

7 Copulas and dependence

- 7.1 Copulas
- 7.2 Dependence concepts and measures
- 7.3 Normal mixture copulas
- 7.4 Archimedean copulas
- 7.5 A proof for subadditivity of ES
- 7.6 Fitting copulas to data

7.1 Copulas

- We now look more closely at modelling the dependence among the components of a random vector $\mathbf{X} \sim F$ (risk-factor changes).
- **In short:** $F = \text{dependence structure } C \circ \text{marginal dfs } F_1, \dots, F_d$
- **Advantages:**
 - ▶ Most natural in a static distributional context (no time dependence; apply, for example, to residuals of an ARMA-GARCH model)
 - ▶ Copulas allow us to understand and study dependence independently of the margins (first part of Sklar's Theorem; see later)
 - ▶ Copulas allow for a bottom-up approach to multivariate model building (second part of Sklar's Theorem; see later). This is often useful for constructing tailored F , for example, when we have more information about the margins than C or for stress testing purposes (to challenge the existing model and see how it performs).

7.1.1 Basic properties

Definition 7.1 (Copula)

A *copula* C is a *df* with $U(0, 1)$ margins.

Characterization

$C : [0, 1]^d \rightarrow [0, 1]$ is a copula *if and only if*

1) C is *grounded*, that is,

$$C(u_1, \dots, u_d) = 0 \text{ if } u_j = 0 \text{ for at least one } j \in \{1, \dots, d\}.$$

2) C has standard *uniform* univariate *margins*, that is,

$$C(1, \dots, 1, u_j, 1, \dots, 1) = u_j \text{ for all } u_j \in [0, 1] \text{ and } j \in \{1, \dots, d\}.$$

3) C is *d-increasing*, that is, for all $\mathbf{a}, \mathbf{b} \in [0, 1]^d$, $\mathbf{a} \leq \mathbf{b}$,

$$\Delta_{(\mathbf{a}, \mathbf{b}]} C = \sum_{\mathbf{i} \in \{0, 1\}^d} (-1)^{\sum_{j=1}^d i_j} C(a_1^{i_1} b_1^{1-i_1}, \dots, a_d^{i_d} b_d^{1-i_d}) \geq 0.$$

Equivalently, if existent: *density* $c(\mathbf{u}) \geq 0$ for all $\mathbf{u} \in (0, 1)^d$.

Preliminaries

Lemma 7.2 (Probability transformation)

Let $X \sim F$, F continuous. Then $F(X) \sim U(0, 1)$.

Proof. $\mathbb{P}(F(X) \leq u) = \mathbb{P}(F^{\leftarrow}(F(X)) \leq F^{\leftarrow}(u)) = \mathbb{P}(X \leq F^{\leftarrow}(u)) = F(F^{\leftarrow}(u)) = u, u \in [0, 1]$; more details in the appendix. \square

Note that F needs to be continuous (otherwise $F(X)$ would not reach all intervals $\subseteq [0, 1]$).

Lemma 7.3 (Quantile transformation)

Let $U \sim U(0, 1)$ and F be any df. Then $X = F^{\leftarrow}(U) \sim F$.

Proof. $\mathbb{P}(F^{\leftarrow}(U) \leq x) \stackrel{(G15)}{=} \mathbb{P}(U \leq F(x)) = F(x), x \in \mathbb{R}.$ \square

Probability and quantile transformations are the key to all applications involving copulas. They allow us to go from \mathbb{R}^d to $[0, 1]^d$ and back.

Sklar's Theorem

Theorem 7.4 (Sklar's Theorem)

- 1) For any df F with margins F_1, \dots, F_d , there exists a copula C such that

$$F(x_1, \dots, x_d) = C(F_1(x_1), \dots, F_d(x_d)), \quad \mathbf{x} \in \mathbb{R}^d. \quad (27)$$

C is uniquely defined on $\prod_{j=1}^d \text{ran } F_j$ and given by

$$C(u_1, \dots, u_d) = F(F_1^{\leftarrow}(u_1), \dots, F_d^{\leftarrow}(u_d)), \quad \mathbf{u} \in \prod_{j=1}^d \text{ran } F_j,$$

where $\text{ran } F_j = \{F_j(x) : x \in \mathbb{R}\}$ denotes the *range* of F_j .

- 2) Conversely, given any copula C and univariate dfs F_1, \dots, F_d , F defined by (27) is a df with margins F_1, \dots, F_d .

Proof.

- 1) **Proof for continuous F_1, \dots, F_d only.** Let $\mathbf{X} \sim F$ and define $U_j = F_j(X_j)$, $j \in \{1, \dots, d\}$. By the probability transformation, $U_j \sim U(0, 1)$ (continuity!), $j \in \{1, \dots, d\}$, so the df C of \mathbf{U} is a copula. Since $F_j \uparrow$ on $\text{ran } X_j$, (G13) implies that $X_j = F_j^{\leftarrow}(F_j(X_j)) = F_j^{\leftarrow}(U_j)$, $j \in \{1, \dots, d\}$. Therefore,

$$\begin{aligned} F(\mathbf{x}) &= \mathbb{P}(X_j \leq x_j \ \forall j) = \mathbb{P}(F_j^{\leftarrow}(U_j) \leq x_j \ \forall j) \stackrel{(G15)}{=} \mathbb{P}(U_j \leq F_j(x_j) \ \forall j) \\ &= C(F_1(x_1), \dots, F_d(x_d)), \quad \mathbf{x} \in \mathbb{R}^d. \end{aligned}$$

Hence C is a copula and satisfies (27).

(G14) implies that $F_j(F_j^{\leftarrow}(u_j)) = u_j$ for all $u_j \in \text{ran } F_j$, so

$$\begin{aligned} C(u_1, \dots, u_d) &= C(F_1(F_1^{\leftarrow}(u_1)), \dots, F_d(F_d^{\leftarrow}(u_d))) \\ &\stackrel{(27)}{=} F(F_1^{\leftarrow}(u_1), \dots, F_d^{\leftarrow}(u_d)), \quad \mathbf{u} \in \prod_{j=1}^d \text{ran } F_j. \end{aligned}$$

2) For $\mathbf{U} \sim C$, define $\mathbf{X} = (F_1^{\leftarrow}(U_1), \dots, F_d^{\leftarrow}(U_d))$. Then

$$\begin{aligned}\mathbb{P}(\mathbf{X} \leq \mathbf{x}) &= \mathbb{P}(F_j^{\leftarrow}(U_j) \leq x_j \ \forall j) \stackrel{\text{(G15)}}{=} \mathbb{P}(U_j \leq F_j(x_j) \ \forall j) \\ &= C(F_1(x_1), \dots, F_d(x_d)), \quad \mathbf{x} \in \mathbb{R}^d.\end{aligned}$$

Therefore, F defined by (27) is a df (that of \mathbf{X}), with margins F_1, \dots, F_d (obtained by the quantile transformation). \square

Example 7.5 (Bivariate Bernoulli distribution)

Let (X_1, X_2) follow a bivariate Bernoulli distribution with $\mathbb{P}(X_1 = k, X_2 = l) = 1/4$, $k, l \in \{0, 1\}$. $\Rightarrow \mathbb{P}(X_j = k) = 1/2$, $k \in \{0, 1\}$, $\text{ran } F_j = \{0, 1/2, 1\}$, $j \in \{1, 2\}$. Any copula with $C(1/2, 1/2) = 1/4$ satisfies (27) (e.g. $C(u_1, u_2) = u_1 u_2$ or the copula $C(u_1, u_2) = \min\{u_1, u_2, (\delta(u_1) + \delta(u_2))/2\}$ with $\delta(u) = u^2$).

- We say that \mathbf{X} (or F) *has copula C* if (27) holds.
- A *copula model for \mathbf{X}* means $F(\mathbf{x}) = C(F_1(x_1), \dots, F_d(x_d))$ for some (parametric) copula C and (parametric) marginals F_1, \dots, F_d .

Invariance principle

Lemma 7.6 (Core of the invariance principle)

Let $X_j \sim F_j$, F_j continuous, $j \in \{1, \dots, d\}$. Then

$$\mathbf{X} \text{ has copula } C \iff (F_1(X_1), \dots, F_d(X_d)) \sim C.$$

Proof. See the appendix (“ \Rightarrow ” seen in the proof of Sklar’s Theorem). \square

Theorem 7.7 (Invariance principle)

Let $\mathbf{X} \sim F$ with continuous margins F_1, \dots, F_d and copula C . If $T_j \uparrow$ on $\text{ran } X_j$ for all j , then $(T_1(X_1), \dots, T_d(X_d))$ (also) has copula C .

Proof. W.l.o.g. assume T_j to be right-continuous (T_j has at most countably many discontinuities and we thus change $T_j(X_j)$ at most on this null set). Since $T_j \uparrow$ on $\text{ran } X_j$ and X_j is continuously distributed, $T_j(X_j)$ is continuously distributed and we have

$$\begin{aligned}
 F_{T_j(X_j)}(x) &= \mathbb{P}(T_j(X_j) \leq x) = \mathbb{P}(T_j(X_j) < x) \stackrel{(G15)}{=} \mathbb{P}(X_j < T_j^{\leftarrow}(x)) \\
 &= \mathbb{P}(X_j \leq T_j^{\leftarrow}(x)) = F_j(T_j^{\leftarrow}(x)), \quad x \in \mathbb{R}.
 \end{aligned}$$

This implies that $\mathbb{P}(F_{T_j(X_j)}(T_j(X_j)) \leq u_j \forall j)$ equals

$$\mathbb{P}(F_j(T_j^{\leftarrow}(T_j(X_j))) \leq u_j \forall j) \stackrel{(G13)}{=} \mathbb{P}(F_j(X_j) \leq u_j \forall j) \stackrel{\text{L.7.6}}{\underset{\text{"}\Rightarrow\text{"}}{=}} C(\mathbf{u}).$$

The claim follows from the if part (" \Leftarrow ") of Lemma 7.6. □

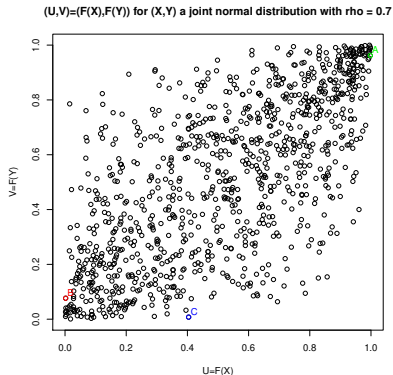
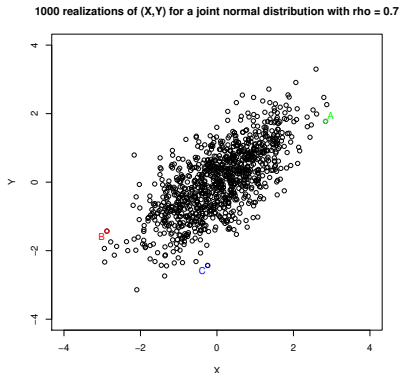
Interpretation of Sklar's Theorem (and the invariance principle)

- 1) Part 1) of Sklar's Theorem allows one to **decompose any df F into its margins and a copula**. This, together with the invariance principle, allows one to **study dependence independently of the margins via the margin-free $\mathbf{U} = (F_1(X_1), \dots, F_d(X_d))$ instead of $\mathbf{X} = (X_1, \dots, X_d)$** (they both have the same copula!). This is interesting for statistical applications, e.g. **parameter estimation** or **goodness-of-fit**.
- 2) Part 2) allows one to **construct flexible multivariate distributions** for particular applications (credit risk, stress testing, etc.).

Visualizing Part 1) of Sklar's Theorem

Left: Scatter plot of $n = 1000$ samples from $(X_1, X_2) \sim N_2(\mathbf{0}, P)$, where $P = \begin{pmatrix} 1 & 0.7 \\ 0.7 & 1 \end{pmatrix}$. We mark three points A, B, C.

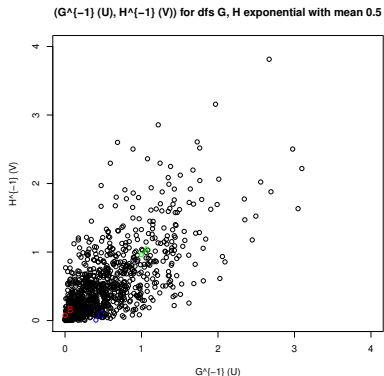
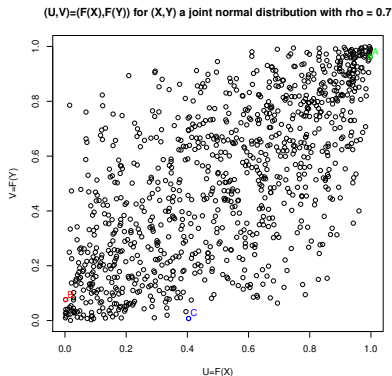
Right: Scatter plot of the corresponding Gauss copula (after applying the df Φ of $N(0, 1)$). Note how A, B, C change.



Visualizing Part 2) of Sklar's Theorem

Left: Same Gauss copula scatter plot as before. Apply marginal Exp(2)-quantile functions ($F_j^{-1}(u) = -\log(1-u)/2$, $j \in \{1, 2\}$).

