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An Alternative Framework of Central Banking from a Post-Keynesians Perspective

Financialization, Securitization and Central Banking *in USA & Euro-Area*

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Overview

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2. Financialization?
3. Securitization (motives, process, development)?
4. Monetary Policy and Securitization (Monetary Transmission Mechanism)?
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Motivation

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- It is a central banking crisis
- The use of one instrument to achieve the primary objective of price stability through inflation Targeting (IT), 'Taylor rule', (Arestis & Sawyer, 2006) .
- Central banks policies along with deregulation allowed the expansion of financial markets and financial innovations.
- Financial innovations (as securitization) changed to the banks behaviour from (originate & hold) to (originate, repackage & distribute). Increasing banks' liquidity and profitability, increasing banks' risk, reducing capital reserve requirements, (Altunbas et al, 2009).
- Securitization reduced banks dependency on central bank and made monetary policy less effective.

What is Financialization?

- Epstein (2005) defined Financialization as ‘the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies’
- Over the past thirty years, the ratio of global financial assets to global GDP has risen almost three times (Blankenberg and Palma 2009).
- De-regulation of the financial system itself and the economy more generally (Frangakis, 2009)
- The expansion of financial instruments (innovations, such as securitization) and services.
- The dominance of finance over industry.
- Associated with rising inequality of incomes and of inequality more generally
- In short, financialisation is a complex term, containing several different dimensions and aspects.

Securitization

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- Securitization: process where banks transform illiquid assets to liquid assets, by selling Loans (Account receivables) to SPVs where they are bundled together into tradable securities to be sold in the secondary markets.
- Locally based, globally traded

The process of Securitization

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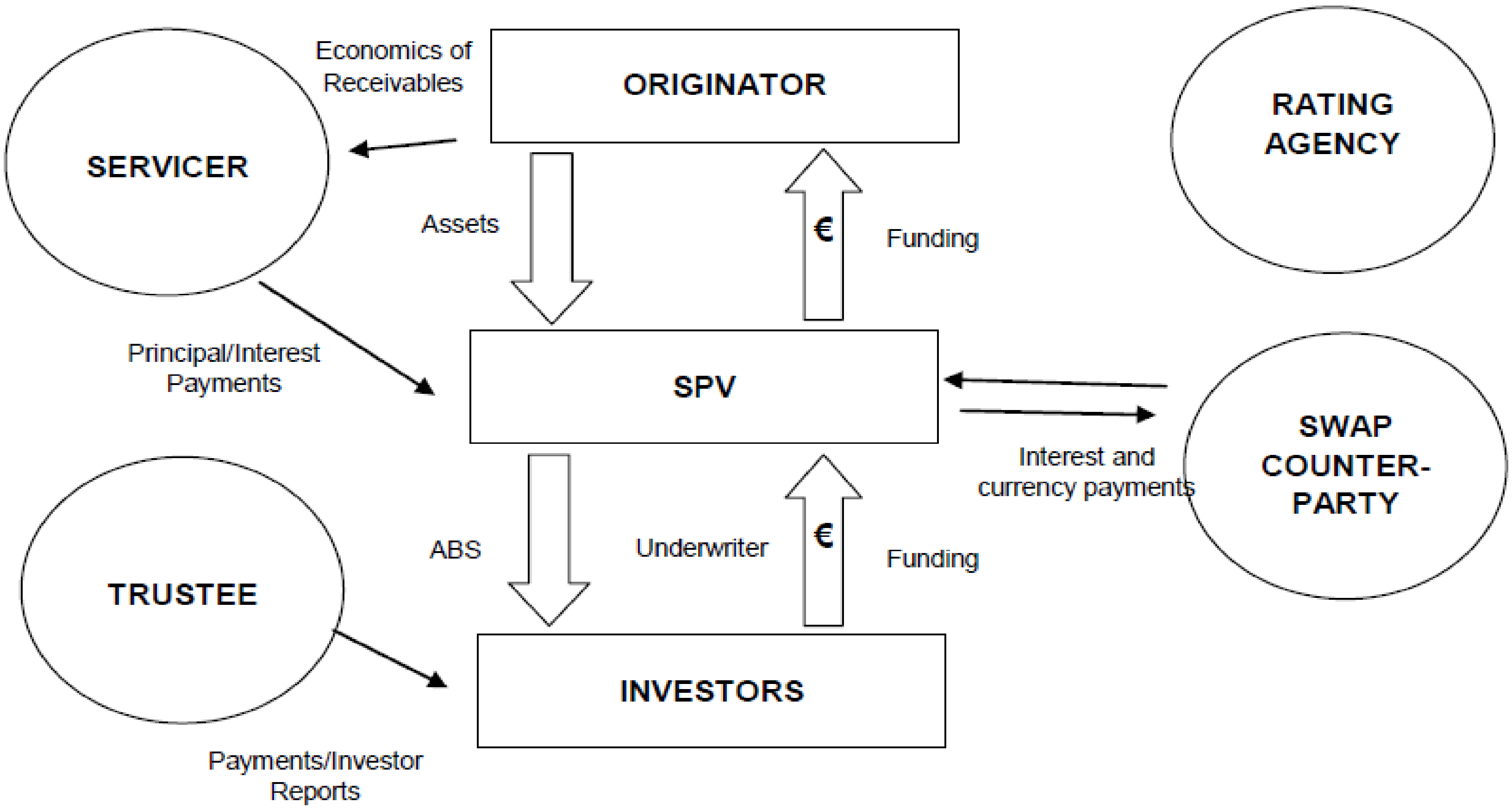

