EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

CREDIT RISK TRANSFER FROM BANKS TO NON-BANK FINANCIAL INSTITUTIONS

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During the past five years banks have shifted vast amounts of credit risk to non-bank financial institutions and to other banks. In Europe and the USA banks have been net buyers of credit protection by selling loans directly or indirectly through securitisation, or by buying credit derivatives. The notional value of the market for credit derivatives alone is expected to more than double from USD 2 trillion in 2002 to USD 5 trillion in 2004, possibly exceeding 10 percent of the loan stock. According to Fitch (Sept 2003) the insurance industry has absorbed USD 381 billion worth of credit risk through derivatives. Of this amount USD 229 billion originates in the banking industry.

The phenomenon of trading in risk and shifting it from one kind of institution to another does not necessarily increase financial instability. It may rather increase the ability of the financial system as a whole to absorb risk and it may improve the efficiency of risk allocation. Trading in credit risk also enables banks to adjust the risk profile of their portfolios. Nevertheless, the rapid increase of trading in, and shifting of, risk has become a concern of regulators and practitioners.

Trading in risk and efficiency

In spite of their expertise in credit risk evaluation, banks may be less suited than other financial institutions to bear a substantial amount of credit risk. It may thus be appropriate for them to sell credit risk to those with stronger ability to bear such risk. This is the case if financial markets are well functioning in the sense that the incentives of sellers and buyers are not distorted, and information is available to all actors in the market place. Even if there are distortions, trading in risk is efficient provided that regulation corrects for these distortions by means of, for example, capital requirements

A part of the credit risk transfer seems to be driven by arbitrage opportunities arising from different regulatory capital requirements applied to different kinds of financial firms, e.g. an insurance company is buying a loan from a bank since it faces a lower regulatory capital requirement on the loan. The financial advantage of achieving a more favourable expected return/required capital ratio can be divided between the bank and the insurance company.

Under what conditions can the shifting of risk increase systemic instability and reduce the efficiency of the allocation of risk? We identify the following possible sources of excessive risk taking in the financial system as a result of banks’ shifting of risk to non-banks financial institutions and life insurance companies in particular:

1. Banks may be able to evade the burden of capital requirements by selling risk.
2. Risk may be shifted to institutions with inferior expertise in risk evaluation, or lacking incentives to monitor.
3. There could be conflicts of interest among different entities within a financial conglomerate with respect to risk bearing.

Banks may be able to evade the burden of capital requirements by selling risk

Banks have an incentive to, e.g. securities loans if they thereby can reduce capital requirements and sell the securities to firms that don't face similar constraints. They may then provide further lending and develop customer relations. The contracts associated with securitisation are often quite complex, however, with the consequence that it is uncelar how much of the original risk ultimately remains with the bank. Furthermore, much of the legal framework enabling securitisation is untested. Thus, the originating bank may face substantial legal risk in times of stress.

A bank selling risk may also put its reputation as credit evaluator and monitor at stake. Therefore it may find it justified to bear a proportion of losses associated with the sold risk in order to retain its credibility. Capital should appropriately be held against such reputational risk, as well as legal risk although these risks are not captured by the current Basel capital adequacy rules.

Risk may be shifted to institutions with inferior expertise in risk evaluation, or lacking incentives to monitor

Typically, credit risk is transferred from banks to insurance companies, as well as to pension funds, other banks, and in some cases also non-financial corporations. The question arises whether non-banks that buy the risks are sufficiently aware of the risks they are taking over. Insurance companies have built up much less experience than banks in this field. At least, insurance companies are facing a learning phase in which they have to professionalize their risk assessment capabilities. The problem of adequate risk assessment is exacerbated by the non-transparent nature of the markets for bank loans and credit derivatives (lack of data, different accounting methodologies, etc.). Some insurance companies have already discovered their underestimation of the transferred credit risks and decided to slow down their activities in these markets.

Regulation might aspire to actively assure that those who buy or absorb risks do not underestimate the risks and absorb more risks than they can bear given their equity buffer. The need for active intervention is all the more likely if the relevant information is not available to shareholders and potential buyers of new insurance policies, and if switching between insurance companies is difficult for those who already hold a policy.

History and theory offer grounds for caution in the rapid growth of markets for new financial instruments, such as credit risk transfers, before the market participants have experienced a full range of economic conditions. Although there have been some major defaults in the recent recession, such as those of Enron and Worldcom, these have not been on the scale e.g.

of those observed in 1990-2, when there were correlated downturns in commercial property markets following a boom in lending. The growth of the markets for credit risk transfer instruments has been explosive since the recession and any periods of extreme stress have not yet been observed. Therefore, it is difficult to make probabilistic assessments of potential losses. Under such circumstances there is a danger that risk pricing will be inaccurate and capitalization inadequate.

Aggravating the situation in the short term is the fact that information on exposures to CRT instruments is inadequate, both in terms of the volume of exposures by each institution and the varied terms under which exposure is transferred. Lack of disclosure by individual institutions is reflected in inability of authorities to detect the sectoral or national location and concentration of credit risks transferred.

Regulators can help improve market discipline by enhancing transparency. This can be accomplished by requiring insurers and similar risk-takers to disclose their financial situation fully and in a timely manner along the lines suggested by the International Accounting Standards Board (IASB)--something which is not yet common practice in all European countries, as shown by recent developments in Germany.

There are conflicts of interest among different entities within a financial conglomerate

Markets for many financial services are dominated by entities belonging to financial conglomerates wherein, for example, a bank and an insurance company may co-exist. If the markets for one of the financial services offered by the conglomerate are not competitive, the entity operating under imperfect competition may price its services to serve the goals of a particular stakeholder group at the expense of another. If so, the governance of the group and its entities becomes a concern. For example, in a conglomerate consisting of a bank and a life insurance company, the life insurance policy holders have an interest in retaining short term profits within the life insurance company in order to offset possible future declines in asset values. At the same time the shareholders may have an interest in having profits distributed. This conflict of interest is aggravated if the life insurance company is governed as a mutual company in which profit distributions are restricted, while the conglomerate as a whole is incorporated. In many European countries life insurance companies are governed as mutuals while being part of an incorporated group. Within such groups it could be advantageous for shareholders to overprice credit risk transfers to the insurance company in order to shift profits from the mutual life insurance company to the company that doesn't face restrictions on distributions. Safeguards against such internal profit transfers can be created by strengthening the separation of the governance structures of the different entities.

Recommendations

Integrated regulation may be a suitable response to the heightened mutual risk exposure of the bank and non-bank financial sectors generated by credit risk transfers. The aim should be to ensure that «best practice» in risk management is utilized in all types of financial institutions.

Haste is needed in the implementation of risk sensitive regulation that encourages market discipline across the financial sector. Market discipline needs to be complemented by macroprudential surveillance procedures which evaluates aggregate credit risks, inter alia via stress testing of credit risks at a financial sector and economy wide level.

Transparency must be emphasised. Insurers and similar risk-takers should be required to disclose their financial situation fully and in a timely manner along the lines suggested by the International Accounting Standards Board (IASB). This will also facilitate the sharing of data and benchmarking across Europe.

We question whether it is appropriate that within an incorporated financial conglomerate one or more entities are governed as mutual companies, wherin the interests of major stakeholders differ from the group shareholders' interests. Where this is the case independent governance of the mutual should at least be assured.