

Global financial crises and the future of securitization essay



GLOBAL FINANCIAL CRISES AND THE FUTURE OF SECURITIZATION Contents

1. Introduction.....	3	2.
Overview.....	3	3.
Structured-finance securitization	5	4.
Key segments of the securitization market.....	6	5.
Rating Agencies Deficiencies.....	8	6.
Future of Structured-finance securitization.....	10	
7. Conclusion.....		
11 8. References.....	12	

LIST OF FIGURES Figure 1.

Securitization markets: key participants.....4 Figure 2.

European securitization issuance 2002-2010..... 7 Figure

3. American securitization issuance 2002-2010..... 7 1.

Introduction This case describes and analyzes how securitization and structured products work and the value they add to finance, and how structured products are constructed, their value and how they are used in finance. The 2007 – 2009 financial crisis was a key catalyst for the global liquidity crisis that mutated into a full-blown credit crisis, bringing the international financial system to the edge of the abyss.

In hindsight, the numerous structural shortcomings of the structured- finance securitisation market – particularly in the US – may have seemed obvious.

The misalignment of incentives was evident in every link along the structured-finance securitization chain. Proper risk evaluation was not always undertaken by professional investors and intermediaries, while too much faith was put in credit rating agencies whose own methodologies for valuing

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complex structured finance products were at times flawed. In addition, other gatekeepers of the public trust including auditors, securities lawyers, regulators and supervisors failed, to varying degrees. 2. Overview In general, securitized instruments can be defined through three distinct characteristics[1]: 1) pooling of assets (either cash-based or synthetically created); 2) delinking of the credit risk of the collateral asset pool from that of the originator, usually through the transfer of the underlying assets to a finite-lived, standalone special purpose vehicle (SPV); 3) tranching of liabilities (ie issuance of claims with different levels of seniority) that are backed by the asset pool.

One implication of the pooling and tranching that characterizes securitization markets is the need to involve a relatively large number of parties in the securitization process (Figure 1). Figure 1. Securitization markets: key participants [pic] The process starts with the originators, who extend loans or other forms of credit to ultimate borrowers. Those originators who, in the ordinary course of business, do not retain a portion of the loans that they have extended will have weakened screening incentives, something that may be exacerbated by business models emphasising volume over quality.

Credit rating agencies have been another important part of the process, supplying investors with assessments of the credit risk (expressed as expected loss or probability of default) of securitized instruments. Because of the high proportion of their rating revenues derived from structured finance prior to the crisis, rating agencies may have been encouraged to rate highly complex products for which little or no historical performance data existed.

At the end of the securitization chain, investors are usually expected to exert

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discipline on other parties involved in the production process through the price mechanism. . Structured-finance securitization Securitization has traditionally offered banks with a key source of long-term funding, and thereby allowed for improved balance sheet management. It has been credited with increasing the availability of credit, while decreasing its cost. Investors also benefit from securitization by gaining direct risk exposure to diversified sectors of the economy. More generally, the key benefit of structured finance securitization was said to be the ability to disperse and redistribute credit risk to a broader and more diverse investor base.

Ironically, risk concentration turned out to have risen sharply, and was a key contributor to the widespread banking sector losses witnessed during the global financial crisis. In the run-up to the financial crisis, banks were allowed to significantly leverage up their balance sheets with limited disclosure, concentrating both their investment and funding needs in an asset class that proved to be illiquid at the first signs of financial stress. Financial stability was also weakened because securitization led in several instances to a lowering of banking standards[2].

A number of new structured products became overly complex and opaque, while risks were seriously underpriced[3]. The considerable size of the securitization markets made them an important factor in the global “liquidity-cum-credit crisis”. However, it is important to note that not all structured-finance securitization was as unsound as was the case in the US subprime mortgage sector[4], which by itself represented less than 10% of all US securitised mortgages.

