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Recent Policy Issues Regarding Credit Risk Transfer

Over the last decade, a variety of financial tools have been developed for transferring credit risk between financial institutions. Credit risk is defined as the risk that the value of a corporate loan (or debt obligation more generally) will decline due to a change in the borrower's ability to make payments, whether that change is an actual default or a change in the probability of default. Credit risk transfer (CRT) mechanisms range from outright selling of loans to credit derivatives that permit shifting credit risk without necessarily referencing specific loans.

As new varieties of CRT mechanisms have developed, so has the volume of CRT transactions, and this has increased liquidity in the underlying bond and loan markets. In conjunction with this growth, the policy issues surrounding CRT transactions have changed in important ways. For example, if a seller of a credit derivative fails to fulfill its contractual obligations, the purchaser of credit risk protection could unexpectedly find itself exposed again to that risk. In addition, regulatory concerns regarding CRT arise from the potential damage that might be caused by credit risk concentrations within the financial system. This *Economic Letter* provides a brief description of the common types of CRT mechanisms and reviews the policy issues surrounding their use, especially with respect to credit derivatives.

CRT mechanisms

In originating a commercial loan, the lender acquires much information on the borrower's overall financial condition and prospects of repayment. Two key issues for designing CRT mechanisms emerge from this information-gathering process. The first involves protecting the valuable, ongoing relationship the lender has forged with the borrower; specifically, the lender may want to be careful not to harm that relationship by raising the possibility of reducing its commitment to the borrower with a CRT transaction. The second involves the information advantage that the original lender has over potential counterparties to the CRT transaction; specifically, counterparties may be concerned that the original lender may conceal some relevant risks about the borrower. This issue is known as "adverse selection."

Both issues arise in the simplest CRT mechanism, the loan sale, in which a lender sells all of its obligations and future payments from a commercial loan to a third party. Given the covenants in such loans, borrowers typically must be informed of the sale, which could have an impact on the business relationship. In addition, the adverse selection problem is most clearly visible in this type of transaction. In fact, Dahiya et al. (2003) found that half of the public corporations whose loans were sold from 1995 to 2000 filed for bankruptcy within three years.

Loan syndication, in contrast, addresses these two issues directly. In a typical syndication, the lead bank (or banks) and the borrower agree on the terms of the loan, and the lead bank then assembles a syndicate of lenders. Syndicates can take several forms; for example, in a firm commitment syndicate, the loan amount is set, and the lead bank's share diminishes as more lenders join. Unlike loan sales, syndication allows the lead bank both to reduce its credit exposure to a borrower without damaging its business relationship and to avoid many adverse selection issues. After the syndication is completed, banks may sell their loan shares in the secondary market, either by assignment, which requires the consent of the borrower since the purchaser becomes a direct lender, or through participations in which the seller retains the relationship but passes the payments on to the purchaser.

Securitization is a third kind of CRT mechanism. Although more widely used for retail lending (such as through residential mortgage-backed securities), it is used increasingly for corporate lending. A traditional securitization involves transferring a pool of loans or other debt obligations to a third party, typically a corporate entity established just to own the loan pool, which then issues securities that are claims against the pool's interest and principal payments. Various securities tranches with differing degrees of risk are typically issued; for example, the best rated tranches would be very unlikely to experience payment disruptions regardless of the underlying pool's credit quality, while lower rated or unrated tranches would be more likely to be affected.

Investors in these securities, while not having a direct lending relationship with the underlying borrowers, are protected from the adverse selection problem through a series of contractual obligations placed on the pool's administrator and often through oversight provided by the rating agencies. With respect to the borrowers, the originating banks can, and often do, act as the servicer of the loan pool and hence can easily retain the lending relationship.

The fourth kind of CRT mechanism, and the most recently developed, is credit derivatives, which are financial instruments that transfer some or all of the credit risk of an underlying debt obligation or a borrower (or groups of obligations or borrowers) from one party to another without necessarily transferring the underlying asset; see Lopez (2001). Since their introduction in the mid-1990s, the credit derivatives market has grown dramatically. According to estimates by the British Banker's Association, the notional amount of credit derivatives outstanding grew from almost \$600 billion in 1999 to approximately \$5 trillion in 2004.

The two main types of credit derivatives are credit default swaps (CDS) and collateralized debt obligations (CDOs). In a CDS transaction, the buyer of credit protection makes regular payments in exchange for a contingent payment in case a defined credit event, such as bankruptcy of the original borrower, occurs. While the contingent payment could be tied explicitly to the value of a specific debt obligation after the credit event, it could also be determined independently; that is, the contingent payment could be tied to the value of a specific loan in case a borrower defaults, or it could be tied simply to whether the borrower defaults. In this sense, CDS transactions are more like standard insurance contracts that protect the purchaser from an adverse event. Some industry estimates suggest that CDS transactions based on individual corporate borrowers make up about 60% of total credit derivatives volume.

