

**Comparing the performance of market-based and accounting-based bankruptcy  
prediction models**

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**Abstract**

Recently developed corporate bankruptcy prediction models adopt a contingent-claims valuation approach. However, despite their theoretical appeal, tests of their performance compared with traditional simple accounting-ratio-based approaches are limited in the literature. We find the two approaches capture different aspects of bankruptcy risk, and while there is little difference in their predictive ability in the UK, the z-score approach leads to significantly greater bank profitability in conditions of differential decision error costs and competitive pricing regime.

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## 1. Introduction

There is renewed interest in credit risk assessment, inter alia, driven by the requirements of Basle II and explosive growth in the credit derivatives market.<sup>1</sup> This, and the concern about the lack of theoretical underpinning of traditional accounting-ratio-based models such as the Altman (1968) z-score, has led to the application of the contingent claims valuation methodology for predicting corporate failure with the KMV model now extensively employed by banks and financial institutions. However, empirical tests of the relative power of the two approaches are lacking in the literature. The only published study, that of Hillegeist et al. (2004), is deficient in comparing the market-based approach with the Altman (1968) and Ohlson (1980) accounting-ratio-based models which are known to suffer from high misclassification rates (e.g. Begley et al., 1996). It also does not take into account differential error misclassification costs and the economic benefits of using different credit risk assessment approaches. In any case, a more valid comparison would be with the commercially available Zeta® (Altman et al., 1977) model which has far superior performance (e.g. Altman, 1993:219-220).

Under Basel II, banks are allowed to use internal ratings-based approaches to set capital charges with respect to the credit risks of their portfolios. Hence, research in this area assumes greater significance because a poor credit risk model could lead to sub-optimal capital allocation.

Accounting-ratio based models are typically built by searching through a large number of accounting ratios with the ratio weightings estimated on a sample of failed and non-failed firms. Since the ratios and their weightings are derived from sample analysis, such models are likely to be sample specific. Mensah (1984) finds that the distribution of accounting ratios

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<sup>1</sup> This interest is also demonstrated by the wide range of papers in the special issue on 'Credit Ratings and the Proposed New BIS Guidelines on Capital Adequacy for Bank Credit Assets' in the *Journal of Banking and Finance* (ed. Altman, 2001).

changes over time, and hence recommends that such models be redeveloped periodically. In addition, the very nature of the accounting statements on which these models are based casts doubt on their validity: (i) accounting statements present past performance of a firm and may or may not be informative in predicting the future, (ii) conservatism and historical cost accounting mean that the true asset values may be very different from the recorded book values, (iii) accounting numbers are subject to manipulation by management, and in addition, (iv) Hillegeist et al. (2004) argue that since the accounting statements are prepared on a going-concern basis, they are, by design, of limited utility in predicting bankruptcy.

Market-based models using the Black and Scholes (1973) and Merton (1974) contingent claims approach provide a more appealing alternative and there have been several recent papers using this approach for assessing the likelihood of corporate failure (e.g., Bharath and Shumway, 2004; Hillegeist et al., 2004; Reisz and Perlich, 2004; Vassalou and Xing, 2004; Campbell et al., 2006). Such a methodological approach counters most of the above criticisms of accounting-ratio-based models: (i) it provides a sound theoretical model for firm bankruptcy, (ii) in efficient markets, stock prices will reflect all the information contained in accounting statements and will also contain information not in the accounting statements, (iii) market variables are unlikely to be influenced by firm accounting policies, (iv) market prices reflect future expected cashflows, and hence should be more appropriate for prediction purposes, and (v) the output of such models is not time or sample dependent.

However, the Merton model is a structural model and operationalizing it requires a number of assumptions. For instance, as Saunders and Allen (2002: 58-61) point out, the underlying theoretical model requires the assumption of normality of stock returns. It also does not distinguish between different types of debt and assumes that the firm only has a single zero coupon loan. In addition, it requires measures of asset value and volatility which are unobservable. It is therefore not surprising that the empirical evidence on the performance

of market-based models is mixed. Kealhofer (2003) and Oderda et al. (2003) find that such models outperform credit ratings, and in their empirical comparisons Hillegeist et al. (2004) suggest their derived model carries more information about the probability of bankruptcy than poorly performing accounting-ratio based models. On the other hand, Campbell et al. (2006) find such market-based models have little forecasting power after controlling for other variables. Similarly, Reisz and Perlich (2004) find that Altman's (1968) z-score does a slightly better job at failure prediction over a 1-year period than both their KMV-type and computationally much more intensive down-and-out barrier option models, though their market-based models are better over longer horizons (3 to 10 years).

This paper compares the performance of the well-known and widely used UK-based z-score model of Taffler (1984) originally published in a special issue of this journal on international credit risk models against carefully developed market-based models over a 17-year period from 1985 to 2001 using Receiver Operating Characteristic (ROC) curves and information content tests. Importantly, we use the framework of Stein (2005) and Blöchliger and Leippold (2006a), and extend the analysis to compare the market shares, revenues and profitability of banks employing these competing models taking into consideration differential error misclassification costs. Using a sample of middle-market borrowers, Stein (2005), in a largely theoretical paper, demonstrates that small differences in model power can lead to significant economic impact for the user. In contrast, we use the mixed regime framework of Blochliger and Leippold (2006a), and apply this to all UK-listed firms over a 17-year period. We also introduce a specific risk-based performance measure based on the Foundation Approach under Basel II. As Caouette et al. (1998:148) point out:

“Ultimately, however, the real issue is how well the models work and to what extent their use contributes to improved financial performance of the institution. A conceptual model that does not perform has no advantage over a statistical model that does.”

The main conclusions of this study are: (i) while the z-score model is marginally more accurate, the difference is statistically not significant, (ii) in a competitive loan market, a bank using the z-score approach would realize significantly higher risk-adjusted revenues, profits, return on capital employed, and return on risk adjusted capital than a bank employing the comparative market-based credit risk assessment approach, and (iii) relative information content tests find that both the z-score and market-based approaches yield estimates that carry significant information about failure, but neither method subsumes the other.

