Why securitisation should secure a revival
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Securitisation was central to the rapid expansion of finance before the global financial crisis. Groups of assets were bundled together and sold directly to investors, with no recourse to a financial intermediary. The dramatic contraction of this securitisation made the overall financial implosion worse. Can this souffle rise again?

The conventional wisdom of a decade ago was that intermediated finance (such as bank lending) would be substantially replaced, over time, by capital market-based transactions.

Capital markets have a long history, of course, with governments and companies selling bonds directly to investors. But in this new world, the capital markets would, through securitisation, also handle assets more traditionally found on the balance sheets of financial intermediaries: mortgages, credit card debt, commercial paper and vehicle finance.

This, indeed, occurred. In the United States in 2006, securitisation accounted for half of mortgage finance. In Australia, it accounted for one-quarter.

In the US, however, the GFC has undermined central elements that made securitisation work. If things go wrong with a securitised asset, the investor has no recourse to the originator, but only to the specific bundle of underlying assets. The investor has to be able to evaluate and monitor these underlying assets. If not, the investor needs to rely on some form of credit enhancement (such as credit insurance) or on the endorsement of a credible credit rating agency.

In the US (although not in Australia), investors' expectations were disappointed. Investors were probably never in a position to evaluate the strength of the underlying assets. They were probably unaware of the slippage in credit standards, with the inclusion of sub-prime and NINJA (no income, no job or assets) loans. The expanding asset bubble also put the value of the underlying security at more risk of sudden deflation. Credit insurance, through AIG and monoline insurers, could handle a small number of idiosyncratic defaults, but could not cope with a systemic problem under which all asset values fell and many borrowers defaulted.

The evaluations of the credit rating agencies turned out to have limited meaning. It was routine in the US for the bundles of assets to be "tranched": that is, divided into segments, with the "equity" tranch taking the first losses, reducing the risk of the "senior" tranch. This tranch was routinely given the highest, AAA rating, seemingly putting it on a par with sovereign debt. It is now clear that these were fair-weather evaluations, which took little account of correlation or systemic risk.

As the GFC unfolded, 90 per cent of the AAA asset-backed collateralised debt obligations (CDOs) in the US were downgraded, 60 per cent of them to B or lower (that is, not even investment grade). Unsurprisingly, the securitisation market collapsed, with no new issues of private paper and dramatic falls in values on secondary markets.

Can securitisation be revived?

In principle, securitisation has attractive characteristics. Portfolio theory suggests that diversification reduces risk. Tranching allows investors to tailor their investment to their risk appetite. Similar packages of homogenous securities were generally marketable, which might provide the added advantage of liquidity, at least in good times.

There are advantages, too, for financial institutions, which could get the assets off their own balance sheets and save capital. For regulators, too, securitisation seemed positive, as it

shifted liabilities off the balance sheets of banks (historically the main source of systemic problems) into the general capital market, where "buyer beware" prevailed.

If the promise of securitisation was oversold, then the answer maybe to claim less and accept a smaller role in future, along the following lines.

First, only investors who can make a well-based assessment of the values and risks of the underlying assets should buy securitised assets. Because of the inevitable complexity of the securitisation process, this means that only homogeneous assets of clearly defined high quality(such as fully compliant mortgages) are suitable. The more slicing and dicing there is, the harder it is to evaluate the security. Investors need to recall that originators have an incentive to downplay risk: they are no longer responsible.

Second, risk management techniques need to recognise that statistics from the good times will be irrelevant in bad times, when it matters. These assets will be more volatile than ordinary corporate bonds. Third, investors should understand that the apparent liquidity in good times, when the value of underlying assets is rising, will evaporate in weak markets. These assets should be seen as "buy and hold to maturity".

This will make them unattractive for active fund managers who are obliged to mark to market. When some assets go bad, this will poison the well for all investors: investors cannot readily know if their bundle of assets contains toxic elements. Market prices reflect the worst risks and good assets are unsaleable at a fair price. Anyone who has to mark to market in these circumstances will be in trouble. Fourth, regulators need to be especially vigilant to ensure that the securitised assets are compulsorily quarantined from the originating bank's balance sheet. Any liquidity support promised by a bank will absorb the riskiest component of the security and needs strong capital backing. Overall, regulators should be unenthusiastic about any innovation that allows the financial sector to expand with less capital. Supporters of a revival of securitisation say this facility is needed to provide competition to the banks and provide a good flow of funds for housing. Much of the sorry sub-prime saga in the US begins with the political need to finance mortgages. We can observe the unhappy outcome: de facto government guarantees for securitisation via Fannie Mae and Freddie Mac.

A better alternative might be European-style covered bonds, which facilitate bundling of assets but leave the investor with recourse to the issuer which, if it is a bank, will have to hold regulatory capital against this liability.

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