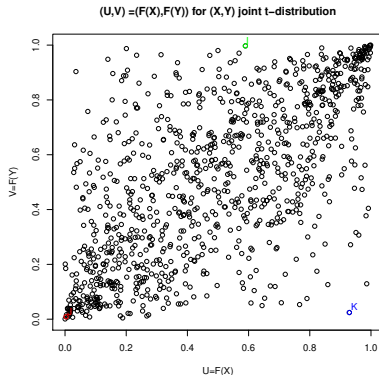
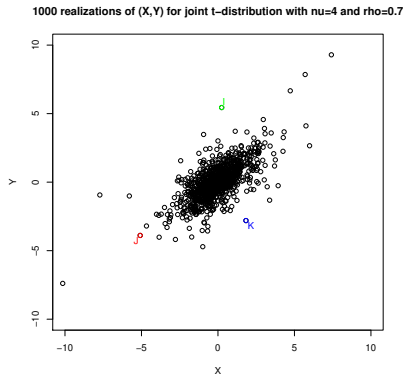
Right: The corresponding transformed random variates. Again, note the three points A, B, C.



Visualizing Part 1) of Sklar's Theorem

Left: Scatter plot of $n = 1000$ samples from $(X_1, X_2) \sim t_2(4, \mathbf{0}, P)$, where $P = \begin{pmatrix} 1 & 0.7 \\ 0.7 & 1 \end{pmatrix}$. We mark three points I, J, K.

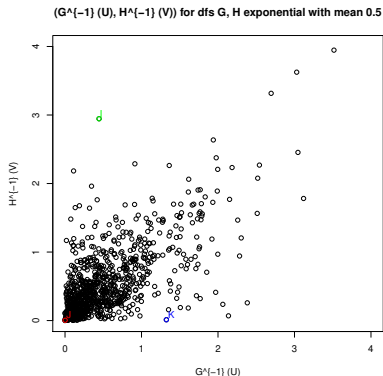
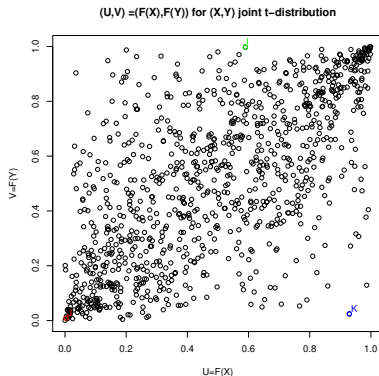
Right: Scatter plot of the corresponding t_4 copula (after applying the df t_4). Note how I, J, K change.



Visualizing Part 2) of Sklar's Theorem

Left: Same t_4 copula scatter plot as before. Apply marginal Exp(2)-quantile functions ($F_j^{-1}(u) = -\log(1-u)/2$, $j \in \{1, 2\}$).

Right: The corresponding transformed random variates. Again, note the three points I, J, K.



Fréchet–Hoeffding bounds

Theorem 7.8 (Fréchet–Hoeffding bounds)

Let $W(\mathbf{u}) = \max\{\sum_{j=1}^d u_j - d + 1, 0\}$ and $M(\mathbf{u}) = \min_{1 \leq j \leq d} \{u_j\}$.

1) For any d -dimensional copula C ,

$$W(\mathbf{u}) \leq C(\mathbf{u}) \leq M(\mathbf{u}), \quad \mathbf{u} \in [0, 1]^d.$$

2) W is a copula if and only if $d = 2$.

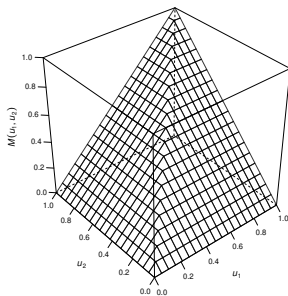
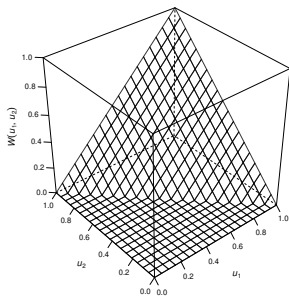
3) M is a copula for all $d \geq 2$.

Proof. See the appendix. □

■ It is easy to verify that, for $U \sim U(0, 1)$,

- ▶ $(U, \dots, U) \sim M$;
- ▶ $(U, 1 - U) \sim W$.

- Plot of W, M for $d = 2$ (compare with $(U, 1 - U) \sim W$, $(U, U) \sim M$)



- The Fréchet–Hoeffding bounds correspond to perfect dependence (negative for W ; positive for M); see Proposition 7.14 later.
- The Fréchet–Hoeffding bounds lead to bounds for any df F , via

$$\max\left\{\sum_{j=1}^d F_j(x_j) - d + 1, 0\right\} \leq F(\mathbf{x}) \leq \min_{1 \leq j \leq d} \{F_j(x_j)\}.$$

We will use them later to derive bounds for the correlation coefficient.

7.1.2 Examples of copulas

- *Fundamental copulas*: important special copulas;
- *Implicit copulas*: extracted from known F via Sklar's Theorem;
- *Explicit copulas*: closed form, arising from construction principles.

Fundamental copulas

As usual, we assume the appearing margins F_1, \dots, F_d to be continuous.

- $\Pi(\mathbf{u}) = \prod_{j=1}^d u_j$ is the *independence copula* since $C(F_1(x_1), \dots, F_d(x_d))$
 $\stackrel{\text{Sklar}}{=} F(\mathbf{x}) \stackrel{\text{ind.}}{=} \prod_{j=1}^d F_j(x_j)$ if and only if $C(\mathbf{u}) = \Pi(\mathbf{u})$ (replace x_j by $F_j^{\leftarrow}(u_j)$ and apply (GI4)). Therefore, X_1, \dots, X_d are independent if and only if their copula is Π ; the density is thus $c(\mathbf{u}) = 1, \mathbf{u} \in [0, 1]^d$.
- W is the *countermotonicity copula*. It is the df of $(U, 1 - U)$. It can be shown that if X_1, X_2 are perfectly negatively dependent (X_2 is a.s. a strictly decreasing function of X_1), their copula is W .

- M is the *comonotonicity copula*. It is the df of (U, \dots, U) . It can be shown that if X_1, \dots, X_d are perfectly positively dependent (X_2, \dots, X_d are a.s. strictly increasing functions of X_1), their copula is M .

Implicit copulas

Elliptical copulas are implicit copulas arising from elliptical distributions via *Sklar's Theorem*. The two most prominent parametric families are the *Gauss copula* and the *t copula* (stemming from normal variance mixtures).

Gauss copulas

- Consider (w.l.o.g.) $\mathbf{X} \sim N_d(\mathbf{0}, P)$. The *Gauss copula* (family) is given by

$$\begin{aligned} C_P^{\text{Ga}}(\mathbf{u}) &= \mathbb{P}(\Phi(X_1) \leq u_1, \dots, \Phi(X_d) \leq u_d) \\ &= \Phi_P(\Phi^{-1}(u_1), \dots, \Phi^{-1}(u_d)) \end{aligned}$$

where Φ_P is the df of $N_d(\mathbf{0}, P)$ and Φ the df of $N(0, 1)$.

- Special cases: If $P = I_d$ then $C = \Pi$, and if $P = J_d = \mathbf{1}\mathbf{1}'$ then $C = M$.
If $d = 2$ and $\rho = P_{12} = -1$ then $C = W$.
- Sklar's Theorem \Rightarrow The density of $C(\mathbf{u}) = F(F_1^{\leftarrow}(u_1), \dots, F_d^{\leftarrow}(u_d))$ is

$$c(\mathbf{u}) = \frac{f(F_1^{\leftarrow}(u_1), \dots, F_d^{\leftarrow}(u_d))}{\prod_{j=1}^d f_j(F_j^{\leftarrow}(u_j))}, \quad \mathbf{u} \in (0, 1)^d.$$

In particular, the density of C_P^{Ga} is

$$c_P^{\text{Ga}}(\mathbf{u}) = \frac{1}{\sqrt{\det P}} \exp\left(-\frac{1}{2} \mathbf{x}'(P^{-1} - I_d)\mathbf{x}\right), \quad (28)$$

where $\mathbf{x} = (\Phi^{-1}(u_1), \dots, \Phi^{-1}(u_d))$.

t copulas

- Consider (w.l.o.g.) $\mathbf{X} \sim t_d(\nu, \mathbf{0}, P)$. The t copula (family) is given by

$$\begin{aligned} C_{\nu, P}^t(\mathbf{u}) &= \mathbb{P}(t_\nu(X_1) \leq u_1, \dots, t_\nu(X_d) \leq u_d) \\ &= t_{\nu, P}(t_\nu^{-1}(u_1), \dots, t_\nu^{-1}(u_d)) \end{aligned}$$

where $t_{\nu,P}$ is the df of $t_d(\nu, \mathbf{0}, P)$ and t_ν the df of the univariate t distribution with ν degrees of freedom.

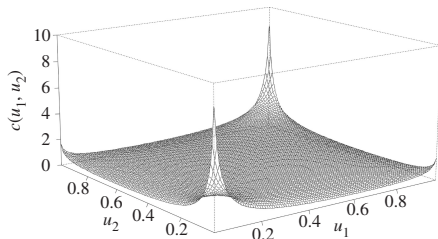
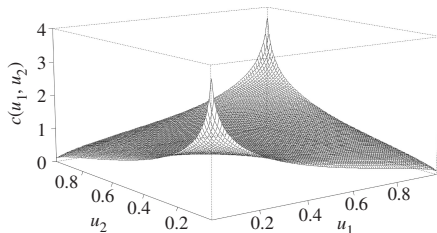
- Special cases: $P = J_d = \mathbf{1}\mathbf{1}'$ then $C = M$. However, if $P = I_d$ then $C \neq \Pi$ (unless $\nu = \infty$ in which case $C_{\nu,P}^t = C_P^{\text{Ga}}$). If $d = 2$ and $\rho = P_{12} = -1$ then $C = W$.
- Sklar's Theorem \Rightarrow The density of $C_{\nu,P}^t$ is

$$c_{\nu,P}^t(\mathbf{u}) = \frac{\Gamma((\nu + d)/2)}{\Gamma(\nu/2)\sqrt{\det P}} \left(\frac{\Gamma(\nu/2)}{\Gamma((\nu + 1)/2)} \right)^d \frac{(1 + \mathbf{x}'P^{-1}\mathbf{x}/\nu)^{-(\nu+d)/2}}{\prod_{j=1}^d (1 + x_j^2/\nu)^{-(\nu+1)/2}},$$

for $\mathbf{x} = (t_\nu^{-1}(u_1), \dots, t_\nu^{-1}(u_d))$.

- For more details, see Demarta and McNeil (2005).
- For scatter plots, see the visualization of Sklar's Theorem above. Note the difference in the tails: The smaller ν , the more mass is concentrated in the joint tails.

Perspective plots of the densities of $C_{\rho=0.3}^{\text{Ga}}$ (left) and $C_{4,\rho=0.3}^t(\mathbf{u})$ (right).



Advantages and drawbacks of elliptical copulas:

Advantages:

- Modelling pairwise dependencies (comparably flexible)
- Density available
- Sampling simple (for Gauss, t)

Drawbacks:

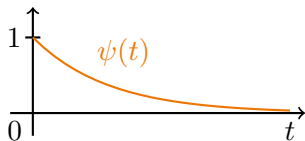
- Typically, C is not explicit
- Radially symmetric (so the same lower/upper tail behaviour)

Explicit copulas

Archimedean copulas are copulas of the form

$$C(\mathbf{u}) = \psi(\psi^{-1}(u_1) + \cdots + \psi^{-1}(u_d))$$

where ψ is the (*Archimedean*) *generator*.

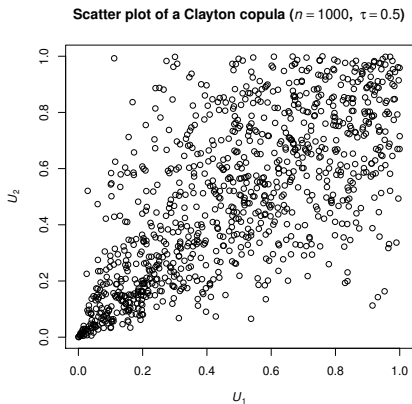
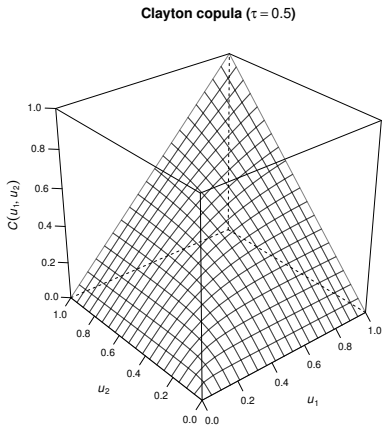


- $\psi : [0, \infty) \rightarrow [0, 1]$ is \downarrow on $[0, \inf\{t : \psi(t) = 0\}]$ and satisfies $\psi(0) = 1$, $\psi(\infty) = \lim_{t \rightarrow \infty} \psi(t) = 0$.
- We set $\psi^{-1}(0) = \inf\{t : \psi(t) = 0\}$.
- The set of all generators is denoted by Ψ .
- Not every generator $\psi \in \Psi$ generates indeed a proper copula (there are conditions, e.g. complete monotonicity, i.e. derivatives alternating in sign).
- If $\psi(t) > 0$, $t \in [0, \infty)$, we call ψ *strict*.

Clayton copulas are obtained for $\psi(t) = (1+t)^{-1/\theta}$, $t \in [0, \infty)$, $\theta \in (0, \infty)$.
For $\theta \downarrow 0$, $C \rightarrow \Pi$; and for $\theta \uparrow \infty$, $C \rightarrow M$.

Left: Plot of a bivariate *Clayton copula* (Kendall's tau 0.5; see later).

