

Innovative Credit Risk Transfer Instruments and Financial Stability in Austria

Eleonora Weiss
Vanessa Redak¹

In the course of an investigation initiated by the Banking Supervision Committee (BSC) of the European System of Central Banks in the fall of 2003, the Oesterreichische Nationalbank (OeNB), together with the Financial Market Authority (FMA), conducted a survey among Austrian banks about the extent of and the motives for the use of innovative credit risk transfer instruments (securitizations, credit derivatives) in Austria. Based on the results of the survey, which are published here for the first time, this paper explores the potential implications for financial stability in Austria. It was found that Austrian banks currently use credit risk transfer instruments primarily to generate additional income and to optimize portfolios. The nominal volumes of the credit risk transfer instruments used by Austrian banks are currently rather small compared with their total assets. Therefore it can be assumed that in the foreseeable future the Austrian banking system will continue to be largely able to cope with problems that may arise from the use of these instruments. Nevertheless, supervisors should closely monitor the development of these instruments and banks' risk management practices to address potential risks to financial stability in a timely fashion.

Introduction

The surge in the use of innovative credit risk transfer instruments² (CRT) by credit and financial institutions on an international level has repeatedly raised the question of which effect these instruments may have on financial stability. Recent accounting scandals (e.g. Enron or Worldcom) involving the use of these instruments and the ensuing insolvencies contributed to directing supervisors' increased attention to this topic. The OeNB has also stepped up its focus on CRT instruments.³ In the course of an investigation initiated by the BSC of the European System of Central Banks, in the fall of 2003, the OeNB, together with the FMA, conducted a joint survey among Austrian banks about the extent of and the motives for the use of credit risk transfer instruments in Austria. Based on the results of the survey, which are published here for

the first time, this paper looks into potential implications for financial stability in Austria.

Risks and Opportunities of Innovative Credit Risk Transfer Instruments

Before presenting the results of the investigation in detail and analyzing the implications for financial stability in Austria, we will define the term *credit risk transfer*, describe its evolution and outline the risks and opportunities attributed to CRT instruments in scientific and political discussions. However, in doing so, we will focus on those opportunities and risks relevant to financial stability.⁴ We will then discuss these aspects against the background of the results of the Austrian survey and examine them for relevance.

The survey included the investigation of both securitizations and credit derivatives as innovative credit risk

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² In order to differentiate new from traditional credit risk transfer types (such as credit insurance, guarantees etc.), we use the term "innovative" instruments for securitizations and credit derivatives.

³ For example, in October 2003 the OeNB organized a workshop on "Asset Securitization and its Impact on Financial Stability" with international experts. Also, the OeNB has published a guideline on the risk management of securitization, which should spark further discussions of the credit risk transfer issue (OeNB, 2004). See also: Scheicher (2003).

⁴ See, for example, Kiff, J. et al. (2003).

transfer instruments.⁵ Securitization is here defined as a structure which transfers credit risk from a defined pool of assets in the form of at least two differently rated tranches as tradable security to investors, risk takers and also originators. A credit derivative is a bilateral financial contract which enables investors to isolate credit risk from other risks (especially market risk) of financial instrument and to transfer it to a counterparty without transferring ownership of the underlying asset.

Credit risk transfer instruments have been in use for a long time. The market for syndicated loans started to develop in 1970 and the secondary market for bank loans in the U.S.A. in the 1980s. The first securitizations were also carried out in that period. Other instruments, e.g. bank guarantees and credit insurance, also have a longstanding tradition.

Recent developments, however, indicate a significant change in the approach to understanding and managing credit risk. Banks increasingly view both loans and credit risk as tradable goods which no longer need to be kept in the balance sheet until they mature as used to be the case, but can be transferred to investors even before maturity. Innovations in the field of credit risk transfer instruments thus enhance the options of risk managers and allow banks to modify their risk profiles, regardless of the original transaction, as securitization and credit derivatives make it possible

to isolate credit risk and transfer it to investors willing to assume the risk. Furthermore, banks shift the focus of their risk management from individual loans to portfolios. At the same time, demand for credit risk by financial firms outside the banking sector (e.g. insurance companies, hedge funds)⁶ has been on the rise as many financial institutions are looking to raise their profits in a low-interest environment by means of profitable, although at times more risky, instruments. In addition, securitizations may allow refinancing under favorable conditions, which makes these financial instruments more attractive to banks faced with declining profit margins in an environment of increased competition in the deposit business.

