Jean-Pierre Landau: Some thoughts on securitization and financial turbulences

Remarks by Mr Jean-Pierre Landau, Deputy Governor of the Bank of France, at the Paris EUROPLACE, Financial Forum, New York, 22 October 2007.

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There is a paradox in the current situation. However we measure it (by the level of spreads or volatility), the shock created in credit markets by losses on subprime loans is without precedent. And yet, the losses themselves, while significant and spectacular for some institutions, would not seem to pose a major risk to the health of the financial system. Most notable, the turbulences occurred in a very favorable macro economic environment.

This disproportion between the cause and the effect points to some existing fragilities – that need to be addressed – in the securitized model of capital markets. There is no rush to take measures, even less regulate. But there is no room for complacency either. Rather, we need to come to a diagnosis and think of the desirable characteristics of a robust securitization model.

The current model of securitization, as it has developed in the last decade, has two distinctive features:

- One we were aware of: an increasing complexity of instruments, which combine an extensive use of derivatives with customization to individual investors' needs. This has made valuation and risk assessment more difficult.
- One we rediscovered during the turmoil: the fragility of off-balance sheet structures and vehicles which underpinned securitization. Conduits, especially SIVs, were not built to absorb shocks. Their relationships with sponsor banks are sometimes very ambiguous. There may be a gap between the legal commitments taken by the banks through liquidity support and credit enhancements, and the “true” level of responsibility they felt obliged to take to protect their reputation.

This conjunction of complexity and fragility may have been too much for the system to bear. So it is worth to pause and ask ourselves whether we can eliminate those vulnerabilities and still keep the benefits associated with securitization, especially in terms of financial innovation.

One good starting point is to look at the economic and financial rationale for securitization. Securitization is meant to perform two functions: the first, and most "advertised" in recent years, is to allocate and distribute risks, hopefully to those agents and investors best equipped and most willing – to carry it. The "slicing and tranching" process allowed banks to offload credit risk from their balance sheets and transfer it to other financial investors. But, historically, securitization is borne out of the more simple desire to shortcut banking intermediation by using markets to directly match the needs of lenders and borrowers. Since both have different liquidity preferences, this usually involves the issuance of tradable – i.e. liquid-securities which can be sold to the ultimate investors.

Thus, a well functioning securitized system would meet two characteristics: (1) allow for a permanent reallocation of risk between market participants according to their preferences, expectations and risk aversion; and (2) make liquidity (market liquidity) permanently available throughout the system.

The question we need to ask is how those two characteristics relate to each other. In other words, what is the link between liquidity and risk? Here we could use a very simple framework. Investors have a perception that a market is liquid if they feel they can trade their assets (and positions) with no constraints and without moving prices by too wide a margin.

Liquidity exists when there are counterparties available to trade at any moment in time. It follows that liquidity is both an expression and a consequence of the ability of market participants to take risks on each other. For liquidity to exist, therefore, there must be a general sense, in the market, that each participant (or, at least, most of them) are suitably equipped to face the risks they are taking. This is what we call confidence.

Looking at discussions on the current phase of market turmoil, two views have emerged as to what determines confidence.

The first view emphasizes information and transparency. Crisis of confidence and drying up of liquidity occur when there is too much opacity in the system, when investors are unable to assess risks, or when market participants do not trust whatever information is available. One good example is valuation. Valuation of complex instruments is currently at the forefront of discussions between regulators, market participants and investors. There is, of course, a circularity involved, since liquidity depends on valuation, fair value must be based on a market price, and the ability to price an asset itself depends on sufficient liquidity in the market. The difficulty to get out of this circularity in periods of stress is currently creating significant uncertainty.

Another example is risk measurement. In a securitized world, investors heavily depend on rating agencies for information about the risks attached to various instruments. These agencies have been strongly criticized recently. It is not my purpose to enter into any blame game. Suffice it to say that there has been a deep misunderstanding between investors and rating agencies as to the scope and true meaning of ratings. Most investors were not fully aware that rating did not encompass liquidity risk; nor did they realize that ratings for structured products were intrinsically more volatile than for more simple "plain vanilla" securities. The use of identical metrics for rating what are fundamentally different categories of assets certainly did not help and may have contributed to the confusion.

Some observers have argued that investors should be faulted for relying too much on ratings. Instead, the argument goes, they should do their homework and put themselves in a position to directly assess risks. But it is doubtful that we can dispense of the rating process. If each and individual investor had to carry their own due diligence, the costs of gathering information would be prohibitive and this would introduce important frictions in the functioning of the market. So, future work should concentrate on how to make the rating process clearer and more explicit and to preserve and strengthen its integrity.

A second, alternative view, on the collapse and confidence and liquidity would point at the inadequation of capital to risk in the new securitized model. Ultimately, the ability of an investor to carry risk is determined by her capital base. Capital must be sufficient to absorb the potential losses if risk materializes. If not, confidence may vanish and liquidity may disappear. To quote Stephen Cecchetti[1], "in the context of financial intermediaries, capital plays the role of collateral".

So, for the securitized model to work, there cannot be too big a disconnect between the allocation of risk and capital in the system. This is true both at the aggregate level and for each individual issuer of securities. At the aggregate level, insufficient capital leads to excess leverage and, as a consequence, to excess fragility. For each individual issuer of securities, carrying risks with little (or no) capital increases the probability of a liquidity crisis.

It may be that, as time goes by and we look more closely at what happened, this second view will gain in importance. I would note that cracks occurred in those places – the conduits and especially the SIVs – where there was no capital available to absorb shocks. Conduits and SIVs have no capital of their own, and they depend heavily on the liquidity support and credit enhancement from their sponsor banks, whose terms, and conditions, as I said, may

[1] Market Liquidity and Short Term credit : The Financial Crisis of August 2007 ; 3 September 2007.

be variable and uncertain. And yet, they undertook maturity transformation on a significant scale. So those risks which materialized directly translated into liquidity shortage. Conversely, the reason why most hedge funds weathered the shock – at least until now – may be that they managed to strengthen their capital base by imposing strict redemption rules to their investors.

Strong capital will not guarantee liquidity in all circumstances. There can be panics and sudden increases in the demand for liquidity. That's the job of Central Banks to help in those circumstances. But a strong capital base in the system – and in all its components – is likely to limit future liquidity shocks.

In the period to come, Central Banks, regulators and market participants will debate on the ways and means to restore the securitized model on a robust and sound basis. The implementation of Basel II will bring significant improvements in the measure and management of risks. Had it been into place some years ago, we may have avoided some of the problems we currently face. Other evolutions in the regulatory environment and business practices may prove necessary. But, as I said, now is the time to analyze and think.