The CDO market Functioning and implications in terms of financial stability

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Abstract

The result of relatively recent financial innovations, collateralised debt obligations (CDOs) are securities that represent a portfolio of bank loans and/or different financial instruments. Part securitisation instrument part credit derivative, these increasingly-popular structured finance products are used by financial institutions for various purposes, ranging from reducing their cost of financing to exploiting arbitrage opportunities or transferring credit risk. Irrespective of their form, CDOs are issued in different tranches that are tailored using securitisation techniques. The process of tranching allows credit risk and returns on their underlying portfolio to be redistributed to investors in an ad hoc fashion. CDOs are part of an ongoing trend of converting credit risk into a marketable commodity. This process started with securitisation, and was then sustained by the development of credit ratings and corporate bond markets and, more recently, by that of credit derivatives. While CDO issuance represents at most the equivalent of a sixth of that of corporate bonds, the influence of these products has a far greater significance because of the amount of credit risk they allow to be transferred. The sharp growth in synthetic structures backed by credit derivatives, especially in Europe, has heightened this trend. The rapid development of CDOs has improved non-bank investors' access to credit markets and has enabled them to overcome the obstacles posed by the size and limited diversification of the corporate bond market, notably in Europe where bank intermediation remains predominant. Investors can now choose portfolios with specific risk-return profiles and take exposures to credit risk previously confined to banks' balance sheets, such as SME loans. Given that CDOs are credit risk transfer instruments, they facilitate the redistribution of this risk within the financial and banking sector and even beyond, while increasing the degree of completeness of the credit market. They should therefore have a positive impact on financial stability. However, as is often the case with financial innovations, evaluating CDOs and the risks they entail, particularly in the case of Synthetic CDOs, requires the use of complex techniques that are not always sufficiently tried and tested. Both investors and market participants may thus be exposed to relatively high potential losses. At present, this risk does not appear to be of a systemic nature given the size and relative newness of the market. Nonetheless, if this market continues to grow at its current pace, attracting increasing numbers of investors, in particular in Europe where CDOs are predominantly synthetic, systemic risk may emerge. Moreover, growth in CDO issuance seems to have contributed to the marked narrowing of spreads over the past two years on all credit markets. This trend raises questions as to the links between the CDO market and the corporate bond and credit derivatives markets, and deserves particular attention with regard to the risk of the propagation and amplification of strains that may arise on the CDO market due to its still limited liquidity and transparency.

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