FINANCE & ECONOMICS

Bank lending

Who's carrying the can?

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Banks are shifting vast amounts of their lending risk out of the banking system. Healthy diversification, say some. Dangerous, say others

THE world's leading banks decided some years ago that lending is a mugs' game. They began to get rid of their loans, repackaging them and selling them off as securities, or getting others to re-insure their risk. And the policy has been bearing fruit. The glut of corporate bankruptcies in 2001 and 2002—including the two biggest of all time, Enron and WorldCom—have not had the devastating effect on the big banks' balance sheets that might have been expected. The two biggest banks in America, for instance, have hardly registered a tremor. Citigroup's profits for the second quarter of this year were $4.3 billion (12% up on a year earlier), and those of J.P. Morgan Chase were $1.8 billion for the same period (78% higher than last year).

Alan Greenspan, chairman of America's Federal Reserve, said in a speech in May that this spreading of the banks' risks has made the financial sector more resilient, and individual institutions within it less vulnerable to shocks. It can indeed be argued that the world's financial system is safer if banks carry less of the overall credit risk. Their previous mismanagement of credit has caused so many damaging banking crises in the past; and banks, with their unique role in the payment system and the distribution of liquidity, are prone to systemic risk in a way that is not true of other financial institutions. Better, in that case, that they are strong, and that risks and losses are borne by a wider investment pool.

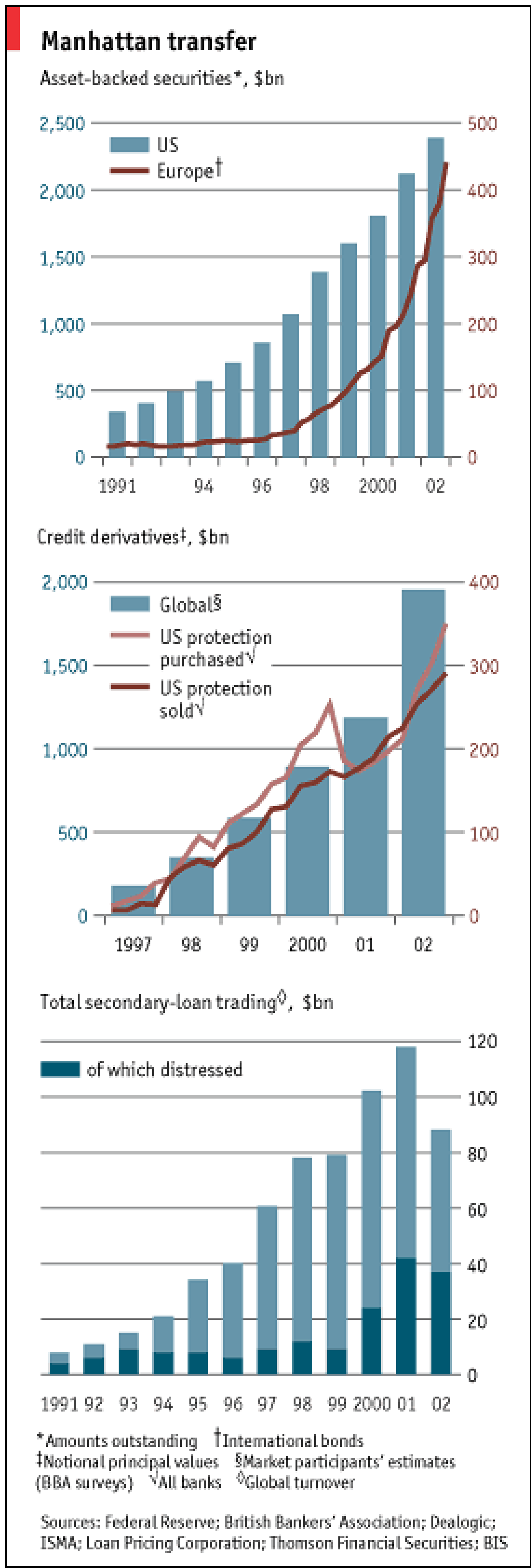
Others, though, are less sanguine. They fear that credit losses, buried today, will show up in new places later, causing unpredictable damage deep in the world economy.

