

Securitization vs. subprime

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Resumen

El mecanismo financiero conocido como titulización ha sido considerado como una de las causas más importantes de la crisis financiera actual. Este procedimiento que ha sido aplicado ampliamente en el mercado americano plantea varias preguntas: ¿Ha sucedido en España también? ¿Causa los mismos riesgos a nuestro sistema financiero que al sistema americano? ¿Es necesario renunciar a su uso con el fin de contar con un sistema financiero sólido, estable y saludable?. En esta investigación expresamos la necesidad de implementar medidas de control estrictas y supervisar los mecanismos para administrar el mercado de titulización por todos los participantes involucrados. El objetivo es evitar la falta de uso de este tipo de préstamos, por lo que creemos que puede ser una herramienta útil para su uso.

Securitization, subprime.

Abstract

The financial mechanism known as securitization has been considered as one of the main causes of the present financial crisis. The term subprime includes low quality loans that have caused risk and uncertainty to the whole financial system. This procedure, which has been applied widely in the American market, raises several questions: Has it happened in Spain too? Does it cause the same risks to our financial system than to the American one? Is it necessary to give up its use in order to have a solid, stable and healthy financial system? In this paper we express the necessity of implementing strict control measures and supervising mechanisms to manage the securitization market by all the participants involved. The objective is to avoid the lack of use of this type of loans so we think it can be a useful tool to use.

Securitization, subprime.

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Introduction

As a result of the last crisis in the Financial Markets, sub primes have generated uncertainty about the financial process in Spain known as Securitization. This has been defined, (Blanco 2001, p.15), as the process in which the mortgage assets balance in an entity it could be pre-aggregated, modified some of its features, sell in parts or as a whole to the investors in form of securities.

Assets Securitization have played a relevant roll in the financial crash in an international level, introducing a systematic risk, not identified or corrected early enough by the agents, in the financial system. The riskiness along with the fiscal imbalances and the debt balances achieved, have been protagonists of the financial crisis (Trujillo del Valle 2011).

This stigma is unfair in the case of Spain case, if we analyze all the financial system. In fact, the market voices claim the value of securitization as a financing instrument in the real economy and necessity to restore this activity on solid foundations, correcting the mistakes of the past (Martin 2012).

The work begins in Section 2, where it compares to the US market and the Spanish one, followed in section 3 with the exposure of the financial mechanism of securitization, its development, applications and effects in the Spanish Financial system. Finishing in section 4, we will defined the securitization benefits as financial mechanism to the Economic and Financial system, once the excesses and the errors are detected in the Securitization Market.

Different markets different purposes

In the early 2000s, the Federal Reserve of the US made a decision to lower the interest rates to 1% this trigger and increased in consumption. The increased in the property demand caused prices to rise, not only in US market but in other markets as well. This new demand with higher prices caused the called "property bubble"

Us mortgage market

The U.S. Mortgage Market is classified based on the following four criteria (AFI 2007):

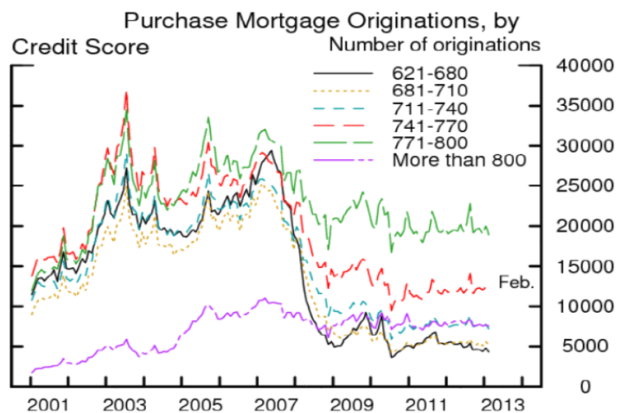
- i. Credit history and Borrower's Financial strength, based in a standard called FICO.
- ii. The debt to income service ratio (debt to income o DTI) and Loan to Value ratio (Loan to Value o LTV).
- iii. The accreditation\ documentation degree.
- iv. Its amount.

