

Shadow Banking and Why Banks Become Involved in Securitisation

Posted on October 10, 2018

The shadow banking system is understood as a set of financial institutions that carry out banking operations but do not have a bank license. This system began to develop actively in the early 2000s, and to date, the volume of its operations has approached 100% of world GDP. The American economist Paul McCully introduced the term “shadow bank” in 2007. Shadow banking participants include structural investment companies, hedge funds, investment banks and broker-dealers, who carry out activities through the attraction of repo loans.

The main feature of the activity of shadow banks is that they do not serve the real sector of the economy. Shadow banks, for the first time, attracted the attention of many experts due to their growing role in the transformation of housing mortgages into securities (securitization) before the beginning of the global financial and economic crisis of 2008. Thus, practically the whole mechanism passed beyond the zone of direct visibility of the financial regulation bodies. To date, the United States, Ireland, the Netherlands and Luxembourg have the largest shares of shadow banking. Most researchers note that in the case of the rapid development of the shadow banking system in the future, this may entail a significant risk of global systemic instability. It is a collection of financial institutions that operate under banking schemes, but formally, they are not banks.

The shadow banking system began to develop actively after 2000, and by 2012, the actual volume of capital in the shadow banking system was estimated at 100% of the world GDP. The push to develop the shadow banking system has become a new technology, as well as the desire of the banking system to enter a new, more complex level of synthesis and management of its assets. The 1990s were also a period of rapid economic growth in the US and China, as a result of which a massive inflow of capital was observed in the world banking system, for which it was required to find appropriate application. Traditionally, a high proportion of long-term mortgage loans in the economies of developed countries also required a financial grouping of the money supply at a higher level, which made it possible to derive greater benefits, albeit at greater risks. Because of their relative novelty, the legislative mechanisms governing the activities of the shadow banking system often did not keep pace with its development, even in developed countries. Therefore, on the one hand, parabanking has become an attractive sector for large legal entities seeking to enter the gray zone. This, as well as the rapid growth of the system itself, made para-banking quite risky but, accordingly, a more profitable sector of the economy in comparison with the traditional banking system.

The leader in the volume of the shadow-banking sector is the US economy. In this country, the first precursors of para banks – trusts – appeared at the beginning of the 20th century. Then, they began to specialize in servicing highly qualified investors and taking advantage of the fact that the

regulating regime of this category of investors for a long time was more liberal, they received higher incomes. Trusts attracted funds from large and medium-sized investors at higher rates and, therefore, confidently occupied their niche within the financial market of the country. The rapid flow of speculative capital into the weakly regulated sector of the shadow banking economy was recognized as one of the reasons why the country was hit by the most powerful mortgage crisis in 2007-2009, which provoked the world recession.

The assets of the shadow banking sector are traditionally less significant than in many other countries of the world. The basis of the informal sector is the long-term mortgage loans grouped into assets, which are traditionally less developed in CIS countries since a significant part of the population received housing free of charge from the state. Millionaires and rulers also long preferred foreign mutual funds. For example, as of the end of 2007, the total assets of mutual funds amounted to less than 5% of the baled assets of the banking system, which, however, made the system less profitable but more stable than those countries where shadow banking was characterized by a high degree of penetration and volatility.

A distinctive feature of shadow banks (most of which are headquartered in the US and the UK) operating in developing countries is that they prefer to invest in fairly ephemeral, short-term, volatile, highly liquid financial papers (i.e., shares, government and corporate bonds, games on the exchange of national currencies, various derivative financial and credit instruments, etc.). (Financial Stability Board, 2013) They are practically not interested in long-term investments in real assets (equipment, software, production, transport, infrastructure, technical education, etc.), in which underdeveloped and developing countries are in great need. According to some analysts, China, Argentina, Greece, Venezuela and Ukraine are among the countries whose economies are being undermined by highly speculative foreign shady banking systems.

Discuss the main reasons why banks become involved in securitization activity.

Securitization is the financing of certain assets through the issuance of securities. The word comes from English securities – “securities”. Securitized can be, for example, mortgage loans, car loans, leasing assets, etc. The method of securitization is as follows: Suppose a company or a bank has a portfolio of loans issued on mortgages, leasing contracts, etc. In order to free up its funds, the lender can issue its own debt securities secured by these assets, that is, the rights of claiming the debt.

