BRIEF ANALYSIS OF THE PATH FROM BANK-BASED FINANCIAL INTERMEDIATION TO SECURITIZATION

Andreea ALEXANDRU, PhD Candidate*

Abstract

Financing through securitization can be seen most probably as one of the most important financial innovations in the second part of the last century, unfortunately as we all know the rapid growth of the securitization market was also a primary factor in the 2008 global financial crisis. This paper shall shortly outline the transition from banking intermediation to a structural shift away from financing by banks and the role of securitization in this process. Within the securitization process, a company is able to obtain funds in the capital markets at a lower cost, than if it could have raised the funds directly by issuing more debt or equity. This technic allows for credit to be provided directly to market rather than through financial intermediation, which can be seen in an increasing trend towards disintermediation, also often referred to as "cutting out the middlemen." However, the financial crises taught us that banks should keep a critical role in the finance system, guaranteeing that their interests are aligned with those of investors thus trying to prevent the excesses of the total disintermediation models that have substantially led to subprime crisis.

Keywords: securitization, banking, ABS, capital market, structured finance, intermediation

JEL Classification: G21, G 23, G24

In this paper, I am giving a short overview on the nature of financial intermediation, on the birth of financial disintermediation and the rise of securitization as a method of financial intermediation. The latter is often seen as a method facilitated by banks and other financial institutions, but unlike the traditional banking activity the institution does not stand as a permanent intermediary between debtor and creditor.

1. Review of financial Intermediation and its advantages

A market with a perfect competition structure, so called *"in vitro"* case, can be described as a market with no transaction costs,

* *"Costin C. Kirițescu" National Institute for Economic Research, Romanian Academy.*

whose players operate in a rational manner in the absence of any restrictions. Both buyer and seller own complete information on a particular product offered as well as on the prices charged by each company. I would also refer to a perfect market as one with pure competition, the other side of the coin being describing a monopoly market.

According to Riegler (2004), a perfect competition market should meet the following features:

- Competition is perfect - there are numerous companies and none of them holds a significant market share; no manufacturer and no purchaser may influence the price;
- Perfect information, complete information - meaning that the market prices precisely reflect the existing information; the prices set by all the companies are known to all manufacturers and consumers;
- There are no frictions generated by the transaction costs and taxes; all goods may be traded or distributed according to the needs, meaning that there are no constraints / limits for absorption or deposit of capital;
- The products are homogeneous and the company may easily enter or exit the respective branch. Homogeneous products means that similar products of various companies may be substituted for each other
- The market players maximize their expected likely profit.

In a perfect financial market, the gain of the financial intermediaries is zero. The banks, rating agencies or insurance companies could not exist as financial intermediaries in such a perfect market.

Ignoring however this ideal form of financial market, one can notice that there are two types of economic subjects in a real world modern economy based on work division. On the one hand, there are those who obtain much higher income than they need to cover their planned expenses and, on the other one, there are those whose income is not sufficient in order to cover their necessary expenses. In a real market, a balance between the two groups is always precarious, and I think most of the time being impossible to reach. The financial intermediaries are making use of the market imperfections, taking over some of its functions - more precisely, transferring the surplus payments of the first group to the second one, that need resources for investment.

In theory, the definitions actually designate as financial intermediaries those institutions mediating between those who offer capital and the beneficiaries, guaranteeing to the latter the satisfaction of their financial preferences. The banks, which take over capital from various depositors, in order to make it afterwards available to those requiring financing, in the form of loans, may be regarded as financial intermediaries in a limited sense, as described by Hartmann-Wendels et al. (1998). During the last years it could be noticed that gradually, the circle of financial intermediaries extended considerably, including in a broad sense, in addition to traditional banks, building societies, insurance companies, companies such as venture-capital funds, credit card companies, as well as leasing companies. Consequently, this broad sense includes those institutions facilitating or simplifying trade between those who have and those who need capital.

The appearance of the financial intermediation is first of all the result of the will to save the transaction costs and simplify the transmission of information (Paul, 2003).

If there were neither organized capital markets nor intermediaries, those offering capital would be forced to look themselves, among potential applicants, for those corresponding to their own expectations in terms of risk, benefits and time horizon. However, such search would generate high costs with the initiation of the deal, with its conclusion and performance, with the control operations, etc. considerably reducing the chances to sign such contracts. The financial intermediation facilitates the reduction of the costs related to transactions, starting from the fact that these institutions specialized in operating with concrete, valuable information regarding the respective market, having the possibility to provide to the creditors and credit beneficiaries a meeting space, which reduces both the transaction costs and the insecurity related to the borrower’s creditworthiness. The price for such an operation is much smaller than in the case of direct contacts.

