Chapter 6 **Securitization**

Chapter 1 showed that firms may borrow directly from investors by issuing *securities* (stocks and bonds) that can be traded in open markets. *Securitization* is the process by which financial institutions pool various assets (typically residential and commercial mortgages or consumer loans) and transform the collected assets into securities that give the owner a claim on the payments from the pool and that trade in open markets. The process of assembling and distributing such *asset-backed securities* (ABS) is sometimes called *structured finance*.

What are the benefits of securitization? Securitization utilizes the efficiency of markets to lower the cost of borrowing. It does so by: (1) facilitating diversification of risks; (2) making assets liquid; (3) allowing greater specialization in the business of finance; (4) broadening markets; and (5) fostering innovation. These advantages are all closely related to core principle 4: markets determine prices and allocate resources.

Let us examine each of the five mechanisms by which securitization enhances efficiency. First, it promotes *diversification* or *risk-spreading*. As we saw in Chapter 5, selecting assets whose payoffs are unrelated spreads risks. So owning a security that provides a claim on a tiny portion of the payments from several thousand mortgages is less risky than owning a few mortgages in their entirety. By making it easier for investors to bear the total risk of thousands of mortgages, diversification lowers the cost of funding to home buyers.[1]

Second, securities are easier to buy and sell – they are more *liquid* – than the underlying assets on which they are based. Liquid assets usually have higher prices because buyers worry less about being able to sell them in the future. Again, the effect is to lower the cost of funding for borrowers.

Third, securitization allows for greater specialization and innovation in finance. Some financial institutions are relatively effective in *originating* (creating) the assets that are then securitized, while others are more proficient at pooling the resulting assets and at issuing and *distributing* the securities. This pattern of financial activity has come to be known as the *originate-to-distribute* model of securitization because the processes of origination and distribution are often distinct and separate.

Fourth, securitization broadens and deepens financial markets, making it easier for borrowers to raise the resources they need. For example, a home buyer in a small town need not depend on the ability of a small, local bank to bear the entire risk of holding their long-term mortgage. Instead, securitization gives that home buyer access to investors across the globe who can readily afford to buy a tiny portion of the home buyer's mortgage in the form of a marketable security.

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[1] Chapter 11 makes a similar argument with regard to risk-pooling by banks: each depositor owns a very small stake in the thousands of loans made by the bank.

Fifth, securitization allows for innovation over time. Financial firms seeking to lower the cost of funds to borrowers can broaden the range of assets that are transformed into securities. They can also learn to shape the securities, customizing them to fit the preferences of the ultimate buyers.[2]

What is the role of securitization in practice? Securitization has been a prominent feature of U.S. financial markets for decades, and has gradually displaced banks as the ultimate source of funds lent to households. An early example was so-called *mortgage passthroughs*, in which investors purchased shares in the returns on a pool of mortgages that were guaranteed by an agency of the U.S. Government. Over time, securitization came to dominate mortgage finance because it was more efficient. *Mortgage-backed securities* (MBS) are just one form of ABS. Assets underlying ABS also commonly include consumer finance instruments, such as student and auto loans and credit card debt.

Table 1 highlights the rise of securitization in the mortgage market, which is the largest debt market in the United States. At the end of 2008, U.S. mortgages totaled $14.6 trillion. Of this, mortgage pools accounted for more than half of the total ($7.6 trillion). By contrast, as recently as 1980, most mortgages were still held directly by banks and savings institutions.

Table 1. U.S. Mortgages Outstanding (Trillions of Dollars), 1980-2008

	2008	**2000**	**1990**	**1980**
Mortgages	14.6	6.8	3.8	1.5
Pools & ABS	7.6	3.1	1.1	0.1

Source: Federal Reserve Board Flow of Funds.

[2] You may recall from the Chapter 3 module: Shadow Banking that customization also can create systemic risks because customized securities may be difficult to value or sell in a crisis.