

# [The role of assets securitization in the financial crisis finance essay](https://assignbuster.com/the-role-of-assets-securitization-in-the-financial-crisis-finance-essay/)

## ABSTRACT

In looking at the role of assets securitization in the financial crisis of 2007-2009; we looked at the definition and tried to understand the workings of the financial innovation asset securitization, how asset securitization tends to benefits Large complex financial institution, and was used to the detriment of the financial world. A quick look at what information asymmetries comes to play in asset securitization. Then the paper asset securitization in the mortgage market, the exposure to risk that the mortgage market caused the LCFI and how asset securitization aided the financial crisis.

## INTRODUCTION

The origins of securitization in the United States was traced to the late 1970s when the word itself first appeared in the Wall Street Journal by Ranieri (1996). Alan Greenspan (1998) noted asset securitization is one of the major financial innovations to have occurred over recent decades. Asset securitization can be defined as the partial or complete segregation of a specific set of cash flows from a corporation’s other assets and the issuance of securities based on these cash flows, i. e exchanging one asset for another (Iacobucci and Winter. 2005: 161). The types of financial assets involved in asset securitization transactions are often receivables (Schwarcz 1994). The practice of securitization originated with the sale of securities backed by residential mortgages, but the framework of asset securitization has rapidly expanded from its initial root of mortgages and receivables to other more variable cash flows in home equity loan markets, commercial loan markets, credit card receivables, auto loans, small-business loans, corporate loans, state lottery winnings (Dolan 1998), and litigation settlement payments (Dolan 1998)and other types of loans.

Asset securitization is the transformation of a mix of illiquid individual loans that are combined into relatively similar pools and transformed into highly liquid bonds traded in securities markets and usually, when securities are backed by non-mortgage loans, they are referred to as asset-backed securities (ABS). Securities issued exclusively against credit and loans with mortgage guarantees are referred to as mortgage-backed securities (MBS). Assets like ABS, MBS and it likes are now widely spread in fixed income portfolios at both the institutional and individual investor level. Although the largest and most well known example of asset securitization is the residential mortgage market. The dealings of asset securitization transactions vary, the typical transaction involves the sale by a bank or financial institution (who are called originator) of certain assets on its balance sheet to a trust, corporation or a separate entity, called special purpose vehicle (SPV). Thus, through the asset securitization process, SPV is funded by issuing securities whose payments are backed by the performance of the bought assets. Usually, the securities issued by the SPV to enhance the marketability are usually evaluated by bond-ratings agency, such as Moody’s, Fitch and Standard and Poor’s. The least risky tranches receive the highest credit rating and the most risky tranche receives no rating at all also, like in the event of a private placement, ratings are not always necessary since investors with technical know-how themselves can evaluate the securities (Schwarcz 1994,). The credit rating received depends on the risk of the pool of assets as collateral.

## BENEFITS OF ASSETS SECURITIZATION TO THE BANKS

Asset securitization sometimes can lead to profitability as a result of the reduction in assets and through the reinvestment of the new received funds. Also, when the loans have been transferred to the SPV, the bank decides to monitor and service these loans on behalf of the entity for a fee. This effectively converts income that is based on a margin on assets into a fee collecting income. Then the liquidity created is used to fund new loans, which increases the business for the same or a similar level of assets and capital. Wolfe (2000) notes that banks can create an asset securitization structure through which existing loans are channeled to investors and the cash proceeds are used to generate new loans in order to repeat the process. While under a non-agency structure, the lender will receive cash proceeds net of transaction costs from sale of the securities issued.

For banks, an additional benefit is that securitization reduces the level of regulatory capital required. Calem and LaCour-Little (2004) and Passmore et al. (2002) are of the opinion that, for most mortgage loans, existing regulatory capital levels are too high, creating an incentive to securitize the least risky loans. By securitizing loans the bank is only required to hold capital and reserve requirements against the residual tranche of the SPV that it is forced to keep.

