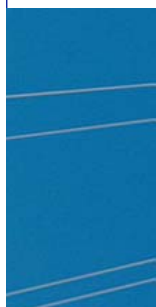


# Credit Derivatives and their Impact on the Incentive Structure for Corporate Lending

Workshop on “The future of corporate financing in an integrating EU financial market”  
DG EcFin, Brussels, 27 November 2006



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# Agenda

- 1 Credit derivatives: the issues
- 2 Some facts on the CDx market
- 3 Credit derivatives: supporting a wider trend
- 4 Credit derivatives: impact on corporate lending markets
  - Monitoring of debtors
  - Incentives in cases of (imminent) default
  - Relative impact on small vs. large banks
- 5 Conclusions



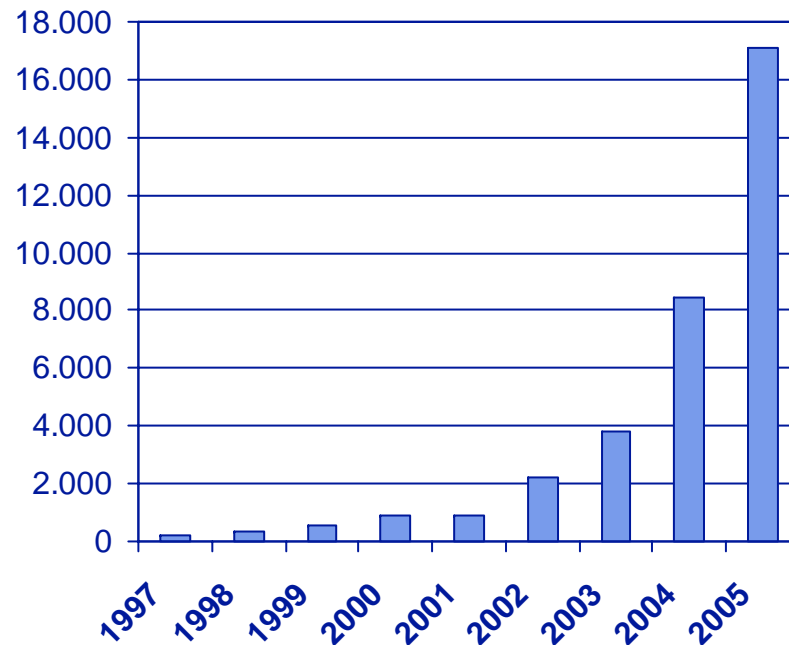
# 1. Credit derivatives: the issues

- Financial stability issues
  - Documentation and settlement
  - Pricing
  - Market concentration
  - Transparency about distribution of risk
- Consequences for incentive structures
  - Monitoring of debtors' behaviour
  - Incentives and processes in situations of (imminent) default
- Consequences for banking structures
  - Favouring small or large banks?

