

# 11

## newsletter

### Financial Services Authority

# Cross-sector risk transfers

May 2002

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## Executive summary

Banks transfer credit risk to each other, and to other types of firm, in various ways. This paper focuses primarily on credit risk transfers from banks to insurance companies, and on some of the complex and innovative structures that have been used for this purpose.

Insurance companies take on credit risk from banks in two main ways:

- by insuring or reinsuring credit risk, whereby the insurance company underwrites or guarantees the risk; or
- by investing (as part of their investment strategy) in instruments that transfer the credit risk.

The other focus of this paper is on the transfer of insurance risk from insurance companies to the capital markets, primarily using catastrophe bonds.

The credit risk transfer market is growing rapidly. The products used to transfer risk have become increasingly complex. Some of the more exotic transactions generate products with very high risk characteristics. It is clear that financial institutions without long experience of credit derivatives have been entering the market. There has also been evidence of risk being transferred across sectors and into unregulated institutions. This raises a question of whether differences between the regulatory regimes applying to different sectors are, at least in part, driving this business.

For these reasons, the credit risk transfer market has attracted the attention of regulators both nationally and internationally. This has been a topic of discussion in the Financial Stability Forum and the Forum has encouraged initiatives in this area.

### Our research

Against that background, we decided to research the market in London, which is one of the most important centres for this activity. Our aim was to ascertain how well the firms involved were understanding and managing the risk, and whether there were any aspects of the regulatory regime that were driving this activity.

We obtained the information in this report through desk-based research and interviews with selected market participants (16 on credit risk transfers and 17 on insurance risk transfers), undertaken mostly in the last quarter of 2001. So, the report does not claim to be an exhaustive survey of the market and should be interpreted accordingly.

## The research results

Our research confirms that the market has been growing rapidly. The total global credit derivatives market in 2001 was over \$1 trillion, from a base of \$180 billion in 1997. Insurance companies were said to have a 20 to 25 per cent market share, as risk buyers. In contrast, there has been little transfer of insurance risk to the capital markets to date.

The paper concludes that, in general, the firms who are active in the market understand the nature of the transactions, although there is some evidence that a few insurance companies that have been involved have “burnt their fingers”. Much of this naïve capacity has now left the market, however.

Our research also shows that the main drivers of the growth seem to have been the different risk appetites of different companies in different sectors, rather than capital regimes themselves. There is however some evidence of risk transfer to unregulated firms and to firms in offshore centres, which may owe something to the different regulatory regimes in force there.

## Lessons for the firms in this market

The research has produced some important lessons for firms who wish to be active in this market. The main ones are:

- there should be greater senior management scrutiny of these activities;
- firms must make sure that they understand the products, including the documentation, pricing and valuation risks in these instruments; and
- firms must ensure that they understand if they have actually transferred the risk: for example, is the risk transferee able and willing to pay?

## Lessons for regulators

From a regulatory point of view, there are some lessons for the design of capital regimes in the future. And it is also important for regulators to monitor the risk management of firms involved in the business. So we will in future scrutinise, as part of our firm-specific supervision, where the firms are taking material risks in these markets and where they may not be adequately managing these risks.

We will also consider whether enhanced regulatory and reporting requirements would help us track developments in these markets. And we will continue to participate actively in international discussions and initiatives to discover more about the cross-border aspects of these transfers, where the risks ultimately reside, and whether adequate capital is held against them.

## Next steps

We are publishing this paper in the interest of transparency. Publication also provides an opportunity for market participants to contribute to our understanding of the current structure of the market and to influence our regulatory response. We may, as appropriate, publish a statement in response to industry comments.

We would be interested in comments on the paper and the suggestions in it. Please send your comments to reach us by 31 July 2002.

The Financial Services Authority invites comments on this Discussion Paper. Comments should reach us by 31 July 2002.

Please send comments by electronic submission using the e-mail address: [risk.transfers@fsa.gov.uk](mailto:risk.transfers@fsa.gov.uk)

Alternatively, comments may be sent in writing to:

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