

2010

## The Use of Mortgage-Backed Securities in International Comparative Perspective: Lessons and Insights

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# The Use of Mortgage-Backed Securities in International Comparative Perspective: Lessons and Insights

## ABSTRACT

*The secondary mortgage market in the United States has helped millions of people purchase homes over the past half century. Following the burst of the real estate bubble and the credit crisis, it is important for American policymakers not to lose sight of the importance that the secondary mortgage market has played in increasing home ownership. The financial engineering in the form of securitization that led to the success of the secondary mortgage market needs to be preserved, although it should also be reworked so that the externalization of unappreciated risk is reduced and the possibility of a large-scale financial meltdown of the kind experienced in 2008–2009 is not experienced again. In this respect, American policymakers could use ideas from other countries, where synthetic securitization is the key financial tool that has helped the secondary mortgage market to develop. Synthetic securitization offers ways of reducing default risk by integrating financial derivatives such as credit default swaps into the instrument. Such an arrangement also offers the possibility of making securitization more transparent, consequently providing investors new ways of assessing risk and reducing their reliance on credit ratings agencies, and in turn hopefully reducing the concomitant systemic risk that the widespread use of these instruments has created.*

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## I. INTRODUCTION

The subprime crisis in the United States delivered one of the largest shocks to the American financial system in decades.<sup>1</sup> Although the total impact of the crisis is not yet clear, the collapse of the subprime market ravaged international credit and equity markets, which in turn threatened the stability of economies around the world.<sup>2</sup> The reaction from the American public has generally been one of outrage.<sup>3</sup> They see the financial system as having failed ordinary people by cajoling them into mortgages they did not understand through predatory lending practices and enriching the financial elite at the expense of everyone else.<sup>4</sup> The American public is demanding greater government vigilance to ensure that a similar crisis does not happen in the future.<sup>5</sup> Congress and the Administration—their thumbs on the nation's pulse—have responded with promises of regulation and greater government oversight.<sup>6</sup>

At this point, we can only speculate as to the future content of legislation or regulation. Developments between now and whenever the U.S. government takes action will likely influence the contours of the response. Already, however, consensus is emerging between world leaders on what problems need to be fixed, and governments from around the globe are taking aim at certain targets.<sup>7</sup> These same

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1. See Editorial, *Money Really is Fungible*, N.Y. TIMES, Nov. 8 2008, at A20 available at [http://www.nytimes.com/2008/11/08/opinion/08sat1.html?\\_r=1](http://www.nytimes.com/2008/11/08/opinion/08sat1.html?_r=1) (calling for government action to limit the compensation of those whose decisions led to the current financial crisis).

2. Joseph Stiglitz, *Financial Crisis: Europe's Leaders Can Seize This Opportunity to Fill the Leadership Gap*, DAILY TELEGRAPH (London), Nov. 11, 2008, available at <http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3425000/Financial-crisis-Europes-leaders-can-seize-this-opportunity-to-fill-the-leadership-gap.html>.

3. Arturo Cifuentes, *PR Crisis is Taking Heavy Toll on Credit Derivatives*, FIN. TIMES (London), Nov. 11, 2008, available at <http://www.ft.com/cms/s/0/a7cecd2-af8f-11dd-a4bf-000077b07658.html>.

4. Paul Hazen, *There's a Cooperative Way Out of This Financial Mess: Look to an Old Standby, The Business Co-op Model*, HOUSTON CHRON., Nov. 2, 2008, available at <http://www.chron.com/disp/story.mpl/editorial/outlook/6091220.html>.

5. See, e.g., Posting of Robert Borosage to United Steelworkers Blog, <http://blog.usw.org/2008/09/> (Sept. 30, 2008, 17:09 EST) (demanding that Congress attach conditions to its planned bailout effort).

6. See, e.g., Rachele Younglai, *SEC's Cox: Strong, Effective Regulation Needed*, REUTERS, Oct. 23, 2008, available at <http://www.reuters.com/article/ousiv/idUSTRE49M5XR20081023> (discussing the Securities and Exchange Commission Chairman's recommendations for regulation in the wake of the financial crisis).