Our results demonstrate that traditional accounting-ratio-based bankruptcy risk models are, in fact, not inferior to KMV-type option-based models for credit risk assessment purposes, and dominate in terms of potential bank profitability when differential error misclassification costs and loan prices are taken into account. The apparent superiority of the market-based model approach claimed by Hillegeist et al. (2004) reflects the poor performance of their comparator models, not a particularly strong performance by their option-pricing model.

The paper proceeds as follows: the next section describes data sources and different models used, and section 3 presents the evaluation metrics adopted. Results are reported in section 4 and conclusions drawn in section 5.

## **2. Data and method**

This section describes our sample, data and market-based and accounting-ratio-based models.

### *2.1. Sample selection*

This study covers all non-finance industry UK firms fully listed on the London Stock Exchange (LSE) at any time during the period 1985-2001. If a firm changes industry or exchange of listing, it enters the respective portfolio only after it has been listed on the (main)

London Stock Exchange and/or is classified as non-financial for twenty-four months. To be included in the sample, firms are required to have been listed for at least 24 months before the portfolio formation date to ensure that only post-listing accounting information is used.

To ensure that the required accounting information is available at the time of portfolio formation, a five-month lag between the fiscal year-end date and the reporting date is assumed. So, for the portfolio formed on 30<sup>th</sup> September, book value of equity and z-score are derived from the latest available financial statements with fiscal year-end on or before April 30<sup>th</sup>. The final sample consists of 2,006 firms, a total of 15,384 firm years, and 103 failures (0.67%), with the failure event defined as entry into administration, receivership, or creditors' voluntary liquidation procedures. The yearly number of firms in the sample ranges from a minimum of 798 in 1992 to a maximum of 1,014 in 1997.

<b>Table 1 here</b>
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## 2.2. Data

The accounting data is collected from Thomson Financial Company Analysis, EXSTAT, MicroEXSTAT and DATASTREAM databases in that order. Exchange of listing and firm stock exchange industrial classifications are collected from the London Business School London Share Price Database (LSPD). The risk free rates (1-month Treasury bill (T-Bill) rates), market value of equity and daily stock prices are collected from DATASTREAM. The list of firm failures is compiled from LSPD (codes 7, 16 and 20), the *Stock Exchange Official Yearbook*, and *CGT Capital Losses* published by FT Interactive.

## 2.3. Method

### A. Market-based models

Two market-based models, one following Hillegeist et al. (2004), and the other a naïve market-based model following Bharath and Shumway (2004) are used. Both the models are

based on the Black and Scholes (1973) and Merton (1974) contingent claims model and view equity as a call option on the assets of the firm with strike price equal to the face value of the liabilities. The probability of bankruptcy is the probability that the call option will expire worthless or, in other words, that the value of the assets is less than the face value of the liabilities at the end of the holding period. The probability that the value of assets is less than the face value of debt at the end of the holding period is given by McDonald (2002):

$$p = N\left(-\frac{\ln(V_A/X) + (\mu - \delta - 0.5 * \sigma_A^2) * T}{\sigma_A \sqrt{T}}\right) \quad (1)$$

where  $N()$  is the cumulative normal density function,  $V_A$  is value of assets,  $X$  is face value of debt proxied by total liabilities,  $\mu$  is expected return on the firm,  $\delta$  is dividend rate estimated as total dividends / (total liabilities + market value of equity),  $\sigma_A$  is asset volatility, and  $T$  is time to expiry (taken to be 1-year).

$V_A$ ,  $\mu$  and  $\sigma_A$  are not observable and need to be estimated. The Hillegeist et al. (2004) and Bharath and Shumway (2004) computations of probability of failure using equation (1) differ in the way  $V_A$  and  $\sigma_A$  are estimated. Hillegeist et al. (2004) simultaneously solve the following two equations to estimate  $V_A$  and  $\sigma_A$ :

$$V_E = V_A e^{-\delta T} N(d_1) - X e^{-rT} N(d_2) + (1 - e^{-\delta T}) V_A \quad (2)$$

$$\sigma_E = \frac{V_A e^{-\delta T} N(d_1) \sigma_A}{V_E} \quad (3)$$

where  $V_E$  is market value of common equity at the time of estimation (September 30 each year), and  $\sigma_A$  is annualized standard deviation of daily stock returns over 12 months prior to estimation. The starting value of  $V_A$  is set to  $V_E + X$ , and for  $\sigma_A$  it is set to  $\sigma_E V_E / (V_E + X)$ .

Bharath and Shumway (2004) on the other hand use:

$$V_A = V_E + X \quad (4)$$

$$\sigma_A = \frac{V_E}{V_A} \sigma_E + \frac{X}{V_A} \sigma_D \quad (5)$$

$$\sigma_D = 0.05 + 0.25 * \sigma_E \quad (6)$$

Hillegeist et al. (2004) estimate expected return as:

$$\mu = \left( \frac{V_{A,t} + \text{Dividends} - V_{A,t-1}}{V_{A,t-1}} \right) \quad (7)$$

and bound this between the risk free rate and 100%. This method of estimating expected return has a serious shortcoming in that it assumes that there is no change in debt or equity between t-1 and t.

Bharath and Shumway (2004), on the other hand, use the previous year stock return bounded between the risk free rate and 100%, or the risk-free rate as an estimate of expected return. This method also is not without its problems. First, it is proxying expected return on assets by realized return on equity, even if realized return on equity is a good proxy for expected return on equity, it will be a good proxy for expected return on assets only if the expected return on debt is the same for all the firms. Second, though distressed firms should have higher expected returns, evidence suggests that distressed firms have lower past returns (Beaver, 1968), hence using past returns as a proxy for expected returns is problematic. However, as it turns out, the market-based model probability estimates are not sensitive to the choice of expected return generating model.

