Can Securitization Work? Economic, Structural and Policy Considerations

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Summary

This paper addresses whether securitization can work in a properly balanced market environment. A U.S. perspective is emphasized, with later consideration of China. In addressing this issue, I provide historical perspectives and a conceptual framework for understanding the economic benefits and costs of securitization relative to traditional balance sheet lending. In terms of assessing economic tradeoffs, discussion is organized around three themes: the *good*, the *bad,* and the *ugly* of securitization. The *good* considers the positives of securitization; the *bad* addresses challenges in managing a vertically disintegrated loan production and servicing process; and the *ugly* corresponds with securitization's systemic linkages to the broader financial system.

Policy implications are considered. My perspective in formulating policy recommendations is driven largely by two basic guiding principles: 1) a social contract in the U.S. that emphasizes opportunity and entrepreneurship, and 2) an economic structure in the U.S. that embraces transaction-based financial intermediation relative to relationship-based approaches. These principles cause me to favor market-based policy responses that emphasize increasing market transparency, information production, and accountability of agents along the supply chain. These mechanisms can bring effectiveness and time consistency to a transaction-based and very complex financial system.

Although I believe that securitization can work, I am less optimistic about whether securitization will work in this next iteration of financial market regulation. The tension is between addressing "too big to fail" in the formal banking sector versus "too hard to regulate" in the shadow banking sector. The current thinking (as of March-April 2011) seems to be that shadow banking is too hard to regulate, so instead allow big banks to get bigger, monitor them closely, and hope that shadow banking becomes less systemically important. I don't think this approach is going to work very well, as favoring large banks makes regulatory capture likely, and there is little reason to believe that shadow banking is going to become any less important going forward.

Finally, in terms of of China, given China's relatively undeveloped financial markets, together with concerns about the "controllability" of securitization within the formal and shadow banking systems, I conclude that securitization is unlikely to become a meaningful financing channel in the near future.