Rocky relationships

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At the heart of the current banking crisis is a key change to the way in which banks operate: a change which has created a relational deficit.

Traditionally, banks lent money to companies and to people who wanted a mortgage, and then the banks collected the repayments of that money for themselves. There was therefore an ongoing relationship between the bank which lent the money and the customer who borrowed the money. The fact of this ongoing relationship meant that the bank had a direct financial interest in making sure that the customer was likely to be able to repay the money. This model of banking is now being described as "originate and hold" because the bank which originates the loan holds on to the loan. The direct relationship between the original customer and the originating bank is maintained throughout the life of the loan.

In the 1970s, U.S. government-backed social mortgage lenders, Fannie Mae (Federal National Mortgage Association), Ginnie Mae (Government National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation), started using a different model. They would make loans on generous terms to people who would otherwise have found it difficult to get a mortgage and, rather than waiting for those loans to be repaid over the lifetime of the loan, would sell on the loans to commercial financial institutions. Those loans were attractive to commercial financial institutions because, if the borrowers could not repay the loans, the U.S. government had guaranteed their repayment. By selling on their loans, Fannie Mae, Ginnie Mae and Freddie Mac received cash up front instead of having to wait for the loans to be repaid. This meant that they could lend more money more quickly to other borrowers. This new model of banking is called the 'originate and distribute' model, because the bank which originates the loan then distributes the loan to other banks, so that, whether the customer knows it or not, the banks who are expecting to be repaid are not the bank which originally made the loan.

It didn’t take private banks long to realise that what Fannie Mae and Freddie Mac were doing, they could also do. Banks would bundle together mortgage loans and sell them on to other banks. By doing this, some banks were able to grow their business far faster than their depositor base or shareholder investment would otherwise have allowed. Northern Rock expanded its business rapidly by making mortgage loans, selling them on to other banks, using the money received from the other banks to make more mortgage loans and then repeating the cycle. Changes in the ways banks were regulated, reached in an international agreement called the Basel Capital Accord in 1988, encouraged this practice, but it really exploded between 2003 and 2006 when the percentage of mortgage-backed securities issued by private sector banks increased from 24% of those issued in the USA to 60%.

The result was that by the summer of 2007, banks all over the world had bought bundles of American mortgage loans from those American banks which had made them in the first place. Then house prices began to drop in the U.S.A. Banks suddenly realised that if enough American borrowers could not repay their mortgages then there was a real risk that they would not be repaid on the loans they had bought. No-one knew how much the mortgage debt they had bought was worth. It might even be worthless. Banks stopped lending to one another. So when Northern Rock in the summer of 2007 went to the markets to ask to borrow more money to finance its business, they all said ‘no’. As a last resort, it went to the Bank of England to borrow money, and the rest, as they say, is history.

The ‘originate and hold’ model of banking is not perfect. The Jubilee Centre has long argued that debt finance is inherently problematic in relational terms, creating as it does imbalances of power and conflicts of interest between the lender and the borrower. However, at least the originating bank and the original borrower have a direct relationship, and one in which the originating bank is directly interested in the question of whether the borrower will be able to repay the loan.

Under the ‘originate and distribute’ model of banking, the aim of the bank which has made the loan is to sell the loan to another bank. This bank has no direct interest in making sure that the borrower is able to repay the loan because, if the borrower is unable to make the repayments, it will be another bank which loses out. Of course, a bank which becomes known for making reckless loans may find it difficult to sell them on, but that fact may not be discovered for several years, by which time the people who sold the loans in the first place will have collected their bonuses and may well have moved on.

The 'originate and distribute' model of banking creates a serious problem which economists call 'moral hazard'. The originating bank does not have sufficient incentive to be careful in who it loans to and how much it loans. As the House of Commons Treasury Committee noted, there were looser standards of lending and underwriting mortgages which 'are linked to the decisive loosening of the link between creditor and debtor under the "originate and distribute" banking model. This model encourages reckless lending. Reckless lending has serious consequences for everyone. Reckless lending means borrowers are lent money they cannot afford to repay. They then buy houses they cannot afford to live in, spend money on consumer goods they cannot afford, and when they fail to make their mortgage repayments, suffer the consequences, often including family break-up, which accompany serious debt. Reckless mortgage lending also affects everyone in society, driving house prices upwards beyond a point which is sustainable. If only the super-rich can afford to buy a family house in the South-East of England, then those providing services to the super-rich have to commute further and further distances to get to work, with consequential damage to the environment in terms of pollution and to family life, as parents have less time to spend with their children.

A modest proposal

It is disastrous, from a relational perspective, for a bank which makes a loan to be able to sell on the whole of that loan to other banks. The economic consequences of this taking place on a massive scale are ones which we are all living with at the moment. At the very least, originating banks ought to be required to retain 20% of the risk in relation to the original loan, so that they have sufficient incentive to take proper precautions to see if the borrower can afford to make the repayments. In relation to more complex forms of on-selling, where the repackaged loans have been divided up into different tranches, the originating bank ought to be required to hold on to a greater percentage of the so-called equity tranche, i.e. the riskiest portion of the loans, which bears the highest risk of non-repayment.