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Securitization and Banking

Securitization is not a word that can be found in the dictionary but is heard with increasing frequency in financial markets. Securitization is the process of turning an otherwise illiquid financial asset into a marketable piece of paper. The securitization of mortgages, automobile loans, accounts receivable, credit card receivables and a variety of other financial assets is a growing practice in both U.S. and international financial markets.

This *Letter* examines the causes of rapid growth in securitization and evaluates the implications. As we shall see, securitization increases the efficiency of financial markets but also brings a special type of risk and has important implications for the structure of the banking system in particular.

Securitization

Securitization refers to the practice of creating marketable debt instruments that are backed by specifically designated assets. A mortgage-backed security, such as those guaranteed by the Government National Mortgage Association (GNMA) for example, is backed by specific mortgages on specific parcels of real estate. The payments of interest and principal to holders of such securities are supported by the payments on the underlying loans. (Indeed, in the case of GNMA "pass-through" securities, the payments on the underlying mortgages are simply passed through to the holders of the GNMA securities.)

Although securitization of an asset is, in some sense, tantamount to selling the asset, the original holder of the asset usually retains some responsibilities related to the asset. For example, the responsibility for servicing securitized loans (that is, collecting interest and principal payments) may remain with the originator of the loan. The issuer of a loan-backed security may even *guarantee* interest and principal payment, thereby retaining the responsibility to manage default risk. In such a case, creation of a loan-backed security involves "transfer [of the loan] with recourse." Unlike a true sale of a loan out of portfolio, transactions with recourse relieve the issuer (such as a bank) of the securitized asset of interest rate risk (the risk that changes in interest rates will affect the loan's value) but leave him with credit risk (default risk).

Securitization and financial intermediation

To understand better the causes and implications of securitization, it is helpful to relate securitization to the process of financial intermediation as it has traditionally been performed by commercial banks and others. In general, financial intermediaries facilitate the flow of funds from savers to borrowers. They do this by creating liability and asset instruments that simultaneously satisfy the diverse needs of lenders and borrowers, respectively.

Individual savers, for example, may wish to loan out their funds in smaller denominations and for shorter periods of time than borrowers may wish to borrow. Among the services financial intermediaries provide is the matching of small denomination savers with large denomination borrowers ("denomination intermediation") and making long-term loans to borrowers using funds provided by the short-term deposits of savers ("interest rate intermediation"). In addition, because financial intermediaries loan out deposited funds in a diversified manner, savers implicitly enjoy some reduction in the credit or default risk to which they would otherwise be exposed.

Securitization, in contrast, involves savers directly in the process of lending to borrowers. Although financial intermediaries may originate the securitized assets (such as mortgage loans), in the end, securitization creates a direct obligation between specific borrowers and specific lenders and is more nearly like direct placement of debt. The extent to which securitization occurs depends, in part, on how economically the goals of savers and borrowers can be achieved in this manner rather than through financial intermediaries.

With modern electronic transactions technology and with the growth of certain specialized financial markets, it has become increasingly easy to synthesize the services of the financial intermediary in an "unbundled fashion," leading to increased demand for securitized debt by savers. Until recently, for example, it was difficult for savers to avoid the interest rate risk associated with making long-term loans directly.Today, active financial futures and options markets permit individual savers to buy directly the desired degree of protection from interest rate risk in specialized markets. Similarly, mutual funds permit an individual saver to acquire relatively small-denomination, diversified interest in debt securities. Such developments make it possible for savers and borrowers to satisfy their diverse needs without employing a financial intermediary in the traditional sense.

Government protection and securitization
Various government policies also intentionally or unintentionally encourage securitization. Certain securities backed by residential mortgages, for example, are guaranteed against loss of principal or interest by the federal government. These guarantees make such securities — notably those issued by GNMA — easier to market. They also promote an active secondary market for residential mortgages that helps mortgage lenders adjust the composition of their asset portfolios.

Securitization also is stimulated, perhaps inadvertently, by the implicit and explicit protection of bank liabilities that results from the reluctance of policymakers to let banks fail. This encourages banks to sell guarantees or recourse services for securitized assets. These guarantees —in the form of Standby Letters of Credit (SLCs) or Recourse Notes — are essentially liabilities of the bank and may therefore be perceived by the marketplace as enjoying some of the protection explicitly afforded insured deposit liabilities. The result is that banks may be able to offer credible guarantees more competitively than noninsured institutions. (Indeed, it was only very recently that the Supreme Court ruled that SLCs are *not* to be treated as insured liabilities.)

Deposit protection only encourages securitization in general, but when combined with other regulatory policies, it also encourages insured financial intermediaries to sell their own assets with recourse. The reason is that, under current regulation, removing the asset from their portfolios makes it easier for financial intermediaries to comply with capital/asset ratios and, at the same time, profitably increase their effective degree of leverage.

Growth of securitization
Securitization is thus one manifestation of how financial innovation — driven by technological and other changes — is moving some parts of financing activity away from financial intermediaries. Even venerable securitized instruments such as "pass-throughs" backed by residential mortgages grew 40 percent between 1983 and 1985 versus only 20 percent and 17 percent, respectively, for mortgages and commercial and industrial loans (C&I) held in the portfolios of financial intermediaries. The growth trend is even more pronounced for the newer asset-backed securities such as collateralized mortgage obligations (CMOs), and securitized automobile loans, commercial mortgages and credit card receivables. Public offerings of securities backed by automobile loans, for example, reached approximately $1.5 billion in the first half of 1986 — twice the volume in all of 1985, and CMOs (a more complicated variant of the mortgage pass-through) grew by over 300 percent between 1983 and 1985.

