Systemic Credit Risk Transfer

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Urgent and Precedent-Setting Next Steps

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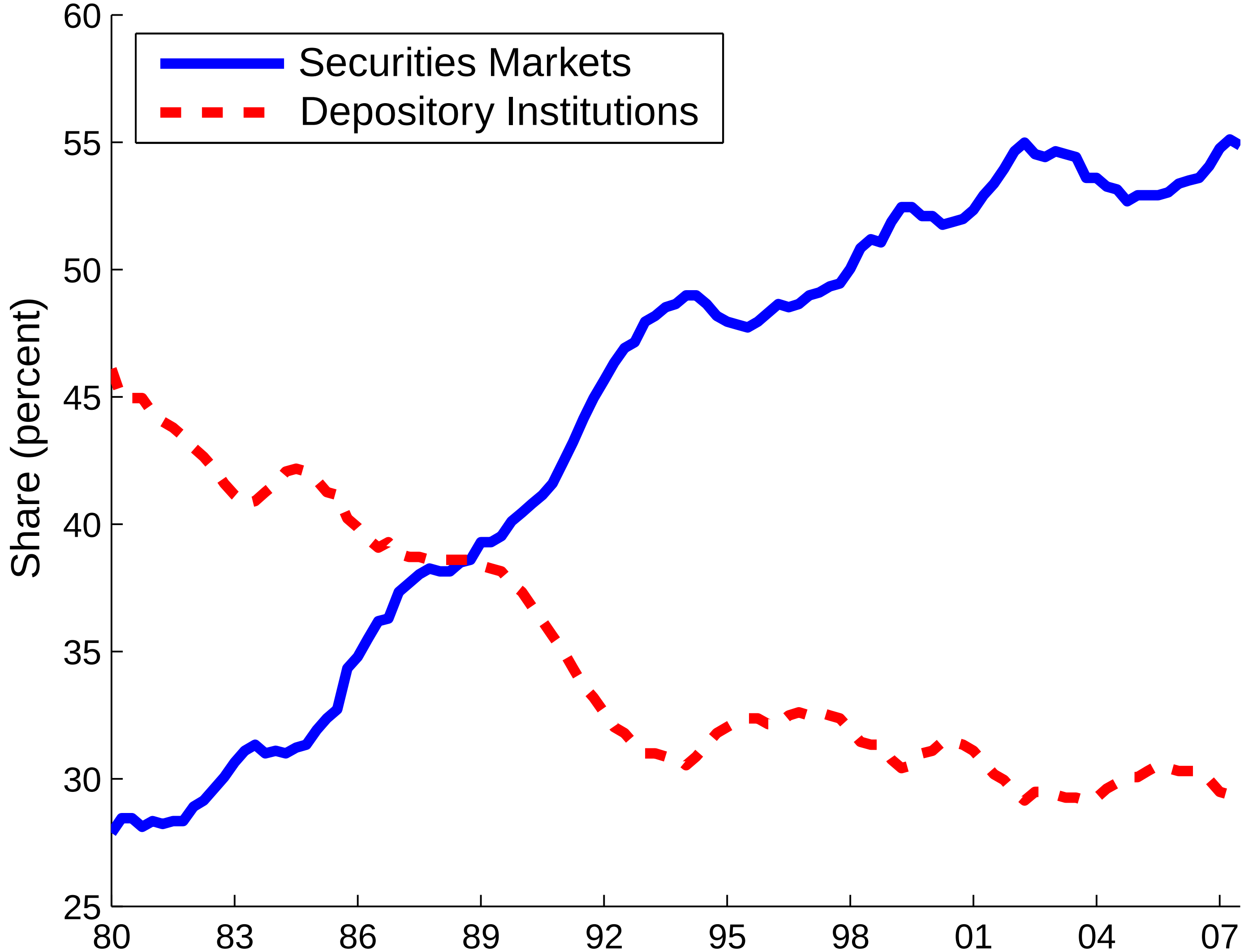
