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A General Framework for Modelling PD-LGD Correlation in Loan Portfolios (Some Interesting Observations)

Economic capital is defined as capital that banks are legally mandated to hold as a cushion against severe losses. The Basel Committee on Banking Supervision (BCBS) imposes strict guidelines on how economic capital is to be calculated, and those guidelines require a detailed understanding of so-called PD-LGD correlation. We show that a number of PD-LGD correlation models that have been proposed in the literature are special cases of a more general framework, and analyze this framework in detail. We highlight several (potentially dangerous) features of the framework that have not been addressed in the literature, and of which we believe most end users are unaware. For instance the model parameters are overidentified, and the link between model inputs and outputs can be surprisingly counter-intuitive. This is joint work with R. Mark Reesor and Wisdom S. Avusuglo.