Asset securitization is also an alternative financing source to equity and debt financing and for financial institutions, in contrast to debt, the originator firm does not need to repay. Pennacchi (1988) shows that loan sales allow some banks to finance loans less expensively than by the traditional deposit or equity issue, because bank funds received via loan sales can avoid cost associated with required reserves and required capital.

## INFORMATION ASYMMETRIES IN ASSET SECURITIZATION

In addition to regulatory capital rules favouring securitization, the presence of information asymmetries may also encourage asset securitization. It is believed when the lender as a good information about the borrower’s credit quality than are the purchasers of the securitized debt, the purchasers would then set credit requirement that are higher than those of the lender. Informational asymmetries may therefore arise regarding the returns on the general assets of the firm when investors are equally informed about the possible returns on the assets. This means that issuing claims on the receivables avoids the problem that would be associated with an issue of claims on general assets (Akerlof 1970).

Another understanding of securitized assets is the possibility of informational asymmetries among different classes of outside investors, and the asymmetry is about the securitized assets. Virtually all investors specialize to some degree in information about specific securities. Structured finance is sometimes associated with specialization by financial intermediaries in the valuation of the particular cash flows being offered by the originator. As earlier mentioned, private placement is made for some SPV, for securitization and technical know-how investors that are fully informed about the value of the securities that the services of rating agencies are not purchased (Schwarcz 1994, pp. 138-39).

## ASSETS SECURITIZATION AND MORTGAGE MARKET

Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation popularly known as Fannie Mae and Freddie Mac respectively are government sponsored enterprises (GSE) that have being very important in the development of securitization of mortgages. A brief history of both organisations can give a better understanding; Fannie Mae was created by the U. S. Congress. In its early years, Fannie Mae functioned as a government agency that purchased mainly mortgages insured by the Federal Housing Authority (FHA). Later in the sixties, Fannie Mae became a public corporation and its functions changed. Freddie Mac was chartered by Congress in 1970 to provide stability and liquidity to the market for residential mortgages, whose major function was to focus on mortgages that originated from savings institutions. By the nineties, both Fannie Mae and Freddie Mac were dealing in the purchase of mortgages, for either securitization purposes and mortgage-backed securities (MBS) (large pools of loans are swapped with a single lender) would be issued or just to keep them in their books to sell credit protection to the original lender and this usually enhances liquidity. In the first case, the originating bank retains no stake in the mortgage. In the second case, the bank continues to fund the mortgage and bear the interest rate risk, but obtains the option to sell it off as an MBS (because of the credit protection).

Asset securitization in the mortgage market works like this, large pools of loans are exchanged with a single lender in return for a MBS collateralized by the same pool of loans. Interest on the pool of loans covers servicing costs, and its paid to the originator, a guarantee fee is then paid to the agency, and the balance of the available interest payments are available for the coupon on the security. Also as for the loans held, the agencies purchase smaller pools of loans and combine them into larger multi-lender pools and issue securities backed by them. In either case, the originator can realize all loan fees collected in excess of costs as current period profits and can continue to earn ongoing fees for loan servicing with limited balance-sheet exposure and without any credit risk. Also to note, is another market that developed at about this period, known as the non-agency mortgage-backed securities. Loans that are regarded as too large to meet conforming size limits or do not meet agency underwriting guidelines (Alt-A or subprime)may be securitized in these private label issues, though alternative credit enhancement structures are required, since guarantees are not available from the agencies.

Sub-prime mortgages was setup in other to service a great proportion of low-income and higher-risk households which could be granted access to financial markets and the opportunity to become home owners. The marketing of the sub-prime, alt-A, and home equity loans was reliant on independent mortgage originators who were part of a financial network that developed in parallel to the issuance and securitization of conventional mortgages by the government sponsored enterprises (GSEs) and agencies. As earlier noted the standards of the GSEs were too high for conforming mortgages, and full documentation of the borrower’s financial condition and the valuation of the property was required. While, the sub-prime market operated with less difficulty. The originators wrote the mortgage loans, provided a short-term guarantee (usually 90 days), and sold the loans to private arrangers who pooled the mortgages and MBS.

