Rethinking Securitization from an Asian Perspective

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Since the subprime mortgage debacle, "securitization" has become something of a dirty word. What future, if any, is there for the securitization business? In five or 10 years' time will it be merely of historical interest or will it be reborn under a new regulatory regime ("Securitization II")?

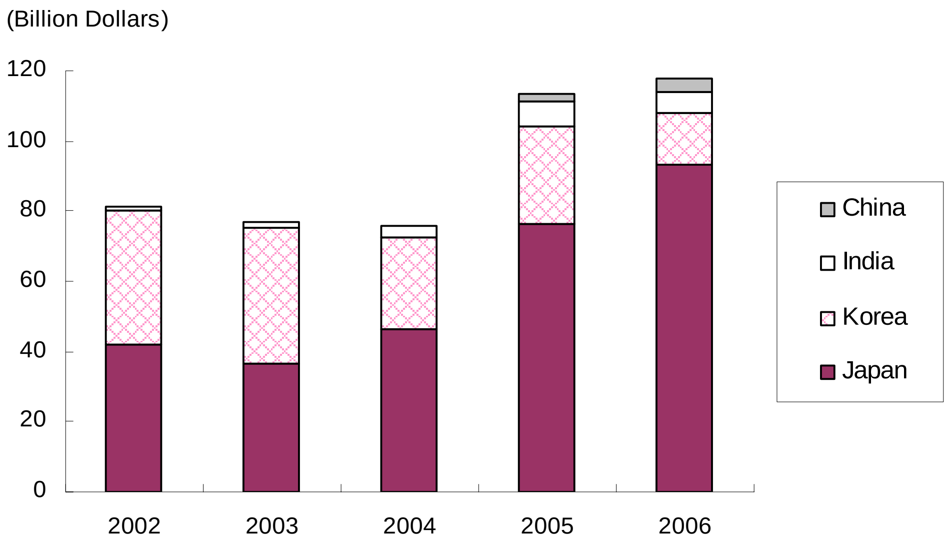
The subprime mortgage debacle revealed a number of shortcomings. For example, structured products were not designed to prevent moral hazard; products were too complex (e.g., as a result of resecuritization); and risk management at financial institutions was inadequate (not least with regard to remuneration). In other words, the shortcomings that were revealed were in the product details rather than in the basic aims of securitization (e.g., to transfer and diversify risk, and supply the market with assets with different risk profiles).

We therefore do not agree with those who argue that securitization is unnecessary or should be subject to much tighter controls as that is like saying that kitchen knives should be strictly regulated because they are sometimes used to murder people. What is needed is rules that ensure a healthy market but do not discourage financial innovation. With this in mind, we take a closer look at the Asian securitization markets, which are much less developed than their US counterpart.

I. Overview of Asian securitization markets: simple products and public-sector involvement

Issuance of structured products on the main Asian securitization markets (Japan, Korea, India and China) totaled a mere $120 billion in 2006, the latest year for which figures are available (Figure 1). This compares with $800 billion in the US and $300 billion in Europe in 2005. $120 billion is the same level of issuance as in the US in 1995.

Figure1: Issuance in major Asian securitization markets



Source: Nomura Securities, R&I, ChinaBond, Vinod Kothari *"Indian Securitization Market"*

Although the Asian securitization markets are still in their infancy, they have grown steadily, and we expect them to continue to do so without the kind of market collapse that recently occurred in the US. This is not only because the Asian securitization markets have always been small (with the result that any problems that occur are unlikely to get out of hand) but also because simple products and public-sector involvement have ensured that these markets remain healthy.

While the US securitization market has developed into a large market, it cannot be said to have developed into a healthy market. Market participants have tended to relax their risk management as soon as they have sighted a profit, while a government that believes in free markets has had no choice but to take extreme action that ultimately violates the very principles of free markets because of its failure to intervene early to prevent a crisis.

On the Asian securitization markets, however, the public sector has had a big say right from the start, whether it be with regard to market rules or to issuers. As this could impede the development of these markets in the long term, a balance eventually needs to be struck between deregulation and unimpeded competition. Following the global credit crisis, however, we think there is much to be said for retaining the current system, which allows the authorities to intervene early, at least for the time being.

China is an example of a securitization market where the regulator intervened at an early stage in response to the credit crunch.

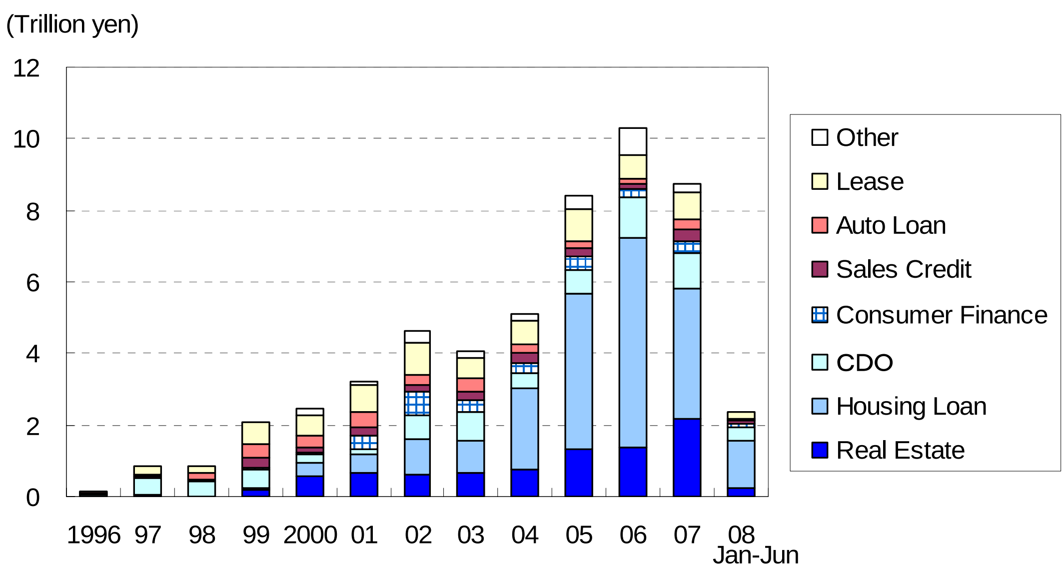
In China, securitization began as a pilot project in 2005 under the auspices of both the banking and securities industry regulators. Prospective issuers of structured products need to obtain the approval of the regulator first. However, there have been no issues of leasing or credit card receivables or any cases of resecuritization, and we see little prospect of this happening in the near future.