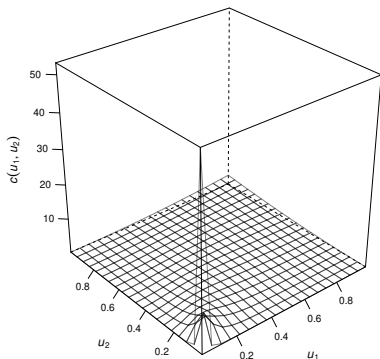
Right: Corresponding *scatter plot* (sample size $n = 1000$)



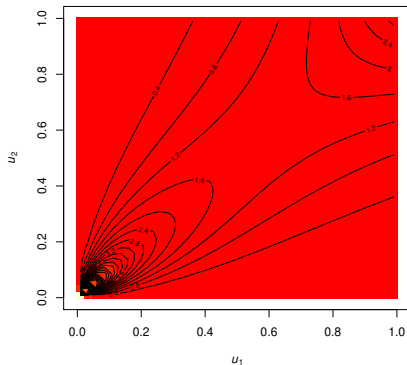
Left: Plot of the **corresponding density**.

Right: **Level plot** of the density (with heat colors).

Clayton copula density ($\tau = 0.5$)



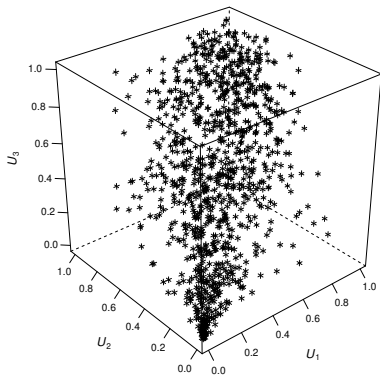
Level plot Clayton copula density ($\tau = 0.5$)



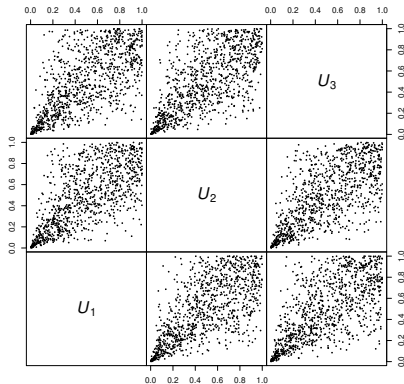
Left: Cloud plot of a trivariate Clayton copula (sample size $n = 1000$; Kendall's tau 0.5).

Right: Corresponding scatter plot matrix.

Clayton copula cloud plot ($n = 1000$, $\tau = 0.5$)



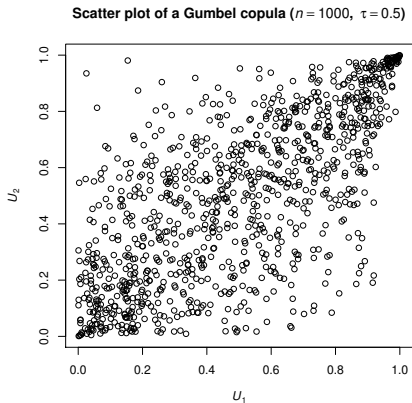
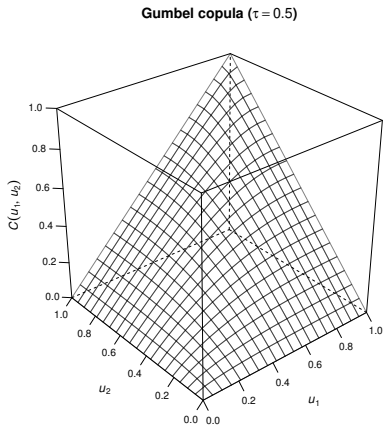
Scatter plot matrix of a Clayton copula ($n = 1000$, $\tau = 0.5$)



Gumbel copulas are obtained for $\psi(t) = \exp(-t^{1/\theta})$, $t \in [0, \infty)$, $\theta \in [1, \infty)$. For $\theta = 1$, $C = \Pi$; and for $\theta \rightarrow \infty$, $C \rightarrow M$.

Left: Plot of a bivariate *Gumbel copula* (Kendall's tau 0.5).

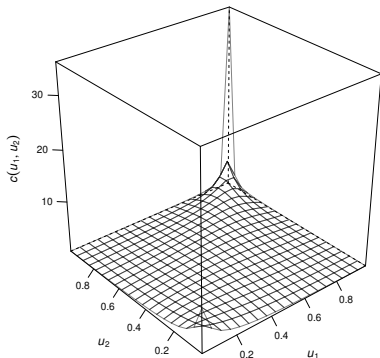
Right: Corresponding *scatter plot* (sample size $n = 1000$)



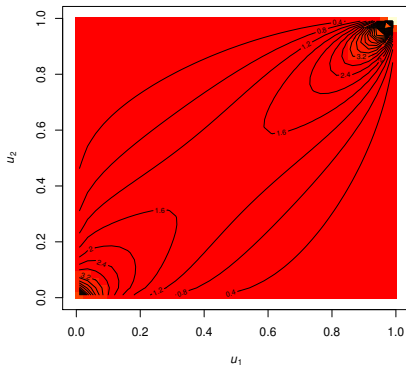
Left: Plot of the **corresponding density**.

Right: **Level plot** of the density (with heat colors).

Gumbel copula density ($\tau = 0.5$)



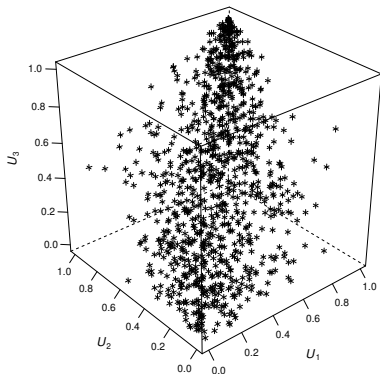
Level plot Gumbel copula density ($\tau = 0.5$)



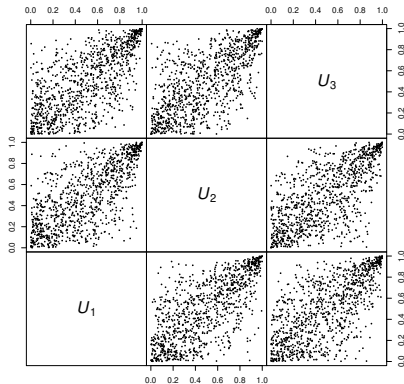
Left: Cloud plot of a trivariate Gumbel copula (sample size $n = 1000$; Kendall's tau 0.5).

Right: Corresponding scatter plot matrix.

Gumbel copula cloud plot ($n = 1000$, $\tau = 0.5$)



Scatter plot matrix of a Gumbel copula ($n = 1000$, $\tau = 0.5$)



Advantages and drawbacks of Archimedean copulas:

Advantages:

- Typically **explicit** (if ψ^{-1} is available)
- Useful in calculations:
Properties can typically be expressed in terms of ψ
- **Densities** of various examples available
- **Sampling** often simple
- **Not restricted to radial symmetry**

Drawbacks:

- All margins of the same dimension are equal (symmetry or **exchangeability**; see later)
- Often used only with a small **number of parameters** (some extensions available, but still less than $d(d-1)/2$)

7.1.3 Meta distributions

- *Fréchet class*: Class of all dfs F with given marginal dfs F_1, \dots, F_d ;
Meta- C models: All dfs F with the same given copula C .
- **Example**: A *meta- t model* is a multivariate df F with t copula C and some margins F_1, \dots, F_d .

7.1.4 Simulation of copulas and meta distributions

Sampling implicit copulas

Due to their construction via Sklar's Theorem, implicit copulas can be sampled via Lemma 7.6.

Algorithm 7.9 (Simulation of implicit copulas)

- 1) Sample $\mathbf{X} \sim F$, where F is a df with continuous margins F_1, \dots, F_d .
- 2) Return $\mathbf{U} = (F_1(X_1), \dots, F_d(X_d))$ (probability transformation).

Example 7.10

- Sampling **Gauss copulas** C_P^{Ga} :

- 1) Sample $\mathbf{X} \sim N_d(\mathbf{0}, P)$ ($\mathbf{X} \stackrel{d}{=} A\mathbf{Z}$ for $AA' = P$, $\mathbf{Z} \sim N_d(\mathbf{0}, I_d)$).
- 2) Return $\mathbf{U} = (\Phi(X_1), \dots, \Phi(X_d))$.

- Sampling **t_ν copulas** $C_{\nu, P}^t$:

- 1) Sample $\mathbf{X} \sim t_d(\nu, \mathbf{0}, P)$ ($\mathbf{X} \stackrel{d}{=} \sqrt{W}A\mathbf{Z}$ for $W = \frac{1}{V}$, $V \sim \Gamma(\frac{\nu}{2}, \frac{\nu}{2})$).
- 2) Return $\mathbf{U} = (t_\nu(X_1), \dots, t_\nu(X_d))$.

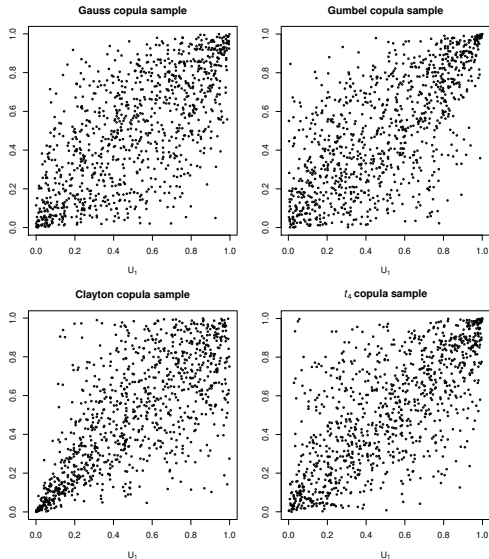
Sampling meta distributions

Meta- C distributions can be sampled via Sklar's Theorem, Part 2).

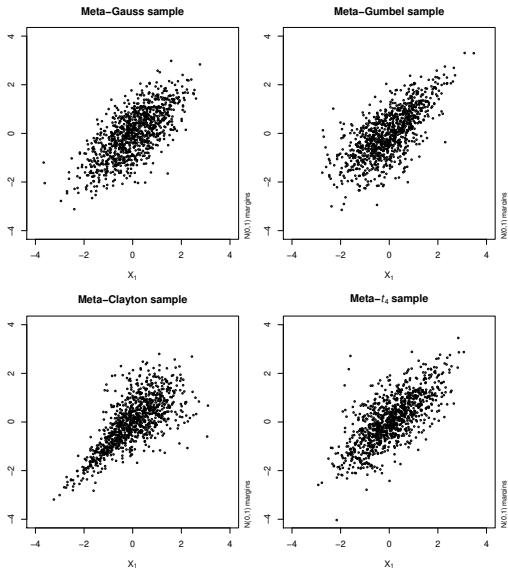
Algorithm 7.11 (Sampling meta- C models)

- 1) Sample $\mathbf{U} \sim C$.
- 2) Return $\mathbf{X} = (F_1^{\leftarrow}(U_1), \dots, F_d^{\leftarrow}(U_d))$ (**quantile transformation**).

2000 samples from (a): $C_{\rho=0.7}^{\text{Ga}}$; (b): $C_{\theta=2}^{\text{G}}$; (c): $C_{\theta=2.2}^{\text{C}}$; (d): $C_{\nu=4, \rho=0.71}^t$



... transformed to $N(0, 1)$ margins; all have linear correlation ≈ 0.7 !



A general sampling algorithm

For a general copula C (without further information), the only known sampling algorithm is the conditional distribution method.

Theorem 7.12 (Conditional distribution method)

If C is a d -dimensional copula and $\mathbf{U}' \sim U(0, 1)^d$ then $\mathbf{U} \sim C$, where

$$U_1 = U'_1,$$

$$U_2 = C_{2|1}^{\leftarrow}(U'_2 | U_1),$$

$$U_3 = C_{3|1,2}^{\leftarrow}(U'_3 | U_1, U_2),$$

$$\vdots$$

$$U_d = C_{d|1,\dots,d-1}^{\leftarrow}(U'_d | U_1, \dots, U_{d-1})$$

and where $C_{j|1,\dots,j-1}(u_j | u_1, \dots, u_{j-1}) = \mathbb{P}(U_j \leq u_j | U_1 = u_1, \dots, U_{j-1} = u_{j-1})$, $j \in \{2, \dots, d\}$.

Theorem 7.13 (Schmitz (2003))

Let C be a d -dimensional copula which admits, for $d \geq 3$, continuous partial derivatives w.r.t. u_1, \dots, u_{d-1} . For a.e. $u_1, \dots, u_{j-1} \in [0, 1]$,

$$C_{j|1, \dots, j-1}(u_j | u_1, \dots, u_{j-1}) = \frac{D_{j-1, \dots, 1} C^{(1, \dots, j)}(u_1, \dots, u_j)}{D_{j-1, \dots, 1} C^{(1, \dots, j-1)}(u_1, \dots, u_{j-1})},$$

where $C^{(1, \dots, j)}(u_1, \dots, u_j) = C(u_1, \dots, u_j, 1, \dots, 1)$ and $D_{j-1, \dots, 1}$ is the differential operator w.r.t. u_1, \dots, u_{j-1} .