Certainly, there is a conundrum. Loans of some $34 billion were wiped out in the bankruptcies of Enron and WorldCom alone. Yet only millions, rather than billions, of losses are showing up in the quarterly reports of big financial institutions. Where have all the losses gone, if not through the profit-and-loss accounts of the few big banks that do most of the lending to giant corporations? One theory is that they have ended up on the books of insurance companies which, since they record loan losses just as they would a property or casualty loss, are under no obligation to reveal them separately in their accounts (as banks do). But analysts and central bankers do not have a complete picture of where the banks' risks have ended up.

One thing is certain. Such risk does not neatly disappear into thin air. In a weak economy, bad debts increase and banks traditionally take a big hit. If they are not taking the hit in this economic slowdown, then somebody else is. Credit risk is like air in a squishy balloon. You can squeeze the balloon into any shape you like, but the air does not disappear.

Risk shifting

In its annual report in June, the Bank for International Settlements drew attention to the huge growth of credit-risk transfer—the shifting of risk from banks on to the buyers of securities and loans, and on to the sellers of credit insurance. In the early 1990s, the transfer involved a few billion dollars-worth of loans; by 2002, that figure had grown to more than $2 trillion (see chart). “The markets lack transparency about the ultimate distribution of credit risks,” it wrote. “Some market participants may take on more risk thanothers...or the authorities, are aware of.”



The risk, and the losses that inevitably flow from it, may be being redistributed to entities that are less well capitalised and less expert in analysing borrowers than banks. Moreover, they may be feeding through to places where they could eventually be socially and politically painful—for example, to pension funds, mutual

funds, or life-insurance policies.

There is some evidence to show that these institutions are worse at evaluating and managing credit risk: in the three years to 2003, non-bank financial institutions took an increasing share of syndicated bank loans. At the end of 2002, they had 10% of the syndicated loan market in the United States. Yet their share of the bad and doubtful loans within that market was 22.6%. "The transferors may have proper insight into the nature of the risks," said Sir Andrew Large, deputy governor of the Bank of England, in a recent speech. But "are the transferees actually aware of the risks they have taken on? And are they in the best position to monitor these risks as they evolve?"

Over the past 30 months one big bank, Deutsche Bank, has reduced the loans on its books by over 40%, from *euro*281 billion to *euro*165 billion ($264 billion to $187 billion). And the reason is not hard to find. Loans produce on average only half the 15% return on equity that banks and their shareholders demand these days. Until that changes, through regulation or by a reduction in the number of banks, bankers who do their sums will continue to unload their loans on to other parts of the financial system whenever they can.

Deutsche Bank is the most dramatic example, but other big banks also shrank their loan books in 2002: ABN Amro by *euro*34 billion, Credit Suisse by SFr12 billion ($8.6 billion), and UBS by SFr10 billion. Many banks have reduced their exposure to risk even more with the purchase of credit derivatives, a form of credit insurance. A worrying factor for regulators is that a good chunk of that credit insurance has been provided by smaller, regional banks which may have misjudged the risk as well as the price put on it.

Forthcoming bank regulation is likely to strengthen this trend. New rules on how much capital banks must hold, due to come into force in 2007, will make certain types of lending even less profitable—in particular, loans to medium-sized businesses, arguably the very group that needs banks the most. Lending between banks could also shrink, leaving smaller banks less liquid and more vulnerable to shocks. Some of the world's top bankers are currently asking regulators to look again at the potentially perverse consequences of these new capital rules.

For the moment, the incentive to banks is to make loans that are not sufficiently profitable, but that they know can be sold to entities that face lesser regulatory and capital costs. This is a form of arbitrage that is driving credit risk out of institutions where it is well understood and managed, and into institutions where it is far less so.

