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12th OECD-WORLD BANK GROUP-IMF GLOBAL BOND MARKET FORUM

SESSION II : FUTURE FOR STRUCTURED FINANCE SECURITISATION

Prepared by Bank of Italy

This document is circulated as a background paper to the 12th OECD-WB-IMF Global Bond Market Forum, beginning on 5th May 2011 at 9.00am. Questions concerning this document can be addressed to Hans J. Blommestein, Co-ordinator of the OECD Working Party on Debt Management; mailto:hans.blommestein@oecd.org.

12th OECD-WBG-IMF Global Bond Market Forum

Session II:
Future for Structured Finance Securitisation

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BASICS: THE KEY CONCEPTS

What is traditional securitisation – Pooling of financial assets and subsequent sale to an SPV, which then issues fixed-income securities for sale to investors, the principal and interest of which depend on the cash flows produced by the pool of underlying financial assets.

The tranches of an ABS – In the simplest transaction, the securities issued by the SPV would be broken down into the senior tranche, the mezzanine tranche and the equity tranche.

Covered bonds and ABS – Covered bonds generally attract a different investor base from ABS because they often have: (i) a fixed and known maturity date; (ii) the additional protection of a special legal framework; (iii) greater liquidity. ABS, on the other hand, have amortising structures.

SECURITISATION AS A DOUBLE-EDGED SWORD

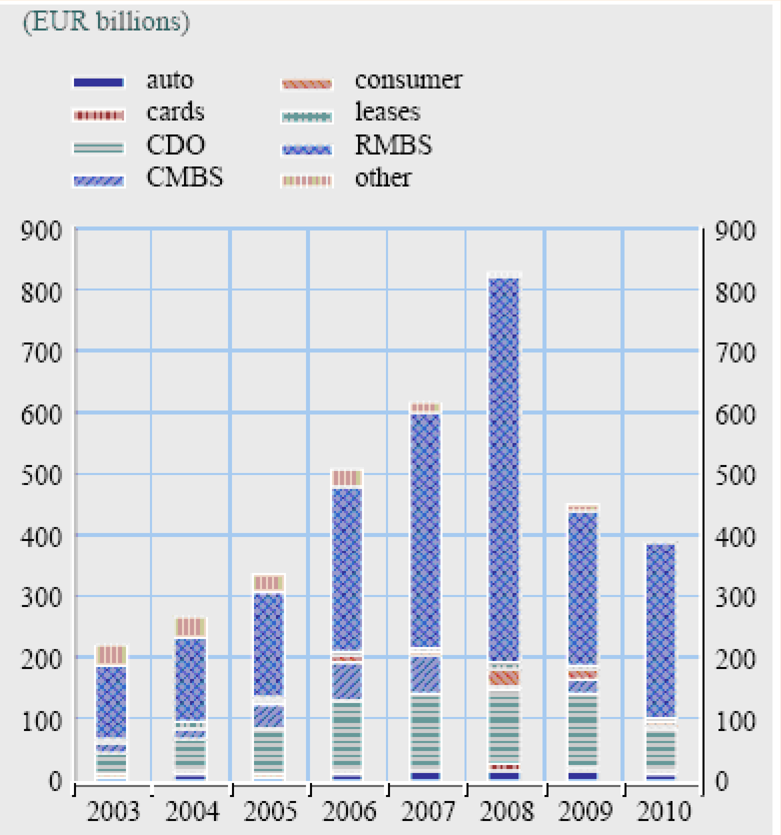
Positive view (prevalent before 2007) – Securitisation enables a more efficient allocation of risk to a wider range of agents; allowing more effective risk management; relaxes constraints on credit availability; and enhances transparency, pricing and market liquidity (Greenspan, 2000)

Negative view (became prevalent after the turmoil, but existed before it) – Securitisation misaligns incentives, leads to contagion between different sectors, and increases the risk of crisis (CGFS, 2003 and 2005; Rajan, 2005; Fender and Mitchell, 2005; Allen and Carletti, 2006)

ISSUANCE OF SECURITISED PRODUCTS: WEAK BUT NOT DEAD IN EUROPE…

Issued volumes, all asset classes, Europe

(reprinted in ECB, 2011)

