

Jean-Paul Redouin: Risks may be transferred, but they do not disappear!

Address by Mr Jean-Paul Redouin, Deputy Governor of the Bank of France, at the Paris Europlace, Financial Forum, Stockholm, 29 March 2007.

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The international **financial system is going through an extraordinarily benign phase**. The world is enjoying stable inflation and strong and broad-based GDP growth. At the macrofinancial level, corporate profits have been sustained, risk premia have been very thin for a broad set of asset classes, and volatilities remain unusually low. Based on these market signals, risks appear very low.

Do risk premia correctly reflect the risks currently facing the financial system? Or is their low level the result of excessive risk appetite on financial markets? Indeed, some recent warning signals have reminded us how **fragile the current pricing of risk is, and how much it relies on the expectation that an “ideal scenario” of strong growth and contained inflation will prevail**.

In this context, I would like to focus my remarks on a very important structural development: credit risk transfer.

Basically, the transfer of risks helps to spread them, according to a process I shall call the “atomisation of risk” (namely risk being split into elementary particles and then re-packaged). But do these techniques mean that risks disappear?

The breakthrough of CRT has gone hand in hand with constant innovation and the emergence of powerful non-bank players. The financial markets are therefore in a state of permanent revolution in which globalisation and disintermediation have made the channels risk can take more complex and affected its traceability.

This evolution can bring stability and resilience to the system only under certain conditions. The role of a central banker and supervisor is to list them, to inform the financial community of the systemic aspects of their development and to implement certain key policy measures.

1. CRT can improve distribution of risk and stronger resilience to shocks. How?

The First benefit is linked to a process of “atomisation” of risk. **Greater risk dispersion among investors may increase the resilience of the financial system in the event of shocks**. Financial engineering has enabled credit risk to be extracted from banks’ balance sheets and broken down into portions of risk that are repackaged into portfolio products. This is the essence of securitisation mechanisms: the default of a large issuer has less chance of resulting in the default of its creditors, and default losses are absorbed by a large number of investors.

Second, **the emergence of powerful non-bank players to whom risk is transferred contributes to greater risk dispersion and market efficiency**. One example is hedge funds, which have become large risk absorbers on credit markets. Their share in derivative trading is estimated at up to 25%. Hedge funds trade mainly on the riskiest segments and often buy equity tranches of CDOs, previously the preserve of banks. Another example is institutional investors (mutual funds and pension funds, insurance companies, etc.), which have increased their exposure to risk transfer instruments, even though their investment policies remain fairly conservative.

Third, **banks themselves may, via credit derivatives, improve their risk management. They diversify their risk profiles** by gaining exposure to companies or sectors in which they do not have customer relationships and by hedging risks while retaining customer relationships. Credit risk transfer mechanisms are also used by banks to deal with single-name concentration risk.

Consequently, major improvements in risk measurement have been made. **From a prudential viewpoint, the Basel II framework** takes better account of risk mitigation techniques employed by banks, including the use of credit risk derivatives, and applies specific treatment to securitisation.

2. **But this evolution should make us more – not less – vigilant regarding the assessment and tracking of risks.**

The wider benefits that CRT can bring should not give rise to a false sense of security. Risks do not disappear as a consequence of their transfer. Banks need to pay attention both to "residual risks" (e.g. tail or extreme event risks) and all of the risks (e.g. operational risk, documentation and settlement risk, legal risk) arising from the use of CRT. Furthermore, the growing complexity and volume of CRT transactions call for enhanced monitoring. Actually, understanding where risk ultimately lies and how risky exposures can build up is an **essential prerequisite** for safeguarding financial stability. The argument is fourfold:

First, historically low interest rates and abundant liquidity have prompted an intense search for yield. Lower interest rates have encouraged risk-taking and higher leverage as investors have wanted to secure high rates of return. A case in point is insurance companies, which have to service guaranteed rates of return, and pension funds that have agreed to specific benefits. As the return on risk free bonds has declined, investors have been increasingly led to search for yield and increase the share of risky assets, including credit derivatives, in their portfolios. This contributes to the compression of risk premia. This can continue as long as long-term interest rates stay low. But there is some circularity in the situation. On the one hand, institutional investors are "victims" of low long-term interest rates. On the other hand, they help to maintain this situation as they continue to look for even longer-dated bonds. Therefore, if the pricing of long-term government bonds, which is the reference for the pricing of many other assets, remains distorted, credit risk premia may be based on shaky foundations.

Second, risk transfer mechanisms contribute to a certain opacity in the distribution of risks. Most transactions are conducted on OTC markets and are not recorded in a centralised manner: there is therefore a "knowledge gap" in the financial system as regards CRT exposures. More fundamentally, **risks are usually transferred by banks, which are regulated and transparent, to entities that are unregulated** and are not required to disclose their positions. It is therefore impossible for market participants and regulators to identify the situation of the ultimate risk holders.

Third, the atomisation of risk has been accompanied by higher leverage embedded in the instruments themselves, making it hard to assess which of these countervailing effects prevails. While atomisation of risk mitigates the impact of a shock, leverage amplifies it. For instance, "single-tranche" collateralised debt obligations (CDOs) substantially increase "embedded" leverage: a single-tranche CDO is generally leveraged 5 to 10 times, meaning that potential losses are 5 to 10 times greater than the losses on the underlying portfolio. This is a type of leverage that does not show up in lending figures. Assessing the extent and effect of embedded leverage on a system-wide basis is therefore a real challenge.

Lastly, market liquidity can be very fragile. Indeed, it is now much easier to trade credit exposures thanks to standardised credit derivative indexes. However, liquidity remains very uneven among CRT markets and cannot be guaranteed under stressful market conditions. Many institutions are also vulnerable to "runs". Market liquidity dry-ups therefore constitute one of the risks to be assessed.

3. **What are the implications for central bankers and supervisors?**

I would like to suggest three approaches:

First, remind market participants and investors that benign times, such as the current credit environment, should not be the benchmark for assessing risks. Credit risk transfer markets remain untested in stress situations. The US subprime mortgage market is a bellwether reminding us that excesses in credit growth and relaxation of lending standards are paid for sooner or later by much higher risk premia.

Second, transparency must be improved in the financial system and for CRT in particular. Indeed, for stress tests to be fully relevant, we need reliable data at the aggregate level. Without good reporting of exposures, mitigation actions are not efficient. Increased transparency can take various forms. One means is to **increase the transparency of institutions** such as hedge funds or private equity funds. Another possibility is to **increase the transparency of market operations**, with trades recorded in a central depository, for example. Such **infrastructure improvements** can also produce transparency in a "seamless" way, avoiding an excessive reporting burden.

Third, there is a need to **work to better understand and assess risk at a system-wide level**, including the linkages that bind together the various elements of the financial system. Like in physics, there are **resonance frequencies**, propagating tensions from one knot of the network to another. **Stress testing** plays a key role here. To complement individual stress tests, policymakers are developing global and cross-country stress tests. These impact studies consist in measuring the impact of linkages between business cycle fluctuations and a range of key observable variables that best characterise the banking sector. These exercises should also incorporate potential market contagion through different channels: banks' interlinkages (domino effects) and bank portfolios' exposures to shocks.

To sum up, we should not forget that the current financial system is multidimensional and closely interlinked. It remains essentially an untested world in stress situations. History has shown that it is precisely in good times that the seeds of financial distress develop. In the present context of the desperate hunt for yield, risk transfer markets may encourage investors to take on more risk. Therefore, financial innovation should not only concentrate on extracting yield but also on pricing risk at a sustainable level. This is one of the most demanding challenges of the coming years for both the private sector and the public authorities.