Unfreezing Securitization: Restoring the Market's Confidence in Itself

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According to Wharton finance professor Richard J. Herring, more than half of the lending to households over the last five to six years "has come from the securitization market, not from banks' balance sheets." For that reason, Herring and Allen Levinson, founder and principal of Credit Risk Advisors, say that the Obama administration's efforts to resuscitate the ailing economy should be focused not only on restoring bank lending, but also on enabling "the flow of securitizations." This can be accomplished through the establishment of a private-sector oversight committee that "reflects the full range of stakeholders in the securitization process" -- a market-based solution costing taxpayers nothing, they argue.

An edited transcript of the conversation follows.

Knowledge@Wharton: A good starting point might be to look at what exactly securitization means and how it came to become so critical a part of credit markets. Dick, would you want to start?

Dick Herring: I think Allen is actually the perfect person to start because he tried starting securitization about 10 years before it actually happened.

Knowledge@Wharton: There you go, Allen. Take it way.

Allen Levinson: Financial institutions do a variety of things. Some [of those things] involve having a balance sheet where they invest in assets that they create or buy from others and hold for a period of time. But financial institutions are unique originators of assets. They know borrowers. They have ongoing dialogues with borrowers ranging from very big companies down to individual consumers. And they are able to create assets in the form of loans to these various types of borrowers. Now, if an institution has the ability to create loans, they may find, just like in many other places in life, that a manufacturer can create more of something than they want to consume. It's easy to imagine a farm cooperative growing more oranges than they want to eat. It's easy to imagine a country building more good cars than they consume in the country. And so what you want to do is to take these good things that you create and essentially sell them to other people. So the concept of creating loans and selling those loans to investors who have capital makes a lot of sense.

So in our society we were able to grow our economy much more quickly. And it became very evident through the 1990s and also in the current decade that good originators of assets created loan assets of all sorts in excess of what they could comfortably hold on their own balance sheets. They took these assets and, through the securitization process, created very attractive investments for pension funds and other types of institutional investors. So, where we wound up was that securitization was a tool that very efficiently allowed capital to flow from end investors back to borrowers who genuinely needed the money. And the securitization process, as a tool, worked very well for much of this time in many cases, and worked very badly when it was abused.

So what we have now is a circumstance where we've seen, for the last two or three years, serious abuse of the securitization process, which has caused meaningful harm to investors of various sorts and to the underlying financial institutions. And what we'd like to try to do, through our proposals, is to allow the securitization process to regain the credibility that it needs with investors so that new securitizations can get done, which will allow investors to invest again and allow borrowers to have access to credit that we've all become accustomed to in recent years and doesn't exist right now because of the failure of the securitization market.

Herring: Interestingly enough, historically, [it means] almost redoing the origination of privately sponsored securitizations. This is an innovation that actually began in the government sector with Fannie Mae when they were a government agency and they were able to guarantee the creditworthiness of a security. The private sector had to figure out a way to substitute for that government guarantee, and Allen, of course, was part of a group [of individuals] who have figured out substitutes. And we have to go back to first principles and see how to re-create that confidence.

Levinson: I think the key to the process is to create an environment where investors can genuinely evaluate the risk in the opportunities that they're given to invest in -- the various instruments that are offered to them -- and have confidence that their analysis of the risk is consistent with what the underlying risk will turn out to be. No investments are risk-free. But responsible instruments allow responsible investors to evaluate the risk. The problem in recent times was that investors were misled.

Knowledge@Wharton: Before we talk about the solutions that you have come up with, and we'll get to that in a minute, I wonder if you could tell me from each of your perspectives some of the main factors why securitization got debased.

Herring: Well, there are micro and macro factors involved. There are a number of people who have noted that apart from the details of it being securitization and it having spread so rapidly globally, it's not all that different from a number of banking crises we've had over the last 200 or 300 years. And it usually begins with a long placid period that enables people to feel extraordinarily confident about the future and to believe that without taking more risk consciously, they can take more leverage, they can reach for assets they would not have ordinarily taken on, because -- we actually had a name for it in this case, "the great moderation" -- [they think,] "things are different now," which is probably the most dangerous set of words in the English language. And we had a very placid period during the early days of the new millennium. It was a very shallow recession. Some people don't even count it as a real recession, and both volatility and credit spreads were at absolute minimums. The spread between a U.S. Treasury and a junk bond was about 100 to 200 basis points, which was really pricing in perfection. And in that kind of environment, institutions that were being pressed for returns were willing to reach hard.

