Joint Seminar

Risk Management Institute
And
Department of Economics

Details of Seminar
Date: 4 December 2008, Thursday
Time: 4:00pm – 5:30pm
Venue: Lim Tay Boh Seminar Room, AS2/03-12

Speaker
Prof. Christine Parlour
University of California, Berkeley

Title
Laying off Credit Risk: Loan Sales versus Credit Default

Abstract
After making a loan, a bank finds out if the loan needs contract enforcement ("monitoring"); it also decides whether to lay off credit risk in order to release costly capital. A bank can lay off credit risk by either selling the loan or by buying insurance through a credit default swap (CDS). With a CDS, the originating bank retains the loan's control rights but no longer has an incentive to monitor; with loan sales, control rights pass to the buyer of the loan, who can then monitor, albeit in a less-informed manner. In a single-period setting, for high levels of base credit risk, only loan sales are used in equilibrium; risk transfer is efficient, but monitoring is excessive. For low levels of credit risk, equilibrium depends on the cost of capital shortfalls. When capital costs are low, only poor quality loans are sold or hedged; risk transfer is inefficient, and monitoring may also be too low. When capital costs are high, CDS and loan sales can coexist, in which case risk transfer is efficient but monitoring is too low. In both cases, if gains to monitoring are sufficiently high, the borrowing firm may choose to borrow more than is needed to finance itself so as to induce monitoring. Restrictions on the bank's ability to sell the loan expand the range where CDS are used and monitoring does not occur. In a repeated setting, reputation concerns may support efficient outcomes where CDS are used and the bank still monitors. Because loan defaults trigger a return to inefficient outcomes in the future, total efficiency cannot be sustained indefinitely. Reputational equilibria are most likely for firms that have high base credit quality or for firms where monitoring has a high impact on default probabilities.