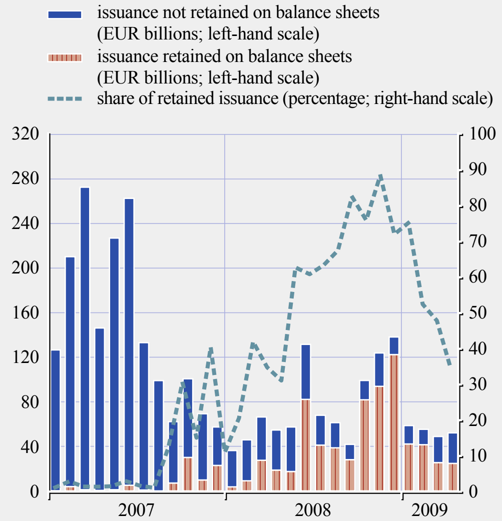
Box 2

SECURITISATION AND THE CONDITIONS FOR ITS RESTORATION

There has been a dramatic reduction in securitisation activity since 2007. Although significant amounts of highly-rated securities have been issued by some banks, these have been retained for use as collateral for accessing central bank liquidity (see the chart). This mechanism has played a crucial role in providing banks with necessary liquidity and has stabilised the securitisation market. As the securitisation process can be regarded as an innovation which, if properly managed, contributes to welfare, its restoration is important for the functioning of the financial system.[1] This box explains why the securitisation market has frozen and explores the conditions that would be required to restore it, which may, in turn, contribute to an easing of credit market conditions.

Securitisation in the global banking sector

(Jan. 2007 – Apr. 2009)



Sources: Dealogic and ECB calculations.

Securitisation has been central to the originate-to-distribute model, whereby banks could re-use their capital by selling some tranches of securitised assets to external investors and funding some other tranches relatively cheaply via off-balance-sheet vehicles using short-term commercial paper. This business model, which involved substantial maturity mismatching, became an early victim of the crisis.

Banks and their off-balance-sheet conduits were the major buyers of securitised assets, accounting for as much as 70% of holdings of asset-backed securities (ABSs) before the turmoil erupted. The disappearance of conduits caused funding problems for banks as the demand for securitised assets faded away.

This was exacerbated by the forced deleveraging of the hedge fund industry and the impact of the crisis on insurance companies, which had typically been investors in the mezzanine tranches of securities. At the time of finalisation of this issue of the FSR, banks were not able to rely on securitisation as a source of funding, despite their need for wholesale funding.

An important reason for the loss of confidence in ABSs was the capital-drain effect resulting from the, sometimes multiple notch, downgrading of AAA-rated tranches of these securities. This first affected collateralised debt obligations and then some residential mortgage-backed securities (RMBSs) of lower quality. According to the practices adopted by rating agencies, the extent of credit quality deterioration seen on AAA tranches should not happen more frequently than once

1 Some studies suggest that securitisation may have facilitated access to credit markets for some borrowers, leading to a better utilisation of private projects and ideas contributing to economic progress.

per century. Therefore, investors initially had very high confidence in the security of the capital invested. However, once the values of these tranches began to erode across various asset classes and were subsequently downgraded, it became clear that the rating models had not taken all risks into account. The models assumed that the delinquency rates of sub-prime borrowers would not exceed a historical high of 15% and assumed that US house prices would not decline on a nation-wide basis. Risks related to sub-prime borrowing therefore seem to have been underpriced. As a result, fixed income products created from the cashflows of these mortgages could not meet their obligations. Moreover, conflicts of interest may have arisen as both originators and rating agencies may have had incentives to structure deals in a way that securities had a AAA-rating for the largest possible share of the portfolio pool. Furthermore, the cash flows of ABSs are determined by the ability of the creditors to repay, and the price reflects market participants' expectations about the future path of economic developments until the security matures. In particular, the expected unemployment rate, an important determinant of the ability of mortgage borrowers to repay their debts, strongly influences RMBS prices. Uncertainty about the severity and length of the current economic downturn, however, leads to uncertainty surrounding the assumptions underlying the pricing of securities, thus making it difficult to determine intrinsic values. The extreme uncertainty surrounding the fundamental value of securities has created a significant gap between the price demanded by sellers (mostly banks) and potential buyers.

For securitisation to resume, the above-mentioned obstacles must be overcome. First, uncertainty related to economic fundamentals, especially concerning the severity and length of recessions in mature economies, must decrease and expectations regarding future developments must converge. Importantly, the US housing market must stabilise, as this is crucial for pricing in the RMBS sector, the position of US household balance sheets, and thus the timing and strength of the economic recovery. Second, rating agencies' models need to regain credibility. Increased transparency in the assumptions behind the models, along with independence in the rating process, may increase investor understanding of these complex products and decrease perverse incentives. Furthermore, credit risk must be re-priced and credit margins increased to reflect underlying credit risks in order to improve the competitiveness of ABSs vis-à-vis other fixed-income products. Finally, the major pre-turmoil buyers, namely banks, must regain their purchasing power. Apart from the conditions described above, the burden of the portfolios of securities which remain on their balance sheets needs to be decreased. This can only happen when prices reach levels that will not precipitate further substantial write-downs. The prices of ABSs that prevailed around the time of finalisation of this FSR may have already become attractive to potential buyers of distressed assets, but financing these investments remained difficult. An easing of financing conditions for distressed assets and allowing for some leverage in this regard could encourage potential buyers to offer prices closer to those at which these assets are currently booked on banks' balance sheets.

The recent US Treasury Private-Public Investment Program could trigger sales of troubled assets from banks. Under the programme, the US government provides guaranteed debt, allowing buyers to employ leverage to buy these securities. This government-guaranteed leverage should allow buyers to bid prices higher.

Securitisation has been an important element in the development of modern financial systems that will doubtless recover in some form or another. Nevertheless, as this box has outlined, both private and public efforts are necessary to restore confidence and get the market working again.