## 2.1 Credit derivatives – some facts about the market

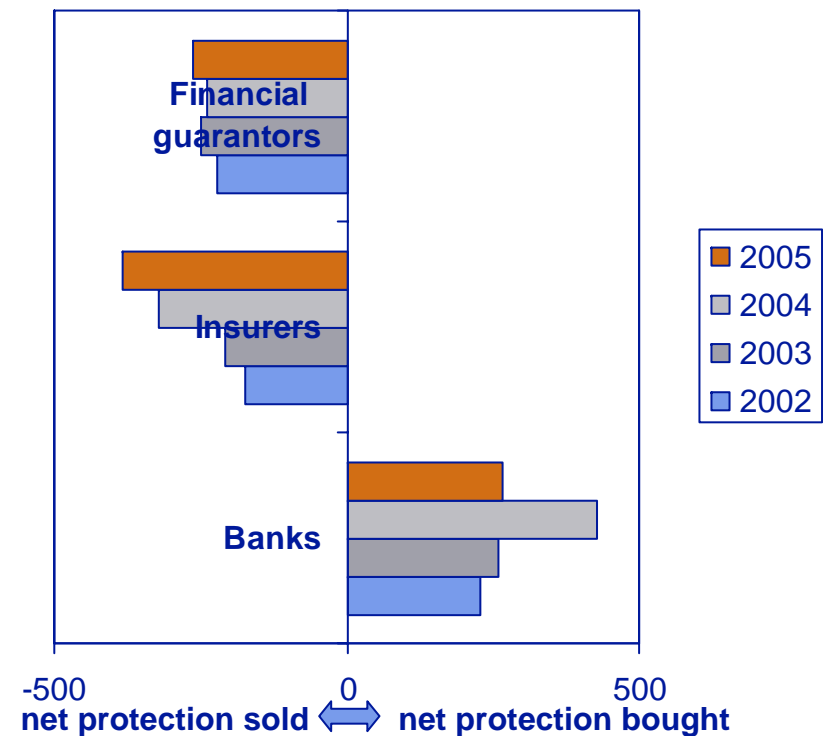
### Volumes and net positions

**Volume of CDx markets**  
(USD bn)



Source: ISDA

**net positions in CDx market**



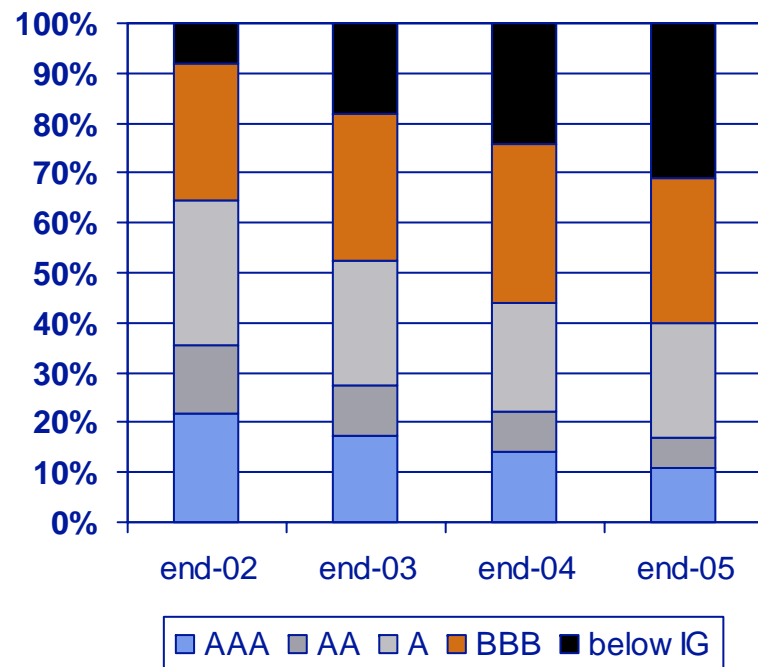
Source: FitchRatings



## 2.2 Credit derivatives: market facts

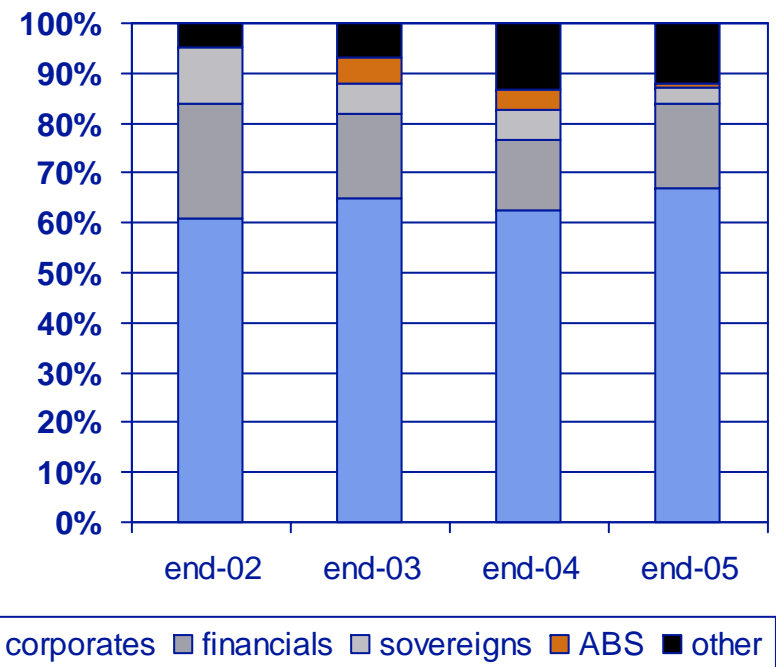
### characteristics of reference entities