The asymmetrical transmission of the information is a second reason for increasing the role of the financial intermediaries. According to Avado (2013), depending on their education level, the contractual partners, a principal and an agent, may face several problems:

- Some hidden information may arise throughout the Principal – Agent relationship. The Agent’s actions may be transparent or observable, but the Principal has limited information and cannot have a comprehensive understanding of the operation modality of the agent. The Agent’s opportunism to the disadvantage of the Principal is called Moral Hazard
- Just like the “hidden information”, “hidden action” may also arise during the P-A relationship. The agent may choose negotiation modalities which are not known or are hidden from the Principal that the latter may use only with additional payments. The Principal shall have the solution but it does not know how the result was reached – either by a turn of events or due to the agent (Spreman, 1990).

By such asymmetrical distribution of the information, one of the participants in the negotiations could have additional advantages and, for this reason, the financial intermediaries facilitate a balanced distribution of the information. For a quantitative and qualitative balancing of the offer with the demand for capital, the financial intermediation has the following functions: transfer, sizing of the capital volumes, supervision of loan maturity terms and turning them into liquidities, balancing the risks undertaken by the parties, transfer of logistics, services and information.

2. Disintermediation - a new trend on the financial market

One of the most revolutionary changes in the financial markets is the increasing trend towards disintermediation, also often referred to as "cutting out the middlemen." Financial disintermediation can take different forms, from traditional bond issuance to direct lending to companies by non-bank investors up to securitization. Disintermediation has become increasingly important in financial markets, largely because of the increasing use of securities to raise capital from capital markets, rather than from banks.

At the beginning of the 80's, a trend of the investors and debtors to get rid of the intermediaries was noted for the first time in the financial markets. An increasing number of institutions, who held consistent reserves of liquidities, started to bypass the companies dealing with intermediation and to directly reach the investors in the capital market (Franzen, 1988). The direct relationship between those who offer capital and those benefiting from such, bypassing the intermediary, has been defined as Disintermediation. Companies that would once have financed themselves with bank loans are increasingly looking for finance from the bond markets. As disintermediation one can name any situation that occurred whenever bank lenders could be offered a better deal from non – banking alternatives. It was mainly driven by high deposit insurance premiums above the ceilings set by the old Regulation Q, high cost of raising bank capital and very often also by the impossibility of even obtaining it, Napoli and Baer (1991). Capital seekers started to meet their financing needs not with bank loans but with securities issues, as well as investors who turned away from investing in time- or savings deposits respectively other long-term refinancing instruments, to directly investing on the capital market. As a response to this behavioural change, financial institutions do no longer play a mediating role in the traditional banking transaction but initiate disintermediation and increasingly start to act as facilitators or conduits of financial transactions.

As mentioned above, a first aspect of the process of disintermediation is the listing of numerous companies on the stock exchange market or their opening to the foreign capital markets, bypassing the banks as secured or unsecured lenders. A second aspect is the “birth” of the so-called asset-based financing (Bertl, 2004), the concept of securitisation going hand in hand with the trend of disintermediation. Historically, although perceived as a financial innovation of the 80’s, securitisation existed as a trend as early as the 50’s, when an important part of the new issues were industrial bonds. Asset based securitisation can be seen as indirect disintermediation – while disintermediation emulates traditional financial intermediation, securitisation breaks with it and changes the form of claims from loans to securities.

Mainly, three steps of the Disintermediation phenomenon may be identified. The first, called banking intermediation, is characterized by the fact that the bank takes over, in its capacity as financial intermediary, the function of liaison between the investor and the debtor. The bank develops independent relations with each of the two players. The intermediated market, the second stage, consists in facilitating / the possibility of concluding the contract only by the existence of intermediary institutions between the parties involved - creditor and borrower. Finally, the third step is the direct relationship between the two parties, who assume all the risks of the transactions. The credit institution, as intermediary, is excluded from the financing process and, consequently, what is called “disintermediation” is a complete action.

However, the financial intermediaries have no fears of the risk of a possible complete elimination or obsolescence of their function up to the point that they are no longer used. This trend represents, however, for the financial intermediaries, the replacement of the interest-based business with an off-balance sheet built around fees. Thus, the question “why do we still need the banks”, asked by Engels (1993), receives an answer: the private budgets of the small and medium-sized entrepreneurs find it impossible nowadays to find - without the help of the credit institutions as intermediaries - a way to financing of securities. Nowadays, banking loan (still) remains the most flexible lending modality.

