The Effect of Credit Risk Transfer on Financial Stability

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We study under which conditions debt securitization such as collateral debt obligations (CDOs) of banks can increase the systemic risks in the banking sector. In the European Union, securitizations is still growing and issuance reached its highest quarterly total ever in 2005. One of the reasons is that they reduce the individual banks' economic capital requirements by transferring risks to other market participants and hence offer new investment opportunities. We use a simple model to show this transfer of risk.

Furthermore we show that systemic risks do not decrease due to the securitization. Systemic risks can increase and impact financial stability in two ways. First, if the risks are transferred to unregulated market participants such as hedge funds there is less capital in the economy to cover these risks. And second, if banks invest in CDOs, the transferred risk causes interbank linkages to grow. This results in an increasing systemic risk for which the economic capital put aside is insufficient.

Credit default swaps (CDS) are a second way to transfer risk, often referred to as synthetic securitization. The differences of CDOs and CDS in contributing to these risks are analyzed. The main difference is that the debt remains on the balance sheet and that there are regular payments to the buyer of the CDS that provides the insurance.

An empirical analysis for the hypothesis that credit risk transfer of banks increases systemic risks in the financial sector is carried out.

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We use the CDO issuance for monthly data for the years 2000 until 2005 and systemic risk is measured with coexceedances. A significant relation between them can be found.