Now, an interesting aspect of it from the U.S. point of view is that regulation inadvertently created a situation where this was more likely to happen. It went back to the 1930s when the U.S. government made use of the ratings agencies -- both state governments and the federal government -- to regulate institutions both with regard to the quality of assets they had to hold and with regard to, in some cases, what they had to hold to be regarded as a particular kind of institution. This led to a lot of pressure for grade inflation on the part of investors because they wanted to get both very high returns and very high grades for creditworthiness. It's of course been made much worse by the Basel Agreement, which will actually create bank capital charges based on ratings, at least in one version of it.

It was also made worse -- in a good example of the law of unintended consequences -- by the Europeans who forced the U.S. investment banks to voluntarily create consolidated, regulated entities under Basel II principles. And they were to do it under the auspices of the SEC [U.S. Securities and Exchange Commission], which had no experience in doing such a thing, and as far as we know never did figure out quite how to do it very well. But when the investment banks looked at the asset side of their portfolio using internal models and using five years of very placid data, they decided that they had almost no risk at all. And so their leverages shot up from 10% to 15% to over 30%, which meant that they were really much more vulnerable to increased volatility in the market.

And then the other thing that can't be overlooked is the pressure of Congress on Freddie Mac and Fannie Mae to increase the flow of credit to low-income borrowers. This in itself is perhaps a good thing to do, but it's probably the wrong tool to use because you really don't want to give greater leverage to people who already have volatile incomes. It should be in the form of grants for equity, but they chose not to do that. Freddie and Fannie made a deal with their regulators that they could satisfy that requirement by buying up triple-A tranches of subprime securitizations. So you had a not very discriminating buyer that ended up owning about 50% of the market, which led to an increasing supply of really shoddily produced products.

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I guess a spin I would put on what Allen was saying is that what had worked very well before broke down because the incentives were so strong. We used to believe that reputation was a sufficient constraint on ratings agencies to keep them doing an honest job, but by the time of the peak of the subprime market, some of these agencies were making as much as 50% of their profits in rating this kind of debt. And it was worse than that because in rating a corporate bond, corporations will come to the market from time to time, but they don't have the capacity to bring huge amounts of money to a ratings agency. In the case of subprime debt, there were a few players that had literally the capacity to bring billions of dollars of revenue to these agencies and it strained one's belief in reputation, shall we say.

Levinson: If I can add one point. I think Dick just did an excellent job of outlining the economic environment and the key financial aspects to it. He alluded to the fact that there were also some issues that have more to do with human behavior and human nature. One of the key things here is that the securitization process requires a large number of different types of institutional service providers. You have some institution that makes the original loans, but then after that you have lawyers and accountants involved. You clearly have the rating agencies involved. In some cases you have monoline insurers or other credit guarantors involved. And then you have an underwriter who brings all this together and brings it to institutional investors. Now, if I can draw an analogy: If you went back to the early days of manufacturing cars or airplanes, the manufacturers of each part would want to be very careful to make sure their part was made well, but they'd also want to be absolutely certain that the car or airplane that it was put into was still safe, that if anything failed, they wouldn't be associated with that bad vehicle. But as time goes on, and you take for granted the way the manufacturing process works, everyone focuses on their own little piece and spends very little time worrying about whether the other people do their job well. You simply take it for granted.

So, what we found in the creation of, pardon the pun, a securitization vehicle was that each service provider perhaps did a very honest job on their own piece, but even if they just looked a little bit they might have noticed that some of the other things just didn't smell exactly right. So maybe the originator wasn't really being honest about the credit quality of the borrower. Or maybe the ratings agencies were making assumptions that didn't really fit with what we could see about the collateral, but [they thought,] "That's the ratings agency's job, not mine." And so everyone took for granted that the other people were doing things well. And ironically, it was the very success of the securitization product that investors no longer looked skeptically at securitizations, but rather accepted that these things were put together by credible professionals who were being very honest and very rigorous.

