



Background and Perspectives on the
National Economic Research Associates, Inc. Study
on the Impact of Securitization on
Consumers, Investors, Financial Institutions and the Capital Markets

American Securitization Forum
June 17, 2009

I. Background on NERA Study: ASF Purpose and Goals

In the fall of 2007 the American Securitization Forum (ASF)¹ commissioned an independent research study to evaluate the impact of securitization on consumers, investors and the broader financial markets. Through a request for proposals circulated to a number of economic and financial market research organizations, ASF ultimately selected National Economic Research Associates, Inc. (NERA) to perform this work.

A principal motivation for commissioning this study was ASF's assessment that, notwithstanding the size, scope and significance of securitization market activities as of the mid-2000s, there was surprisingly little academic or other research that attempted to evaluate and quantify the broader economic impact of securitization in an analytically rigorous way. By selecting NERA—a highly-regarded and well-respected economic and financial markets research organization—to conduct this work, ASF hoped to close this gap in part, and to make a meaningful contribution to the industry and academic literature surrounding securitization market activities.

Accordingly, among other research topics, ASF asked NERA to examine the following issues:

- 1) The degree to which securitization affects the cost and availability of credit to consumers and businesses;
- 2) The effect that securitization has had on the allocation and dispersion of risk within the financial market system; and
- 3) The influence of securitization on market liquidity and transparency.

¹ The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 350 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. The ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to <http://www.americansecuritization.com>. The ASF is an affiliate of the Securities Industry and Financial Markets Association.

The NERA study concluded that securitization has in fact produced significant economic benefits. Focusing mainly on the securitization of residential mortgages and certain other consumer loans (including both prime and subprime loans), and based on an extensive review of loan-level and other data over the period 1990 – 2006, the study found that:

- Securitization lowers the cost of consumer credit, reducing yield spreads across a range of products, including certain types of mortgages, credit card receivables and automobile loans.
- Increases in the secondary market purchase and securitization of mortgage loans have positive and significant impacts on the amount of mortgage credit available per capita, including among traditionally underserved populations. Conversely, the study found that declines in secondary market purchase and securitization activities negatively impact the amount of available mortgage credit to consumers.
- A reduction in securitization activity has a negative impact on all types of lending activity, including but not limited to residential mortgages. The study predicts that bank lending activity is likely to be significantly and negatively impacted if securitization remains at its current, depressed level.

The complete NERA study, including detailed findings and research methodology, is being released simultaneously with this summary, and is available on the ASF website, located at www.americansecuritization.com. ASF hopes that this work will make a useful contribution to existing and future academic and industry research exploring the role and impact of securitization on consumers, businesses and the economy.

II. Additional ASF Perspectives on the Relevance of the NERA Study in Light of Ongoing Market Dislocations

At the time the NERA study plan was designed, securitization markets were robust, with continuing growth and strong issuance volumes in major asset classes: residential mortgage-backed securities (both prime and non-prime); credit card, automobile and student loan asset-backed securities (ABS); asset-backed commercial paper; collateralized debt obligations and other structured credit instruments (CDOs). Yet there were growing questions and concerns about the sustainability of this trend.

For example, even as the housing market boom propelled home prices higher throughout the country, there were widespread concerns both inside and outside the securitization industry that mortgage credit underwriting standards were deteriorating. Related concerns surfaced that the risk-layering features and credit performance characteristics of certain “non-traditional” and “affordability” mortgage products (including but not limited to subprime adjustable-rate mortgages (ARMs), pay-option ARMs, and low-doc and no-doc loans) were untested, and therefore unpredictable, in a declining economic and housing environment.

Similarly, many market participants harbored concerns that the historically low spreads and highly compressed risk premiums that characterized the primary issuance and secondary trading markets over the previous decade did not adequately reflect the true credit, market, liquidity and other risks inherent in securitization and structured credit instruments and markets. These concerns were particularly acute in the case of certain products (including CDOs of ABS, SIVs, securities arbitrage and other structured vehicles) that contained embedded leverage, held concentrated risks that were highly correlated with performance in the residential mortgage sector (especially subprime), and depended on the continued availability of ample and cheap short-term funding.

Notwithstanding these widely-held concerns, few market participants or outside observers could have envisioned the magnitude of the credit and liquidity disruption that subsequently ensued, or the impact that this disruption would have on the securitization and global financial markets.