Source: *A Resource Guide*, European Securitisation Forum (2006).

Securitization Motives

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- Gorton and Pennacchi (1995) Securitization increases bank liquidity and profitability.
- Bannier and Hansel (2008) found that the main purpose of securitization is credit risk transfer.
- Pennacchi (1988) banks securitize in order to reduce their capital requirements.

Securitization in US & Euro-Area

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- In USA the market for asset-backed securities developed during the first half of the twentieth century by means of government-sponsored agencies that issue and guarantee, but not originate, asset-backed securities.
- Glass-Steagall Act (1933), where investment banking, commercial banking, and securities firms were separated. In 1999 this regulation was replaced by the Gramm-Leach-Bliley Act (GLBA), which allows banks to associate with securities firms, in order to accommodate the needs of the financial sector
- In contrast, the development of the asset securitization market in the euro area started in the late 1990s, after the launch of euro which increased the financial integration and removed the exchange rate risk among Euro-Area countries.
- regulatory framework, which has adapted to the needs of this sector. For instance, with the introduction of Law 130 (1999), known as The Italian Securitization Law, Italian financial institutions were allowed to securitize and act as SVP's

Securitization in the World

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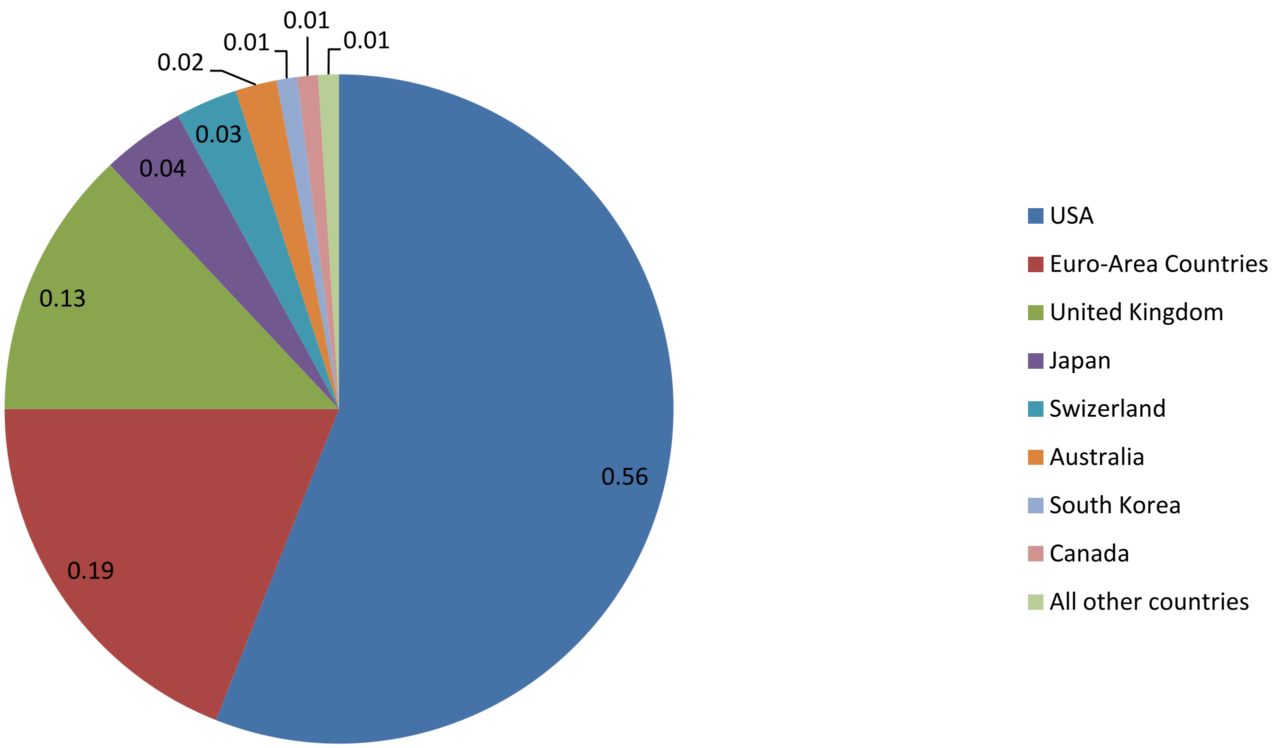
Private Label Issuance by Originator Nation (Total Issuance 1999-2012)