We got to a point where bad things were able to get in and, unfortunately, we see in many types of markets that the bad often drives out the good, and that's what has happened in significant parts of the securitization market over the last two years or three years. We believe that we can re-create a market where there's a higher degree of discipline on the part of each of these service providers, and that can help solve the problem. By the way, one of the service providers that also took a lot of things for granted were the regulators themselves. They also didn't blow the whistle and notice the things that were wrong.

Knowledge@Wharton: Thank you very much for that analysis of what went wrong and has led pretty much to a freezing of the securitization market. Talking about possible solutions and restoring confidence, the Obama administration has come out with recommendations for how the whole regulatory process should be reformed. To what degree have the problems that you're seeing been addressed by these recommendations?

Herring: Until now, the Obama administration has focused largely on what were called "toxic assets" but now are legacy assets that are the residual of the bad securitizations. But while it's necessary to deal with those assets in the sense of recapitalizing banks, and I think they've done it in a very inefficient way; they've lost sight of the fact that the real objective is not only restoring bank lending, but even more important, restoring the flow of securitizations, because more than half of the lending to households over the last five to six years has come from the securitization market, not from banks' balance sheets.

Levinson: Since 2001, a majority has come from the securitization market.

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Herring: And there's no prospect of putting enough capital back into banks to be able to support that kind of lending again. So unless the flow of securitizations is restored, we're going to see a credit crunch the likes of which we've never experienced before. Yet until this proposal, there's been almost no talk of restoring the flow of securitizations, even though I think it's at least as essential as restoring the flow of bank lending.

Levinson: I think there are a couple of points here worth making. First, the Obama administration seems to favor two tools. One is the use of taxpayer money to essentially replace private-sector debt with public-sector debt. Second is regulatory fiat, putting regulators in place to tell performers in the private sector what they must do or face regulatory consequences. It is our belief that if you want to restore confidence in the market, the best way is to facilitate the use of market forces. So from our perspective, there's a way with no taxpayer money required and with no new regulatory regime for the government to facilitate the creation of a body that will assure that in the case of certain securitizations the information presented to end investors is absolutely consistent with the underlying attributes of the asset. If that can be done in the private sector in a way that brings back confidence, what the government has now done is facilitated the restoration of an efficient capital market without a need for new fiat and without a need for new government spending. And that's a very important part of what we think must happen if we're going to finance growth in the economy. And just to reemphasize what Dick said, there's a sense of urgency here. If we want the economy to come out of a recession, private-sector capital has to be available in efficient ways so that borrowers can get access to the credit they need.

Herring: I think there's another aspect to the point Allen's just made. First, it isn't just the securitization agents who have lost a lot of credibility; it's also the regulators. So having a new regulatory fiat is not necessarily going to instantly restore credibility. But beyond that, one has to think about the world capital market. The G-20, and indeed the Obama proposal, urges each individual nation to develop their own more stringent regulations for credit-rating agencies. The European Union is already a long way down this road. They've developed a double registration system that will require anyone rating securities that will be bought by Europeans to register in a home country and to register with CESR [the Committee of European Securities Regulators], which is the coordinating agency among securities agencies. If they come up with a different set of standards, as they quite plausibly will, than other regulators in other countries, you are going to have a fragmentation of a world capital market that by and large has served us really very well. I think one of the great advantages of the voluntary program that Allen alluded to is that if there is a market solution you don't need to involve elaborate negotiations among governments. The superior standards will simply dominate because those are the standards that will appeal to investors who are concerned.