Securitization acted primarily as a legitimate funding tool in Europe, as opposed to securitization being an “end in itself” for capital arbitrage reasons as was often the case in the US. Moreover, there was much less disengagement by European underwriters (and hence, more “skin in the game”) than by their US colleagues, and regulation and underwriting standards were seen to be significantly more robust in Europe. It was never really a credit story for the European securitization market, but one of investors taking mark-to-market losses as securitization markets became illiquid and prices fell.

In the wake of the crisis, structured-finance securitization issuance has dropped sharply. Key segments of the market continue to rely on government-backed liquidity and asset purchase programs. Yet despite the aforementioned structural shortcomings, it seems likely that in the long run, structured-finance securitization will once again become an important channel for debt markets; in the shorter term, securitization may even rebound to support the global economic recovery, provided certain important pre-conditions are in place. . Key segments of the securitization market Prior to the global financial crisis, benign economic and financial conditions fuelled an explosion in global securitization issuance. Following the crisis, issuance of private-label securitization slumped. Although there have been some signs of a re-emergence in European issuance in 2010, key segments of the securitization market continue to rely on support from the ECB’s liquidity program, and is aptly named “retained[5]” issuance (Figure 2).

European banks create internally-structured securitisations (typically

Residential Mortgage-Backed Securities) that can be used as collateral for <https://assignbuster.com/global-financial-crises-and-the-future-of-securitization-essay/>

liquidity generation via the ECB, in turn freeing up their own balance sheets for further lending. Figure 2. European securitization issuance 2002-2010, EUR bn [pic] Source: Association for Financial Markets in Europe European “placed” issuance totaled EUR88 billion in 2010, made up largely of UK and Dutch prime RMBS (residential mortgage-backed securities).

While this figure was a marked improvement on the EUR25 billion of placed issuance recorded in 2009, it fell significantly short of the EUR460 billion of placed issuance seen at the height of the market in 2006. Perhaps the best indication of a recovery taking shape in Europe is the increase in “placed issuance as a proportion of total issuance”, from 6% in 2009 to 23% in 2010. At the peak of the market in 2006, issuance of structured finance securitization in the United States was almost four times that of Europe issuance (Figure 3). Figure 3. American securitization issuance 2002-2010, USD bn [pic]

Source: Securities Industry and Financial Markets Association In the US, the federal mortgage agencies (including Freddie Mac, Fannie Mae and Ginnie Mae) are currently funding more than 90% of US mortgages, and as a result are crowding out any near-term recovery in private-label issuance. Indeed, US non-agency issuance fell from USD2.2 trillion in 2006 to a mere USD129 billion in 2010. This 2010 non-agency issuance figure was largely confined to the relatively vanilla segment of ABS (asset-backed securities, excluding mortgages) – in most part made up of auto loans and student loans. . Rating Agencies Deficiencies As in the Penn Central crisis back in the 1970s, most of the companies selling short-term commercial paper were able to do so

because of the prime rating given to those securities by the international
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rating agencies such as S&Ps, Moody's, Fitch and others. In a number of cases, rating agencies rated investments without the ultimate investors knowing exactly what was behind the bonds. In fact, every market player had an incentive to make the deal, regardless of the homebuyers' ability to repay the loan.

The buyer hoped to make a fast profit while the real estate agent and mortgage broker were taking the fees. The banks in turn, by selling rapidly the loan, alleviated much of the implied risk. One of the criticisms addressed to the rating agencies is the fact that they have been notoriously slow in spotting the signs of the crisis. The credit agencies failed to signal company's huge exposure. Then, the regulatory institutions all over the world designed a voluntary code for the agencies.

But this was mainly aimed at sorting out the conflicts of interest whereby agencies were being paid by the companies they rate. Moreover, the agencies have been criticised for giving upbeat assessments of investments which turned out to be linked to risky home loans in the US. The failure of rating agencies to warn over the sub-prime crisis has already made both US and EU to take steps to bring in legislation in order to improve and monitor the performance of the agencies and make them legally responsible for their actions.

