

Is securitization dead?

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- **Is securitization dead?**

I will probably not have this question at all if I was clear about what securitization is. It is important to understand some key **similarities** of securitization to traditional on-balance sheet methods of funding, so as to realize that securitization is dead only when funding in general is dead.

Below, we talk about some distinctive features of securitization, and highlight that these are present in traditional funding methods also:

<p>Securitization is all about transporting loans off the balance sheet and having them funded by external investors</p>	<p>Securitization is surely about having loans originated by the bank funded by external investors, but “transporting off-the-balance sheet” or off balance sheet accounting itself are technicalities, which have emanated from the prevailing practices of US-style securitization. These practices are the fringes, and not the heart of securitization.</p> <p>Securitization is all about funding of assets originated by the bank by external investors – but that is true for all methods of funding. Does a bank otherwise fund its assets out of capital? Banking would be non-existent as unviable, if banks played with their capital only.</p>
<p>Securitization is all about having loans packaged as marketable securities and offering them to capital market investors</p>	<p>Surely yes, but that is exactly what a bank does when a bank holds loans on its own balance sheet and issues bonds. There is nothing wrong in marketable securities – that only provides liquidity to the funding that the bank raises. Investors are surely happier with marketable bonds, than they are with traditional bank deposits.</p>
<p>In case of securitization, the bank does not hold the risk of loss of the loans it securitizes.</p>	<p>Once again, this is the produce of a misconception. Let us think of the following situation – a bank goes to market with a capital of \$ 5 and raises bonds/deposits of \$ 95 (this is clearly permitted under capital norms, depending on the risk-weights on the loans the bank holds). Now, it has \$ 100 to invest, which it invests in residential mortgages. How much risk of default on the loan portfolio is the bank holding? Technically, the bank has all the risk, but the bank cannot suffer more than its capital of \$5. If the assets default more than \$5, the bank will go bankrupt, in which case external investors will have</p>

	<p>to take the rest of the losses.</p> <p>There is absolutely no difference between this and a securitization transaction. In every securitization transaction, the risk of default of the loans securitized is tranching out in multiple tranches. The first loss risk, equivalent of the capital of the bank in the above example, is held by the bank. In fact, there are other mezzanine risk tranches that variety of investors hold, with senior investors holding a credit-enhanced piece.</p>
Securitization uses structured finance devices	<p>Funding itself is structured finance. Every bank, nay, every corporate's balance sheet in the world is an example of structured finance.</p> <p>What in essence is structured finance? Structuring of liabilities into various layers of claims, based on their priorities. That is exactly what is done on the balance sheet of every corporate – there are senior secured loans, senior unsecured loans, subordinated loans, preferred stock and equity which have different rankings.</p> <p>The concept of structured liabilities is common to all forms of lending.</p>
Securitization is complex	Complexity is all there in the mind
In securitization transactions, the extent of first loss piece held by the originating bank is minimized	<p>The extent of first loss piece held by the originator in securitization transactions is based on what pieces can be sold to external investors. What cannot be sold off, is held back. In the benign credit markets of the yester-years, investors' appetite for risk immensely increased, and at the same time, the historical default experience allowed rating agencies to provide good ratings based on thin levels of credit support. If a transaction is structured and sold today, there is no way it can find its way into the market without a substantial retained loss with the investor.</p>
Securitization is a product of the originate-to-distribute model, a new model on which banks today work	<p>Originate-to-distribute is a new, and very funny, word that has been coined by international banking regulators. If I am a shoe-maker, I originate shoes to distribute, not to wear. Banks, for centuries of their existence, have originated risks that they distribute, either in form of equity, or in form of liabilities. It is only that the market has searched for off-balance sheet methods of distribution.</p>
Securitization is off-the-balance sheet and	Off the balance sheet is not the heart of securitization. US-style securitization relies upon the

hence off the radar	true sale method, which, again, is a product of US bankruptcy laws. If the law was to recognize bankruptcy-protected rights of a secured lender or bond-holder, like the covered bonds laws of most European countries do, there is no reason to rely on a true sale, and there is no reason for the asset to necessarily go off the balance sheet. It is a pity that we have been addressing accounting and legal questions in isolation – the proper way is to find a proper legal structure, and an accounting treatment, as a cohesive solution.
If there was nothing wrong with securitization, why did we have all this problem?	It is like, I was driving a car like crazy, and met with an accident. Now, I say, cars are bad and should be removed from the road.
So, what was wrong, essentially?	<p>First, of course, is the very human tendency to gain too much confidence out of past history, without realizing that history repeats itself only upto a limit. So, we tend to overplay things, thus causing a damage to ourselves and others.</p> <p>Two, subprime mortgage lending in the USA is a simple case of too much money served to a section of humanity.</p> <p>Quite obviously, mortgages are still best assets, and there are millions, billions, on the earth who still need houses, and have incomes and intentions to pay for the same. So, it is just a question of proper allocation of resources.</p>

- **So, will securitization resurface?**

If banks have to be in business, they have to lend. If they have to lend, they have to refinance themselves. There is no better place than capital markets, which is a product of technology, to raise finance for banks. So, some capital market instrument will continue to finance banks. Since it is a capital market instrument, we call it “security”, and hence, there is “securitization” as a concluded necessity. It is only the legal form, and the accounting implications that may change.