Repairing the Damage Securitization Caused

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Abstract: The process of transferring loans from banks to institutional investors transformed the traditional bank-based US financial system and made more of the debt and savings of American families subject to the rules and risks of capital markets. Because the process of securitization and its products are inherently complex, opaque and impossible to monitor, it will be difficult to craft reforms that are now widely seen as necessary to ensure improved due diligence, disclosure, simplicity, standardization and curbs on compensation incentives. As an alternative to securitization, incentives to encourage a shift to covered bonds as a source of funding for mortgages and other long- and medium-term loans would accomplish those objectives and help revive portfolio lending – a development that would both increase market stability and mitigate the damaging effects of fair value accounting across the financial system.

Because of its profound impact on the structure of financial markets, securitization – packaging pooled loans for resale in securities markets – is arguably the most important financial innovation that occurred in the final decades of the 20th century. As the process gained momentum, a larger share of the credit banks had once supplied to households was transformed into securities issued by investment banks and sold to institutional investors. At the same time, there was a symmetrical shift in households' savings from banks to pension and mutual funds. As a result, the major portion of borrowing and saving by households moved to the capital markets and the scale of that shift transformed US financial structure from a bank-based to a market-based system. Securitization erased many of the protections households had enjoyed under the bank-based regulatory structure put in place by New Deal reforms in the 1930s and, by 2005, the International Monetary Fund (IMF) noted that households had become the shock absorbers of last resort for the financial system. Subsequently, they were called on to absorb the risks that brought the system to collapse in 2008 when, as taxpayers, they undertook the role of rescuing financial institutions from the consequences of flawed markets for opaque securitized products.

In the following sections, this *Policy Brief* describes key developments that led to and increased the momentum for securitization and analyses some of the reforms proposed to prevent a repetition of the problems it caused. I argue that meaningful reform is not possible if the regulatory and structural flaws in markets for securitized products are not addressed.

The pressure for securitization. Securitization was a solution to the break-down in the structure created in the 1930s to augment the Federal Reserves' control over credit expansion and allocate credit to housing. Under the 1930s structure, interest rate ceilings were imposed on banks and thrifts such as Saving and Loan Institutions (S&Ls) with a half percent higher rate for thrifts to encourage a flow of deposits to institutions that were restricted to making loans for residential mortgages. Put in place when depository institutions held a dominant role in credit markets, this structural framework not only supported housing but also made banks an effective channel for transmitting monetary policy initiatives. Although the Fed had other important monetary tools such as reserve requirements, interest rate caps supplemented its efforts. When the Fed bought or sold Treasury bills in open market operations, it pushed the interest rate on those securities above or below the interest rate caps on banks and thrifts. One outcome of these operations was to change incentives for savers to hold

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funds in deposits or shift to Treasury securities and thus to expand or constrain lending by banks and thrifts.

By the end of the 1960s, interest rate ceilings as a monetary tool had eroded as a result of the buildup of dollar assets and liabilities in the external (so-called euro-) markets. The Fed had decided not to regulate US banks' offshore operations and their foreign branches and affiliates were not subject to interest rate ceilings. At year-end 1969 when the Fed tightened by selling Treasury bills, the largest banks with overseas operations were able to offset the effect of the ceiling by borrowing dollar funds from their branches at higher interest rates and continuing to lend to the US corporate sector. The Fed responded by pushing up interest rates to historically high levels but was unable to shrink the flow of credit through the largest banks. However, the disintermediation effect embedded in the 1930s ceilings had a devastating effect on banks without access to Eurodollars and on thrifts. Thus the brunt of the credit freeze was felt by small businesses and housing.

Securitization, a response to this development, was initiated in the early 1970s to address the effects of the Fed's inability to maintain the interest rate stability needed for mortgage lending. Congress authorized Fannie Mae and Freddie Mac, the government sponsored enterprises (GSEs) engaged in mortgage lending to buy mortgages from thrifts and package them as securities to be sold in the market. It was a solution that allowed thrifts to continue to originate long-term loans for housing by providing a safety valve when interest rate increases raised the cost or dried up the flow of deposits needed to support the loans they held.