A large number of new CRT instruments has emerged recently. As it is often the case with new types of financial instruments gaining importance in the market, this fact has incited a debate about potential risks to economic development and financial stability. The following aspects are considered to be among the positive effects of credit risk transfer instruments on financial stability:⁷

- These instruments open up new risk management opportunities for banks, as credit risk becomes tradable and therefore more easily manageable. Also, the management of both the regulatory and economic capital can be refined.
- Credit losses can be covered by several investors and do not neces-

⁵ This includes the following instruments, which have been used in Austria for a few years: credit default swaps (CDS), credit spread forwards, credit spread options, total rate of return swaps, credit linked notes (CLN), asset-backed securities (ABS), mortgage-backed securities (MBS), as well as collateralized debt obligations (CDO). For a description of the instruments see the glossary at the end of the paper as well as, among others, Scheicher (2003), OeNB (2004), Gregory (2003), BIS (2003).

⁶ See BIS (2003), p. 4.

⁷ See, among others, IMF (2002), European Central Bank (2002), Kiff et al. (2003), Ferguson (2002), Prato (2002), Rule (2001a, 2001b).

sarily accumulate in the books of only one or just a few banks. If credit risk transfers in fact spread credit risk over a broader range of investors, it can be argued that financial stability does indeed increase.

- The reallocation of credit risk may take place not only between different players in the financial market (such as banks, insurance companies, hedge funds, etc.), but also between banks alone, thus leading to an improved distribution of certain risks *within* the banking system. For example, the mutual exchange of credit risk can reduce banks' risk of geographical or structural/sectoral concentration (a high amount of assets in one industry).
 - The use of credit risk transfer instruments can generate liquidity and/or income. If the bank receives liquidity when revenues and profitability are uncertain, it will become more flexible in managing its finances.
- The following aspects of CRT instruments are generally considered to have a negative impact on financial stability:⁸
- So far, on an international level, no exact aggregated data are available about the use of CRT instruments by the various market players (banks, insurance companies, hedge funds, pension funds, etc.). Furthermore, even with already existing data it is often difficult to determine the actual economic net credit risk. Therefore, the CRT market is at present not very transparent.
 - There is also concern that credit risk may be concentrated with financial institutions (e.g. insurance companies, pension funds, hedge funds, etc.) which are not subject to the same rigid risk management provisions (capital requirements) as banks.⁹
 - Many market participants buying credit risk rely heavily on the opinion of external rating agencies, since they often do not have the possibility to assess the credit risk exposure themselves. A bank with a long-standing relationship with its customer selling the underlying risk is likely to have more information on the respective customer than the bank acquiring the credit risk, which often relies on external rating agencies. For this reason, rating agencies play a key role for many market participants in the CRT market.
 - As is the case with interbank liabilities from underlying lending relationships, credit derivatives and securitizations may involve systemic risk, which may occur if a loan default with one bank triggers a chain reaction of defaults with other banks (a “domino effect”, see Elsinger et al., 2002).
 - The security design (see Jobst, 2003) is of key importance for the effectiveness of the credit risk transfer, and the contracting parties should be aware of it. The complexity of the specific design of credit risk transfer instruments and partly as yet incomplete statutory contractual provisions often lead to enhanced legal and documentation risks. Due to these legal uncertainties, issuing banks are

⁸ See, among others, European Central Bank (2002, 162f), Scheicher (2003), Rule (2001a, 2001b).

⁹ See, for example, Rule (2001a, 2001b), IAIS (2003), FSA (2002), Standard & Poor's Correct (2003).

also exposed to, for example, recourse risk, i.e. they may have to return payments already received from investors.

