

Credit Risk Transfer

- the Joint Forum Report (October 2004)

Richard Diggory
Financial Services Authority
London

Background to the JF Report

- Credit Risk Transfer – a topical issue
- Financial Stability Forum's remit
 - Is there a clean transfer of risk?
 - Do CRT market participants understand the risks involved?
 - Are there any undue concentrations of risk inside or outside the regulated financial sector?
- Focus of Joint Forum Report
 - Credit derivatives (CDS and CDO)
 - Recommendations

Understanding Credit Risk Transfer

- Rapid growth of CRT market
- Credit Default Swaps
 - credit risk
- Collateralised Debt Obligations
 - tranches with own risk characteristics
- Indices

Understanding Credit Risk Transfer

Example (from Annex 1 to JF report)

Table 1: A stylised hypothetical CDO
(dollar amounts in millions)

Tranche	Attachment points	Notional amount	Credit rating	Spread (basis points)
Equity	0-3%	30	Not rated	1200
Mezzanine	3-10%	70	A	200
Senior	10-100%	900	AAA	10
MEMO:				
Entire portfolio	0-100%	1,000	A	60

Sources of information

- Rating Agencies' surveys
- Market participants
 - 11 presentations
 - 60 interviews
- Review of regulatory reporting
- Coordination with EU projects

Clean transfer of risks?

- Good record to date
- But lessons being learnt –
 - Counterparty risk
 - Legal certainty
 - Understanding what risk is being transferred

Understanding of risks?

- Generally, participants in CRT markets appear to understand risks
- But risk management issues arising –
 - Leverage
 - Correlation
 - Model risk
 - Reliance on Credit Rating Agencies

Undue concentrations of risk?

- Notional amounts vs. transfer of risk
- Aggregate risk transfer is modest
- Most credit risk stays in banking sector
- Some concentration outside banking –
 - Monoline insurers
 - Hedge funds
- Concentration in market makers

Other findings in JF Report

- Benefits of Credit Risk Transfer market
- Longer term effects on credit markets
 - impact on corporate funding costs
- Links between CRT market and other markets
- Potential concentration of risk management methodology

Recommendations

- understanding risks of credit derivatives
 - Role of senior management
 - Credit risk
 - Credit model risk
 - External ratings
 - Dynamic and structured transactions
 - Counterparty credit risk

Recommendations

– legal and other operational risks

- Legal documentation risk
- Appropriateness of transactions
- Use of material non-public information
- Documentation and settlement
- Operational risk
- Market liquidity risk

Recommendations

– market discipline and supervision

- Disclosure
- Aggregate information
- Supervisory efforts
- Supervisory and Regulatory review
- Supervisory information sharing

Conclusions

- CRT an innovative, technically complex, and rapidly expanding area
- But report contains much that is familiar –
 - Pressures and hazards of rapidly growing and developing market
 - Need for understanding and analysis of risks by management and supervisors
 - Importance of adequate systems and controls, including management information

Summary and next steps

- No serious evidence of systemic issues at present
- Need for good risk management by firms and ongoing vigilance by supervisors
- Hence JF recommendations, endorsed by Financial Stability Forum in September
- Implementation guidance agreed by JF
- Consultation with industry