## EXPOSURE TO RISK

The sub-prime market was not properly regulated and issues or loan quality were not priority for the originators, its was just sales of the loans that was on there mind.

The costs of entry and exit from the industry were pretty low, as long as firms meet the minimum capital requirements they were allowed to operate. Sub-prime mortgages often incorporated low down payment requirements and a significant prepayment penalty. Underwriting standards declined as loan originators focused on collecting fees on loans that they quickly resold. The subprime market laacked transparency and had an undue complexity about its operations and this made purchasers of MBS in the secondary market fail to evaluate the quality of the assets and to take-note of the risks involved. Due to the absence of regulators, the only institutions used as a source of information on the risks of the mortgage-backed securities were the credit rating agencies e. g Standard & Poor’s, Fitch, and Moody’s. These agencies also failed to provide a true assessment of risk. The credit rating agencies received payment for their ratings directly from the issuers of the Financial products being rated, thereby creating a clear conflict of interest and a subsequent tendency for issuers to seek the agency willing to give them the favourable rating. This resulted to an underestimation of the degree of risk associated with these new securities, and the sheer complexity of their design prevented anyone from taking a closer look.

Sub-prime mortgages expanded rapidly in 2000, especially the period between 2001- 2007. Researcher noted that, without the large role played by sub-prime mortgages, the increase in home prices would have peaked earlier: Potential buyers would not have been able to purchase mortgages at such high levels which was inconsistent to there means of livelihood. A few other financial innovated products that covered-up the risk accompanied the growth of the sub-prime mortgage market. Collateralized debt obligations (CDOs), backed by the cash flow from a portfolio of mortgage-backed securities (MBS), were issued in a series of tranches, where the losses were borne by the equity and junior tranches, giving higher tranches the appearance of greater protection. The transaction appeared to give low-risk senior tranches access to the high returns of the underlying sub-prime mortgages. The rapid growth of these securities occurred in off-balance sheet entities called Structured Investment Vehicles (SIVs), which also led to increases in the size of the issuing institutions without a matching increase in capital.

## Financial CRISIS AND ASSET SECURITIZATION

The financial crisis showed its first signs in the first quarter of 2006 when the housing market turned. A number of subprime mortgages, that were designed with a high interest payment begn to default. Many of the loans were highly risky and only possible due to the clever creation of products like “ 2/28” and “ 3/27” adjustable rate mortgages (ARMs). These loans offered a fixed rate for the first two or three years, and then adjustable rates for the remaining twenty- eight or twenty-seven years, respectively. After the first two or three years, the adjustment of rates would be substantial enough as to be unaffordable for the subprime borrowers; thus, the mortgages were designed to be refinanced. But for the most part, this would be possible for subprime borrowers only if the collateral on the loan had increased in value, otherwise, they would default.

Because these mortgages were all originated around the same time, mortgage lenders had inadvertently created an environment that could lead to a systemic wave of defaults if the price of housing had declined two or three years later, when the mortgages reset (Ashcraft and Schuermann 2008; Gorton 2008). Alas, in 2006 when Ownit Mortgage Solution’s went bankrupt and later on April 2, 2007 with the failure of the second largest subprime lender, New Century Financial, it was clear that the subprime mortgage boom had ended.

The next wave of the crisis began on August 9, 2007, BNP Paribas which is a large, complex financial institutions (LCFI), could not assess the mark-to-market values of their securitized investments backed by subprime mortgages. This led to a suspension of redemptions by Paribas, which, in turn, caused the asset-backed commercial paper market for OBSEs to “ freeze”: Purchasers of ABCP suddenly realized that assets backing the conduits were of such dubious quality that they might have little to no resale value, especially if they were all hit at once with delinquencies and defaults (Acharya et al 2008) and given there was little to distinguish between BNP Paribas’ conduits and those of other financial institutions, the lack of transparency on what financial institutions were holding and how much of the conduit loss would get passed back to the sponsoring institutions caused the entire market to shut down. All short-term markets, such as commercial paper, began to freeze, only to open again once the central banks injected liquidity into the system.