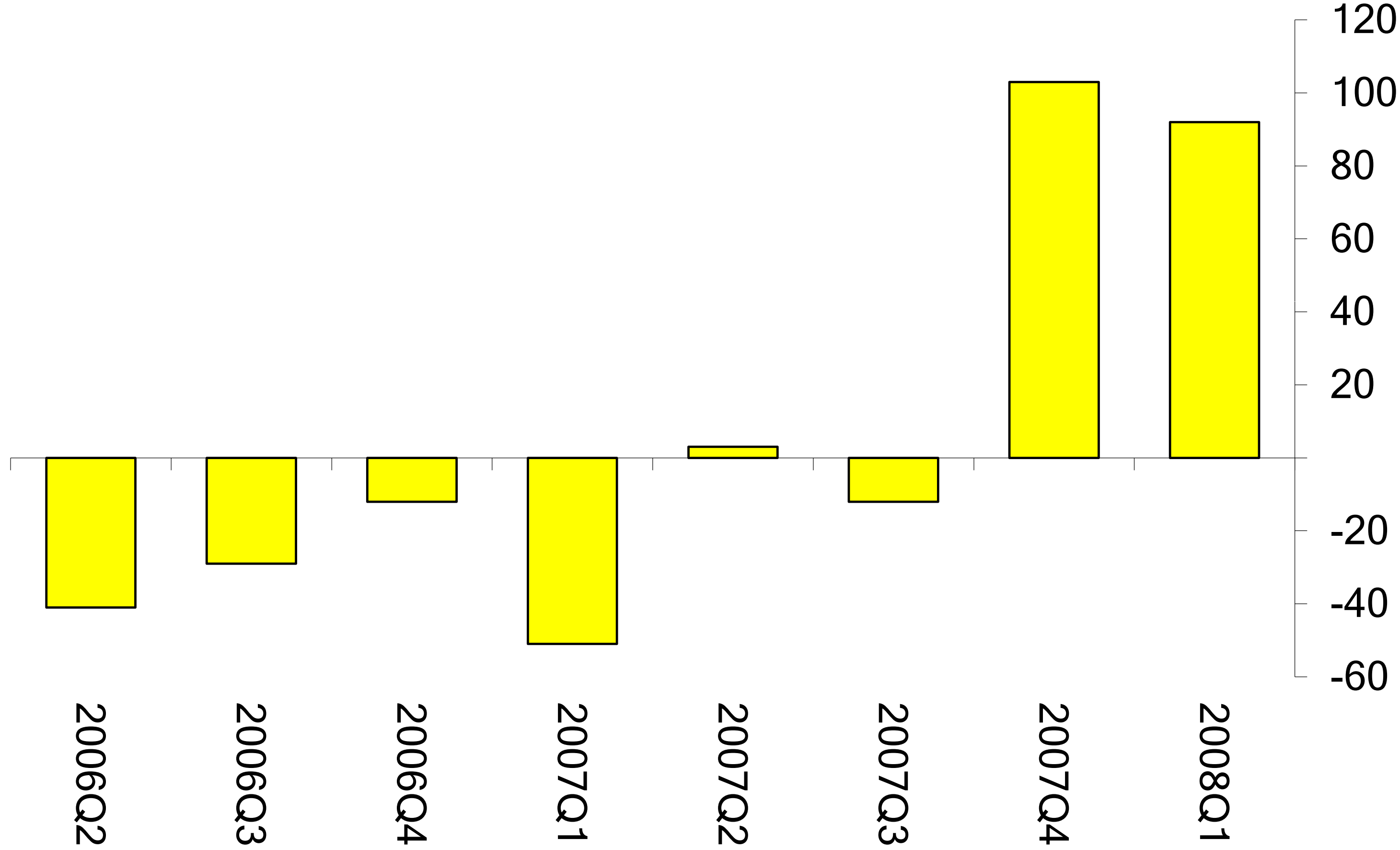
Figure 1: Share of Private Nonfinancial Debt Outstanding. Source: Morgan Stanley from Federal Reserve Flow of Funds Data.



