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Handout Econ 335A-Fall 1987

SECURITIZATION

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Heraclitus: "You can not step twice in the same river."

AT THE ANNUAL BANKING STRUCTURE AND COMPETERTION CONFERENCE OF THE FEDERAL RESERVE BANK OF CHICAGO IN MAY 1987 THE BUZZWORD IN THE CORRIDORS AND BY MANY OF THE SPEAKERS WAS "THAT WHICH CAN BE SECURITIZED, WILL BE SECURITIZED".

Introduction

It is necessary to understand what securitization involves and how it might affect the development of the world economy if central bank interventions and the government interventions that guide institutional developments are to be successful. Securitization leads to the creation of financial paper that is eminently suitable for a global financial structure. There is a symbiotic relation between the globalization of the world's financial structure and the securitization of financial instruments. Globalization requires the conformaty of institutions across national lines and in particular the ability of creditors to capture assets that iunderlay the securities.

Securitization reflects a change in the weight of market and bank funding capabilities: Market funding capabilities have increased relative to the funding abilities of banks and depository financial intermediaries.

Securitization is in part a lagged response to monetarism. The fighting of inflation by constraining monetary growth opened opportunities for non banking financing techniques. The monetarist way of fighting inflation, which preceeded the 1979 "practical monetarism" of Volcker, puts banks at a competetive disadvantage in terms of the short term growth of their ability to fund assets. Furthermore by opening interest rate wedges monetary constraint provides profit opportunities for innovative financing techniques.

The interest rates of the monetarist experiment destroyed the funding capabilities of the thrift "industry" in the United States by impairing their net worth through undermining the value of mortgages. The ability of the thrifts to create mortgages was unimpaired even as their ability to fund holdings was greatly impaired. Securitization as we know it began in the U.S. mortgage market. It enabled the thrifts to continue to initiate mortgages even though their funding ability was sorely compromised. Although modern securitization may have begun with the thrifts, it has now expanded well beyond the thrifts and mortgages.

Securitization also is a response to the cost structure.of banks. Banks seem to need a 450 basis point margin if fund income is to be the source of profits. This provides a great deal of profit space for innovative suppliers with lower costs. Bank participation in securitization is part of the drive, forced by costs, to supplement fund income with fee income.

The development of the money market funds, the continued growth of mutual and pension funds and the emergence of the vast institutional holdings by offshore entities provide a market for the instruments created by securitization.

Any attempt to place securitization in context needs to start with early 19th century commercial bill banking in Britain and a recognition that accepting contingent liabilities is a fundamental banking act. The modern contribution is the developement of techniques to "enhance credits" without accepting contingent liabilities or the investment of pure equity funds.

Securitization throws light on the nature of money: *Money is a financial instrument (a debt) that develops out of the financing of activity and positions in assets that becomes generally accepted in an economic community as a means of payment for goods and services and as an instrument by which debts are discharged.* It is conceivable that in the not too distant future we can be using $100. interest bearing short term securities as currency. Private money is a distinct possible future outcome of current developements.

Securitization implies that there is no limit to bank initiative in <u>creating</u> credits for

1. there is no recourse to bank capital and
2. the credits do not absorb high powered money.

Both capital and reserve absorption may occur at the initiating stage of the credit. This has led to the "bridge financing" terminology.

Securitization lowers the weight of that part of the financing structure which the Central Banks (Federal Reserve in the United States) is commited to protect. A need by holders of securities who are committed to protect the market value of their assets (such as mutual or money market funds or trustees for pension funds) may mean that a rise in interest rates will lead to a need by holders to make position by selling position, which can lead to a drastic fall in the price of the securities.

Securitization and globalization reflect the new technology of communication,computation and record keeping.

The two fundamental banking interfaces
Bank is a generic term
not restricted to legally defined banks.