Note: $C_{2|1}(u_2 | u_1) = \frac{D_1 C(u_1, u_2)}{1} = D_1 C(u_1, u_2)$ which also follows from

$$\begin{aligned} & \lim_{h \downarrow 0} \frac{C(u_1 + h, u_2) - C(u_1, u_2)}{h} \\ &= \lim_{h \downarrow 0} \frac{\mathbb{P}(U_1 \leq u_1 + h, U_2 \leq u_2) - \mathbb{P}(U_1 \leq u_1, U_2 \leq u_2)}{h} \\ &= \lim_{h \downarrow 0} \frac{\mathbb{P}(U_2 \leq u_2, u_1 < U_1 \leq u_1 + h)}{\mathbb{P}(u_1 < U_1 \leq u_1 + h)} = \lim_{h \downarrow 0} \mathbb{P}(U_2 \leq u_2 | u_1 < U_1 \leq u_1 + h). \end{aligned}$$

7.1.5 Further properties of copulas

Survival copulas

- If $U \sim C$, then $1 - U \sim \hat{C}$, the *survival copula* of C .
- \hat{C} can be expressed as

$$\hat{C}(u) = \sum_{J \subseteq \{1, \dots, d\}} (-1)^{|J|} C((1 - u_1)^{I_{J(1)}}, \dots, (1 - u_d)^{I_{J(d)}})$$

in terms of its corresponding copula (essentially an application of the inclusion–exclusion principle). For $d = 2$, $\hat{C}(u_1, u_2) = 1 - (1 - u_1) - (1 - u_2) + C(1 - u_1, 1 - u_2) = -1 + u_1 + u_2 + C(1 - u_1, 1 - u_2)$. We can also verify this directly by noting that $\hat{C}(u_1, u_2)$ equals

$$\begin{aligned} \mathbb{P}(1 - U_1 \leq u_1, 1 - U_2 \leq u_2) &= \mathbb{P}(U_1 > 1 - u_1, U_2 > 1 - u_2) \\ &= \mathbb{P}(U_1 > 1 - u_1) - \mathbb{P}(U_1 > 1 - u_1, U_2 \leq 1 - u_2) \\ &= 1 - (1 - u_1) - (\mathbb{P}(U_2 \leq 1 - u_2) - \mathbb{P}(U_1 \leq 1 - u_1, U_2 \leq 1 - u_2)) \\ &= u_1 - (1 - u_2 - C(1 - u_1, 1 - u_2)). \end{aligned}$$

- If C admits a density, $\hat{c}(\mathbf{u}) = c(\mathbf{1} - \mathbf{u})$.
- If $\hat{C} = C$, C is called *radially symmetric*. Check that W , Π , and M are radially symmetric. All elliptical copulas are radially symmetric, too.
- One can show: If X_j is symmetrically distributed about μ_j , $j \in \{1, \dots, d\}$, then \mathbf{X} is radially symmetric about $\boldsymbol{\mu}$ if and only if $C = \hat{C}$.
- Sklar's Theorem can also be formulated for survival functions. In this case, the main part reads

$$\bar{F}(\mathbf{x}) = \hat{C}(\bar{F}_1(x_1), \dots, \bar{F}_d(x_d)),$$

where $\bar{F}(\mathbf{x}) = \mathbb{P}(\mathbf{X} > \mathbf{x})$ with corresponding marginal survival functions $\bar{F}_1, \dots, \bar{F}_d$ (with $\bar{F}_j(x) = \mathbb{P}(X_j > x)$). Hence survival copulas combine marginal to joint survival functions.

Exchangeability

- \mathbf{X} is *exchangeable* if

$$(X_1, \dots, X_d) \stackrel{d}{=} (X_{\pi(1)}, \dots, X_{\pi(d)})$$

for any permutation $(\pi(1), \dots, \pi(d))$ of $(1, \dots, d)$.

- A copula C is *exchangeable* if it is the df of an exchangeable \mathbf{U} with $U(0, 1)$ margins. This holds if only if $C(u_1, \dots, u_d) = C(u_{\pi(1)}, \dots, u_{\pi(d)})$ for all possible permutations of arguments, i.e. if C is *symmetric*.
- Exchangeable/symmetric copulas are useful for approximate modelling homogeneous portfolios.
- **Examples:**
 - ▶ Archimedean copulas
 - ▶ Elliptical copulas (such as Gauss/ t) for equicorrelated P (i.e. $P = \rho J_d + (1 - \rho)I_d$ for $\rho \geq -1/(d - 1)$); in particular, $d = 2$

Copula densities

- By **Sklar's Theorem**, if F_j has density f_j , $j \in \{1, \dots, d\}$, and C has density c , then the density f of F satisfies

$$f(\mathbf{x}) = c(F_1(x_1), \dots, F_d(x_d)) \prod_{j=1}^d f_j(x_j). \quad (29)$$

This implies

$$c(\mathbf{u}) = \frac{f(F_1^{-1}(u_1), \dots, F_d^{-1}(u_d))}{f_1(F_1^{-1}(u_1)) \cdots f_d(F_d^{-1}(u_d))}.$$

- It follows from (29) that the **log-density** splits into

$$\log f(\mathbf{x}) = \log c(F_1(x_1), \dots, F_d(x_d)) + \sum_{j=1}^d \log f_j(x_j)$$

which **allows for a two-stage estimation** (**marginal** and **copula parameters separately**); see Section 7.6.

7.2 Dependence concepts and measures

Measures of association/dependence are scalar measures which summarize the dependence in terms of a single number. There are better and worse examples of such measures, which we will study in this section.

7.2.1 Perfect dependence

X_1, X_2 are *countermonotone* if (X_1, X_2) has copula W .

X_1, \dots, X_d are *comonotone* if (X_1, \dots, X_d) has copula M .

Proposition 7.14 (Perfect dependence)

- 1) $X_2 = T(X_1)$ a.s. with decreasing $T(x) = F_2^{\leftarrow}(1 - F_1(x))$ (countermonotone) if and only if $C(u_1, u_2) = W(u_1, u_2)$, $u_1, u_2 \in [0, 1]$.
- 2) $X_j = T_j(X_1)$ a.s. with increasing $T_j(x) = F_j^{\leftarrow}(F_1(x))$, $j \in \{2, \dots, d\}$, (comonotone) if and only if $C(\mathbf{u}) = M(\mathbf{u})$, $\mathbf{u} \in [0, 1]^d$.

Proof. See the appendix. □

Proposition 7.15 (Comonotone additivity)

Let $\alpha \in (0, 1)$ and $X_j \sim F_j$, $j \in \{1, \dots, d\}$, be comontone. Then $\text{VaR}_\alpha(X_1 + \dots + X_d) = F_{X_1 + \dots + X_d}^\leftarrow(\alpha) = F_1^\leftarrow(\alpha) + \dots + F_d^\leftarrow(\alpha) = \sum_{j=1}^d \text{VaR}_\alpha(X_j)$.

Proof. We consider the case where $F_j \uparrow$ and continuous for all j (for the general case, see the appendix). Since $X_j \stackrel{d}{=} F_j^{-1}(U)$, $j \in \{1, \dots, d\}$, for $U \sim U(0, 1)$, and since $T(u) = F_1^{-1}(u) + \dots + F_d^{-1}(u)$ is \uparrow and continuous,

$$\begin{aligned} F_{\sum_{j=1}^d X_j}(T(\alpha)) &= F_{T(U)}(T(\alpha)) = \mathbb{P}(T(U) \leq T(\alpha)) \\ &= \mathbb{P}(U \leq T^{-1}(T(\alpha))) = \alpha, \end{aligned} \tag{30}$$

hence

$$\text{VaR}_\alpha\left(\sum_{j=1}^d X_j\right) = F_{\sum_{j=1}^d X_j}^{-1}(\alpha) \stackrel{(30)}{=} T(\alpha) = \sum_{j=1}^d \text{VaR}_\alpha(X_j).$$



7.2.2 Linear correlation

For two random variables X_1 and X_2 with $\mathbb{E}(X_j^2) < \infty$, $j \in \{1, 2\}$, the (*linear* or *Pearson's*) *correlation coefficient* ρ is defined by

$$\rho(X_1, X_2) = \frac{\text{cov}(X_1, X_2)}{\sqrt{\text{var } X_1} \sqrt{\text{var } X_2}} = \frac{\mathbb{E}((X_1 - \mathbb{E}X_1)(X_2 - \mathbb{E}X_2))}{\sqrt{\mathbb{E}((X_1 - \mathbb{E}X_1)^2)} \sqrt{\mathbb{E}((X_2 - \mathbb{E}X_2)^2)}}.$$

Classical properties and drawbacks of linear correlation

Let X_1 and X_2 be two random variables with $\mathbb{E}(X_j^2) < \infty$, $j \in \{1, 2\}$.

Note that ρ depends on the marginal distributions! In particular, **second moments have to exist** (not the case, e.g. for $X_1, X_2 \stackrel{\text{ind.}}{\sim} F(x) = 1 - x^{-3/2}!$)

- $|\rho| \leq 1$. Furthermore, $|\rho| = 1$ if and only if there are constants $a \in \mathbb{R} \setminus \{0\}, b \in \mathbb{R}$ with $X_2 = aX_1 + b$ a.s. with $a \geq 0$ if and only if $\rho = \pm 1$. **This discards other strong functional dependence such as $X_2 = X_1^2$, for example.**

- If X_1 and X_2 are independent, then $\rho = 0$. However, the converse is not true in general; see Example 7.17 below.
- ρ is invariant under strictly increasing linear transformations on $\text{ran } X_1 \times \text{ran } X_2$ but not invariant under strictly increasing functions in general. To see this, consider $(X_1, X_2) \sim N_2(\mathbf{0}, P)$. Then $\rho(X_1, X_2) = P_{12}$, but (as one can show) $\rho(F_1(X_1), F_2(X_2)) = \frac{6}{\pi} \arcsin(P_{12}/2)$.

Proposition 7.16 (Hoeffding's formula)

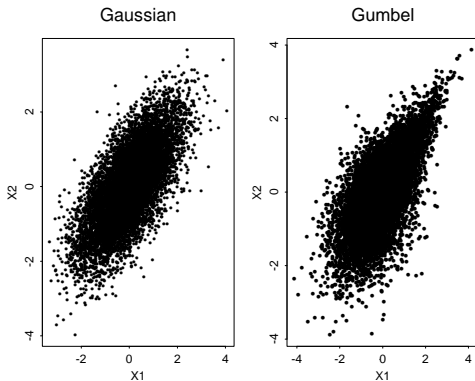
Let $X_j \sim F_j$, $j \in \{1, 2\}$, be two random variables with $\mathbb{E}(X_j^2) < \infty$, $j \in \{1, 2\}$, and joint distribution function F . Then

$$\text{cov}(X_1, X_2) = \int_{-\infty}^{\infty} \int_{-\infty}^{\infty} (F(x_1, x_2) - F_1(x_1)F_2(x_2)) \, dx_1 dx_2.$$

Correlation fallacies

Fallacy 1: F_1 , F_2 , and ρ uniquely determine F

This is true for bivariate elliptical distributions, but wrong in general. The following samples both have $N(0, 1)$ margins and correlation $\rho = 0.7$, yet come from different (copula) models:



Another example is this.

Example 7.17 (Uncorrelated \nRightarrow independent)

- Consider the two risks

$$X_1 = Z \quad (\text{Profit \& Loss Country A}),$$

$$X_2 = ZV \quad (\text{Profit \& Loss Country B}),$$

where V, Z are independent with $Z \sim N(0, 1)$ and $\mathbb{P}(V = -1) = \mathbb{P}(V = 1) = 1/2$. Then $X_2 \sim N(0, 1)$ and $\rho(X_1, X_2) = \text{cov}(X_1, X_2) = \mathbb{E}(X_1 X_2) \underset{\text{ind.}}{=} \mathbb{E}(V)\mathbb{E}(Z^2) = 0$, but X_1 and X_2 are not independent (in fact, V makes (X_1, X_2) switch between counter- and comonotonicity).

- Consider $(X'_1, X'_2) \sim N_2(\mathbf{0}, I_2)$. Both (X'_1, X'_2) and (X_1, X_2) have $N(0, 1)$ margins and $\rho = 0$, but the copula of (X'_1, X'_2) is Π and the copula of (X_1, X_2) is the convex combination $C(\mathbf{u}) = \lambda M(\mathbf{u}) + (1 - \lambda)W(\mathbf{u})$ for $\lambda = 0.5$.