7. Valentina Pop, *U.S., EU Agree on Global Financial Reform*, BUS. WK., Nov. 10, 2008, available at [http://www.businessweek.com/globalbiz/content/nov2008/gb20081110\\_963813.htm?chan=globalbiz\\_europe+index+page\\_top+stories](http://www.businessweek.com/globalbiz/content/nov2008/gb20081110_963813.htm?chan=globalbiz_europe+index+page_top+stories) (discussing

governments are also showing prudence—calling for reasoned regulation, lest the rush to regulate end up hurting the financial markets.<sup>8</sup>

Chief among the complaints advanced by both the public and the American government is that the secondary mortgage market (where mortgage-backed securities were the engines of capital raising) failed in large part because it suffered from a fundamental misalignment of financial incentives.<sup>9</sup> Those selling the mortgages in the first place (originators), as well as those repackaging them in the form of mortgage-backed securities (arrangers), were able to avoid internalizing the default risk that these securities carried with them.<sup>10</sup> As a result, both the originators and the arrangers had little incentive to properly monitor the creditworthiness of individual borrowers as well as the mortgage-backed securities themselves.<sup>11</sup> In order to be effective, government regulation in response to the subprime crisis ought to include components which correct the incentives currently in place. Doing so would correct a structural problem in the secondary mortgage market and hopefully help avoid a similar crisis in the future.

This Note attempts to weigh in on the kind of regulation that might be effective at avoiding future crises. First, the Note will consider the prevalent method of financing in the U.S. secondary mortgage market today—traditional asset-backed securitization.<sup>12</sup> In particular, the Note will examine the implications of traditional asset-backed securitization with regard to credit default risk externalization. Second, the Note will consider an alternative form of mortgage financing used in other countries around the world, especially Germany: synthetic securitization.<sup>13</sup> The Note will

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EU proposals to revise accounting standards, supervise credit rating agencies and hedge funds, implement an early-warning system and establish a more central role for the International Monetary Fund).

8. Klaus C. Engelen, *The Post-Subprime Regulation Scramble: The Regulators and the Market Players Pick Up the Pieces*, INT'L ECON., Winter 2008, available at [http://www.entrepreneur.com/tradejournals/article/176131425\\_1.html](http://www.entrepreneur.com/tradejournals/article/176131425_1.html).

9. See Diane Francis, *Subprime Mess is a Crime Story*, FIN. POST (Ontario), Nov. 17, 2007, available at <http://www.financialpost.com/scripts/story.html?id=39d470d5-e383-4991-bdb5-0abb1f6a94bd&k=23884> (discussing the seemingly criminal nature of subprime lending practices).

10. Richard J. Rosen, *The Role of Securitization in Mortgage Lending*, 244 CHI. FED. LETTER 1, 1 (Nov. 2007).

11. See Randall Dodd, *Subprime: Tentacles of a Crisis*, FIN. & DEV., Dec. 2007, at 15, 19, available at <http://www.imf.org/external/pubs/ft/fandd/2007/12/dodd.htm> (discussing risk management benefits of securitization for originators).

12. See Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSP. 93, 99 (2005) (discussing the percentage of American mortgages held in the secondary mortgage market in 2003).

13. Christopher L. Peterson, *Over-Indebtedness, Predatory Lending, and the International Political Economy of Residential Mortgage Securitization: Comparing the U.S. Subprime Home Mortgage Lending Crisis to Home Finance in the United*

compare the two methods and attempt to delineate their respective strengths and weaknesses. Most importantly, the Note will explain how synthetic securitization differs from traditional securitization in terms of allocating default risk. Finally, the Note will propose a solution that unites elements of the traditional asset-backed securitization model with elements of the synthetic securitization model. The key insight of the Note will be that synthetic securitization's use of credit default swaps has the potential to make assessing credit risk more transparent and market-based, rather than relying on credit rating agencies to issue ratings opinions that are often subject to easy manipulation. Hopefully, such an arrangement will respond constructively to the critics of the current system, while preserving the capital markets' ability to raise money for mortgage financing.

