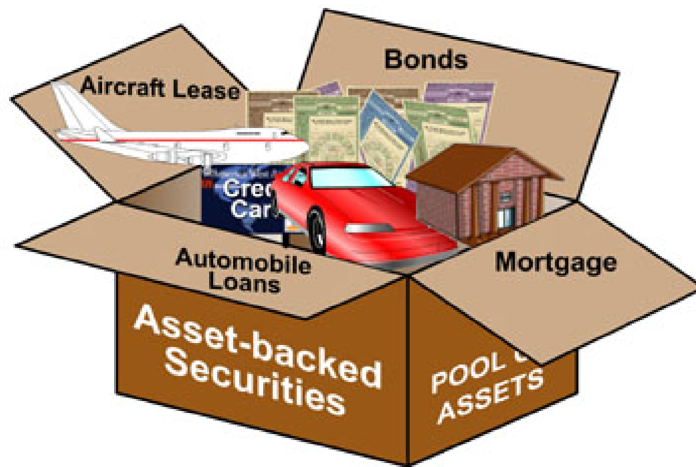
Econ 103 Money and Banking – Dr. Douglas Rice
Week 14 Lecture - Asset-Backed Securities



This week covers securitization, both mortgage backed and asset backed. Asset securitization is taken to mean a device of structured financing where an entity seeks to pool together its interest in identifiable cash flows over time, transfer the same to investors either with or without the support of further collaterals, and thereby achieve the purpose of financing. Though the end-result of securitization is financing, but it is not "financing" as such, since the entity securitizing its assets it not borrowing money, but selling a stream of cash flows that was otherwise to accrue to it.

Securitization is more than just a financial tool. It is an important tool of risk management for banks that primarily works through risk removal but also permits banks to acquire securitized assets with potential diversification benefits. When assets are removed from a bank's balance sheet, without recourse, all the risks associated with the asset are eliminated, save the risks retained by the bank. Credit risk and interest-rate risk are the key uncertainties that concern domestic lenders. By passing on these risks to investors, or to third parties when credit enhancements are involved, financial firms are better able to manage their risk exposures.

Big banks have sold bundles of loans to investors who want assets that have a specific credit quality. The apparent effect is to take loans and risk off banks' balance sheets and thus free up capital. In fact, although it does free up capital, it shifts very little risk from banks' balance sheets, say many regulators. That is because banks have to put aside less capital for the same risks. The Basle committee that considers the rules governing banks' capital ratios is trying to rework them, mainly because it thinks too many banks have found ways to get round the existing capital rules. In 1998, according to the Basle committee, outstanding non-mortgage securitizations of the ten largest bank holding companies amounted to about $200 billion—over a quarter of their risk-weighted loans. For some banks, the combined issuance of asset-backed securities and commercial paper (short-

dated securities) amounted to about half of all their loans. The authors put this down to significant and rapidly growing "regulatory arbitrage", especially among the largest banks. "In many cases the effect is to increase a bank's apparent capital ratio relative to the riskiness of its actual book." Translation: securitization, encouraged by the way regulators treat different sorts of assets, has increased banks' riskiness

Securitization and the more active management of loans are clearly in fashion. Banks used to make loans and keep these on their books until they were repaid. Or, if things went wrong, the loans were written off. Now, banks increasingly look to pass on the credit risk of the loans they originate, preferring to book only the loan-origination fees. In theory, this should shift much of the credit risk of loans away from banks and on to investors in securitized loans. In reality, things are not so simple. Depending on how loans are securitized, much of the credit risk may remain with the originating bank, and to an extent that can be fiendishly hard for anyone, regulators included, to discover.

The securitization process is complex and involves banks playing a wide range of roles. Banks may act as the originator of the assets to be transferred, as the servicing agent to the securitized assets, or as sponsors or managers to securitization programs that securitize third party assets. In addition, banks may act as a trustee for third-party securitizations, provide credit enhancement or liquidity facilities, act as a swap counter-party, underwrite or place the ABS, or invest in the securities.

Banks that securitize assets are able to accomplish several objectives. First, in selling or otherwise transferring, rather than holding, the originated assets, banks are able to 1) reduce their regulatory capital requirements; 2) obtain an additional source of funding, generally at a lower cost; 3) enhance financial ratios; and 4) manage their portfolio risk, e.g. reduce large exposures or sectoral concentrations. As investors, banks are able to diversify their portfolios by acquiring different asset types from different geographic areas.

While benefits accrue to banks that engage in securitization activities, these activities have the potential of increasing the overall risk profile of the bank if they are not carried out in a prudent manner. Generally, the risk exposures that banks encounter in securitization are identical to those that they face in traditional lending. These involve credit risk, concentration risk, operational risk, liquidity risk, interest rate risk (including prepayment risk), and reputational risk. However, since securitization unbundles the traditional lending function into several limited roles, such as originator, servicer, sponsor, credit enhancer, liquidity provider, swap counter-party, underwriter, trustee, and investor, these types of risks may be less obvious and more complex than when encountered in the traditional lending process. Accordingly, there needs to be oversight as to whether banks fully understand and adequately manage the full range of the risks involved in securitization activities.

Securitization is often said to result into financial disintermediation and banks are increasingly facing the threat of disintermediation. When asked why he robbed banks, the infamous American criminal Willie Sutton replied "that's where the money is." No more so, a bank would say ! In a world of securitized assets, banks have diminished roles. The distinction between traditional bank lending and securitized lending clarifies this situation.

Traditional bank lending has four functions: originating, funding, servicing, and monitoring. Originating means making the loan, funding implies that the loan is held on the balance sheet, servicing means collecting the payments of interest and principal, and monitoring refers to conducting periodic surveillance to ensure that the borrower has maintained the financial ability to service the loan. Securitized lending introduces the possibility of selling assets on a bigger scale and eliminating the need for funding and monitoring.

The securitized lending function has only three steps: originate, sell, and service. This change from a four-step process to a three-step function has been described as the fragmentation or separation of traditional lending.

It is, however, important to understand that securitization does not eliminate the need for the intermediary: it merely redefines the intermediary's loan. As capital markets become more complete, financial intermediaries become less important as contact points between borrowers and savers. They become more important, however, as specialists that (1) complete markets by providing new products and services, (2) transfer and distribute various risks via structured deals, and (3) use their reputational capital as delegated monitors to distinguish between high- and low-quality borrowers by providing third-party certifications of creditworthiness. These changes represent a shift away from the administrative structures of traditional lending to market-oriented structures for allocating money and capital.