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Formulaic Transparency: The Hidden Costs of Mass Securitization

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Thomas Schmidheiny Professor
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August 1978

Transactions costs 1989

‘a sad, largely deserted place’ [Bertoneche (1984)],

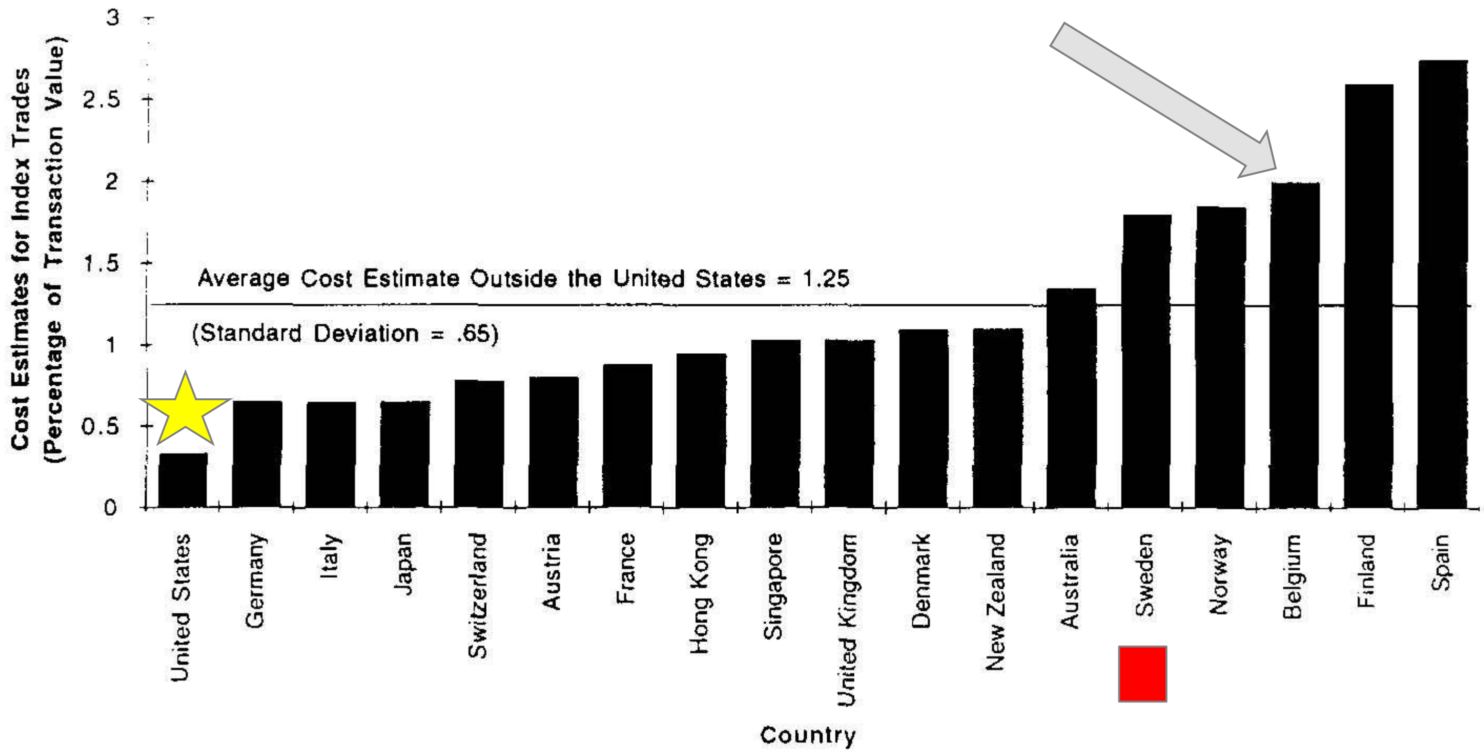


Fig. 1. Cost estimates for index trades by country, 1989 (percent of transaction value).

Source: Hidden Costs of Stock Market Liquidity (Bhidé 1993)

Convergence in securitization

What rules necessary?

- **Not ones currently proposed**

Is are US rules worth adopting?

