

We learned in an earlier module that securitization takes advantage of the efficiency of markets (core principle 4) to lower the cost of funding to borrowers.

Securitization typically separates asset *origination* (the creation of the loans or mortgages) from *distribution* (the sale of the securities backed by a pool of loans or mortgages), and is sometimes characterized as the *originate-to-distribute* model of finance.

Securitization can fail because of either: (1) problems with *origination* that result in the creation of low-quality assets with higher default risk, or (2) problems in *distribution* that result in concentration, rather than spreading, of risk. On occasion, the failure of securitization can be large enough to threaten the financial system.

Problems in origination. When a bank makes a loan that it will continue to hold as an asset, the bank has an incentive to make sure that the borrower is willing and able to pay back the loan. As the holder of the loan, the lender will pay a significant cost to *screen* borrowers before making a loan and then *monitor* borrowers once they have it. For example, the bank may examine information about income, wealth and past credit patterns from potential borrowers. The bank also may include in the loan contract the authority to demand faster payback if the borrower behaves in a risky way (say, by taking out a further loan against the same asset).¹

In the case of securitization, the originator plans to sell (rather than hold) a loan that it creates. As a result, it has less incentive to pay the costs of screening and monitoring. If the purchasers of the asset do not undertake or pay for such information gathering, the default risk of the asset is likely to be higher than if the originator had planned to hold it.

Because purchasers of asset-backed securities (ABS) own only a small portion of the underlying loan payment, they may act as if someone else will pay the screening and monitoring costs. For example, they may rely on others (such as credit rating agencies) to screen and monitor, but similar problems could apply to others, too (including rating agencies). If everyone behaves like such a *free rider*, insufficient information gathering and assessment will lead to lower credit quality and higher default risk.

Problems in distribution. One benefit of securitization is that it facilitates diversification or the spreading of risk. Diversification adds to the resilience of the financial system, because it reduces the vulnerability of financial institutions to a shock. For example, a tornado that destroys homes could threaten the existence of a lender that holds mortgages from that area only. The lender would face much less risk if it held a small portion of a pool of mortgages from many geographic locations.

¹ See the discussion in Chapter 11 that describes how financial intermediaries use screening and monitoring to address the asymmetric information problems that plague lending arrangements.

However, if the securities are held by small class of owners, the underlying risks will still be concentrated. In the event of a shock, such as a sharp decline in market prices, *concentration* of such risks in the financial sector can pose a threat to the system as a whole (see Chapter 5 module: Systemic Risk).

Experience in the Financial Crisis of 2007-09. Poor origination and distribution both contributed to the crisis in the United States.

On the origination side, firms that created mortgages for securitization reduced costly screening and relaxed lending standards before the financial crisis. As a result, they provided mortgages to many borrowers with poor credit, little wealth and low incomes who, when housing prices began to decline, were unable to repay. Surging defaults prompted a sharp market reassessment of risks associated with such mortgages, driving down the market prices of key mortgage securities and triggering the crisis.

Compared to the goals of the originate-to-distribute model, the distribution also was poor, with banks still holding large volumes of securitized loans, rather than spreading the risks more broadly. Investors in the securities backed by these mortgages often relied on the faulty assessments of credit rating agencies, who severely underestimated the probability of default (see Chapter 7 module: Rating Agencies).

Distorted rewards probably contributed to the problems of securitization at every stage of origination and distribution. Originators often were paid to create loans, even if they failed to screen borrowers adequately. Intermediaries that pooled these loans were paid to create the securities, not to monitor them. Premiums paid for customized instruments resulted in securities that were more difficult to sell in a crisis. Rating agencies were paid to help plan and structure the securities, but may have lacked incentive to pay for costly screening and monitoring. Finally, the managers of large financial institutions that stockpiled (rather than distributed) these securities often were highly rewarded for cumulating these risks until plunging asset prices undermined their firms.

A key lesson from the crisis is that effective securitization requires appropriate rewards for screening and monitoring, along with penalties for concentration of risk within financial intermediaries during and after origination.