The powers behind the throne

What started as a trickle two decades ago has become a torrent. In the 1980s, American banks started to bundle together a number of mortgages that they had on their books, and to issue securities backed by them. Those securities they then sold off to others. After mortgages, they moved on to other sorts of consumer lending: credit-card receivables, car loans, commercial property loans and so on. The rationale was that they could make more money by generating the business (and the fees associated with it) than they could by holding on to the loans until they matured. All they needed was to find investors who were happy to take the loans (and their associated risks) off their back.

In the early 1990s, that was not difficult. In a climate of falling interest rates, investors who were once happy investing in low-risk treasury bonds were tempted to look for a higher yield, accepting that this meant a higher risk of default.

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They were helped in their search by the credit-rating agencies (of which there are only three that matter: Standard & Poor's; Moody's Investors Service; and Fitch). On the basis of its own data and details given to it by the banks, a ratings agency can produce a reasonably independent assessment of, say, the likely number of defaults in a pool of residential mortgages from Minnesota, under different interest rate

conditions. A bank, naturally, has an interest in getting the highest possible rating for any pool of its assets. The rating agency has a tendency to be sympathetic since the bank pays its fees. This has radically changed the function of big banks. The traditional image of the great banking hall and the armoured vaults stuffed with bullion has little to do with the way banks make their money. These days they make loans and then pass them on as quickly as possible, pocketing the margin. That leaves them more room to take bigger risks elsewhere: in trading securities, derivatives, and foreign exchange, for example, or investing in private equity.

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Two other developments have allowed banks to grow as conduits of risk rather than as holders of it. In the early 1980s, after Mexico, Brazil and various other countries defaulted on their debt, banks had to accept that their loans to such countries were worth considerably less than 100 cents in the dollar. So, as the countries in default negotiated with their creditor banks, some banks decided to get rid of their country loans at a discount.

A secondary market for these loans began to develop, and it spread from trading in sovereign debt to trading in corporate debt as well. Some big banks, notably J.P. Morgan in America and Swiss Bank Corporation (now part of UBS) in Europe, made a virtue of holding as little sovereign and corporate debt on their balance sheets as they could get away with. Other banks followed suit. Nowadays big banks sell as much as possible of their syndicated loans to those remaining smaller, traditional banks whose main business (even today) is taking short-term or medium-term deposits and using them to make longer-term loans to consumers or companies. Such banks are growing scarcer.

Derivative issues

The other development that has made credit risk even less likely to stay on banks' balance sheets is the business of credit derivatives. A buyer of a credit derivative buys insurance relating to a single company, from a seller. If the company defaults, the seller of the protection makes good the loss.

Credit derivatives began in a small way in the mid-1990s. By 2000, there was $800 billion-worth outstanding, and by 2002 the total was close to $2 trillion. That means there is credit insurance outstanding on a notional $2 trillion-worth of bonds and loans. The derivatives bought and sold can exceed the credits outstanding. Nevertheless, those who have bought the insurance have $2 trillion of protection—which might mean that there are plenty of firms in the financial markets, with net long positions, who are either indifferent to, or even eager for, the default of particular borrowers.

Fitch, one of the big three credit-rating agencies, quizzed 150 participants in the credit-derivatives market and found that banks in the United States and Europe are net buyers of credit protection, to the tune of nearly $190 billion; insurance companies and other financial organisations are net sellers, to the tune of $300 billion.

This has radically changed the relationship between lenders and borrowers. A lending bank may have gone through all the necessary credit checks before making a loan, but if it buys credit protection, it passes the worry on to somebody else—an investor or a bank with no relationship to the borrower. Inevitably, saving companies from bankruptcy has become a more complex task than ever before.

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Capital ideas

In many ways, credit-risk transfer can be seen as a positive development. If the risks are properly analysed, why not package them and sell them to those with a more appropriate appetite? One part of the answer is that these buyers with the right appetite are not regulated in the special way that banks are.