Securitization is one of the fastest-growing segments of the world financial markets. In developed countries, the volume of circulating securitized assets is comparable to the volume of the corporate bond market, and gradually, securitization is gaining popularity in developing countries. The development of the securitization market in recent decades has had a huge impact on global capital markets. Thanks to securitization, new classes of debt instruments have appeared, and access to the market for new participants has been ensured, which has contributed to the expansion and deepening

of the world capital market.

In recent years, more and more American banks have expressed interest in the securitization mechanism. Several years ago, American financial market participants actively discussed the issues of attracting international financing through the organization of syndicated loans or by issuing Eurobonds; recently, more and more talked about more sophisticated financing instruments, one of which is securitization.

In essence, securitization is the financing or refinancing of any assets of the company that generates income by “converting” such assets into a traded, liquid form through issuing bonds or other securities.

The essence of the scheme is that a potential borrower forms a pool of homogeneous assets on the basis of which debt obligations are issued. Liabilities are structured in such a way that their holder receives a certain share of revenues generated by the pool, either through direct distribution of payments from primary debtors to ultimate holders of securities or according to a prearranged scheme. The key to successful securitization is the separation and isolation of the generated pool of assets from ordinary risks associated with a company that wants to use the securitization mechanism (originator). In particular, in the classical version of securitization, the choice is assumed: the issue of securities by the originator itself or the separation and transfer of certain assets held by the originator to a new specially created entity (SPV), which subsequently issues securities secured by these assets for placement among a broad circle of investors.

One of the most important factors constraining the development of the economies of emerging markets is the high cost of borrowed capital as a result of the underdeveloped national banking sector and the stock market, as well as the country's low country rating, which makes it difficult to enter the international market.

The market for asset-backed securities can become an alternative source of long-term capital for the borrower. Thus, in countries with a low sovereign rating, the securitization mechanism allows us to create a class of securities whose rating will be even higher than the country rating and, thus, attract more conservative investors. Thus, on the one hand, securitization opens direct access to the global financial market, and on the other hand, the emergence of such an alternative source can be an impetus to improve the efficiency of the banking sector, as financial institutions will have to compete for customers who need financing, as well as help development of the national stock market.

The key to the success of any new financial instrument or scheme is directly dependent on the potential benefits that it can bring to its participants. The borrower will use the new instrument only if it allows it to reduce the cost of financing or to manage assets more efficiently, while alternative investing opportunities may be important for the investor.

The advantages of the securitization scheme for its participants

Originals, which may include banks, mortgage and insurance companies and public sector enterprises, securitize their assets, based on a number of reasons:

- The attraction of financing through the sale of SPV-securitized assets;
- increasing the effectiveness of funding – leads to a reduction in all funding costs in comparison with traditional financing and lengthens the term;
- limitation of credit risk by asset risk. Usually, as a result of securitization, the originator ceases to bear credit risks or its credit risk is limited by amounts provided by the originator to improve credit quality. At the same time, the originator often retains the possibility of obtaining future profits on assets;
- Improvement of the balance sheet. With securitization through “actual sale,” assets can be withdrawn from the originator’s balance and replaced with cash, which will lead to an improvement in the corresponding balance sheet indicators;
- Less capital is needed to maintain assets, which increases the ability and ability of new borrowings. According to the Basel Agreement, financial institutions are required to maintain a certain amount of capital against risk assets. For accounting purposes, securitization can be viewed as a sale of assets rather than as a loan. Thus, securitization allows you not to show the debt on the balance sheet, as it would be with a different source of financing, and eliminates the need to maintain capital adequacy.
- Access to various sources of funding. Securitization allows the originator to diversify sources of financing, not limited to banks, and gain access to capital markets directly without the need to issue their own securities;
- decrease in the cost of financing. The average weighted cost of securitization may be lower than the current costs of attracting financing through banks or other types of borrowings. It should be noted that this advantage often occurs when the credit quality of assets involved in securitization is higher than the credit quality of the balance of the originator as a whole;
- also, securitization provides a more flexible instrument for balancing assets and liabilities.

