

Can regulation build a better market for securitized bank loans without risking taxpayer bailouts? Not if banks are the only buyers

Rasheed Saleuddin highlights one of the many esoteric regulatory rule changes that may not be in society's best interests

The European Central Bank (ECB) and the Bank of England – as the dominant regulators of the European financial system – have an opportunity to fix the broken securitization market that has the promise to bring growth potential back to the anaemic Eurozone, but not in the way the bankers desire. *Regulating Securitized Products* addresses what went wrong in securitizations such as those for US subprime mortgage loans, and applies the latest regulation and finance theories to develop a framework for securitization regulation in a post-crisis world (Saleuddin 2015).

Securitization involves the transformation of a portfolio of (usually) credit contracts such as small business loans into at least two 'tranches', one junior taking the first losses to the portfolio, and one senior that does not suffer any principal or interest loss until the loss absorption capacity of the junior one is exhausted. The worst pre-2008 concept in financial markets was to place a large amount of these securities in highly leveraged vehicles with the result that the risk was kept within important sectors of the financial system, all the while relying on liquid markets and market price-based triggers to achieve the illusion of safety. Contrary to the generally accepted view of securitization, Acharya, Schnabl and Suarez (2013) showed without a doubt that most securitization during the global financial crisis actually moved non-bank risk (e.g. subprime loans) to the banking system without capital being set aside for this additional risk burden. In 2007–09, those institutions exposed to a toxic combination of (i) unfortunate credit risks (i.e. poor-quality US mortgages) hidden in opaque and illiquid long term assets and (ii) equally hidden, short-dated and contingent lev-

erage were forced to sell securitized bonds to repay fleeing short term lenders. What began as a crisis isolated to US subprime lending spread to other asset classes, leading to the most severe financial crisis since the Great Depression. It is clear from this recent crisis that the developed world financial sector had been characterized by: (1) the innate fragility of fractional reserve banking; (2) mispriced government guarantees (explicit and implicit); and (3) inadequate margin of safety within the regulated sector for the tail risks taken.

Soon after the crisis, regulators and politicians vowed to introduce tough new rules for banks to protect the public against harmful financial market volatility as well as to prevent banks from resorting to the public purse for their survival. One such significant attempt in the US to make financial markets safer and less likely to need a taxpayer-funded bailout was passed into law in 2010 as the Dodd-Frank Act. But as time passes and lawmakers and regulators work through each aspect of a new regime, there is pressure to water down any proposed tough new limits, and such dilution becomes more likely as public attention wanes. In fact, we have recently been witnessing a meeting of the minds among those charged with protecting our interests and the banking industry. If you believe bank lobbyists, politicians, many regulators, and often, the financial and popular press, without lighter regulation for securitization in Europe the markets will dissolve and a major driver of economic growth will be removed through the 'ignorance' of the regulators.

It should come as no surprise that the financial industry is resisting in-

creased regulation as memories of the crisis fade. As economist and ex-member of the Bank of England's Monetary Policy Committee Charles Goodhart (2014) observes, '[i]f regulation is to be effective, it must have the effect of preventing the regulated from doing what they want to do'. The overriding issues in fixing global finance are that the scale of the problem is so vast, while many problems have complicated, difficult to implement, and most importantly, highly contested 'solutions'. As a result, as Goodhart writes, 'the financial crisis has spawned a ferment of ideas for improving regulation. As with most fermentation, some rather odd ideas have bubbled up.' I have found, however, that it is very difficult for the public to involve themselves in what are often highly technical arguments, while on the other hand lobbyists have unparalleled access and resources. As regards the specialized subject of securitization, potential public interest groups, academics, regulators and politicians generally fail to comprehend market microstructures that only experienced market participants can fathom, while financial practitioners are not only highly biased, but also extremely well informed as to the state of financial markets.