The review of the preview criteria, classify the higher and lower mortgage risks as:

- Prime-conforming Mortgages: Granted to borrowers with high FICO, DTI maximum to 40% and LTV less than 80%. Not only these are bought in commercial banks, but also in agencies.
- Prime-non conforming Mortgages: Also called jumbo, make reference to mortgages granted to borrowers considered Prime but with a higher amount than the established limits and with longer accreditation requirements.
- Subprime Mortgages: These are mortgages that do not meet the requirements to be classify as prime mortgages and therefore with a less probability of repayment. Those borrowers with a "no clean" credit history and with a little financial backing, with a DTI higher than 55% and\ or a LTV higher than 85% are generally considered subprime.

- Alt-A Mortgages: This kind of mortgages are in the middle of prime y subprime. Its definition is "fuzzy" especially in the recent years. They began like a more flexible alternative than the prime mortgages, to borrowers who meet the requirements of FICO, DTI and LTV but with a not completed credit income.
- FHA / VA Mortgages: With social order, granted to borrowers with a low ability to pay, granted by the Federal Housing Administration and the Veterans Association, acting like risk guarantors.

Grouping the above classification in prime and subprime terms, in a range between 300 and 850 points, the subprime loans would be those with a score below 620 points. According to Duke (2013) a member of the Board of Governors in the Federal Reserve System, the steeper decline slope at the beginning of the crisis has been located in the higher risk issuance of loans. Between the 2007 and 2012, the first granting for home purchases mortgages fell to 30% for the borrowers with a credit score over 780, compared with a fall to 90 % for the borrowers with score between 620 and 680, leading to a nonexistent loans granting with a credit score bellow 620, as shown in chart 1.



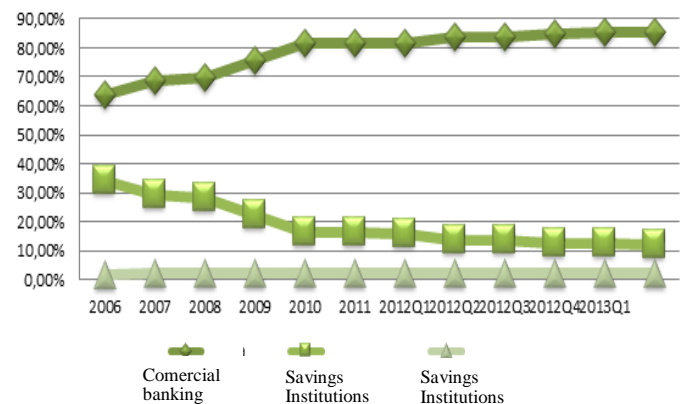
Graphic 1. Source¹: <http://www.federalreserve.gov/newsevents/speech/duke20130509a.pdf>

¹ The underlying data are provided by mortgage servicers
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Who grants the mortgage loans?

Board of Governors of the Federal Reserve System brings together the "loan issuers" in Financial Entities, Saving Institutions and Insurance Companies.

The graphic 2 shows, since the financial crisis the bank entities have assumed the lender roll in mortgage industry before 2009 when Saving Institutions held an intermediate position in the sector.



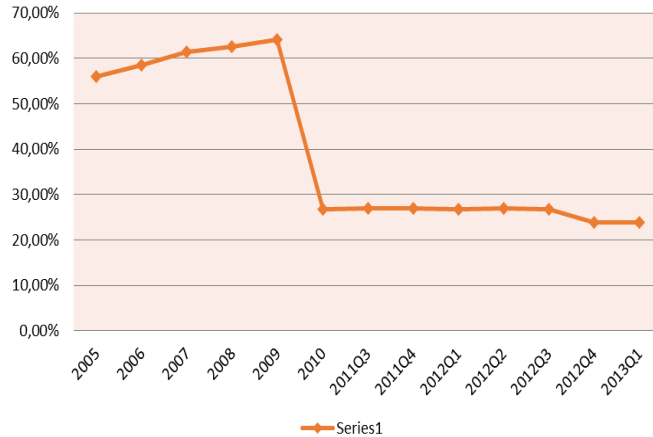
Graphic 2. Credit lenders for housing

What about issued loans?

The graphic 3 shows how the application of the Securitization process in the US Market is massive, reaching a 70% in issued loans. In 2009, in the epicenter of the financial crisis the fall in the Securitization market of mortgage loans is almost vertical, to levels below 30%.