3. Securitisation: Introduction to the major financial innovation of the 20th century

Explained in simple words, securitization allows depository institutions, finance companies and other non – financial institutions to obtain liquidity from non – tradable assets they own, that otherwise could not be sold in liquid markets but would remain on their balance sheet until their maturity. Within the securitization process, a company partially “deconstructs” itself by separating certain types of illiquid assets from the risks generally associated with the owning company and is able to obtain funds by using these in the capital markets at a lower cost, than if it could have raised the funds directly by issuing more debt or equity. This technic allows for credit to be provided directly to market rather than through financial intermediation. Asset securitization, as a form of disintermediation, enables a company to raise reduced-cost financing through bypassing of intermediaries such as bank lenders, which previously stood between a company and the ultimate source of money, the financial markets.

Within the general securitisation trend, two main directions may be noticed:

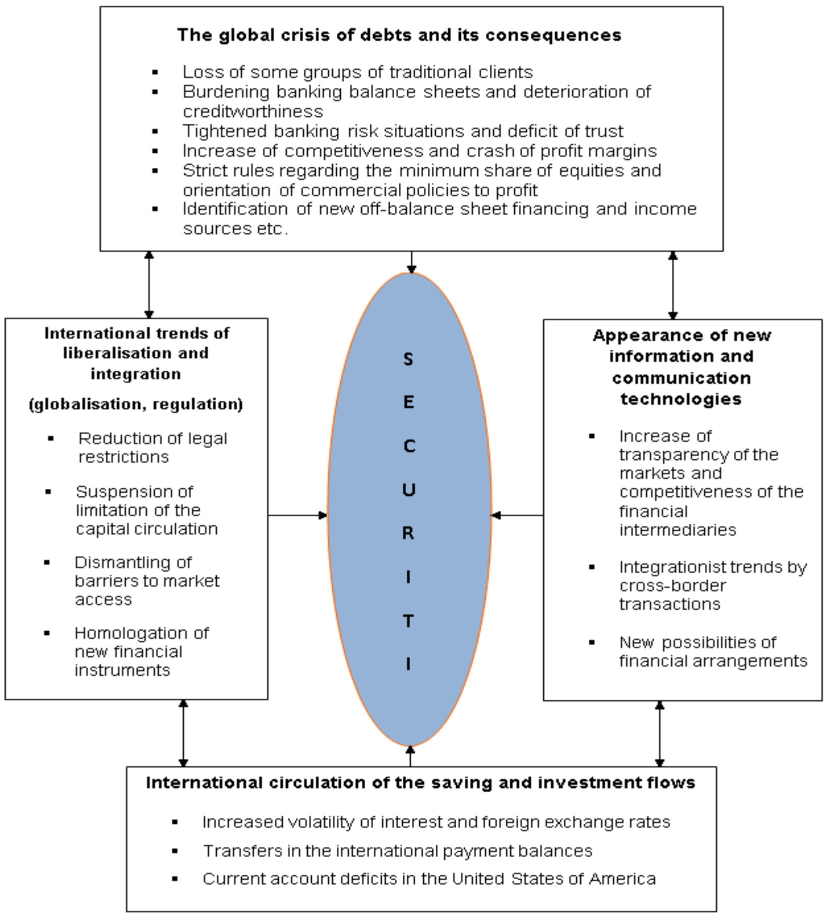
- Securitization in the broad sense, referring to obtaining capital by issuance of negotiable instruments on the capital market (this may also include regular industrial bonds); an increasing number of entrepreneurs choose to issue securities instead of absorbing traditional financial instruments, such as loans; in this respect we can describe this translation as a displacement process.
- Securitization in the strict sense, also known as asset-backed securitisation, is perceived as the most recent form of Securitisation, the conversion of assets, formerly not liquid, into securities with a high quality of credit, sustainable and marketable backed by assets such as credit card receivables, home equity loans, consumer loans, student loans and auto loans. Previously existing receivables are converted to securities and issued on the capital market. This innovative process allows firms to obtain liquidity from assets that, otherwise, cannot be sold in liquid markets. From an economic perspective, securitisation of assets replaces traditional financial methods offered by banks, excludes financial intermediaries and as such avoids increased transaction costs charged by intermediary financial institutions. It also offers the possibility for a company to raise funds economically based on allocation of risks assessed by rating agencies. This form of financing opens the capital market to those entrepreneurs whose rating does not give them the possibility of accessing low cost financing. In this type of financing, the rating of the receivable is more important than the rating of the issuing company. Securitisation is facilitated by banks or other financial institutions, differing from standard bank activity due to the fact that the institution does not stand as a permanent intermediary between capital seeker and provider.

