



BANK OF ENGLAND

News release

Press Office

Threadneedle Street

London EC2R 8AH

T 020 7601 4411

F 020 7601 5460

press@bankofengland.co.uk

www.bankofengland.co.uk

1 September 2011

Tail risks and contract design from a financial stability perspective – paper by Paul Fisher

In a co-authored paper presented at a University of Cambridge/Lille Catholic University conference in Cambridge, Paul Fisher – Executive Director for Markets – considers, using practical examples from the crisis, how the true value of a financial contract can differ from what it was intended to be because of a failure to take into account how the financial system as a whole operates. This happens especially during stress situations and therefore affects financial stability.

The first category of contracts considered essentially fails to take account of the fact that a rare extreme event – a tail risk – affecting the insured, can also affect the insurer and thus fail to pay out. These risk correlations have not always been taken into account by market participants or regulators in the past. Apparently robust balance sheets, insured against bad outcomes, can look extremely weak once a major system-wide event occurs. The paper considers a number of practical examples, mostly based on the use of credit default swaps (CDS) as the insurance instrument.

The second category refers to situations where a contractual provision that is ‘in the money’ may not be exercised because the reputational repercussions – or wider market impacts - are perceived to cause more damage to the recipient than whatever could be gained financially from behaving strictly according to contract. Practical examples include the problems arising from the funding problems of structured investment vehicles (SIVs) and money market funds; calling (or not) master trust residential mortgage backed securities (RMBS) and hybrid sub-debt securities; and the enforcement of break clauses in derivative contracts. In each case behaviour by market participants has been influenced by wider considerations than the narrow consequences of exercising a contractual provision.

The authors draw a number of policy conclusions. Regulators, investors and analysts need to take account of true stress correlations; if they do not, the impact of tail events will not be captured properly. Tail events seem to happen far more often than people assume. If the risks were properly acknowledged at the outset, many contracts would be avoided or risks re-structured so as to limit losses in the event of tail risks crystallising. Properly designed stress tests should be an important part of the regulator’s toolkit: “A lot of the surprise seemed to come from the fact that virtually all risk management had been done within a ‘local’

framework, rather than genuinely extreme stress tests. If regulators, rating agencies or, for that matter, bond and equity investors had demanded analysis based on extreme stress tests, many of the repercussions in the system could have been identified.”

The paper also notes that the second set of examples illustrate that contractual designs which are exclusively relevant in the extreme tails, are best avoided. The reason is that features that do not seem to matter in most states of the world end up being treated as if they will never matter. Market participants need to make sure that an exercise of an option is seen as just that, a normal exercise of an option, devoid of reputational signalling.

The authors argue that these issues are an important consideration to bear in mind as the debate over how much capital banks should hold continues. For example, there is a good case to be made for contingent capital securities – debt that will turn into equity once certain trigger points are met. But it is crucial from a financial stability standpoint that the trigger point for conversion of such securities should not be set at a level which would completely disrupt the market if it was ever met. The paper also argues that the holders of tail risk should not be concentrated in leveraged players where losses might generate further spillovers. In relation to contingent capital: “...regulators could play a constructive role in allowing a broad range of ‘real money’ investors to own sensible amounts of this systemic risk.”

Notes to Editors

The paper is co-authored with Patrik Edsparr, Visiting Fellow at the Bank of England.

Key Resources

[Tail risks and contract design from a financial stability perspective – Full paper](#)