This administrators classify the credits in prime, subprime or FHA. Subprime loans include requirements for selling companies sponsored by the GSE (Government Sponsored Enterprises), like those with favorable credit but loan amounts that exceed the GSE guidelines.

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Graphic 3. Percentage of Securitized mortgage loans in US

Spanish mortgage loans

A feature of the Spanish Market is that the mortgage is a specific guarantee that is available to the Lender Entity and usually the property itself.

The existence of the mortgage guarantee allows the credit institution to offer an extended repayment period and a lower interest rate to other entities but is counterbalanced by the possibility, in case of default, to cover the debt (all or part) through the property sale and the mortgage guarantee execution.^{2 3.}

² Payment exists in eleven states: Alaska, Arizona, California, Iowa, Minnesota, Montana, Nevada, N. Dakota, Oregon, Washington y Wisconsin. However, doesn't avoid eviction, just allows to settle the debt by providing the house, only if it's in the contract. Also we have to keep in mind that the interest rate of the loan is higher and the debtor must sign a credit default, which increases the cost. The admission or initial outlay of housing is usually quite high and in the case that the debtor becomes insolvent is enrolled in a registry that prevents him to have access to credit for seven years.

There are two cases in which the principle of the debtor universal liability does not apply: if the parties have expressly agreed in the writing of mortgage limitation to the value of the home and when the credit institution accept by express agreement, the called payment in kind.

Usually, in the procurement operations of the residence Institutions do not grant a funding percentage higher than 80% of the appraised value.

Recently many regulations have been approved in order to establish the bases for responsible loan concessions but without explicit conditions:

- The operation transparency regulations develops the laid principles in 2/2011 Law, of Sustainable Economy, in order to promote a responsible lending concessions by credit institutions⁴.
- Annex 6 of Circular 5/2012 of the Spain Bank about "General Principles for responsible lending".

So far in our country, this situation has not been common in mortgage lending.

It has also been approved the Royal Decree Law 6/2012, march 9, urgent measures to protect mortgage borrowers without resources, this norm provides several mechanisms to allow the restructuring of the mortgage debt and the flexibilization of the foreclosure for those borrowers who are in an extreme situation. These mechanisms are implemented through a Practice Code, of voluntary adherence to credit institutions or any other entity that carries out the function of granting mortgage loans. SPAIN BANK, Access Guide to the mortgage loan. July 2013

⁴Check your Credit History, included the contained information in the Risk Information Center (CIR) of the Spanish Bank.

-Take into account the applicant's income.

-To assess the applicant ability and guarantors to meet payment obligations, taking into account their income, savings, outstanding debts, guarantees and other fixed expenses.

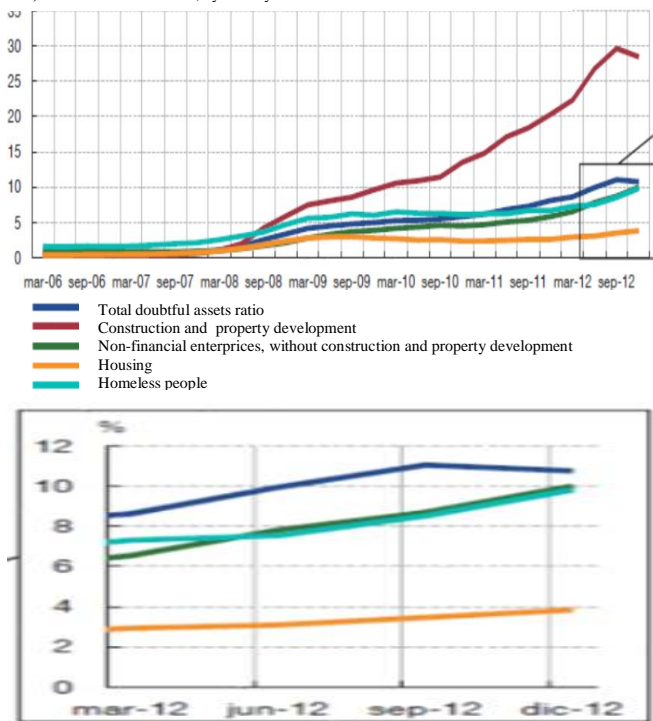
-Make a prudent valuation of the property, in order that they can respond effectively returning the borrowed capital.