Fallacy 2: Given F_1, F_2 , any $\rho \in [-1, 1]$ is attainable

This is true for elliptically distributed (X_1, X_2) with $\mathbb{E}(R^2) < \infty$ (as then $\text{corr } \mathbf{X} = P$), but wrong in general:

- If F_1 and F_2 are not of the same type (no linearity), $\rho(X_1, X_2) = 1$ is not attainable (recall that $|\rho| = 1$ if and only if there are constants $a \in \mathbb{R} \setminus \{0\}, b \in \mathbb{R}$ with $X_2 = aX_1 + b$ a.s.).
- What is the attainable range then? Hoeffding's formula

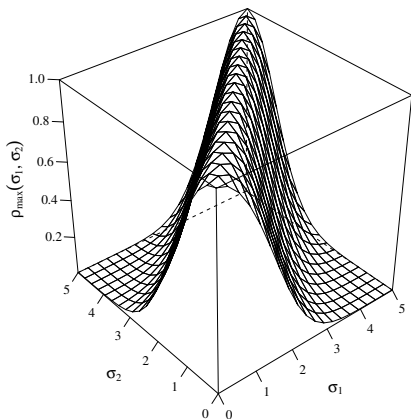
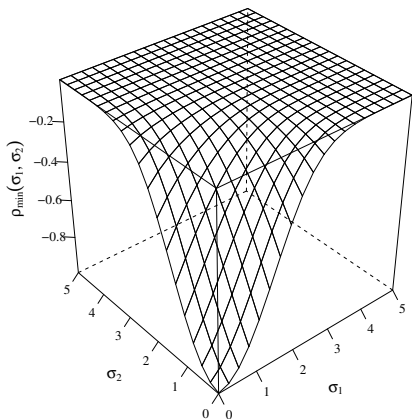
$$\text{cov}(X_1, X_2) = \int_{-\infty}^{\infty} \int_{-\infty}^{\infty} (C(F_1(x_1), F_2(x_2)) - F_1(x_1)F_2(x_2)) \, dx_1 dx_2.$$

implies bounds on attainable ρ :

$$\rho \in [\rho_{\min}, \rho_{\max}] \quad (\rho_{\min} \text{ is attained for } C = W, \rho_{\max} \text{ for } C = M).$$

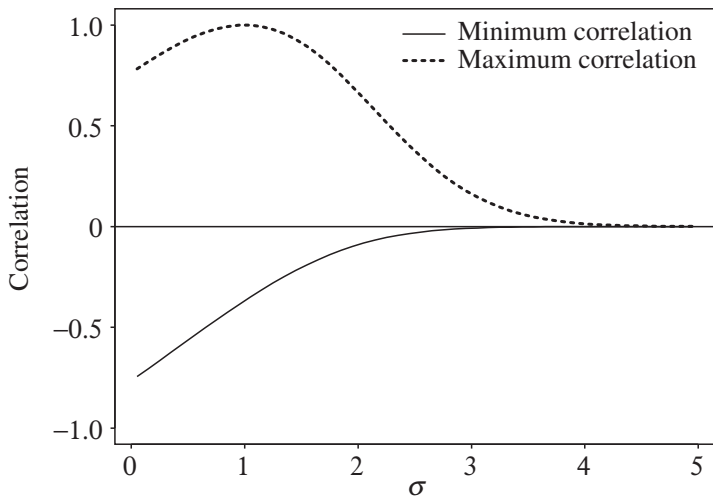
Example 7.18 (Bounds for a model with $\text{LN}(0, \sigma_j^2)$ margins)

Let $X_j \sim \text{LN}(0, \sigma_j^2)$, $j \in \{1, 2\}$. One can show that minimal (ρ_{\min} ; left) and maximal (ρ_{\max} ; right) correlations are given as follows.



For $\sigma_1^2 = 1$, $\sigma_2^2 = 16$ one has $\rho \in [-0.0003, 0.0137]!$

Specifically, let $X_1 \sim \text{LN}(0, 1)$ and $X_2 \sim \text{LN}(0, \sigma^2)$. Now let σ vary and plot ρ_{\min} and ρ_{\max} against σ :



Fallacy 3: ρ maximal (i.e. $C = M$) $\Rightarrow \text{VaR}_\alpha(X_1 + X_2)$ maximal

- This is true if (X_1, X_2) is elliptically distributed since the maximal $\rho = 1$ implies that X_1, X_2 are comonotone, so VaR_α is additive (by Proposition 7.15) and additivity provides the largest possible bound in this case as VaR_α is subadditive (by Proposition 6.24).
- Any superadditivity example $\text{VaR}_\alpha(X_1 + X_2) > \text{VaR}_\alpha(X_1) + \text{VaR}_\alpha(X_2)$ serves as a counterexample as the right-hand side under comonotonicity (so maximal correlation) only equals $\text{VaR}_\alpha(X_1 + X_2)$; see Section 2.3.5 and Proposition 7.15.

7.2.3 Rank correlation

Rank correlation coefficients are...

- ... always defined;
- ... invariant under strictly increasing transformations of the random variables (hence only depend on the underlying copula).

Kendall's tau and Spearman's rho

Definition 7.19 (Kendall's tau)

Let $X_j \sim F_j$ with F_j continuous, $j \in \{1, 2\}$. Let (X'_1, X'_2) be an independent copy of (X_1, X_2) . *Kendall's tau* is defined by

$$\begin{aligned}\rho_\tau &= \mathbb{E}(\text{sign}((X_1 - X'_1)(X_2 - X'_2))) \\ &= \mathbb{P}((X_1 - X'_1)(X_2 - X'_2) > 0) - \mathbb{P}((X_1 - X'_1)(X_2 - X'_2) < 0),\end{aligned}$$

where $\text{sign}(x) = I_{(0, \infty)}(x) - I_{(-\infty, 0)}(x)$ (so -1 for $x < 0$, 0 for $x = 0$ and 1 for $x > 0$).

By definition, Kendall's tau is *the probability of concordance* ($\mathbb{P}((X_1 - X'_1)(X_2 - X'_2) > 0)$; probability of two independent points from F to have a positive slope) *minus the probability of discordance* ($\mathbb{P}((X_1 - X'_1)(X_2 - X'_2) < 0)$; probability of two independent points from F to have a negative slope).

Proposition 7.20 (Formula for Kendall's tau)

Let $X_j \sim F_j$ with F_j continuous, $j \in \{1, 2\}$, and copula C . Then

$$\rho_\tau = 4 \int_0^1 \int_0^1 C(u_1, u_2) dC(u_1, u_2) - 1 = 4\mathbb{E}(C(U_1, U_2)) - 1,$$

where $(U_1, U_2) \sim C$.

Proof. See the appendix. □

An estimator of ρ_τ is provided by the *sample version of Kendall's tau*

$$r_n^\tau = \frac{1}{\binom{n}{2}} \sum_{1 \leq i_1 < i_2 \leq n} \text{sign}((X_{i_1 1} - X_{i_2 1})(X_{i_1 2} - X_{i_2 2})). \quad (31)$$

Definition 7.21 (Spearman's rho)

Let $X_j \sim F_j$ with F_j continuous, $j \in \{1, 2\}$. *Spearman's rho* is defined by $\rho_S = \rho(F_1(X_1), F_2(X_2))$.

Proposition 7.22 (Formula for Spearman's rho)

Let $X_j \sim F_j$ with F_j 's continuous and copula C . For $(U'_1, U'_2) \sim \Pi$,

$$\rho_S = 12 \int_0^1 \int_0^1 C(u_1, u_2) du_1 du_2 - 3 = 12\mathbb{E}(C(U'_1, U'_2)) - 3.$$

Proof. By Hoeffding's formula, we have $\rho_S(X_1, X_2) = \rho(F_1(X_1), F_2(X_2))$
 $= 12 \int_0^1 \int_0^1 (C(u_1, u_2) - u_1 u_2) du_1 du_2 = 12 \int_0^1 \int_0^1 C(u_1, u_2) du_1 du_2 - 3.$

□

- An estimator r_n^S is given by the sample correlation computed from componentwise scaled ranks (the so-called *pseudo-observations*) of the data.
- For $\kappa = \rho_\tau$ and $\kappa = \rho_S$, Embrechts, McNeil, et al. (2002) show that $\kappa = \pm 1$ if and only if X_1, X_2 are co-/countermonotonic. In general, $\kappa = 0$ does not imply independence.

- **Fallacy 1** (F_1, F_2, ρ uniquely determine F) is **not solved by** replacing ρ by **rank correlation coefficients κ** (it is easy to construct several copulas with the same Kendall's tau, e.g. via Archimedean copulas).
- **Fallacy 2** (For F_1, F_2 , any $\rho \in [-1, 1]$ is attainable) is **solved** when ρ is replaced by ρ_τ or ρ_S . **Take**

$$F(x_1, x_2) = \lambda M(F_1(x_1), F_2(x_2)) + (1 - \lambda) W(F_1(x_1), F_2(x_2)).$$

This is a model with $\rho_\tau = \rho_S = 2\lambda - 1$ (choose $\lambda \in [0, 1]$ as desired).

- **Fallacy 3** ($C = M$ implies $\text{VaR}_\alpha(X_1 + X_2)$ maximal) is **also not solved by rank correlation coefficients $\kappa = 1$** : Although $\kappa = 1$ corresponds to $C = M$, this copula does not necessarily provide the largest $\text{VaR}_\alpha(X_1 + X_2)$; see Fallacy 3 earlier.
- **Nevertheless**, rank correlations are useful **to summarize dependence**, to parameterize copula families to **make dependence comparable** and for copula parameter calibration or estimation.

7.2.4 Coefficients of tail dependence

Goal: Measure *extremal dependence*, i.e. dependence in the *joint tails*.

Definition 7.23 (Tail dependence)

Let $X_j \sim F_j$, $j \in \{1, 2\}$, be continuously distributed random variables. Provided that the limits exist, the *lower tail-dependence coefficient* λ_l and *upper tail-dependence coefficient* λ_u of X_1 and X_2 are defined by

$$\lambda_l = \lim_{u \downarrow 0} \mathbb{P}(X_2 \leq F_2^{\leftarrow}(u) \mid X_1 \leq F_1^{\leftarrow}(u)),$$

$$\lambda_u = \lim_{u \uparrow 1} \mathbb{P}(X_2 > F_2^{\leftarrow}(u) \mid X_1 > F_1^{\leftarrow}(u)).$$

If $\lambda_l \in (0, 1]$ ($\lambda_u \in (0, 1]$), then (X_1, X_2) is *lower (upper) tail dependent*.
If $\lambda_l = 0$ ($\lambda_u = 0$), then (X_1, X_2) is *lower (upper) tail independent*.

As (conditional) probabilities, we clearly have $\lambda_l, \lambda_u \in [0, 1]$.

- Tail dependence is a copula property, since

$$\begin{aligned}\mathbb{P}(X_2 \leq F_2^{\leftarrow}(u) \mid X_1 \leq F_1^{\leftarrow}(u)) &= \frac{\mathbb{P}(X_1 \leq F_1^{\leftarrow}(u), X_2 \leq F_2^{\leftarrow}(u))}{\mathbb{P}(X_1 \leq F_1^{\leftarrow}(u))} \\ &= \frac{F(F_1^{\leftarrow}(u), F_2^{\leftarrow}(u))}{F_1(F_1^{\leftarrow}(u))} \stackrel{\text{Sklar}}{\underset{\text{(GI4)}}{=}} \frac{C(u, u)}{u}, \quad u \in (0, 1), \text{ so } \lambda_1 = \lim_{u \downarrow 0} \frac{C(u, u)}{u}.\end{aligned}$$

- If $u \mapsto C(u, u)$ is differentiable in a neighborhood of 0 and the limit exists, then $\lambda_1 = \lim_{u \downarrow 0} \frac{d}{du} C(u, u)$ (l'Hôpital's Rule).
- If C is totally differentiable in a neighborhood of 0 and the limit exists, then $\lambda_1 = \lim_{u \downarrow 0} (D_1 C(u, u) + D_2 C(u, u))$ (Chain Rule). If C is exchangeable, $\lambda_1 = 2 \lim_{u \downarrow 0} D_1 C(u, u) \stackrel{\text{Th. 7.13}}{=} 2 \lim_{u \downarrow 0} C_{2|1}(u \mid u) = 2 \lim_{u \downarrow 0} \mathbb{P}(U_2 \leq u \mid U_1 = u)$ for $(U_1, U_2) \sim C$. Combined with any continuous df F . (the same for both components) and $(X_1, X_2) = (F^{\leftarrow}(U_1), F^{\leftarrow}(U_2))$, one has

$$\lambda_1 = 2 \lim_{x \downarrow -\infty} \mathbb{P}(X_2 \leq x \mid X_1 = x) \quad (32)$$

which is useful for deriving λ_1 for elliptical copulas.

- Similarly as above, for the upper tail-dependence coefficient,

$$\begin{aligned}\lambda_u &= \lim_{u \uparrow 1} \frac{1 - 2u + C(u, u)}{1 - u} = \lim_{u \downarrow 0} \frac{\hat{C}(u, u)}{u} \\ &= \lim_{u \uparrow 1} \frac{2(1 - u) - (1 - C(u, u))}{1 - u} = 2 - \lim_{u \uparrow 1} \frac{1 - C(u, u)}{1 - u}.\end{aligned}$$

- For all **radially symmetric copulas** (e.g. the bivariate C_P^{Ga} and $C_{\nu, P}^t$ copulas), we have $\lambda_l = \lambda_u =: \lambda$.
- For **Archimedean copulas with strict ψ** , a substitution and l'Hôpital's Rule show:

$$\begin{aligned}\lambda_l &= \lim_{u \downarrow 0} \frac{\psi(2\psi^{-1}(u))}{u} = \lim_{t \rightarrow \infty} \frac{\psi(2t)}{\psi(t)} = 2 \lim_{t \rightarrow \infty} \frac{\psi'(2t)}{\psi'(t)}, \\ \lambda_u &= 2 - \lim_{u \uparrow 1} \frac{1 - \psi(2\psi^{-1}(u))}{1 - u} = 2 - \lim_{t \downarrow 0} \frac{1 - \psi(2t)}{1 - \psi(t)} = 2 - 2 \lim_{t \downarrow 0} \frac{\psi'(2t)}{\psi'(t)}.\end{aligned}$$

Clayton: $\lambda_l = 2^{-1/\theta}$, $\lambda_u = 0$; **Gumbel:** $\lambda_l = 0$, $\lambda_u = 2 - 2^{1/\theta}$

7.3 Normal mixture copulas

... are the **copulas of multivariate normal** (mean-) **variance mixtures** $\mathbf{X} \stackrel{d}{=} \mathbf{0} + \sqrt{W} \mathbf{A} \mathbf{Z}$, $\mathbf{A} \mathbf{A}' = \mathbf{P}$, $(\mathbf{X} \stackrel{d}{=} \mathbf{m}(W) + \sqrt{W} \mathbf{A} \mathbf{Z})$; e.g. Gauss, t copulas.