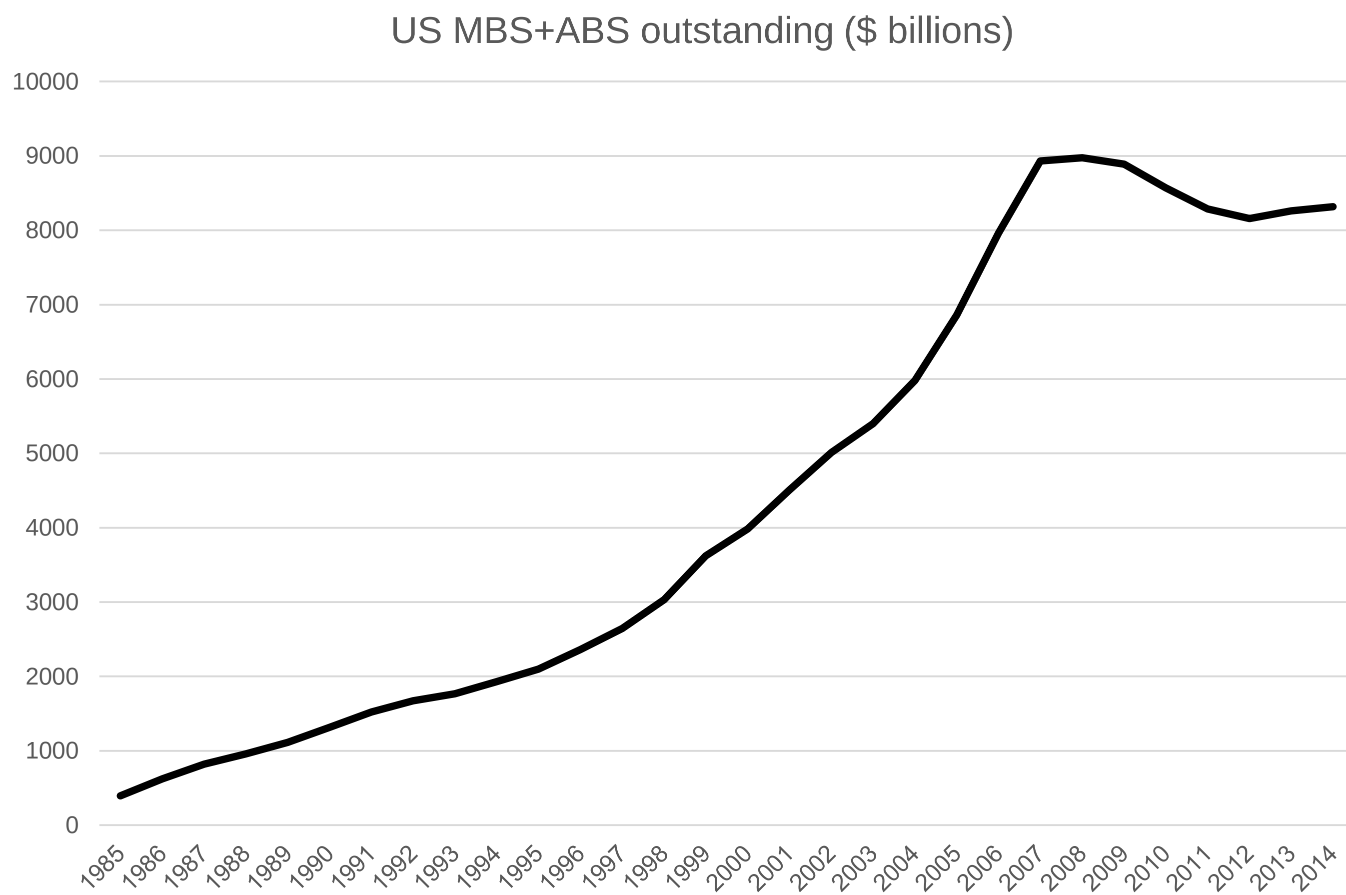
- **No**

Bryan’s Prophecy

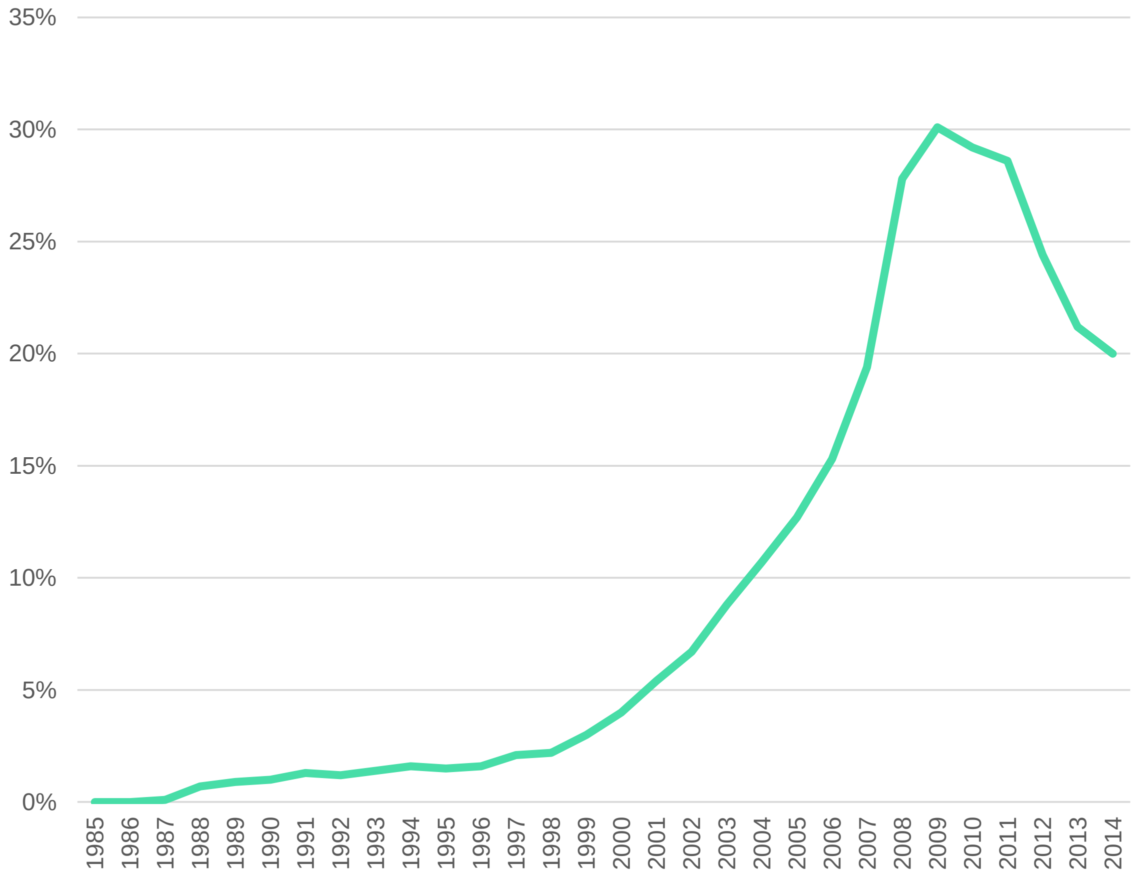
“A new technology for lending--securitized credit--has suddenly appeared on the scene. This new technology has the capacity to transform the fundamentals of banking, which have been essentially unchanged since their origins in medieval Europe.”

Harvard Business Review (January-February 1987)
The Credit Bomb in our Financial System

