution with \( d > 1 \) degrees of freedom is 0.) Then,

\[ F[x] \equiv G(\ln x / \sigma ; d) \]

where \( \sigma > 0 \) is the scaling factor.
5 Results

5.1 Sensitivity Analysis

Sensitivity to the stress varies across clients. We will determine its main drivers in this section using the theoretical findings from section 3.2 with details about annuity and income change distribution from section 4.3.

Remind that the sensitivity analysis studies one-period changes and period of annuity payment is usually one month. Parameters of the model will be chosen with respect to this fact. They will reflect the scenario of growing interest rates, inflation and real income, which will turn out to be the riskiest one for mortgages.

The stressed annual loan interest rate will be probably 0.25% or at most 0.5% above the expected rate. For the annual expected interest rate of 5.5%, the expected monthly rate is \( r_t = 0.055/12 \) and the stressed will be chosen \( r_t' = 0.0575/12 \). The sensitivity increases with the growing time to maturity. For the typical mortgage loan 240 months to maturity and discussed \( r_t \), \( r_t' \) we have \( a_t'/a_t \approx 1.02 \).

Growing interest rates are usually accompanied by the increase of inflation. We will assume a monthly price level stress by 0.5%. The stressed real income is assumed to increase also by 0.5% and so the nominal income grows by 1%. Parameters of the income distribution are set to be \( d = 4 \) and \( \sigma = 0.02 \).

Impact of IIR and SIR according to equation (15) is depicted in Figure 1. IIR has clearly a greater effect on the PD stress because real annuity change is higher than the price level stress. To sum up, the following transaction-specific drivers of sensitivity to stress were identified: IIR, SIR and the time to maturity.

IIR determines the sensitivity of PD change caused by the stress of real annuity. The nominal annuity is either constant (consumer loans) or may be changed (mortgages). Its change is then caused by the stress of loan interest rate and the extent is determined by the time to maturity. Another factor contributing to real annuity and the only one for consumer loans is the price level. It is relatively less volatile than the nominal annuity in time of re-fix.

SIR expresses sensitivity to the stress of price level. The purchasing power of savings depends on the price level, hence clients with relatively high savings are subject to risk of price level stress but, on the other hand, they are generally less risky than those with no savings. However, level of savings depends on client's decision and cannot be directly influenced by the financial institution.

Hence, the most risky segment is mortgages with principal risk drivers being large IIR and long time to maturity.

5.2 Dynamics of PD

We will demonstrate the dynamic model on the example in this section. The exogenous scenarios of macroeconomic development are presented in Figure 2. They specify the annual interest rate \( 12R_t \), index of per capita income \( I_t \) (wages adjusted for the income of the unemployed) and price level index \( P_t \). The time period is equal to one month.

Realization of client's savings and income development was performed via equations (4) and (5) using error terms of the income change \( \varepsilon_t \) generated from the distribution (16). This step was repeated 1 000 000 times and rates of default computed.

The following loan and client properties were used in the simulation:

\[
\begin{align*}
a_0 &= 12 000 \text{ CZK} \\
r_0 &= \frac{0.055}{12} \\
\gamma_t &= 0.5 \\
\alpha &= 0.05 \\
\sigma &= 0.02 \\
d &= 4 \\
\end{align*}
\]
In the first example, loan interest rate is re-fixed each 12 months. This is the case of a mortgage loan. Results can be seen in Figure 3. In the first graph there is the mortality function from the time of loan granting till the time \( t \). The second graph describes probability of default in time \( t \) of the loans performing till time \( t-1 \). The third and fourth graph depicts development of annuity and loan interest rate in time.

In the second example, parameters of the loan are the same but annuity is constant over the whole life of the loan (resp. at least for the observed period). This may be the case of consumer loan or mortgage loan with a long fixation period. Note that maturity of the loan does not matter in this case. Default rates are depicted in Figure 4.

In both examples but especially in the second one, we can observe peak in \( P[D_t \mid \neg D_{t-1}] \) in time \( t=1 \). It is due to the fat-tailed distribution of income change: The peak is even more significant for \( d=1 \) and not present for \( d=\infty \).

The gradual increase of \( P[D_t \mid \neg D_{t-1}] \) after time \( t=2 \) is caused by decreasing income of part of the clients. Contrary to this acts the effect of increasing average savings of those who did not default, which prevails in our example after the time of \( t\approx 10 \), when PD starts to decline.

While in the second example no serious impact of different scenarios on PD is observed we have identified a serious risk of interest rate increase in the first example. It is caused by re-fixation of mortgage loans, when annuity substantially increases and causes the immediate growth of the probability of default of the non-defaulted loans in the next months.

6 Conclusion

We proposed a dynamic macroeconomic model of individual client's PD. Scenarios of macroeconomic development and eventual fixation periods were specified exogenously.

The transaction-specific drivers of sensitivity to the stress were identified to be IIR, SIR and for mortgages also time to maturity. IIR determines sensitivity to the stress in real annuity, which is either given solely by the price level stress for the fixed nominal annuity or contains also nominal annuity change depending on the interest rate stress and time to maturity. SIR expresses sensitivity to the stress of price level. Although clients with high SIR are more sensitive to the stress, they are generally less risky. However, level of savings cannot be directly influenced by the financial institutions.

In the empirical simulation, an important risk was found in the segment of mortgages under the scenario of growing interest rates. IIR and time to maturity are the key risk drivers in this case.

This conclusion sends also another clear message: Potential allowing for higher IIR and maturity length for mortgages in the granting process should be treated carefully.

Bibliography


Summary

Zde napište abstrakt článku včetně názvu v anglickém jazyce (max. 10 řádků). Pokud je článek v jiném než českém (nebo slovenském) jazyce, pak napište summary v jazyce českém (nebo slovenském).


**Figure 1:** Sensitivity of PD to the change of IIR and SIR. The reference values are price level stress $P_t'/P_t = 1.005$, per capita income stress $I_t'/I_t = 1.01$, annuity stress $a_t'/a_t = 1.02$, degrees of freedom $d = 4$, and scaling parameter $\sigma = 0.02$.

**Figure 2:** Scenarios of the macroeconomic development: interest rate p.a. $12R_t$, index of per capita income $I_t$ and price level index $P_t$.

**Figure 3:** Annuities and PD's under different scenarios with re-fix each 12 periods (months).

**Figure 4:** PD's under different scenarios with constant annuity.