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The Economics of Structured Finance

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Abstract

This paper investigates the spectacular rise and fall of structured finance. The essence of structured finance activities is the pooling of economic assets like loans, bonds, and mortgages, and the subsequent issuance of a prioritized capital structure of claims, known as tranches, against these collateral pools. As a result of the prioritization scheme used in structuring claims, many of the manufactured tranches are far safer the process of securitization allowed trillions of dollars of risky assets to be transformed into securities that were widely considered to be safe. We highlight two features of structured finance products - the extreme fragility of their ratings to modest imprecision in evaluating underlying risks, and their exposure to systematic risks - that go a long way in explaining the spectacular rise and fall of structured finance. We conclude with an assessment of what went wrong and the relative importance of rating agency errors, investor credulity, and perverse incentives and suspect behavior on the part of issuers, rating agencies, and borrowers.

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G21 Banks; Other Depository Institutions; Micro Finance Institutions; Mortgages

G24 Investment Banking; Venture Capital; Brokerage; Ratings and Ratings Agencies