

How to draw distinction between good and bad uses of securitisation

By Robert Senior

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Securitisation, eh? Isn't that the smoke-and-mirrors business those fat-cat bankers have been doing: parcelling up dodgy loans and flogging them to widows and orphans whilst buying yachts with the massive fees?

I've tried to get as many cliches and misconceptions as I can into that sentence.

My kids love a panto villain they can "boo" every time he appears on stage. But we need to get serious and reasonable, because securitisation is important for Ireland and the wider economy.

So what is this securitisation, then? The 'Economist' calls it "bundling up loans and floating bonds on the back of them".

It's a big market: €1.4 trillion outstanding in Europe, which is around seven times the gross domestic product of Ireland.

Portfolios

Over half of this amount funds mortgages. Why is it done? It brings borrowers and investors together.

Long-term investors such as pension funds and insurers need long-term assets, and strong assets with a higher yield than government bonds can form an important part of their portfolios.

Strong assets? Am I joking? Hasn't it all gone bad? No, it hasn't. We have to draw a clear distinction between the good and bad uses of securitisation.

The knife I used to carve the joint last Sunday could equally have been used to stab someone, so obviously "knives bad".

In other words, it is misuse of a thing which causes problems, not the thing itself. Packaging mortgages and selling different risk pieces to investors with different risk preferences makes sense. It's no different from equity, subordinated loan and senior debt investors in a normal company having different risk preferences.

As an illustration of the strength of properly-structured securitisations, Fitch, the rating agency, did a stress test on Irish residential mortgage-backed bonds in June.

They assumed in their "severe" case 9pc defaults and 40pc market value declines -- a pretty stiff test.

But not only did the highest-rated AAA bonds not default, they were not even downgraded. The same does not apply to the too-clever-by-half products, or those based on poor assets!

There should be a clear distinction between bonds based on straight forward and understandable assets, such as mortgages, car loans and trade receivables; and the too-clever-by-half products such as CPDOs (Constant Proportion Debt Obligations) which were a 15-times geared bet on an index of bonds.

They yielded 10 times more than a straightforward property-backed bond. My old dad used to say, "If a thing looks too good to be true, it is". Many of us pointed this out at the time. We know the rest of the story.

The US sub-prime problem was caused by lax underwriting standards. While property prices rose, everyone was fine.

When they fell . . . well, as the great Warren Buffett once put it: "It's only when the tide goes out that you find out who's been swimming naked".

There's nothing inherently wrong in packaging bad loans. There have been securitisations of non-performing loans which have performed well (you always expect to recover something -- the skill is in estimating how much). But if you have bad underwriting you will have bad bonds.

Positives

Securitisation matches the term of assets and liabilities. If Northern Rock had securitised more assets

rather than relying on wholesale funding, it is highly unlikely that there would have been a run on the bank.

We need to get funding to banks. Many banks have been structuring assets to a rated standard.

This gets their systems and procedures into shape; enables them to use European Central Bank funding in the short term; and puts them in a good position to issue to the capital market when calm returns.

Covered bonds, which are bonds issued by banks secured on pools of assets such as mortgages, are likely to become more popular.

They are certainly not something which can be seen as a fancy, over-engineered product.

The Germans have been issuing them under the name of Pfandbriefe for 250 years. Ireland has specific regulations to cover these, under the name of Asset-Covered Securities.

Funding

Banks need to get funding to smaller and medium-sized companies, the backbone of the economy.

This can be done by helping the banks to fund themselves; funding their trade receivables via securitisation; and making loans and pooling them via securitisation.

There is, in Ireland, an excellent infrastructure for capital markets and securitisation in particular, which has created many jobs and contributed greatly to national income.

While this needs to adapt to changed circumstances, a churlish "securitisation bad" reaction would endanger this competitive and important sector of the economy.

In other words, let's get rid of the bathwater by all means; but not the baby.

- *Robert Senior*