- Intermediation theory often refers to a change in the role of banks which might have an impact on financial stability. If the increased use of credit risk transfer instruments causes more and more banks to move from an originate-and-hold-to-maturity to an originate-and-distribute strategy, banks may lose their traditional monitoring function in lending and thus fundamental information about the underlying relationship with the debtor. Even if banks retain their monitoring function, problems may arise in connection with asymmetric information. For example, the originator may have an incentive to select low-quality loans for a transaction (adverse selection), or the original lender may have a lower incentive to monitor the loan (moral hazard).¹⁰

In summary, the current international debate indicates that there are both positive and negative implications of credit risk transfer instruments for financial stability. Before turning to the assessment of the situation in Austria, in the following we present the results of the survey of banks' CRT activities.

Austrian Banks' Activities in the Field of Innovative Credit Risk Transfer Instruments

Survey among Austrian Banks

In order to analyze the actual implications of credit risk transfer instru-

ments for financial stability, the extent of their actual use in the financial market has to be determined first. The lack of information is often considerable, as in most countries there has been no systematic and comprehensive documentation of the use of these instruments with financial market participants (banks, insurance companies, hedge funds, etc.). In order to improve the level of information at least on the use of CRT instruments at banks within the EU, the Banking Supervision Committee initiated interviews with specifically selected banks in 15 EU countries. In the fall of 2003, eight selected Austrian banks were surveyed by the OeNB and the FMA about innovative CRT instruments.¹¹ The banks were selected according to their (presumed) activities in the field of CRT. The questions followed a standardized questionnaire and focused mainly on qualitative aspects in the use of these instruments. Information was collected on the extent of CRT activities and banks' motives, risk management and risk awareness, the assessment of the CRT market developments as well as on the impact of these instruments on banks' business strategies.

Motives for the Use of Credit Risk Transfer Instruments

At present, the Austrian banks surveyed use innovative credit risk transfer instruments primarily for managing their portfolios and less for trading, thus acting as net credit risk buyers in terms of unconsolidated nominal values, i.e. the purchased loan exposure in nominal terms is higher than the volume sold. This,

¹⁰ For a detailed description of the problem see BIS (2003).

¹¹ As of June 2003, the unconsolidated balance sheet total of the banks surveyed amounted to EUR 286 billion, which corresponds to 48.4% of the unconsolidated overall balance sheet total of all Austrian banks.

however, applies only unless portfolio effects, which, owing to increasing diversification, might even reduce banks' overall credit risk exposure, are taken into account.

The motives given for assuming credit risk are, on the one hand, the chance to generate additional income in a difficult economic environment, and, on the other hand, risk diversification through the purchase of credit risk which is not or hardly correlated with the existing portfolio. The sale of credit risk through credit derivatives is currently rather modest in Austria, which, according to the banks surveyed, is attributable to the fact that many medium-sized Austrian borrowers are not externally rated and the Austrian corporate bond market currently lacks depth.

Furthermore, Austrian banks play the role of intermediaries of securitization transactions by selected corporate clients, albeit still to a small extent. They provide, for example, liquidity facilities for asset-backed commercial paper (ABCP) programs or credit enhancements. Since Austrian enterprises have recently shown increased interest in this alternative form of (re)financing, banks' intermediary function is likely to gain importance in the future.

Approximately half of the banks surveyed have conducted asset securitizations as originators either in Austria or abroad via subsidiaries. The main motives of the banks surveyed to act as originators of securitizations include the possibility of optimizing regulatory capital requirements as well as the possibility of using another (possibly more favorable) form of refinancing and safeguarding liquidity. Another purpose of these transactions is to actively manage risks. Generally, however, the securitization of assets in

Austria is – compared with other European countries – still in an early stage of development. Some banks say that this is attributable, in particular, to high transaction costs, the currently limited possibility of using multi-seller securitizations and low liquidity needs as well as the fact that at present, banks seem to maintain a sufficient capital cushion.

Type and Extent of the Credit Risk Transfer Instruments Used

At present, the banks surveyed use most frequently credit default swaps (CDS), credit linked notes (CLN), asset-backed securities (ABS), mortgage-backed securities (MBS) and collateralized debt obligations (CDOs) (see glossary), whereas credit spread forwards, credit spread options and total rate of return swaps play a rather insignificant role.

