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Asset Securitization: Revolution, Evolution, Devolution. The Rise and fall of the Most Important Financial Instrument in Banking

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Asset Securitization: Revolution, Evolution, Devolution. The Rise and Fall of the Most Important Financial Instrument in Banking.

In May 2008, Mr. Nechemia announced that he saw a systemic financial crisis brewing and warned that in the months to come the United States was likely to face a once-in-a-lifetime financial crisis, an oil shock, sharply declining consumer confidence and, ultimately, a deep recession. In that article he also foretold of homeowners defaulting on mortgages, trillions of dollars of mortgage-backed securities unraveling worldwide and the global financial system shuddering to a halt. Many were pessimistic as well as dismissive of his analysis. Six months later, his forecasts proved accurate.

As a response for UNCTAD call for paper, Mr. Nechemia has authored the following article on Asset Securitization. It describes the history of the creation and evolution of the-then revolutionary Asset Securitization product and the various permutations the product morphed into since first being introduced into the United States banking and credit system in the 1970s. It enabled the unprecedented growth of markets in both the U.S. and abroad, set new benchmark standards of innovation and productivity, credit enhancement and risk analysis, but in the end, left unchecked and to open market devices, is what he suggests, contributed greatly to the U.S. financial collapse. Today, many measures are required to repair what has become a badly damaged international financial system and proven dysfunctional financial architecture; readers will find this article, as others Mr. Nechemia has authored exclusively for our publication, interesting, fascinating, provocative and even useful to those who call investment banking their profession.

Advance in Contemporary Financial Technology

Securitization got its start in the 1970s, when home mortgages were pooled by U.S. government-backed agencies. Starting in the 1980s, other income-producing assets also started to become securitized. Since then, securitization technology evolved rapidly and was adapted to various types of asset class, and in recent years the market has grown and the use of securitization has grown dramatically. In some markets, such as those for securities backed by risky subprime mortgages in the United States, the unexpected deterioration in the quality and value of some of the underlying assets undermined investor confidence.

Asset securitization has been recognized by eminent academics as the most important engine of reform in our financial system to emerge in recent times (Greenbaum and Thakor 1995) and it is viewed as a revolution in the banking and financial services industry by industry practitioners. In its simplest form, it is a process where ill-liquid assets owned by a financial institution, are pooled and sold in the legal or economic sense, to a third party referred to as a Special Purpose Vehicle (SPV). The SPV in turn issues securities backed by these asset pools in financial markets to the general public, usually after obtaining some form of credit quality enhancement to the securities. Securities marketed in this manner are referred to as asset backed securities (ABS).

Asset securitization was initially practiced by financial institutions that securitized home mortgage loans, transforming them to mortgage backed securities.

Over time asset securitization has emerged as a main funding option for commercial banks to redress growing monetary constraints and acquire diversified sources of liquidity. Commercial banks have traditionally funded themselves on a short-term basis. However, over the recent two decades, they have come under pressure from the customers to improve their term financing as retail deposits have not always kept up with surging credit growth of mortgage and consumer loans.

Aside from senior debt, balance sheet securitization of residential mortgages and later on the securitization of retail credit has become a key mechanism to fund the US housing deficit. The bank-sponsored securitization of retail asset portfolios, in particular car loans and residential mortgages has been the main source of supply, with the biggest securitization asset classes mapping directly how the bank's major loan portfolio are comprised.

Since its inception, the basic asset securitization process has now been extended in a variety of ways. Asset securitization techniques are now applied to a wide range of different asset classes, and by a variety of institutions ranging from financial institutions to trading and manufacturing firms, and infrastructure project operators. Non-financial institutions adopt asset securitization techniques principally as a financing technique, and as a means of enhancing corporate liquidity.

Structured financing is an extension of asset securitization, which adds a degree of complexity to the basic process. In structured financing the traded securities created by the securitization process are structured into several classes of derivative securities with different characteristics and sold to investors whose investment requirements match those of these particular type(s) of securities. Structured financing has added value to the basic asset securitization process and further served to develop the growth of asset-backed financial markets.

