Mildly Reformed Securitization

The IMF has backed joint ECB and Bank of England proposals to relax curbs on securitization. The proposals anticipated the role of these instruments in the recently announced ECB package of measures aimed to provide further monetary and credit stimulus to the Euro Area economies.

The fact that these instruments are again being encouraged by the IMF, so soon after the financial and euro crises in which they played a central role looks like a striking further example of "This Time is Different" syndrome. Closer inspection confirms that is so. And this is all the more remarkable as covered bonds constitute an alternative option on which efforts could focus which could better achieve the monetary stimulus goals and avoid the associated stability risks. The fact that covered bonds are included in the EC stimulus package is therefore appropriate. But the parallel encouragement of securitization risks considerably more than it gains.

The IMF-ECB-BOE suggestion is that securitization suffers unduly from “stigma” because investors have learned from their mistakes, face higher risk retention and transparency requirements in the EU now, and the default record of European securitizations was anyway always better than that of their U.S. counterparts.

But in various critical ways, these points mislead.

First, the (implicit) suggestion that the absence of securitization is unduly damaging to growth in the short- and long-runs is contradicted by the near identity of pre-crisis GDP trajectories in Sweden and the UK, and Sweden’s swift and full post-crisis recovery, given that Sweden eschewed securitization almost entirely in favor of covered bonds throughout (as will be elaborated in my book, "Two Routes" forthcoming in 2015).

Second, the suggestion that the stability risks inherent in securitization are lower than pre crisis is probably true while investor memories of loss are fresh. But the associated investor aversion to securitization itself constrains the effectiveness of stimulus focused on those instruments. By contrast, markets in covered bonds have bounced back sharply after the crisis. And over time, as investor memories fade and securitization market recovers in that context, so the stability difficulties associated with securitization may well recur too.

Third, the posited defenses against recurrence of those risks in securitization —"increased" risk retention and transparency—do not persuade.

The EU Second Capital Requirements Directive(2011) now specifies a minimum of 5 % risk retention by originators, with various exemptions while the loan-by-loan transparency requirements are defined in the current eligibility requirements for Asset Backed Securities at central banks' discount windows.

But required risk retention falls far short of that implicit in covered bonds—where risk retention always goes all the way to bankruptcy for the originator, not just the first 5 percent. Further, the risk retention percentage and the other prudential rules governing ABS are inherently flexible and so are liable to be eased, especially if securitization issues continues to be low. Indeed, the IMF has already made such calls itself.

And far from securing better quality credit standards, these risk retention rules could even have perverse effects on those. In particular, originators may pass on to borrowers the charge for the modest risk retention and alongside, in a "gamble for redemption" strategy, even increase the share of high risk credits they originate. Thus, the 5% rule could both raise spreads and increase high risks in the system.

The suggestion that loan-by-loan transparency will address that last problem is a triumph of hope over experience. In particular, markets did not require those data prior to crisis when they could easily have done so, indicating that they place little value on that information. This is often ascribed to their "general" pre-crisis failure to conduct thorough credit assessments. But a simpler reason is that most of the underlying loans being securitized are new—so, by definition, there is little information in their individual service records from which markets might draw appropriate conclusions. In contrast, markets in covered bonds do not rely on individual loan records, but on the incentives the originators face and the security that they provide and maintain.

And fourth, those—including the IMF—who assert that the low ex-post default rate of European securitizations is sufficient proof of their quality overlook the wrenching macroeconomic adjustments that were required (in the UK, Spain, and elsewhere in Europe) to produce those results ex-post. The fact that the IMF overlooks such matters is both testament to its myopia and to its compartmentalization—as this recommendation emanates from its specialist Monetary and Capital Markets Department, not from one of its area departments.

Simply, the IMF should not be supporting securitization-focussed initiatives from the ECB to stimulate demand and credit, even though the ECB should be seeking ways to provide such stimulus. And the fact that (even) the French Ministry of Finance has rejected this ECB encouragement of securitization should alert the IMF that reconsideration of its own stance on the matter may be in order.

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