When interpreting the data, especially those on credit derivatives, it has to be taken into account that the gross nominal value alone may not reflect the underlying risk correctly. Attention should also be paid, for example, to netting or collateral agreements for assessing the risk of the counterparty. For a more accurate assessment of the actual risk, the credit rating of the underlying assets should also be considered.

Caution is also warranted when analyzing the nominal values involved in the sale of credit risk through securitization. Since transferring credit risk is not necessarily the prime motive of securitization transactions, originators frequently retain the so-called first loss position and transfer the senior tranches, i.e. the tranches with a relatively lower risk, to investors. Therefore, for instance, a true sale securitization may have a financing effect and cause a reduction in

total assets, but it does not necessarily mitigate the risk to a corresponding extent.

Since there has been little aggregated information available so far about the size and the risks of the Austrian CRT market and in spite of the problems mentioned above, the nominal values of the CRT instruments used were collected in the survey among Austrian banks to provide a first insight in banks' CRT activities.

Buying Credit Risk

As of June 2003, credit risk purchased by the eight surveyed banks in the form of credit derivatives and securitizations on an unconsolidated basis totaled approximately EUR 9.8 billion, with ABS, MBS and CDOs (52.8%) accounting for a slightly larger percentage than credit derivatives (47.2%). Thus, on an unconsolidated basis, purchased credit risk accounted for some 3.4% of the total assets of the banks surveyed. The amounts of the individual positions were in the single and lower double digit million euro figures. Most of the underlying assets and tranches were highly rated (investment grade) and represented almost exclusively foreign credit risk exposures, in particular from the U.S.A., United Kingdom, Germany, Switzerland, France, the Netherlands and Australia. Credit risks from emerging markets were also bought to a small extent. Most of the positions were held in the banking book (72.2% as opposed to 27.8% in the trading book) until maturity.

Selling Credit Risk via Credit Derivatives

As of June 2003, credit risk sold by the eight banks surveyed in the form of credit derivatives on an unconsolidated basis amounted to some EUR

2.3 billion. Single name and portfolio CDS accounted for the biggest share (EUR 2.1 billion), equaling some 0.7% of the unconsolidated total assets of the surveyed banks. The underlying loans of some portfolio CDS represent existing ABS and CDO positions. 67.7% of the credit risk transferred is recorded in the banking book and 32.3% in the trading book. In addition, from January 2003 through June 2003, the surveyed banks issued credit linked notes worth EUR 192 million on an unconsolidated basis. The CLN issued served to meet investors' demand and were not issued for the purpose of reducing credit risk. In other words, the underlying assets of these CLN were acquired for the specific transaction.

Just like credit risk purchases, credit risk sales via credit derivatives and securitizations are almost exclusively cross-border transactions, mostly with other European countries. EU-based large banks and investment firms seem to account for the majority of credit risk buyers and investors in tranches of securitization transactions by Austrian banks.

Owing to the international scope of the CRT market, the extent to which Austrian banks assume credit risk from other Austrian banks is apparently fairly small. At present, credit risk sales and purchases through the innovative instruments mentioned are primarily cross-border transactions.

Major Securitization Transactions in Austria

Leasing transactions and CDOs in particular accounted for the major securitization transactions by Austrian banks and their subsidiaries in the recent past. In 2003, for example, a subsidiary of Erste Bank, EBV Leasing

GmbH, launched a true sale transaction dubbed “Edelweiss Auto.” The volume of this transaction, which involved mostly car leasing receivables, came to EUR 220 million. In 2002, Bank Austria Creditanstalt issued a EUR 1 billion synthetic CDO under the name of “Promise Austria 2002.” This synthetic securitization was carried out in cooperation with KfW bank (Kreditanstalt für Wiederaufbau) as a partly financed structure. Also in 2002, the Italian subsidiary of Hypo Alpe-Adria-Bank launched a EUR 250 million true sale transaction, which primarily involved leasing receivables.