Source: Thomson One Banker.

Securitization in US & Euro-Area

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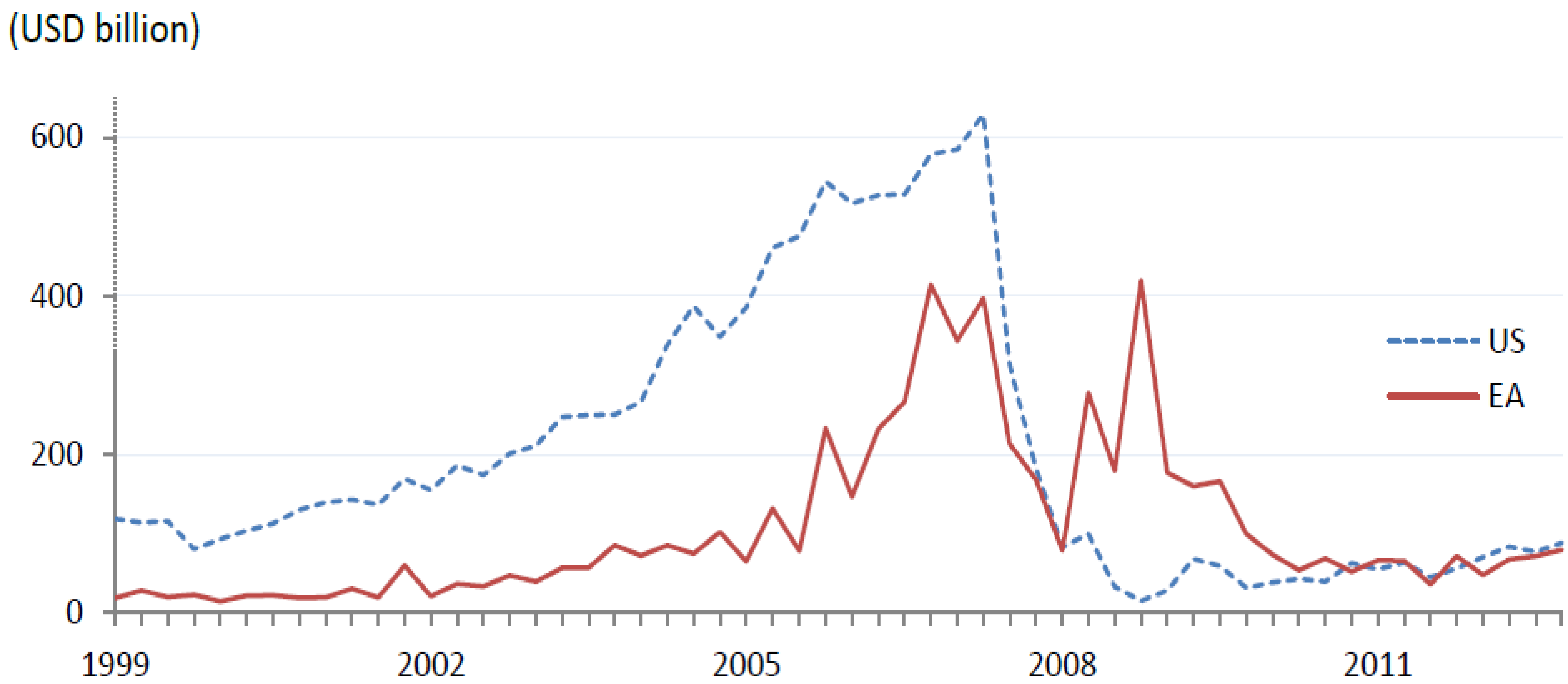
Private Label ABS Issuance: US and Euro Area Marketplace



