Not so elite anymore?: The uneasy boundaries between financial governance and financial engineering

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Aims

1. To provide a brief overview of securitisation and the crunch

2. To explain how subprime defaults and credit risk should have been contained

3. To explore the uneasy boundaries between the elites of governance and financial engineering – regulator or collaborator?

Methodology

Semi-structured interviews (n=40)

Conducted in 2006-2007

Included senior directors and junior executives in the UK

Organisations included: mortgages lenders (building societies, centralised lenders, banks), **investment banks**, asset managers, trade bodies, credit referencing agencies, corporate service providers, law firms and **bond-rating agencies**

Respondents sourced from searches of the financial media from leading firms identified in the financial press

Securitisation at the heart of the crisis

RMBS Residential Mortgage Backed Securities

Process used to sell bonds as debt

£100k bonds backed by mortgages

Sale of assets

ABS: Asset Backed Securities

Credit cards, consumer loans, commercial property

Why securitize?

Capital adequacy ratios

Basel 8 per cent reserves

£1 billion in mortgage assets = £80 million

Diversify their funding away from other sources, such as deposits

Why securitize?

To gain finance to lend and expand market share

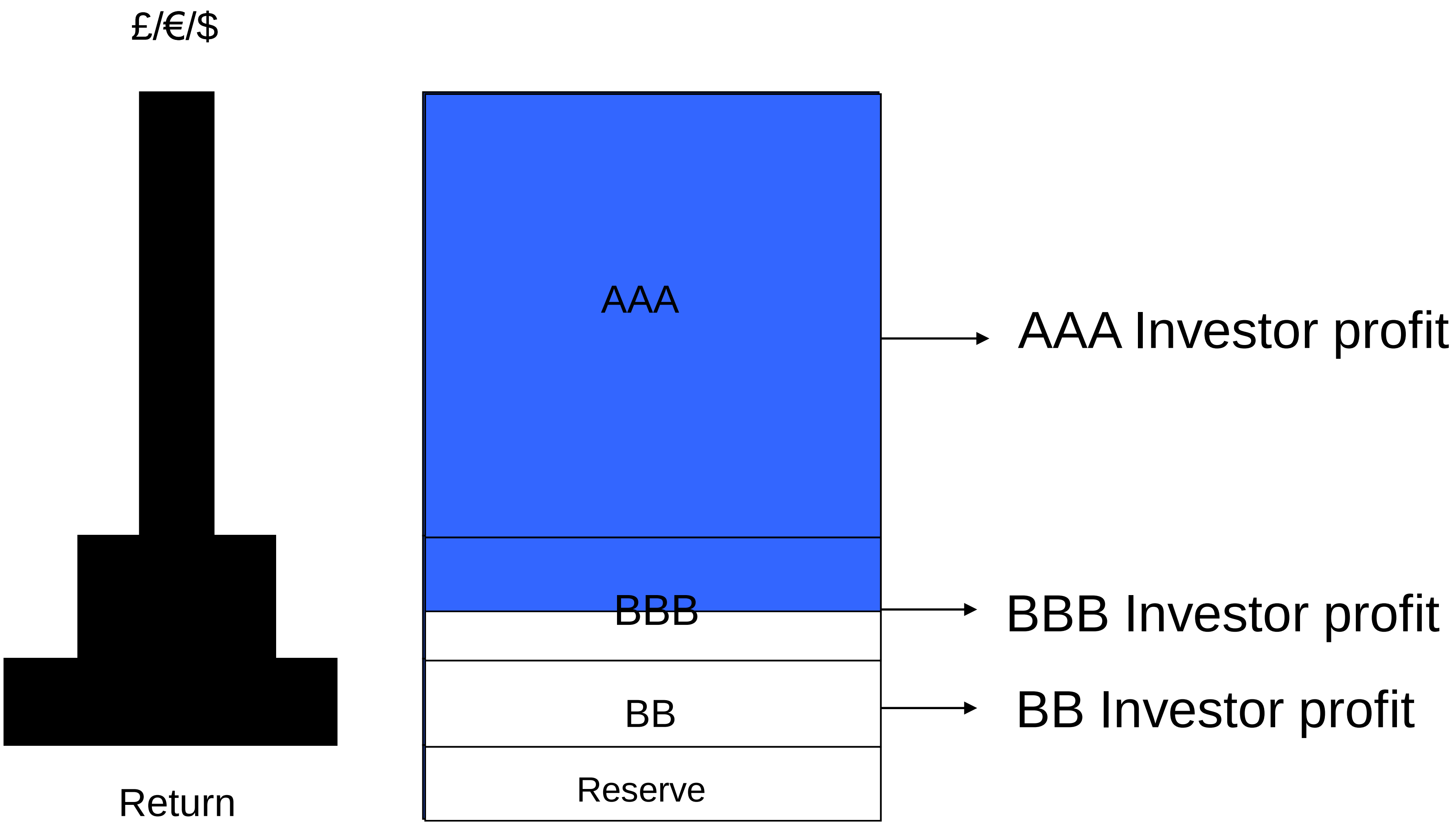
Borrow money to issue mortgages via a ‘warehouse line’ - a huge overdraft