Levinson: One thing that is very important, again, is the multiplicity of service providers. When you approach things with regulatory fiat you focus only on certain service providers. The administration so far is focusing primarily on the banks and the underwriters. A more voluntary approach can also include lawyers. It can include accountants. And, very important, it will influence the ratings agencies to a much greater extent. The other point that is also very relevant is that we've seen in the past that when you deal with regulatory fiat, regulators change their minds overnight. And when they do it affects the entire system dramatically. One example is that a few years back in an overnight change, large investment banks were allowed to lever their balance sheets dramatically more than the day before. We now know we paid a severe price for that. So if we put by regulatory fiat limits on the behaviors of certain people in the securitization system, in the future when things are good they're going to go back to the regulators and ask for forbearance. And things will change radically overnight and perhaps in a not very well-thought-out way. Market disciplines tend to evolve more and not move as dramatically.

Knowledge@Wharton: Coming back to your suggestion of creating a voluntary body and a market-based solution, who would create this body and how would it help solve the problems the markets are facing today?

Levinson: One of the really wonderful things about this is that the service providers themselves would benefit. The securitization market is moribund. There are no new securitizations getting

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done. Every service provider still has a large staff of talented people who spent the last decade earning a very good living by providing these types of services. Now in a few cases perhaps we don't want those people to do it going forward because they misbehaved, but the vast majority of them were hardworking, honest and diligent. They'd like nothing more than to be gainfully employed again. So if you can create confidence, the demand for the loans is there. The capital is there on the other side. But the investors don't have the confidence to buy the instruments. If everyone in the process cooperatively were to work together, then we can create a very vibrant market again and everyone will profit and the economy will grow. So it would meet everybody's best interest. It's very hard, though, to get the critical momentum to get all these different people working on new rules. And that's the role that the government needs to play. They simply need to be a facilitator to organize this process.

Herring: Yes. I think it is quite true that as a piecemeal process it probably won't work. But the role of government need not be one of providing funds, as we've stressed, but it probably should be one of designating the structure of the committee so that it reflects the full range of stakeholders in the securitization process, and I would say probably weights the interest of investors a little more heavily than those of others. At the same time, that gives them two clear objectives that have been missing. One is to improve transparency and the other is to align the actions of each agent with the interests of the final investor. And that will probably involve linking compensation to each of the agents to the outcome to the final investor. But that's about all they need to do. I would suggest that securitizations that meet those standards be differentiated from other kinds of securitizations. We used Allen's clever acronym, STAR, which stands for the -- I always have trouble with the actual name, but Washington is full of acronyms so it would work well there.

Levinson: The STAR acronym stands for Securitization Transaction Approval Review process.

Herring: And it would be a set of standards that each STAR-approved securitization would have to meet, and presumably investors would feel much more secure with them than with a normal securitization, and you might well have good transactions driving out bad.

Levinson: To reemphasize a couple of Dick's points, the end investor is the key consumer in this process. At the end of the day, they should have very significant input as to what the best practices are that the STAR review process requires. When we get there, investors will have confidence. Could we get there piecemeal? Well, Dick said he didn't think we could. I think we probably could, but it takes more years than we want to wait. We don't want to have a recession that goes on for years while we wait for this to happen piecemeal. There's a way to make it happen much more quickly. If you bring together the universe of investors and say, "What do you need to rely on? What do you need to know?" and take that information and create a best practices review process such that it is certified that those practices went on for any securitization that gets the approval of this committee, now you have a product that works. Will other products work as well? Perhaps in the future, but in the short run this would radically alter capital flows.

Knowledge@Wharton: We were talking about the ratings agencies and I would love to get your reaction on something I heard just last month in an interview with Neel Kashkari after he stepped down as the head of the Office of Financial Stability. Somebody asked him a question about the ratings agencies and how their credibility had been completely compromised. His answer was that he looks at ratings agencies very much in the way he looks at sell-side research. Essentially, his point, I think, was that you've got to know how these ratings agencies are compensated, where their money comes from, where their incentives lie, and you basically treat it for what it's worth. There are two questions. One ...

Herring: I think that's a false analogy.

Knowledge@Wharton: That was my first question. My second question is how would the STAR system overcome that issue?