Source: Thomson One Banker.

Securitization in Euro-Area

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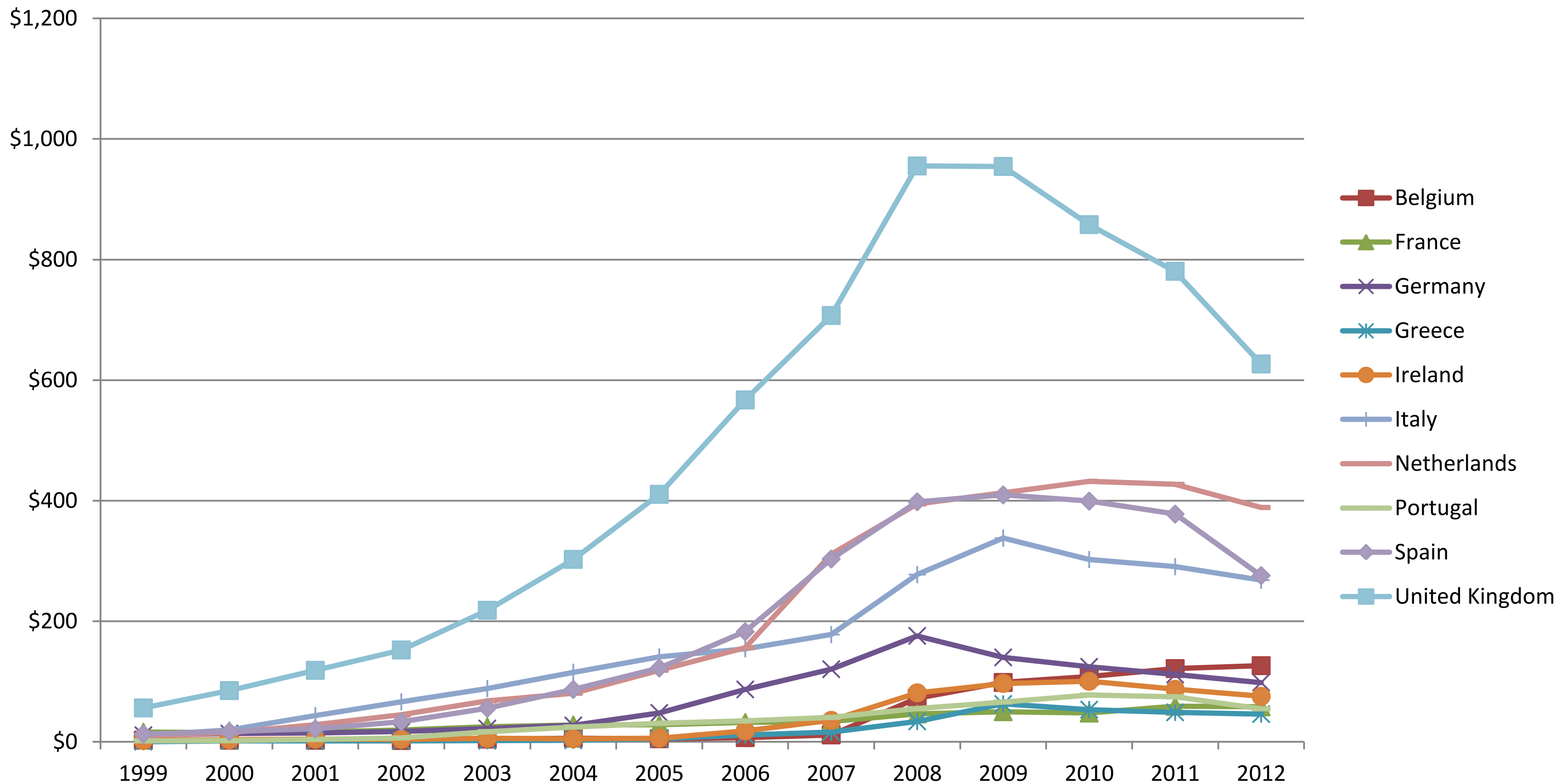
Euro-Area & UK Securitization Outstanding (USD Billions) 1999-2012



