Credit Risk Transfer Mechanisms

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Types of Credit Derivatives

- Credit risk is the risk of a borrower defaulting.
- **Credit default swaps** (CDSs) enable an investor to transfer credit risk on a loan product to an insurance company. They pay a quarterly insurance premium to buy downside protection.

Types of Credit Derivatives (continued)

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- **Collateralized debt obligations** (CDOs) enable loan originators to repackage loan products into large baskets of loans and then resell those bundles of loans to investors on the secondary markets. CDOs are organized in tranches (slices of bundled loans) with differing exposures to default risk.

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捆綁貸款的切片

- A **collateralized loan obligation** (CLO) is very similar to a CDO except that it holds primarily underwritten bank loans as opposed to the mortgage bias of CDOs.

Mitigating Credit Risk

- Banks may use various traditional approaches to mitigate credit risk exposures, including purchasing third-party insurance, exposure netting, marking-to-market, requiring collateral, including termination clauses, and possibly loan reassignment.

終止條款

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- Another option is to syndicate a loan. In this approach, a lead bank will retain some of the loan and find other banks to hold the remainder of the desired loan amount.

The Role of Credit Derivatives in the Financial Crisis

- The existence of credit derivatives did not cause the financial crisis of 2007–2009, but the misuse of these products certainly did.
- Investors used CDS contracts for speculation 推測 rather than risk mitigation.
- Collateralized debt obligations also held a very complex mixture of mortgages 抵押貸款組合 that included both subprime 次級貸款 loans and adjustable-rate 可調利率貸款 loans as well. CDO^2

The Role of Credit Derivatives in the Financial Crisis (continued)

- As typically happens after a crisis, new regulation was created.
- Dodd-Frank was formed to better regulate the credit derivatives space and to keep bank trading in check.
- The SEC also added Section 15G to further protect investors.

Securitization and Special Purpose Vehicles

- The securitization process involves a bank sourcing loans, transferring them to an off-balance sheet entity known as a special purpose vehicle (SPV), organizing the loans into 分批 tranches, and ultimately selling the structured loan products to investors.
- Has potential issues for investors when the originate-to-distribute (OTD) model sources loans with low quality in such a way that disguises this fact from investors.

1) lower borrowing cost
2) lower cap reqt
3) more investments