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Address by Dr Stephen Grenville AO, Visiting Fellow

Lowy Institute for International Policy

Can Securitisation be Revived?

What a fascinating eighteen months we have been through!

1. Lessons of the GFC relevant to the securities market

- How should we evaluate the performance of the US financial sector over the last 5-10 years? The short answer is "NOT GOOD". It gets poor marks on each of its basic functions. At price discovery, looking after savers' funds; channeling these funds into highest-return investments, providing the financial link between the present and the future, and spreading risk. And yet the sector was paid 40 percent of US total company profits to deliver this pathetic result.

- First, let's talk about FINANCIAL MARKETS, because these are critical to the functioning of securitisation. The thrust of securitisation was to replace intermediation with capital markets. The markets would organise the financial flows between savers and investors. Price discovery was an essential market function. Asset prices were the critical building block of balance sheets. The market has not performed well in its price discovery function. Big swings in asset prices are endemic, hard-wired into human nature which will extrapolate price movements and run with the herd. Big changes of risk assessment: too euphoric, too pessimistic. Call these dramatic swings "the time-varying element in the unforcastable component of expected returns" if you like (as they do in Chicago), but the simple fact is that asset prices vary far more than they ought to over the course of the business cycle. The EFFICIENT MARKETS HYPOTHESIS has been blown out of the water. Prices are not anchored by fundamentals, and do not respond just to new 'news'.

- The financial system itself made this endemic problem worse, through pro-cyclical responses, pro-cyclical regulation, and through endogenous price feed-back. A cyclically-responsive financial sector fed the asset price bubbles and gave borrowers more rope to hang themselves (home borrowers with sub-prime borrowing). It certainly did not act as the guardians on the gateway to investment. While the music was playing, participants at the party not only felt the need to go on dancing, but also competed with each other to dance more actively, with more abandon, driven by the salary and bonus incentives. On top of this there was ENDOGENOUS PRICE RISK: there is a dynamic in market price setting that makes the overall system exacerbate the swings, rather than be self-equilibrating. Prices respond to the actions of markets themselves, rather than by the arrival of "news" or the intrinsic value of the assets themselves. In the text-books, a price fall generates a self-equilibrating response: demand rises in response to the lower price. In markets, the opposite can happen, and does at the most awkward and inconvenient times. As well, market players are forced to sell in unison by their desire to stay with the pack (as Keynes said: 'better to be wrong conventionally than succeed unconventionally'). Sometimes regulation or credit ratings made asset-holders sell into ‘crowded markets’, full of others trying to sell. When assets fell below investment grade, many fund managers had to sell.

- These swings in asset prices are intrinsic and a market pathology. We need systems that can cope with this and lessen the effects.

- Mark-to-market makes balance sheets very vulnerable: asset valuation changes pass directly into the P&L, exaggerating both upswing and downswing. Mark to model can’t be trusted.

- Liquidity evaporates. Hedge funds added to liquidity only in the UP direction.

- No Greenspan spare tyre. Too much interconnection (and everything is keying off (and correlated with) the economy. As well, the economy came to rely on the spare tyre.

- Risk metrics poor. Rating agencies imperfect/unreliable. 90 percent of their AAA ratings on ABS CDOs have been downgraded, by far the majority (60%) to B i.e. much less-than-investment-grade.

2. Where to from here?

- Open/vulnerable to reform, for better or worse.

- A characteristic of the rescue is that CBs and MoFs were prepared to venture into new dangerous territory: guarantees and accepted lower-standard collateral, as well as normal LoLR. Banks now bigger, more concentrated. More “too-big-to-fail”. Moral hazard worse. Few troubled institutions were closed up, as had been threatened/promised in the lecture on moral hazard. A bad precedent?

3. What to do?

- Regulation: everyone agrees about more capital and that it needs to move counter-cyclically (problems: realistically, can’t get enough capital; banks will take more risks: revival of the shadow banking sector; will subvert regulatory capital requirements; a decade to implement Basel II). Counter-cyclical capital and LVRs. You would need massive increase to fix the problems: most of the troubled institutions had excess capital anyway.

- Financial sector structure. WE need a range of institutions with DIFFERENT and CLEARLY DEFINED attributes of liquidity, government protection and certainty of capital value. Critical issue is to separate the core institutions from the main risk, especially asset-price risk (previous bubbles more easily absorbed). Separate the casino from basic functions of deposit taking, payments and intermediation. Back to Glass-Steagall? Decline of shadow banking sector. Accept that the system is intrinsically volatile and design an array or spectrum of intuitions to suit this risky environment.

