Yandraduth Googoolye: Credit risk and market risk – the journey ahead

Opening and closing remarks by Mr Yandraduth Googoolye, First Deputy Governor of the Bank of Mauritius, at the working session on "Credit risk and market risk – the journey ahead" at the Federation of Indian Chambers of Commerce and Industry and Indian Bank's Association Conference on "Global Banking: Paradigm Shift" Theme: "Navigating successfully in an uncertain world" Mumbai, 7 November 2008.

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Ladies and Gentlemen

It is a pleasure for me to chair this afternoon session on Credit risk and Market risk, a subject whose importance is gaining momentum among policymakers these days.

Economic theory tells us that Credit risk and Market risk are intrinsically related to each other and are not separable (Jarrow and Turnbull: 2008). With financial innovation, the interaction between Credit risk and Market risk has itself become even more complex today. The recent financial crisis has indeed showed us how a credit risk event can trigger other market related and liquidity related risk events.

The sub-prime crisis in the United States, which has its origin in protracted low interest rate policy, has shown us how our interest rates setting decisions impact on credit risk – a linkage that has been somehow neglected over recent times. As we coordinate our efforts to ease monetary conditions to curb the growing risk that our economies would dip into recession; we need to be vigilant on the long term consequence of our decisions today, to avoid another financial turmoil in future.

Financial innovation has spurred the development of risk management tools but it has also brought together various other forms of risk into financial products, making the art of risk management even more sophisticated. The rapid growth of derivative instruments blurs the dividing line between the established concepts of Credit risk and Market risk. The trading of credit derivatives and other exotic securities has transformed credit risk into market risk.

When the credit conflagration morphed into a fully-fledged panic in financial markets over the last few weeks, the major stock markets plunged.

A decade or so ago, technological innovation produced securitized and other credit derivatives to help financial institutions to manage risks (credit or liquidity). Those instruments quickly gained popularity among practitioners as they promised to transfer credit risk to those who were supposedly in a better position to bear those risks while contributing to financial stability. As these instruments grew in complexity, existing risks were transformed into other risks and new risks emerged. Those risks were typically measured and managed in isolation from one another, whereas in reality, they are closely linked. A credit event that drives down the value of a particular asset is likely to reduce the liquidity and price of that asset as well, at least in the short term. Therefore, as trading in those credit instruments grew, new portfolio models were developed to take on board the interaction between Credit risk and Market risk.

Traditionally, regulation has distinguished between Credit risk and Market risk, and has treated both risks independently. The Basel II Accord requires banks to keep capital for Credit risk for banking book exposures and Market risk for trading book exposures. However, it does not provide an implicit capital cushion for correlation between the two risks, other than a capital charge for counterparty credit risk for certain trading book exposures. However, emphasis is put on stress testing credit portfolio for these types of events.

The recent events in financial markets have brought Central Bankers, Regulators and risk managers to rethink and question the reliability of these new risk management systems for

Credit risk and Market risk; and the diversification effects and the relevance of risk aggregation embedded in these instruments.

Having said this, it may also be opportune to reflect over the future of regulatory practices for Credit risk and Market risk.

Ladies and Gentlemen, as my time is almost over, let me take the next few minutes to tell you more on our distinguished speakers for this session. We welcome today, experts from McKinsey & Company.

(Presentations by the speakers)

Concluding remarks

I thank you all gentlemen for your fruitful presentations on such an interesting topic. This session has indeed been very informative for all of us present today and I hope that we may all draw lessons from your presentation on Credit risk and Market risk, particular on part of the presentation that was focused on the experience of Indian banks in managing those risks.

I now wish to quote a few sentences from the report: "Towards Superior Risk Management in Indian Banking."

> *"Banks will need to continuously refine today's practices. It is important to constantly revisit the risk architecture through the on going refinement of models, stress testing scenarios, revalidating limits, redesigning customer facing processes and restructuring of the organization. This also implies broadening the traditional purview of risk management to include newer practices such as reputational risk, business process re-engineering and concurrent audit improvement."*

To conclude, as banking gets more sophisticated, risk management systems should be able to size up the newer risks the operations expose a bank to. Therefore, while the banking sector has grown rapidly and displayed high resilience, the need for continuous vigil on the part of bank managements and the regulator can hardly be overemphasized. For me therefore, it is the systems and processes for being able to anticipate risk events in time in a complex financial world that should be the focus area for banks the world over including the banks in India.

Thank you all for you attention.