With the advent of credit derivative products, a further innovation in asset securitization processes has emerged in the form of a product called Synthetic Securitization. In Synthetic Securitization, a financial institution holding a pool of assets transfers the credit risk attached to the asset pool to a third party by means of credit derivatives, rather than by the direct transfer of ownership of the assets. This "transfer" might also take place via a credit default swap, or a total return swap to transfer the credit risk attached to an asset pool to a third party, rather than by selling the assets.

The popularity of Synthetic securitizations among financial institutions has given rise to concerns about the regulatory aspects of addressing the risks associated with synthetic securitization. Synthetic securitization has advantages over conventional securitization because the legal cost associated with the transfer of asset ownership is avoided. Determining the capital requirements relating to Synthetic Securitizations can be complicated due to uncertainties regarding the degree of risk transference and the extent of risk retained by the originator. These myriad issues and ways to address them are presently under review by the Basel Committee on Bank Supervision, with reports forthcoming.

The Subprime Implosion of the U.S. Housing Market

Subprime mortgages are predominantly securitized in the form of mortgage-backed securities (MBS). These securities are enhanced with mechanisms to protect higher-rated tranches from shortfalls in cash flows from the underlying collateral (for instance due to defaults or lower than expected interest income). These mechanisms include various kinds of explicit insurance, for instance as provided by mortgage insurers. However, most of the credit enhancement comes from structural features such as subordination, overcollateralization, and excess spread.

Until the subprime crisis exploded on the U.S. housing market, the impact of securitization appeared largely to be positive and benign. But securitization also has been indicted by some for compromising the incentives for originators to ensure minimum standards of prudent lending, risk management, and investment. This, at a time when low returns on conventional debt products, default rates below the historical experience, and the wide availability of hedging tools were encouraging investors to take more risk to achieve a higher yield. Many of the loans were not kept on the balance sheets of those who securitized them, perhaps encouraging originators to cut back on screening and monitoring borrowers, that subsequently resulted in a systematic deterioration of lending and collateral standards issued by financial institutions and its impact on markets not just in the United States, but by extension, world-wide.

Government bodies, such as but not limited to, the US Securities and Exchange Commission **(**SEC**)** and the Federal Reserve Board of Governors in Washington DC, together with the international organization failed to understand the evolution in financial technology, and perhaps were not sure as to which of the government agencies has responsibility for oversight. This led to lack of oversight coupled with a failure to establish new guidelines that would mitigate risks associated with evolution of contemporary financial technology by imposing stricter safety standards and higher capital requirements in overall terms on the financial institutions in developed financial markets, compared to the previous standards contributed greatly to the present day global financial debacle. Both the scale and persistence of the attendant credit crisis seems to suggest that securitization—together with poor credit origination, inadequate valuation methods, and negligently insufficient regulatory oversight—have severely damaged global financial stability.

I contend that the minimum-risk-based capital requirements set by the 1988 Basle Capital Accord, which are based on arbitrary definitions of asset categories, do not necessarily correspond to their true credit risks, and therefore, are not determined in accordance with any meaningful goals of prudent regulation. For example, clamor for regulatory capital arbitrage engaged by banks is the natural reaction of banks to exploit a set of weak and ineffective regulatory rules.

From Healthcare to Financial Instruments: A New Monitoring System for Banking and Financial Institutions

Financial innovation in products and institutions may reap rewards, but is likewise potentially harmful. There is without question, as proven, a drastic need to regulate financial innovation. I propose to model a solution after by the US- Food and Drug Administration ("FDA"). The FDA is an agency of the United States Department of Health and Human Services and is responsible for regulating and supervising the safety of foods, dietary supplements, drugs, vaccines, biological medical products, blood products, medical devices, radiation-emitting devices, veterinary products, and cosmetics.

The programs for FDA safety regulation vary widely by the type of product, its potential risks, and the regulatory powers granted to the agency. For example, the FDA regulates almost every facet of prescription drugs, including testing, manufacturing, labeling, advertising, marketing, efficacy and safety, yet FDA regulation of cosmetics is focused primarily on labeling and safety. Here's how it works:

a. First, there is an officially published report similar in nature to the report which is published by the FDA, *"Market Withdrawals and Safety Alerts."* This report will publish "Safety Alerts" which includes but is not limited to a positive list of financial instruments

and institutions. Other issues and programs to consider when monitoring and administrating financial product innovation also include: Critical Path Initiative, "investor's rights to access unapproved financial instruments," and "Post-marketing instrument safety monitoring." Anything that is not explicitly allowed under any of the programs, which are officially sponsored by the Agency are considered strictly forbidden.