The purpose of this Note, therefore, is not primarily to discuss one single method of securitization in great detail, nor is it to argue that one method of securitization should prevail over another. Rather, this Note argues that the different types of securitization methods should be amalgamated in order to overcome the shortcomings that hamper traditional securitization when used individually. In this sense, the Note seeks to understand how already existing financial tools can be used together in order to create stronger, more transparent, and ultimately, more valuable investment vehicles.

Discussing complex financial instruments is necessary in a Note such as this; however, care has been taken to avoid making the text inaccessible to non-financial readers. This Note intends to contribute to a policy discussion in broad terms, not to explore the intricacies of certain financial products in excruciating detail.

## II. BACKGROUND: THE MORTGAGE MARKET IN THE UNITED STATES

### A. *Traditional Lending Institutions as the Early Key Players*

The financing of American mortgages has undergone a radical transformation in the past seven decades.<sup>14</sup> Before the 1940s, banks originated the majority of mortgages to individuals desiring to purchase a home.<sup>15</sup> The money for the mortgage came directly from deposits held by the bank.<sup>16</sup> Banks thus had an incentive to make

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*Kingdom, Germany, and Japan* (Jan. 11, 2008) (unpublished manuscript, on file with the Vanderbilt Journal of Transnational Law), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1083184](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1083184).

14. Dodd, *supra* note 11, at 15.

15. *Id.* at 15–16.

16. *Id.*

sure that borrowers were sufficiently creditworthy; in case of a borrower default, the bank would directly suffer a loss.<sup>17</sup> As a result, banks were generally prudent in their lending practices, with the concomitant result that fewer people were able to afford home ownership.<sup>18</sup> Typically, banks were conservative in the amount of money they lent on a particular mortgage relative to the amount that the property itself was worth.<sup>19</sup> This is known as the loan-to-value ratio.<sup>20</sup> Generally, banks before the 1940s did not loan more than 50% of the property's value.<sup>21</sup> Banks typically kept their loan-to-value ratios low so that they could be assured of some return if the mortgage became delinquent and the bank had to repossess the property.<sup>22</sup> By way of comparison, non-bank mortgage originators often made subprime loans in the past few years with loan-to-value ratios well in excess of 100%.<sup>23</sup>

### B. *The Beginning of Government Involvement in the Mortgage Market*

The Great Depression and subsequent collapse of housing prices introduced new forces and actors into the American mortgage market. The mid-1930s saw close to 10% of American homes go into foreclosure and mortgage lending decrease significantly because financial institutions were both unwilling, and in some cases unable, to lend money to prospective homeowners.<sup>24</sup> It was at this point that the federal government entered the mortgage market through the Home Owner's Loan Corporation, which used government money raised through selling government bonds to buy defaulting mortgages from banks, rearrange their terms, and finally reinstate them.<sup>25</sup> For the first time long-term, fixed rate, and amortizing mortgages came into being, making it easier and less risky for homeowners to take out mortgages.<sup>26</sup> To encourage investors to buy the newly reinstated mortgages, the federal government established the Federal Housing Administration and tasked it with providing insurance to mortgage investors who feared another housing collapse.<sup>27</sup> Having established

17. *Id.*

18. Hoover Institution, Facts on Policy—Homeownership Rates, <http://www.hoover.org/research/factsonpolicy/facts/26963064.html> (last visited Mar. 30, 2010).

19. Green & Wachter, *supra* note 12, at 94.

20. *Id.*

21. *Id.*

22. *Id.*

23. Les Christie, *Subprime Freeze Plan: Who's Left Out?*, CNN MONEY, Dec. 8, 2007, [http://money.cnn.com/2007/12/08/real\\_estate/Bush\\_plan\\_limitations/index.htm?postversion=2007120909](http://money.cnn.com/2007/12/08/real_estate/Bush_plan_limitations/index.htm?postversion=2007120909).

24. Green & Wachter, *supra* note 12, at 94–95.

25. *Id.* at 95.

26. *Id.*

27. *Id.*

a foothold in the mortgage market, the federal government would continue to play a crucial role in developing the secondary mortgage market over the coming decades.