Of course, we know that regulators can be cognitively, if not actually, 'captured' or that they can start to take on attributes of the industry. That is, those responsible for controlling the industry can begin to think like the regulated and be influenced by their interests. The shared language of experts in the same field (on both sides) can also lead to homogeneity of thought. Worse still, regulators can descend into deference to industry, as was observed in the last crisis. This

can be considered capture on the ground. As such, cognitive or cultural capture of supervisors is the dark side of the idea of shared language facilitating regulation. As a result, rules intended to prevent unwanted behaviour can, for many reasons, be remade during the supervisory and enforcement process on the ground. Financial practitioners are generally ideologically inclined to resist regulation, and most financial experts learned the same flavour of economics and politics. As such, the power of market liberalism to interfere with day-to-day regulatory activities should not be underestimated, and this can affect the morale of regulators, the budgets and the personal viewpoints of those charged with protecting the financial system.

This bias towards industry is highlighted by the recent behaviour of regulators and politicians in relaxing – on more than one occasion since the original draft rules were released – the rules that determine how much capital banks must hold when they purchase other banks' securitizations. Unsurprisingly, the tendency for the banking sector to accumulate securitized product risk as identified by Acharya and others has not diminished post-crisis, and most all parties involved in making regulation – *regulators and politicians included* – tend

to support banks in their attempt to do so. As argued in my book, there are many reasons why this re-leveraging is a bad idea, yet few are in a position to contest such a powerful coalition of public and private sector interests.

The key argument for allowing very low capital requirements (less than 2 per cent for the most senior 'AAA' tranches, allowing for 50 times leverage) for banks holding securitizations is that most asset classes did not experience the distress that occurred in the subprime mortgage sector in the US. Unfortunately, there is a lot of hubris that passes for real analysis here. Most importantly, the avoidance of major meltdowns in many underlying asset classes beyond US subprime was only possible through unprecedented efforts by central bankers and state policy makers, resulting in the largest ever global injection of liquidity, combined with overwhelming relief efforts for borrowers. In Ireland, for example, there were foreclosure moratoria and other protections put in place that allowed some reflation to save some homeowners, even while Eurozone interest rates were cut to zero. Crisis level defaults and recoveries in the more



benign banking portfolios should by no means be viewed as the worse possible case in designing capital requirements. Capital requirements should be set so that tail risk in such products cannot bring down the financial system (again!).

The key questions to be answered when regulating esoteric markets such as those for securitization are not being answered. Can the risks to the financial system from allowing banks to hold other banks' securitization with very low capital charges be justified? Can bank holdings of securitization, as contemplated by the most recent capital requirements, allow for more capital to enter the banking system (in order to back increased lending to the real economy in Europe)? Well, the regulators themselves actually state that increasing bank holdings of these products is not the answer. For example, the Bank of England's David Rule (2015) believes that 'a sustainable securitization market needs to be based on genuine risk transfer and not regulatory arbitrage, requiring a broader, real money investor base'. Mario Draghi, current president of the European Central Bank, has often mentioned likewise. That is, while the ECB and others call for lower capital requirements for banks so they can hold more securitized products, they readily admit that the only way that the securitization channel can help the lending market to expand in Europe is for it to allow new non-bank sources of funding and capital to enter the market. The problem cannot be solved by banks taking the funding and/or credit risks of other banks.

The bottom line is that banks and their supporters, including many politicians and bureaucrats, are campaigning for lower capital charges for banks (and more regulation of bank

'competitors', among other pro-industry rules). They are winning. Regulatory theory provides us with the tools to recognize when the public is being excluded from an important regulatory conversation, and the methods to design and enforce



better regulation in the public interest (see, for example Balleisen and Moss, 2010). My book (Saleuddin, 2015) provides a thorough explanation of the structure and operation of the markets for securitized products, documents how theory and previous experience can (and should) guide regulatory practice, and a full reckoning of the public policy implications of basing, as my works suggests, future regulation on an understanding of the risks of such products as well as the motivations of all market participants. Only by fully understanding the markets themselves can our policy makers

and regulators design and police an environment that protects the global financial and real economies from crisis while not overburdening a banking industry that is used by most of the productive elements of our global economy. Given that a major policy window is closing and final rules are in the process of being written, I hope it is not too late for informed yet less biased views to be heard and heeded.

References

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