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PRESS RELEASE

Financial Intermediation Theory and Implications for the Sources of Value in Structured Finance Markets

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Structured finance instruments represent a form of securitization technology which can be defined by three characteristics: pooling of financial assets (such as loans, bonds, or credit-default swaps); separation of the credit risk of the asset pool from the credit risk of the originating financial institution usually through the use of a finite-lived, special purpose vehicle (SPV); and issuance by the SPV of tranching liabilities backed by the asset pool. The feature of tranching accomplishes the division of cash flows from the asset pool into separate classes of liabilities with varying risk and return characteristics. Tranching is often used to create securities with differing levels of seniority: senior tranches are paid first, followed by "mezzanine" tranches, followed by the most junior, or "equity" tranche. This implies that equity tranche holders will suffer losses are soon as there are any defaults in the underlying asset pool, and mezzanine tranche holders will begin earning losses once the defaults in the asset pool have reached a high enough level so as to have completely depleted the equity tranche. Senior tranche holders earn losses only if the equity and mezzanine tranches have been completely exhausted; that is, only in extremely adverse circumstances.

This paper reviews finance literature relating to security design and securitization, in order to identify the economic forces underlying the creation of structured finance instruments. One of the questions addressed is under what conditions the issuance of structured finance instruments creates value; that is, what explains the appearance of this market? Tranching is the key feature that distinguishes structured finance instruments from traditional securitization products. A related question addressed by the paper is when a structured finance product would be expected to be used rather than a traditional securitization product. Financial intermediaries' motivations for issuing structured finance instruments include access to new sources of funding, reduction of economic or regulatory capital, and arbitrage opportunities. Investors are motivated by portfolio diversification and the expectation of attractive risk-return profiles in an environment of low interest rates.

Like past financial innovations, structured finance products have been developed in response to imperfections in financial markets. Market imperfections playing a key role in the value creation of structured finance include asymmetric information and market segmentation, the latter of which is partly due to ratings-based investment mandates.

Two types of asymmetric problems are important for structured finance markets. One occurs when the financial institution originating the underlying assets has more knowledge of the quality of the assets than do investors in the asset-backed securities. The second occurs when certain investors are better able to judge the quality of securities than other investors. Both of these problems can make it beneficial for financial intermediaries to pool assets and issue tranching claims backed by these assets. Indeed, the more severe are the problems of asymmetric information, the more likely it is that structured finance instruments will be used. Moreover, differing groups of investors may be expected to purchase specific tranches; in particular, investors who are less able to judge asset quality may purchase the senior tranches, which will be insulated to a greater or lesser extent from default, and more "informed" investors may purchase the subordinated tranches.

Structured finance products can also create value for originators, arrangers, and investors when these products help to complete markets by offering investors securities with cash flows that are specifically tailored to their individual needs. This is especially true when financial markets are segmented. Given that the tranching (i.e., structuring) process is costly, however, certain conditions must exist in order for structured finance arrangers to have an incentive to issue these tailored securities. Either the arranger must be able to practice price discrimination among investors so that the arranger can capture some of the premia that investors are willing to pay for the tailored securities or the arranger must possess some comparative advantage relative to other, competing arrangers, such as a cost advantage in acquiring the underlying assets.