

It's Securitization, Stupid

by Paul Conlin

The financial reform undertaken since the 2008 Financial Crisis and subsequent economic downturn contains many commendable elements, especially the partial standardization of the credit default swap marketplace. But, as pointed out by many critics, it does not address the (only) two institutions that have no intention of paying back their bailout money – Fannie Mae and Freddie Mac. Further, it did not address a related issue – the securitization of residential mortgages.

Securitization of American residential mortgages has harmful effects at the Main Street-, Wall Street-, and international-levels.

On Main Street, it facilitates and reinforces the removal of the source of funds from the uses of funds. Rather than local lending officers making an evaluation of credit standards in their local community, they can quickly and easily sell their loans in the international financial markets. Gone forever are the days of the local lending officer, like Jimmy Stewart in “It’s a Wonderful Life,” understanding the credit needs of his local community and directly funds, not too little and not too much, to productive investment. The originating lending institution should have significant skin in the game when it makes a loan – the securitization process removes this important financial control.

On Wall Street, the investment banks have too much of an incentive to make money packaging, mis-rating, and trading the resulting securities, and derivatives (credit default swaps) on those securities. And the more opaque and volatile the instruments are, the larger are the fees. Even the best regulation can only mitigate this temptation and incentive, not remove it.

Internationally, securitized mortgages facilitate the funneling of huge amounts of funds from developing-country savers to American home-owners. This both reduces the yields on the funds of those (relatively low income) savers, and encourages price bubbles in the assets of the (relatively well-off) suburban home purchasers. There is no economic value in artificially reinforcing this cycle.

When insurance companies cede their liabilities, they remain on the hook, should the assuming reinsurer fail. They can never wash their hands of a liability they originated. Residential home loan originators should not have this privilege either. It needs to be removed.

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