This paper evaluates the two market-based models above:<sup>2</sup>

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<sup>2</sup> We also estimated two variations of the model HKCL, one with the risk-free rate as a proxy for expected returns ( $\mu$ ) and the other with last year's stock return (bounded between the risk-free rate and 100%) as the proxy. We additionally estimated a variation of the BS model with last year's stock return (bounded between risk-free rate and 100%) as a proxy for  $\mu$ . The rank correlations between probability estimates derived using these various specifications are all in excess of 0.90, and all our results are unchanged with other specifications. The results are not reported here for brevity but are available from the authors.



HKCL:  $V_A$  and  $\sigma_A$  are estimated simultaneously by solving equations (2) and (3) and expected return is estimated from equation (7) bounded between the risk free rate and 100% (Hillegeist et al., 2004).

BS:  $V_A$  and  $\sigma_A$  are estimated using equations (4) to (6) and expected return is set to the risk free rate (Bharath and Shumway, 2004).

## B. Z-score model

To provide an appropriate benchmark for the option-pricing model approach in predicting corporate bankruptcy, its performance is compared with that of a widely-used accounting-ratio-based z-score model. The UK-based z-score model employed in this study is derived in a similar way to Altman (1968) using a discriminant modeling approach (see Taffler, 1984 for details), and firm z-score is calculated as follows:

$$z = 3.20 + 12.18 \cdot x_1 + 2.50 \cdot x_2 - 10.68 \cdot x_3 + 0.029 \cdot x_4 \quad (8)$$

where  $x_1$  is profit before tax (PBT)/current liabilities,  $x_2$  is current assets/total liabilities,  $x_3$  is current liabilities/total assets, and  $x_4$  is no-credit interval computed as (quick assets – current liabilities)/ ((sales – PBT – depreciation)/365).

The model was developed in 1977, hence derived z-scores are completely out-of-sample.

## 3. Model evaluation approaches

To compare the performance of estimates from the market-based and accounting-ratio-based models, three approaches are employed in this paper: (i) the ROC curve to assess predictive ability, (ii) the economic value of using different models, and (iii) information content tests similar to Hillegeist et al. (2004).

### 3.1. The ROC curve

The Receiver Operating Characteristics (ROC) curve is widely used in the field of medicine for testing the efficacy of various treatments and diagnostic techniques. It is also a popular technique for assessing various rating methodologies (see Sobehart et al., 2000 for details). Sobehart and Keenan (2001) provide a detailed explanation of how to use the ROC curve to validate internal credit rating models and their main conclusion is that the area under the curve is an indicator of the quality of the model. Engelmann et al. (2003) show that the accuracy ratio is just a linear transformation of the area under the ROC curve, i.e.:

$$\text{Accuracy ratio} = 2 * (\text{area under ROC curve} - 0.50) \quad (9)$$

The area under the ROC curve is estimated using the Wilcoxon statistic following Hanley and McNeil (1982) who show that it is an unbiased estimator. Faraggi and Reiser (2002) compare estimates of the area under the curve using four different methods and conclude (p. 3,105) that although the non-parametric estimate ‘... is usually not the best in terms of RMSE it is often close to the best’. Using Wilcoxon statistic also allows easy comparison of various rating models.

To compare the area under the curve for two different models, the Hanley and McNeil (1983) test statistic, which adjusts for the correlation induced due to application of the two models on the same sample, is used.

The ROC curve is constructed as in Vassalou and Xing (2004): at the end of September of each year all the firms in the sample are ranked based on their risk of default from highest risk to lowest risk. For every integer (x) between 0 and 100, look at how many firms actually failed within one year within the first x% of firms with highest bankruptcy risk. The number of firms that fail within the first x% of default risk is then divided by the total number of failures in the sample and plotted against x.

### 3.2. Economic value when misclassification costs differ

The ROC curve treats the costs of a type I error (classifying a subsequently failing firm as non-failed) and a type II error (classifying a subsequently non-failed firm as failed) the same. In the credit market, the costs of misclassifying a firm that subsequently fails are very different to the costs of misclassifying a firm that does not fail. In the first case, the lender can lose up to 100% of the loan amount while, in the latter case, the loss is just the opportunity cost of not lending to that firm. In assessing the practical utility of failure prediction models, differential misclassification costs need to be explicitly taken into account. Stein (2005) and Blöchlinger and Leippold (2006a) provide a method to link the power of different credit risk models to distinguish between good and bad loans, loan pricing and associated decision making. In the credit market, lenders will refuse credit to customers perceived to be too high a risk, and will offer credit to all other customers with credit spread increasing with perceived default risk. Assuming that lenders will only grant loans with a positive net present value, and ignoring the strategic value of granting a loan (relationship banking), Blöchlinger and Leippold (2006a) derive the credit risk spread as a function of the credit score (S) by:<sup>3</sup>

$$R = \frac{p(Y = 1 | S = t)}{p(Y = 0 | S = t)} LGD + k \quad (10)$$

where R is credit spread,  $p(Y=1|S=t)$  is conditional probability of failure for a score of t,  $p(Y=0|S=t)$  is conditional probability of non-failure for a score of t, LGD is loss in loan value given default, and k is credit spread for the highest quality loan.

We assume a simple loan market worth £100 billion with two banks competing for business. Bank 1 uses the z-score model and Bank 2 uses a market-based model for credit risk assessment and pricing. Both banks reject customers that fall in the bottom 5% according to their respective models and quote a spread based on equation (13) for all the other

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<sup>3</sup> Stein (2005) provides a similar formula for loan pricing.

customers. Further, the customer chooses the bank which quotes the lower spread. If the quoted spreads are equal, the customer randomly chooses one of the two banks (or equivalently, the business is split 50:50 between the two banks). In this regime, there may be some customers who are refused credit by both the banks, hence, the market share of the two banks may not sum to 1. Since we have a small number of failures in our sample (103), for each of the two models we group the scores into 20 categories. Similar to Stein (2005) and Blöchlinger and Leippold (2006a), we also assume that LGD is exogenous and the same for all firms, and all loans are of the same size. Finally, we work with credit spread to 3 decimal places.