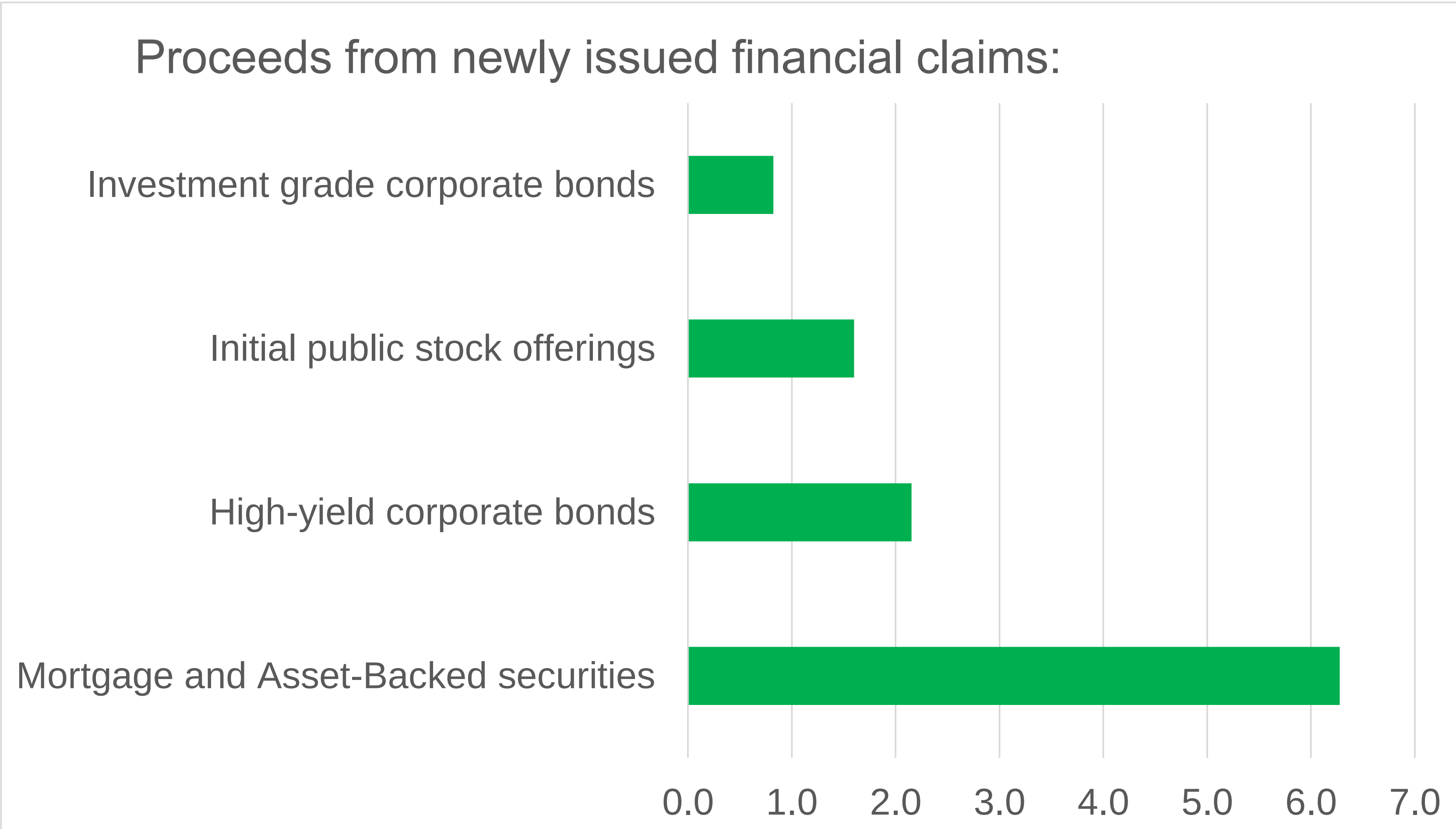
Growth of Securitization in the US



European vs US outstanding (percent)



Not simply aversion to anonymous markets or innovation



US Proceeds/European Proceeds (2007-2014 average)

Exceptional US securitization

Undergirded by exceptional rules

- induce strict, universal reliance on standardized ("FICO") credit scoring
- Strict reliance mitigates distinctive information asymmetry problems in securitizing small loans

US policies inducing reliance on standardized scoring

Fair lending rules and examinations

- Favor standardized over customized scoring
- Discourage discretionary overrides

Fannie Mae/Freddie Mac ("GSE") underwriting

Credit reporting rules

More lending mistakes, less variance than without the rules

Effects of rules on lending practices

More lending mistakes, less variance in practices

- Possibly more lending

Contrast with small business lending in the US

- Not subject to same policy inducements
- Standardized scores offered, but not commonly used
- More variance in lending procedures than in consumer credit

Contrasts with European consumer lending

Limited availability of reliable standardized scores

- Less incentive to share data ➔ less incentive to regulate
- Privacy rules

Limited and decreasing policy incentives

- Not subject to “fairness” inducements
- Increasing pressure to analyze repayment capacity

Virtually no use (by Handelsbanken and 11 large banks)

- Customized models and scoring
- More discretionary overrides
- Favor “known” customers

How standardized scoring promotes securitization

Distinctive information problems from pooling small loans

Type of Securitization	Size of Loans backing security ($s)	Number of Loans needed for $1 billion issuance
Consumer loans and Residential Mortgages		
Credit Card Receivables	$1,500-3,000	330,000-500,000
Auto Loans	$20-30,000	33,000-50,000
Student Loans (private)	$15-20,000	50,000-70,000
Non-Agency RMBS (sub-prime)	$150-200,000	5,000-7,000
Agency RMBS	$170-250,000	4,000-6,000
Commercial loans		
Collaterlized Loan Obligations	$3-10 million	100-300
Aircraft leases	$20-50 million	20-50
Non-Agency Commercial MBS	$3-100 million	10-300
Agecny Commercial MBS	$50-100 million	10-20

Role of standardized scoring

Mitigates information problems

- Issuers' ignorance is investors' bliss
- (assuming rates reflect higher losses)

Increases supply of securitizable credit

- Low cost "industrialized" loan production
- Incentive to compensate for more noise with more volume (potentially)
- Enables GSE securitization of mortgages

Suggestive contrasts

Small business loans in the US

European consumer loans

- Alternative explanations cannot explain magnitude of gap
- Cultural aversion to borrowing may have some explanatory power in a few countries

Costs of standardized scoring/securitization

Reducing loan quality

Systemic problems

- Centralized model errors
- Increased correlations (what if FICO gets repriced?)

Ambiguous fairness benefits

Concluding comments:

Seductive chimera of "completing" anonymous markets

- Float/supply of interchangeable goods claims
- Restrictions on information sellers can provide buyers(or buyers can acquire on their own)
- *Minimal* conditions

Reality of second hand car market

- Examine specific good – match defects to needs
- Know and question seller

Concluding comments:

Technology increasing communication of idiosyncratic information

- BDSM intermediation

Better matching, less commoditized anonymity

Why go backwards in finance ????