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 [illegible] actually far riskier than originally advertised. We examine how [illegible] 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

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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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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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