To assess the economic value of using different models for mixed regime loan pricing, we use two measures to evaluate bank profitability, return on assets (ROA) and return on risk weighted assets (RORWA):

$$ROA = \frac{\text{Pr ofit}}{\text{Assets lent}} \quad (11)$$

$$RORWA = \frac{\text{Pr ofit}}{\text{BIS risk – weighted assets}} \quad (12)$$

While ROA is a conventional performance measure, it ignores the inherent riskiness of profits. RORWA, on the other hand, takes into account the risk of the outstanding loans, and provides a more suitable risk-based performance measure. We calculate the risk-weighted assets using the Basel II Foundation Internal Ratings-based Approach as laid out in the latest version of the *International Convergence of Capital Measurement and Capital Standards* document prepared by the Basel Committee on Banking Supervision (2006: 63-64), for obligations not already in default.

### 3.3. Testing relative information content

Hillegeist et al. (2004) argue that predictive accuracy is not a valid test of rating models because, inter alia, the decision maker is generally not faced with a dichotomous decision. She is more likely to use the output of the rating model to decide the interest rate to be charged. In addition, since the costs of type I and type II errors are context specific, it is difficult to evaluate alternative credit risk models based on their predictive accuracy alone. Hence, a more appropriate test is the information content of the model. To test for information content, a discrete hazard model of the form similar to that of Hillegeist et al. (2004) is used:

$$p_{i,t} = \frac{e^{\alpha(t) + \mathbf{X}_{i,t}\boldsymbol{\beta}}}{1 + e^{\alpha(t) + \mathbf{X}_{i,t}\boldsymbol{\beta}}} \quad (13)$$

where  $p_{i,t}$  is probability of failure of firm  $i$  at time  $t$  in the next 12 months,  $\alpha(t)$  is baseline hazard rate proxied by the trailing year failure rate,  $\mathbf{X}$  is matrix of independent variables, and  $\boldsymbol{\beta}$  is column vector of estimated coefficients.

This expression is of the same form as logistic regression, and Shumway (2001) shows that it can be estimated as a logit model. However, the standard errors will be biased downwards since the logit estimation treats each firm year observation as an independent observation, while the data has multiple observations for the same firm. He suggests dividing the test statistic by the average number of observations per firm to obtain an unbiased statistic.

Since the use of probability of failure as an independent variable is not consistent with the underlying assumptions of the logit model, following Hillegeist et al. (2004), the probability estimates generated by our market-based models are transformed into logit scores by:

$$\text{score} = \ln\left(\frac{p}{1-p}\right) \quad (14)$$

Since the log transform means that values close to 0 or 1 will become arbitrarily small (large), similar to Hillegeist et al. (2004), all observations with probability of failure  $<0.00000001$  are set to 0.00000001 and those with probability of failure greater than 0.99999999 are set to 0.99999999. This results in scores from the market model being bounded between  $\pm 18.4207$ . For consistency, the z-scores are also winsorized to be in the same range.

Finally, both the parametric test of Vuong (1989) and the non-parametric test of Clarke (2003) are used to test whether the log-likelihood ratios of various logit models are significantly different. Clarke (2005) shows that the Clarke (2003) test is more efficient for platykurtic distributions, while the more widely used Vuong (1989) test is more efficient for normal and leptokurtic distributions. The distribution of individual log-likelihoods in the sample is extremely fat-tailed (kurtosis of more than 200) suggesting that Clarke (2003) is a more appropriate test here. However, both test-statistics are reported in this paper; their results are qualitatively the same.<sup>4</sup>

## 4. Results

### 4.1. Summary statistics

Table 1 presents the summary statistics of probability of failure generated by each of our three models (HKCL, BS, and z-score). The z-score is transformed using a logistic cumulative function ( $p = e^{\text{z-score}} / (1 + e^{\text{z-score}})$ ) to generate a probability of failure equivalent to the market-based models.<sup>5</sup>

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<sup>4</sup> The test statistic may be biased upwards since the credit defaults are likely to be clustered in time. However, as the testing period here spans more than one credit cycle, the assumption of independence is warranted (Blochliger and Leippold, 2006b).

<sup>5</sup> Maddala (1983) shows that discriminant scores can be converted into probabilities using a linear probability model after suitable transformation through regression sum of squares. However, since we do not have access to the RSS for the original model, we follow Hillegeist et al. (2004) in using a logit transformation.

<b>Table 1 here</b>
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Table 1 shows that the average probability of failure for firms that subsequently fail is significantly higher than that for firms that do not fail for all the models considered. The miscalibration of the model outputs is also obvious, while the average failure rate in our sample is 0.67%, the two market-based models produce average probability of failure of 1.4 and 3.2 times that, while the z-score model produces an extremely high average probability of failure. The average probabilities in Hillegeist et al. (2004) are around 5.8%, much higher than those reported here. However, poor calibration is not relevant for tests of predictive ability or information content as calibration provides a test of how close the model default probabilities are to actual default probabilities, and not a test of how good a model is at discriminating between good and bad credits (Stein, 2004). Similarly, Hillegeist et al. (2004) argue that poor calibration does not necessarily mean that these models will not carry information about the true probability of failure in cross-section.