Similarly, in February 2008, as the subprime mortgage crisis intensified, the Chinese authorities informed originators that they would, amongst other things, have to step up their risk management, prevent moral hazard, and improve their disclosure. At the same time, the authorities applied the same, tighter standards to their issuance rules; and, since May 2008, no new structured products have been issued at all. We think the Chinese authorities are unlikely to alter their stance until the global credit crisis has abated.

II. Lessons from the Japanese securitization market

In Japan, securitization began in 1996, and the issuance reached the ¥10 trillion mark in 2006, 10 years after its inception (Figure 2). Although Japan's social and political systems are different from those of China, its securitization market has also remained healthy as a result of public-sector involvement. For example, according to Moody's Investors Service, only 0.4% of the changes to its ratings of Japanese structured products in 2007 were downgrades. This was considerably less than the global average of 7.4%. As a matter of fact, there have been no defaults on a Japanese structured product since 2001.

Figure2: Issuance in Japanese securitization market



Source: Nomura Securities

We think the healthy state of the Japanese securitization market can be largely attributed to the Japan Housing Finance Agency. Established in 2007 as part of the government's fiscal and administrative reform program, the Agency has focused on promoting the use of securitization and, unlike its predecessor (the Government Housing Loan Corporation), it has not been involved in the direct mortgage business. This reflects its mandate to assist and complement the work of the private sector.

Under its securitization support scheme, the Agency provides two types of assistance to private-sector financial institutions: it can either buy mortgages from them, which it then securitizes, or it can provide a guarantee for mortgages which they themselves issue. In most cases, however, it buys the mortgages. Readers may be interested to know that this type of assistance was modeled on that provided by Fannie Mae in the US.

We can see from Figure 2 that the issuance of structured products on the Japanese securitization market has declined since the subprime mortgage crisis began even though none of these products contain subprime mortgages. The Agency has served as an anchor for the market during this difficult period, both by ensuring a minimum level of issuance and by helping to make the market more transparent through its public offerings.

Despite the important role that the Agency has played, some have argued that this role should be reviewed as part of the government's moves to review the role of the public sector and downsize its institutions. However, in the light of recent US experience, we would question the wisdom of assuming that privatization solves every problem.

What we have seen in the US is that, when huge public-sector financial institutions are privatized and listed on a stock exchange, the shareholders receive any profits while the taxpayer has to cover any losses in a crisis. As a result, those who used to argue that Fannie Mae and Freddie Mac should be fully privatized now appear to be keeping a low profile while those who argue that they should retain their existing status or be subject to more stringent regulation like public utilities appear to have the upper hand.

The author's personal view is that, if the Japan Housing Finance Agency is to continue to implement government housing policy and therefore be covered by an implicit government guarantee, it would be best to retain its current status as an incorporated administrative agency[1]. Alternatively, it could become a joint-stock company wholly owned by the government (like the Japan Finance Corporation) and covered by an explicit government guarantee.

Yet others argue the very opposite: namely, that the Agency's political mandate and (implicit) government guarantee should be abolished and that the Agency should be fully privatized. However, those who advocate this should not forget that it would make the Agency just one of the many financial institutions that participate in the

1 In Japan, an "incorporated administrative agency" is an organization responsible for providing public services that are important but do not necessarily need to be provided directly by the government.

market and deprive it of the credibility, economies of scale, and ability to set market standards that it derives from its status as a quasi-governmental organization.

III. Taking crisis as an opportunity

Although the US and European securitization markets lead the Asian securitization markets in many respects, the fact that the former have recently come a cropper should serve as an opportunity to reflect on what is needed for a securitization market to develop in a healthy way. Moreover, the fact that the Asian securitization markets are underdeveloped should make them a good place to learn what a securitization market does and does not need.

Furthermore, the fact that the Asian securitization markets are less volatile than their US and European counterparts should remind us of the risk that securitization markets may head off in the reckless pursuit of profit if they are not restrained to a certain degree by the public sector. Similarly, a comparison of the Asian securitization markets with their US and European counterparts shows that simple products facilitate traceability and risk management, and that measures to prevent moral hazard are essential if a securitization market is to develop in a healthy way.

The problem, however, is to decide where to strike a balance so that regulation is effective without hampering innovation. For example, the European Union has been discussing whether to require the originators and sponsors of structured products to keep at least some of the cash flow (and therefore the risk) from the underlying assets they want to sell. However, some argue that it would suffice to require them to disclose how much of the subordinate tranche they hold. Perhaps we should see the subprime mortgage debacle (like the many other crises that have occurred in the past) in a positive light: namely, as an opportunity to discuss some of the aforementioned issues and as a point from which securitization markets can make a fresh start.