

## REPAIRING THE DAMAGE SECURITIZATION CAUSED

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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. The securitization process transformed the US financial structure from a bank-based to a market-based system and erased many of the protections households had enjoyed under the bank-based regulatory structure put in place by New Deal reforms in the 1930s. Originally developed in the early 1970s as a response to the Fed's inability to maintain the interest rate stability needed for mortgage lending, securitization was propelled by two key legislative acts. First, in the early 1970s 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. 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. As a result, the MBS market expanded rapidly as less-regulated, non-depository lenders such as mortgage brokers and finance companies began to originate and sell mortgages. However, by 2004, 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, and culminated in the latest financial crisis and the unprecedented government intervention aimed at rescuing the financial sector.

### Reform proposals

Reforms that have been proposed to prevent a repetition of the problems caused by securitization include:

- Higher capital ratios: This measure has emerged as the one-size-fits-all solution to all concerns for reform. However, in order 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: Increasing disclosure and transparency at each stage of the securitization process allows for the evaluation of the risk of each underlying mortgage and helps to ensure that the owners of MBS as well as mortgage borrowers can be identified if needed. Moreover, MBS issuance should not be permitted going forward without insisting at a minimum on the same requirements for disclosure (including disclosure of information about the assets in the pool) that apply to the issuance of all other securities.
- Simplification, standardization and documentation: 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: compensation based on quantity targets or on the amount of risk passed along the chain must be outlawed in order to reinstate due diligence in the securitization process.
- Improved quality standards and incentives for due diligence: More stringent and prudent standards must be reinstated to remove the systemic threat posed by securitization. However, it is also necessary to introduce other incentives that ensure more diligent assessments of the loans underlying securitized products. Institutions should be required to retain a meaningful share of the credit risk they are packaging into securitized and other structured products.
- Covered bonds as a complement/replacement for securitized products: Unlike the reforms above, which only would provide improvements at the margin, the replacement of securitization by a system of covered bonds would provide the new rules needed to accomplish many of the objectives mentioned so far. 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. Thus, covered bonds allow for the sharing of risks on long-term assets by both lenders and funders and ensures that both have strong incentives to engage in diligent screening of the credit risks they assume.

## References

D'Arista, Jane (2009). "Repairing the Damage Securitization Caused," Political Economy Research Institute, October.