Enabled the repackaging of higher risk subprime loans, and into lower risk securities

Then refinance this overdraft with securitisation

Northern Rock/HBOS did this to become a hybrid

The ‘waterfall structure’



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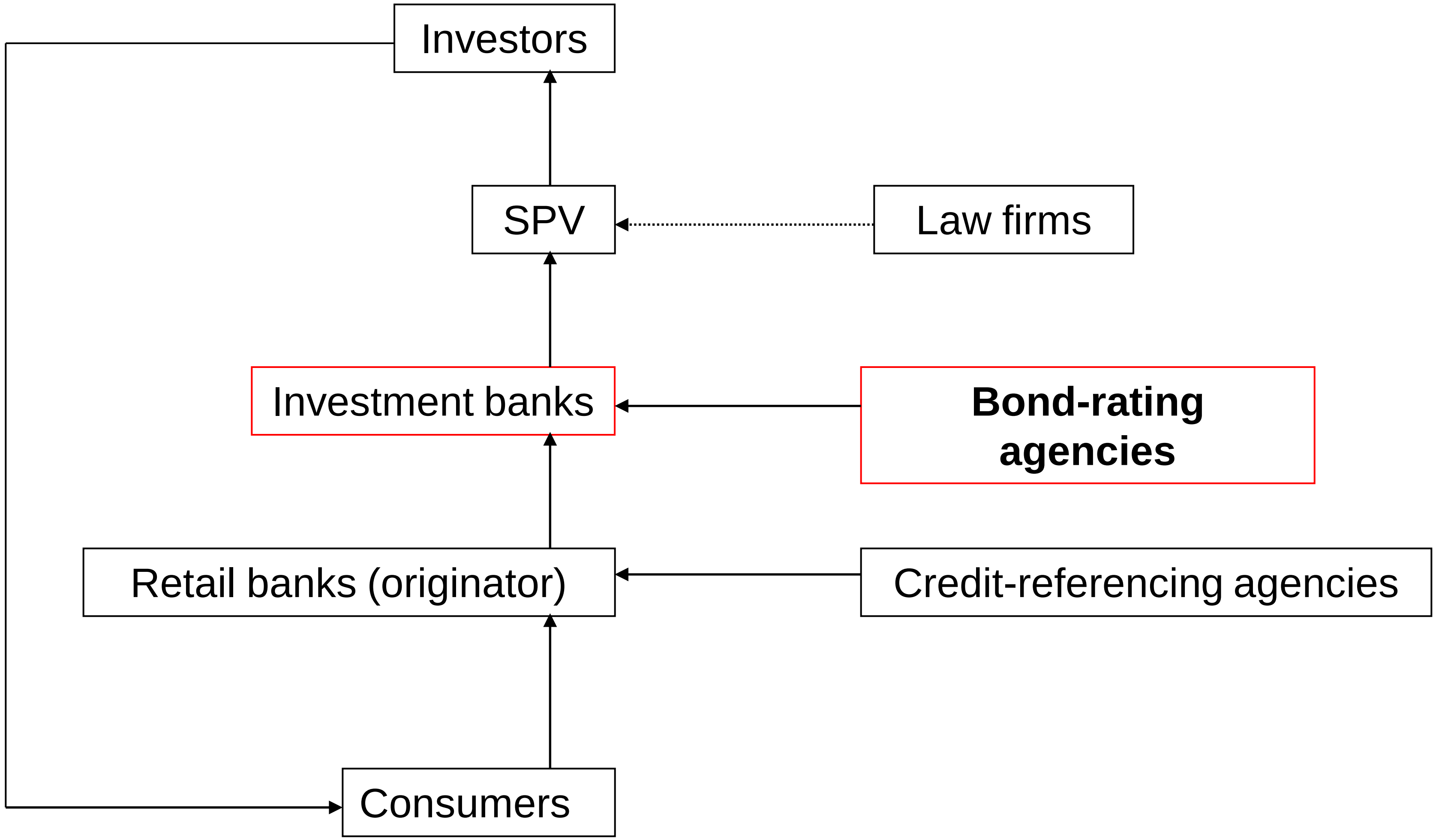
STRUCTURED FINANCE SECURITIES

