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Securitization and economic activity: The credit composition channel[☆]

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ABSTRACT

Using an international panel of 104 countries over the period 1995–2012, we analyze the relationship between country-level securitization and economic activity. Our findings suggest that securitization is negatively related to various proxies of economic activity – even prior to the crisis of 2007–2009. We explain this finding as the results of securitization spurring consumption at the expense of investment and capital formation. Consistent with this, we find that securitization of household loans is negatively associated with economic activity, whereas business securitization displays a weak positive association with it, and that household securitization increases an economy's consumption-investment ratio. Our results inform recent initiatives aimed at reviving securitization markets, as they indicate that the impact of securitization crucially depends on the underlying collateral.

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1. Introduction

Securitization is an important feature of modern financial systems. Starting in the early 60s, securitization of mortgage loans first

became common in the U.S. Securitization steadily became more widespread until the 2000s, when it reached around 50% of outstanding mortgage and consumer loans in the U.S. The years prior to the crisis of 2007–2009 were characterized by a boom in worldwide securitization markets. Between 2000 and 2006, issuance of securitization products more than tripled, from less than \$700 billion to about \$2800 billion.¹ The crisis then caused an effective breakdown of securitization markets. Securitization activities retreated to levels only seen before the 2000s and have stabilized at a low level since then.

Amid the carnage, a discussion has emerged about the future of securitization. Several policy-makers have spoken out against, others in favor of securitization markets. Recently, the [European Central Bank and the Bank of England \(2013\)](#) have issued a paper stating their intention to revive securitization markets, focusing on the high quality segment of the ABS market.

Clearly, there are economic benefits and costs to securitization. First and foremost, securitization allows banks to shift risk off their

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¹ Sources: Flow of Funds database, AB Alert and CM Alert databases.

balance sheet and frees up capital for new lending. Securitization is also an important risk management tool, allowing banks to achieve a more diversified pool of exposures. This should lower their cost of taking on risks, the benefit of which should, at least partially, be passed on to borrowers in the form of more favorable lending conditions and higher credit availability. Securitization also allows banks to better insulate themselves from funding shocks, potentially stabilizing credit extension.

On the downside, securitization has demonstrated the potential to reduce the efficiency of financial intermediation. The main reason is the presence of informational problems. In particular, banks, which tend to securitize, become less exposed to borrower risk, which undermines their incentives to screen and monitor. This may result in lower quality lending, and erodes the benefits of intermediation – relative to market-financing. High complexity has also been identified as a potential cost to securitization, as it reduces the ease with which outsiders can evaluate securitization products, potentially resulting in inefficient investment decisions.

There is significant body of evidence supporting the idea that securitization affects intermediation. The literature has typically focused on the impact of securitization on banks themselves (such as their lending behavior or their risk-taking), the impact on loan conditions (e.g., the pricing of loans) and the impact on borrowers (such as their likelihood of default). This focus on the micro-level has clear advantages in providing good settings for identification.

In this paper, we consider the relationship between securitization and aggregate outcomes, in particular economic activity. While identification is more challenging at the aggregate level, this focus offers distinct advantages. Securitization is likely to be associated with important externalities that cannot be captured by micro-studies. For example, while securitization may very well increase profits and lower risk for the bank that is shedding the risk, it may be detrimental to the buyers of securitization products. In addition, securitization may also affect the efficiency of capital allocation in the economy (it can either increase or decrease it), which has implications that will not be visible at the immediate bank-firm nexus.

Specifically, in this paper we exploit country-level variations in securitization activities to analyze the relationship between securitization and economic aggregates. Based on a large international sample of securitization issuances from 1995 to 2012, we find securitization activities to be negatively correlated with proxies for economic activity, such as GDP per capita growth, capital formation and changes in the number of new firms established. The effect is economically significant and is not driven by the period of the Global Financial Crisis, suggesting that it is a structural property of securitization.

What can explain this finding? Our results indicate that the effect is neither driven by the amount nor the quality of credit in the economy, which rules out most of the common channels through which securitization affects macroeconomic outcomes. We put forward a new channel, based on the idea that securitization affects the aggregate composition of credit in the economy. Securitization of residential mortgage and consumer loans (which are more homogenous and less information sensitive) is easier than for business loans. The development of securitization is thus expected to broadly favor loans to households, as opposed to loans to business. As both types of borrowers are competing for an economy's scarce resources, this may result in an aggregate reduction in investment and lower economic activity.²

² Consistent with the different implication for economic activity, Beck et al. (2012) show that, for a sample of developed and developing economies, enterprise credit facilitates economic growth, whereas household credit has no impact on growth. Sassi and Gasmi (2014), studying 27 European countries, find that enterprise credit

The data is broadly consistent with the *credit composition channel*. We show that only securitization of loans to households is negatively related to economic activity. Securitization of business loans instead displays a positive association with economic activity, albeit a weak one. In addition, we find that securitization increases an economy's consumption-investment ratio. Furthermore, securitization has a more pronounced (negative) impact on proxies of the supply side of the economy than on economic growth. This is consistent with a shift from investment to consumption constraining the supply side of the economy, while potentially boosting demand (and hence leading to a more muted impact on GDP).

The remainder of this paper is organized as follows. The following section discusses various channels that have been emphasized in the literature and through which securitization may affect economic activity. We relate them to the *credit composition channel* and form hypotheses. Section 3 describes the data and the empirical methodology. Section 4 contains the empirical results. The final section concludes and discusses implications for policy.

2. Securitization and economic activity: channels and hypotheses

Before turning to a discussion of the impact of securitization on banks and the wider economy, one should first understand the rationale behind securitization. In particular, why are banks and other financial institutions (and also some non-financial institutions) securitizing? In an early contribution, Greenbaum and Thakor (1987) theoretically show that in a frictionless environment (with full information and no regulation) securitization funding and deposit funding are identical, but they also show how public policy, regulation and information asymmetry change this. The literature proposes regulatory capital arbitrage, gaining extra liquidity, better bank performance and more efficient risk sharing (risk transfer) as driving factors behind securitization (see Cardone-Riportella et al. (2010) for a summary of the empirical literature). The empirical findings, however, are rather mixed. On one hand, Panetta and Pozzolo (2010), for instance, find that the results of securitization are ex-post in line with the expectations (securitizing banks increased their capital ratios and reduced their riskiness) in a cross-country bank level analysis. Again, using individual bank data, Affinito and Tagliaferri (2010) find that, once they securitize, banks have higher profits and lower bad loans. On the other hand, in their study with U.S. bank data and a propensity score matching technique, Casu et al. (2013) conclude that first-time securitizing banks would have comparable costs of funding, credit risk and profitability if they chose not to securitize. A crucial point is the complexity of these financial instruments. Creating a high fixed cost to originate securities, this complexity is a barrier to entering the securitization market (Panetta and Pozzolo, 2010), but there are no effective barriers to buying these highly sophisticated securities and participating in the market as a buyer rather than originator.

The literature on the dynamics of securitization almost exclusively focuses on bank level securitization.³ Many papers touch upon the factors explaining country level securitization. The importance of a legal framework for securitization is raised both in Maddaloni and Peydro (2011) and Altunbas et al. (2009). Altunbas et al. (2009) emphasize the importance of legal origin (common vs. civil law – with common law not requiring any legal background for securitization). Maddaloni and Peydro (2011) use legal obstacles to

is positively related to economic growth, whereas household credit has a negative effect.

³ An exception is Peersman and Wagner (2015). Using structural identification of different types of financial shocks based on sign restrictions, they find that innovations in securitization markets have important effects for U.S. business cycles.

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