Securitization:

Greatest Financial Innovation or Cause of Concern…….

By

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Abstract: Securitization is one of the revolutionary innovations in finance in 20th century. It has given all new dimensions to the mortgage business and has also helped in reducing the risk of bankruptcy and thereby obtaining lower interest rates from potential lenders. Unlike conventional corporate bonds which are unsecured, securities generated in a securitization deal are "credit enhanced," meaning their credit quality is increased above that of the originator's unsecured debt or underlying asset pool. This increases the likelihood that the investors will receive cash flows to which they are entitled, and thus causes the securities to have a higher credit rating than the originator. But, there are two different schools of thoughts regarding the advantages and disadvantages of securitization; one of these believes securitization as greatest financial innovation because the biggest driver of securitization transactions is typically the lower cost of funds. This arises because the securities, backed by the cash flow being securitized, have a higher credit rating than the company itself. A further advantage of securitization is that it will lower the risk profile of the issuer. This is a direct result of the future cash flow risks being transferred. With the transfer of risks however, comes the transfer of potential future profit arising from these risks. Whereas, according to the second school of thought, securitization, like all important innovations, has been used in harmful ways too. They believe, easy access to cheap money can encourage people and companies to borrow more than they should, exacerbating the usual ups and downs of credit cycles. Further supporting their view, Adelson and other experts have also highlighted a major flaw in the securitization process that's been exposed by this year's subprime crisis. Mortgage lenders have been making riskier loans because they know that, after they securitize, or sell the assets on to other investors in a securitization, it's no longer their problem. Such concern has reached into the upper echelons of the financial world, troubling officials from the Federal Reserve to the Bank for International Settlements, the main counterparty for the world's central banks.

Introduction

Securitization is the process of pooling and repackaging of homogenous illiquid assets into marketable securities that can be sold to the investors. In other words, securitization is the transformation of illiquid assets into liquid securities. For example, a group of consumer loan can be transformed into a publically-issued debt security. A security is tradable, and therefore more liquid than the underlying loan or receivables. Securitization of assets can lower risk, add liquidity, and improve economic efficiency. Sometimes, assets are worth more off the balance sheet than on it. Securitization has grown tremendously in recent years, with the global securitized assets reaching over USD 12 trillion in 2008. The option to sell loans to investors has transformed the traditional role of financial intermediaries in the mortgage market from “buying and holding” to “buying and selling”. The perceived benefits of this financial innovation, such as improving risk sharing and reducing bank’s cost of capital, are widely cited (Pennacchi 1998).

However, in the light of the 50% increase in delinquencies in the heavily securitized subprime housing market from 2005-2007, critique of the securitization process have gained increased prominence (Stiglitz 2007).

Securitization helps lenders finance their business more efficiently by selling the loans they have originated, rather than keeping the assets on their balance sheets. Advocates of the concept say that in theory, by spreading the risk of the defaults among a broad range of investors, securitization makes the financial system more stable.

Securitization got its start in the 1970s, when home mortgages were pooled by U.S. government-backed agencies. Starting in 1980s, other income producing assets began to be securitized, and in recent years the market has grown dramatically. In some of the markets, such as those for securities backed by risky subprime mortgages in the United States, the unexpected deterioration in the quality of some of the underlying assets undermined investor confidence.

Securitization, hailed as the greatest financial innovation of the 20th century, isn't getting such rave reviews anymore after subprime mortgage crisis exposed some weaknesses.

- Market Watch

In the U.S. housing market, where securitization has made the biggest in-roads, roughly half of all home loans are packaged into mortgage-backed securities. That's brought down the cost of mortgages and made them more accessible to more borrowers, increasing homeownership.

Securitization is the “greatest financial innovation” of the past century. But, like all important inventions, securitization has been used in harmful ways too.