## CONTRIBUTION OF ASSET SECURITIZATION TO THE FINANCIAL CRISIS

Asset securitization without doubt added to the financial crisis in the following ways:

The LCFIs (the universal banks, investment banks, insurance companies, and even hedge funds) that dominate the financial industry, did not follow their mode of operation in terms of securitization and chose not to transfer the credit risk to other investors. They became the major purchasers of these securities, instead of acting as intermediaries between borrowers and investors by transferring the risk from mortgage lenders to the capital market, the banks became primary investors, and this was one of their undoings.

Securitization allowed for lenders to make loans available to riskier borrowers, simply by generally expanding the supply of credit. When originators could securitize their loans, they had a new source of finance for loan origination. The result could have been a reduction in the cost of credit that led to a credit expansion. With lower borrowing costs, households will on average borrow more. Moreover, the lower cost of credit may have made lending to riskier borrowers profitable, resulting in more subprime lending

Mortgages were granted to people with little ability to pay them back, and was also designed to systemically default or refinance in just a few years, depending on the path of house prices. There was the securitization of these mortgages, which allowed credit markets to grow rapidly, but at the cost of some lenders having little, contributing to the deterioration in loan quality. Some securitized mortgages were rubber-stamped as “ AAA” by rating agencies due to modelling failures and, possibly, conflicts of interest, as the rating agencies may have been more interested in generating fees than doing careful risk assessment.

The fact that there was conflict of interest as regards the rating of the assets by the rating agencies allowed room for default, by allowing investors to buy inapproiately rated asset.

Asset securitization were divided into mortgage pools into “ tranches” according to the predicted riskiness of the loans. Holders of shares in the riskier tranches received higher premium payments, but in exchange, they were subject to losses before the holders of shares in the less-risky tranches. Thus, the holders of the least-risky tranches, as determined by the rating agencies got a lower risk payment, but they would feel any effect of non performance in the structured security only after its “ subordinated tranches” had stopped performing through delinquency or default.

Asset securitization allowed for assets to be placed in off-balance-sheet entities, therefore banks did not have to hold significant capital reserves against them. The regulations also allowed banks to reduce the amount of capital they held against assets that remained on their balance sheet, if those assets took the form of AAA-rated tranches of securitized mortgages. Thus, by repackaging mortgages into mortgage-backed securities, whether held on or off their balance sheets, banks reduced the amount of capital required against their loans, increasing their ability to make loans many fold.

All this loop holes allowed for the failure of the likes of Fannie Mae, Freddie Mac, and Lehman Brothers, which invested in the securities created out of these mortgages, which had its toll on the capital markets and thus caused the worldwide recession. Standing behind the collapse of the investment banks and the GSEs was the systemic failure of the securitization market, which had been triggered by the popping of the overall housing bubble, which in turn had been fuelled by the ability of these firms, as well as commercial banks, to finance so many mortgages in the first place. The severity of the resulting recession and its worldwide scope has been magnified by the huge decline in lending by commercial banks, including not just BNP Paribas, Citibank, Royal Bank of Scotland, and UBS, Bank of America, J. P. Morgan Chase, and others, such as Wachovia, IndyMac, CIT Group, that no longer exist. All these banks had been huge buyers of subprime mortgages.

## CONCLUSION

In conclusion, asset securitization, was a very good financial innovation and if it was properly put to use it would have being for great advantage to all the parties involved, the financial institutions, the investors, the government sponsored enterprises and even for the economy has a whole. But the greed and wittiness of investment bankers and financial workers to always want to utilize every financial innovation to their best possible advantage even if it gets to the extent of abuse of the innovation, was what partly caused the financial crisis and thereby eroding the any positive advantage that asset securitization has in the financial industry. One thing is just mean to be noted that for every financial regulations and supervision would always have to be on their toes and constantly evolve as financial innovation springs up, so as to always checkmate the possible abuse by LCFI.