All Classes for **HMI 2007-2X** HOLMES MASTER ISSUER PLC

	Class	Crncy	Orig Amt (000s)	Comp Rating	Orig WAL	Index	Spread	Coupon	Factor	BGN-Mid
* 1)	1A1	USD	1,225,000	AAA	0.95	LIBOR01M	3.0	4.682	1.0000	-
* 2)	1A2	EUR	1,200,000	AAA	0.95	EUR003M	4.0	4.772	1.0000	99.901
* 3)	2A	CAD	600,000	AAA	2.82	CDOR01	8.0	4.729	1.0000	-
* 4)	2A1	USD	2,750,000	AAA	2.82	LIBOR03M	5.0	5.293	1.0000	-
* 5)	3A1	USD	1,250,000	AAA	4.07	LIBOR03M	8.0	5.322	1.0000	98.732
* 6)	3A2	EUR	1,300,000	AAA	4.07	EUR003M	9.0	4.822	1.0000	98.886
* 7)	3A3	GBP	450,000	AAA	4.07	BP0003M	9.0	6.383	1.0000	99.133
* 8)	4A	USD	750,000	AAA	5.07	LIBOR03M	10.0	5.343	1.0000	-
* 9)	1B	USD	82,000	AA-	0.95	LIBOR03M	7.0	5.313	1.0000	-
*10)	2B1	USD	25,000	AA-	3.07	LIBOR03M	12.0	5.363	1.0000	-
*11)	2B2	EUR	95,000	AA-	3.07	EUR003M	13.0	4.862	1.0000	-
*12)	2B3	GBP	50,000	AA-	3.07	BP0003M	14.0	6.433	1.0000	-
*13)	2M1	USD	10,000	A	3.07	LIBOR03M	22.0	5.463	1.0000	-
*14)	2M2	EUR	20,000	A	3.07	EUR003M	22.0	4.952	1.0000	-
*15)	2M3	GBP	38,000	A	3.07	BP0003M	24.0	6.533	1.0000	-
*16)	1C	USD	128,400	BBB	0.95	LIBOR03M	23.0	5.473	1.0000	-
*17)	2C1	USD	34,000	BBB	3.07	LIBOR03M	41.0	5.652	1.0000	-
*18)	2C2	EUR	106,000	BBB	3.07	EUR003M	41.0	5.142	1.0000	-


Investors
SPV
Law firms
Investment banks
Bond-rating agencies
Retail banks (originator)
Credit-referencing agencies
Consumers

Financial elites

Financial products are produced at the boundaries of firms (Thrift, 1994)

Until recently, there has been a lack of attention on elites (Savage & Williams, 2008; Hall, 2009)

Financialised elites (Hall, 2009)

Capital market intermediaries (Folkman, et al. 2007)

'Proactive initiators' investment bankers, corporate lawyers
'Responsive functionaries' bond-rating agencies in governance

Has the role of bond-rating agencies become more blurred?

