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J. Finan. Intermediation

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Editor's Introduction

Special issue: Credit risk transfer and bank regulation

In June 2006, the Bank for International Settlements and the *Journal of Financial Intermediation* jointly organized a conference on credit risk transfer and regulation in banking. This conference was the third in a series of biannual conferences held at, and generously funded by, the Bank for International Settlements in Basel. The two previous conferences gave rise to widely noted special issues of the *Journal of Financial Intermediation* (see von Thadden, 2004; Flannery and Thakor, 2006). In keeping with this tradition, the journal now publishes the special issue devoted to the 2006 conference.

The conference attracted more than 90 submissions, 10 of which were selected for presentation in Basel. A total of 9 of the papers submitted for the conference were submitted for editorial review at the *Journal of Financial Intermediation*. All of these 9 submissions were subjected to the journal's usual double-blind refereeing procedure and 4 submissions were eventually selected for publication. One of these papers had already been submitted to the journal earlier and was published in 2007 (Freixas et al., 2007). The other three papers are collected in this special issue.

The topics discussed at the conference ranged from credit derivatives to risk taking in financial conglomerates, interest rate risk, and the securitization of consumer loans, all viewed from the perspective of banking regulation under "Basel II." In retrospect, the conference program could not have been more topical, given that only one year later exactly these issues led to the turmoil in financial markets that turned into the worst global financial crisis since the Second World War.

Two papers in the special issue deal with the theory of credit risk transfer. Misguided or unfortunate credit risk transfer lies at the heart of the current financial crisis, and a better theoretical understanding of these practices is urgently needed (see Duffie, 2007, for a description of many of the problems). In their paper "Credit Derivatives, Capital Requirements, and Opaque OTC Markets," Nicolò and Pelizzon consider a bank that seeks to achieve maximum loss protection on its credit portfolio. Such maximum loss protection is in line with the regulatory approach taken in Basel II (see Basel Committee, 2004, 2005). Nicolò and Pelizzon note that such protection can be achieved fairly easily through a menu of credit protection products such as binary credit default baskets, even if there is asymmetric information about the riskiness of the bank's portfolio. The reason is that the flexibility in the choice of derivative contracts allows the bank to signal its quality through a separating equilibrium in the financing game with the market. Regulation such as the Basel II requirement that retained equity-like tranches of a portfolio must be deducted from bank capital, however, can compromise the use of these tranches as signaling devices, because it makes such signaling more costly. Yet, Nicolò and Pelizzon show that this negative conclusion can change if the market for credit derivatives is opaque. In this case, a commitment to retain risk on the balance sheet is less credible, which reduces the attractiveness of derivatives as signaling devices. Hence, capital requirements have less of a negative side effect.

Nicolò and Pelizzon show how risk transfer instruments can improve bank performance in the context of asymmetric information about hidden bank characteristics. The paper "Optimal Credit Risk Transfer, Monitored Finance and Banks," by Chiesa, on the other hand, analyzes the role of these instruments in the context of asymmetric information about hidden actions by banks. Chiesa's point

of departure is the standard observation that banks can create value in lending through monitoring, but that this activity is subject to moral hazard. Different from conventional wisdom, however, Chiesa argues that the heavy debt and deposit financing of banks may distort their monitoring incentives. The reason for this distortion is that monitoring can be most effective in bad macroeconomic states and make little difference in good macro states (“a rising tide lifts all boats”). Hence, debt contracts, which pay off most in good states, do not reward the bank efficiently for its monitoring activity and thus induce too little monitoring.

In such a situation, properly designed credit risk transfer can improve incentives and hence create value. If the bank securitizes its loan portfolio but enhances the resulting security through a put option, it can establish first-best monitoring incentives, because this structure makes it forego the high rewards due to macroeconomic good luck and exposes it to the losses caused by insufficient monitoring. Interestingly, Chiesa shows that prudential regulation has an important role to play in this context, because a bank’s promise to redistribute risk in the described way is not credible once it has collected its deposit base. Properly designed risk-based capital standards are necessary to give the bank the right incentives to structure the securitized assets the same way as it would under commitment.

The design of regulatory capital standards thus is clearly an important problem in the theory of credit risk transfer. The paper by Lang, Mester, and Vermilyea, “Competitive effects of Basel II on US bank credit card lending,” shows how important it is also empirically. The conventional wisdom is that sophisticated securitization strategies will benefit banks that use the advanced internal ratings-based (IRB) approach to measuring portfolio risk under the Basel II accord. Because in the US these will be a small number of large banks, smaller banks, which rely on the standardized approach of Basel I, are said to be at a disadvantage in market segments where risk transfer is important. Lang, Mester, and Vermilyea show that this argument is likely to be incorrect, at least for credit card lending.

Their argument is as that under current regulation, which largely reflects the standardized approach of Basel I, the data suggest that regulatory capital requirements are not binding. The empirical question therefore is to estimate whether, and if so at what shadow cost, IRB approaches would make regulatory capital requirements binding. To this end, Lang, Mester, and Vermilyea first show that currently the ratio of equity capital to managed assets at credit card specialty banks (CCSBs) in the US is statistically indistinguishable from that of comparable other banks. In other words, the market seems to evaluate banks by considering managed assets rather than on-balance-sheet assets (and thus disregards the balance sheet effect of ABSs). Lang, Mester, and Vermilyea then scrutinize the rules for consumer credit card assets under Basel II and calculate the corresponding regulatory capital requirements given today’s balance sheet information of CCSBs. With this information, they calculate expected actual changes in capital if today’s CCSBs were to move from Basel I to Basel II and find that Basel II regulatory capital requirements for total capital (differently from tier 1 capital) may well present a binding constraint for several current CCSBs.

Lang, Mester, and Vermilyea’s careful institutional and empirical analysis shows how the details of bank regulation matter. In this sense the paper complements the two theoretical papers of this special issue very nicely. Traditional bank capital regulation under Basel I has been widely criticized as inviting regulatory arbitrage in particular through credit risk transfer. However, if the market understands credit risk transfer, more sophisticated capital requirements must be careful not to eliminate the benefits of such instruments. The paper by Lang, Mester, and Vermilyea shows that there is the actual possibility of this happening, and the papers by Nicolò and Pelizzon and by Chiesa exhibit two important theoretical links between credit derivatives and capital requirements. The papers in this special issue should therefore provide interesting food for thought for researchers and regulators alike. The recent report by the [Basel Committee \(2008\)](#) shows that these considerations are likely to fall on fertile ground.

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Available online 23 August 2008