The originate-to-distribute business model

The new originate-to-distribute business model …

Many elements of the recent credit market turmoil mirror features of past financial cycles and, as such, form part of the mechanisms that bring about the alternation of periods of financial booms and sharp contractions. A relatively novel element specific to the latest episode is the central role of the so-called originate-to-distribute (OTD) business model for financial intermediation. This model relies on the dispersion of originated exposures through markets for risk transfer, and a layered structure of players is involved in different stages of the process, from origination and repackaging to the ultimate bearing of the risk. While securitisation is not a recent innovation, its growth in recent years had accelerated substantially, supported to a large extent by the introduction of more complex structures.

… facilitates risk transfer …

The growth in securitisation markets was an integral part of the expansion phase of the current credit cycle. Financial innovation, in the form of new structures that govern the distribution of cash flow generated by the securitised assets to the ultimate investors, was an important factor behind the abundant supply of credit to households and firms. The repackaging of mortgages into tranched securities with different risk characteristics energised funding from various types of investors with varying degrees of risk tolerance. Moreover, the wider distribution of the risk across the financial system arguably contributed to the compression of risk premia, as investors felt better able to match their risk appetite to the composition of their portfolios.

… but harbours structural weaknesses …

Conversely, the market turmoil that ushered in the contraction phase of the cycle exposed some of the weaknesses in this business model of financial intermediation, and especially in some of the practices introduced in the most recent period. These weaknesses relate primarily to the interactions between the incentives of individual participants in the securitisation chain and the quality of the information flow. A successful securitisation process relies on complementarities between the roles of different participants to ensure that decisions at every stage are based on adequate information and are conducive to better allocation of risk and economic resources.

… in the process of loan origination …

Originators play a key role in the success of a securitisation structure. Information generated by other parties at subsequent stages is at best only an imperfect substitute for the asset quality assessment made by originators.

Information deficiencies stemming from the lack of due diligence or lax underwriting standards at this initial stage are very difficult to overcome. These weaknesses were evident in the securitisation market for subprime mortgages. Competition between originators who never intended to bear the risk and were motivated solely by income tied to the origination volumes contributed to a decline in standards of verification and documentation of mortgages. In the most extreme cases loans were granted to borrowers who would clearly not be able to repay them except under very optimistic scenarios of future house price appreciation.

Financial intermediaries specialising in the creation and management of securitisation vehicles face similar incentives as originators. Their income is primarily linked to the volume of business rather than to the underlying risk-return profile of the securitised assets. They typically bear only a small portion of the risk, and in the prevailing euphoria of the market boom they were able to substantially reduce this exposure. Further, the creation of complex structures that insert several layers of securitisation between the original asset base and the cash flows to the ultimate risk bearers often obscured the risk borne by the structures' managers.

… securitisation …

A key role for the ultimate investor and bearer of risk is to inject discipline into the securitisation process by demanding and receiving pertinent information about the underlying risks before taking positions. The incentive to do this was weakened, however, by the fact that new and complex securitisation transactions resulted in very large portions of these holdings being structured as senior claims and receiving the highest creditworthiness assessments by rating agencies. The compensation of investors in this class of claims, while generous compared to other similarly rated instruments, is not substantial enough to justify the effort of performing a full review of the underlying risks in highly structured transactions. Hence, their decisions rely on external risk assessments and due diligence performed by the so-called "mezzanine" investors, who hold less senior and higher-yielding claims. However, their capacity to screen and instil financial discipline was undermined by the very substantial volume of securitisation issues that came to the market in the past few years, overstretching their resources. In addition, the practice of layered securitisation, which created new structures and more senior claims from the packaging of mezzanine tranches of securitised assets, further lessened the ability of this class of investors to reliably assess and monitor the risks.

… and rating assessments

The growth of more complex forms of securitisation may have weakened the incentives of originators and managers to do due diligence and elevated the importance of credit ratings for the functioning of the market. Investors in the more senior tranches placed increased weight on the credit rating agencies' assessment, often without regard to the fact that credit ratings focus mainly on average (or expected) credit losses and do not fully describe the potential range of those losses. In fact, the complexity of the more layered securitisation structures meant that this range of potential losses was much wider than for similarly rated loan or bond exposures. Ratings also abstract from the possible losses stemming from the interaction between market and credit risk drivers,

which are also more pronounced in the context of some of these structures. Indeed, as a result of the lessons learned from the turmoil, investors seem to have shunned complexity, and rating agencies have started looking for ways in which to better communicate the important nuances in their assessments.

Initiatives to overcome these shortcomings

In spite of its identified shortcomings, amply illustrated during this period of stress, the potential benefits of the OTD model for individual institutions and for the efficiency of the financial system as a whole remain. The main challenge facing market participants and policymakers is to address these shortcomings while enhancing its positive features. Several efforts are in train. Private sector initiatives include moves towards more complete documentation at origination and better dissemination of information throughout the securitisation chain, a heightened recognition that discipline is stronger when participants in every step of the process retain sufficient exposure to the overall risk, and efforts to refine the assessments by rating agencies. Policymakers are also seeking to incorporate the lessons learned about the risks inherent in more complex securitisation structures in designing and implementing prudential standards and to address the weaknesses exposed by the links between market and funding liquidity and overall risk in financial institutions.

A general lesson derived from the financial turmoil is the close interdependence of markets and institutions in the functioning and resilience of the financial system. The OTD model of financial intermediation is based on the premise that risk is ultimately shifted to the investors through market transactions. However, as the events during the period under review demonstrated, it is the capital of financial institutions that in the end underpins the stability of all these transactions. As mentioned above, originators and managers of securitised assets found themselves under pressure to provide support to the securitisation structures and investment vehicles with which they were associated. Uncertainty about the ability of institutions to sustain losses from related exposures engendered a general distrust of securitised assets and brought activity to a halt not only in the market for seasoned securities but also in the primary market for new transactions. Finally, as money market liquidity evaporated, the funding of off-balance sheet vehicles became entirely dependent on the ability of the sponsoring financial institutions to meet their backup liquidity commitments.

From a policy point of view, this interdependence between financial institutions and markets argues in favour of strengthening the macroprudential elements in the design of the framework and the calibration of its instruments. The shortcomings of the originate-to-distribute model can be attributed mainly to the failure of individual players to develop a holistic view on the risks due to excessive focus on their narrow, individual perspective, losing sight of system-wide drivers of risk and interdependencies. Policy that has a similarly narrow focus can also fail to take ex ante preventive action as the risks of disruptive interactions build up. At the same time, the management of the period of stress has already shown that, to be effective, policy responses may entail interventions aimed at easing the strain in the markets while at the same time helping institutions to cope with distress.