Have they moved beyond a role of supervision and are they interacting more proactively with other elites?

The role of bond-rating elites in the development and operation of securitisation

The role of bond-rating agencies in finance

Since the 1980s, financial organisations moved from intermediation to disintermediation - where borrowers accessed credit directly from investors by issuing bonds, instead of through bank deposits (French & Leyshon 2008)

This created the emergence of a new private mode of financial surveillance, creating a regime of governance, not government (Sinclair, 1994)

Bond-rating agencies provide a key role in providing independent metrics, and ratings of the quality of bonds to investors (Sinclair, 1994)

These agencies provide ‘judgements’ on bond quality that have assisted the financialisation of Anglo-American economies through their judgements (Erturk, et al (2004)

The aim of these metrics has been to calculate estimates that bond issuers will default, or not, to overcome information asymmetries (Sinclair, 2005)

This has created a global elite of private governance with private analysts that control the metrics provided to bond issuers

Bond-rating agencies emerged in the US and have moved into Europe, Asia and Latin America

There are three main agencies that rate the credit quality of bonds globally, including corporate bonds, sovereign bonds and securitisation notes

FitchRatings STANDARD &POOR'S MOODY'S

The agencies use the following rating measures for RMBS bonds:

	Low Risk				*High Risk*
Standard & Poor's	AAA	AA	A	BBB	BB
Fitch Ratings	AAA	AA	A	BBB	BB
Moody's	Aaa	Aa	A	Baa	Ba

Usually, 90pc of a securitisation is of low risk AAA

Theoretically the same risk as holding a sovereign bond, but with a higher yield

Different investors sought bonds of varying risk to meet their investment mandates

3 agencies wield considerable power over financial markets

Small global teams with considerable power, especially in London

Before bonds are issued, bond-rating agencies run stress tests including the quality of the issuer, liquidity risk, credit risk, repayment of the notes

However, the quality of a bond issue is monitored over its lifetime - increasing and decreasing the rating

Bond-rating agencies have a powerful location within financial networks – ratings limit access to investors

Expanding British RMBS markets: The role of bond agencies

Bond-rating agencies and their metrics have provided greater transparency for investors

Enabling them to compare different bonds and asset classes - especially for RMBS

The early UK RMBS market was mainly inhabited by UK investors, including banks, insurance companies and pension funds

Reputation was important for investors, as was local knowledge

Most investors undertake due-diligence into RMBS, scrutinising the mortgage portfolio, lender and transaction details

Rating agencies assisted the expansion of the UK market by enticing international investors

Expanding British RMBS markets: The role of bond agencies

International US investors were unsure of the market, but they were familiar with US bond-rating agency metrics

This provided reassurance for investors who began to buy UK assets. widening the market to other international investors

This also sped up the market as investors would happily purchase AAA bonds, with reduced due-diligence

The introduction of bonds explains why, at the peak of the market, 70 per cent of investors in UK RMBS were from overseas (CML 2010)

Bond-rating agencies had facilitated this with the power of their metrics

This enabled the housing market to grow, subprime issuance to increase, profitability, for lenders to increase

Critiquing bond-rating elites

If elites conducting surveillance suppose that a bond is weakening, they will downgrade the bond. This increases the risk, and often increases the interest rate that the issuer must pay to investors

Bodenman (1996) has argued that these metrics, especially downgrades, on US municipal bonds have increased the debt of poorer cities, increasing the proportion of tax revenues being spent on bond repayments, not city services