7.3.1 Tail dependence

Coefficients of tail dependence

Let (X_1, X_2) be distributed according to a normal variance mixture and assume (w.l.o.g.) that $\boldsymbol{\mu} = (0, 0)$ and $\mathbf{A} \mathbf{A}' = \mathbf{P} = \begin{pmatrix} 1 & \rho \\ \rho & 1 \end{pmatrix}$. In this case, $F_1 = F_2$ and C is symmetric and radially symmetric. We thus obtain that

$$\lambda \stackrel{\text{radial}}{=} \lambda_l \stackrel{\text{symm.}}{=} \underset{(32)}{2} \lim_{x \downarrow -\infty} \mathbb{P}(X_2 \leq x \mid X_1 = x).$$

Example 7.24 (λ for the Gauss and t copula)

- Considering the bivariate $N(\mathbf{0}, \mathbf{P})$ density, one can show (via $f_{X_2|X_1}(x_2 \mid x_1) = \frac{f_{X_1, X_2}(x_1, x_2)}{f_{X_1}(x_1)}$) that $(X_2 \mid X_1 = x) \sim N(\rho x, 1 - \rho^2)$. This implies that

$$\lambda = 2 \lim_{x \downarrow -\infty} \mathbb{P}(X_2 \leq x \mid X_1 = x) = 2 \lim_{x \downarrow -\infty} \Phi\left(\frac{x(1-\rho)}{\sqrt{1-\rho^2}}\right) = I_{\{\rho=1\}}.$$

- For $C_{\nu, \rho}^t$, one can show that $(X_2 \mid X_1 = x) \sim t_{\nu+1}(\rho x, \frac{(1-\rho^2)(\nu+x^2)}{\nu+1})$ and thus $\mathbb{P}(X_2 \leq x \mid X_1 = x) = t_{\nu+1}\left(\frac{x-\rho x}{\sqrt{\frac{(1-\rho^2)(\nu+x^2)}{\nu+1}}}\right)$. Hence

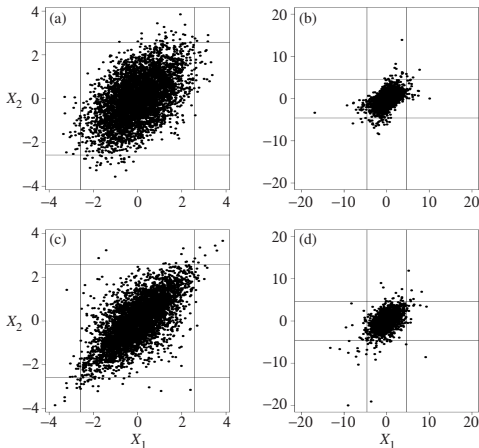
$$\lambda = 2t_{\nu+1}\left(-\sqrt{\frac{(\nu+1)(1-\rho)}{1+\rho}}\right) \quad (\text{tail dependence; } \lambda \uparrow \text{ in } \rho \uparrow \text{ and } \nu \downarrow).$$

- λ values for various ν, ρ :

ν	$\rho = -0.5$	$\rho = 0$	$\rho = 0.5$	$\rho = 0.9$	$\rho = 1$
∞	0	0	0	0	1
10	0.00	0.01	0.08	0.46	1
4	0.01	0.08	0.25	0.63	1
2	0.06	0.18	0.39	0.72	1

One can show that if W has a power tail, $\lambda > 0$, otherwise $\lambda = 0$.

Joint quantile exceedance probabilities



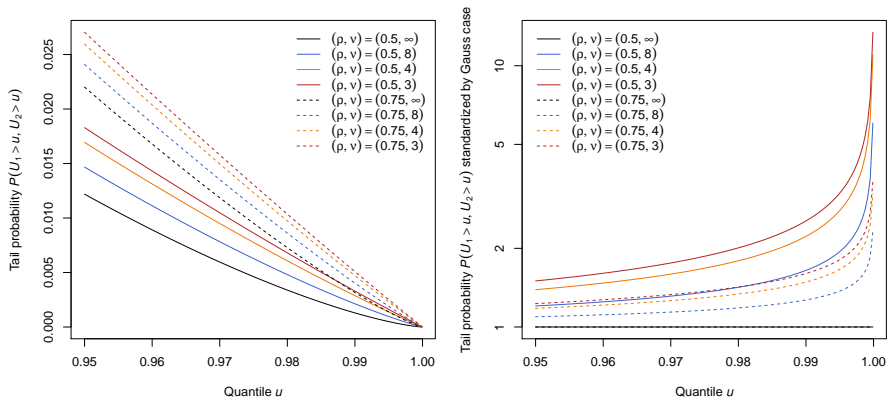
5000 samples from

- (a) $N_2(\mathbf{0}, P = \begin{pmatrix} 1 & \rho \\ \rho & 1 \end{pmatrix})$, $\rho = 0.5$;
- (b) C_ρ^{Ga} with t_4 margins (same dependence as in (a));
- (c) $C_{4,\rho}^t$ with $N(0, 1)$ margins;
- (d) $t_2(4, \mathbf{0}, P)$ (same dependence as in (c)).

Lines denote the true marginal 0.005- and 0.995-quantiles.

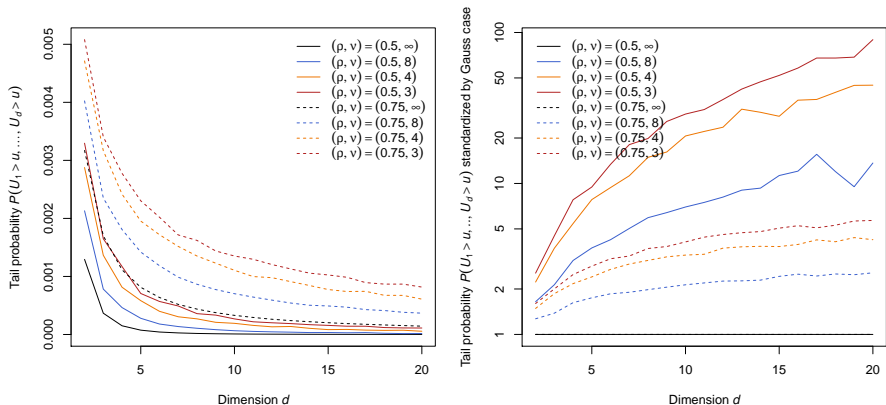
Note the different number of points in the bivariate tails (all models have the same Kendall's tau!)

Joint tail probabilities $\mathbb{P}(U_1 > u, U_2 > u)$ for $d = 2$



- **Left:** The higher ρ or the smaller ν , the larger $\mathbb{P}(U_1 > u, U_2 > u)$.
- **Right:** $u \mapsto \frac{\mathbb{P}(U_1 > u, U_2 > u)}{\mathbb{P}(V_1 > u, V_2 > u)} \stackrel{\text{radial}}{=} \frac{C_{\nu, \rho}^t(u, u)}{C_{\rho}^{\text{Ga}}(u, u)}$

Joint tail probabilities $\mathbb{P}(U_1 > u, \dots, U_d > u)$ for $u = 0.99$



- Homogeneous P (off-diagonal entry ρ). Note the MC randomness.
- **Left:** Clear; less mass in corners in higher dimensions.
- **Right:** $d \mapsto \frac{\mathbb{P}(U_1 > u, \dots, U_d > u)}{\mathbb{P}(V_1 > u, \dots, V_d > u)} \stackrel{\text{radial}}{\underset{\text{symm.}}{=}} \frac{C_{\nu, \rho}^t(u, \dots, u)}{C_{\rho}^{\text{Ga}}(u, \dots, u)}$ for $u = 0.99$.

Example 7.25 (Interpretation of joint tail probabilities)

- Consider 5 daily negative log-returns $\mathbf{X} = (X_1, \dots, X_5)$. Assume they follow an elliptical distribution and have pairwise correlations $\rho = 0.5$. However, we are unsure about the best joint model.
- If \mathbf{X} are multivariate normal (and thus $C_{\rho=0.5}^{\text{Ga}}$), the probability that on any day all 5 negative returns lie above their $u = 0.99$ quantiles is

$$\mathbb{P}(X_1 > F_1^{\leftarrow}(u), \dots, X_5 > F_5^{\leftarrow}(u)) = \mathbb{P}(U_1 > u, \dots, U_5 > u) \\ \underset{\text{MC error}}{\approx} 7.48 \times 10^{-5}.$$

In the long run such an event will happen once every $1/7.48 \times 10^{-5} \approx 13\,369$ trading days on average (\approx once every 51.4 years; assuming 260 trading days in a year).

- If \mathbf{X} is multivariate t_3 (and thus $C_{\nu=3, \rho=0.5}^t$), however, such an event will happen approximately 10 times more often, i.e. \approx once every 5.14 years. This gets worse the larger d !

7.3.2 Rank correlations

Proposition 7.26 (Spearman's rho for normal variance mixtures)

Let $\mathbf{X} \sim M_2(\mathbf{0}, P, \hat{F}_W)$ with $\mathbb{P}(\mathbf{X} = \mathbf{0}) = 0$, $\rho = P_{12}$. Then

$$\rho_S = \frac{6}{\pi} \mathbb{E} \left(\arcsin \frac{W \rho}{\sqrt{(W + \tilde{W})(W + \bar{W})}} \right),$$

for $W, \tilde{W}, \bar{W} \stackrel{\text{ind.}}{\sim} F_W$ with Laplace–Stieltjes transform \hat{F}_W . For Gauss copulas, $\rho_S = \frac{6}{\pi} \arcsin(\frac{\rho}{2})$.

Proof. See the appendix. □

Proposition 7.27 (Kendall's tau for elliptical distributions)

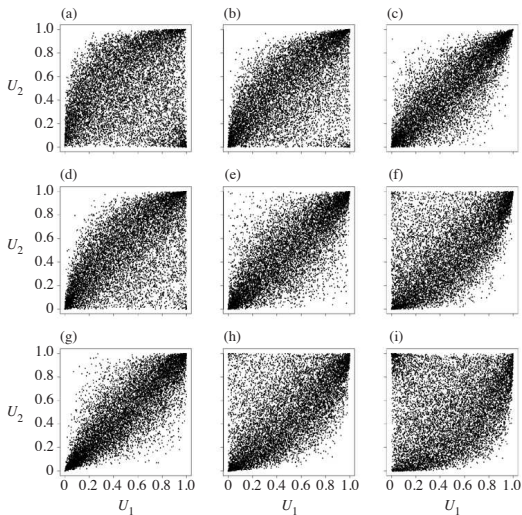
Let $\mathbf{X} \sim E_2(\mathbf{0}, P, \psi)$ with $\mathbb{P}(\mathbf{X} = \mathbf{0}) = 0$, $\rho = P_{12}$. Then $\rho_\tau = \frac{2}{\pi} \arcsin \rho$.

Proof. See the appendix. □

7.3.3 Skewed normal mixture copulas

- *Skewed normal mixture copulas* are the copulas of normal mixture distributions which are not elliptical, e.g. the *skewed t copula* $C_{\nu,P,\gamma}^t$ is the copula of a generalized hyperbolic distribution; see MFE (2015, Sections 6.2.3 and 7.3.3) for more details.
- It can be sampled as other implicit copulas; see Algorithm 7.9 (the *evaluation of the margins requires numerical integration* of a skewed t density).
- The *main advantage* of such a copula over $C_{\nu,P}^t$ is its *radial asymmetry* (e.g. for modelling $\lambda_l \neq \lambda_u$)

10 000 samples from $C_{\nu=5, \rho=0.8, \gamma=0.8(I_{\{i<2\}}-I_{\{i>2\}}, I_{\{j>2\}}-I_{\{j<2\}})}$:



(a) $\gamma = (0.8, -0.8)$

(b) $\gamma = (0.8, 0)$

(c) $\gamma = (0.8, 0.8)$

(d) $\gamma = (0, -0.8)$

(e) $\gamma = (0, 0)$

(f) $\gamma = (0, 0.8)$

(g) $\gamma = (-0.8, -0.8)$

(h) $\gamma = (-0.8, 0)$

(i) $\gamma = (-0.8, 0.8)$

7.3.4 Grouped normal mixture copulas

- *Grouped normal mixture copulas* are copulas which attach together a set of normal mixture copulas.
- Let $\mathbf{Y} \sim N_d(\mathbf{0}, P)$ (so $\mathbf{Y} \stackrel{d}{=} A\mathbf{Z}$ as before). The *grouped t copula* is the copula of

$$\mathbf{X} = (\sqrt{W_1}Y_1, \dots, \sqrt{W_1}Y_{s_1}, \dots, \sqrt{W_S}Y_{s_1+\dots+s_{S-1}+1}, \dots, \sqrt{W_S}Y_d)$$

for $(W_1, \dots, W_S) \sim M(\text{IG}(\frac{\nu_1}{2}, \frac{\nu_1}{2}), \dots, \text{IG}(\frac{\nu_S}{2}, \frac{\nu_S}{2}))$; see Demarta and McNeil (2005) for details.

- Clearly, the marginals are t distributed, hence

$$\mathbf{U} = (t_{\nu_1}(X_1), \dots, t_{\nu_1}(X_{s_1}), \dots, t_{\nu_S}(X_{s_1+\dots+s_{S-1}+1}), \dots, t_{\nu_S}(X_d))$$

follows a *grouped t copula*. This is straightforward to simulate.

- It can be fitted with pairwise inversion of Kendall's tau.
- If $S = d$, grouped t copulas are also known as *generalized t copulas*; see Luo and Shevchenko (2010).

7.4 Archimedean copulas

Recall that an (Archimedean) generator ψ is a function $\psi : [0, \infty) \rightarrow [0, 1]$ which is \downarrow on $[0, \inf\{t : \psi(t) = 0\}]$ and satisfies $\psi(0) = 1$, $\psi(\infty) = \lim_{t \rightarrow \infty} \psi(t) = 0$; the set of all generators is denoted by Ψ .