In 2001, the province of Lower Austria launched the “Blue Danube” transaction, a true sale MBS with a volume of EUR 2.6 billion. The true sale securitization of Porsche Bank, “FACT-2001”, which was issued the same year, involved car leasing receivables in the amount of EUR 400 million. In 2000, the Italian subsidiary of Hypo Alpe-Adria-Bank launched a EUR 157 million true sale securitization of leasing assets. In 1998 and 2000, Bank Austria Creditanstalt issued CDOs entitled “Amadeus” (synthetic) and “Mozart” (true sale) with a total value of EUR 1.8 billion. The underlying assets were bonds and ABS.

Altogether, Austrian banks and the province of Lower Austria securitized credit risk in the amount of some EUR 6.4 billion in the past few years.

Risks and Risk Management of Credit Risk Transfer Instruments

According to the banks surveyed, the main risks associated with innovative credit risk transfer instruments are counterparty, legal, liquidity and price risks. Owing to the complex transaction documentation, legal risk

is considered particularly significant. A few banks reported individual defaults of positions acquired through credit risk transfer instruments. Irregularities arising with the servicer of a securitization transaction were also reported, just as a few cases that currently pending before a court of law. Furthermore, banks experienced downgradings of certain exposures by rating agencies.

Before using the various credit risk transfer instruments, the majority of the surveyed banks had followed appropriate product launch procedures and established internal regulations for the risk management of such products. Some banks are currently implementing these procedures in order to be able to actively use these products in the future. The risk management regulations include, for example, rules on the use of credit risk transfer instruments, limit definitions and approval procedures. Some banks devise their own valuation models for these innovative credit risk transfer instruments use established models. Some banks rely primarily on rating agencies for assessing their exposures.

Development Prospects for the Austrian CRT Market

The market for innovative credit risk transfer instruments has grown considerably in Austria in the past few years; compared with other EU countries, however, it is still in its early stages. The banks surveyed expect the market to continue to grow, especially with regard to the purchase of credit risk from other (foreign) market participants. Furthermore, the sale of Austrian borrowers’ credit risk via credit derivatives, which is currently very limited owing to the lack of external ratings for many medium-sized Austrian borrowers, should also in-

crease. According to the banks' assessment, the market for securitizations of assets should also gain in importance, in particular in the area of leasing assets.

As to potential lasting shocks adversely affecting the CRT market, banks identified the following problem areas:

- Austrian banks share the concerns voiced in several studies¹² regarding the heavy concentration of counterparties in the credit derivatives market. This situation is aggravated by the fact that these relatively few international investment banks claim top positions in the “traditional” derivative business, too, and are therefore important counterparties for Austrian banks in several respects. Consequently, if one of these counterparties defaulted, both the credit derivatives market and the market for “traditional” derivatives would presumably be adversely affected.
- Another frequently mentioned problem are legal uncertainties due to differing interpretations of crucial contract parts, for example, the definition of an actual credit event or the extent of the risk transfer.¹³ The ISDA (International Swaps and Derivatives Association) has created standard definitions of CRT transactions, which describe six typical cases of credit events. However, the attempt to include in a contract all possible occurrences in the lending relationship between bank

and borrower, i.e. the options of deferring payment, restructuring, etc. is a big challenge for CRT contracting parties.

- If the assessments by rating agencies prove to be incorrect (e.g. risks and hazards are not detected in time), the loss of trust in rating agencies may create sustained uncertainty among market participants.

Asked about the implications of the New Basel Capital Accord (Basel II) for the credit risk transfer market, the banks surveyed expressed different opinions, especially about securitizations. Some banks believe that Basel II will foster the harmonization of banks' rating systems and credit risk will thus become more easily tradable. More uniform rating systems should also facilitate the pooling of assets of different originators in one securitization transaction (multi-seller securitizations). Other banks, in turn, argue that the high risk weights for lower-rated tranches, as suggested in the current Basel II proposals, might render investment in these positions economically unattractive; Basel II may therefore have a negative effect on the securitization market.

The Impact of Credit Risk Transfer Instruments on Banks' Customer Relationships and Business Models

At present, the banks surveyed consider the implications of credit risk transfer instruments for existing customer relationships to be rather small. Typically, the originator continues to provide servicing for the assets that

¹² See, for example, *Standard & Poor's Correct* (2003), *FitchRatings* (2003) as well as *British Bankers' Association* (2002).

