Editorial

Mishandling of the First Loss Piece and Misalignment of Bank Manager Compensation are Causes of the International Financial Crisis

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Our analysis focuses on the relationship between manager incentives and risk management. Irresponsible lending, overly complex financial instruments, and conflicts of interest impaired market transparency and translated into market illiquidity.

One important misalignment relates to the first loss piece in securitizations. In simplified terms, consider a 1,000,000,000 US$ reference portfolio of assets consisting of 100 entities. A special investment vehicle (SIV) with no assets or liabilities at start wants to purchase this portfolio. Rather than borrowing 1,000,000,000 US$ in one go it borrows in tranches which have different risks associated with them. For example, 10% are AAA rated (class 1), 80% are A+ rated (2), 7% are B+ rated (3) and 3% are unrated (4). The latter class is called the first loss piece, because when there is a total loss of 1.2% of the entire portfolio, class 4 noteholders cover this sum completely. When the total loss of the entire portfolio sums-up to 3.5%, class 4 noteholders cover "the first" 3% and in addition class 3 noteholders loose 0.5%.

Information asymmetries enable the originator of a securitization transaction to benefit from adverse selection and moral hazard at the expense of investors. The standard cure for these problems is that the originator retains a substantial fraction of the first loss piece. Over the years it appears that originators sold more and more of this piece, invalidating their incentives to safeguard the quality of the securitized assets. Since originators refuse to tell investors about the retained first loss piece, investors were not aware of this problem for a long time – and opacity in financial asset valuation translates into opacity of institutions trading or holding those assets. Therefore, the risks of these institutions cannot be evaluated by peer institutions, and the interbank market will collapse, too.
Another important incentive misalignment relates to bank manager compensation. A substantial part of the compensation is an annual bonus which can never be negative. By setting up SIVs, and similar structures, and by strongly leveraging their activities, managers can raise their bonus income. Therefore we observe leverage ratios which endanger financial stability.

One way to discourage managers from taking excessive risk is to supplement the bonus system by appropriate malus components.
Therefore, the bursting of the house price bubble may have triggered the financial crisis, but it is not its primal cause. In the paper "The Future of Securitization" which has recently been presented and discussed at the Brookings-Tokyo Club-Wharton conference on "Prudent Lending Restored", we propose several measures to improve transparency in a specific way, and give regulation the role to enforce this transparency:

1. Markets need to know at all times the size and the fraction of first loss position retained by the originator. There should not be mandatory retention, however, because a rule can always be gamed.
2. Compensation schemes of managers needs to balance bonus and malus components. Again, no regulation is required, only transparency on remuneration policy, including an independent assessment of incentive properties of the scheme, e.g. by rating agencies.
3. An extra capital charge should be imposed on banks whose risks are opaque, reflecting the externality imposed on the market as a whole.
4. Rating processes should not be regulated, while rating performance measurement (i.e. the validation of ratings) should – and be made public. Also, ratings should provide information on incentive alignment in complex transactions.
5. Comprehensive data on risk exposure of financial intermediaries (a risk map) should be collected and published quarterly, signaling early warnings.

(The article can be retrieved at:
http://www.ifk-cfs.de/index.php?id=1462)