Credit Risk Transfer through Credit Derivatives and regulatory issues

Sue Kean

Chair of the

IAIS Investment Sub-Committee

Michael Fermor

Financial Services Authority, UK

16 July 2002

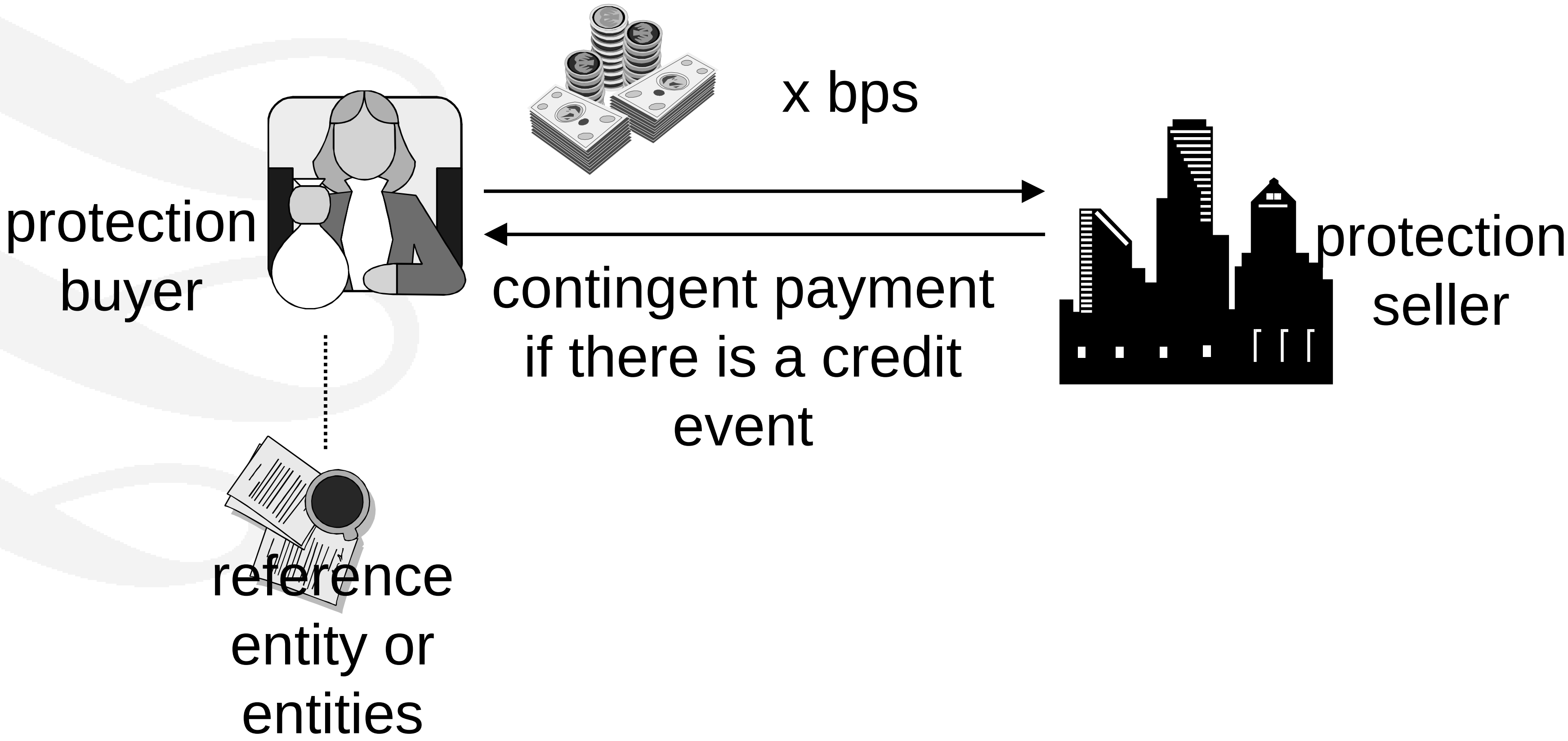
CREDIT RISK TRANFERS

- **Definition of credit risk : the risk that an obligor defaults (borrower, issuer, counterparty).**

- **Transfer of credit risk**
  - transfer of the underlying asset
  - transfer of the credit risk synthetically using credit derivatives

CREDIT DERIVATIES
Uses and applications

CREDIT DEFAULT SWAP



Credit derivatives

- **Types of credit derivatives**
  - Credit default swap
  - Credit linked note
  - Total return swap

