

Structured Finance and Credit Risk of European Banks

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Abstract

This study investigates the impact of structured finance on risk management for banks. A linear model derived from the one of Salah N and Fedhila H (2012) is followed, using the sample of European banks which have been employed structured finance from 2001 to 2020. The objective of the study is to find out whether structure finance is associated with any change in the quality of loan portfolios and the level of credit risk of banks. It should lead to the discussion of the relationship between structured finance and banking stability during financial crisis.

Existing literature suggests that banks use structured finance as a risk transfer tool over the last decades to actively manage credit risk. However, empirical studies on the effect of structured finance on credit risk generate mixed results. Gorton and Pennacchi (1995) provide evidence in supporting that securitization is adopted to separate loans from originators, therefore reduces credit risk. Jiangli and Pritsker (2008) find that American bank holding companies use MBS (Mortgage-backed securities) to reduce the risk of insolvency, which is consistent with Casu et al. (2010). More recent studies concentrate on the role securitization has on risk-taking and how it makes banks more aggressive in risk management. Aggarwal and Jacques (2001) and Dionne and Harchaoui (2003) find a positive association between securitization and bank risk in Canada. Krahnen and Wilde (2006), and Baur and Joossens (2006) report the increase of systematic risks after securitization announcements. Michalak and Uhde (2010) find that securitization harms banks' financial stability. Accordingly, the choice of the observation period (e.g. pre or post 2007 financial crisis), the geographic region of the study (e.g. American, Spain), and the underlying asset (e.g. mortgage, credit loan) distinguish the test results.

For the European banking industry, apart from the 2007 financial crisis, the European debt crisis peaked between 2010 and 2012, the Brexit which is formally notified in 2017, and the ongoing Covid-19 have brought persistent challenges. As a consequence, low interest rates, regulatory changes, and competition from shadow banks and new digital entrants are changing the traditional risk management for banks. As one of the most important financial innovations, the role of structured finance played within the banking sector has also been varying over the last decades. An investigation of the changing relationship between structured finance and credit risk helps to justify the mechanism of risk transfer within structured finance, and to clarify the impact of structured finance on banks' risk-taking behaviour under different economic statuses.

The study, hence, could provide new evidence of whether structure finance works for the risk management purpose; moreover, generate recommendations for banks who use structured finance to stabilize financial status under tighter regulation and a more competitive financial market.

Keywords: Structured finance, Credit risk, Banking stability, Financial crisis

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