J.P. Morgan Chase & Co.'s Dealer Net Notional Protection Purchased
(Billions of Dollars)



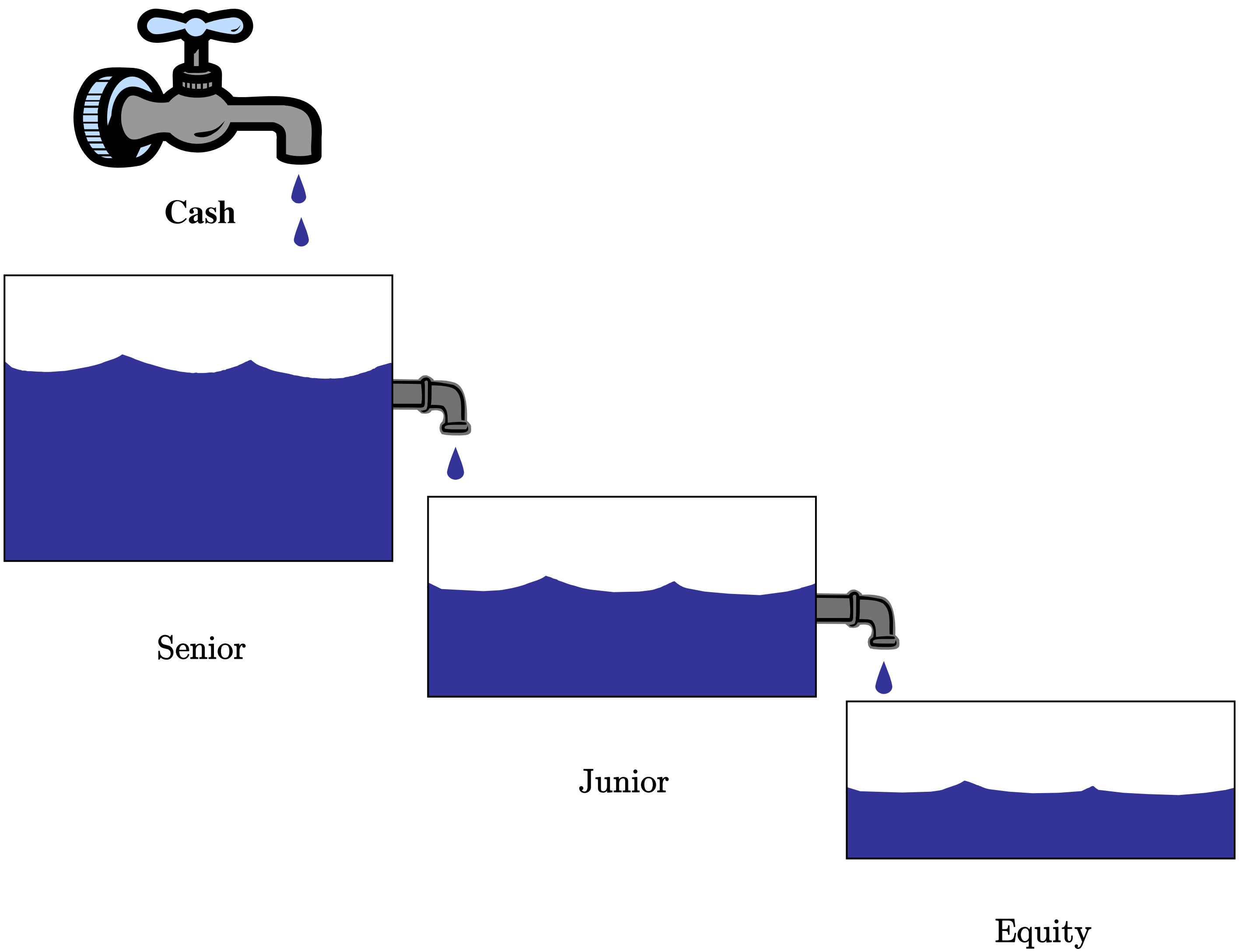


Figure 3: “Waterfall” of a collateralized debt obligation.