¹³ The definition of a credit event is controversial even for banks' regular credit business. In Austria, for example, there are currently no uniform qualification criteria as to when a loan is considered “defaulted” similar to the “90-days-delay-of-payment” rule suggested by Basel II.

it securitizes; thus, for the most part, the customer relationship remains unaffected by the sale of credit risk. Similarly, the sale or purchase of credit risk through credit derivatives usually does not affect the underlying original relationship between bank and customer.

With regard to the impact of the increased use of innovative credit risk instruments on the business model of banks, no substantial changes were reported. The banks surveyed do not expect this to change in the near future. Some market participants, however, think that in the medium to long term, some Austrian banks may switch from an originate-and-hold-to-maturity approach to an originate-and-distribute approach. This would imply that banks no longer hold credit risks in their books until they mature, but transfer them to those market participants willing to bear them. Thus, each bank could best utilize its market position and its specific expertise by granting major loans without actually bearing the underlying credit risk.

Implications for Financial Stability in Austria

The increased use of credit risk transfer instruments, especially the purchase of credit risk, by Austrian banks found in the survey is primarily attributable to banks' efforts to generate additional income as well as to diversify risk. Despite the ongoing international discussion on whether the increased use of CRT instruments (see above) potentially jeopardizes financial stability, the findings of the survey indicate that the risk to financial stability in Austria is currently rather low. This can be traced to several reasons:

- In nominal terms, Austrian banks currently purchase a larger vol-

ume of loans on an unconsolidated basis via CRT instruments than they sell. This perspective, however, does not take into account portfolio effects, which might even reduce the entire credit risk of the bank thanks to increased diversification. When interpreting nominal values of CRT instruments used by banks – as done above – additional caution is advised; they serve only as a first indicator of the activities of credit institutions in the CRT market. Given banks' total assets and the amount of individual exposures, the overall volume of credit risk transfer instruments currently purchased by Austrian credit institutions still seems relatively small. Therefore the banking system has had little difficulty in tackling the problems with CRT instruments that have arisen so far, such as legal problems and a few defaults. International surveys (e.g. FitchRatings, 2003) have also concluded that, despite some uncertainty in connection with credit risk transfer agreements, relatively few legal disputes have been reported and the market for CRT instruments has obviously been working well. Despite the expected growth of the CRT market in Austria, it can be assumed that in the near future the Austrian banking system is generally likely to be highly capable of absorbing potential problems that may arise from the use of CRT instruments. Nevertheless, supervisors should closely monitor the development of these instruments, as well as the risk management practices of banks because they – as mentioned above – may jeopardize financial stability.

- The Austrian banks surveyed seem to be well aware of the risk of the prevailing high counterparty concentration. However, further analyses and observations are necessary to ascertain whether this awareness is reflected accordingly in risk management practices.
- Owing to the low securitization transaction volume no change has been found in the function of banks as intermediaries. The practice frequently used in securitizations to leave the first loss position with the originator seems to be sufficient incentive for banks to actively retain its monitoring function. In addition, it is common practice for the issuing bank (originator) to simultaneously adopt the servicing and thus also the monitoring function. Generally, banks seem to gain importance in connection with securitization transactions, since – like in stock offerings (IPOs, etc.) – customers use their banks as intermediaries and arrangers for asset securitizations and the transactions are not executed *directly* through the market.
- There has been some concern that the credit risk transfer market involves particular risks for inexperienced participants. In the future, special care has to be taken that all Austrian market participants adequately take account of the risks of these products within their risk management activities.
- As the survey has shown, Austrian banks currently use CRT instruments primarily to generate income. An improved income situation increases banks' financial power and business flexibility.
- As Austrian banks' CRT transactions are mainly cross-border transactions, there is currently no concentration risk within Austria; therefore, the systemic risk within the Austrian banking system as regards securitizations and credit derivatives can currently also be considered to be low.

