Press Points for Chapter 2:
Restarting Securitization Markets: Policy Proposals and Pitfalls

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Key points

- Sound securitization provides important benefits—to allocate credit more efficiently, transfer credit risk away from banking sector to more diversified investors, and more finely tailor risks and returns to potential end investors.
- Failure to restart securitization would come at the cost of prolonged bank funding pressures and a diminution of credit, and a continuing need for central banks and governments to take up the slack.
- The new model of sound securitization should leave behind the "high octane" markets of the past and establish markets that reliably fulfill lender funding needs without increasing product complexity and ramped up leverage.
- The variety of proposals to restart sustainable securitization—increased capital requirements, tighter accounting standards for off-balance sheet entities, retention requirements, and enhanced disclosure requirements—all move in the right direction.
- However, if all are implemented in combination, the interaction of these proposals could make restarting securitization too costly. Impact studies should be conducted before such proposals go into effect to ensure that, in combination, they foster—not suffocate—sound securitization.

The soaring securitizations seen during 2005-07 resulted from misaligned incentives from a variety of sources—issuers and credit rating agencies interacted to overrate securities, regulatory and accounting arbitrage motivated inappropriate investment structures and products, and short-term-focused performance-based compensation boosted issuance. Many investors also failed to apply proper due diligence to their securitization positions, often because the information required to do so was not freely available. When all these weaknesses came to the fore—seen, in part, in mounting defaults by borrowers and a breakdown in pricing—securitized product prices and issuance plummeted and much of the market effectively shut down in 2008 and 2009.

This chapter examines the rise and fall of private-label securitization markets and evaluates the various initiatives aimed at restarting them on a sustainable basis. These proposals aim to correct misaligned incentives and opportunities for regulatory arbitrage, which have encumbered the efficient distribution of risk, weakened market discipline, and induced slippage in both underwriting and monitoring standards. Proposals under discussion include increased regulatory capital charges, tighter accounting standards for moving assets off-balance sheet, increasing retention requirements for originators, and enhanced disclosure requirements.

In particular, the chapter evaluates initiatives put forward in both the United States and Europe to introduce a minimum 5 percent retention requirement for originators to have more "skin in the game," ensuring that someone takes responsibility for diligent underwriting and monitoring. The chapter demonstrates that flexible implementation is required to achieve a broad-based alignment of incentives, because as default probabilities change, as well as economic conditions and loan qualities, originators of securitized products have varying incentives to screen loans.

Policy proposals

Several policy proposals arise from the chapter, some of which encompass activities already under consideration and which also build on earlier GFSR proposals.

- Policies should reduce incentives for "rate shopping" and for ratings-related arbitrage of regulatory requirements, including by having ratings agencies disclose their methodologies and publish their rating performance data, and reducing regulatory reliance on ratings.

- Retention requirements should be tailored to the type of financial product, its underlying risks, and forward-looking economic conditions—barring this, policymakers should choose a second-best retention scheme that covers most outcomes.

- Financial statement disclosure and transparency should be enhanced, especially as regards off-balance sheet exposures. However, disclosures should concentrate on materially relevant information and not overburden securitizers or investors with irrelevant data.

- Securitizer compensation should be revised toward a longer-term horizon and recent changes to accounting standards for securitizations move us closer to this goal.

- Securitized products should be simplified and standardized in order improve liquidity, ensuring prices better reflect actual transactions.

A fundamental message of this chapter is that, although individually all of these measures are aimed in the right direction, before they are implemented, their interaction needs to be carefully evaluated. Impact studies should be conducted to ensure that, in combination, they promote sustainable securitization.