Whither originate and distribute?

Some argue the crisis in structured credit markets signals the demise of the originate-and-distribute model of banking, but this fails to take into account the pattern of all revolutions, argues ***David Rowe***

In a comment I wrote in 2002, I cited Thomas Wurster, an early advocate of the profound impact the internet would have on business models and organisational structures.[1] In the aftermath of the dot.com implosion, he made an important point about the pattern of revolutions: these rarely evolve in an uninterrupted trajectory. One consistent pattern is that, at some point, a manic phase ends in the revolution eating its own children. Robespierre, the French Revolution's 'sea-green incorruptible', was guillotined, face up, following the Coup de Thermidor (July 27, 1794) by the very movement he claimed to embody. Trotsky was exiled, deported and eventually assassinated on orders of Joseph Stalin. John C Frémont was impoverished by his attempts to capitalise and construct the first US transcontinental railroad. In all these cases, however, the world did not revert to the status quo ante.[2]

Some have argued the crisis in structured credit markets since last August signals the demise of the originate-and-distribute model of banking. I believe this is just as mistaken as the view in 2002 that the internet was a passing fad. First, the evolution of banking from originate-and-hold to originate-and-distribute has been going on for more than 25 years. Arguably, this process began with innovations introduced by Charles Sanford at Bankers Trust in the early 1980s.[3] Relative to most revolutions, this one has been a slow-moving affair.

Nevertheless, this revolution's crisis finally arrived and the injury to its children has been dramatic. Despite this, the chances of reversion to a simple buy-and-hold model of banking are slim to none. Furthermore, such a reversion would not re-establish some warm and comfortable golden age. To be sure, mark-to-market accounting has its weaknesses, especially when there is no second means of valuation in the face of evaporating liquidity. That said, utterly misleading historical cost accounting was an important element in the massive failure of US savings and loan institutions in the late 1980s and early 1990s. It is remarkable that a wholesale return to such methods is touted by some as the solution to our current ills. Memories are short indeed!

Having said that, revolutionary crises do have consequences. It is therefore useful to speculate what the current harsh experience implies for banking and financial markets. Here are some plausible expectations:

- **The demise of gratuitous complexity.** Innovations in financial markets inevitably entail increased complexity. To some degree, this is an unavoidable characteristic of progress in any field. But such complexity tends to be overdone in the midst of the euphoria accompanying a boom. Just as happened in the interest rate derivatives market in the early 1990s, such complexity will be sharply curtailed in the structured credit market for the foreseeable future.
- **The rise of transparency.** Markets are likely to demand greatly improved visibility and continuous reporting of the actual content and micro-characteristics of credit-backed securities. Such reporting will support analysis that starts to bridge the gap between top-down credit pricing models and more traditional microanalytic approaches.
- **More attention to richer structural models.** Improved microanalytic models inevitably involve a larger and more eclectic array of systematic drivers. This makes these models harder to calibrate, but their richer structure offers an improved framework for the application of seasoned judgment. For example, explicit treatment of housing inflation in modelling defaults on subprime mortgages is likely to have led some investors to focus much sooner on the magnitude of their exposure to a general decline in housing prices.
- **Increasing market regard for sound credit underwriting.** A commonly cited, and apparently verifiable, characteristic of the recent growth in structured credit products has been a deterioration in underwriting standards.[4,5] Separation of the underwriters from the ultimate permanent holders of loans tended to erode institutional credit discipline. Improved microanalysis offers the promise of greater future rewards for banks that establish and maintain high credit standards, since credit-backed securities based on obligations they originated should trade at a premium.

As in all revolutions, a return to the status quo ante in how banks operate is very unlikely. Nevertheless, significant changes will ensue from the current crisis – changes that are fraught with danger but also pregnant with opportunity. ■

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