-Base your decision of grant financing preferably in the applicant's ability to meet its payment obligations during the life of the loan, without the guarantee value.

In Spain there are no classifications about the loans by their level of risk like in US.

The main indicator in order to establish the risk of mortgage loans default is being the evolution of default rate, indicating the high degree of financial pressure faced by families. The unemployment rate evolution and the decline in housing prices determine the reduction in net wealth in the recent years.

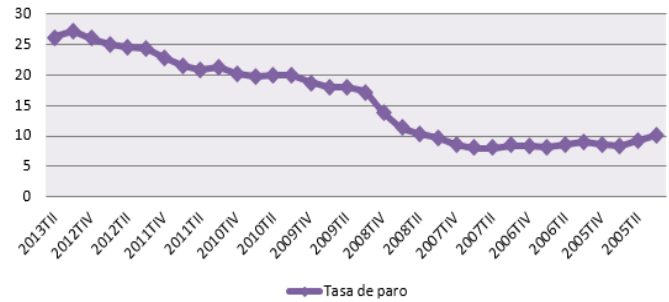
Non-performing loans ratio to private resident sector Business in Spain, DI. Deposit entities a) Doubtful assets ratio, by activity area



Graphic 4. Ratios de morosidad del crédito al sector privado residente, negocios en España, DI entidades de depósito. Source: Spain Bank. Financial Stability Report. May 2013.

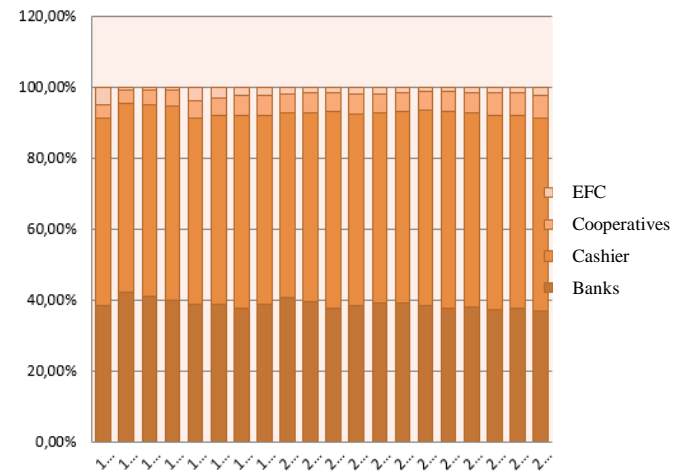
We can see a turnaround in the insolvency levels of the mortgage loans is the indicated trend in the second quarter of this year is mantein, and with a sligth fall in the rate, (27,16% to 26,26%) we can see a turnaround in the insolvency levels of the mortgage loans, as shown in graphic 5.

Unemployment Rate



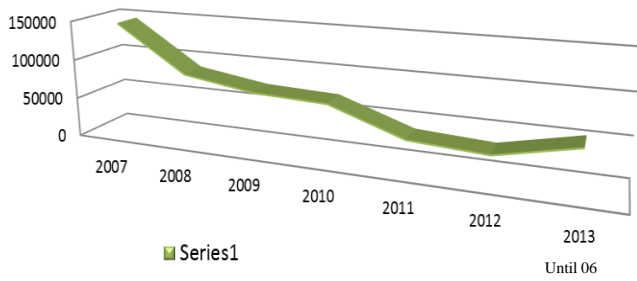
Graphic 5. Unemployment Rate Evolution. Source: NSI. National Statistics Institute.

Graphic 6, shows the mortgage providers distribution to families who purchase a house. Most credits is provided by Major Banks and saving Banks. The least credit is provided by Cooperatives and the EFC.



Graphic 6. Outstanding Balance. Mortgage loans for families for the house purchase. Source: AHE. Spanish Mortgage Association.

A decline in the mortgage lending to Spanish households shows a rebound in the last quarter of 2012, as shown in Graphic 7, possibly due to the advancement of family purchasing, caused by the elimination of desgravación for purchase in the income tax, which became to be apply early in 2013.



Graphic 7. Mortgage Loan. Amount of new Issues. Source: Statistical Bulletin of Spain Bank.