### C. Securitization and the Secondary Mortgage Market Take Off

The “stagflation” period of the 1970s changed the mortgage lending framework radically by realigning investor incentives.<sup>28</sup> Due to high inflation, banks were unable to match the returns on capital that other financial vehicles offered.<sup>29</sup> The result was a flight of capital from banks and into other financial instruments, such as U.S. Treasury bonds.<sup>30</sup> More generally, investors withdrew their money from banks and put it to work in the capital markets, which promised higher rates of return.<sup>31</sup> With more money flowing into the capital markets, the securitization of mortgages also began to accelerate.<sup>32</sup>

Traditional securitization involves the packaging of an income-generating asset and the subsequent sale to an investor of the right to receive a portion of the income generated by the asset.<sup>33</sup> Securitization is not limited to the mortgage industry however—indeed, it has proved to be a revolutionary engine of wealth creation based on all different types of assets.<sup>34</sup> In the mortgage context, securitization operates by creating securities out of pooled individual home loans and then selling those securities to investors.<sup>35</sup> The income-generating assets, therefore, are the pooled home loans and the payments investors receive are the monthly payments that the owners of the underlying mortgages make.<sup>36</sup> In this way, investors can effectively own an interest in a mortgage pool made up of many individual mortgages<sup>37</sup>—much the same way an investor can own stock in a company.

The securitization of mortgages is a complicated process, but can be broken down into a few essential steps. The U.S. secondary mortgage market has had two dominant groups of players: government-sponsored entities (GSEs) and private firms, such as investment banks.<sup>38</sup> Although the specifics of a particular

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28. *Id.* at 98.

29. *Id.*

30. Green & Wachter, *supra* note 12, at 98.

31. *Id.*

32. *Id.* at 98–99.

33. Investopedia, What is Securitization?, <http://www.investopedia.com/ask/answers/07/securitization.asp> (last visited Mar. 23, 2010).

34. John C. Edmunds, *Securities: The New World Wealth Machine*, 104 FOREIGN POLY 118, 120 (1996).

35. Dodd, *supra* note 11, at 16.

36. *Id.*; Rosen, *supra* note 10, at 1.

37. Dodd, *supra* note 11, at 16.

38. *Id.* at 16–17.



arrangement may vary depending on the parties involved, the basic features of a securitization transaction are the same. First, an originator sells a home loan to a consumer in return for a promise to repay the loan.<sup>39</sup> The originator then passes the mortgage to an investment bank or other financial institution, called the arranger.<sup>40</sup> This process is repeated until the arranger has a large number of mortgages that it can pool together and package. Once pooled and packaged, the mortgages are transferred to a special purpose vehicle (SPV), which acts as a trustee over the mortgages.<sup>41</sup> By transferring the pooled mortgages to an SPV, the arranger achieves two things: (1) it reduces its tax exposure,<sup>42</sup> and (2) it can get the pooled mortgages off its balance sheet.<sup>43</sup> Securities—especially those issued through private firms, as opposed to government agencies—are then issued in the pooled mortgages to investors according to tranches, or categories of default risk.<sup>44</sup> Investors with a greater appetite for risk can purchase lower tranches, whereas risk-averse investors can purchase higher tranches, which have a smaller chance of default.<sup>45</sup> The key point about this process is that the originator and the arranger pass on the risk of default to third party investors, who assume that risk in return for monthly payments on the pooled mortgages from homeowners across America.<sup>46</sup>

#### i) The Government Agencies' Involvement in Securitization

Government agencies such as Fannie Mae and Freddie Mac were instrumental in establishing the securitization of mortgages in the United States.<sup>47</sup> They were also responsible for providing a stable and steady expansion of the secondary mortgage market, which relied on these securitizations.<sup>48</sup> The GSEs bought mortgages from originators, packaged them, and sold them to investors, much like any other arranger would.<sup>49</sup> Most importantly, however, Fannie Mae

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39. *Id.*

40. Adam B. Ashcraft & Til Shuermann, *Understanding the Securitization of Subprime Mortgage Credit*, 2 FOUND. & TRENDS IN FIN. 191, 201 (2008).

41. *Id.* at 202.

