Risk Pooling

The risks to the financial system are extremely high, according to Morgan Stanley. At present, investors have not prepared themselves for the real possibility of a further downturn in the financial sector and a systemic shock to the entire sector.

The centre of concern is the risk of a systemic shock and the breakdown of the securitization process. Securitization involves banks and other financial institutions pooling loans or other assets into single securitized assets which can then be sold onto investors. In the case of home loans these were commonly known as collateralized debt obligations, (CDOs), reflecting the mortgage-backed nature of the loan. As these were sold onto investors, the originating bank collected a (profitable) fee.

The value or interest in these securitized assets stemmed from a number of interesting characteristics. First, the loans were collateral backed. As mortgage-based debt, the lender had the option to repossess the mortgaged property should the borrower default. In this way the sale of the home could be used to repay the loan. Secondly, the pool of loans that made up the securitized assets was diversified portfolio. Diversification came from many areas but included geographic location of the borrower, age, occupation, income level and even credit history.

However, rising delinquencies in the mortgages backing the structures has dried up all demand for the products leading to massive write-downs in the value of the deals. Many have also carried the safest "AAA" ratings, and confidence in this rating system has now completely eroded.

"For several years, investors of all types have taken great comfort in financials - given claims on the diversification of risk that sat on the balance sheet, as well as the miracles of risk-shedding/mitigation tools of securitization and credit default swaps," Morgan Stanley said.

The problem for investors is that risk pooling is only an effective means of risk management when risks are not borne by all members of the pool. Rising interest rates, a cooling economy and falling property prices tend to have an impact on a greater proportion of mortgage holders. These macroeconomic issues are sufficiently broad in scope to reduce the diversification which is thought to be present within a pooled set of

risks. In the insurance industry, hurricanes, which impact large proportions of the population, are known as catastrophic risks. The same might now be said of CDOs and macroeconomic events.

Questions

1. What is risk pooling, provide examples?

2. How can credit rating agencies reduce adverse selection?

3. How might an investor protect themselves against the risks presented by CDO’s?