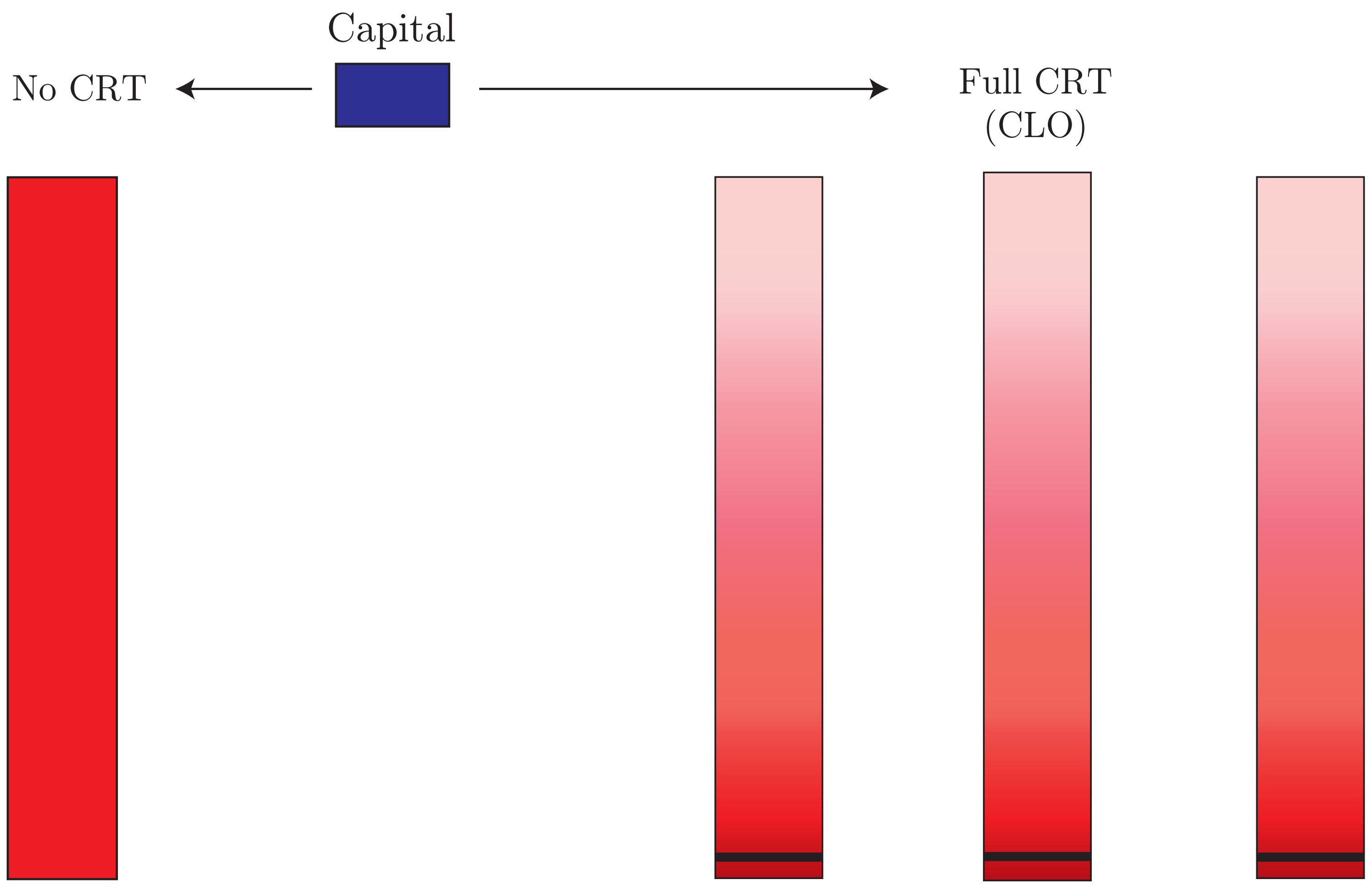
