

Axel A Weber: Risk transfer – challenges for financial institutions and markets

Dinner speech by Professor Axel A Weber, President of the Deutsche Bundesbank, at the Joint Bundesbank-CEPR-CFS conference “Risk Transfer: Challenges for Financial Institutions and Markets”, Frankfurt am Main, 11 December 2008.

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1 Introduction

Ladies and gentlemen

I wish to extend a warm welcome to you at this conference dinner on the occasion of the joint Bundesbank-CEPR-CFS conference here in Frankfurt.

The many aspects of credit risk transfer (CRT) that you addressed in your research papers – from the pricing of subprime mortgage risk through to counterparty risk in financial contracts – reveal just how broad and complex this topic is. And the current financial turmoil provides striking confirmation of how relevant this topic is, as CRT may adversely affect financial stability. The different forms of CRT are playing a key role, not least in the world wide discussion on regulatory responses to this crisis. I therefore believe that this conference presents a great opportunity for you as researchers to exchange your findings and views on risk transfer. However, I also hope that it makes a contribution to the current search for an adequate regulatory framework for the financial markets.

In my following remarks, I would like to comment briefly on CRT in the recent crisis and on some measures that are about to be taken.

2 Credit Risk Transfer (CRT) in the recent crisis

When analysing an economic event such as the current financial crisis, it is usually very helpful to consult some economic theory. In the case of CRT general economic theory tells us that CRT is, in principal, beneficial.

First, it may lead to a better risk allocation as it disconnects the originator of a risky asset from the ultimate risk taker. Second, referring to a result of the model by Hakenes and Schnabel presented at this conference, better risk allocation provides scope for socially beneficial projects that, otherwise, would not have been financed. Finally, as the Basel Committee on Banking Supervision points out in The Joint Forum on Credit Risk Transfer (2008), “CRT has made the market pricing of credit risk more liquid and transparent”.

However, in the current financial crisis different methods of CRT applied by financial institutions have made for negative headlines in the newspapers:

Securitisation – Financial institutions (for example, IKB) that were engaged in the American mortgage market through financial products such as RMBS suffered major unexpected losses when house prices in the US started to decline.

Credit Default Swaps (CDS) – Some insurance companies and other financial institutions are involved in insuring structured products linked to the US mortgage market in the form of CDS. Some of them experienced large losses and had to be rescued by the government (for example, AIG). The bankruptcy of a big credit risk insurer threatens the insured financial institutions, which often undervalue counterparty risk. The crisis may be exacerbated in this way.

Off-balance-sheet vehicles – Banks have transferred their credit risk to off-balance-sheet vehicles, such as SIVs and conduits, in order to save capital costs. The business model of these vehicles built on maturity transformation broke down leading to liquidity problems of the

SIVs and conduits. Owing to reputation concerns, the banks took the suffering SIVs and conduits back on to their balance sheet. This transferred the credit and liquidity risk back to the banks and triggered the loss of confidence in the money market.

All these examples show that we are experiencing severe problems with CRT. I would therefore like to pose two questions. What are the weaknesses in CRT markets? How can we change the institutional framework in order to profit from the social benefits of CRT?

3 Weaknesses in CRT markets

Concerning weaknesses in CRT markets, I would like to draw your attention again to general economic theory as this enables us to identify fundamental problems that are well known to an economist. We deal with problems such as wrong incentives for economic agents, insufficient transparency, and regulatory arbitrage. Let me point out just a few examples.

Moral hazard – One possible weakness in the CRT market results from the securitisation and subsequent distribution of credit risk. Once the credit risk is forwarded, there is no incentive for the originator of the credit risk to monitor the debtor. Hence, we are dealing with the classical phenomenon of moral hazard. The empirical results of a paper by Mora and Sowerbutts at the conference indicate that this is not only a theoretical reflection, but a present mechanism in the securitisation market. They show that retaining a greater fraction of credit risk in the balance sheet of the originator significantly lowers the probability of default of the underlying loan. The same problem may arise in the case of CRT via CDS, as Parlour and Winton show in their paper. In their theoretical model, the monitoring of the underlying loan is inefficiently low if a bank frees up regulatory capital by buying a CDS. The reason for this is that while the insured originator of the loan has no incentive to monitor, the insurer lacks the control rights.

Transparency – Another weakness in the CRT market results from its potential opaqueness. During the past decade, we have experienced a hitherto unique process of credit risk dispersion that had its roots in the US subprime market. The decodification of the actual degree of entanglement is still in progress. In a recently published paper, Gary B. Gorton gives a very detailed description of the different steps of CRT. And he argues that while the interlinking of securities, structures and derivatives made it possible for risk to be spread among many capital market participants, it simultaneously resulted in a loss of transparency as to where these risks ultimately ended up.