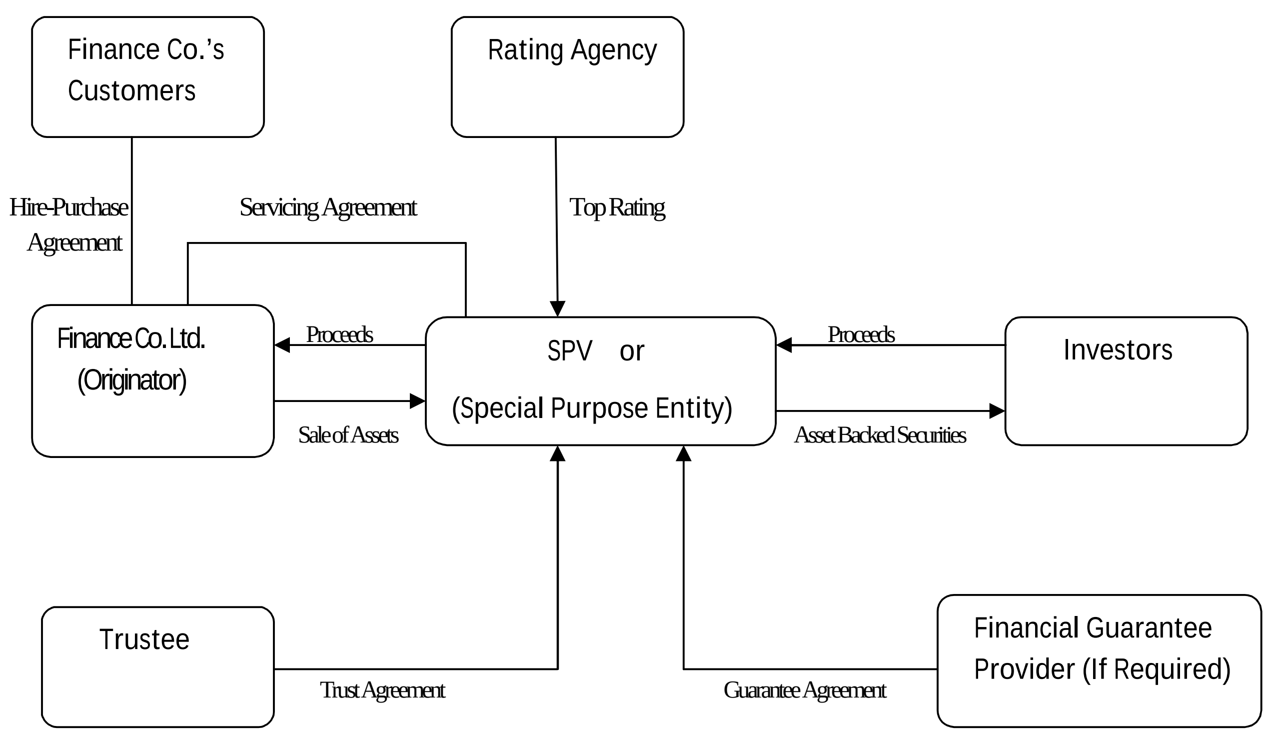
Mark Adelson

Easy access to cheap money can encourage people and companies to borrow more than they should, exacerbating the usual ups and downs of credit cycles, explained Adelson (co-founder of consulting firm Adelson & Jacob Consulting LLC).

Process of Securitization

The process of securitization leads to the creation of financial instruments that represent ownership interests in, or are secured by a segregated income producing assets or pool of assets. This pool of assets collateralizes securities. These assets are generally secured by personal or real property (e.g. automobiles, real estate, or equipment loans), but in some cases are unsecured (e.g. credit card debt, consumer loans, insurance products etc). The process of securitization can be described in steps from asset origination to sell of securities as:

1. Assets are originated by a company, and funded on that company's balance sheet. This company is normally referred to as the "Originator".
2. Once a suitably large portfolio of assets has been originated, the assets are analyzed as a portfolio, and then sold or assigned to a third party which is normally a special purpose vehicle company (an " SPV") formed for the specific purpose of funding the assets. The SPV is sometimes owned by a trust, or even, on occasions, by the Originator.
3. Administration of the assets is then sub-contracted back to the Originator by the SPV.
4. The SPV issues traceable "securities" to fund the purchase of the assets. The performance of these securities is directly linked to the performance of the assets - and there is no recourse (other than in the event of breach of contract) back to the Originator.
5. Investors purchase the securities, because they are satisfied (normally by relying upon a rating) that the securities will be paid in full and on time from the cash flows available in the asset pool. A considerable amount of time is spent considering the different likely performances of the asset pool, and the implications of defaults by borrowers on the corresponding performance of the securities. The proceeds upon the sale of the securities are used to pay the Originator.
6. The SPV agrees to pay any surpluses which arise during its funding of the assets back to the Originator - which means that the Originator, for all practical purposes, retains its existing relationships with the borrowers and all of the economics of funding the assets (i.e. the Originator continues to administer the portfolio, and continues to receive the economic benefits (profits) of owning the assets).
7. As cash flows arise on the assets, these are used by the SPV to repay funds to the investors in the securities.



In the process of securitization, the biggest flaw is the asset quality or pool of assets being securitized, because the investor's repayment depends solely on the performance of the securitized asset or the cash flow from the securitized assets i.e. for the repayment of the amount invested, investors do not depend on the SPV or Originator. So, in securitization, investors rely on the credit quality of the securitized assets and if the originator has compromised with the quality of asset in order to increase business volume, it directly affects the cash flow of the securitized asset due to high default rate on those pools of asset thereby, affecting the investor's confidence and ease of securitization process.

