A guarantee is not the way to fix securitisation
Stephen Grenville
The Australian Financial Review
6 December 2010
P. 23

The global financial crisis brought securitisation markets to a halt around the world. The question is, was this a temporary glitch or something more fundamental?

Securitisation is one of the key innovations of deregulation. The Wallis Committee of Inquiry into the Australian Financial System saw it as the future of finance. The promise was that markets would provide well-based price discovery, transparent links between borrowers and lenders, and would price risk accurately and consistently.

Thus securitisation seemed to have many advantages. It removed the intermediary's costs. Risk could be sliced and repackaged (collateral could be tranched, with some asset-holders having a higher claim on the collateral than others). Investors could tailor their asset-holdings to their risk appetite. Diversification of assets in the securitised bundle would spread and reduce risk. If the assets were sufficiently homogeneous, a deep trading market would provide the investor with liquidity.

The crisis demonstrated that this was an overly optimistic view of financial markets. In the United States, the assets had been made homogeneous for trading purposes by the expedient of being uniformly rated as AAA. Risky assets were not held by those best able to bear the risk, but by those who least understood it. When the market came to re-evaluate these assets, the change in market price was dramatic, and worse still, some became untradeable.

Here in Australia the situation was less parlous, as the collateral behind securitised assets was much stronger. But the market still became illiquid and it was only the purchases of the Australian Office of Financial Management that kept the market functioning.

How can this market be revived? One suggestion ("Securitisation revival crucial" by Ian Harper, Ric Simes and Mike Thomas, AFR, November 18) is that the government should guarantee securitisation instruments. This, they wrote, would restore competitive neutrality and revive competition in the banking sector.

This is a dubious solution. The government guarantee was provided to the banks in recognition of their special place in the intrinsically fragile world of finance. Intermediation involves maturity transformation, with short-term deposits funding illiquid assets. Without government backing, deposits

are subject to bank runs. The guarantee not only inhibits self-reinforcing runs, it also preserves the integrity of the payments system and ensures there is a basic level of lending available through the ups and downs of the business cycle.

In return for this guarantee, banks hold substantial capital as a buffer so that a troubled bank's shareholders bear the first losses, before the taxpayer is called on. Banks are also subject to rigorous prudential supervision, with many restrictions on their balance sheets to reduce the likelihood that the guarantee will be needed. Guaranteeing securitisation without similar requirements would not achieve competitive neutrality.

In any case, a guarantee may not be enough to bring the securitisation market back to life. The problem was not just doubts about the assets. When the crisis began, investors switched their preferences dramatically in favour of very liquid assets, depriving securitisation of funding.

Here the banks have two advantages. They can draw on the central bank's liquidity and they don't have to mark their loans to market. Instead they make their own decisions on provisioning against default. Does "competitive neutrality" suggest that a liquidity back-up should be given to securitisation, as well as a guarantee? Surely not. In the US, the quasi-government mortgage agencies Freddie Mac and Fannie Mae showed how populist pressures can lead to huge taxpayer losses. It is possible, even easy, to lend too much for housing.

The basic rationale of securitisation was to provide an alternative channel of finance, free of these distortions. If it is to retain a rationale, it needs restructuring, not wider government support.

First, in a world where investors cannot hope to know enough to evaluate assets, all mortgage assets must be of uniformly high quality. This clearly cannot rely on the endorsements of rating agencies: the incentives for overrating assets are too great. This filtering has to be done by the gatekeepers of the asset-creation process, not by the market's changeable views on risk. Mortgage origination needs to be done by substantial companies with long-term reputations at risk.

Second, investors have to abandon their fetish for liquidity. Long-term assets such as mortgages need to be funded from instruments held by the investor until maturity. Given the main source of non-bank funds is superannuation, the task is to make mortgages attractive for these funds. This shouldn't be difficult. Stability is most important to pension funds.

The characteristics of these assets maybe laid down by regulation and will have to be simple. Responsibility for assessing the asset has to remain with the fund.

With such arrangements, a true alternative to banks could emerge.

None of this is easy. But seeking government guarantee is a reversion to a mindset that deregulation was supposed to overcome.

Stephen Grenville is a visiting fellow at the Lowy Institute for International Policy and a former deputy governor of the Reserve Bank of Australia.