Text Lecture 1.5 - Summary

Hi, welcome to the first summary of this course.

As I told you, during this course, every week, we will have a short video, the summary video, that will try to summarize the most important topics that we have seen together, in the different weeks.

So, during this first week, we have introduced many important new concepts.

The first one is obviously the definition of credit risk.

We have seen that credit risk is mainly composed by two different elements.

Default risk, that is to say the risk which is linked to the default of a counterparty, and so to the losses that are generated by the default of a counterparty.

But [credit risk is] also [due] to chances in the creditworthiness of a counterparty. In the deterioration of the creditworthiness of a counterparty. And this is the deterioration of credit, or credit deterioration.

It is very important to remember these two components, because considering credit risk exactly as a synonym of default risk is not correct.

Then we have embedded credit risk into the Basel Accords framework. We have considered Basel II and Basel III.

In Basel II, we have seen that credit risk belongs to the first pillar, the "Minimum Capital Requirements" pillar, together with market risk and operational risk.

We have seen that, according to the Basel II framework, credit risk can be approached with three different approaches: the standardized approach, the F-IRB and the A-IRB.

These three approaches are in an increasing order of sophistication. So, the standardized approach is the simplest one, the advanced approach as the name suggests is the most advanced.

The increasing level of sophistication is compensated by the possibly smaller capital requirements for banks.

So…the more money is invested by the banks in generating a more complex and advanced approach to credit risk management, the more likely the capital requirements will decrease, because banks will have a more detailed understanding of credit risk.

Then we have seen Basel III.

Basel III has been proposed to overcome some of the flaws of Basel II.

And we have seen that Basel II has manifested many problems during the 2007 and 2008 world crisis. From pro-cyclicality to bad risk management practices, to the underestimation of liquidity risk and excessive leverage.

Now…in Basel III we have seen that we have very different novelties; most of them are just meant to ameliorate Basel II. And we have seen that the most important things for us are the new capital definitions and requirements, and the more stringent definition and treatment of counterparty credit risk, especially for what concerns derivatives.

We will see that the first point, so... the new definitions, the new capital definitions will be our companion through the course.

For what concerns counterparty credit risk, again in particular with respect to derivatives, it's completely your choice. Because, as I told, you will have the possibility of choosing the last topic of this course, so the content of the last week, Week 7.

And counterparty credit risk is one of the two possibilities, together with stress tests and scenario analysis.

Ok, so, this was the summary of this week.

See you next week.

Goodbye.