7.4.1 Bivariate Archimedean copulas

Theorem 7.28 (Bivariate Archimedean copulas)

For $\psi \in \Psi$, $C(u_1, u_2) = \psi(\psi^{-1}(u_1) + \psi^{-1}(u_2))$ is a copula if and only if ψ is convex.

- For a strict and twice-continuously differentiable ψ , one can show that

$$\rho_{\tau} = 1 - 4 \int_0^{\infty} t(\psi'(t))^2 dt = 1 + 4 \int_0^1 \frac{\psi^{-1}(t)}{(\psi^{-1}(t))'} dt.$$

- If ψ is strict, $\lambda_l = 2 \lim_{t \rightarrow \infty} \frac{\psi'(2t)}{\psi'(t)}$ and $\lambda_u = 2 - 2 \lim_{t \downarrow 0} \frac{\psi'(2t)}{\psi'(t)}$ (as seen before).

- The most widely used one-parameter Archimedean copulas are:

Family	ρ_τ	λ_l	λ_u
A	$1 - 2(\theta + (1 - \theta)^2 \log(1 - \theta)) / (3\theta^2)$	0	0
C	$\theta / (\theta + 2)$	$2^{-1/\theta}$	0
F	$1 + 4(D_1(\theta) - 1) / \theta$	0	0
G	$(\theta - 1) / \theta$	0	$2 - 2^{1/\theta}$
J	$1 - 4 \sum_{k=1}^{\infty} 1 / (k(\theta k + 2)(\theta(k - 1) + 2))$	0	$2 - 2^{1/\theta}$

Family	θ	$\psi(t)$	$V \sim F = \mathcal{LS}^{-1}(\psi)$
A	$[0, 1)$	$(1 - \theta) / (\exp(t) - \theta)$	$\text{Geo}(1 - \theta)$
C	$(0, \infty)$	$(1 + t)^{-1/\theta}$	$\Gamma(1/\theta, 1)$
F	$(0, \infty) - \log(1 - (1 - e^{-\theta}) \exp(-t)) / \theta$		$\text{Log}(1 - e^{-\theta})$
G	$[1, \infty)$	$\exp(-t^{1/\theta})$	$S(1/\theta, 1, \cos^\theta(\pi/(2\theta)), I_{\{\theta=1\}}; 1)$
J	$[1, \infty)$	$1 - (1 - \exp(-t))^{1/\theta}$	$\text{Sibuya}(1/\theta)$

7.4.2 Multivariate Archimedean copulas

ψ is *completely monotone (c.m.)* if $(-1)^k \psi^{(k)}(t) \geq 0$ for all $t \in (0, \infty)$ and all $k \in \mathbb{N}_0$. The set of all c.m. generators is denoted by Ψ_∞ .

Theorem 7.29 (Kimberling (1974))

If $\psi \in \Psi$, $C(\mathbf{u}) = \psi\left(\sum_{j=1}^d \psi^{-1}(u_j)\right)$ is a copula $\forall d$ if and only if $\psi \in \Psi_\infty$.

Bernstein's Theorem characterizes all $\psi \in \Psi_\infty$.

Theorem 7.30 (Bernstein (1928))

$\psi(0) = 1$, ψ c.m. if and only if $\psi(t) = \mathbb{E}(\exp(-tV))$ for $V \sim G$ with $V \geq 0$ and $G(0) = 0$.

We thus use the notation $\psi = \hat{G}$ and call all Archimedean copulas with $\psi \in \Psi_\infty$ *LT-Archimedean copulas*.

Proposition 7.31 (Stochastic representation, related properties)

Let $\psi \in \Psi_\infty$ with $V \sim G$ such that $\hat{G} = \psi$ and let $E_1, \dots, E_d \stackrel{\text{ind.}}{\sim} \text{Exp}(1)$ be independent of V . Then

- 1) The survival copula of $\mathbf{X} = (\frac{E_1}{V}, \dots, \frac{E_d}{V})$ is Archimedean (with ψ).
- 2) $\mathbf{U} = (\psi(X_1), \dots, \psi(X_d)) \sim C$ and the U_j 's are conditionally independent given V with $\mathbb{P}(U_j \leq u \mid V = v) = \exp(-v\psi^{-1}(u))$.

Proof.

- 1) The joint survival function of \mathbf{X} is given by

$$\begin{aligned}\bar{F}(\mathbf{x}) &= \mathbb{P}(X_j > x_j \ \forall j) = \int_0^\infty \mathbb{P}(E_j/V > x_j \ \forall j \mid V = v) \, dG(v) \\ &= \int_0^\infty \mathbb{P}(E_j > vx_j \ \forall j) \, dG(v) = \int_0^\infty \prod_{j=1}^d \exp(-vx_j) \, dG(v) \\ &= \int_0^\infty \exp\left(-v \sum_{j=1}^d x_j\right) \, dG(v) = \psi\left(\sum_{j=1}^d x_j\right).\end{aligned}$$

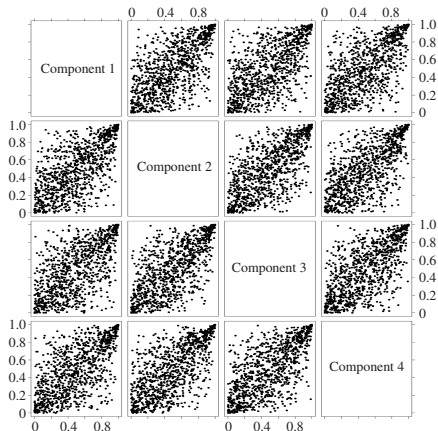
The j th marginal survival function is thus (set $x_k = 0 \ \forall k \neq j$)
 $\bar{F}_j(x_j) = \mathbb{P}(X_j > x_j) = \psi(x_j)$ (\downarrow and continuous) and therefore
 $\hat{C}(\mathbf{u}) = \bar{F}(\bar{F}_1^{\leftarrow}(u_1), \dots, \bar{F}_d^{\leftarrow}(u_d)) = \psi(\sum_{j=1}^d \psi^{-1}(u_j))$.

- 2) $\mathbb{P}(\mathbf{U} \leq \mathbf{u}) = \mathbb{P}(X_j > \psi^{-1}(u_j) \ \forall j) \stackrel{1)}{=} \psi(\sum_{j=1}^d \psi^{-1}(u_j))$. Conditional independence is clear by construction and $\mathbb{P}(U_j \leq u \mid V = v) = \mathbb{P}(X_j > \psi^{-1}(u) \mid V = v) = \mathbb{P}(E_j > v\psi^{-1}(u)) = \exp(-v\psi^{-1}(u))$. \square

Algorithm 7.32 (Marshall and Olkin (1988))

- 1) Sample $V \sim G$ (df corresponding to ψ).
- 2) Sample $E_1, \dots, E_d \stackrel{\text{ind.}}{\sim} \text{Exp}(1)$ independently of V .
- 3) Return $\mathbf{U} = (\psi(E_1/V), \dots, \psi(E_d/V))$ (conditional independence).

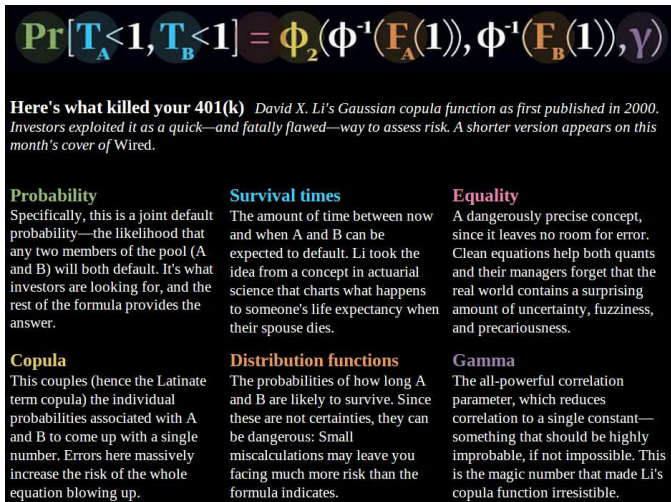
1000 samples of a 4-dim. Gumbel copula ($\rho_\tau = 0.5$; $\lambda_u \approx 0.5858$)



- Various non-exchangeable extensions to Archimedean copulas exist.
- For fixed d , c.m. can be relaxed to d -monotonicity; see McNeil and Nešlehová (2009).

7.4.3 Copulas and credit risk

Felix Salmon: “Recipe for Disaster: The Formula That Killed Wall Street”



Pr $[T_A < 1, T_B < 1] = \Phi_2(\Phi^{-1}(F_A(1)), \Phi^{-1}(F_B(1)), \gamma)$

Here's what killed your 401(k) *David X. Li's Gaussian copula function as first published in 2000. Investors exploited it as a quick—and fatally flawed—way to assess risk. A shorter version appears on this month's cover of Wired.*

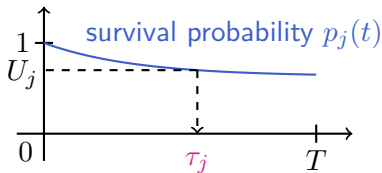
Probability Specifically, this is a joint default probability—the likelihood that any two members of the pool (A and B) will both default. It's what investors are looking for, and the rest of the formula provides the answer.	Survival times The amount of time between now and when A and B can be expected to default. Li took the idea from a concept in actuarial science that charts what happens to someone's life expectancy when their spouse dies.	Equality A dangerously precise concept, since it leaves no room for error. Clean equations help both quants and their managers forget that the real world contains a surprising amount of uncertainty, fuzziness, and precariousness.
Copula This couples (hence the Latinate term copula) the individual probabilities associated with A and B to come up with a single number. Errors here massively increase the risk of the whole equation blowing up.	Distribution functions The probabilities of how long A and B are likely to survive. Since these are not certainties, they can be dangerous: Small miscalculations may leave you facing much more risk than the formula indicates.	Gamma The all-powerful correlation parameter, which reduces correlation to a single constant—something that should be highly improbable, if not impossible. This is the magic number that made Li's copula function irresistible.

How intensity-/copula-based default models work

Intensity-based **default model**:

$$p_j(t) = \exp\left(-\int_0^t \lambda_j(s) ds\right)$$

$$\tau_j = \inf\{t \geq 0 : p_j(t) \leq U_j\}$$



Note: $\lambda_u = 0$ (as for the Gauss copula!)

\Rightarrow (Almost) **no joint defaults!** (p_j typically **very flat**)

Copulas for the **triggers** U :

- 1) Li (2000): **Gauss** (Sibuya (1960): $\lambda_u = 0$)
- 2) Schönbucher and Schubert (2001): **Archimedean** ($\lambda_u > 0$)
- 3) Hofert and Scherer (2011): **nested Archimedean** ($\lambda_u > 0$, **hierarchies**)

Typical application: **CDO pricing models** based on iTraxx data.

7.5 A proof for subadditivity of ES

Proposition 7.33 (Subadditivity of ES)

$$\text{ES}_\alpha(L) = \frac{\sup_{\{\tilde{Y} \sim B(1, 1-\alpha)\}} \mathbb{E}(L\tilde{Y})}{1 - \alpha},$$
 which is subadditive; the supremum is taken over all copulas between $L \sim F_L$ and $\tilde{Y} \sim B(1, 1 - \alpha)$.

Proof.

- Let $L = F_L^\leftarrow(U)$ and $Y = I_{\{U > \alpha\}} \sim B(1, 1 - \alpha)$ for $U \sim U(0, 1)$.
- Then $\text{ES}_\alpha(L) = \frac{1}{1-\alpha} \int_\alpha^1 F_L^\leftarrow(u) \, du = \frac{1}{1-\alpha} \int_0^1 F_L^\leftarrow(u) I_{\{u > \alpha\}} \cdot 1 \, du = \frac{1}{1-\alpha} \mathbb{E}(F_L^\leftarrow(U) I_{\{U > \alpha\}}) = \frac{1}{1-\alpha} \mathbb{E}(LY)$.
- L and Y are comontone. For any other (L, \tilde{Y}) with $\tilde{Y} \sim B(1, 1 - \alpha)$,
$$\mathbb{E}(L\tilde{Y}) = \text{cov}(L, \tilde{Y}) + \mathbb{E}(L)\mathbb{E}(\tilde{Y}) \underset{\text{Hoeffding}}{\leq} \text{cov}(L, Y) + \mathbb{E}(L)\mathbb{E}(Y) = \mathbb{E}(LY)$$

and thus $\text{ES}_\alpha(L) = \frac{1}{1-\alpha} \sup_{\{\tilde{Y} \sim B(1, 1-\alpha)\}} \mathbb{E}(L\tilde{Y})$. □

7.6 Fitting copulas to data

- Let $\mathbf{X}, \mathbf{X}_1, \dots, \mathbf{X}_n \stackrel{\text{ind.}}{\sim} F$ with cont. margins F_1, \dots, F_d and copula C .
 - We assume that we have data $\mathbf{x}_1, \dots, \mathbf{x}_n$, interpreted as realizations of $\mathbf{X}_1, \dots, \mathbf{X}_n$; in what follows we work with the latter.
 - Assume
 - ▶ $F_j = F_j(\cdot; \boldsymbol{\theta}_{0,j})$ for some $\boldsymbol{\theta}_{0,j} \in \Theta_j$, $j \in \{1, \dots, d\}$;
($F_j(\cdot; \boldsymbol{\theta}_j)$ is assumed to be continuous $\forall \boldsymbol{\theta}_j \in \Theta_j$, $j \in \{1, \dots, d\}$)
 - ▶ $C = C(\cdot; \boldsymbol{\theta}_{0,C})$ for some $\boldsymbol{\theta}_{0,C} \in \Theta_C$.
- Thus F has the true but unknown parameter vector $\boldsymbol{\theta}_0 = (\boldsymbol{\theta}'_{0,C}, \boldsymbol{\theta}'_{0,1}, \dots, \boldsymbol{\theta}'_{0,d})'$ to be estimated.
- Here, we focus particularly on $\boldsymbol{\theta}_{0,C}$. Whenever necessary, we assume that the margins F_1, \dots, F_d and the copula C are absolutely continuous with corresponding densities f_1, \dots, f_d and c , respectively.
 - We assume the chosen copula to be appropriate (w.r.t. symmetry etc.).