Source: Sifma

Securitization in the Euro area

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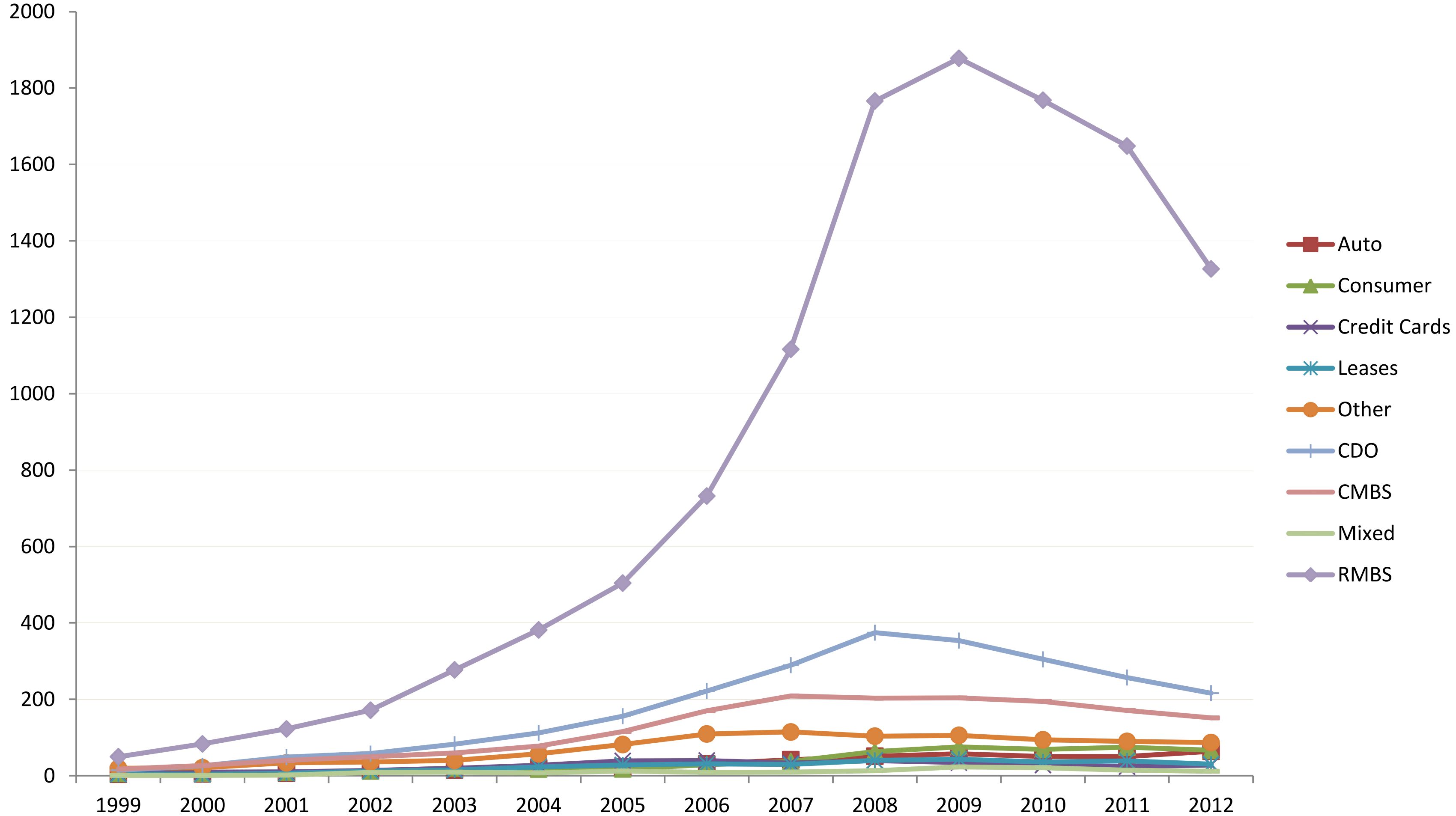
Europe Securitization Outstanding by Collateral Type: 1999-2012 (USD Billions)