Thus, as the NERA study moved toward completion in late 2008, the securitization and broader debt capital markets entered crisis mode. Issuance collapsed, liquidity and investor demand evaporated, and spreads widened to historically elevated levels. Many debt market product innovations and technologies (including securitization) that had come to be viewed as efficient mechanisms for funding credit demand and dispersing risk throughout the global economy instead came to be seen as root causes of the crisis. Some suggested that, if not for securitization and the funding and leverage provided by the debt capital markets, large volumes of unaffordable and ill-conceived lending products would not have been originated. Similarly, questions were raised regarding whether, without the proliferation of securitization and complex structured finance instruments, global financial institutions would have been able to create, distribute and assume large concentrations of credit, market and liquidity risk, thereby exposing themselves and the investing public to a cascading downward spiral of losses, deleveraging and value destruction when economic conditions worsened. Some commentators suggested that if securitization can be used to fund imprudent extensions of credit and facilitate systemically dangerous concentrations of risk, perhaps it is not beneficial at all.

As this critical analysis began to reverberate globally, some began to question the relevance and utility of the NERA study itself. The study indicated that securitization had contributed to an increase in the availability of credit and a reduction of its cost, but if some or much of that credit ultimately turned out to be unaffordable, is that a good outcome? In addition, since the core data set analyzed in the NERA study extended only through 2006, and not into the more recent period of extreme credit market dislocations, some were concerned that research findings may be regarded as inaccurate or incomplete.

After careful consideration, ASF concluded that the scope of the original study and data analysis it provided still yielded worthwhile and robust conclusions that have longer-term relevance across economic cycles. In addition, the study was updated to examine available data from 2007 and assessed its empirical findings in light of the current financial crisis. By making the study public at this stage, and by including a full description of research methodology employed, ASF hopes that this work will make a

relevant contribution to critical policy analysis of securitization market activity that is now taking place globally. ASF also hopes that future research will build upon the methodology employed by the NERA study, and that those studies will apply a similar analysis to more recent data.

III. Broader ASF Perspectives on the Role, Impact and Benefits of Securitization

In addition to the specific findings of the NERA study, ASF believes that several important perspectives should be considered in any critical examination of the role, impact and benefits of securitization.

First, research results indicating that securitization *can be* beneficial, or that securitization *has been* beneficial in the past, does not necessarily mean that securitization is *inherently* or *always* beneficial.

Recent experience appears to demonstrate readily that securitization is not inherently “good” or “bad.” As with other financial technologies, the final judgment depends upon the application and results of securitization in specific settings. There are many examples of uses of securitization that have served to fund essential credit extension activity in the real economy, and to distribute risk efficiently. However, other examples can be cited where securitization has supported the extension of credit that ultimately turned out to be imprudent, and where securitization has produced or enabled undesirable concentrations of risk. Effectively distinguishing among these different outcomes, and managing market growth and development toward positive outcomes, is thus of paramount importance to the future of securitization.

Second, securitization can be used in ways that reduce and distribute risk, or that increase and concentrate risk.

In its basic form, funding assets via securitization is a zero-sum game that redistributes a finite amount of risk. The amount of risk inherent in a securitization is equal to the risk embedded in the securitized assets themselves. The act of securitization neither increases nor decreases the aggregate amount of that risk. However, related and ancillary practices and strategies employed in some securitization transactions by some market participants—for example, the use of additional leverage and the addition of new risk via credit default swaps, reliance on short-term funding of long-term liabilities, or the absence of effective risk management controls—can amplify and concentrate those risks. The important point is that the outcome (*i.e.*, reduction/dispersion versus addition/concentration of risk) is not linked to securitization *per se*, but to the way that securitization technology is applied by the parties that create, distribute, assume and manage risks associated with securitization activities.

Third, while securitization has sometimes been criticized as “marginal” or “esoteric,” it is in fact a central and mainstream financing technique.

Over the past 40 years, securitization has grown in the United States to fund approximately one-half of all extension of consumer credit, with a higher share in some products such as residential mortgage loans. Securitization structuring technology is innovative and has evolved in some applications to be complex. However, the basic concept of securitization is, at its core, asset-based financing, a commercial financing technique that has been used for centuries. By “asset-based financing,” we refer to a method of raising capital and generating liquidity that is based on the value or cash flow-producing capacity of a specified asset or asset pool, rather than on the general profit making potential or claims-paying ability of an operating company. Asset-based financing transactions are not novel developments, and have been widely employed throughout the world in varying forms since the use of land rents as a mechanism for capital financing in 12th century France.² While securitization today represents a more modern and powerful extension of those basic financing techniques, they share a common and mainstream commercial heritage.

Fourth, and perhaps most importantly, securitization is necessary.

While there are valid criticisms of imprudent and undesirable uses of securitization, it nevertheless represents an essential tool for providing affordable credit to consumers and businesses, and is a necessary ingredient in the path to global economic growth and recovery. This is especially true in light of current capital and liquidity constraints confronting financial institutions and markets. Simply put, the absence of a well-functioning securitization market, and the efficient funding and liquidity it has historically provided, adversely impacts consumers, businesses, financial markets and economies globally. The recovery and restoration of confidence in securitization is therefore a necessary ingredient for economic growth to resume.

