

### Box 13

#### THE “ORIGINATE AND DISTRIBUTE” BANKING BUSINESS MODEL AND RECENT CREDIT MARKET TURMOIL: SOME TENTATIVE LESSONS

Since the issuance of the first mortgage-backed securities in the 1980s, banks have been moving towards greater segmentation of their financial intermediation activities. Rather than retaining loans they originated, banks gradually began to distribute loans to the secondary market, either directly or by repackaging them into various financial instruments which fall under the general category of asset-backed securities (ABSs). This activity has the advantages of diversifying banks’ funding sources, reducing concentrations of credit risk, minimising overall funding costs and, under certain conditions, reducing regulatory capital. Furthermore, the process frees up capital for new lending, provides income from the sale of the loans, and generates fees from continuing servicing of the underlying loans (collecting interest and principal repayments and passing them on to the holders of the securities). In the last couple of years, in the US in particular, non-bank institutions, such as mortgage brokers, have also become important participants in the origination of loans that could be sold on to banks which specialise in structuring various financial instruments. This box recaps some of the lessons that have been learnt for the originate and distribute model as a result of recent market turmoil.

Financial innovations of the past decade facilitated the expansion of the “originate and distribute” model across a wider pool of credit. These innovations included the design of instruments such as collateralised debt obligations (CDOs) that pool the cash flows of the underlying assets, which can include mortgage-backed securities and other asset-backed securities, and reallocate them to a second layer of securities. The credit quality of the CDO is usually enhanced by various structural features, including subordination (which involves dividing the cash flows into tranches with different degrees of seniority in terms of exposure to possible credit losses), over-collateralisation, water-fall payment structures and credit risk protection provided by specialist insurers. Due to these features, the expected losses from the tranches higher up in the subordination structure are generally sufficiently low to qualify them for the highest available credit ratings. Lower-rated and unrated tranches are more exposed to credit risk and consequently pay out higher returns. Generally speaking, however, the yields on all structured finance securities are typically higher than those on conventional corporate and government bonds. The upshot of the past decade of financial innovation is that risk is now more widely

repackaged and dispersed, making concentrations of risk among individual institutions much more unlikely, and allocating risk – at least in theory and most of the time – to those who have an understanding of the various risks inherent in complex securities.

In the low-yield environment which was a characteristic of the euro area and most financial systems for a good part of the past decade investors had strong incentives to take on more leverage with the possibility of further boosting expected returns on tranches with given credit ratings. This was typically done by using the packaged securitised instruments themselves as collateral in additional layers of structured financing.<sup>1</sup> Soaring demand for CDOs and other structured credit products increased the revenues of the banks that distributed assets to the secondary market. It also attracted new banks to the business model and may have encouraged some banks to dilute their lending standards by excessively originating loans that are particularly attractive for the purposes of securitisation and re-packaging, i.e. loans characterised by a higher risk profile (in terms of the rating of the borrower and conditions of the loan) and higher yield. In order to convince investors that the originating banks had incentives to continue monitoring the borrowers after the loans had been securitised, they typically retained a “first-loss exposure” to credit risk, meaning that they themselves would absorb the loss from a relatively small number of borrower defaults. More recently, however, the intensifying search for yield by investors allowed banks to rid themselves of even these riskiest tranches, which were often purchased by hedge funds and institutional investors with aggressive investment strategies. This, in turn, most likely impaired banks’ incentives to screen and monitor borrowers properly.

The credit market risk re-pricing that started in July-August 2007 contributed to a marked decline in investors’ appetite for structure finance securities. Consequently, there was also a dramatic slowdown in issuance of securities backed by structured credit products which quickly spread through various parts of the structured finance market with feedback effects to the primary issuance market. Several types of banks involved to varying degrees in the originate and distribute business model turned out to be vulnerable to the rapid re-pricing of the ABS products. These included banks with small deposit bases and strong reliance on wholesale funding, banks which held loans originating from the US sub-prime mortgage markets and banks with substantial pipelines of other loans to be distributed to the secondary market. These institutions suddenly found themselves in situations where the asset side of their balance sheets had become larger than originally planned, requiring them to seek financing from an already stressed money market. Other banks, as a way of generating leveraged returns, had set up multiple off-balance sheet vehicles that held structured assets and financed themselves through the issuance of short-term asset-backed commercial paper (ABCP), and to which banks had extensive back-stop funding commitments. For some banks, the contingent credit lines were triggered after investors refused to roll over any ABCP where there was a possibility that the asset pools included US sub-prime mortgage assets. Overall, the liquidity problems that originated from the rapid deterioration in credit quality in a rather minor part of the US mortgage markets seemed to have particularly severe implications for banks that were either actively pursuing the originate and distribute model or had no diversification benefits in the form of earnings from business lines that were not directly affected by the turbulence.

<sup>1</sup> In an environment of tight credit spreads, taking on more leverage can generate additional returns for investors and institutions structuring these securities. Investors who purchased the securities sometimes used them as collateral for other structures including “CDO squared”, which represent an additional layer of CDOs, or as collateral for asset-backed commercial paper (ABCP) structures.

All in all, the originate and distribute model has many advantages and, in principle, it has the capacity to enhance financial system stability. That said, at the time of finalisation of this FSR, the severity and breadth of the effects of the risk re-pricing appears to have created an important argument in favour of enhanced and more meaningful transparency on the part of all the main actors in the financial system. There is also a need for investors to better understand the potential risks embedded in complex structured products. This calls for increased stress-testing to analyse the likely behaviour of the prices of such instruments following low-probability but high-impact events. Some of the banks that had adopted elements of the originate and distribute model, but were not sufficiently well capitalised or sophisticated enough in their credit and liquidity risk management to weather the storm, may need to reconsider the suitability of the business model. Individual institutions may also face the need to take some of the distributed assets back onto their balance sheets in order to avoid adverse reputational consequences. From a broader financial stability perspective, the potential problems with the originate and distribute model may become acute if the failure of the distribution leg of the banks' business model causes problems with the origination leg, thus threatening a credit crunch in the wider economy. This is because key prerequisites for the success of this business model are a constant demand from investors for the financial instruments created by banks by the re-packaging of loans and an ability on the part of investors to adequately appreciate both the risk and return profiles of these instruments.

#### Box 14