



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 than the average asset in the underlying pool. This ability of structured finance to repackage risks and to create "safe" assets from otherwise risky collateral led to a dramatic expansion in the issuance of structured securities, most of which were viewed by investors to be virtually risk-free and certified as such by the rating agencies. At the core of the recent financial market crisis has been the discovery that these securities are actually far riskier than originally advertised. We examine how 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

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JEL Classification

G10 General Financial Markets: General (includes Measurement and Data)

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

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

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