Thus, America undoubtedly has something to take from the securitization mechanism. Perhaps it would be an additional impetus to the development of the banking and financial sectors. However, will American participants be able to cope with the securitization mechanism? As with any scheme, there are a number of points that need to be considered before resorting to its use. Before you allow yourself to introduce a takai mechanism, such as securitization of assets, you need to ensure good legal and financial protection for potential participants since there are so many different interests in this market.

Explain how and why the risk associated with the securitization process was Miscalculated before 2007.

As you know, the factors that directly provoked the crisis of low-quality mortgage loans were the fall in prices in the US real estate market and the growth of interest rates on mortgage loans, according to which borrowers planned their subsequent refinancing on more favorable terms. The change in the real estate market played against the plans of a large number of borrowers, as a result of which the refinancing became much more complicated and a wave of non-payments swept the country. So, during 2007, almost 1.3 million US real estate objects were in the process of foreclosure of the debtor's mortgage of mortgaged property on mortgage loans, which exceeded the previous year's figure by 79%². Problems with delinquencies or full non-fulfillment of obligations faced creditors, investment banks, insurers and, finally, investors.

In connection with the current crisis situation, the forecast of the famous economist H. Minsky, which he presented in 1987 in his work on the American real estate market and mortgage securitization, is interesting. Professor R. Vray³, an expert in monetary policy, provides evidence that the author of the hypothesis of financial instability was a harbinger of the crisis that erupted almost 20 years before it began. This circumstance is also pointed out in particular by Ch. Walen and Magnus.

Despite the fact that in modern economic literature, researchers have already created a voluminous picture of the crisis, which includes a range of causes and factors of its occurrence, we propose to dwell on some aspects of the work of R. Vray, interpreted by him through the prism of D. Minsky's research. This approach will allow to build of a chronological chain of development of "instability" in the American financial system, which resulted in the mortgage crisis.

Many contemporary analysts, including then-Federal Reserve Chair Ben Bernanke, described the state of the economy at the time as "great stability" in their work. A few years ago, it seemed quite fair. Among the factors of modern "financial stability" were:

- effective policy of central banks to combat inflation and cyclical fluctuations in the economy;
- globalization, mitigating shocks due to the effect of their spread around the world;
- the progress of IT technologies, which made it possible to better and faster evaluate risks and simplify communications;
- increased profit and a decrease in the share of borrowed funds in the capital of corporations, which led to the growth of shares;
- securitization, which made it possible to better allocate risks among participants who can manage these risks;
- derivatives used to hedge risks.

The transition of the financial system to an unstable state and the "fragility" of the financial markets

went unnoticed against the backdrop of rising real estate prices, a boom in low-quality mortgage loans and the issuance of securities secured by them. The crisis showed that, in addition to some advantages, the modern model of financial markets has the opposite side. So, globalization allowed the crisis to spread far beyond the US. Despite the complex econometric models used to predict the behavior of securitized assets, the risks have been underestimated. Unlimited growth in fee and commission income of originators and brokers due to the uncontrolled expansion of mortgage loans led to a decline in asset quality.

Among the main characteristics of the current crisis situation in the financial markets – are investors' distrust of financial instruments/ratings, lack of liquidity and high price volatility. A number of financiers, for example, R. Vray, T. Boeri and L. Guizo, see the main reason for the crisis as emerging in the mechanism of securitization of financial assets as such and the high demand of American banks for using this funding technique in the monetary policy reform carried out by the Federal Reserve System. (Gorton & Metrick, 2012)

From the point of view of the authors, to question the viability of the securitization mechanism and to see in the financial innovation itself the main cause of the problems that have arisen is premature; at the same time, the need to reassess the risks associated with securitization of assets is obvious. As for the reform in monetary policy, then, indeed, the stimulation of the development of the stock market was purposeful.

References

Financial Stability Board. (2013). *Policy framework for strengthening oversight and regulation of shadow banking entities*. https://www.fsb.org/2013/08/r_130829c/

Gorton, G., & Metrick, A. (2012). Securitized banking and the run on repo. *Journal of Financial Economics*, 104(3), 425–451. <https://doi.org/10.1016/j.jfineco.2011.03.016>