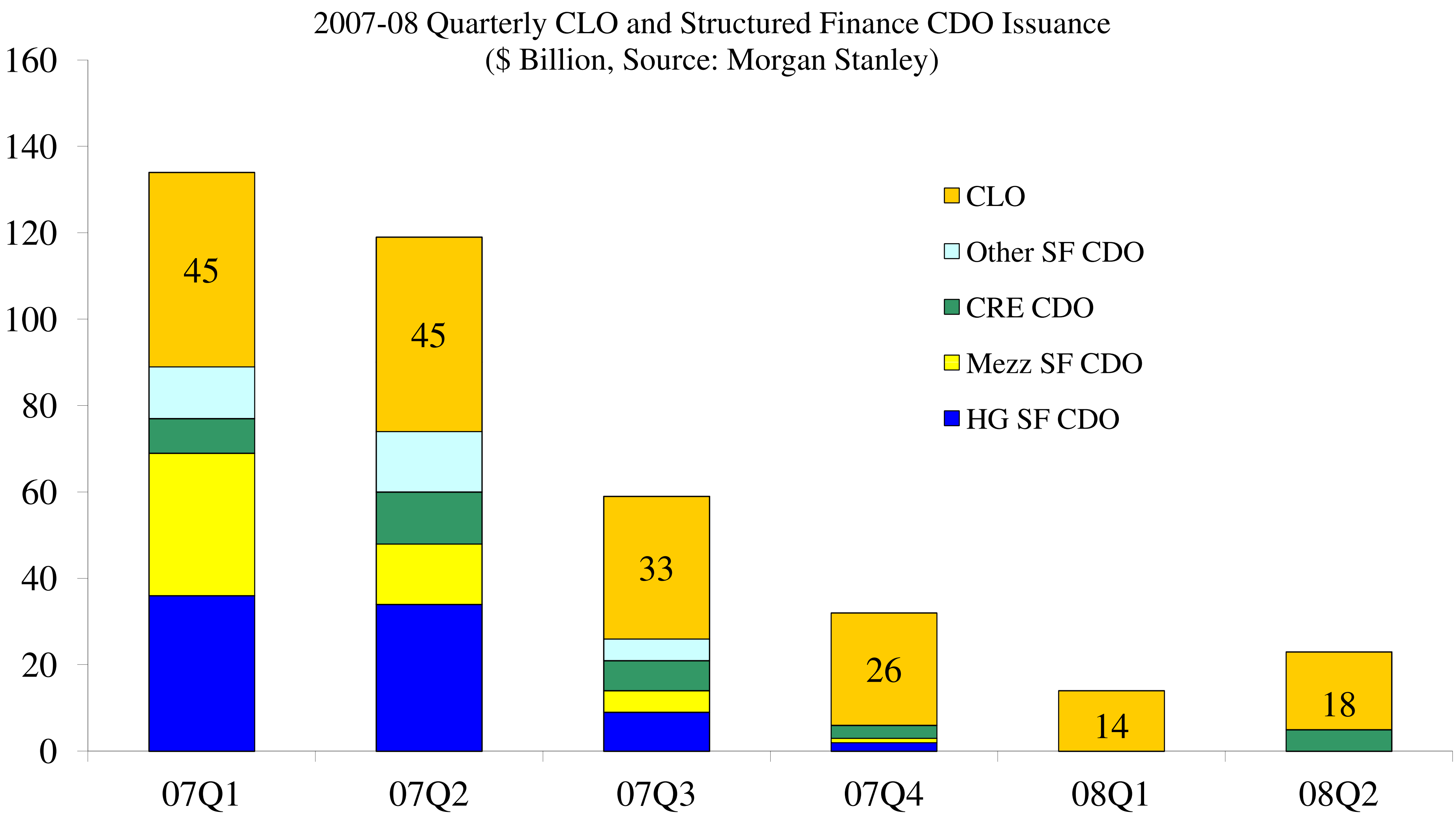
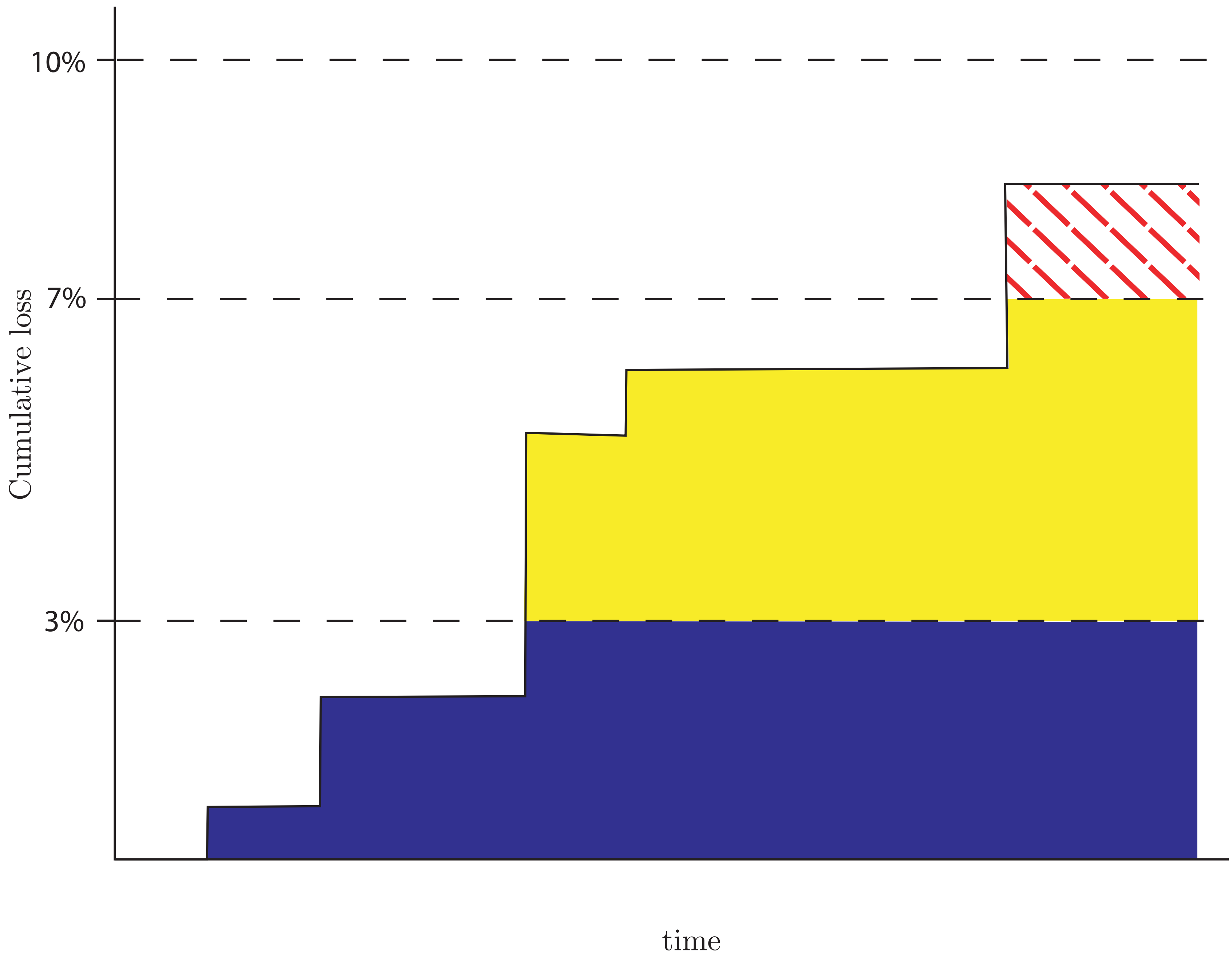


Figure 4: Retention of toxic waste at low leverage.