Herring: First, I think it's a false analogy because no government regulation that I'm aware of makes use of the ratings of sell-side analysts. Yet we have a plethora of government ratings that depend on the ratings agencies. In a sense, several government departments have outsourced credit

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analysis to ratings agencies. Now ratings agencies grew up in the United States. They were actually originated here because we started corporate bond markets. Before that there were certainly bond markets, but they were usually sovereign markets. And sovereign markets ... As long as the sovereign is dealing in their own currency we're pretty secure. But we financed infrastructure in the U.S. -- largely railway bonds -- with corporate money and there was a real demand for trying to figure out the good corporations from the bad corporations. And [John] Moody started the first service just after the turn of the century. And then you had Standard & Poor's. And Fitch is a latecomer. But these institutions were very well aligned with investors because their revenue model was to sell manuals to investors. And it was a very straightforward business. They could make money as long as their ratings turned out to be credible. It was based heavily on their reputation and maintaining their reputation. So their temptation to shave a rating or to alter something in favor of an issuer was negligible because it would lose their business.

Well, in the 1930s, because of some bad experiences with corporations, a number of different players -- including the comptroller of the currency briefly and including state pension boards and insurance companies and a number of other regulators -- started to use ratings as a regulatory tool. That immediately changed the kind of dynamic because now you had regulated institutions essentially getting regulatory mandates as well as ratings. And there was a pressure for grade inflation that you can see in the statistics over time. But it didn't seriously affect the quality of the ratings. Interestingly, the industrial structure was always that of an oligopoly. There were never more than two or three ratings agencies that were of any importance.

Finally, in the 1970s, I believe it was, the SEC decided that if they were going to use ratings for regulatory purposes they really ought to have a way of deciding whose ratings they should use. So they developed the terminology and the criteria for nationally recognized statistical ratings organizations, which is always a mouthful to say. And it was quite circular. How did you become a nationally recognized statistical rating organization? Well, you were nationally recognized. So that made it a little tough. But after a bit of time, they were under a lot of pressure to try to make the market more competitive. I think in some sense that it is always going to be something of an oligopoly. But I do think there was a misuse of, or a lack of attention to, antitrust policy. One of the big losses, or big missed opportunities, during that time was when [KMV], which had a radically different way of rating corporate credit by using market prices and backing out corporate credit ratings, now was used by a number of institutions in preference to ratings because they, on the whole, turned out to be more accurate.

Levinson: Well, given that the ratings were regulatory, they used both.

Herring: Yes. That's true. ... [KMV] was acquired by Moody's and it's no longer an alternative rating.

Levinson: Although the product is still sold and is still available. And many banks still use it for risk management. If I can interrupt, I think it's important to understand that ratings agencies simply produce ratings. The actual underlying risk of an instrument can't very easily be summed up in one or two or three letters. So what has happened to ratings agency ratings is that they've become a little bit like pornography over time in that nobody can describe exactly what a triple-A or a single-A or a double-B means, but we sort of know it when we see it. So you have this very interesting concept where we are regulating institutions based upon these letter grades that don't fully assess the underlying risk. And what makes that much, much worse, and where the ratings agencies really fell down in the world of securitization, is that I can have a large number of separate investments that all have relatively good ratings be much riskier than other investments that have lower ratings but aren't as highly correlated that provide better diversification. And the ratings agencies never figured out how to communicate these diversification issues or even how to assess them very well in the world of securitization. So one of the problems was that the ratings agencies chose to use these very same letters on securitization investments that they previously used on corporate bonds when in fact the risks were radically different.

Herring: I can give you an example of just how different they were. The absolute worst year we had for corporate bond downgrades, and they're usually measured in terms of notches, pluses to minuses, and so forth ... If you look at the three-notch or greater downgrades for corporate bonds, the worst year was 2001. We had Enron, we had WorldCom, and we had Argentina, the largest

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country default in history. There were virtually no discernible triple-notch downgrades except in the below-investment-grade area, where everybody expects things to be volatile and it's not alarming. But if you look at the year 2007-2008 for structured products you'll find that of the triple-B-rated securitizations, 68% were downgraded three notches.

