Leverage, Securitization and Global Imbalances

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Summary

A widespread opinion before the credit crisis of 2007-8 was that securitization enhances financial stability by dispersing credit risk. After the credit crisis, securitization was blamed for allowing the "hot potato" of bad loans to be passed to unsuspecting investors. Both views miss the endogeneity of credit supply.

One attribute of securitization is crucial in understanding the leverage of the financial system as a whole. By tapping new sources of funding, securitization enables credit expansion through higher leverage of the financial system as a whole even if the leverage of individual financial intermediaries are unchanged.

If the expansion of assets entailed by the growth in financial system leverage drives down lending standards, securitization may end up undermining financial stability rather than promoting it. As balance sheets expand, the "hot potato" of bad loans sits in the financial system on the balance sheets of large banks or the off-balance sheet vehicles sponsored by them rather than being sold on to final investors. This is because a consequence of the increased leverage of the financial system as a whole is to expand lending in order to utilize slack in aggregate balance sheet capacity. When prime borrowers already have mortgages, lending standards must be lowered in order to create new assets that fill up the expanding balloon of financial sector balance sheets. Subprime borrowers thus begin to receive credit.

The expanding balloon of the aggregate financial sector balance sheet also has implications for external adjustment, since it sucks in savings from abroad, especially from foreign central banks. The most rapid increase in foreign capital flows into the United States has been for debt securities associated with residential mortgage lending. Lending by foreigners to non-financial companies in the US has not seen a similar increase. Thus, the increased foreign claims on U.S. debt securities has the hallmarks of a "supply push" adjustment of debt portfolios rather than a "demand pull" adjustment. The large current account deficit sustained by the United States can thus be seen as a consequence of the loosening of credit conditions in the U.S. entailed by financial innovation and the increased leverage of the U.S. financial system.

Going forward, the mechanism that blew up the balloon is likely to go into reverse. Thus, one consequence of the housing crash in the United States and the associated contraction of residential mortgage lending will be to reduce the U.S. current account deficit, possibly quite sharply.