Credit Risk Transfer
- the Joint Forum Report (October 2004)

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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)

<table>
<thead>
<tr>
<th>Tranche</th>
<th>Attachment points</th>
<th>Notional amount</th>
<th>Credit rating</th>
<th>Spread (basis points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>0-3%</td>
<td>30</td>
<td>Not rated</td>
<td>1200</td>
</tr>
<tr>
<td>Mezzanine</td>
<td>3-10%</td>
<td>70</td>
<td>A</td>
<td>200</td>
</tr>
<tr>
<td>Senior</td>
<td>10-100%</td>
<td>900</td>
<td>AAA</td>
<td>10</td>
</tr>
</tbody>
</table>

**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 J F 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