The Future of Securitisation

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Securitisation is at a crossroads. Even as the secondary market for existing securities has come back to life, new private issuance activity is barely a trickle compared to the years before the crisis. Some ask if securitisation in some markets will ever return.

Some clues on the answer lie in the role played by the banking sector in the boom years. Securitisation was meant to disperse risks associated with bank lending so that deep-pocketed investors who were better able to absorb losses would share in the risks. When the crisis dented this benign view of securitisation, conventional wisdom swung to the opposite extreme and emphasized the chain of unscrupulous operators who passed on bad loans to the greater fool next in the chain. One could dub this the “hot potato” argument. The idea was attractively simple, and there was a convenient villain to blame, and so has figured in countless speeches given by central bankers and politicians on the causes of the subprime crisis.

But the new conventional wisdom is just as flawed as the old one. Remember that the bulk of the losses were borne by the banking sector. Roughly two third of the losses from subprime mortgages were borne by the banks themselves. Of the remaining one third borne by non-banks, AIG accounts for a large chunk, and so relatively little of the losses from subprime fell on the unsophisticated final investors. In this way, rather than dispersing credit risk into the hands of final investors, securitisation served to concentrate credit risk in the banking sector itself – a sector that is leveraged, and hence most vulnerable to credit losses.

In a traditional banking system that intermediates between savers and borrowers, the core funding available to the banking sector is retail deposits, which grow in line with the

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aggregate wealth of the household sector. However, during a credit boom, the rapid increase in bank lending outstrips the core deposit funding available to a bank. As the boom progresses, the bank resorts to alternative, non-deposit funding to finance its lending.

Securitisation is a way for intermediaries to tap non-deposit funding by creating securities that can be pledged as collateral. Securitisation opens up new sources of funding such as from domestic pension funds and mutual funds, as well as from foreign investors including foreign central banks who hold US GSE securities. The demand for collateral assets for securitisation is therefore a demand for leverage. As balance sheets expand, new borrowers must be found. When all prime borrowers already have a mortgage, but still balance sheets need to expand, then banks have to lower their lending standards in order to create more collateral assets. Subprime is thus born.

One has to distinguish selling a bad loan down the chain and issuing liabilities backed by bad loans. By selling a bad loan, you get rid of the bad loan from your balance sheet. In this sense, the hot potato is passed down the chain to the greater fool next in the chain. However, issuing liabilities backed by bad loans does not get rid of the bad loan. The hot potato is sitting on your balance sheet or on the books of the special purpose vehicles that you are sponsoring. While investors who buy your securities will end up losing money, the intermediaries that have issued the securities are in danger of larger losses. Since the intermediaries are leveraged, they are in danger of having their equity wiped out, as many have found to their cost.

What does all this imply for the future of securitisation? To the extent that the boom years were an aberration when securitisation was being driven by the banks themselves in their search for leverage, the securitisation activity that flourished most during that period is least likely to make a come-back.
Figure 1 plots the monthly series of new private issuance of asset-backed securities in the United States between 2000 and 2008, sorted by collateral asset category. The largest boom and bust is in residential subprime mortgages, followed by commercial real estate.

ABS issuance recovered somewhat in 2009, encouraged by liquidity programmes such as the Federal Reserve’s TALF (term asset-backed security loan facility), but the take-up rate in TALF has been low. The low take-up should come as no surprise. To the extent that the boom years were an exception to the norm driven by the search for leverage, securitisation that flourished only in during boom years is likely to be subdued even when the economy returns to normal.

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