The Role of Ethics in the Current Financial Crisis: The Ethics of Securitization

John R. Boatright
Loyola University Chicago

The Crisis is a Failure of. . .

- Market actors (mortgage companies, commercial/ investment banks, central bankers, regulators, rating agencies, borrowers, investors)
- Market functions (loan origination, securitization, credit insurance, leveraging, ratings, asset pricing)
- Government policy (interest rates, home owner-ship, deregulation, reserves, GSEs, SIVs, TBTF)
- Risk management (reliance on metrics, e.g. VaR, black swans, fat tails)

Other Factors in the Crisis

- Competition for high returns
- Globalization (savings glut, contagion)
- Asset price bubble/collapse, credit freeze, downward spiral
- Interconnectedness (multifunctional firms, correlations, counterparty risk)
- Wall Street compensation, bonus culture, conflicts of interest, perverse incentives

What’s the Role of Ethics?

- The current crisis is mainly a failure of beliefs, judgments, assumptions, and system design
  - “perfect storm,” “an accident waiting to happen”
- Although there was some greed, imprudence, dishonesty, and recklessness, the crisis is mostly the result of good intentions gone awry
- Premise: the role of ethics lies not in obvious individual moral failures but in more subtle system factors.

Hanlon's Razor: "Never attribute to malice that which can be adequately explained by stupidity."

Attrib. to Robert J. Hanlon

"Never attributed to malice or stupidity that which can be explained by moderately rational individuals following incentives in a complex system of interactions."

Douglas W. Hubbard,
The Failure of Risk Management

The Securitization Process

- Traditional bank loans (originate to hold)
  - Loan funded by depositor's savings
  - Income stream held by bank
  - Risk of default/prepayment/run borne by bank
- Incentives of traditional bank loans
  - Assess creditworthiness, ability to repay
  - Enforce underwriting standards
  - Maintain adequate reserves

The Securitization Process

- Originator (originate to distribute)
  - Sell loans (payments, collateral interest) to arranger
- Arranger
  - Package loans into CDOs
  - Divide into tranches/strips
  - May retain some tranches/strips
- Rating Agency
  - Rate quality of tranches/strips
- Investors
  - Buy tranches/strips according to risk/return profile

Benefits of Securitization

- Shifts risk from (undiversified) bank to market (diversified, less risk averse investors)
  - More efficient risk bearing
- Increases volume of available loan funds
  - Investors worldwide vs. (local) bank depositors
- Loans available to less qualified borrowers
  - Because risk is borne more efficiently
- Provide higher returns for investors with less risk than holding the underlying loans

Problems with Securitization

- Reduces incentives for due diligence by bank
  - No doc, NINJA loans; lower underwriting standards; inflated appraisals of collateral
- Creates incentives for predatory lending/ borrowing (ARMs, 2/28s, negative equity, refinancing, etc.)
- Increases conflict of interest at rating agencies
- Reduces incentives for due diligence by arrangers
- Creates incentives for predatory selling, imprudent buying

Maybe Stupid, but Is This Unethical?

- Loans may be rational if
  - Asset prices continue to increase
  - The market for assets remains liquid
  - Credit remains available
- Securities (CDOs) may be sound if
  - Risk is properly priced by the market
  - The market for CDOs remains liquid

The Theory Behind CDOs

- Risk of loans is shifted from banks to market
- The market is able to accurately price the risk
  - Claim of efficient market hypothesis
- The market is better able to bear the risk because of diversification
- Because of diversification, loan quality does not matter (as long as it is known)
- All securities have a market and can be sold

Can the Market Price CDO Risk?

- Need sufficient information (about loans, historical data)
- Need to conduct adequate assessment of risk/return (by means of risk management)
  - Problem of assessing the extremely unlikely (tails)
- Need to have appropriate incentives (especially for rating agencies, fund managers)
- Need to avoid the free-rider problem of diversification

Can the Market Bear the Risk?

- Market = Diversified Investors, who. . .
- Have less information than originators—but more complex and asymmetric information
- Are "rationally disinterested"
- Are more dependent on intermediaries—despite process of disintermediation
- May not actually be very diversified
- May be highly risk averse
- Lack opportunity to give consent

Does Loan Quality Matter?

- Loan quality is only one kind of information for assessing risk (especially in a less diversified portfolio), but it is useful. . .
  - As an additional source
  - For revealing declining loan quality
  - For facilitating intervention
  - For protecting borrowers (whom no one has any incentive to protect because of disintermediation)

Are CDOs Marketable?

- Opaqueness/complexity
- Need for trust
- Problem tranches: “Super senior” and “toxic waste”
- Difficulty of renegotiating claims
- Difficulty of enforcing legal claims

Credit Default Swaps (CDSs)

- CDSs (like CDOs) involve shifting of risk
- In theory, this would be more efficient risk bearing if CDSs are correctly priced
- Were CDSs correctly priced?
  - Insurers have less information, but more complex and asymmetric information, than banks
  - Insurers were not adequately diversified; CDSs may have actually concentrated risk
  - Insurers used faulty risk analysis (esp. correlation)
  - Insurers lacked incentives to consider systemic risk (moral hazard)

For both CDOs and CDSs:

In an efficient market, securities will be held by the party which can manage the risk most efficiently, i.e. at the lowest cost.

In an inefficient market, securities will be held by party which will accept the lowest compensation for risk, whether the risk is properly priced or not.

Ethical issue: Is it ethical to transfer risk without consideration of the efficiency of the market?

Where’s the (Lack of) Ethics?

- One cause of the crisis was a shifting of responsibility for handling risk
- Shifting responsibility is ethical only if the receiving parties are able to handle risk
- In theory, securitization and insurance allows receiving parties to handle risk only if certain conditions are met
- These conditions were not met
- Therefore, the risk shifting was not ethical

What Role for Ethics?

- Moral outrage is a valuable but scarce commodity; need to use it wisely (efficiently)
  - The problem is less greed, than stupidity, recklessness and moral hazard in transferring risk
- Need to develop greater responsibility in transferring risk
  - Less reliance on ratings and market
  - Better risk management
  - More careful attention to incentives
  - More emphasis on intermediation
  - Greater regulatory oversight for systemic risk

The End