Securitization has a bad rap. It's high time to restore confidence in this vital economic instrument.

MY INSIGHT

Putting Cred Back Into Credit

by José M. González-Páramo

OF ALL THE COMMODITIES EXCHANGED in financial markets, the most important one is trust. The loss of trust seriously hampers the ability of markets to function: Credit and loans will not be extended to borrowers – namely, households and small businesses – who cannot otherwise access capital, and when that happens, society as a whole loses out.

Our current wariness of securitization is a case in point. Although tarred by the role it played in the global financial crisis, I believe securitization remains vital for restoring the liquidity and investor confidence needed to revive our financial markets, albeit in a more transparent, sustainable way.

Securitization, at root, is a sound concept: Illiquid assets, such as credit cards and mortgage loans, are pooled and then sold to general investors; by pooling diverse assets so that each security represents a small fraction of the total value, the risks are spread across a broader, more diversified set of holders. This can help to unblock credit supply constraints and enhance the efficiency of the economic system at a time when it is sorely needed.

Of course, we know the role that subprime mortgage-backed securities played in the global financial crisis, leading to the stigmatization of anything to do with securitization. The global volume of securitizations is currently a quarter of what it was in 2007 – and even lower in Europe. But this, I would argue, is a consequence of their fraudulent use and a lack of transparency rather than the fault of securitization itself.

It's true that until 2012, investors had only patchy access to outdated data on the underlying assets of securities, hindering proper risk management. Currently low interest rates and tighter regulations make securitization even less attractive. This, coupled with flight-to-quality – the tendency of investors to flee high-risk assets in favor of those perceived as safer during times of turmoil – has unfortunately deprived society of the potential benefits of a dynamic securitization market. But that may be changing.

The European Central Bank (ECB), for one, decided that something had to be done to improve this situation, given that the securitization market is vital for the European banking system, since the possibility of securitizing assets provides liquidity and can extend more credit.

But for that to happen, the ECB recognized that investors and rating agencies needed more transparent and timely information on the underlying loans or pools of asset-backed securities (ABS) and their performance, available in a standardized format, to help market participants perform proper due diligence. This led to a series of public consultations, culminating in the setting up of the Frankfurt-based European DataWarehouse in June 2012.

> "Securitization remains vital to revive our financial markets."

As its name implies, the DataWarehouse serves as a single, centralized database where loan-level data can be submitted and accessed electronically in a fast, timely and reliable manner, facilitating risk assessment for European ABS deals. Crucially, this initiative is endorsed by the Eurosystem and owned by market institutions that have a direct stake in the veracity of the information – shareholders such as BBVA, BNP Paribas, Crédit Agricole, Intesa, Moody's, Santander, Société Génerale and UniCredit.

While this initiative alone will not suffice to reopen blocked markets, I am confident it will serve as an important trigger toward structurally changing the way different market participants interact within securitization markets. By increasing the transparency, availability and quality of the information on the underlying assets, and by ensuring a regular updating of that information, market participants will have a sounder base on which to build valuation, risk and surveillance models.

If managed well, this should become a welfare-improving tool that allows financing, funding and the related risks to be adequately distributed among households, enterprises, banks and investors. And that would represent a significant step toward more complete credit markets, a more efficient economic system and, above all, a revival of credit to households and small business that most countries seek. ■

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