Systemic Credit Risk Transfer

Darrell Duffie
Graduate School of Business, Stanford University

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Urgent and Precedent-Setting Next Steps

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Figure 1: **Share of Private Nonfinancial Debt Outstanding.** Source: Morgan Stanley from Federal Reserve Flow of Funds Data.
J.P. Morgan Chase & Co.'s Dealer Net Notional Protection Purchased (Billions of Dollars)
Figure 3: “Waterfall” of a collateralized debt obligation.
Figure 4: Retention of toxic waste at low leverage.
2007-08 Quarterly CLO and Structured Finance CDO Issuance
($ Billion, Source: Morgan Stanley)
Systemic Risks of Poor Credit Risk Transfer

1. Credit squeeze: Hoarding of credit.
2. Interference with central-bank monetary policy.
3. Bank runs (Northern Rock, Florida Pool, Bear Stearns).
4. Too-big-to-fail adverse incentives.
5. Spillover to other credit markets (e.g. muni bonds).
Default Insurance on $10 Million Investment Grade Corporate Debt Portfolio
Annual Premiums on 5-Year Coverage

Feb. 19, 2007
$31,000

Feb. 25, 2008
$157,000

Source: CDX.NA.IG.5yr Tranche Pricing, Morgan Stanley
Default Insurance on $10 Million Investment Grade Corporate Debt Portfolio
Annual Premium on 5-Year Coverage

Feb. 25, 2008
$157,000

Source: CDX.NA.IG.5yr Tranche Pricing, Morgan Stanley

July 14, 2008
$145,000

Source: CDX.NA.IG.5yr Tranche Pricing, Morgan Stanley