2007-08 Quarterly CLO and Structured Finance CDO Issuance
($ Billion, Source: Morgan Stanley)
160
140
120
100
80
60
40
20
0
45
45
33
26
14
18
07Q1
07Q2
07Q3
07Q4
08Q1
08Q2
CLO
Other SF CDO
CRE CDO
Mezz SF CDO
HG SF CDO

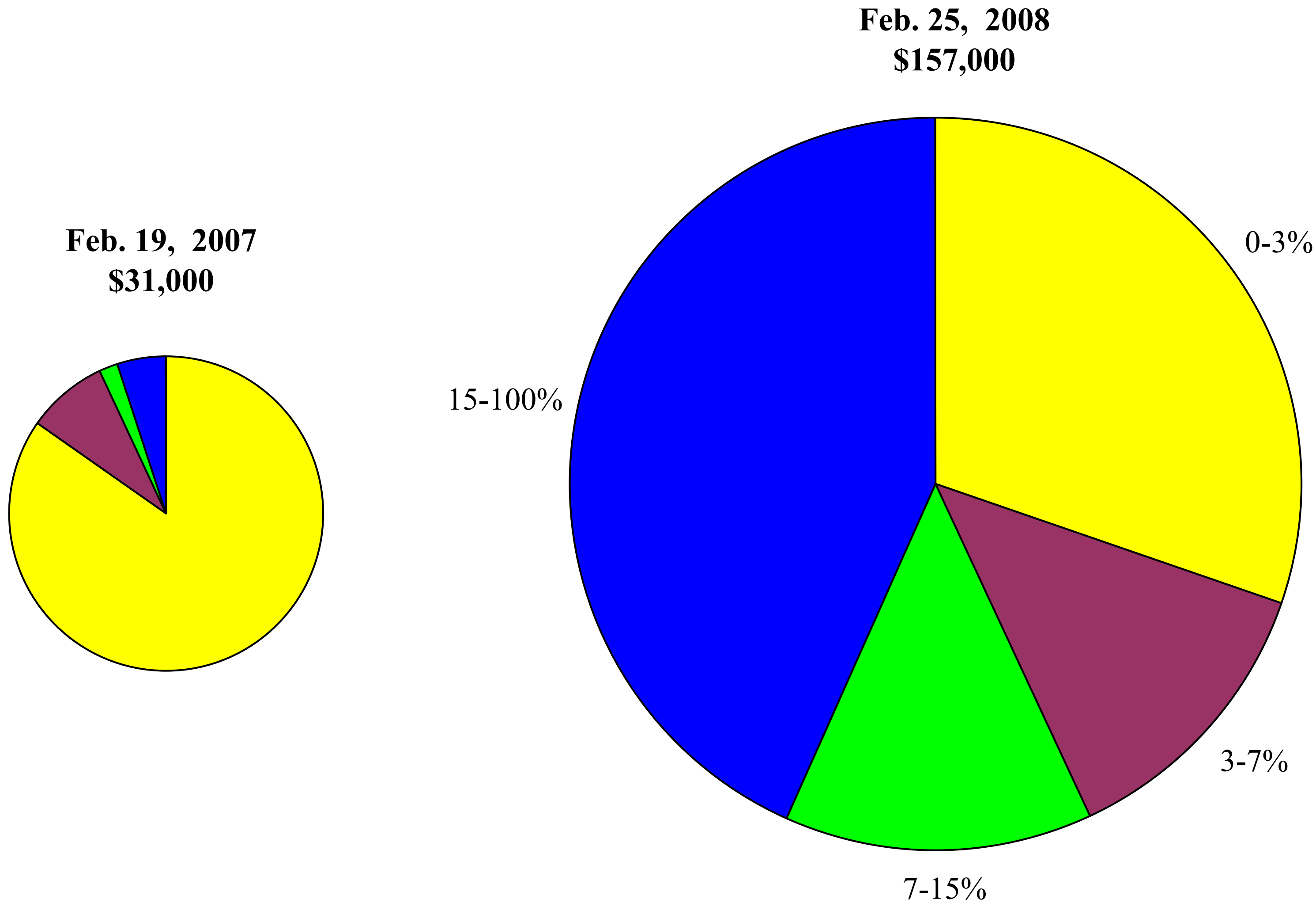
Systemic Risks of Poor Credit Risk Transfer

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).