The extremely high rank correlation of 0.93 between the two market-based model estimates, HKCL and BS, shows that using simultaneous equations to estimate  $V_A$  and  $\sigma_A$ , or the choice of  $\mu$ , do not have a material impact on probability estimates. The results here are similar to those of Bharath and Shumway (2004) who find similar high correlations among the various specifications they use. Further, estimates of  $\sigma_A$  obtained by simultaneously solving a system of equations (as by Hillegeist et al., 2004), and those obtained by a simpler approach (as by Bharath and Shumway, 2004), have a Pearson (Spearman) correlation of 0.97 (0.91)<sup>6</sup> showing there is little value in solving simultaneous equations to obtain an estimate of  $\sigma_A$ . Correlations between market-based models estimates and those from the z-score model are relatively low (0.39 for HKCL and 0.52 for BS) indicating the two modelling approaches

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<sup>6</sup> Bharath and Shumaway (2004) report a rank correlation of 0.87.

are carrying information incremental to each other.<sup>7</sup> All the probability estimates have low correlation with the actual outcome indicating such measures will not have high explanatory power in our cross-section regressions.<sup>8</sup>

#### 4.2. Test of predictive ability

Figure 1 presents the ROC curves for the market-based models and the z-score model. It clearly shows two things: (i) there is little to choose between the ‘naïve’ model (BS) and the model that solves simultaneous equations (HKCL), and (ii) the z-score model has a slightly larger area under the ROC curve than the two market-based models, demonstrating marginal z-score outperformance.

**Figure 1 here**

Summary statistics for all the models along with those for market value of equity, book-to-market ratio and prior-year return are presented in table 2. It shows that each of the models does a better job at predicting corporate failure than the random model (z values are all extremely large). It also shows that all three models do much better than simple variables (market value, book-to-market or prior-year return). However, the simultaneous-equation-based model performs marginally less well (lower accuracy ratio) than the naïve model (BS) or the z-score model. The areas under the curves reported in the table compare favourably with those reported by Vassalou and Xing (2004) and Reisz and Perlich (2004).<sup>9</sup> The accuracy ratio for market value of equity reported in Vassalou and Xing (2004) is just 0.09,

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<sup>7</sup> Hillegeist et al. (2004) report a correlation of 0.43 between their estimates from their market-based model and Altman’s (1968) z-score.

<sup>8</sup> 0.09, 0.10, 0.11 with HKCL, BS, and z-score based probability measures respectively. Hillegeist et al. (2004) also report a similar correlation between their estimates and the actual failure event.

<sup>9</sup> Vassalou and Xing (2004) report an accuracy ratio of 0.59 (AUC=0.80) for their model, while reported accuracy ratios in Reisz and Perlich (2004) are all under 0.80. Bharath and Shumway (2004) do not report accuracy ratios but their highest probability decile contains approximately 66% of failures and highest probability quintile contains approximately 80% of failures. Corresponding figures for the market-based models here are approximately 66% and 79% respectively, while those for the z-score model are 67% and 89% respectively.



much lower than the 0.49 here. The z-score model outperforms all other models with an accuracy ratio of 0.79.

<b>Table 2 here</b>
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To test whether the z-score model does significantly better than our market-based models, the area under the ROC curve for the z-score model is again compared with that for the two market-based models. The z-score model strongly outperforms the simultaneous-equation-based market model ( $z = 2.39$ ) while there is no significant difference between the performance of the z-score model and the naïve market-based model ( $z = 1.32$ ).

#### *4.3. Economic value when misclassification costs are different*

In this sub-section we use the BS model as our market-based model because of its superiority over other formulations. To evaluate the economic value of using different model approaches, we use equation (10) to derive the credit spread which is a function of the probability of both failure and non-failure, and hence both the power of the model, and its calibration. Since our focus here is on the impact of model power differences on bank profitability, and all our models are miscalibrated (as table 1 shows), we recalibrate our z-score and BS models by assigning each rating category its actual default rate over the entire 17-year period. We assume that the two banks are following the Basel II Foundation Internal Ratings-based approach, and that all loans are unsecured senior debt (i.e., the loss given default is 45%). Further, similar to Blöchliger and Leippold (2006a), we assume the risk premium for a high quality customer ( $k$ ) to be 0.30%.

Table 3 presents the revenue, profitability, and other statistics for the two banks (Bank 1 using the z-score model and Bank 2 using the BS model for making lending and pricing decisions) under the competitive loan market described earlier.

<b>Table 3 here</b>
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Table 3 shows that Bank 1 has a market share of 53% as compared to the market share of 45% for Bank 2. The quality of loans granted by Bank 1 is also better since it has 34% of the defaulters while Bank 2 has 39% of the defaulters. The better credit quality of Bank 1 loans is also reflected in the lower average spread it earns (39bp against 42bp for Bank 2). The risk-adjusted revenue of Bank 1 is 11% higher than Bank 2 and risk-adjusted profit is 55% higher than that for Bank 2.<sup>10</sup> Perhaps most importantly, Bank 1 outperforms Bank 2 by 57% on the risk-based performance measure, return on risk-weighted capital, clearly demonstrating the superior performance of the z-score model.<sup>11</sup> On this basis, the economic benefit of using the z-score approach over the market-based approach is clear.

#### *4.4. Test of information content*

Table 4 presents comparative tests of information content for different formulations of a simple hazard model, similar to that of Hillegeist et al. (2004) estimated by logistic regression, with the test statistics adjusted for the fact that there are multiple observations for the same firm.

<b>Table 4 here</b>
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The coefficient on baseline hazard rate (proxied by last year's failure rate) is, unlike in Hillegeist et al. (2004), insignificant across all the models showing it does not carry incremental information about corporate bankruptcy. Models (i), (ii) and (iii) in table 4, (HKCL, BS and z-score respectively), show that the scores produced by the market-based models and the z-score model all carry a significant amount of information about failure

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<sup>10</sup> Assuming a LGD of 30%, Bank 1 has 22% higher revenues and 57% higher profits. The corresponding figures for LGD of 50% are 8% and 61% respectively in favor of Bank 1. The conclusions also remain unchanged for different values of risk premium for a high quality customer (k).

