# Opening remarks: The Pricing of Credit Risk

## Keynote presentation by William R White, Economic Adviser, Bank for International Settlements, at the Workshop on Pricing of Credit Risk, Basel 9-10 September 2004.

## 1. Outreach

Let me begin by thanking you all for coming, first the central bankers but especially the academics and market participants. We at the BIS believe strongly that central banks can learn a lot from both communities. This view has been well accepted for years with respect to issues pertaining to monetary stability, and I am glad that our mutual interest in being increasingly recognized on the financial stability side as well.

In effect, this Workshop is part of a "reaching out" process by the BIS beyond its original core client list of European central bankers, to regulators, academics, market participants and private sector economists. Moreover, the European flavour of the BIS's earlier activities has over the last 10 years been transformed into a truly global one.

## 2. Why is the BIS interested in this topic "The pricing of credit risk"?

To answer this question, it is worth saying a few words first about the BIS and what we do. First, we were set up in 1930 to encourage international cooperation among central banks, and more recently this has been extended to include independent regulatory bodies, with a view to promoting monetary and financial stability. The recent historical record (crisis after crisis) may indicate we are doing a pretty poor job, but we are still at it. Second, the BIS offers banking services to central banks, the IMF and other official bodies, and in that context takes deposits and makes investments of over $200 billion. This range of activities gives us a number of reasons for finding "the pricing of credit risk" an interesting topic.

First, as a bank we need to be able to assess whether the premiums we are paid to take on credit risk are adequate. This is of crucial importance to our banking unit and our risk control unit. It is also of particular importance today since, like many others, we are interested in finding ways to enhance yields in the current (not so welcoming) environment of low interest rates.

Second, as the meeting place for committees of national experts concerned with the health of the financial system, we also need to evaluate pricing practices with a view to recommending "good practice" and dissuading overly bad practice. In this context the work of the Basel Supervisors and the new Capital Adequacy Framework immediately springs to mind. If you "google" on BIS + credit risk you get 89,000 references. However, we also have other committees that are also interested in this issue; in particular the Committee on the Global Financial System, the CPSS and the Markets Committee.

Third, as the employer of a modest (say 35-40) number of economists, the BIS is particularly concerned with systemic mis-pricing of risk, particularly under the name of "pro-cyclicality", and the possibility of important macro-economic implications. Such concerns raised delicate issues with the Basel Committee as Basel II was being prepared. Was it likely to be more procyclical (time-varying weights) or less (new culture of risk management). One possible set of interactions is the following:

- Lower policy rates enhance the search for yield
- This leads to more risk-taking and underpricing of risks
- Safety nets enhance this trend, as does pressure for increased shareholder value
- Lower credit costs encourage 1) debt accumulation, 2) asset price increases, 3) over-investment
- Debt buildups feed back on the economy and potentially the health of the financial system (if financial "buffers" not big enough)
- This raises (perhaps sharply) the price of risk, and everything goes into reverse with Implications for the real economy; growth, jobs, inflation/deflation

Given developments over the last few years, and even the last few months (as spreads have declined sharply, for sovereigns in particular but also high-yield and syndicated loans), attempts to either support or dismiss such stories take on special and very practical significance for central bankers in

particular. This is all the more the case since empirical evidence indicates that joint credit/asset price "booms" do have predictive power for "busts" over horizons of 1-4 years, and we suspect implications for defaults and default correlations as well.

## 3. Conferences at the BIS on measuring credit risk

Some of you may remember the conference we had two years ago on the topic "Changes in risk through time: measurement and policy options". To my mind, the principal findings from the papers presented then were:

- care has to be taken when incorporating market price inputs into risk measurement models. For example, KMV models of expected default frequencies seem "excessively procyclical"
- assessments of risk change over the cycle, but the "appetite for risk" does too. Disentangling these two is not easy
- there is a strong positive correlation between the probability of default and the loss given default. Both reflect cyclical factors
- it would be useful to encourage firms to incorporate more forward-looking macroeconomic (ie cyclical) factors in their credit risk management systems.

All of these findings have interesting implications for the various committees at the BIS that I have just referred to, but particularly the Basel Committee.

What about this Workshop? What do we expect to learn this time? A number of questions suggest themselves from a quick review of the papers already submitted:

- what is the best measure of "the risk-free rate"?
- how large are the risks associated with wrong assumptions about default probabilities and correlations among them?
- will new methods of trading credit risk have an effect on credit spreads?
- why are credit spreads so much larger than the expected losses revealed by historical experience?

- what explains what seem to be major variations over time in credit risk premia?

Whether or not we will arrive at some agreement on the answers to these questions is of course another issue. In any event, may I thank you all again for your attendance and the effort that you have already made to prepare both papers and comments on papers. I am looking forward to both the presentations and discussions.