Answers to questions on notice by Mr Darren Nelson. Asked at a public hearing on 18 September 2017; received 20 September 2017.

Securitization and Fractional Reserve Banking

https://mises.org/library/securitization-and-fractional-reserve-banking

Securitization has been growing for the last few decades and, like the use of derivatives, it has become a salient feature of present-day financial systems. [It is a] process of putting together relatively illiquid assets, of using them as collateral for backing new securities, and of using the proceeds from the sale of the securities to fund the owners of the illiquid assets is called securitization. Analysts observe that securitization depends crucially on the rating process. From an economic point of view, securitization merely intermediates savings. It is commonly admitted that securitization was created in 1970, when the Government National Mortgage Association (Ginnie Mae) issued a mortgage-backed security (MBS) in the form of a pass through. If the contemporary rise of this technique is indeed rooted in mortgage loans, securitization first occurred in the eighteenth century as a means for financing the West Indies plantations. If securitization represented only 2.5 percent of credit-market debt owed by all sectors in 1970, that ratio reached 24.0 percent in 2008.

From the standpoint of the entire banking system, securitization implies, therefore, a simultaneous reduction in credits and deposits. Securitization leads to excess liquidity and to improved compliance with capital provision regulations despite the fact that the central bank has not increased its total liabilities and additional savings have not been channeled into the banking industry. Securitization allows fractional-reserve banks to grant more loans, while keeping total deposits, i.e., the money supply in the broad sense, constant in the economy. As a matter of fact, banks create both the object to be sold (credits) and the means by which it can be purchased (deposits). It is this aspect of [fractional-reserve banks (FRBs)] that makes their use of securitization special.

Securitization allows FRBs to withdraw from the market the liquidities they have created and lent out. It reduces the money supply by the amount of liquid assets used to purchase the asset-backed securities. Therefore, it hides the reverse side of bank credit—the increase in the money supply, i.e., inflation. It makes the economic environment appear less inflationary than it should be, given individuals' growing indebtedness to banks. Securitization portrays a bank-credit driven boom as noninflationary, savings driven growth. It contributes to the widespread illusion that more factors of production are available than in reality, and becomes thereby a factor in the generation of the error-induced boom-bust cycle.

To a certain extent, economists have already recognized that securitization restrains the money-supply growth during a credit boom. From a different approach, central bank economists have come to the conclusion that securitization decreases the power of monetary policy. This, of course, means that securitization insulates banks' lending activity from the central bank's liquidity policy, which confirms our main conclusion and is even overtly stated by other economists, "Using a large sample of European banks, we find that the use of securitization appears to shelter banks' loan supply from the effects of monetary policy." The central bankers' perspective is that of growing concern about loosening their grasp of the money supply. Such a concern implicitly admits that securitization disconnects the money-supply growth from bank-credit growth.

[Also] [t]o a certain extent, our analysis is in conformity with the increasingly common view among economists, at least as far as the outer description of the phenomenon is concerned. However, when it comes to understand what contributes to the spread of securitization, we must part with the traditional approach, which mentions three main factors. First, securitization is presented as a way to circumvent capital adequacy regulations, because it transfers the credit risk of the loans from banks' books to the investors in the asset-backed securities. Second, the "originate and distribute model," according to which credits are only originated by banks and then distributed to investors who fund them, appears more attractive than the "originate and hold model" because of higher frequency of banking fees. Third, asset-backed securities add to the choice of investment opportunities and contribute to the efficiency of financial markets.

Securitization is a financial technique that permits the exchange of relatively nonmarketable credit claims for liquidities. As such, it exploits an exchange opportunity between individuals with opposite liquidity valuations in their preference scales. Its modern usage by fractional-reserve banks has dissociated the growth of credit expansion from the growth of the money supply. Securitization has provided banks with an alternative source of liquidity, different from central banks' open-market operations, thereby weakening the latter's control of the total amount of credit in the economy. It has contributed to de-monetizing bank credits, thereby containing inflation under conditions of growing indebtedness. Securitization has therefore become a tool for spreading the illusion of savings-driven economic growth and for creating the economic cycle.

Banks don't always lend, even under Fractional Reserve Banking

https://mises.org/blog/fractional-reserve-banking-and-money-creation
https://mises.org/library/how-money-disappears-fractional-reserve-money-system

“[E]conomists from the post-Keynesian school of economics have expressed doubt about the validity of the popular framework. It is argued that the key source of money expansion is the demand for loans together with the willingness of banks to lend. The supply of loans, in this way of thinking, is never independent of demand — banks supply loans only because someone is willing to borrow bank money by issuing an IOU to a bank. Accordingly, the driving force of bank credit expansion and thus money supply expansion is the increase in the demand for loans and neither the money multiplier nor the central bank. Bank lending is not constrained here by reserves that are injected by the central bank, but by the demand for loans.”

“The existence of the central bank and fractional reserve banking permits commercial banks to generate credit, which is not backed up by real funding (i.e., it is credit created out of ‘thin air’). Once the unbacked credit is generated it creates activities that the free market would never approve. That is, these activities are consuming and not producing real wealth. As long as the pool of real funding is expanding and banks are eager to expand credit, various false activities continue to prosper. Whenever the extensive creation of credit out of ‘thin air’ lifts the pace of real-wealth consumption above the pace of real-wealth production this undermines the pool of real funding. Consequently, the performance of various activities starts to deteriorate and banks’ bad loans start to rise. In response to this, banks curtail their loans and this in turn sets in motion a decline in the money stock.”