<sup>11</sup> Using the calibration technique of Burgt (2007), Bank 1 earns 14% more revenue, 33% more profits, and 20% more RORWA than Bank 2.

within a year (the coefficients are all significantly different to 0 at the 1% level). The Clarke test shows that the log-likelihood of model (i) is significantly lower than that of both model (ii) ( $z = 7.0$ ) and model (iii) ( $z = 50.2$ ).<sup>12</sup> Model (ii) also does significantly better than model (i) using the Clarke test ( $z = 11.3$ ), though there is no difference using the Vuong test ( $z = 1.4$ ). These results show that there is little to choose between the three credit risk models in terms of information content, though the Clarke test does suggest that the naïve market-based model (BS) carries marginally more information about future bankruptcy than the other two models.

Models (iv) and (v) combine market-based and accounting-based models and carry incremental information compared to any model separately, though the z-score coefficients are larger than the coefficients on the market-based scores. The differences in the log-likelihood of models (i) and (iv), (ii) and (v), (iii) and (iv), and (iii) and (v) are all highly significant,<sup>13</sup> showing that neither of the two approaches produce a sufficient statistic for failure prediction: both modelling approaches carry unique information.<sup>14</sup>

Model (vi) uses only the control variables, with firm size as the only variable with significant information about firm bankruptcy. While it produces a lower log-likelihood than both models (i) and (ii), the Clarke test actually shows that models (i) and (ii) do better than model (vi).<sup>15</sup> It also shows that the models (iii) to (v) all carry more information than model (vi) with control variables only. Models (vii) and (viii) combine market-based model scores and control variables. Similar to the evidence of Campbell et al. (2006), they show the

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<sup>12</sup> The Vuong test statistics are 1.9 and 0.8 respectively.

<sup>13</sup> The Clarke test statistics are 40.7, 22.4, 49.5 and 36.4 respectively. The corresponding Vuong statistics are 5.4, 4.9, 3.3 and 3.0 respectively.

<sup>14</sup> More than one market-based model estimate is not used in the same regression due to the extremely high correlations between the estimates from the two market-based models.

<sup>15</sup> The test statistics are 3.3 and 27.1 respectively. Model (iii) also carries more information than model (vi) with a test-statistic of 17.1. The corresponding Vuong statistics are 1.5, 1.3 and 0.5 respectively.

market-based models' estimates lose their information content once conditioned on control variables though the Clarke test shows that both models have significantly more explanatory power than model (vi) (test statistics are 31.4 and 33.1 respectively).<sup>16</sup> Model (ix) combines z-score with control variables and shows that the z-score of a firm carries incremental information about bankruptcy after controlling for other simpler variables in model (vi) with Clarke test statistic of 37.3 (Vuong statistic = 4.7). However, a significantly lower log-likelihood for model (ix), as compared to model (iii), (Clarke statistic = 53.9 and Vuong statistic = 3.8), shows that z-score does not capture all the information about firm failure.

Table 4 provides clear evidence that neither the market-based nor z-score approach reflects all the information embedded in the other method. This is not surprising given the moderate correlations between the estimates of the market-based models and z-score model. The evidence here is consistent with that of Hillegeist et al. (2004) in this respect. Importantly, the market-based models do not seem to carry much information once simpler market-based variables, in particular market capitalization, are incorporated.

## **5. Conclusions**

This paper compares the performance of two alternative formulations of market-based models for the prediction of corporate bankruptcy with a well-established UK-based z-score model. The results show that in terms of predictive accuracy, there is little difference between the market-based and accounting models. However, employing the analytical approach of Stein (2005) and Blöchliger and Leippold (2006a), which takes into account differential misclassification costs and loan pricing considerations, a small difference in the area under the ROC curve produces economically large differences in profitability for credit risk model users with employment of the z-score model generating much higher risk-adjusted revenues, profits, and return on risk-weighted assets.

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<sup>16</sup> The corresponding Vuong statistics are 2.5 and 2.2 respectively.

However, neither of the market-based models nor the accounting-ratio based model is a sufficient statistic for failure prediction and both carry unique information about firm failure (Hillegeist et al., 2004 reach the same conclusion with their data). While market-based models are conceptually attractive, their lack of superior performance empirically should not be surprising. Hillegeist et al. (2004) suggest two fundamental problems with operationalizing Merton's (1974) contingent claims approach: mis-specification due to the restrictive assumptions of the model (e.g. single class of zero coupon debt, all liabilities mature in one-year, costless bankruptcy, no safety covenants, default triggered only at maturity etc.), and measurement errors (e.g. value and volatility of assets are unobservable). Although the accounting-ratio based approach is criticized for lack of theoretical grounding, it has three things in its favor: corporate failure is generally not a sudden event, it is rare that firms with good profitability and strong balance sheets file for bankruptcy because of a sudden change in the economic environment. Usually, corporate failure is the culmination of several years of adverse performance and, hence, will be largely captured by the firm's accounting statements. Second, the double entry system of accounting ensures that window dressing the accounts or change in accounting policies will have minimal effect on a measure that combines different facets of accounting information simultaneously. Finally, loan covenants are generally based on accounting numbers and this information is more likely to be reflected in accounting-ratio based models.

We conclude that despite extensive criticism of traditional accounting-ratio based credit risk assessment approaches, and the theoretically appealing contingent claims framework, in practice such conventional approaches are robust and not dominated empirically by KMV-type option-based models. In fact, the accounting-based approach produces significant economic benefit over the market-based approach.