Ferri et al (1999) have argued that agencies exacerbated the Asian Crisis in the 1990s, by downgrading debt on bonds, and increasing bond repayments, placing companies under stress, and exacerbating the problem into a self-fulfilling prophecy

The reliance on external capital also increased the UK's dependence on these funds, exacerbating the fallout after the crisis

More recently German Chancellor Angela Merkel criticised bond-rating agencies for not classifying US subprime bonds as high risk investments

This, she has argued, misled investors adding to the intensity of the credit crunch

Understood by many as a conflict of interest between issuers of bonds and bond-rating agencies, where the agency fees are paid by issuers, which may have coerced them into providing favourable ratings

Portes (2008) argues that Moody's generated **44 %** of its revenues from rating activities

Questionable that they would rate high-risk assets with low-risk metrics as it could damage their reputation - problematizes their role as private governors of global capital markets

Investigating the roles of these elites suggest how agencies were implicated in the crisis, but did not seek to give over-optimistic ratings

Making finance: Securitisation and the confused roles of elites?

Structuring RMBS bonds

The development of RMBS transactions relies on a select group of epistemic elites

These include structurers in investment banks that create the waterfall structure and transaction model to develop the note tranching

This model is then stress tested to analyse the effects of different financial scenarios, that could be expected, to see how the transaction responds– this can include increasing interest rates and unemployment

These elites develop the models, and originally the bond rating agencies would then certify their quality and risk, with different ratings

These evaluations of the stability provided independent metrics of private governance, but the agencies have become more involved in this process

In practice, this supervisory role becomes more complex

Investment bank structurers ‘create’ the securitisation structures

But, if the structure fails to meet the guidelines of the bond-rating agencies, the analysts give advice and hints as to how the deal should be amended

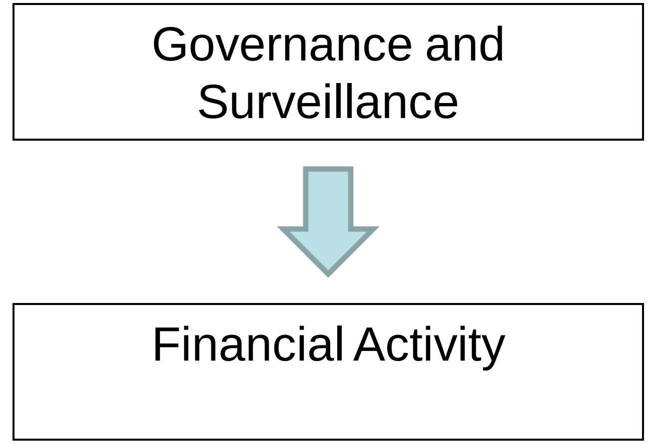
Suggests a complex relationship as they move from governor to a role in shaping transactions

Then structurers started using the methodologies from bond-rating agencies as ‘cook books’, or model answers to build their transactions

The RMBS structures became programmed around the bond-rating assumptions

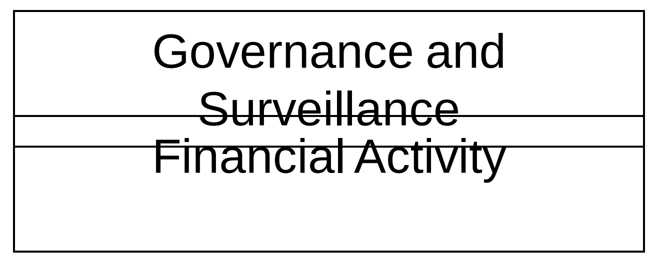
“Yeah, some of them [bond rating analysts] say what you give us [transaction] we will rate, and then you ask for feedback, so if in this scenario, where, what can we do to make this scenario better, it depends on the analyst you’re working with, some are more helpful than others, it depends how busy they are, it’s a bit of give and take on both sides, and experience, some banks will know just as well as the agencies, it’s experience, that will help, they will say try that around, or this doesn’t look right, check your model is working, but there is give and take on each deal,” (Investment Bank, Structurer 2007)