Source: Sifma

Monetary policy & Securitization

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- Ben Bernanke (2007), the previous Fed Chairman, "the globalization of financial markets has not materially reduced the ability of the Federal Reserve to influence financial conditions in the United States [,]" but has only "added a dimension of complexity to the analysis of financial conditions and their determinants."

- (ECB 2010b, p. 77) "[it] worked well for more than thirty years, but, in practice, instead of dispersing the risks associated with bank lending, securitization had the perverse effect of concentrating them in the banking system".

Monetary policy & Securitization

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- Altunbas et al (2009), demonstrated that in the Euro-Area securitizing banks are less responsive to monetary policy.
- Estrella (2002) Securitization leads to changes in liquidity which have reduced Monetary policy effectiveness in USA.
- Gorton and Pennacchi (1995) profitability of transferring assets from banks' balance sheets to markets has discouraged the screening of borrowers, changing the monitoring function of banks.
- Maddaloni and Peydró (2009) argued that Banks in the Euro Area, reduced bank lending standards which lead to increase risk taking.

Monetary Transmission Mechanism and Securitization

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We argue That securitization affects 'bank lending channel' through 'balance lending channel' in three ways:

- Increases banks' liquidity independently of their securities holdings and from central bank , which reduces the effectiveness of the "bank lending channel".
- This mechanism reduces Capital requirements: by removing loans from their balance-sheet, banks can obtain a regulatory capital relief which allows for a credit growth.
- This process reduces bank lending standards which lead to increase risk taking (instead of reducing risk).

Data

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Considering a panel of US banks during the period 1980-2013 and Euro Area Banks for the period 1999-2013, looking at securitization and monetary policy relationship. All aggregate data for US will be taken mainly from the Federal Reserve Bank Economics Database (FRED), while banks level data were obtained from the Report of Condition and Income (call reports) that all insured banks are required to submit to the Federal Reserve. For the Euro-Area ECB and Eurostat are used for macro variables , bank-specific variables from Bankscope database of Borueau Van Dijck,the Securities Industry and Financial Markets Associations (SIFMA) for securitized assets this analysis only mortgages-backed securities (MBS) and assets-backed securities (ABS) are considered as securitized assets.

The econometric model

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The empirical literature about the estimation of this dynamic model (model1) started on Kashyap and Stein (1995), Ashcraft (2006) Altunbas et al. (2009) Lopreite (2012) model..

Growth rate in lending

Nominal GDP

Interest rate changes

Securitization activity indicator

$$\Delta \ln(Loans)_{it} = \Delta \ln(Loans)_{it-1} + \sum_{j=0}^{1} \delta_j \Delta \ln(GDPN)_{t-j} + \sum_{j=0}^{1} \beta_j \Delta i_{M\,t-j} + \sum_{j=0}^{1} \varphi_j \Delta i_{M\,t-j} * SEC_{t-1}$$

$$+ \sum_{j=0}^{1} \sigma_j \Delta i_{M\,t-j} * SIZE_{t-1} + \sum_{j=0}^{1} \lambda_j \Delta i_{M\,t-j} * LIQ_{t-1} + \sum_{j=0}^{1} \chi_j \Delta i_{M\,t-j} * CAP_{t-1} + \eta SEC_{t-1}$$

$$+ \boxed{\kappa SIZE_{t-1} + \vartheta LIQ_{t-1} + \xi CAP_{t-1}} + \tau LLP_{it-1} + \psi EDP_{it-1} + \varepsilon_{it}$$

Individual bank variables

Bank risk variables: Loan loss provisions and Expected Default Frequency

- $i=1,\ldots,N$ and $t=1,\ldots,T$ where N is the number of banks and T is the year.

Summary

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- Securitization increases banks’ liquidity & profitability, increases banks’ risk by lowering lending standards, and reduces banks’ capital requirements.
- Securitization played an important role in changing the traditional role of banks from “originate and hold” to “originate, repackage and distribute” reduces the effectiveness of BLC of monetary policy.
- Bank’s risk profile has a notable impact on increasing banks’ liquidity highlighting the importance of financial stability from a monetary policy perspective.