I. "Bank" and debtors.

1.The initial creation of paper based on cash flows from income creating activities

The liability is of :

a. Business
a prior allocation of profits

b. Households
a prior allocation of wages etc.

c Government
a prior allocation of taxes

d The rest of the world
a prior allocation of export? earnings

2.Note that such paper links the present and the future. Today is the future for some past todays. Prior commitments are falling due even as new commitments are entered upon. Cash flows as both a source of funds and as the validation of prior commitments. The hedge, speculative and Ponzi characterization of cash flows may be relevant.

3. A banker operates on the basis of expectations of cash flows. What determines such expectations?. In particular "How do expectations change?" is a fundamental analytical-banking question in a market based financial structure? In banking the collateral is of secondary importance, the bank customer relation has failed whenever there is a need to capture collateral.

4. Asset or collateral based lending implies that the cash flows to validate commitments will be forthcoming from the sale of the asset. The buyer obviously expects cash flows that will validate the price he pays.

II. Bank and "Funders".

1. Households as the ultimate owners;

2. Intermediation and layers of intermediaries; the descriptive insights of Gurley and Shaw on the one hand and Goldsmith on the other.

III. A bank deals with both the issuer of debts and the funder; a bank's balance sheet reflects this two sidedness of banking. Fund income depends upon the gap between the cost of money and the return on earning assets. Bank equity "enhances credits" Deposit insurance as the enhancer of credit for todays bankrupt banks and savings and loan association in the United States.. Deposit insurance as a government guarantee rather than insurance. What are the actuarial relations?.

IV. In securitization the bank's balance sheet disappears from the financing once the transactions are completed. No question of contingent liabilities and recourse if there is no issue of fraud.

V. In securitization financial instruments and the cash flows they are expected to generate are the proximate basis for issuing marketable paper. Income from paper (cash flows) is substited for the profits earned by real assets, household incomes, or tax reciepts as the source of the cash flow the paper pledges.

THE STEPS AND THE PLAYERS.

1: A. debtor: the fundamental paper emitter and source of the cash flows from income that validate the securities.

2: The paper creater: the bank loan officer who structures the credit and accepts debtor's promises to repay; the negotiations between 1 and 2 ends up with paper that can be negotiated. Steps 1 and 2 are like conventional bank customer relations.

3: The investment banker: NOTE THAT THE INVESTMENT BANKER INTERFACES WITH MANY DIFFERENT TYPES OF UNITS

finds and negotiates with the paper creater, buys the paper (bridge financing, the funding of bridge financing, the relation to commercial banks, exposure, out the window are terms that enter here).

The paper becomes the corpus of the trust.

On the basis of the assets in trust the investment banker creates securities, devising ways to enhance credit (insurance, complex of liabilities, erzatz equity in the form of junk bonds)

The investment banker hires "econometricians" or financial economists to demonstrate that the risks of default on interest and principle of some class of the securities it proposes to issue are so small that these instruments deserve to have an investment rating that implies a low interest rate.

Securitization is viable, profitable for all concerned if the total cash pledged by the securities is less than the total cash the corpus of the trust is expected to yield.

4: The trustee: holds the basic paper-the corpus of collateral for the securities-; acts in the interest of the security holders; recieves the cash flows from the underlying instruments, forwards them to the securiTy holders, empowered to end the trust, sell out the corpus, and transmit proceeds to security hølders according to the heirarchy of rights if the rating of securities fall below some agreed level. If securitization spreads the trustee business will boom. The need to develop equivalents to the U.S. trust company if securitization is to be truly global.

5: The servicing organization: (often the paper creater, a source of bank fee income) recieves payments from the corpus and transmits the funds to the trustee.

6: The rating services: places the resulting securities into risk classes. In the security contract there is a commitment to keep at least some of the securities in some particular set of low risk classes. If the securities fall below some rating or perhaps are threatened to fall below some rating the trustee is supposed to act to protect the interests of the security holders. This may lead to the sale of the underlying assets, the corpus of the trust. There is a danger that the equivalent of making position by selling out position will result.

7: The maker of a secondary market. often the Underwriter, the initiating investment banker. this is usually? a dealer not a broker market. This will be a thin market if price aqnd quality of the securities deteriorate.

8: the funders: household, pension fund, bank with poor paper creating facilities, foreign institutions etc.