6. Lost credibility of CRT products.



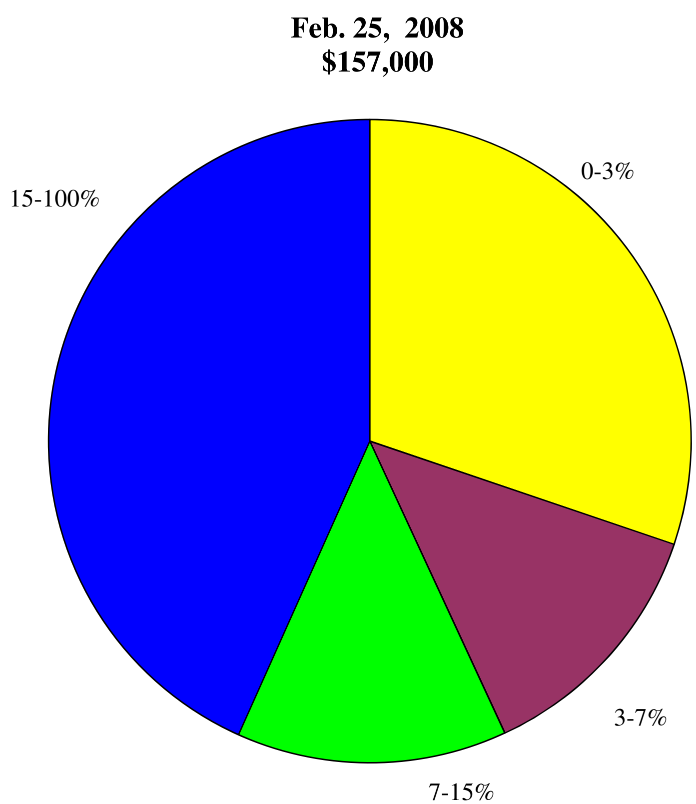
10%
7%
3%
Cumulative loss
time

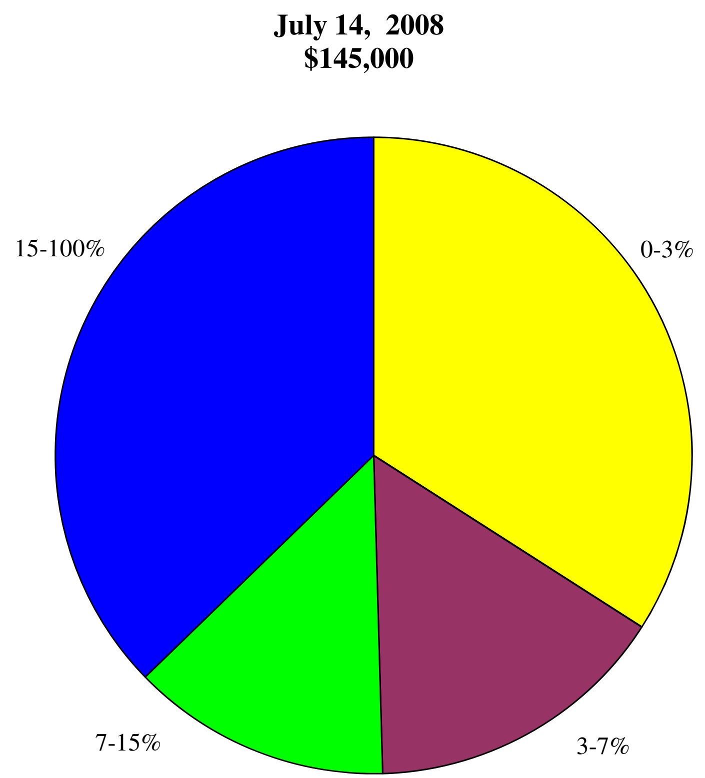
Default Insurance on $10 Million Investment Grade Corporate Debt Portfolio
Annual Premiums on 5-Year Coverage



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





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