42. Dodd, *supra* note 11, at 16.

43. Investopedia, Special Purpose Vehicle/Entity (SPV/SPE), <http://www.investopedia.com/terms/s/spv.asp> (last visited Mar. 23, 2010).

44. Dodd, *supra* note 11, at 17.

45. *Id.*

46. See Ashcraft & Shuermann, *supra* note 40, at 11–12 (discussing the allocation of default risk between originator, arranger, and investor in a securitization transaction).

47. Richard Isacoff, *Could New Rules Avert Another Credit Crisis? Perhaps, but Be Wary*, KNOWLEDGE@WHARTON, June 20, 2008, <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1985>.

48. *Id.*

49. Dodd, *supra* note 11, at 16.

and Freddie Mac implicitly guaranteed those mortgages against default to the investors who purchased them in the form of securities.<sup>50</sup> This was a tremendous boon to investors, who could buy securities from the government agencies while at the same time vastly reducing their risk of default. The fact that the mortgages bought, packaged, sold, and backed by Fannie Mae and Freddie Mac had to conform to high underwriting standards was essential to this arrangement.<sup>51</sup> Practically, this meant that the government agencies only took on and only guaranteed high quality loans, where the borrowers (known as “prime” borrowers) had little risk of default.<sup>52</sup> The system thus had a built-in protection device: although the government was exposed to a significant amount of default risk, the exacting underwriting standards helped insure that the government only took on mortgages from those people who likely would repay the money.

Securitization of home loans had the beneficial effect of vastly increasing the amount of capital available for mortgages.<sup>53</sup> Thanks to the securitization of mortgages, Americans no longer need to rely on conservative lending institutions such as banks, but can access capital raised from the broader capital markets.<sup>54</sup> As a result, more Americans have received a mortgage and home ownership has expanded.<sup>55</sup> Expanded mortgages, however, have also come with more liberal—and sometimes careless—lending practices<sup>56</sup> on the part of private originators and arrangers, who operate in a markedly different way from the GSEs.

## ii) Private-Label Securitization

Private-label securitization is the name given to the purchasing, packaging, and selling of mortgage-backed securities by private, non-GSE firms such as investment banks.<sup>57</sup> Private-label securitization is a relatively new invention, established as an alternative to securitization by GSEs only about fifteen to twenty years ago.<sup>58</sup> The market for private-label securities developed in response to investors’ greater demand for return on their assets in a climate of low interest

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50. Isacoff, *supra* note 47, at 1.

51. Ashcraft & Shuermann, *supra* note 40, at 7.

52. *Id.*

53. See Dodd, *supra* note 11, at 16 (noting that securitization in the mortgage market has “tapped deep sources of capital”).

54. See Rosen, *supra* note 10, at 1 (discussing the evolution of mortgage lending over the past thirty years).

55. Hoover Institution, *supra* note 18.

56. Ashcraft & Shuermann, *supra* note 40, at 10.

57. Issacoff, *supra* note 47, at 1.

58. *Id.*

rates during the 2002–2004 time frame.<sup>59</sup> The market grew so much in fact, that private firms are estimated to have securitized over 6 trillion dollars worth of assets—much of that amount in the form of mortgage-backed securities in 2006.<sup>60</sup>

The key difference between GSEs and the private firms was their respective underwriting standards. Whereas the GSEs were bound by legal requirements to buy only “prime” mortgages, the private-label firms were bound by no such requirement.<sup>61</sup> This is what allowed the subprime market to take off; indeed, “subprime” itself designates those individuals whose credit scores do not qualify their loans for agencies like the GSEs.<sup>62</sup> As a result, loan originators often sold mortgages without down payment or proof of income requirements.<sup>63</sup> Credit rating agencies helped private issuers package their securities in such a way that they would be purchasable even by institutional investors, who are usually hamstrung by investment-quality criteria.<sup>64</sup> Thus, although the securitization process was the same for both the GSEs and the private-label issuers, the standards used to evaluate the underlying loans that made up the mortgage pools were markedly different.

Unsurprisingly, the problems with mortgage-backed securities have been largely confined to the private-label area.<sup>65</sup> This is because of private-label arrangers’ significantly lower underwriting standards compared with the GSEs; lower underwriting standards meant the purchase, packaging, and selling of riskier loans to investors. Although these securities gave investors what they were looking for—higher yields—they also introduced far greater risk into the market than existed before.

