

## March 2008

### SummaryHeading 1

In March 2007 the Financial Stability Forum (FSF) asked that the Joint Forum consider the extent to which its March 2005 report “Credit Risk Transfer” (CRT) required updating as a result of the continued growth and rapid innovation in the CRT markets. The market turmoil since the summer of 2007 led to a desire for the Joint Forum to be able to report quickly and present a brief paper at the March 2008 meeting of the FSF. Accordingly the Joint Forum sought to keep the scope of its work focused on what is achievable in that time scale, yet provide as much useful information as possible.

### Highlights

The main findings of the paper are summarised as follows:

- Some of the more complex CRT instruments developed since 2004 are associated with increased leverage and — in the case of certain tranches of structured finance products — a high variance of loss or high vulnerability to the business cycle. This increased complexity, combined with a more diffuse investor base (including participants that are only recent entrants to the CRT markets), means that some investors may not fully appreciate the higher-risk nature of these products.
- A failure to understand some of these risks contributed to the market turmoil of 2007. A few fundamental tenets of sound financial judgment appear to have been violated. The originate-to-distribute model created incentives that resulted, in some cases, in weak origination standards for products such as subprime mortgages. Some investors placed excessive reliance on credit rating agency ratings, doing minimal or no in-house due diligence on the CRT products employed. Firms also appear to have had few, if any, risk management processes in place to address risk exposures associated with off-balance sheet entities such as structured investment vehicles (SIVs).
- Despite these shortcomings, the structured credit market is likely to survive, but will remain weak for a period of time. Market participants thought that “one-layer” CRT products, such as CLOs or corporate CDOs, make economic sense and will continue. Their assessment of the prospects for “multi-layer” securitizations was less optimistic, and a common view was that the market for ABS CDOs would either shrink dramatically or disappear.
- Supervisors remain concerned about several aspects of the CRT market: its complexity; valuation issues; liquidity, operational and reputational risks; and the broader effects of the growth of CRT. Supervisors believe that market participants must better understand the structure and risks of the CRT products in which they invest, as well as how the rating agencies assign ratings to specific instruments and what circumstances would lead them to downgrade ratings.
- With continued innovation in the CRT markets, the effort and resources that firms and regulators will need to expend to properly understand these instruments increases significantly. Any future “misunderstandings” of risks involving CRT instruments will probably involve a new and different flavour of products and may be no more likely to be detected in advance, with the current level of supervisory resources. Nonetheless, there are steps that the industry and regulatory community can take to enhance the robustness of their risk management and oversight of these products, which are described in Section 10 of this paper.