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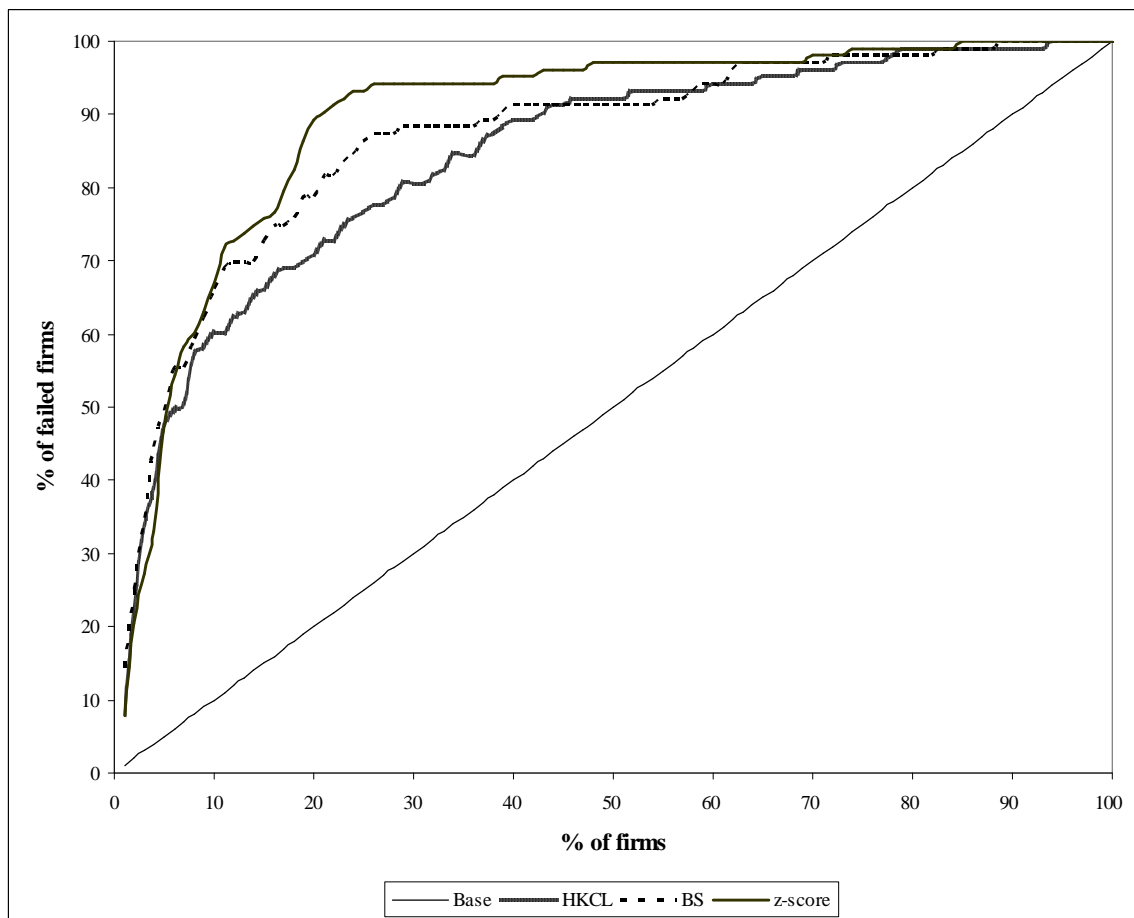


### Figure 1: ROC curves

The probability of failure of all the firms in our sample at the end of September of each year from 1985 to 2001 is estimated using two market-based models and the z-score model.

HKCL refers to the market-based model that estimates  $V_A$  and  $\sigma_A$  simultaneously by solving equations (3) and (4) and sets expected return equal to the risk free rate, and BS refers to the market-based model that estimates  $V_A$  and  $\sigma_A$  using equations (5) to (7) and sets expected return equal to the risk free rate. Z-score refers to the z-score model (equation (8)). Each year, firms are ranked from highest probability of failure to lowest probability of failure based on each of the three models and the percentage of failed firms in each percentile is calculated.

The figures are then cumulated to generate the ROC for each of the models. Base refers to the ROC curve under a model with no predictive ability.



**Table 1: Summary statistics**

The probability of failure of all the firms in our sample at the end of September of each year from 1985 to 2001 is estimated using market-based models or the z-score model. HKCL refers to the market-based model that estimates  $V_A$  and  $\sigma_A$  simultaneously by solving equations (3) and (4), and estimates expected return using equation (8) bounded between the risk free rate and 100%, and BS refers to the market-based model that estimates  $V_A$  and  $\sigma_A$  using equations (5) to (7), and sets expected return equal to the risk-free rate. Z-score refers to the z-score model (equation (8)). Figures in column 2 are the mean probability of failure estimates generated by the six models for all the firms in the sample at the end of September of each year, column 3 provides the mean probability of failure for firms that fail in the next 12 months, and column 4 has the mean probability estimates for firms that do not fail within 12 months of the estimation date. Column 5 has the test statistic for difference between the mean probability of failure for firms that fail and firms that do not fail. The probability of failure for the z-score model is calculated as  $\exp(\text{z-score})/(1+\exp(\text{z-score}))$ .

Model	Mean probability of failure (%)			t-statistic for difference
	All	Failed	Non-Failed	
HKCL	0.96	8.29	0.91	5.55
BS	2.12	15.88	2.03	9.85
z-score	26.33	88.10	25.91	27.76

**Table 2: Area under the ROC curve and accuracy ratios**

The probability of failure of all the firms in our sample at the end of September of each year from 1985 to 2001 is estimated using two market-based models and a z-score model. HKCL refers to the market-based model that estimates  $V_A$  and  $\sigma_A$  simultaneously by solving equations (3) and (4), and estimates expected return using equation (8) bounded between the risk-free rate and 100%, and BS refers to the market-based model that estimates  $V_A$  and  $\sigma_A$  using equations (5) to (7), and sets expected return equal to the risk-free rate and Z-score refers to the z-score model (equation (8)). The probability of failure for the z-score model is calculated as  $\exp(\text{z-score})/(1+\exp(\text{z-score}))$ . Size refers to the market value of equity, B/M refers to the ratio of book value of equity and market value of equity and Prior-Year refers to the buy-and-hold return over the previous 12 months for all the firms in the sample at the end of September of each year. Figures in column 2 are the area under the ROC curve (AUC) estimated as the Wilcoxon statistic. Column 3 has the standard error of the estimated area and column 4 has the test statistic for the null hypothesis that the area under the ROC curve is equal to 0.5. Column 5 has the accuracy ratio ( $AR = 2*(AUC - 0.5)$ ).