For at least two centuries governments have recognised the importance of maintaining a healthy banking system in order to ensure timely payments and keep the wheels of commerce turning. The key is to have a central bank (or monetary authority) that provides the banking system with cash if it runs short. If there is a widespread "liquidity crisis", a central bank steps in and, *in extremis*, its government prints more money. To reduce the likelihood of that, most governments also have rules on the capital that banks must carry in order to cushion themselves against unexpected shocks.

Widely accepted rules for bank capital have been in place since 1988. But loopholes and fancy new instruments have rendered them increasingly unsatisfactory. Hence new rules are being prepared which will make it more costly, in terms of the capital they must hold, for banks to keep certain types of credit risk—in particular, exposure to poorly rated companies, or to companies that are so small that they have no credit rating. The rules are not due to bite for a number of years, but already they are changing banks' behaviour and giving them even less appetite for all but the highest quality risks.

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This would be fine if there were risk-takers elsewhere in the financial system equipped to evaluate, take on and manage credit risk. But there aren't. Whereas Deutsche Bank has 3,500 credit analysts, most institutional investors (such as insurance companies or pension funds) do not have specialised credit departments at all. Yet, in the past few years, these institutions have sought more esoteric credit risk, for potentially higher rewards. Part of the incentive has been the poor performance of equity markets. Where else could they get even close to the returns that they were getting on equities in the late 1990s?

In their hunger for higher yields, insurance companies in particular bought portfolios of loans from banks, or guaranteed them against loss by selling credit protection to the banks. Since they did not have their own credit departments, the rating agencies were their chief guide to the potential riskiness of what they were buying. Their ratings are usually a reasonable guide to the risks of single companies or countries in normal markets. But credit risks bundled up (as they are in the case of asset-backed securities sold by the banks) defy the predictions of most mathematical models. Those that included loans to airlines and technology companies, for example, have involved investors in considerable losses recently—far more than the original credit ratings allowed for, and often more than direct loans to the individual companies would have done.

Several insurance companies which specialise in financial guarantees suffered last year from the deterioration in the quality of their assets. New accounting rules forced them to disclose the mark-to-market losses on the portfolios that they have guaranteed. An American credit guarantor, Financial Security Assurance (FSA), recorded losses of $91m on guarantees for $75 billion of securitised credits. Rivals also suffered losses. After their experiences in 2002, some insurance companies—such as Swiss Re, Chubb and SCOR—decided to write no new credit insurance.

Bundled up credit risks defy the predictions of most mathematical models

Should the regulators be indifferent to these unexpected consequences of credit securitisation? Central-bank studies on credit-risk transfer have concluded that the financial system seems to be coping with the change. On the other hand, some of the risk may have become invisible. It could be a time-bomb sitting in the portfolios of scarcely regulated offshore insurance companies, for example.

Out of sight

Some regulators are beginning to worry about who should be the proper holders of credit risk in a sound financial system, and whether too much credit risk has passed beyond their purview. Equally, there are bankers who blame bank regulators for insisting that large amounts of capital should back bank lending, thereby causing such lending to be unprofitable for them. "No bank ever went bust for want of capital," says one senior banker. "They go bust because of bad management."

Banking systems can be too sound, and the expense of maintaining such a failure-proof system is ultimately borne by other parts of the economy. If sound banks are not performing their lending function, what economic use are they? This has been a particular dilemma in central Europe, where banks were cleaned up at vast expense, often ending up in foreign hands. They have then done little local lending, partly because of worldwide bank capital standards. Instead, they have invested in low-risk government bonds.

With lower capital charges for loans, some bankers argue, big banks would keep more of the credits they originate on their own books. Yet the new bank capital rules are likely to raise capital charges and make lending even less profitable.

Sometimes the course of the financial-services industry needs a correction. Recently, regulators have concentrated on restoring ethical behaviour after a decade of wantonness. Now may be the time for them to look more carefully at the effect of that tumultuous decade on the structure of credit markets, and the function of the institutions within it. If they don't, the process of credit-risk transfer will simply accelerate—with unpredictable and possibly painful consequences.

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