At the present time, approximately \$8.7 trillion in U.S. assets are funded via securitization. It would be extraordinarily difficult to replace those assets with bank-funded deposits in the current or foreseeable economic environment. Moreover, non-bank finance companies, who have played an important role in providing credit to consumers and small businesses, are particularly reliant on securitization to fund their activities. To the extent that securitization markets remain dormant, those parts of the economy will remain underserved.

Policymaking bodies and industry participants globally have recognized the essential nature of securitization market activity, and have taken steps to encourage and facilitate its recovery. Last October, the G-7 issued a statement as part of the “G-7 Finance Ministers and Central Bank Governors Plan of Action,” noting the need to “Take action, where appropriate, to restart the secondary markets for mortgages and other securitized assets.”³ Other prominent policy making groups such as International Organization of

² Kohn, Meir, “The Capital Market Before 1600,” unpublished working paper, from Vinod Kothari, *Securitization: The Financial Instrument of the Future* (John Wiley and Sons, 2006), p.109.

³ U.S. Department of the Treasury, “G-7 Finance Ministers and Central Bank Governors Plan of Action,” Press Release, (October 10, 2008), available at <<http://www.treas.gov/press/releases/hp1195.htm>>.

Securities Commissions,⁴ Financial Stability Forum,⁵ Group of 30,⁶ and President's Working Group on Financial Markets⁷ have also issued statements and recommendations recognizing the importance of properly functioning securitization markets for the broader economy.

There is widespread agreement that actions need to be taken to enhance and improve the securitization infrastructure, including with respect to transparency, standardization, disclosure, valuation, credit ratings methods, due diligence and quality assurance practices, alignment of incentives, credit, liquidity, and market and other risk management practices. Last December, the Global Joint Initiative to Restore Confidence in the Securitization Markets, comprised of the ASF, the European Securitisation Forum (ESF), the Australian Securitisation Forum (AuSF), and the Securities Industry and Financial Markets Association (SIFMA), outlined the significant threat to global economic growth if the securitization sector does not recover and offered recommendations to enhance industry practices in the securitization and structured credit markets.⁸ Additionally, the ASF continues to develop and implement ASF's Project on Residential Securitization Transparency and Reporting (ASF Project RESTART), a broad industry-developed initiative aimed at helping to rebuild investor confidence in mortgage and asset-backed securities through additional standardization and transparency of pool and loan-level information.⁹ These efforts to address market dislocations are well underway, and reflect a common recognition and alignment of interest within the public and private sectors to take steps necessary to restore function and confidence to the securitization markets.

IV. Summary and Conclusions

There is ample evidence that securitization can produce broadly desirable and beneficial outcomes: cheaper and more plentiful credit for consumers and businesses; an efficient source of liquidity and financing for issuers; and highly customized and diverse investment opportunities for investors across the collateral, credit and maturity spectrum. At the same time, there can be no doubt that some uses of securitization have produced marginal or negative outcomes, by funding unaffordable or unsuitable lending products, or by concentrating rather than dispersing risk.

⁴ International Organization of Securities Commissions, "Unregulated Financial Markets and Products," Consultation Report, (May 2009), p. 6.

⁵ Financial Stability Forum, "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," (April 2008), p. 12.

⁶ Group of Thirty, "Financial Reform; A Framework for Financial Stability," (January 2009), p. 49.

⁷ President's Working Group on Financial Markets, "Progress Update on March Policy Statement on Financial Market Developments," (October 2008), p. 2.

⁸ American Securitization Forum, Australian Securitisation Forum, European Securitisation Forum and Securities Industry and Financial Markets Association (SIFMA), "Restoring Confidence in the Securitization Markets," (December 2008).

⁹ See information on American Securitization Forum's Project RESTART, available at <<http://www.americansecuritization.com/restart>>.

ASF and the securitization industry are strongly aligned with promoting uses and applications of securitization that create lasting value and deliver benefits to consumers, businesses, issuers, investors, financial markets, economies and societies. As the securitization industry undergoes—and undertakes for itself—a critical examination of its future role, it is important to identify and distinguish those aspects of securitization that should be preserved and built upon, to ensure that these benefits continue to flow.

It has also become abundantly clear that the benefits and costs of securitization cannot be divorced from the conduct of every participant throughout the securitization value chain: borrowers, lenders, sponsors, underwriters, investors, rating agencies, servicers, trustees, legal and accounting firms, financial guarantors and other market participants. Each party plays a role and must assume shared responsibility for ensuring beneficial uses and applications of securitization. ASF is committed to working collectively and constructively with all of its members to achieve this outcome.

V. Works Cited

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