	AUC	SE	z	AR
HKCL	0.84	0.0187	18.18	0.68
BS	0.87	0.0171	21.64	0.73
z-score	0.89	0.0184	21.20	0.79
Size	0.75	0.0233	10.73	0.49
B/M	0.68	0.0203	8.87	0.36
Prior-Year	0.71	0.0204	10.29	0.42

**Table 3: Comparative economic value of different credit models**

The probability of failure of all the firms in our sample at the end of September of each year from 1985 to 2001 is estimated using the BS model and z-score model. BS refers to the market-based model that estimates  $V_A$  and  $\sigma_A$  using equations (5) to (7), and sets expected return equal to the risk-free rate. Bank 1 uses the z-score model and Bank 2 uses the BS model. Both banks reject all firms with score in the bottom 5% based on their respective models while offering credit to all others at a credit spread derived using equation (10). Firms are assumed to split their loan equally between the two banks if both offer the same credit spread, otherwise they choose the bank offering the lower spread. Market share is the total number of loans granted as a percentage of total number of firm years, share of defaulters is the number of defaulters to whom a loan is granted as a percentage of total number of defaulters. Revenue is market size \* market share \* average credit spread, and Loss is market size \* prior probability of failure \* share of defaulters \* loss given default. Profit is Revenue – Loss. Return on assets is profit divided by market size \* market share, and return on risk-weighted assets is the profit divided by risk-weighted assets computed using the Basel II Foundation Internal Ratings-based Approach. For illustrative purposes, we assume the market size to be £100 billion, equal size loans, loss given default to be 45%, and credit spread for the highest quality customers to be 0.30%. The prior probability of failure is taken to be the same as the ex-post failure rate of 0.67% during the sample period.

	<b>Bank 1</b> <b>(z-score model)</b>	<b>Bank 2</b> <b>(BS model)</b>
Market share (%)	53.1	45.2
Share of defaulters (%)	33.5	39.3
Average credit spread (%)	0.39	0.42
Revenue (£m)	209.2	188.2
Loss (£m)	100.9	118.5
Profit (£m)	108.3	69.8
Return on Assets (%)	0.20	0.15
Return on Risk-weighted Assets (%)	0.69	0.44

**Table 4: Information content tests**

The probability of failure of all the firms in our sample at the end of September of each year from 1985 to 2001 is estimated using two market-based models and the z-score model. HKCL refers to the market-based model that estimates  $V_A$  and  $\sigma_A$  simultaneously by solving equations (3) and (4), and estimates expected return using equation (8) bounded between the risk-free rate and 100%, and BS refers to the market-based model that estimates  $V_A$  and  $\sigma_A$  using equations (5) to (7), and sets expected return equal to the risk-free rate. The probability estimates from HKCL and BS are converted to scores by  $\text{Score} = (p/(1-p))$ , with  $p$  winsorized to be between 0.00000001 and 0.99999999. Z-score refers to the estimates from the z-score model (equation (8)) winsorized to be in the corresponding range ( $\pm 18.4207$ ). The baseline rate is the failure rate over the previous year (in percent),  $\ln(V_E)$  is the natural logarithm of the market value of equity,  $\sigma_A$  is the asset volatility estimated from simultaneously solving equations (3) and (4), B/M is the book-to-market ratio, and Prior-year is the buy-and-hold return over the previous 12 months, all estimated at the end of September of year  $t$ . Figures in brackets are the Wald statistic from the logistic regression with dependent variable taking a value of 1 if the firm fails in 12 months, 0 otherwise. The Wald statistic is adjusted for the fact that there are several observations from the same firm by dividing by 7.67, the average number of observations per firm.

Variable	Model (i)	Model (ii)	Model (iii)	Model (iv)	Model (v)	Model (vi)	Model (vii)	Model (viii)	Model (ix)
Constant	-3.14 (21.57)	-3.35 (25.41)	-5.48 (81.35)	-4.04 (26.36)	-4.24 (31.17)	-5.08 (54.75)	-3.79 (11.45)	-3.97 (16.39)	-5.19 (52.50)
Baseline rate	0.38 (0.38)	0.37 (0.35)	0.59 (0.87)	0.42 (0.44)	0.41 (0.42)	-0.07 (0.01)	-0.08 (0.01)	-0.04 (0.00)	-0.01 (0.00)
HKCL-Score	-0.21 (16.37)			-0.13 (5.76)			-0.11 (2.49)		
BS-Score		-0.28 (11.25)			-0.16 (4.20)			-0.14 (1.99)	
Z-score			-0.26 (27.43)	-0.20 (13.34)	-0.20 (11.62)				-0.22 (13.07)
Ln(V <sub>E</sub> )						-1.19 (16.24)	-0.80 (4.12)	-0.74 (3.00)	-0.60 (3.25)
$\sigma_A$ (simul)						0.79 (1.54)	0.01 (0.00)	0.26 (0.08)	0.19 (0.05)
B/M						-0.01 (0.00)	0.01 (0.00)	0.11 (0.00)	0.13 (0.42)
Prior-year						-1.47 (0.88)	-1.08 (0.52)	-1.33 (0.80)	-1.23 (0.69)
Log-likelihood	-535	-529	-509	-484	-486	-517	-505	-507	-472
Pseudo-R <sup>2</sup>	0.14	0.15	0.18	0.23	0.22	0.17	0.19	0.19	0.25

With 1 degree of freedom, critical  $\chi^2$  value at 1%, 5% and 10% level are 6.63, 3.84 and 2.71 respectively.

# Comparing the performance of market-based and accounting-based bankruptcy prediction models

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