- Better macro: crisis always have a macro mistake in the lead-up (in this case, the very low interest rates after the Tech-Wreck)

- Political Economy: strengthen the role of regulators.

- It looks like not much will change. Can't eliminate big asset price changes. A bit more capital; liquidity; some leverage ratio; some OTC instruments going to central counterparty exchange. Because we can't get the political economy right (the power of Wall Street) we can't get the structure right.

- Get ready for the next crisis ('living wills' and war-books/CMPs). This addresses moral hazard in TBTF. Realistic or Counsel of Despair?

4. What role for Securitisation?

- Wallis Committee (the intellectual force behind APRA and FSA) envisaged that capital markets/securitisation would replace intermediation. This view is generally in retreat and the critical question is "What parts of that vision can be revived?"

- Advantages of securitisation were to get things off the balance sheet of financial institutions (to ease pressure on funding and capital). Also made diversification easier (particularly though slicing-and-dicing and derivative credit-wraps), with its supposed risk-reduction. Securitised instruments purported to offer liquidity through market sale. None of these things turned out well. Economising on capital turned out to be regulatory avoidance, capital dilution and excessive leverage. Risk went to the most ignorant (like winners curse in an auction: the risk went to the people who gave it the lowest valuation). Diversification was no protection as everything was correlated with the cycle and the health of the financial sector. Separation of originator and investor made asymmetric information much more serious.

- Who will supply credit insurance in this new world, replacing AIG and the monolines (like MBIA)?

- What credibility do the credit-rating agencies now have?

- Can't solve problem by retention of 'skin in game' (IMF WEO). We know this because a number of financial institutions got into trouble specifically because they *did* retain a skin in the game: too much of the toxic assets still on their balance sheets.

- There is a place for a securitisation-type instrument which isn't a deposit and isn't a bond. Main beneficial attribute may be ability to consolidate different assets and serve up in right-sized pieces. But we no longer have faith in diversification as risk-mitigation, nor in the credit rating agencies as adjudicators of risk. Investors will want to be able to understand in detail what the underlying assets are, and their risk characteristics. Can't promise market liquidity AND price stability: any investment which seems to offer liquidity must come with an asset-price warning. No promise (even implicit) not to 'break the buck'. Advantages of liquidity may have been overstated.

- Will 'slicing and dicing' return? Not without analysis of what went wrong. Can Credit Default Swaps be revived? Not without big capital backing. What role for derivatives? Obviously simple FX and interest-rate swaps will remain routine financial products. But it's hard to believe that credit-wrap-style instruments play the central role they did before 2008: there simple aren't enough strong brands to back them.

- In retirement planning, there may be a place for an instrument which offers steady income and guaranteed capital return, without promising much in the way of liquidity (like the old bond strategy, where bonds were put in the bottom draw). But this would require the issuer to have a strong brand. The IMF seems to see covered bonds as having the required characteristics (the issuer is still ultimately responsible for the face value, paid on maturity). These do not transfer credit risk and don't reduce regulator capital requirement, so won't be popular with issuers. But this instrument addresses funding issue by offering an attractive investment. See IMF Global Financial System.

- Securitisation may be confined to simple instruments (mortgages, credit card debt). Know your customer still seems a valuable characteristic. Intermediaries have to return to the idea that they are the guardians of the gateway to investment.

- Bank regulators will want to make sure an off-balance-sheet instrument is really off balance sheet: recourse has to be *forbidden* ("not allowed to offer support"). This will make the instrument less attractive. If regulators address moral hazard risks by being more carefully to protect only the depositors (not the creditors), this will also make the instrument less attractive.

- Problem was not asymmetric information (Harper): it is uncertainty. Even the issuer does not know how things will turn out.

5. Asian application

- Non-Japan Asia came through pretty well.

- Half of Asia has very underdeveloped bond markets. Who will fund enormous infrastructure needs? Doubts about PPPs. Greater role for Government bonds.

- China's surplus needs financial infrastructure to diversify assets. This would address external imbalances problems.

- Neglected opportunities of Asian Bond Fund

- Why aren't regional capital flows bigger?

- Eichengreen's distinction about regional versus individual market development

6. It should be in your interests to get a universal strong safe system

- No worries about regulatory 'race for the bottom'. Role of 'front-line' regulators. This battle lost: a casualty of the GFC.