Limitations of Securitization

Securitization, like all important innovations, has been used in harmful ways too. Easy access to cheap money can encourage people and companies to borrow more than they should, exacerbating the usual ups and downs of credit cycles. Adelson and other experts have also highlighted a major flaw in the securitization process that's been exposed by subprime crisis. Mortgage lenders have been making riskier loans because they know that, after they securitize, or sell the assets on to other investors in a securitization, it's no longer their problem.

As real estate loans were often denominated in foreign, rather than home currencies, the debt obligations of borrowers got much larger, which in turn led to more defaults. It was thus the combination of poor underwriting and a lack of understanding of currency risk that contributed to the downfalls of the economies.

Wall Street has witnessed many such crises in past where the role of securitization is prominent. We can return to the United States Savings and Loan crisis to gain some historical perspective. The ignition of inflation in the late 1960s and 1970s altered the ability of depositories to fund long term, fixed rate mortgages: inflation pushed up nominal interest rates and required higher returns on deposits while asset returns were fixed at the low levels of historical fixed rates on long term mortgages which made up most of the thrift industry portfolios. Inadequately capitalized depository institutions (S&Ls) then advanced unsustainable commercial mortgages. Because these institutions often had no equity to protect, their managers had large incentives to make high-risk loans. If the loans failed, the institutions and their depositors were no worse off. If they paid off, however, the institution would return to solvency. Because S&Ls were not required to mark their assets to market, they were able to hide their distress until loans began defaulting. By the late 1980s, poor real estate underwriting produced overbuilding in the U.S. commercial real estate market. This led to high vacancies (the average Class. An Office Vacancy Rate in 1990 was 20 percent) and declining rents. Buildings generated insufficient cash flow to meet debt services, and default rates rose dramatically.

Conclusion

One of the most important issues financial intermediaries have been facing was the principal-agent problem. The major conceptual rationale for the banking sector, the diversification of risk is precisely the mechanism which makes it impossible to track and deter mispricing in one sector. Thoughtful regulatory oversight of lending activities of the financial intermediaries can help to mitigate the principal – agent problem and to ensure that lenders have sufficient capital to absorb potential losses. Securitization of mortgages can mitigate the principal-agent conflict because the information signal is stronger.

Traditionally arguments for the development of markets to securitize mortgage debt are based on the benefits derived from geographical arbitrage and geographical diversification. These are important but can be served by banks as well. A far more salient argument for securitization is the solving of the mismatch between short term deposits and the access of longer term funding to support long term lending. But this too can be provided by a banking system borrowing using long term debt, without securitization. Thus the major benefit to securitization is the gains from trading on information and the increased transparency this could bring to the financial sector. The issuance of tradable securitized assets whose performance can be linked to the revenue flows from the underlying assets encourages the evaluation of credit risk, the creation of standards for credit evaluation, the development of ratings systems and the direct monitoring of the financial risk of these assets over time.

According to the recent report of the U.S. President's Working Group on Financial Markets (2008), among others, suggests that incomplete disclosures and the securitization process caused investors to be duped into purchasing high-risk subprime mortgage securities. The purchasers of these securities, however, almost uniformly include only the most sophisticated institutional investors worldwide. The name "subprime" also seems clear enough, and data documenting the extremely high foreclosure rates on subprime loans have been publicly available at least since 2002. In short, the securitization process per se was not a fundamental source of the subprime mortgage crisis.

"Boom and bust cycles in real estate prices are a recurring phenomena, in good part based on the reinforcing process in which expected rising real estate prices expand mortgage lending, while expanded mortgage lending drives prices higher. Of course, fundamentals eventually take hold, and a crash inevitably ensues. If there has been a "moral hazard" in subprime mortgage lending and securitization, it lies with the failure of lenders, investors, the credit rating agencies, and the monetary authority to recognize that mortgage lending booms almost inevitably end in crashes." - Dwight M. Jaffee

The intensity of the losses suffered by many subprime mortgage investors is primarily the result of their having concentrated the risks by leveraging their positions with borrowed funds. The use of 10 to 1 leverage, for example, can transform a 10% realized loss into a 100% loss for a given initial capital. Furthermore, many of the positions were funded with very short-term loans. This strategy remarkably parallels that of the Savings and Loan Associations of the 1980s, who also used maturity mismatched and leveraged portfolios, and with similarly dire results.

So, in conclusion, we can say that, securitization is very essential financial instrument for the economy, so long as its process is rightly used for the distribution of risk, provides liquidity to the market and is used for the overall development of the financial system, rather than using it for personal greed by the market players and just to increase the business volume in order to compete with each other.

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