Published on *Adam Smith Institute* (http://www.adamsmith.org)

Certainly securitisation increased risk taking: that's the darn point of it [1]

Written by **Tim Worstall** [2] | Saturday 9 February 2013

I thought this was an interesting little piece of research by the New York Fed [3].

> There?s ample evidence that securitization led mortgage lenders to take more risk, thereby contributing to a large increase in mortgage delinquencies during the financial crisis. In this post, I discuss evidence from a recent research study I undertook with Vitaly Bord suggesting that securitization also led to riskier corporate lending. We show that during the boom years of securitization, corporate loans that banks securitized at loan origination underperformed similar, unsecuritized loans originated by the same banks. Additionally, we report evidence suggesting that the performance gap reflects looser underwriting standards applied by banks to loans they securitize.

However, the bit I missed in the subsequent discussion was the point that this is what securitisation is for: to allow greater risks to be taken. Not that I missed seeing what is there, I missed it because they don't mention it.

Just so that we all understand, securitisation is the idea of chopping up a loan or a pool of loans into bonds that can then be sold off to various different groups of investors. It's often associated with structuring the pool of loans: say, one group of investors takes the first 10% of losses, the next the next 20% and so on. But this structuring isn't necessary: securitisation is just the creation of the bonds that can be sold around.

And of course lending is, like any other form of provision of capital or debt to people, all about managing risk. There's the risk, after all, of absolutely any loan not being repaid. Further, there's a constraint as to how much banks can lend and to whom in the risk that is associated with any such loans. This constraint is something we'd rather like to find a way around, too.

We don't want the banks themselves to be taking more risks: but we would rather like those riskier projects to be able to find financing from somewhere. The economy would be a very boring and static place if no one did lend to anything that had any risk associated with it.

The answer thus is to make sure that these extra risks are not being carried by the banks. That they are spread out over some larger or different group of people. People who have both a greater appetite for risk and also a greater capacity to bear it. And that's exactly what securitisation does, is indeed the very purpose of it.

> Finally, we find evidence that all loan investors, including banks, expect that securitized loans will perform worse. Banks appear to do so because they charge significantly higher interest rates on these loans than on the loans they don?t securitize. Institutional investors, who together with the originating bank and CLOs acquire the loans that banks securitize, follow the loan originator and choose to acquire a smaller stake in securitized loans.

And it appears that everyone was entirely aware of this greater risk: so much so that everyone took on a smaller portion of any one risk. Exactly and precisely what we desire to happen.

> Our evidence that securitization led to riskier corporate lending is in line with similar findings unveiled by studies of the effects of securitization on mortgage lending. Taken together, these studies confirm an important downside of securitization.

This isn't a downside: this is the point, the very purpose. We're happy with greater risks being taken as long as those risks are distributed and laid off to those who can bear them. Which is what securitisation does.

One more thing:

> While on average banks retain 26 percent of each syndicated loan they originate but don?t securitize, they retain only 9 percent of each loan they do securitize.

If the banks had held onto zero percent of the loans that they had securitised then there would have been zero financial crisis. If all of that risk had been passed on to the insurance companies, pension funds, individual investors, then we wouldn't have had highly geared banks falling over as they had to liquidate positions in bonds fast falling towards zero. And guess what the solution has been to this little point? Yup, you guessed it, laws that insist that banks must, *must*, hold onto a portion (usually 5%) of any securitisations that they originate. It's almost as if our rulers don't understand the world they rule. They're insisting on concentrating risk in exaclty the manner that caused the crisis instead of dispersing it in the manner that would have avoided it.

blog comments powered by Disqus [5]

Source URL: http://www.adamsmith.org/blog/money-banking/certainly-securitisation-increased-risk-taking-thats-the-darn-point-of-it

Links:
[1] http://www.adamsmith.org/blog/money-banking/certainly-securitisation-increased-risk-taking-thats-the-darn-point-of-it
[2] http://www.adamsmith.org/taxonomy/term/5778
[3] http://libertystreeteconomics.newyorkfed.org/2013/02/did-securitization-lead-to-riskier-corporate-lending.html?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+LibertyStreetEconomics+%28Liberty
[4] http://disqus.com/?ref_noscript
[5] http://disqus.com