Conclusion

Credit risk transfer instruments have gained importance over the past few years and triggered a debate on their possible implications for financial stability. Thanks to the rather modest CRT activities in Austria, the impact of these instruments on the Austrian financial market and, subsequently, on financial stability at present seems to be limited. As the use of credit risk transfer instruments is growing and potential negative effects on financial stability cannot be ruled out in the future, it seems sensible and warranted to continue closely monitoring the activities of Austrian market participants. Against this background, it is becoming increasingly obvious that both market participants and regulators require regularly compiled, standardized data on the use of CRT by banks and other market participants (e.g. insurance companies) on the Austrian and the international level.

Glossary¹⁴

Asset-backed commercial paper program (ABCP)

A form of securitization where the special-purpose entity issues commercial paper. The maturity of ABCP is usually shorter than that of term transactions, i.e. 30 to 360 days.

¹⁴ This glossary is a modified version of the glossary in Scheicher (2003). Scheicher (2003) also includes a detailed description of the individual CRT instruments.

The special-purpose entity in ABCP programs is usually referred to as conduit and set up by the sponsor. Rating agencies assign short-term issue ratings to ABCP programs.

Asset-backed securities (ABS)

Bonds backed by a pool of assets. This pool generates the interest and redemption payments, which are forwarded to the investors in ABS. The pool of assets may comprise, for example, loans, bonds or commercial claims.

Arranger

Supports the originator in the execution of a securitization (for a structuring fee) and, for example as an independent third party, checks the credit rating of the asset pool and determines the structure of the interest and redemption payments.

Credit enhancement

General initiatives taken to limit the credit risk that remains in the asset pool and is to be transferred to the investors. Credit enhancements are mostly granted within the asset pool, through the originator or external third parties for individual tranches of a securitization.

Credit spread

The difference between the yield of a financial instrument with a default risk and the yield of a government bond or interest rate swap.

First loss position

The position in a securitization that bears the first losses in the asset pool. This position often remains with the originator.

Credit derivative

A bilateral financial contract which enables the isolation of the credit risk from other risks (especially the market risk) a financial instrument is exposed to and which transfers it to a counterparty without forcing the transfer of the ownership of the underlying assets. In synthetic securitizations, credit default swaps (CDS) and credit linked notes (CLN) are the most important forms of credit derivatives used.

Liquidity facility

Facility used to guarantee the solvency of a securitization. Liquidity facilities are frequently required in asset-backed commercial paper programs to bridge short-term gaps between the redemption and new issue of commercial paper.

Liquidity risk

Risk that arises if an enterprise, despite being solvent, is unable to meet its payment obligations because of a lack of liquid funds.

Market risk

Risk that the value of a portfolio changes as a result of fluctuating market risk factors, such as interest rates, stock prices or exchange rates.

Mortgage-backed securities (MBS)

Bonds that, as a special form of ABS, are backed by a pool of mortgage-backed assets. MBS include residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS).

Multi-seller securitizations

In multi-seller securitizations, assets of several different originators are securitized. This facilitates the pooling

and securitization of smaller portfolios as well.

Originator

The originator in its regular business activities generates assets which constitute the asset pool for a securitization. In addition to the special-purpose entity, the investors and the servicer, the originator is the main participant in a securitization.

Servicer

Participant in a securitization who is in charge of administering, monitoring, collecting and utilizing securitized assets and collaterals (servicing). In most cases, the originator takes care of the servicing, but it can also be passed on to a third party. In addition to the special-purpose entity, the investors and the originator, the servicer is a major participant in a securitization.

Synthetic securitization

A form of securitization where only the credit risks from the asset pool are transferred to the special-purpose entity and the investors via credit derivatives, whereby the originator remains the owner of the assets.

Tranche

Securitization position to which a defined share of the asset pool's credit risk is assigned and the claims of which are senior or subordinated to the remaining tranches of a securitization. A securitization usually has at least two different tranches.

True sale securitization

A form of securitization where the ownership of the assets and collaterals and all connected risks are transferred to the special-purpose entity, for example via cession or sale. As opposed to the synthetic securitization, a true sale-securitization always has a financing effect for the originator.

Underlying asset

Asset on which a credit derivative is based.

Securitization

Securitization here means a structure which transfers credit risks from an established pool of assets in the form of at least two risk tranches which differ in their exposure to default risks and in the form of a tradable security to the investors and risk takers.

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