#### D. *The Role of the Credit Rating Agencies*

Since credit rating agencies play such a pivotal role in the securitization process, they are worthy of more discussion. Credit rating agencies, which are supposed to be independent analysts of business risk, have come under heavy pressure from lawmakers recently for their perceived contribution to the subprime crisis.<sup>66</sup>

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59. *Id.* at 2.

60. *Id.* at 3.

61. *Id.* at 1.

62. *See* Dodd, *supra* note 11, at 17 (noting that subprime mortgage-backed securities had to be marketed to non-institutional investors whose risk-management strategies did not prevent them from buying below-investment-grade securities).

63. *Id.*

64. *Id.* at 17.

65. Rosen, *supra* note 10, at 2.

66. Gretchen Morgenson, *Credit Rating Agency Heads Grilled by Lawmakers*, N.Y. TIMES, Oct. 22, 2008, available at <http://www.nytimes.com/2008/10/23/business/economy/23rating.html?partner=rssnyt&emc=rss>.

Congress has accused the credit rating agencies of conflicts of interest with clients and a consequent inability to assess the risk of financial instruments, such as mortgage-backed securities, objectively.<sup>67</sup> Indeed, the Securities and Exchange Commission (SEC) conducted a lengthy review of credit rating agencies and their contribution to the subprime debacle.<sup>68</sup> The SEC's report concluded that many of the credit rating agencies surveyed did not have the capability to effectively manage the increase in business they saw in the mortgage-backed securities area.<sup>69</sup> Furthermore, the report found that procedures for minimizing conflicts of interest could have been improved and that the credit rating agencies often did not document and justify "significant steps" and deviations from their rating process when issuing ratings on mortgage-backed securities.<sup>70</sup> While the report overall does not blame the credit rating agencies for the failure of the subprime market, it nevertheless suggests that the agencies were not always able to give the strong, independent, and objective assessments of credit risk that such a large private-label securitization market required.<sup>71</sup>

What exactly did the credit rating agencies do in the securitization process? They helped arrangers (especially in the private-label market, such as investment banks) figure out how to carve up the default risk in mortgage-backed securities so that they could be sold to investors.<sup>72</sup> This involved dividing the securities into different tranches, each with a corresponding level of debt.<sup>73</sup> Each tranche would receive a rating—standard in the industry—such as "AAA" or "AA," which reflected the credit rating agency's assessment of that tranche's creditworthiness.<sup>74</sup> Often, however, the agencies went beyond simply rating the securities once they were packaged.<sup>75</sup> Instead, the credit rating agencies worked with the arrangers to determine the right mix of mortgages to get a particular target rating.<sup>76</sup> In other words, rather than passing on the creditworthiness of the finished product, the agencies became an integral part of the securitization process itself. While not necessarily pernicious, this

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67. *Id.*

68. *See generally*, U.S. SEC. & EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES (2008) (examining major credit rating agencies to understand their practices and market influence).

69. *Id.* at 1.

70. *Id.* at 1–2.

71. *See generally id.* (describing the weak points in credit agencies' practices).

72. Isacoff, *supra* note 47, at 3.

73. *See supra* text accompanying notes 38–46 (describing the mortgage securitization process).

74. Isacoff, *supra* note 47, at 3.

75. *Id.*

76. *Id.*

practice calls into question the independence of the agencies and their ability to avoid conflicts of interest.

*E. The Misalignment of Originator Incentives Inherent  
in Traditional Securitization*

The key to understanding the shift in incentives for mortgage originators is to recognize what the incentives were before securitization and what they are today, especially in the private-label securitization context. Before securitization, banks were the only mortgage originators and their incentive was to loan money only to people who would be sure to pay it back.<sup>77</sup> The reason was that the money the banks lent was *their* money: it came directly from the bank's deposits. While this incentive was reduced somewhat following the entry of the GSEs, prudence remained in the mortgage market thanks to the strict underwriting standards of the GSEs themselves.