It is interesting to note that the vast majority of this securitization activity involves assets that are directly or indirectly guaranteed by government agencies or depository institutions. This is consistent with the notion discussed above that securitization to some extent is "subsidized" by government policies or is the result of tighter capital requirements on banks.

Such is not universally the case, however. Recently, over $1 billion in bonds backed by commercial mortgages were privately sold with a guarantee issued by an insurance company. In addition, Standard and Poor's recently introduced a system of rating the credit quality of commercial mortgage-backed bonds.Thus, the existence of direct or indirect government guarantees is an important but not exclusive contributor to the trend toward more securitization.

Pros and cons
Whether or not a particular class of assets is securitized depends upon whether a sufficiently large and homogeneous population of assets exists. Only when the market can "understand" those assets can they be securitized economically and then sold.

Although many assets are potentially securitizable, the virtues of continued rapid growth in securitization are actively debated. One of the benefits of securitization clearly is that it permits more economical transfer of loanable funds from savers to borrowers. If this were not so, then it would not be competitive with the other major means of bringing borrowers and lenders together, namely, direct placement of general debt obligations and financial intermediation. For securitization to exist and grow so rapidly, it must offer lenders higher rates of return and borrowers lower costs of borrowing, everything else being equal, than the alternatives.

Because securitization of assets requires relatively homogeneous — and therefore standardizable — assets, some also believe securitization enhances competition in the underlying assets. For example, the standardization of residential mortgage loan features that is stimulated by securitization presumably makes it easier for mortgage borrowers to compare the mortgage loan instruments available to them. The result, some claim, is that the standardization also enhances competition among mortgage lenders. Others, however, see such standardization as working to the detriment of at least some market participants with needs not met by the standardized securitizable asset.

A more important criticism is that securitization, by separating the origination and servicing of the asset from its ownership, may create an incentive to perform slipshod analysis of the asset when it is first originated or acquired. The originator of a loan that will be securitized (without recourse), for example, has less incentive to perform a careful credit evaluation than the originator who holds the loan in portfolio. Although the development of appropriate standardization or rating procedures can help avoid this problem, this potential for "adverse selection" must be recognized by market participants, and is a source of risk attending the trend toward securitization.

Securitization and banking

The "unbundling" of intermediation services also has implications for the structure of financial markets. In particular, the role and clientele of commercial banks is likely to change as securitization progresses. Increasingly, bank assets will consist of loans to borrowers who are unable to issue their own liabilities economically, whose creditworthiness is difficult for the marketplace to assess, or whose liabilities are sufficiently "nonstandard" as to be difficult to securitize. In general, these are likely to be individuals and smaller corporations and businesses.

The ability of banks to participate in providing components of the "unbundled" intermediation services will depend upon a number of factors. Because loan origination requires familiarity with local market conditions and companies, and loan servicing requires continued contact with borrowers, banks are likely to retain a comparative advantage over most other organizations in those functions. Their ability to provide guarantee or recourse services competitively, however, flows in part from the combination of government guarantees and capital regulation as currently implemented. Similarly, their ability to provide interest rate risk management for borrowers and lenders will depend upon how economically these services can be provided by banks versus their competitors in the brokerage and underwriting industries, which also depends on the extent of regulation.

In conclusion, the trend toward securitization is a natural consequence of markets evolving to provide fundamental financial services in the most economical manner. Although the pace of its development is contingent on an expanded scale of certain financial markets and the pace of financial innovation, securitization will continue to have an important impact on the relative role of traditional financial intermediaries in our economy.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/11/86	Change from 6/4/86	Change from 6/12/85 Dollar	Change from 6/12/85 Percent[7]
Loans, Leases and Investments[1 2]	200,264	− 903	8,285	4.3
Loans and Leases[1 6]	181,789	− 853	7,941	4.5
Commercial and Industrial	51,880	− 563	− 394	− 0.7
Real estate	66,707	173	3,396	5.3
Loans to Individuals	39,128	− 32	4,805	13.9
Leases	5,638	22	258	4.7
U.S. Treasury and Agency Securities[2]	10,752	20	− 369	− 3.3
Other Securities[2]	7,724	− 69	713	10.1
Total Deposits	204,964	−2,273	7,362	3.7
Demand Deposits	52,091	−2,004	5,153	10.9
Demand Deposits Adjusted[3]	48,174	11,954	17,092	54.9
Other Transaction Balances[4]	16,545	− 153	2,725	19.7
Total Non-Transaction Balances[6]	136,329	− 115	− 514	− 0.3
Money Market Deposit Accounts—Total	46,632	− 162	2,422	5.4
Time Deposits in Amounts of $100,000 or more	35,721	− 124	− 2,624	− 6.8
Other Liabilities for Borrowed Money[5]	19,577	−2,059	− 1,295	− 6.2

Two Week Averages of Daily Figures	Period ended 6/2/86	Period ended 5/19/86
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	127	28
Borrowings	18	41
Net free reserves (+)/Net borrowed(−)	109	− 13

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change