Recently, the US Financial Services subcommittee on capital markets said that it would hold a hearing into the role of credit rating agencies in the structured finance market – including mortgage – backed securities. 6 On 11 June 2008 the U. S. Securities and Exchange Commission proposed far-

reaching rules designed to address perceived conflicts of interest between rating agencies and issuers of structured securities. The proposal would, among other things, prohibit a credit rating agency from issuing a rating on a structured product unless information on assets underlying the product was available, prohibit credit rating agencies from structuring the same products that they rate, and require the public disclosure of the information a credit rating agency uses to determine a rating on a structured product, including information on the underlying assets. The last proposed requirement is designed to facilitate “unsolicited” ratings of structured securities by rating agencies not compensated by issuers.

Rating agencies have recently begun to aggressively downgrade large amounts of mortgage-backed debt. In addition, rating agencies have begun taking action to address perceived or actual conflicts of interest, including additional internal monitoring programs, third party reviews of rating processes, and board updates. 7 6 Liberals and Democrats Workshop, *The International Financial Crisis: its causes and what to do about it?*, February 2008. 7 [http://en.wikipedia.](http://en.wikipedia.org/wiki/Credit_rating_agencies_and_the_subprime_crisis)

[org/wiki/Credit_rating_agencies_and_the_subprime_crisis](http://en.wikipedia.org/wiki/Credit_rating_agencies_and_the_subprime_crisis) 6. Future of Structured-finance securitization

The US subprime securitization market played an important contributing role in the recent global financial crisis. Significant regulatory reform efforts have since been undertaken to improve the disclosure and transparency for this asset class in general, the eventual and cumulative effects of which are yet to be fully assessed. Once pre-conditions for a recovery are in place, investor confidence is expected to return, allowing securitization to once again

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become an important channel for both debt markets and the general economy over the medium term.

During this transition period, it is important for market participants and regulators to weigh the costs associated with regulatory changes versus the benefits that securitization can offer through the redistribution of credit risk. The risk remains that should a recovery in securitization fail to materialize, banks will be forced to raise capital from other sources in order to meet heavy securitization redemption schedules over the coming years. The financial sector depends upon a well-functioning securitization market, one that is built on simple structures and a high level of transparency and disclosure.

Creating the appropriate regulatory framework at the current point in time will help ensure sustainability of the securitization market over the longer term. A sustained recovery in private-label securitization is unlikely to occur until policy makers have enough confidence in their economies to allow securitization markets to be weaned off government support. In this context, important steps are being put in place that should allow the banking sector in developed countries to return to a modicum of good health.

Improvement in housing market conditions is also important to re-establish confidence among consumers, investors and financial sector participants. In the medium term, the US Administration is planning an eventual exit from the securitization market by its government-sponsored agencies, in favour of a return by private interests in the housing-related securitization markets.

This process is likely to take a number of years. 7. Conclusion Over the last

years, there have been an increased interest on the issues concerning financial stability.

However, in spite of the warning signals given by preceding crises, changes required to minimise the impact of future crisis have been slow to being implemented. Numerous recommendations have been made by various working groups, supervisory committees, etc. But decisive measures have, so far, been limited. Structured finance instruments are useful because they offer a higher dispersion of credit risk. But higher dispersion is not automatically a better one; recent events have cast doubts over the functioning of securitised lending.

One problem is that adding structured instruments to a bank's portfolio has proved that it can lead to unanticipated risk concentrations, which, given the existing state of market knowledge together with the current supervisory and regulatory framework, are difficult to be dealt with. Another problem relates to various aspects pertaining to rating agencies in structured finance operations. There are a number of proposed strategies for action that would lead to improved financial stability.

Strengthening national supervisory and regulatory frameworks, improving transparency, regulatory and public disclosure and finally, adopting an international approach to exercising effective surveillance, regulation, and supervision of financial activity. Two of the most important policy challenges ahead are those related to transparency and liquidity. But arguably, the most arduous task is to combat the scope for higher systemic risks when financial innovation is very intense. 8. References 1.

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