Suggestions

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- The current crisis gives us the opportunity to deeply think about the framework for central banking and monetary policy-making.
- given the central bank importance as the centre of monetary and financial policies, then it should play an important role as the main guidance in the financial market.
- It should maintain its ability to regulate and control financial institutions, portfolio strategies, and loans' conditions.
- It should be the one to write the rule of the game, central bank holds a key position due to its monopoly power in the economy as 'the ultimate provider of liquidity'.

Finally

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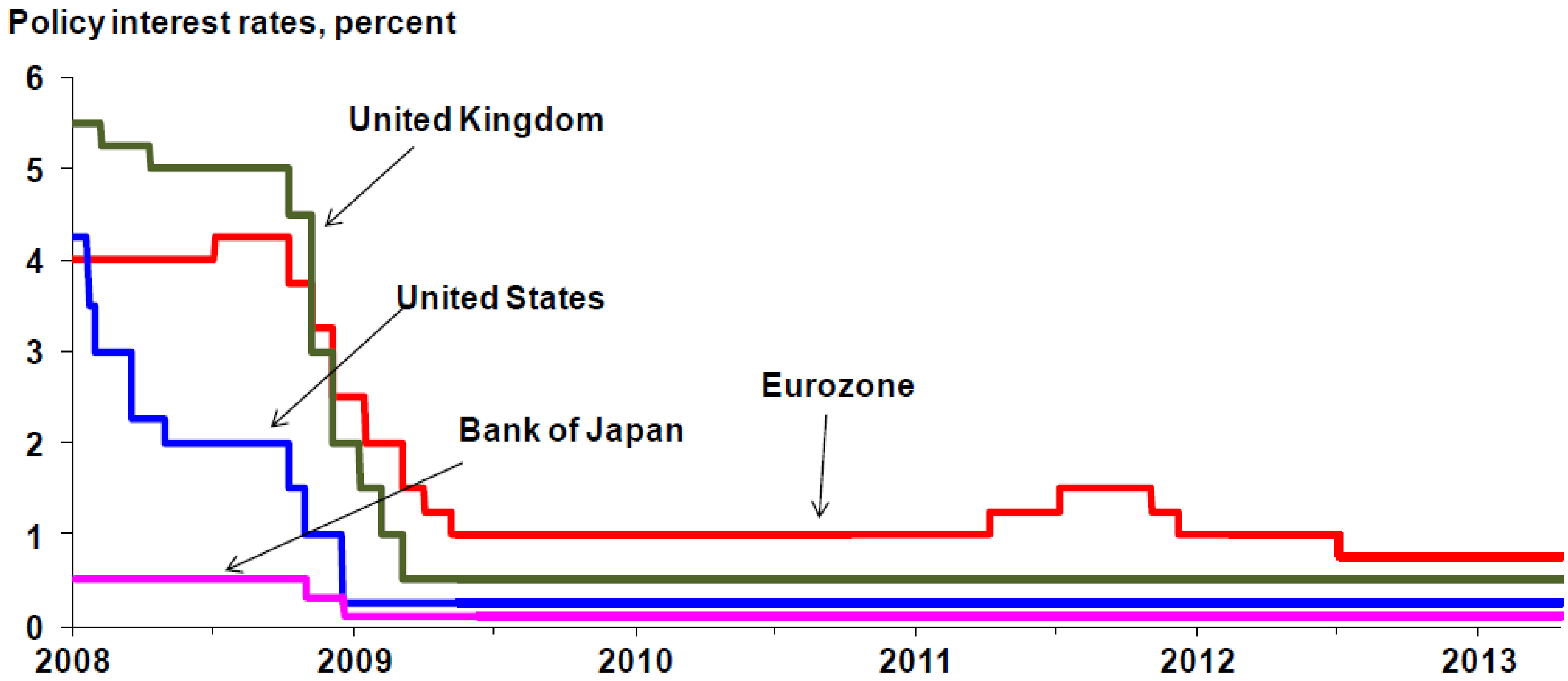
Central bank target interest rates remain low

2013 GLOBAL CONFERENCE



Source: Bloomberg.

Q & A

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Thank YOU