But by the end of the 1970s, interest rate ceilings became meaningless as the Fed's efforts to break inflation led to rate increases that were effectively driving thrifts to insolvency. The Monetary Control Act of 1980 ended interest rate ceilings and thrifts were faced with a high and volatile interest rate environment for deposits. The only rational response was to offer adjustable rate mortgages (ARMs) that shifted the interest rate risk to the home buyer and proved to have only limited popularity. Meanwhile, the thrift industry continued to sink under a legacy of long-term, low-interest-rate mortgage loans. The scale of the problem was apparent in the expansion of the GSEs' role in buying and securitizing mortgages. By the end of 1983, mortgage-backed securities (MBS) issued by these agencies totaled $253 billion or 20 percent of outstanding residential mortgages.

A further boost to securitization was given by the Secondary Mortgage Market Enhancement Act of 1984 which facilitated the expansion of the private market for MBS. Banks had joined thrifts in supporting the legislation because the new "originate and distribute" model removed the uncertainty in portfolio lending in the new interest rate environment and was seen as a way to increase profits by bypassing the constraints of reserve requirements and the capital requirements that had been introduced in 1983. Investment banks were already earning large fees for packaging and selling securities backed by pools of mortgages and they, too, strongly supported the legislation. Thus the channel for mortgage finance shifted from an institutional to a market framework that linked a growing number of financial sectors.

While the 1984 Act was easily approved, some Members of Congress and analysts objected to exempting private issues of MBS from registration and disclosure, arguing that relying on the assessments of a few credit rating agencies was an inadequate substitute. Two of the witnesses before

the securities subcommittee of the House Energy and Commerce Committee – Preston Martin, then vice-chairman of the Federal Reserve Board, and Henry Kaufman, a prominent Wall Street economist – opposed the bill and warned that loosening the link between creditors and borrowers would encourage inadequate loan evaluation. Kaufman characterized securitization as permitting a drift toward a financial system in which credit has no guardian.

After passage of the 1984 Act, the MBS market expanded rapidly as less-regulated, non-depository lenders such as mortgage brokers and finance companies began to originate and sell mortgages. Banks stepped up their involvement, encouraged by the fact that the first Basel Accord on capital adequacy (1988) lacked rules covering securitization exposures. By the end of the 1980s, every financial sector had begun to buy, hold and trade MBS. The privileged position of the MBS markets – both private and public – facilitated the build-up of the housing bubble. As MBS filtered into every corner of US financial markets and beyond, the impact of the rising price of housing gave a substantial boost – and posed a major threat – to the savings of American households. When the bubble burst, households' net worth fell because of the drop in the prices of homes, and then fell further as the value of MBS held in their pension and mutual funds declined.

By 2004, the regulatory concerns raised 20 years earlier appear to have been validated. The absence of capital restrictions on banks' securitization exposures and the unregulated status of many mortgage originators resulted in an undercapitalization of what had become the largest US credit market. As the market developed, most MBS carried high ratings and continued to do so even as the volume of sub-prime mortgages increased. Credit rating agencies, issuers and investors appear to have believed that securitization could actually diminish the risk of sub-prime mortgages when pooled. However, as the crisis unfolded, the absence of disclosure about the pools of mortgages backing these securities contributed to the severe disruption in confidence within the financial system that has exacerbated the credit crunch and made efforts to negotiate loan work-outs far more difficult than in the past. Moreover, managing the crisis has required unprecedented levels of government intervention, including the conservatorship of Fannie and Freddie.

Going forward, however, it is difficult to believe that pressure for securitizing mortgages as well as car loans and other forms of consumer credit will not continue. The removal of interest rate ceilings for depository institutions and their ongoing exposure to a volatile interest rate environment means that holding long-term mortgages and even medium-term car loans in portfolio presents a level of uncertainty and the ongoing threat of insolvency that no increase in capital requirements could alleviate. Reform proposals will, therefore, need to address the concerns that have been raised by this innovative financial technique.

Reform proposals

Higher capital ratios appear to be the one-size-fits-all solution to any area that has been identified by the financial crisis as needing reform [see, for example, US Treasury, 2008; Financial Stability Forum, 2008; Group of 30, 2009, International Monetary Fund, 2009). Concern about adequate capital for banks' exposure to MBS has been addressed in the Basel II requirements but there is concern that these ratios may not be high enough given the low prices at which private investors are willing to buy MBS from banks. Moreover, the widespread losses on MBS and related derivatives throughout the

financial system suggest that failing to apply higher capital ratios to exposures of other financial institutions such as finance companies, brokers and hedge funds that originate and/or trade and hold securitized products would not only give those institutions a competitive advantage over banks in terms of profitability but, equally important, would fail to address the systemic implications of an undercapitalized MBS market. The requirements for capital coverage of securitized exposures should be uniform and cover all appropriate institutions.