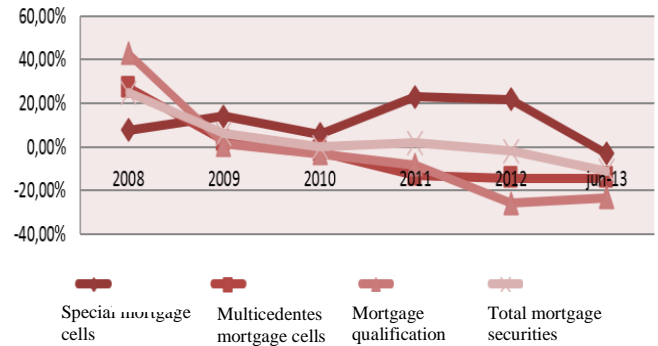
In Spain, Securitization has lived “golden years” during the growth period of the Economic cycle, although its application and development is not comparable to US Market. As Table 1 shows, using data from the National Securities Market Commission (CNMV) on the number fund evolution of securitization since 2010.

Number of securitization funds registered in the period
Distribution by type of transferred asset

Number of funds (1)	2012				2013			
	2010	2011	2012	II	III	IV	I	II
FTH (a)	0	1	0	0	0	0	0	0
FTA	36	47	35	2	1	17	11	5
FTA mortgage	18	10	5	2	0	1	0	1
Mortgage loans (b)	11	9	4	2	0	1	0	1
Mortgage bonds (c)	7	1	1	0	0	0	0	0
Loans to developers (d)	0	0	0	0	0	0	0	0
FTA companies	13	19	7	0	1	4	4	1
PYMES	8	4	4	0	1	3	1	1
Loans to enterprises	4	12	2	0	0	0	2	0
Corporate loans	1	1	0	0	0	0	0	0
Financial leasing	0	2	1	0	0	1	1	0
FTA others	5	18	23	0	0	12	7	3
Subordinated debt	0	0	0	0	0	0	0	0
Treasury bonds	0	0	0	0	0	0	0	0
AAPP credits	0	0	0	0	0	0	0	0
Territorial bonds	0	0	0	0	0	0	0	0
Consumption loans	0	0	0	0	0	0	0	0
Auto loans	1	2	2	0	0	2	0	0
Accounts receivable	0	0	0	0	0	0	0	0
Rights of future credits	0	0	0	0	0	0	0	0
Securitization bonds	0	0	0	0	0	0	0	0
Other credits	2	13	20	0	0	9	7	3
TOTAL BOND FUNDS OF SECURITIZATION	36	48	35	2	1	17	11	5
FUNDS OF PROMISSORY NOTES OF SECURITIZATION	2	2	1	0	0	1	0	0
TOTAL FUNDS OF BONDS AND PROMISSORY NOTES	38	50	36	2	1	18	11	5
Pro memory:								
Mortgage (a,b,c,d)	18	11	5	2	0	1	0	1
Private funds (2)	1	1	2	0	1	0	1	1

1. Number of files: includes programs of promissory notes registered, the renewal of them, emission protected in funding programs.
2. Not included in the previous total.

Table 1. Annual rate of change of outstanding mortgage securities (%).Source: SMA. (Spanish Mortgages Association)- Own elaboration.



Graphic 8. Annual rate of change of outstanding mortgage securities (%).Source: SMA. (Spanish Mortgages Association)- Own elaboration.

According to the Spanish Mortgage Association statistics from July in this year, although the minor uncertainties related to the sovereign debt markets, emissions of mortgage securities in the second quarter of 2013 reduced compared to previous quarters, allowing to be quoted only in mortgage bonds (see chart 8). Between April and June, the volume of mortgage bonds issuance fell to 23% over the previous quarter and the securitization market remained inoperative since January of 2013.

Securitization

Securitization, is a financial transaction that allows the transfer of ownership, assets of homogeneous nature that generate credit rights, present or future, known or estimable amount to an ad hoc entity that receives name of Securitization Fund in Spain for its processing in financial assets, which will be marketed between institutional investors.

This mechanism has been particularly important in the Spanish financial market for the past thirteen years, in a bearish stock context of the market due to the depreciation of new technology companies and pushed by the real estate boom, much of the credit growth during the pre-crisis years was funded through it (Carbó 2013).