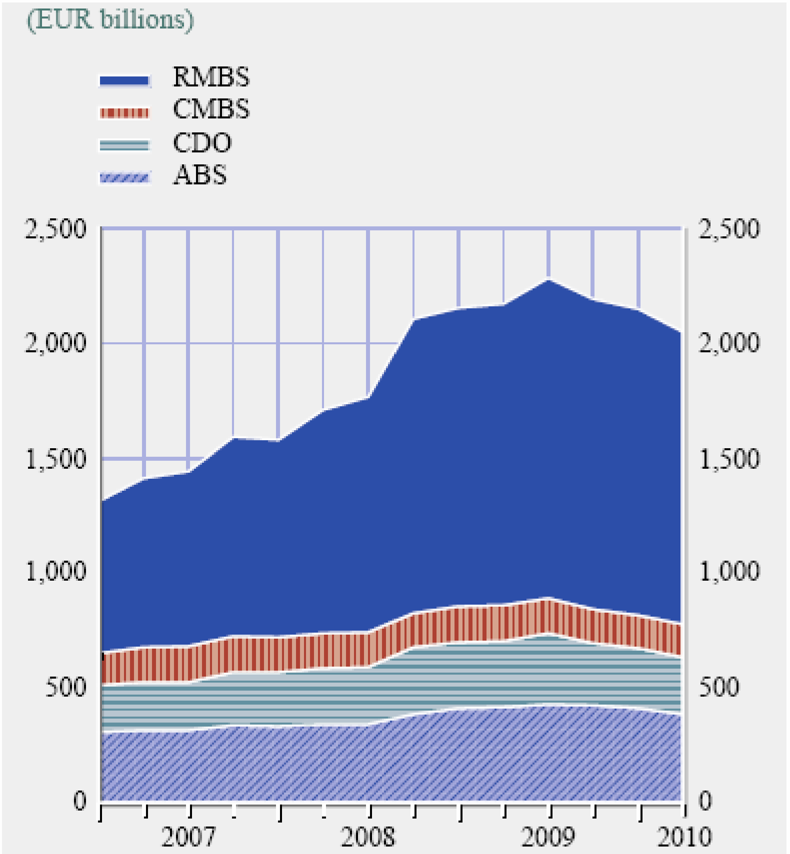


Source: JP Morgan.

… WHILE THE OUTSTANDING STOCK HAS DECLINED ONLY GENTLY

Outstanding volumes, all asset classes, Europe

(reprinted in ECB, 2011)

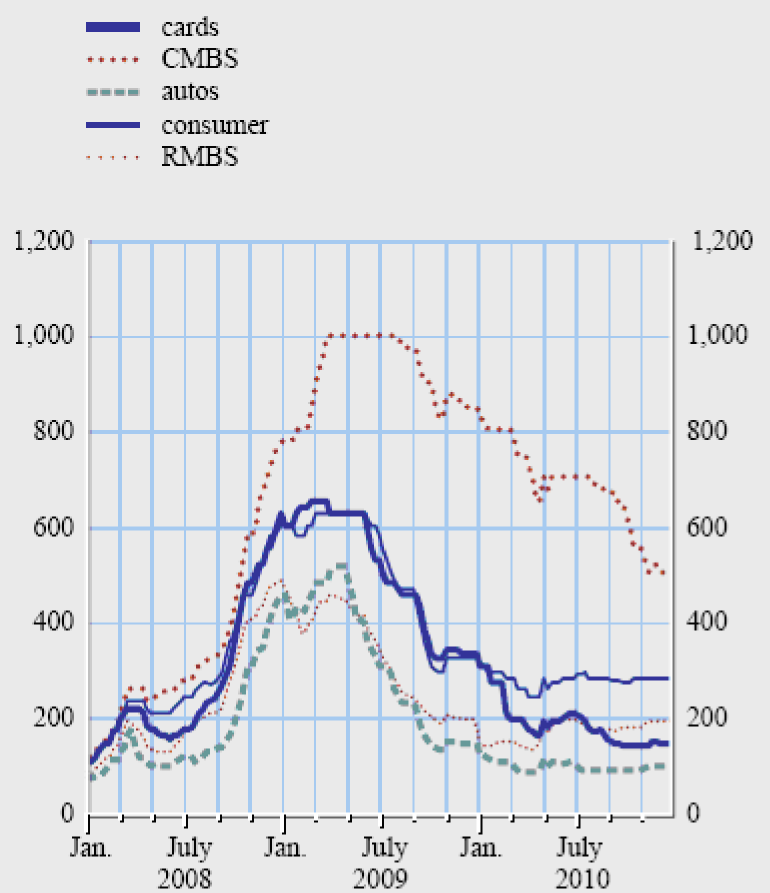


Source: JP Morgan.

THE SECONDARY MARKET LOOKS SELECTIVE

After the pre-crisis frenzy ⇨ return to fundamentals ⇨ clear differentiation of spreads across asset classes

Spreads vs. Euribor for maturities 3-5 years (AAA tranches)



Source: JP Morgan.

CREDIT AGENCIES: A BIRD'S EYE VIEW FROM THE LITERATURE

ABS CDOs: tranches rated solely by one agency, and by S&P in particular, were more likely to be downgraded by January 2008. Further, tranches rated solely by one agency are more likely to suffer more severe downgrades

Benmelech and Dlugosz (2009)

The spectacular failure of top-rated structured finance products has brought renewed attention to the conflicts of interest of Credit Rating Agencies (CRAs):

☞ CRAs are more prone to inflate ratings when there is a larger fraction of naive investors in the in the market who take ratings at face value

☞competition among CRAs in a duopoly is less efficient than having a monopoly CRA, in terms of both total ex-ante surplus and investor surplus

Bolton, Freixas and Shapiro (2009)

SOVEREIGN AND COVERED BOND YIELDS: A TALE OF A TWO-WAY CAUSAL LINK?

"Covered bonds are a good instruments for investigating the spill-over of the increase in sovereign risk volatility into banks' funding conditions and costs.

The direction and magnitude of the displacement of country-level yield curves on covered bonds closely resemble those for sovereign yield curves, supporting the assumption of a positive correlation between sovereign and bank risk."

ECB (2011)

SECURITISATION AND MONETARY POLICY

Asset securitisation significantly reduces the importance of the bank lending channel of monetary policy transmission. This is because

☞ increases banks' liquidity and reduces banks' funding needs in the event of monetary tightening

☞ allows banks to transfer a part of their credit risk to the markets and thereby reduce their regulatory requirements on capital

(Altunbas, Gambacorta and Marqués, 2007)

SOME SELECTED READING

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