b. To get a new instrument or new institution approved, there will have to be testing, scrutiny by regulators, supervisors, academic specialists and other interested parties, and pilot projects. It is possible that once a new instrument or institution has been approved it is only available "with a prescription." For instance, only professional counterparties rather than the general public should be permitted.

c. This approach to financial innovation likely would slow down financial innovation. It may even kill off certain innovations that would have been socially useful. This is the price we must pay to properly and appropriately regulate the industry and protect the public, and even our financial institutions and systems. As we have seen, the dangers of unbridled financial innovation are too manifest.

d. Practices should be instituted that protect the intellectual property rights of "applying person's or institutions" who pursue the creation and development of "innovative financial products and instruments."

THE CREDIT RATINGS AGENCIES

Obtaining a Satisfactory Credit Rating

One of the critical factors determining the success or otherwise of an asset securitization process is the credit rating obtained for the securitized debt sold to the market. The credit quality of the security is directly related to the yield of the issue. The higher the credit quality the lower will be the yield and the more successful will be the issue. The credit rating must also achieve at least the threshold investment grade. A lower than investment-grade quality rating will not be favorably viewed by investment funds and other institutional investors, resulting in an unsuccessful security issue.

Securitization and the development of complex structured credit instruments have undeniably improved access to credit. However, they may also have contributed to greater (and now in hindsight clearly unnecessary, unwarranted and unsubstantiated) aggregate risk-taking and, instead of resulting in an efficient dispersion of risks, have led to a destabilizing shift of risks toward institutions that could not adequately manage them; moreover it has had a counter effect, presently and dramatically seen in the reversion of some of these risks to banks that had supposedly offloaded them, and to much more uncertainty about the actual distribution of risks among market participants. In addition, both banks and the off-balance-sheet Special-Purpose Vehicles created in the securitization process have come to rely excessively on wholesale funding markets, thus incurring maturity mismatches without adequate consideration of the risks of such funding, that we have now seen all but disappear. It is further true that the originating and arranging entities lacked appropriate credit screening and monitoring incentives, with many investors failing to sufficiently question such incentives or examining the quality of the loans underlying structured products.

Instead, institutions/investors, rightly or wrongly, relied excessively if not ostensibly, on the reputation of the institutions involved and on the credit ratings of the instruments.

Quality of the rating process and conflicts of interest

Credit rating agencies have assigned high ratings to complex structured subprime debt based on limited historical data; in some cases, on flawed models; and on inadequate due diligence of underlying collateral. Agencies also failed to adequately disclose assumptions, criteria, and methodologies; they failed to clarify the meaning and risk characteristics of structured finance ratings; nor did they address conflicts of interest. Finally, financial institutions did not always sufficiently disclose the type and magnitude of their on- and off-balance-sheet risk exposures, particularly those related to structured products

Furthermore, shortly after the eruption of the current financial crisis, and after heavy criticism, the various credit rating agencies started taking the necessary steps to revise rating methodologies for structured products; only now are they taking steps to separate rating activities from other business activities; delink rating managers' compensation from the financial performance of their business unit; enhance the surveillance of the rating process; and strengthen internal oversight of rating methodologies.

Moreover, the International Organization of Securities Commissions should revise its *Code of Conduct Fundamentals for Credit Rating Agencies* to further improve the quality of the rating process, address conflicts of interest, and provide investors with more data on the historical performance of ratings by supplying more information on rating methodologies and criteria, and on how data limitations are addressed.

Uses of ratings.

Investors should not use ratings to replace strong risk analysis and management methodologies that would be consistent with the complexity of the instruments they buy and relative to the importance of their holding. In this context, supervisory authorities might consider reviewing the use of ratings in regulations to ensure that such use does not induce uncritical reliance on credit ratings as a substitute for independent evaluation.

