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Awarding of Ca' Foscari Honorary Fellowship to

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London Business School
September, 27th 2017

A New Look at Corporate Default Probabilities

The chance that a corporation will default on its debt is important for many reasons. One is that the default probability plays a central role in the calculation of bank capital requirements, the amount of capital that regulators oblige banks to have in order to limit the likelihood of their own failure. Banks themselves use estimates of default probabilities in managing the risk their loan portfolios. And a third example is the pricing of corporate debt where the credit spread – the difference between the yield on corporate bonds and the yield on Treasury bonds – again depends directly on the likelihood of default.

The most common measure of the probability of default is a company's credit rating – AAA, AA, BBB etc. – produced by the major rating agencies (Moody's, S&P and Fitch). Ratings provide useful *ordinal* measures of *average* default rates; i.e., the *average* default rate for AA is indeed generally lower than the *average* default rate for BBB, but ratings cannot easily or reliably be mapped into numerical estimates of default probability.

In many practical cases – including those just described – the estimate of average default probability for each rating category is obtained as a simple historical average of the realised default rate. This talk will describe some of the drawbacks of this method, suggest a different approach and show how using this different method sheds new light on a long-standing puzzle in finance, the so-called credit spread puzzle.

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He has published widely on fixed income markets, risk management, credit risk and financial regulation. His recent research includes a study of corporate default in the US over the past 150 years which was awarded first prize in the 2011 Fama/DFA award for the Best Paper Published in the Journal of Financial Economics in the Areas of Capital Markets and Asset Pricing. In 2016 another recent paper on credit risk was award a Jack Treynor prize by the Q-group.
Outside academic life, Stephen Schaefer has consulted widely for financial institutions and is a co-author of two major reports for the Norwegian Ministry of Finance on the management of the Norwegian Government Pension Fund (the "Oil Fund"). At various times he has been an Independent Board Member of the Securities and Futures Authority, a Senior Research Advisor to Moody's KMV, a Non-Executive Director of Leo Fund Management, a Trustee-Director of Smith Breeden Mutual Funds and a member of Moody's Academic Research and Advisory Committee.