Box 2

THE ROLE OF STRUCTURED MARKETS IN PROPAGATING THE INITIAL SUB-PRIME SHOCK

Notwithstanding the positive contribution they can make in facilitating portfolio diversification and the distribution of risk across a wide range of investors – thus enhancing credit risk management possibilities – structured finance markets played a central role in propagating the initial sub-prime mortgage market shock across broader credit markets (see Figure A). This box examines some of the factors which contributed to such propagation.

Factors that played a central role in the recent market turmoil included a loss of confidence in the valuation of complex structured products and an increase in uncertainty among investors about the adequacy of their ratings in a context of scant information for risk assessment. This highlighted an already well-known weakness of the originate-and-distribute business model of banks. In particular, it showed that the ability to transfer credit risks may detract from adequate assessment and pricing of credit risk by loan originators and that it can dilute incentives for gathering and passing on accurate information. Whilst reputation risk may mitigate these problems, it cannot fully eliminate them.[1] Furthermore, some instruments that were intended to facilitate a transfer of risk away from the banking sector fell short of their objective, as the triggering of contractual liquidity clauses brought initially transferred risk back onto the sponsoring banks' balance sheets.

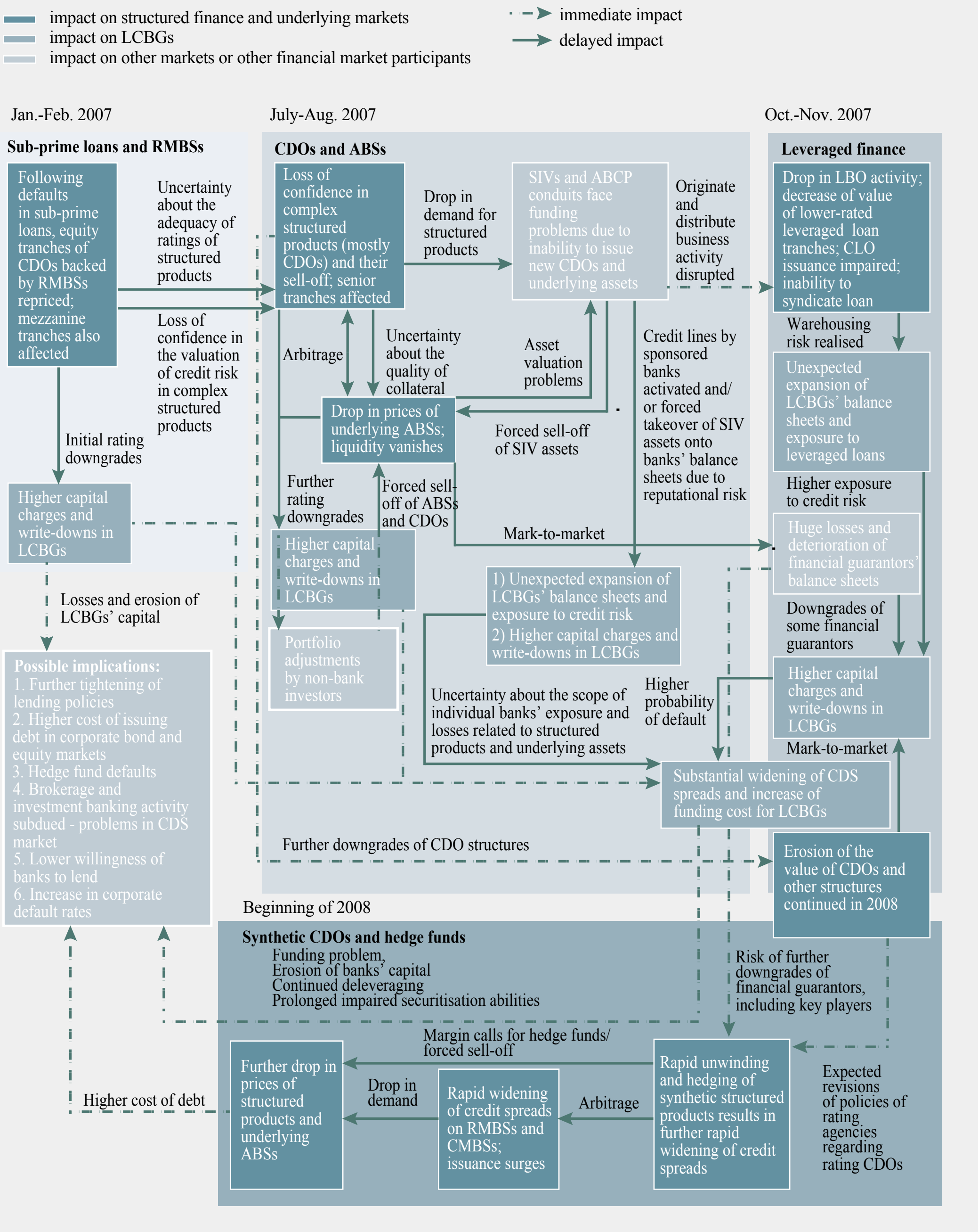
Investor uncertainty about both the value of structured credit products and the extent to which risk had been redistributed within the financial system by them drove an initial asset sell-off. This triggered a further drop in prices and financial institutions which held such securities were obliged to mark them to market, which led to them having to bear sizeable write-downs. In addition to the losses that banks faced due to capital charges and write-downs resulting from downgrades and decreasing prices of collateralised debt obligations (CDOs) and asset-backed securities (ABSs), important links to third parties in the valuation of the structures came to the fore, such as the role of financial guarantors (see Box 4). Banks and insurers faced further mark-to-market losses from higher capital charges on securities guaranteed by these institutions. In addition, banks' exposures to financial guarantors as counterparties in CDS hedges on ABS CDOs proved to represent the lion's share of the burden. Both guarantees and hedging appeared highly concentrated among the largest banks and securities firms, posing a substantial risk for financial stability.[2]

1 It is worthwhile recalling that the term "structured" covers a broad range of products with varying complexity and/or risk. The "principal-agent problems" characterising the products can be influenced by such considerations.

2 According to a Moody's survey, these hedges amount to approximately USD 120 billion and are concentrated among 20 banks and securities firms (see Moody's (2008), "Analytical Update on Guarantor Exposures at Global Banks and Securities Firms", February).

All in all, measures aimed at quickly restoring and strengthening confidence in structured credit markets and in their intermediation function are needed to stop further financial sector deleveraging. This would help to avoid possible negative spillovers to the underlying credit instruments and financial intermediation more generally.

The chronology and links of propagation of the sub-prime shock across structured finance markets



Source: ECB.