Hans Reckers: Interaction of market and credit risk

Welcome address by Dr Hans Reckers, Member of the Executive Board of the Deutsche Bundesbank, at the Conference on the Interaction of Market and Credit Risk, Berlin, 6 December 2007.

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Ladies and gentlemen

I would like to warmly welcome you to our conference on the interaction of market and credit risk, which is being held jointly by the Research Task Force of the Basel Committee on Banking Supervision, the Deutsche Bundesbank and the Journal of Banking and Finance.

As a board member of the Deutsche Bundesbank, I am proud that our institution is hosting this conference of distinguished researchers, bank practitioners, regulators, and central bankers.

I am especially proud that the Deutsche Bundesbank offered to host this conference more than one year ago when it was not at all clear that the interaction of market and credit risk would be receiving as much attention as it is today. Given recent events in the financial markets, the interaction of different risk types has become quite topical.

The conference topic was not chosen as a result of outstanding forecasting power. Rather, the main motivation of the Research Task Force to form a working group on the interaction of market and credit risk was the diversification benefits between market and credit risk – which have not really made it into the headlines. Instead, another aspect of the interaction of market and credit risk has become newsworthy. It is the question of how an economy is affected if credit risk starts to be traded or, in other words, if credit risk transforms into market risk. The uncertainty of who finally bears the risk can have more severe effects than market participants would have expected, say, one year ago.

I will not talk too much about the ongoing turbulence in detail because I am sure that the reasons behind it deserve a rigorous analysis. Instead, let me give you some information on how this conference came into being. At the risk of boring the members of the working group on the interaction of market and credit risk, I think it may help participants from academia, the industry and regulatory authorities to relate the topic of the conference to the interests of these three groups.

Traders in the front office have considered market and credit risk jointly for a long time, not only regarding counterparty risk but also for the purpose of capital arbitrage, for instance. By contrast, ten years ago this was hardly the case for the banking book, for which credit risk was mostly the only risk type considered.

About a decade ago, the trading of credit risk – either by securitisation or credit derivatives – started to grow rapidly. The chance to sell or buy credit risk, instead of holding loans until maturity, placed banks under increased pressure to know the present values of their assets well before maturity. This posed a challenge to risk modeling as present values depend in a complex way on market factors like interest rates or exchange rates. Therefore, it is not surprising that the growth of credit trade was accompanied by rapid technological progress, for instance, by the development of new credit portfolio models. It is difficult to say which came first or – in other words – whether these new risk measurement techniques were the egg and the increased credit trade the hen or vice versa.

Technological progress has continued up to the present day. The interaction of market and credit risk is being taken into account by more and more sophisticated models.

The increased trade of credit on the one hand offers an opportunity to further diversification of credit risk over the whole financial system and to contribute to financial stability. On the other hand, it can also be seen as a development incurring new risks, be it by an inadequate recognition of risks inside a single bank, be it by new adverse risk-taking incentives or by the imperfection of hedges, be it, finally, by new effects that no one had discovered before. These developments are a first reason for bank managers, regulators and central bankers to improve their understanding of the interaction of market and credit risk.

In addition to these developments, some industry representatives were concerned that diversification effects between market risk and credit risk were being ignored by regulators, which could lead to too high minimum capital requirements. A deeper understanding of diversification effects and their relevance for risk aggregation in banks is a second reason to have a conference on the interaction of market and credit risk.

At the end of 2005, the Research Task Force project group on the interaction of market and credit risk received the mandate, first, to collect and summarise information on the state of the art of measuring the interaction of market and credit risk, and second, to set up and to conduct its own research projects in a rather broad field. As this was a vastly unexplored research area, the new working group has become one of the most research-oriented groups of the Research Task Force.

Ladies and Gentlemen, this conference contributes to bringing together three groups involved with the interaction of market and credit risk: bank practitioners, regulators, and researchers. The need to make them exchange their ideas and knowledge is obvious. The interaction of market and credit risk is simply too complex to be recognised without a proper methodological framework. Both bank practitioners and regulators therefore need input from researchers. Researchers, in turn, need to learn from regulators' and bankers' experiences. Finally, bank practitioners and regulators are in close contact either way, and should be so.

Thus, it comes as no surprise that hosting this conference ties in very well with several of the Bundesbank's activities that aim at bringing industry, regulators and research together. Such events are, for instance, the RTF conference on concentration risk in autumn 2005 or the annual series of Bundesbank Spring Conferences and Autumn Conferences, all on science-related topics. This series now enjoy a fairly high reputation.

Ladies and Gentlemen, as my time is almost over, let me take the opportunity to thank Philipp Hartmann from the ECB and Klaus Düllmann from the Bundesbank who have assumed the burden of being main organisers of this conference. I would also like to thank the scientific committee who did a great job of selecting 13 papers out of more than 80 submissions, and Hiroaki Kuwahara from the Basel Secretariat for his support in preparing this workshop. Last but not least, my thanks go to Ms Bothe and her team and all the other people who have contributed to this workshop in one way or another.

Once again, I would like to extend a warm welcome to you at the workshop and hope you have two days of lively and enriching discussion.