**CDx reference entities:  
down the credit curve!**



Source: FitchRatings

**CDx reference entities:  
share of corporates edging up!**



Source: FitchRatings

## 2.3 Drivers for market growth

### **Credit derivatives as new asset class**

- Search for yield
- Isolated trading of credit risk

### **Desire to transfer risk**

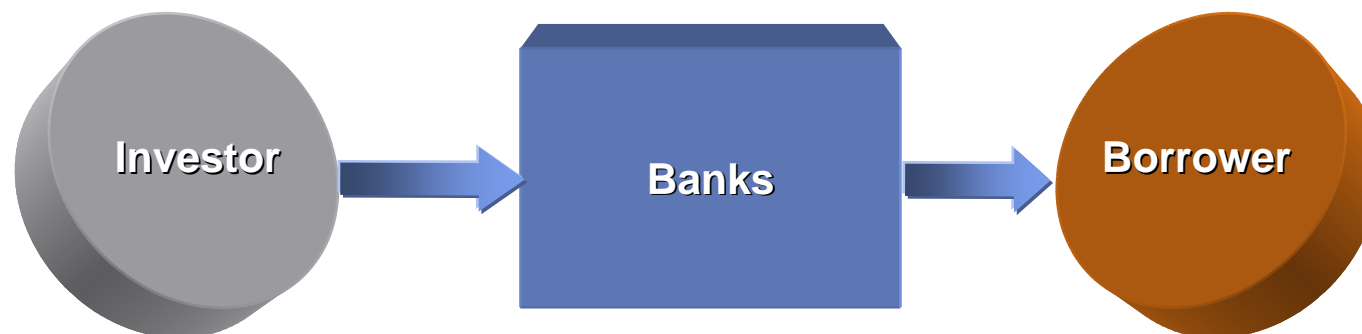
- Reduction of RWA
- Elimination of risk concentrations

### **Active management of risk and capital**

- Regulatory developments (Basel II)
- Optimisation of earnings profile

### 3.1 Supporting a wider trend

The changing role of banks: From asset intermediation...



## 3.2 ... to risk intermediation





## 3.3 Convergence of capital markets and lending

- Capital markets and bank lending become complementary
- Credit risk being passed on to capital markets in the form of
  - securitisations
  - credit derivatives
- Regulatory change (Basel II) and shareholder pressure will support active risk / return management
- Risk-adequate pricing
- From „buy and hold“ to „originate and distribute“
- This explains resilience of banking sector despite several shocks



## 4.1 Incentives for monitoring credit risk

**In „buy and hold“-model, monitoring is rationale for the existence of banks**

- Savers delegate task of monitoring debtors' behaviour to specialists, i.e. banks
- Banks monitor and, more importantly, control debtors' behaviour
- In doing so, banks reduce transaction costs in the economy

**In a world of credit derivatives, incentives for monitoring migrate to the market**

- Creditors' incentive to monitor debtor behaviour is reduced



**Alternatives to monitoring by banks are needed**



## 4.2 Monitoring in a world of credit risk transfers

- Use market signals provided by CDS markets
  - Reliability of pricing signal?
  - Market signal alone insufficient! Enforcement by market discipline is needed
- Incentive-compatible contract design
  - Original debtor to retain share in loss
    - Digital CDS (settlement payment fix, not based on market value)
    - Retention of loss piece by protection buyer
    - Guarantee fund funded by protection buyer
- Repeated contracting / reputation

## 4.3 Behaviour in times of (imminent) debtor default

### Traditional model

- Creditor banks with incentive to limit losses
  - Full exposure to potential loss
  - Interest in continuation of relationship
- Homogeneous group of creditors
  - Similar incentives structures
  - Repeated games between creditors
- ➔ Negotiated restructuring more likely than outright default

### Credit derivatives world

- Creditors' incentive structure changes
  - Default might be attractive if pay-off from CDS is larger than expected recovery rate in restructuring
- In case of physical settlement, new creditor, but:
  - Physical settlement becoming rare
  - New creditor may not be able to participate in restructuring
- More heterogeneous creditor group
  - Diverse incentive structures
  - Less experience with default situations
  - But: general phenomenon!



## 4.4 Impact on banking structures

### **Prima facie, small banks to benefit most**

- Tend to have concentrated lending portfolios
- Hence, opportunity to diversify by means of CDx would be useful

### **But realising this potential is difficult**

- CDx market concentrated in the hands of large banks
    - better expertise and systems (pricing models)
  - Small banks' debtors without public debt history and public disclosure
    - Potential acquirers cannot assess credit risk and hence will offer too a low a price
    - Problem may diminish in future thanks to greater information on small firms, too
  - Portfolio structures alleviate lack of information on small banks' debtors
    - But: Small banks portfolios often too small to be packaged as synthetic CLOs
- ➔ Reverse characteristics for large banks – more likely beneficiaries!**



## 5. Conclusions

- Industry logic supports further growth of CDx markets
- Monitoring of debtors' behaviour more difficult
- No evidence (yet) for more aggressive creditor behaviour in times of corporate difficulties
- Wide-spread use of credit derivatives enhance problem of heterogeneous creditor groups
- Large banks with advantages in exploiting the potential of credit derivatives



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