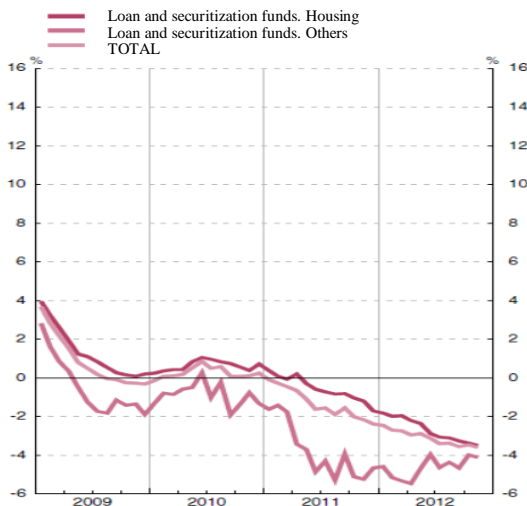
An example of this, is the volume of issuance of mortgage-backed securities between 2000 and 2006 (Figure 9), which represents an 18% of the total mortgage market generated during this period (Martin 2012).



Gráfico 9. Emissions of Mortgage assets AIAF. Source: AIAF. Own Elaboration.

While mortgage securitization stood out among all the securitized assets, there were also other transactions of securitization whose purpose was to serve as an alternative mechanism for financing the Spanish tissue.

FINANCING HOMES ISFLSH
Interannual variation rate



FINANCING HOMES ISFLSH

Contributions to the interannual variation rate

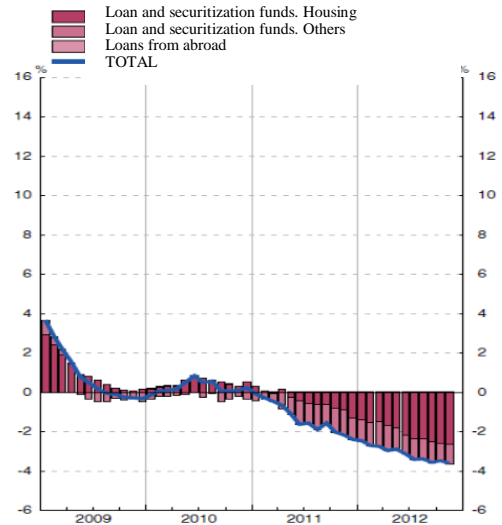


Gráfico 10. Financing homes

In 2007 the securitization market suffered the consequences of the financial crisis, "virtually paralyzed the loans between private investors. However the impact on issuance activity was lower, because the originators, primarily credit institutions could use securitization of its own assets as guarantee in order to obtain liquidity by central banks." (Martin 2011, p 13).

Since 2008 it has been initiated the adoption of measures to help the financial system that indirectly became securitization a useful tool to access to them, especially measures to reduce the weight of the impaired assets on bank balance sheets and began the liquidity programs.

Table 2 shows the type of the originators of securitized assets. Savings banks are the ones most outstanding asset-backed securities because of their involvement in the housing boom.

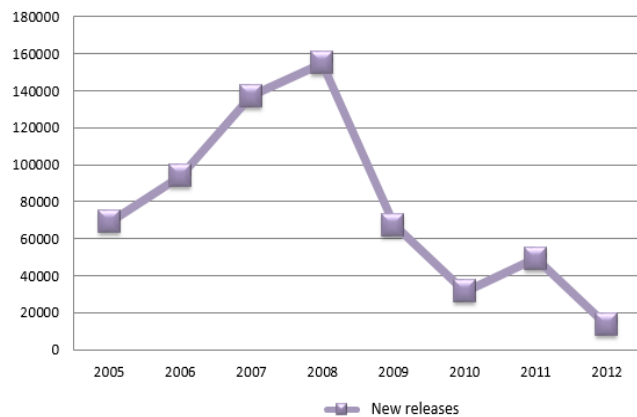
The outstanding bonds and promissory notes of securitization in secondary organized Spanish markets.

Distribution according to assignor's nature.