7.6.1 Method-of-moments using rank correlation

- For $d = 2$ and one-parameter copulas, Genest and Rivest (1993) suggested estimating $\theta_{0,C}$ by solving $\rho_\tau(\theta_C) = r_n^\tau$ w.r.t. θ_C , i.e.

$$\hat{\theta}_{n,C}^{\text{IKTE}} = \rho_\tau^{-1}(r_n^\tau), \quad (\text{inversion of Kendall's tau estimator (IKTE)})$$

where $\rho_\tau(\cdot)$ denotes Kendall's tau as a function of θ and r_n^τ is the sample version of Kendall's tau (computed via (31) from $\mathbf{X}_1, \dots, \mathbf{X}_n$ or pseudo-observations U_1, \dots, U_n ; see later).

- The standardized dispersion matrix P for elliptical copulas can be estimated via *pairwise inversion of Kendall's tau*. If $r_{n,j_1j_2}^\tau$ denotes the sample version of Kendall's tau for data pair (j_1, j_2) , then

$$\hat{P}_{n,j_1j_2}^{\text{IKTE}} = \sin\left(\frac{\pi}{2} r_{n,j_1j_2}^\tau\right).$$

A proper correlation matrix P can be constructed as in Higham (2002).

- One can also use Spearman's rho. For Gauss copulas,

$$\rho \approx \frac{6}{\pi} \arcsin \frac{\rho}{2} \stackrel{\text{Prop. 7.26}}{=} \rho_S.$$

The approximation error is comparably small, so that the matrix of pairwise sample versions of Spearman's rho is an estimator for P .

- For t copulas, \hat{P}_n^{IKTE} can be used to estimate P and then ν can be estimated via its MLE based on \hat{P}_n^{IKTE} ; see Mashal and Zeevi (2002).

7.6.2 Forming a pseudo-sample from the copula

- $\mathbf{X}_1, \dots, \mathbf{X}_n$ typically does not have $U(0, 1)$ margins. For applying the “copula approach” we thus need pseudo-observations from C .
- In general, we take $\hat{\mathbf{U}}_i = (\hat{U}_{i1}, \dots, \hat{U}_{id}) = (\hat{F}_1(X_{i1}), \dots, \hat{F}_d(X_{id}))$, $i \in \{1, \dots, n\}$, where \hat{F}_j denotes an estimator of F_j ; see Lemma 7.6. Note that $\hat{\mathbf{U}}_1, \dots, \hat{\mathbf{U}}_n$ are typically neither independent (even if $\mathbf{X}_1, \dots, \mathbf{X}_n$ are) nor perfectly $U(0, 1)^d$ distributed.
- Possible choices for \hat{F}_j :
 - Parametric estimators (typically if n is small). One often still uses (33) below for estimating $\theta_{0,C}$ (to keep the error due to misspecification

of the margins small).

- ▶ **Semi-parametric estimators** (for example EVT-based: **Bodies are modelled empirically, tails semiparametrically via the GPD-based tail estimator** of Smith (1987)).
- ▶ **Non-parametric estimators** with scaled empirical dfs, so

$$\hat{U}_{ij} = \frac{n}{n+1} \hat{F}_{n,j}(X_{ij}) = \frac{R_{ij}}{n+1}, \quad (33)$$

where R_{ij} denotes the *rank* of X_{ij} among all X_{1j}, \dots, X_{nj} . The scaling is to avoid density evaluation on the boundary of $[0, 1]^d$.

If n is sufficiently large, one typically uses (33).

7.6.3 Maximum likelihood estimation

The (classical) maximum likelihood estimator

- If it exists, the density of $F(\mathbf{x}) = C(F_1(x_1), \dots, F_d(x_d))$ is

$$f(\mathbf{x}; \boldsymbol{\theta}_0) = c(F_1(x_1; \boldsymbol{\theta}_{0,1}), \dots, F_d(x_d; \boldsymbol{\theta}_{0,d}); \boldsymbol{\theta}_{0,C}) \prod_{j=1}^d f_j(x_j; \boldsymbol{\theta}_{0,j}).$$

- The log-likelihood based on $\mathbf{X}_1, \dots, \mathbf{X}_n$ is thus

$$\begin{aligned} \ell(\boldsymbol{\theta}; \mathbf{X}_1, \dots, \mathbf{X}_n) &= \sum_{i=1}^n \ell(\boldsymbol{\theta}; \mathbf{X}_i) \\ &= \sum_{i=1}^n \ell_C(\boldsymbol{\theta}_C; F_1(X_{i1}; \boldsymbol{\theta}_1), \dots, F_d(X_{id}; \boldsymbol{\theta}_d)) + \sum_{i=1}^n \sum_{j=1}^d \ell_j(\boldsymbol{\theta}_j; X_{ij}), \end{aligned}$$

where

$$\ell_C(\boldsymbol{\theta}_C; u_1, \dots, u_d) = \log c(u_1, \dots, u_d; \boldsymbol{\theta}_C)$$

$$\ell_j(\boldsymbol{\theta}_j; x) = \log f_j(x; \boldsymbol{\theta}_j), \quad j \in \{1, \dots, d\}.$$

- The *maximum likelihood estimator (MLE)* of θ_0 is

$$\hat{\theta}_n^{\text{MLE}} = \underset{\theta \in \Theta}{\operatorname{argsup}} \ell(\theta; X_1, \dots, X_n).$$

This optimization is typically done by numerical means. Note that this can be quite demanding, especially in high dimensions.

The inference functions for margins estimator

- Joe and Xu (1996) suggested the *two-step estimation approach*:

Step 1: For $j \in \{1, \dots, d\}$, estimate $\theta_{0,j}$ by its MLE $\hat{\theta}_{n,j}^{\text{MLE}}$.

Step 2: Estimate $\theta_{0,C}$ by

$$\hat{\theta}_{n,C}^{\text{IFME}} = \underset{\theta_C \in \Theta_C}{\operatorname{argsup}} \ell(\theta_C, \hat{\theta}_{n,1}^{\text{MLE}}, \dots, \hat{\theta}_{n,d}^{\text{MLE}}; X_1, \dots, X_n).$$

The *inference functions for margins estimator (IFME)* of θ_0 is thus

$$\hat{\theta}_n^{\text{IFME}} = (\hat{\theta}_{n,C}^{\text{IFME}}, \hat{\theta}_{n,1}^{\text{MLE}}, \dots, \hat{\theta}_{n,d}^{\text{MLE}})$$

- This is typically much easier to compute than $\hat{\theta}_n^{\text{MLE}}$ while providing good results; see Joe and Xu (1996) or Kim et al. (2007).

- $\hat{\theta}_n^{\text{IFME}}$ can also be used as initial value for computing $\hat{\theta}_n^{\text{MLE}}$.
- In terms of likelihood equations, $\hat{\theta}_n^{\text{IFME}}$ compares to $\hat{\theta}_n^{\text{MLE}}$ as follows:

$$\hat{\theta}_n^{\text{MLE}} \text{ solves } \left(\frac{\partial}{\partial \theta_C} \ell, \frac{\partial}{\partial \theta_1} \ell, \dots, \frac{\partial}{\partial \theta_d} \ell \right) = \mathbf{0},$$

$$\hat{\theta}_n^{\text{IFME}} \text{ solves } \left(\frac{\partial}{\partial \theta_C} \ell, \frac{\partial}{\partial \theta_1} \ell_1, \dots, \frac{\partial}{\partial \theta_d} \ell_d \right) = \mathbf{0},$$

where

$$\ell = \ell(\boldsymbol{\theta}; \mathbf{X}_1, \dots, \mathbf{X}_n),$$

$$\ell_j = \ell_j(\boldsymbol{\theta}_j; X_{1j}, \dots, X_{nj}) = \sum_{i=1}^n \ell_j(\boldsymbol{\theta}_j; X_{ij}) = \sum_{i=1}^n \log f_j(X_{ij}; \boldsymbol{\theta}_j).$$

Example 7.34 (A computationally convincing example)

Suppose $X_j \sim N(\mu_j, \sigma_j^2)$, $j \in \{1, \dots, d\}$, for $d = 100$, and C has (just) one parameter.

- 1) MLE requires to solve a 201-dimensional optimization problem.
 - 2) IFME only requires 100 optimizations in two dimensions and 1 one-dimensional optimization.
- If the marginals are estimated parametrically one often still uses the pseudo-observations built from the marginal empirical dfs to estimate $\theta_{0,C}$ (see MPLE below) in order to avoid misspecification of the margins.
 - In this case (and under more complicated marginal models), one can execute the 101 optimizations in parallel, independently of each other.

The maximum pseudo-likelihood estimator

- The *maximum pseudo-likelihood estimator (MPLE)*, introduced by Genest, Ghoudi, et al. (1995), works similarly to $\hat{\theta}_n^{\text{IFME}}$, but estimates the margins non-parametrically:

Step 1: Compute rank-based pseudo-observations $\hat{U}_1, \dots, \hat{U}_n$.

Step 2: Estimate $\theta_{0,C}$ by

$$\hat{\theta}_{n,C}^{\text{MPLE}} = \underset{\theta_C \in \Theta_C}{\operatorname{argsup}} \sum_{i=1}^n \ell_C(\theta_C; \hat{U}_{i1}, \dots, \hat{U}_{id}) = \underset{\theta_C \in \Theta_C}{\operatorname{argsup}} \sum_{i=1}^n \log c(\hat{U}_i; \theta_C).$$

- Genest and Werker (2002) show that $\hat{\theta}_{n,C}^{\text{MPLE}}$ is not asymptotically efficient in general.
- Kim et al. (2007) compare $\hat{\theta}_n^{\text{MLE}}$, $\hat{\theta}_n^{\text{IFME}}$, and $\hat{\theta}_{n,C}^{\text{MPLE}}$ in a simulation study ($d = 2$ only!) and argue in favor of $\hat{\theta}_{n,C}^{\text{MPLE}}$ overall, especially w.r.t. robustness against misspecification of the margins; but see Embrechts and Hofert (2013) for $d \gg 2$.

Example 7.35 (Fitting the Gauss copula)

- Use pairwise inversion of Spearman's rho or Kendall's tau.
- Or the MPLE via the (copula-related) log-likelihood

$$\ell_C(P; \hat{U}_1, \dots, \hat{U}_n) = \sum_{i=1}^n \ell_C(P; \hat{U}_i) \stackrel{\text{Eq. (28)}}{=} \sum_{i=1}^n \log c_P^{\text{Ga}}(\hat{U}_i).$$

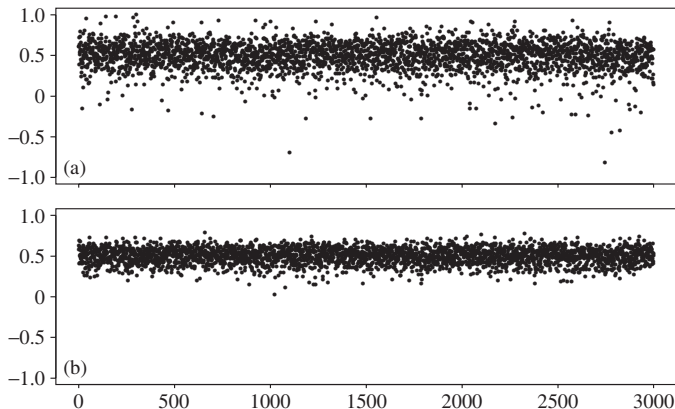
For maximization over all correlation matrices P , we can use the Cholesky factor A as reparameterization and maximize over all lower triangular matrices A with 1s on the diagonal; still this is $\mathcal{O}(d^2)$.

Example 7.36 (Fitting the t copula)

- For small d , maximize the likelihood over all correlation matrices (as for the Gauss copula case) and the d.o.f. ν .
- For moderate/larger d , use Mashal and Zeevi (2002):
 - 1) Estimate P via pairwise inversion of Kendall's tau (see above).
 - 2) Plug \hat{P} into the likelihood and maximize it w.r.t. ν to obtain $\hat{\nu}_n$.

Example 7.37 (Correlation estimation for heavy-tailed data)

Consider $n = 3000$ realizations of independent samples of size 90 from $t_2(3, \mathbf{0}, \begin{pmatrix} 1 & 0.5 \\ 0.5 & 1 \end{pmatrix})$ (\Rightarrow linear correlation $\rho = 0.5$). Shall we estimate ρ via the sample correlation (estimates are shown in (a)) or via inversion of Kendall's tau (shown in (b))? The variance of the latter is smaller!



Estimation is only one side of the coin. The other is *goodness-of-fit* (i.e. to find out whether our estimated model indeed represents the given data well) and *model selection* (i.e. to decide which model is best among all adequate fitted models). Goodness-of-fit can be (computationally) *challenging*, particularly for large d . There are also *graphical approaches* not further discussed here.

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