Improved disclosure. The Financial Stability Board – a multinational organization of central bankers and regulators – and the IMF propose reforms that will provide disclosure and greater transparency at each stage of the securitization process. Some economists stress the need to evaluate the risk of each underlying mortgage and ensure that the owners of MBS as well as mortgage borrowers can be identified to facilitate workouts if needed. The opaque character of the pools of mortgages backing MBS has intensified the problems in establishing value as house prices fell and impeded efforts to help homeowners renegotiate mortgages and avoid default. The losses attributable to insufficient information suggest that MBS issuance should not be permitted going forward without insisting at a minimum on the same requirements for disclosure that apply to the issuance of all other securities. But in the case of MBS, disclosure of information about the assets in the pool is also needed.

Simplification, standardization and documentation. The IMF and others propose that securitization products be simplified and standardized and that *transactions* be documented to the extent possible. That would go a long way toward increasing transparency of both the instruments and the market but not far enough. Nevertheless, accomplishing those objectives would make it possible to move toward the next critical step: requiring that MBS and other securitized products are traded on exchanges to provide real-time information about prices and the volume of trading to investors.

Addressing compensation incentives. Faulty compensation incentives is a familiar theme in assessments of the causes of the crisis. In the case of MBS, compensation based on quantity targets or on the amount of risk passed along the chain are two of the more egregious examples. The IMF suggests such practices be discouraged. Outlawing them altogether would be a more effective way to reinstate due diligence in the securitization process.

Improved quality standards and incentives for due diligence. The relaxation of loan-to-value ratios and screening of borrowers' ability to pay were certainly among the contributing factors to the crisis involving securitized assets. More stringent and prudent standards must be reinstated to remove the systemic threat posed by securitization. But other incentives to ensure more diligent assessments of the loans underlying securitized products are also needed. Often characterized as "increasing skin in the game", proposals that deal with that reform would require institutions to retain a meaningful share of the credit risk they are packaging into securitized and other structured products. Those making such proposals include the Group of 30 under Paul Volcker's leadership, the US government, the European Parliament and many economists. The IMF is less than enthusiastic about these proposals, arguing that retaining too large a share of the credit risk could make some types of securitization too costly and shut down some markets. But, given the amount of MBS held throughout the financial system and the impact of losses on the values of pensions and household savings, the need to protect the ultimate investors in these securities is as high a priority for reform as the goal of restarting the markets.

Covered bonds as a complement/replacement for securitized products. Covered bonds have long been used in Europe to fund longer-term assets held in banks' portfolios. It is a practice that gives banks access to capital markets for funding and can be used to comply with liquidity ratios. The asset covering for the bonds is segregated (ring-fenced) to protect the bondholders against the credit risk posed by the lender while the lender is protected from the interest rate and market risk of having to roll over short-term funding while holding long-term, non-tradable assets. But, while passing on the interest rate and market risk to the bondholders, the lender retains full exposure in the event that one or more of the loans becomes non-performing or defaults. The IMF notes that advocates for covered bonds argue that the sharing of risks on long-term assets by both lenders and funders ensures that both have strong incentives to engage in diligent screening of the credit risks they assume. Moreover, it is a much simpler method of structuring the funding for long-term assets like mortgages and could be used by non-depository lenders as well as banks (IMF, 2009).

Conclusion

Secretary of the Treasury Timothy Geithner has said that addressing the fundamental ways in which the system failed will require comprehensive reform – not modest repairs at the margin, but new rules of the game. Because securitization is inherently complex, opaque and impossible to monitor, attempts to impose new rules on that process are likely to produce only modest repairs at the margin. Introducing covered bonds as an intended replacement for the securitization process is the kind of reform that would provide the new rules needed to accomplish many of the objectives described above: improved due diligence, disclosure, simplicity, standardization, and curbs on compensation incentives. Moreover, a shift to covered bonds as a way of funding mortgage lending would go a long way toward reviving the role of portfolio lending in credit markets, would increase market stability and mitigate the damaging effects of fair value accounting on capital across the financial system.

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