A Remedial Approach to Endemic Problems

a. Rating agencies should be turned into single-activity or single-product line firms. They should provide just ratings, not any other products or services, including advice. The programs for Rating agencies vary widely by the type of product, its potential risks, and the regulatory powers granted to the agency. For example, the FDA regulates almost every facet of prescription drugs, including testing, manufacturing, labeling, advertising, marketing, efficacy and safety, yet FDA regulation of cosmetics is focused primarily on labeling and safety. The FDA regulates most products with a set of published standards enforced by a modest number of facility inspections.The conflict of interest in combining rating activities with advisory services or the sale of other lucrative services or products to customers looking for the best possible rating is obvious and inescapable. Chinese walls don't work and proven to be very ineffective. The Great Wall of China did not keep the barbarians out or the Han Chinese in.

b. The quasi-regulatory role of the rating agencies in Basel II should be eliminated or amend.

c. The customer wishing to have his company, country or instrument rated does not pay the rating agency, ex-ante or ex-post. Instead he pays the regulator, who then allocates/auctions the individual rating activity among the population of competing rating agencies. In the case of the healthcare which I suggested, The FDA receives user fees submitted with New Drug Applications under the Prescription Drug User Fee Act (PDUFA); the company submitting an application pays a fee for the review of the new product to the FDA. A similar process is used for medical devices under the Medical Device User Fee and Modernization Act (MDUFMA) and for animal drugs under a similar act. These fees should be waived or reduced for small businesses.

d. Rating agencies should be paid in part in the securities they are rating. Such securities should be held to maturity and cannot be hedged by the rating agency.

Conclusion

Financial institutions serve unique economic functions, and those functions are directly related to their inherent vulnerability. But banks today are much more vulnerable than they were in the past, or more than they need to be. After a number of warning signs, the U.S. "subprime mortgage crisis" became a headline issue in February 2007. Notwithstanding the bankruptcy of numerous mortgage companies, historically high delinquencies and foreclosures, and a significant tightening in subprime lending standards, the impact thus far on core U.S. financial institutions has been severely damaging. The far-reaching nature of the events that are unfolding, and continue to unfold, is illustrated by the fact that within a period of only one week, large stand-alone investment banks disappeared from the U.S. financial landscape.

This paper reviews the history of securitization and the development of complex structured credit instruments. Going forward, I suggest that in the face of new origination and funding technologies have begun to emerge, but will likewise also require further development, as a main means of funding option for commercial banks to readdress growing monetary constraints and acquire diversified sources of liquidity. Commercial banks have traditionally funded themselves on a short-term basis. However, over the recent two decades, they have come under pressure from the customers to improve their term financing as retail deposits have not always kept up with surging credit growth of mortgage and consumer loans.

The recent experience in the subprime market illustrates the costs and benefits of financial innovation in an environment of shifting asset price dynamics. Furthermore, asset securitization made the financial system more resilient at the expense of undermining the effectiveness of consumer protection regulation. In recent months, lending standards have tightened and ratings models are being strengthened, but subprime credit is still readily available—at a price. Potential solutions to the management of this trade-off should be explored. Policy response should balance greater consumer protection with maintaining the viability of the securitization model.

When considering future policy changes, regulators and lawmakers need to balance carefully the need to limit future predatory lending excesses, while preserving a model that has successfully dispersed losses from higher-risk mortgages away from the banking system and maintaining the ability of stretched but viable subprime borrowers to refinance when confronted with reset payment

shock. This is a challenging task within a regulatory and legal framework ill-suited to provide consumer protection in an originate-to-securitize financial system.

TIGHTEN OVERSIGHT. Federal banking regulators should tighten guidance on nontraditional and hybrid mortgage lending. It is absolutely necessary to address the very fragmented nature of U.S. financial regulation system where such standards are not uniform in observance and enforcement.

Regulators should establish and enforce compliance by their regulated institutions on non-bank lenders and loan brokers that are regulated at the state level; such initiatives also rely on consistent state-level enactment and enforcement. The U.S. Federal Reserve should review its powers to regulate mortgage transactions and tighter restrictions, especially concerning the clarity of disclosures to borrowers and the availability of the riskiest loans, appear warranted.

The introduction of Asset Securitization, and its evolution over two decades, has had a profound impact on consumers and financial institutions as an innovative product and no doubt, it will continue to remain so. In the light of recent events it is clear that more and better regulatory approaches must be instituted in order to ensure that the original model and some of its innovative iterations reconstitute to the original power and value they provided. In this manner, the markets will reset, consumers will benefit and Asset Securitization can regain its rightful perch as one of the most valuable products and financial instruments in banking history.