Standard CDOs are structured much like debt securitizations: the lender transfers credit exposures to a specialized corporate entity that issues different tranches of securities with differing degrees of risk. The credit risk is then borne by the purchasers of the securities. The riskiest is the "equity" tranche. Investors in these securities are said to be in a "first loss" position, since their securities will be the first to lose value in case of a credit event. Typically, they contractually agree to absorb the first 3% to 7% of losses from the reference portfolio. The originator of the CDO often retains some of this tranche to signal confidence in the transaction and to reduce concerns about adverse selection. The second type of

security typically consists of unrated debt securities, whose payments are more directly linked to the underlying loans. The third type consists of debt securities that are commonly over-collateralized to achieve a high credit rating and minimize repayment risk. These securities are referred to as the senior or "super-senior" tranches (i.e., senior to an AAA-rated tranche), because they incur losses only if all tranches subordinate to them have been exhausted. Contractual provisions give additional protection to senior tranches. Mechanically, if defaults cause the loan pool's value or interest proceeds to fall below certain trigger levels, cashflows from the loan payments are diverted to pay down the balances of senior tranches before more junior tranches can receive payments. The contractual terms governing the payout of interest and principal payments on the CDO's reference portfolio are known as the payments "waterfall."

An important recent development in the credit derivatives market is the growing use of "synthetic" CDOs, in which the pooled assets are a collection of CDS transactions that the specialized corporate entity has entered into with one or more lenders. While certainly more complicated than a standard securitization, the underlying economic and financial fundamentals remain the same. According to a report by the Counterparty Risk Management Policy Group (CRMPG 2005), synthetic CDOs and related credit derivatives currently account for about 15% of the total market volume.

Credit derivatives need not impact the relationship between a borrower and a lender, since they may be structured so that the borrower is neither a party to the transaction nor aware of it. In fact, a loan need not be removed from the lender's balance sheet. In terms of adverse selection, issues remain, but credit derivatives address certain aspects, such as imposing requirements on the pool of borrowers in the reference portfolio and requiring the originator to retain some of the "first loss" position.

Supervisory issues

The more traditional forms of CRT, such as loan sales and syndication, have been around for some time, and many issues are already addressed by supervisory rules and experience. For example, the Federal Reserve System's Supervisory and Regulatory Letter 01-12 lays out explicit guidelines for accounting for loans held for sale. Securitization of residential and commercial real estate loans is also well established and widely monitored by public rating agencies.

However, the relatively new and rapidly expanding market for credit derivatives does give rise to some pressing supervisory policy issues. One such issue is

whether a credit derivatives transaction establishes a complete credit risk transfer. Several factors could undermine these CRT transactions and negate their intended purpose. For example, since the seller of protection might fail to meet its obligations, the buyer must be careful to manage this counterparty risk. In addition, various legal issues, such as whether counterparties actually have the legal authority to enter into a transaction, could undermine a transaction. To address this concern, the Joint Forum (2005) report strongly calls for enhanced counterparty risk management, increased standardization of credit derivatives documentation, and diligent legal analysis of individual transactions.

Another key supervisory issue is the risks related to delays in processing the needed documentation. This issue was on the agenda at a recent meeting of leading participants in the credit derivatives market hosted by the Federal Reserve Bank of New York to discuss market practices with regard to assignments of trades and operational issues associated with confirmation backlogs. Industry participants have taken several steps to address these concerns (see CRMPG 2005).

Regulatory concerns

Regardless of the supervisory challenges regarding CRT mechanisms, supervisors generally are able to monitor whether undue concentrations of credit risk are building within supervised institutions. The larger regulatory question is how to detect and respond to such concentrations of risk developing in the financial system as a whole. The Joint Forum (2005) report did not find evidence of such “hidden concentrations” of credit risk in specific sectors of the financial system. However, to address this concern more generally, the report made several recommendations for improving the quality of public disclosures by market participants regarding their CRT transactions and the corresponding aggregate distribution of credit risks. While disclosures need to respect the legal frameworks within which individual financial institutions present their risk profiles, market participants should provide clear qualitative descriptions of the nature of their CRT activities. For example, such descriptions could provide summary information and breakdowns of credit exposures and CRT transactions by instrument type, borrower credit quality, industry, or geographic location.

Conclusion

The underlying economic fundamentals of credit risk transfer are clearly strong and should lead to an increased volume of transactions. Given the dual concerns of preserving lending relationships with borrowers and avoiding adverse selection issues, credit derivatives seem to be a promising avenue for development. While supervisory and regulatory concerns will always be present, prudent oversight of this market should be sufficient to avoid disruptions to the wider financial system.

Jose A. Lopez
Senior Economist

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