This loss in transparency meant that market participants did not evaluate their credit risk adequately. In the CDO market, for example, the inherent systemic risk of certain CDO products, such as RMBS on US housing loans, was not taken into account. Market participants often relied solely on credit ratings and were attracted by the fact that these loan securities had larger spreads than similarly-rated corporate bonds. The resulting increase in demand for these products boosted their supply and allowed a decline in the quality of the underlying loans. Hence, securitisation and the “originate to distribute” business model became more and more attractive, which is highlighted by the fact that in 2005-06 dealer firms transferred more subprime risk to investors than was originated during this period.

In the case of credit derivatives, a further aspect heightens the lack of transparency. The vast majority of these agreements are made over the counter. This not only aggravates the misvaluation of counterparty risk, it also causes an evaluation problem concerning the systemic risk in the CDS market. This, in turn, exacerbates uncertainty and loss of confidence among market participants.

Regulatory arbitrage – In addition, the well-functioning of markets in general is at stake as market participants usually try to find methods to evade regulatory regimes. Financial institutions shifting credit risk to off-balance-sheet vehicles was a typical form of such a regulatory arbitrage. In doing so, banks used a loophole in the old regulatory regime, which

did not capture these vehicles. This loophole has been closed with the introduction of Basel II.

4 Changes to the institutional framework

But how can we change the institutional framework in order to avoid the mentioned frictions in the financial market and gain from the social benefits of CRT?

For more than one year, international institutions, central banks, and politicians have been working together on the lessons to be learnt from the financial crisis. At the Summit on Financial Markets and the World Economy held in New York in November of this year, the Heads of State of the G20 agreed on “Common Principles for Reform of Financial Markets”. International Institutions, such as the IMF or FSF, published valuable reports and recommendations on possible improvement of the financial architecture. Furthermore, national central banks are contributing their expertise to the discussion. However, in order to achieve improvements in the financial architecture that substantially strengthen financial stability, an in-depth analysis of the underlying reasons for the crisis is essential. In this respect, the economic research that takes place at universities and various institutions is of great importance. For that reason, economic research should have a strong voice in the current debate. I therefore believe that events such as this conference are very important.

But let me come back to my question about adequate changes to the institutional framework. As you can surely imagine, there are a great number of aspects that I could mention at this point. However, I fear that would go beyond the scope of my speech. I shall therefore confine myself to mentioning two measures, that are about to be taken.

Central counterparty (CCP) for OTC derivatives – The first measure aims to enhance the transparency of the CDS market by implementing one or more CCPs for OTC derivatives. The advantages would be a reduction in market participants’ open positions due to netting as well as a better management and possible reduction of counterparty risk – for example, by guarantee funds or insurance schemes. In addition, the implementation of a CCP could be accompanied by disclosure requirements for CDS positions of the originator. These requirements could also mitigate the just mentioned moral hazard problem in the case of forwarded credit risk via CDS. As Parlour and Winton showed in their paper, reputation mechanisms may partly solve the problem of inefficient monitoring incentives of the originator. Disclosure requirements are a prerequisite for such a reputation mechanism, as the market participants have to know the track record of the originator. Regulators on both sides of the Atlantic unanimously agree that there is a need for the implementation of a CCP for OTC derivatives. However, there is an ongoing debate on the specific design of such an institution. The first steps towards the implementation of a CCP were initiated by the New York FED aiming for a single CCP located in the US. More recently, the Governing Council of the ECB discussed the idea of an additional European CCP.

The Bundesbank is in favour of this “European solution” as the Eurosystem should be able to influence and to oversee these market infrastructures without any restrictions, especially in times of financial turmoil.

Retention of a share of securitised products on the balance sheet of the originator – Another concept has the objective of solving the moral hazard problem arising from the securitisation of credit risk. The idea is that if the originator has to retain a share of the securitised products on his balance sheet, the incentive to monitor the underlying loan remains. European Commissioner McCreevy has proposed a 5% retention of securitised products on the balance sheet of the originator and the Ecofin Council has agreed to this proposal at its meeting on 2 December. Consequently, this issue will now be discussed in the European Parliament.

The Bundesbank in general agrees with the European Commission's proposal as it is a step into the right direction in terms of avoiding moral hazard problems arising from securitisation. Therefore, the Bundesbank welcomes the decision taken by Ecofin.

5 Concluding remarks

So this is my storyline concerning CRT – it is a story of the continual trade-off for financial regulators between the benefits of free markets and the threat of market failures.

And I would like to emphasise that I believe this struggle for the right regulatory framework will go on. Certainly, we will learn from this crisis and we will enhance regulation and supervision in order to erase the sources of this crisis. However, financial markets will generate new financial products; there will emerge new forms of incentive problems, insufficient transparency, and regulatory arbitrage. Financial regulators as well as researchers in the field of financial regulation have to bear this in mind so that those developments in the financial markets that threaten financial stability can be identified as soon as possible.

Thank you very much for your attention.