

THE FUTURE OF SYNTHETIC SECURITIZATION

A COMMENT ON BELL & DAWSON

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In their article *Synthetic Securitization: Use of Derivative Technology for Credit Transfer*,¹ Ian Bell and Petrina Dawson manage a difficult and impressive feat: in an accessible (indeed, downright readable) account, they explain synthetic securitization, which is among the most complex and arcane transaction structures in use today. Bell and Dawson describe the trajectory that led to synthetic securitization.² The sovereign debt crisis in 1982 led regulators to enact an international agreement, the Basle Concordat, imposing minimum capital requirements on banks.³ For every loan as to which they retained the risk of default, banks were required to keep a certain level of capital. Keeping capital is expensive; banks therefore wished to sell some of their loans. The capital markets were a ready buyer, using the securitization transaction structure. The banks shed the risk of default on the loans they sold, thereby minimizing the amount of capital they needed to hold.

Meanwhile, banks and other financial institutions became keenly aware of risks other than the risk of default; they experienced considerable losses during the various financial crises of the 1980s due to currency risk and basis risk. Financial institutions thus became motivated to deal more effectively with those risks; derivatives transactions were developed, in which the risks were expressly quantified and allocated. The technology of derivative transactions was later

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1. Ian Bell & Petrina Dawson, *Synthetic Securitization: Use of Derivative Technology for Credit Transfer*, 12 DUKE J. COMP. & INT'L L. 541 (2002).

2. *Id.* at 542–51.

3. BASLE COMM. ON BANKING SUPERVISION, PRINCIPLES FOR THE SUPERVISION OF BANKS' FOREIGN ESTABLISHMENTS (1983), available at <http://www.bis.org/publ/bcbssc312.pdf> (last visited Apr. 2, 2002).

adapted for use to allocate credit risk. In credit derivative transactions, one party “buys” from a “protection seller” (effectively, an insurer) protection from credit risk. In a typical structure, the buyer/insured holds a particular loan, and agrees (a) to pay the seller/insurer premiums, and (b) that if there is a default, it will convey the loan to the seller/insurer, in exchange for which the seller/insurer will convey the amount originally owed under the loan to the buyer/insured.

But derivatives transactions could only be done among banks or other financial institutions; it is financial institutions that originate and hold loans and therefore need insurance, and they need insurance from an entity whose continuing creditworthiness can be assured in the event payments on the insurance are required. Assuring the continuing creditworthiness of what may be a shifting pool of capital markets investors is difficult and costly. Synthetic securitization solves this problem. Capital markets investors pay money up front to a special purpose vehicle (SPV). The SPV carefully safeguards the investors’ funds; its activities are carefully constrained so that it has no creditors other than the investors. Throughout the transaction, the investors get the premiums paid by the buyer/insured. The investors’ original investment is held by the SPV, and is available to pay the buyer/insured if the obligation for which the insurance is being purchased defaults. If all goes well, the original investment, plus accrued interest, is returned to the investors at the end of the transaction’s term.

The foregoing is a truncated summary of Bell and Dawson’s account of the history of synthetic securitization. Once Bell and Dawson have concluded their history, they make a bold claim: “[T]he synthetic securitization market is the second great leap forward in the road to a totally disintermediated financial world.”⁴ They point to the explosive growth in transaction volume in the few years since the transactions were first developed.⁵ And they make a persuasive case that synthetic securitization is an important financing innovation.⁶ It permits specialization in loan origination and servicing, allocation of risks with great precision, and direct access to the capital markets.

Their article would be enriched if they were to address some potential objections to their claim. One objection is that the traditional

4. Bell & Dawson, *supra* note 1, at 561.

5. *Id.* at 551.

6. *Id.* at 550–51.

bundling of loan origination, servicing, and risk-retention has more viability in certain market segments than Bell and Dawson acknowledge. Other, likely more important, objections concern Enron. The Enron debacle has focused critical scrutiny on many types of complex financial instruments, and on the accounting rules on which many such instruments (including securitization instruments) depend. Regulators might impose barriers or otherwise constrain financial innovation of the sort involved in synthetic securitization.

In this regard, many securitization transactions are motivated by a desire to “beautify” the firm’s balance sheet.⁷ Beautification is often accomplished by off-balance sheet treatment. In Enron, off-balance sheet treatment was used to deceive—to conceal liabilities. Off-balance sheet treatment is used in securitization transactions not to conceal liabilities, but to reflect that liabilities (the risks associated with the loans) have been transferred to another party. But there are necessarily line-drawing issues. The “buyer” of the loans (or the one who takes on the credit risk) will want some assurances as to the quality of the loans from the “seller” of the loans; at a certain point the assurances are strong enough that the seller hasn’t really shed the risk. Why off-balance sheet treatment should matter has long been a puzzle to academics; that it matters is accepted as a fact on Wall Street.⁸ All but the most conservative uses may be hard to defend in the current climate.⁹

Moreover, Enron has likely created a climate in which buyers of synthetic securitization securities will be quite wary of the sellers. Recall that the sellers are seeking to buy insurance against default on a loan. Rather than buying insurance, the sellers could simply sell the loan. Why don’t they? The capital markets investor may reason that the loan would not withstand the thorough due diligence that the typical buyer of loans, a financial institution, would conduct; the capital markets investor would therefore presume the securitization security the investor was being offered was not worth the price. In this

7. I discuss financial statement beautification in Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for Dirty Pooling and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141 (1997).

8. *Id.* at 142–43.

9. Indeed, a provision in the proposed bankruptcy reform bill that would have provided more assurance that securitization transactions would be respected in bankruptcy was recently deleted; the provision had become politically unacceptable because of Enron. Glenn R. Simpson & Susan Pulliam, *Congressional Negotiators Drop Measure In Bankruptcy Bill Tied to Enron Failure*, WALL ST. J., Feb. 28, 2002, at A4.

climate, sellers of securitization securities likely are not able to rebut that presumption.¹⁰

In sum, Enron has made both regulators and investors wary. Indeed, investors are fleeing, not to “quality” as in typical crises, but to simplicity and transparency. Both investors and regulators may react with what is arguably an excess of caution, tarring much financial innovation with the Enron brush.

10. This is a classic “lemons problem” (so named after transactions in used cars). Such problems were first modeled in the economic literature in George Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). This year, Akerlof won a Nobel Prize in economics for this work.