Million of euros	2012			2013				
	2010	2011	2012	II	III	IV	I	II
Securitization bonds								
Savings banks	152,201	151,070	113,792	134,140	112,105	113,792	104,897	101,297
Credit unions	237,263	210,968	156,042	182,677	168,740	156,042	145,662	142,024
EFC	22,978	21,032	21,013	22,753	21,530	21,013	20,539	20,423
ICO	11,406	9,700	8,569	8,886	8,497	8,569	8,366	8,073
Other financial corporations	17,225	10,044	3,956	6,932	6,932	3,956	3,956	0
Non-financial corporations	0	0	0	0	0	0	0	0
TOTAL BONDS	15,000	9,921	15,264	13,130	13,130	15,264	18,668	20,791
PROMISSORY NOTES AND SECURITIZATION								
Banks	441,089	412,673	318,636	368,517	330,933	318,636	302,088	292,608
Saving banks	2,560	1,533	1,040	1,535	1,455	1,040	1,075	1,045
Credit unions	0	0	0	0	0	0	0	0
EFC	0	0	0	0	0	0	0	0
ICO	43	19	0	0	0	0	0	0
Other financial corporations	0	0	0	0	0	0	0	0
Non-financial corporations	0	0	0	0	0	0	0	0
Non-financial corporations	0	0	0	0	0	0	0	0
TOTAL PROMISSORY NOTES	2,603	1,552	1,040	1,535	1,455	1,040	1,075	1,045
TOTAL BONDS AND PROMISSORY NOTES	443,692	414,225	319,676	370,052	332,388	319,676	303,163	293,653

Table 2. Annual rate of change of outstanding mortgage securities (%). Source: CNMV . Statistics.

Graphic 11 shows the securitization market in Spain, that has a risk of entering in a recession which can be very hard to leave. With issuance volumes below the year 2005. Esta situation is detrimental to the financial agents involved in it and the financial system as a whole.



Graphic 11. New securitization issues caused by the Spanish entities. Source: Spain Bank. Memory of bank supervision

Conclutions

Throughout the exhibition we have shown that the mortgage securitization has provided liquidity to the Spanish financial system. Its participation in the development of an expansionary cycle providing liquidity to the system is also accepted even with the insecurities generated.

The work of rating agencies has not helped. They have not developed the entrusted functions: assess the solvency and emissions creditworthiness. Assigning high ratings in emissions not related to them.

Amount of securitization bonds.

Distribution according to credit rating

Millions of euros	2012			2013				
	2010	2011	2012	II	III	IV	I	II
AAA	60.229	44.391	383	0	0	0	0	0
AA	591	10.051	5.127	1.339	0	668	0	0
A	575	1.023	11.671	0	1.303	6.319	3.931	1.856
BBB	408	1.534	2.946	0	0	2.946	3.053	2.123
BB	221	862	549	119	0	430	835	163
B	272	2.648	675	77	0	0	0	342
Less than B	966	7.903	2.449	0	581	822	233	459
TOTAL	63.261	68.413	23.800	1.535	1.884	11.185	8.052	4.942

Note: Rating grouped according to their equivalent to Standard and Poor's

Table3. Distribution of securitized bonds according to its quality. Source: CNMV.Statistic.

It is necessary to set strict controls from regulatory agencies in the implementation of the financial mechanism of securitization, it has to be establish necessary guidelines to return in this process as means of stable funding guidelines to help revive the economy.

Securitization market participants and other parts have called for its revival as a viable practice and a service to generate positive synergies for the real economy.

Meanwhile for financial institutions provides a way of additional funding that allows it to expand its activity in the credit markets for many sectors of the economy.

An example of securitization applications to reviving the real economy, the proportional Spanish State has provided guarantees of 3,000,000 thousand euros in 2013, in order to ensure fixed values income securities issued by securitization funds assets constituted under agreements that were subscribe to the General State Administration and the managers of asset securitization funds registered with the CNMV, in order to improve the financing of productive entrepreneurial activity.

Another example is provided by the ECB with lower conditions for asset-backed securities that are accepted as a collateral in the Eurosystem, replacing the current requirement of two credit ratings " AAA " by requiring two scores 'A' for six classes bond asset securitization (ABS. It has also reduced the cuts backed securities admitted by the assets of the Eurosystem (European Central Bank, July 2013). This paper concludes with the view that a malpractice securitization cannot hide the benefits that can be generated to the Spanish financial system.

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