During the 1990s, methodologies used by rating elites were made available to structurers to assist the structurers in developing their waterfall and securitisation structures



Created a significant shift in the role of these elites ***from*** private governors to co-producers

‘Independent production’ of RMBS began to converge and conform on particular models and assumptions of bond-rating agencies



"*…bankers used to model the transaction and we used to validate the model, and now we model our own transaction so it's a lot more independent and easier to understand what's going on with the transaction, I think that's the main change, so we can reconcile our model with the banker's model and we know the bank isn't hiding anything,"* (Bond-rating Analyst, 2007) “then you get rating agency templates, which, three different rating agencies have different things they try to populate... you get the rating agency reports and then it’s run through cash flow models, so it’s a big modelling process to come out with, once you run through all the models, do all the different stresses each agency has different stresses, so there’s, it’s just CPR all prepayments from 40% to half a percent, stress arrears going up to, erm, it’s different for different rating categories, err, if you look at the rating methodology of the agencies, so it’s running the cash flow models, coming out with your loss severity which would give you a triple A and how much you would get”, (Investment Bank, Structurer, 2007)

Summary: The conflicting roles of elites in governance

Bond rating agencies should be providing governance of RMBS transactions, but their role has become progressively interrelated with production

The 3 main bond rating agencies use elite analysts to produce key texts that were used to develop securitisation structures

Whilst critics have argued that bond-rating agencies provided metrics that were too low-risk for some transactions, these elites and their methodologies caused a convergence of the transactions, partially contributing to their construction

The assumptions and structures of the bond-rating agencies can be viewed as a contributor to the crisis, as they guided the engineering that underpinned RMBS transactions, especially subprime deals in the US

The European Securitisation Forum (ESF) and the Securities Industry and Financial Markets Association (SIFMA) are arguing for greater transparency within the 'future' securitisation market, and are calling for renewed trust in rating agencies

Findings of the research suggest that the relationship between private governance and finance is more complex than originally thought

To provide added protection against future financial crisis, this complicated relationship needs to be understood in greater detail.

Perhaps the agencies and their models should be scrutinised, but who should fulfil that task?

Would reducing the power of agencies be useful, by forcing more due diligence by investors


REDUCED PRICE
LENDER FORECLOSURE
HOME AUCTION!
OPEN HOUSE
8/4, 8/11, 8/12

New directions: new hybrids of financial, cultural and religious elites

New directions?: Regulatory elites and religious finance

A new generation of financial products have co-evolved with securitisation using similar features

Shariah finance, known as sukuk bonds

Involved in the Dubai's financial downturn, but potentially seen as a new method of accessing Islamic finance markets

Subject to bond-rating agency metrics, but also due to Islamic Law

Sukuk are subject to religious oversight – cultural contrast to capitalism

Shariah Law – Principles of Banking and Finance

1. The prohibition of *Riba*
2. The prohibition of *Gahar*, including risk-taking
3. The avoidance of socially responsible investments, including gambling and alcohol
4. Risk sharing between entrepreneurs and financiers
5. Investments into material and tangible goods and assets
6. Social justice – where neither party of a transaction are exploited

Gait and Worthington (2008:785)

New directions?: Regulatory elites and religious finance

Sukuk are rated for credit quality by bond-rating agencies

Sukuk bonds are governed by Shariah scholars for Shariah compliance

The views and opinions of individual scholars and their social position as elites provides them with the power to determine the Islamic quality of bonds

Sukuk bonds are only rated, as with bond-rating metrics, once these powerful elites are satisfied with the quality of bonds

This quality is compliance with Islamic Law, and not just bond rating metrics

New directions?: Regulatory elites and religious finance

AL QALAM

Shariah Scholar

Bond-rating agencies → Sukuk Bond ← Issuer/ Structurer

STANDARD & POOR'S

Gatehouse Bank

Investor Demand

CIMB Principal
ISLAMIC ASSET MANAGEMENT