EUROPEAN CENTRAL BANK

"The policy implications of credit derivatives and structured finance: some issues to be resolved"

Remarks by

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Ladies and gentlemen,

Welcome to our panel discussion this afternoon. I would like to extend a special welcome to the members of the panel. We are particularly pleased to have brought together such a distinguished and diverse group of speakers, who come from the private as well as the public sector. In my introductory remarks, I will first briefly summarise the current state of our knowledge concerning the impact of credit derivatives on the financial system. Then I will point to, and briefly discuss, a number of issues where our understanding is less than perfect.

I. Background to the CRT debate

Let me start with a few general observations regarding the market for credit risk transfer (CRT) instruments. Despite considerable structural change in the financial system, the risk profile of the banking system is still dominated by its credit exposure. Institutions build up exposure to credit risk not only through their lending activities, but also through their position-taking in the corporate bond market or through transactions in over-the-counter markets, where banks also face the risk of the counterparty defaulting.

In the past, the transfer of credit risk was very difficult and costly. The introduction of credit derivatives less than ten years ago can therefore be seen as a major structural improvement because it has made credit risk tradable. Since this fundamental risk category can now be bought and sold like other financial risks, such as interest rate risk, banks can hedge and diversify most of their positions which are exposed to credit risk. The existence of a properly functioning market for credit risk has enabled banks to improve their pricing and also their management of this risk category. The CRT market has been a major financial innovation in recent years; it has developed at a very fast pace over a relatively short period of time and is already offering significant benefits to banks and institutional investors.

Market participants particularly value the benefits resulting from the ability to transfer risks and reduce risk concentrations. In addition, CRT activity also contributes to more liquid markets for credit risk generally. According to a report by the Joint Forum,[1] CRT activity is also fostering some significant long-term changes in the approach taken by credit market participants. For example, the pricing of credit risk for large investment-grade borrowers is increasingly based on an assessment of the marginal risk contribution to a portfolio of credit exposures, as opposed to a pure "stand-alone" assessment. While a similar approach has been applied to stock markets for a long time, credit markets' progress in this direction will undoubtedly have beneficial effects on their functioning.

[1] Basel Committee on Banking Supervision (2005), "Credit Risk Transfer", report of the Joint Forum, Basel, BIS.

The ECB (in cooperation with the ESCB Banking Supervision Committee)[2] has also published a report on this topic which examines the activities of EU banks in CRT markets on the basis of the most comprehensive survey undertaken by EU supervisors and central banks on the use of CRT instruments. The ECB report presents a tentatively positive overall assessment of trends in the CRT market, arguing that the improved ability of banks and other financial institutions to diversify and hedge their credit risks is helping the financial system to become more efficient and stable.

Nevertheless, the report also identifies the need for improvement in areas such as transparency and risk management practice. More generally, our analysis has frequently highlighted a number of issues where our knowledge of the functioning of this market and its impact on systemic risk is rather limited. I will now focus on those issues, not least in order to provide some material and "food for thought" for our panel discussion. I believe there are at least three interrelated questions to which we have not yet found satisfactory answers.

II. Some open issues in the CRT debate

First: *What are the consequences of the (at least partial) transfer of credit risk from regulated to less regulated, or unregulated, entities?*

The first area where we should extend our knowledge relates to the opacity of the credit risk transfer markets. Here, a particular challenge arises from the growing role of "alternative investors" in the new market. There are concerns that credit risk is being reallocated (more and more) to unregulated market participants who are not subject to sufficient disclosure requirements. Empirical evidence on system-wide risk allocation is still sketchy. Hence, we lack reliable information on the potential distribution of "hidden risks".

With regard to this issue, we can draw some lessons from the first major and real "stress test" of the CRT market, which we witnessed earlier this year. There is some evidence that the downgrading of the credit ratings of GM and Ford to below investment-grade levels in May 2005 had an adverse impact on markets for credit derivatives. In particular, the two downgrades caused abrupt and unexpected changes in the relationships between the prices of a number of assets, forcing many investors, particularly hedge funds, to rebalance their portfolios in order to adjust their hedges and reduce their risk exposures. These transactions reduced liquidity in a number of market segments. As many hedge fund investors had similar positions, the concealed concentration of these positions magnified the selling pressure.

In this context, it may be useful to emphasise that credit risk transfer by means of credit derivatives or securitisation transactions does not always eliminate the entire credit risk from the protection seller's

[2] European Central Bank (2004), Credit risk transfer by EU banks: activities, risks and risk management.

portfolio. For instance, in most collateralised debt obligation (CDO) transactions, the equity or "first-loss" component remains with the issuer and serves as the first level of protection against defaults in the underlying assets in the pool. Another example of an incomplete risk transfer stems from single-name products such as credit default swaps. In this case, the underlying default risk is certainly transferred, but in exchange the protection buyer acquires exposure to counterparty risk. These two examples show that credit risk transfer also entails risk transformation.

The second question that must be addressed is: *To what extent are risks being transferred from better-informed to less-informed market participants? And what are the implications of this?*

Credit markets are, in general, characterised by asymmetry in the information available to banks and their creditors. In the CRT market specifically, there is an asymmetric distribution of information between those who evaluate risk and those who bear it. The role of rating agencies in structured finance is therefore crucial, as they provide an external risk assessment on many transactions, such as collateralised debt obligations.

A report published earlier this year[3] by the Committee on the Global Financial System has voiced considerable concern about the role of rating agencies in the credit risk transfer market. In particular, it argues that ratings may provide an incomplete description of the risks incurred in structured finance. If structured finance investors rely too much on ratings, they may unintentionally become too strongly exposed to unexpected losses, as the rating agencies mainly consider only the expected losses in transactions. In this context, due diligence is a key requirement for investors. Those willing to invest in structured finance should not only rely on rating information, but rather develop the necessary know-how for their independent risk analysis.

Hence, in order to mitigate this concern, we need to expand our knowledge on the information available to investors in credit derivatives or structured finance instruments. In particular, the new instruments require prudent valuation and risk-management practices, as they may entail significant risks for un-sophisticated market participants.

The third, and final, question we must answer is: *What are the consequences of CRT for financial stability monitoring?*

In my view, CRT presents a number of interrelated challenges for financial stability monitoring. First, we need to draw the appropriate conclusions from the fact that the information content of notional values is quite limited. Currently, banks' CRT exposure is mainly reported as the nominal value of their positions. However, in order to analyse an institution's exposure, it is crucial for central banks to try to collect information, at least about the rating or expected loss of a specific collateralised debt obligation tranche.

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[3] Committee on the Global Financial System (2005), "The role of ratings in structured finance: issues and implications", Working Group Report No 23.

Second, there are significant concerns about the reduced information content of the balance sheets of the new holders of credit risk. For instance, more detailed information on the insurance sector's exposures may be required. For central banks' monitoring of financial stability, these two uncertainties certainly complicate a comprehensive analysis of systemic risk in the financial system.

Third, the importance of monitoring market liquidity is also increasing. Given the pivotal role of these new markets, their orderly and uninterrupted functioning is crucial for the financial system as a whole. This is also one of the lessons learned from the downgrades in May 2005 which I have already mentioned. Compared with other risk categories, we know relatively little about liquidity risk, both from an academic as well as a policy angle.

Unless we can expand our knowledge in these areas, it may not be possible to draw definite conclusions about the overall impact of credit derivatives or structured finance instruments on the stability of the financial system. Keeping these three questions in mind, I hope that we can have a lively and informative discussion.

Thank you for your attention.