The graph below based on Baer (2004) shall give a deeper insight of the reasons of assets securitisation (see Figure 1).

The financing by securitisation of assets may be regarded as a financing technique, in which an entrepreneur (for instance, an industrial company), a bank or a leasing company sells to an asset based security type company, either directly or through a special purpose vehicle (SPV), a pool of assets, chosen based on mutually agreed criteria and with effect of balance sheet discharge. The originator receives in exchange liquid means of the value of the offered services, minus the fees and other costs. The SPV is refinances itself on the capital market through issuance of securities usually purchased by institutional investors. The purpose of the financing vehicle is exclusively to purchase the assets, selling them afterwards for refinancing purposes.

Figure 1

Causes and fundamental reasons for Securitisation with assets



Source: *Bär, H.P. (2000) „Asset Securitisation: Die Verbriefung von Finanzaktiven als innovative Finanzierungstechnik und neue Herausforderung für Banken“*

The central aspects of *Asset-backed securities (ABS)* financing are, on the one hand, diversification of the risks and, on the other hand, avoiding the concentration of individual risks. In the case of a loan in a traditional sense, the bank undertakes all the risks resulting from granting such. In the case of asset backed securities financing, a distribution of the risks may be obtained, which belong either to the investors or are transferred to a third party. In the case of a company which is not necessarily a credit institution, the risks such as non-payment or default of payments are taken over by their off-balance sheet recording.

In order to balance the high risks, adequate equity is necessary. In general, this accumulation of equities is considered as too expensive and this disadvantage is eliminated by the concept of securitisation. For this purpose, a substantial pool of receivables, as homogeneous as possible, is extracted from the entrepreneur's balance sheet and is offered for sale to an independent, legal and economic SPV. According to Baer (2000),the volume of the seller's equities is reduced by this sale, which discharges the balance sheet (Off-Balance-Sheet).

In the USA, the following are perceived as main instruments for securitisation of assets: various types of *ABS,* as well as *Real estate mortgage-backed securities* (MBS), to which loans secured by a mortgage are attached. This difference has historical circumstances, even if the rights consist in mortgage loans: the mortgages were the first securitised assets. Regarded from the current perspective, MBS are also part of the ABS class, which means that a distinction between them does not seem to make a lot of sense.

In Europe, a more precise distinction is necessary between the types of ABS depending on the type of the receivable:

- ABS itself;
- Collateralised debt obligations (CDO);
- Mortgage-backed securities (MBS).

For the issuance of the asset-backed securities, almost all the types of receivables may be used if they fulfil certain requirements. The possibility to transfer civil rights over the property, the right to divide the assets put for sale, as well as the existence and predictability of a flow of liquidities derived from these assets can be found among these requirements.

The fundamental idea of *securitisation with assets* consists in allowing the entrepreneurs with a pool of strong financial assets to obtain low cost financing in the capital market, through these instruments. The most important feature of securitisation is the legal independence of the establishment of a homogeneous fund of assets.

4. Conclusion

The direct, traditional relationship between capital borrowers and lenders, core business of commercial banking, has changed over years and has probably declined in value. Increased volatility of interest and foreign exchange rates, international trends of liberalisation and integration, appearance of new information and communication technologies, increased competition from foreign banks and other intermediaries have favoured securitisation on the long run. On the other side, volatility in financial asset prices, 2008 global financial crisis have slowed down the rapid growth of the securitization market. Overall, all that factors have permitted the securitisation markets to replace traditional intermediation in many ways.

Still, one comes to question itself - are these developments healthy for our financial markets? Are Disintermediation and Financial Innovation techniques good or bad?

One the one side, there are clear benefits of slowly moving away from banking business model, such as lower costs as less money are going to intermediaries, innovative and varied sources of funding are definitely improving the negotiating power of corporate treasurers,

But there is also the *dark side*. Disintermediation of financial institutions goes hand in hand with disintermediation of human judgment, leaving more to the sometimes impulsive markets. Intermediaries offer added value in this respect and have a role to play just as they do for example in securitizations. Also markets often show a tendency to turn reasonable ideas to unreasonable extremes. Investors get fast interested in new products with high return and underestimate the chance that some of these products might eventually blow up. Used recklessly, financial innovation techniques can be dangerous, as proven by the subprime mortgage crisis.

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