Now, if you're an institution required to hold investment-grade securities, that is fatal because that takes you below investment grade. And it shows that there's something very, very different in the nature of your ratings. It would have been helpful to use a different symbol. The SEC in fact suggested that they do that. But the industry convinced them not to. So in January or December, I've forgotten which it was last year, they decided to duck all of the far-ranging proposals, which might have helped, like taking ratings out of regulation and having different scales for different kinds of risk, and went for what looks like low-hanging fruit. They said that ratings agencies should separate the consulting business from the ratings business. Now that to me is a phony issue because the whole nature of ratings is bringing different packages to the rater and having him tell you what they are. I don't see how that differs from consulting. It's just a serial process, but it made everybody feel they'd done something and that was supposed to fix it.

Levinson: So to summarize there are really two key issues vis-à-vis the ratings agencies, and if we want to establish confidence in a securitization process both these issues have to be dealt with. One is this alignment of incentives. Dick pointed out that the ratings agencies currently in their revenue model have a fairly serious conflict in how they are incented. And in the world of securitization we think that needs to change.

Herring: I think I forgot to explain how that happened. Selling manuals worked perfectly well until the introduction of the Xerox machine. And after the Xerox machine was introduced in the early '70s, that revenue model simply fell apart.

Levinson: And, of course, the other side of it is, as the regulatory implication of ratings became more important, it became much easier for the ratings agencies to demand more and more money from issuers and, in fact, they became a very lucrative business. But the second issue with the ratings agencies has to do with transparency. We can't simply rely on a letter or a number or a number of stars. We have to understand how they went about doing their analysis, what assumptions were made, what quantitative models were used so that we can have a better sense of what the risk of massive downgrade is. So perhaps the rating is correct today as to what the probability is, but how much can things change in the future? And I think that all these things are quite doable, but the ratings agencies need to be incented to move in this direction by having an opportunity to do business.

Knowledge@Wharton: If you were to look five years out and then look back in retrospect, what does the future face of securitization look like to you?

Herring: I think it will be much simpler. Part of the problem is that securitization got incredibly baroque so that it literally took people who were serious about doing their homework a week or more to get back to the underlines and even make a decent forecast of how much the tranche they held was worth. So I would guess that they will be much simpler and much more transparent, much more straightforward, and that model worked perfectly well for a very long time.

Levinson: I agree. I think the key is that securitization is a tool. The ends are to allow borrowers to get the credit they need on terms and prices that are reasonable and to allow investors to invest in instruments that meet their risk needs in a fashion that they can evaluate those risks and have confidence that the risks that they think they're taking are the risks they are actually taking. So that's why simplicity is important. That's why transparency is important. And most important, it's why the alignment of incentives of everyone involved in the process is quite crucial. And, to reemphasize, this can all be done without taxpayer money and it can all be done successfully in the private sector.

Herring: And I think this is a time when there is a strong enough mutual interest among all the players in the securitization process in restarting the game that it really could be accomplished relatively quickly.

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Knowledge@Wharton: I have one last question for each of you and that is to ask you to imagine that at this table along with the three of us there is a fourth chair, and that President Obama is sitting there. If you were to give him one piece of advice about what he needs to do to get things back on track to restore confidence, what would that piece of advice be?

Herring: Well, I think sometimes less is more. It strikes me that with regard to the thrust into the financial system at this point there is way too much expenditure of taxpayer money, way too little emphasis on market discipline, in fact undermining market discipline in many cases, and I guess if the whole stack of proposals that were in the white paper, the most important one to implement, and it's only sketched in the vaguest of terms, is a way to resolve any institution no matter how large it is without intolerable spillovers. Because unless you can do that, the taxpayer is held hostage to any institution that is too big, too interconnected, too internationally complex to fail. And I think we've established we can no longer afford to do that.

Levinson: I would suggest that the President faces a remarkable host of challenging economic problems. Some of them can only be solved by using taxpayer money to prime the pump. Some can only be solved through regulatory fiat. Whenever there is an opportunity to use free-market forces and to incent participants in the free market to solve their own problems, that's a terrific way to go, and we should look for those everyplace we can.

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