- **Variations amongst instruments**
  - single name vs portfolio / basket
  - definitions of credit events

- **For the protection buyer**

  (the risk seller)

  – to transfer credit risk on an entity without transferring the underlying instrument

  – regulatory benefit

  – reduction of specific concentrations / portfolio management

  – to go short credit risk

- **For the protection seller** ***(the risk buyer)***
  - diversification
  - leveraged exposure to a particular credit
  - access to an asset which may not otherwise be available to the risk buyer
    - sourcing ability
    - new asset class

- **For intermediaries**
  - Market-making
  - Exploiting price differentials
  - Structuring products to meet demands from originators and investors

OTHER FORMS OF RISK TRANSFERS

- **Outright asset transfers**
  - traded loans
  - securitisations, e.g. mortgage-backed, CLOs, CBOs
- **Synthetic CDOs**
  - meeting of securitisation and credit derivatives technology
- **Bank or insurance guarantees**

ROLE OF INSURANCE COMPANIES IN CREDIT RISK TRANSFERS

- **Insurers as underwriters of credit risk**
  – guarantees
  – trade indemnity / mortgage indemnity insurance
  – back-to-back insurance of (portfolio) credit derivatives using transformers

- **Insurers as investors in credit-linked assets**
  - Investments in asset-backed securities, CDOs, credit-linked notes, alongside other bonds, loans
  - Hedging using credit derivatives

REGULATORY CONCERNS

- **New / complex new markets growing rapidly**
  - Credit derivatives estimated at $170bn in 1997 => $1 - $1.5 trillion in 2001 (notional outstanding)
- **Many bilateral / bespoke and very large transactions**
  - e.g. underlying portfolio of $5 billion
- **New entrants**
  - insurers - 20-25% as risk buyers in credit derivatives

- **Nature of the motivations**
  - role of regulatory arbitrage?
  - excessive risk-taking?

or

  - diversification
  - risk management
  - different risk appetites of different players

- **Lack of transparency / concentrations**

- **Nature of the products**
  - – legal / documentation issues
    - is contract sufficiently tight that it will function?
    - is counterparty able / willing to pay?

  => (Hollywood funding, JP Morgan)
  - – mispricing
    - no standard model / joint correlations
    - motivations - yield / new premiums

- **How much understanding is there of the risks?**
  - – for protection buyers - replacing old risks for new risk (e.g. credit risk => operational risk)
  - – for protection sellers - lack of familiarity with the risks
  - – for intermediaries - temporary or permanent retention of the risks
    - warehousing risk / first loss piece
    - lack of liquidity
  - – Impact on the portfolio of the risk buyer / seller

- **Adequacy of infrastructure**
  - adequacy of in-house expertise
    - credit analysts, legal advisers, modelling experts
  - monitoring
  - aggregation of positions
- **Do supervisors know that firms are involved ?**
  - new products

- **New markets that are growing**
  - not all about regulatory arbitrage

  => different risk appetites of different players
- **Challenges to firms and supervisors**
  - monitoring and transparency
  - impact of the products on individual firms
  - adequacy of existing regulations
- **Impact on macro-economic stability**
  - CGFS

Why did the Sub-Committee do this work?

- A topical issue, e.g. conferences, FSF
- A perception that transfers between banks and insurance companies are growing rapidly
- A perception that transfers are driven by regulatory arbitrage

Measuring the extent of transfers

- **Members of the Sub-Committee interviewed a few dozens firms around the world**
- **Not an exhaustive survey**
  - Little evidence of significant activities by insurers
  - But a growing interest from insurers
  - Gaps in data (US and international reinsurers)

Credit risk transfers and insurance

- Blurred distinctions between underwriting and investment
- Increasing use of, and demand for, investment products
- Restrictions on underwriting activities have led to use of transformers
- Review of restrictions on complex investment products (credit derivatives, structured credit bonds)

Regulatory arbitrage

FSA

- **Lack of sensitivity of Basel rules is a driver for transferring credit risk**
- **Variation in the regulatory treatment of underwriting activities**
- **Intra-group transactions**
- **Greater understanding / consistency between the sectors**
  - financial guarantees?

Next steps

- **Consultation to get more input from observers (end-Aug 2002)**
- **Focus on supervisory issues**
- **Revisiting of existing supervisory standards**
  - asset management
  - derivatives

CONCLUSIONS

- **Credit risk transfers - stabilising mechanism or more concentration?**

- **Supervisory issues**
  - – sound risk management practices
  - – need for a more holistic view by firms and supervisors
  - – group issues