This incentive, however, was virtually wiped out following the growth of the private-label securitization market. Neither the originators nor the arrangers that packaged the pooled mortgages retained any of the default risk associated with the mortgages; instead, the risk was passed on to the investors.<sup>78</sup> The incentive on the part of originators to only lend to creditworthy individuals was eliminated. Riskier borrowers, of course, faced higher interest rates (usually through adjustable rate mortgages which began with a "teaser" rate which later increased), but this still provided no incentive for originators to be more prudent.<sup>79</sup> On the contrary—the more risky mortgages with a high interest rate that the originator sold, the greater the potential return on the mortgage-backed securities packaged for investors.<sup>80</sup>

III. SYNTHETIC SECURITIZATION: AN ALTERNATIVE  
METHOD OF WEALTH GENERATION

Although traditional securitization and synthetic securitization have elements in common, the two differ most importantly in the way that investors make money from the securities. Put simply, investors in a traditional securitization transaction make their money by actually buying a stake in income-producing assets. In the context of

77. See Dodd, *supra* note 11, at 16 (discussing depository banks' exposure to default risk).

78. Ashcraft & Shuermann, *supra* note 40, at 11–12.

79. Isacoff, *supra* note 47, at 2.

80. See *id.* at 3 (discussing investor appetite for high yield securities in a climate of low interest rates).

mortgage-backed securities, for instance, investors receive periodic returns on their investment based on the payments that millions of Americans make on their home mortgages each month. In a synthetic securitization, however, investors make money by “insuring” the risk of loss on assets owned by a financial institution and receiving periodic payments from the financial institution for the protection offered.<sup>81</sup> These “insurance” policies are known as credit default swaps. As a result, investors in a synthetic securitization transaction usually do not actually own any of the assets that they are providing protection for.<sup>82</sup> This is markedly different from traditional securitization, where ownership of the underlying assets is the mechanism for making money.

A caveat should be added here: investors do not provide insurance in the technical, legal sense of the word.<sup>83</sup> Synthetic securitization, in fact, is designed specifically to *avoid* the “insurance” label.<sup>84</sup> What the investors provide, however, is functionally equivalent to insurance in that investors will pay the asset-owning institution when a write-down in the value of the assets occurs.<sup>85</sup>

#### A. *How Synthetic Securitization Works*

Although the basic elements of synthetic securitization are fairly straightforward, more complicated permutations are also possible. The precise terms of a synthetic securitization transaction can become complex based on the nature of the transaction in question. Generally speaking, the investors “insuring” the holder of the assets against the risk of loss are known as the protection sellers.<sup>86</sup> The protection sellers typically organize themselves into a large group.<sup>87</sup> Furthermore, the protection against credit risk is itself divided into different tranches (similar to the tranching of default risk in traditional securitization transactions).<sup>88</sup> These tranches represent the different obligations that investors would have if the asset-holding institution (the protection buyer) calls on the protection

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81. Mary Fontaine et al., *Synthetic Securitizations Under Basel I and Basel II*, 24 REV. OF BANKING AND FIN. SERVICES 79, 79–80 (2008).

82. *Id.* at 79.

83. *Id.* at 79 n.1.

84. *Id.* (noting that this has the effect of absolving investors from having to be licensed as insurance companies).

85. See Diane Lam, *Asian Securitization Trends*, 22 INT'L FIN. L. REV. 10 (Oct. 2003) (discussing the function of credit protection sellers in synthetic securitization transactions), available at <http://www.iflr.com/Article/2026824/Asian-securitization-trends.html>.

86. *Id.*

87. Fontaine et al., *supra* note 81, at 80.

88. *Id.*; see *supra* text accompanying notes 44–46 (discussing the tranching of default risk in traditional securitization transactions).

sellers to make good on their promises to pay in case of default.<sup>89</sup> The first tranche that will have to pay out in case of default is called—unsurprisingly—the first loss position.<sup>90</sup> This tranche is then followed by multiple mezzanine tranches and finally a super senior position.<sup>91</sup> A more senior tranche carries a smaller likelihood of having to pay out in case of a default experienced by the protection buyer and consequently poses less risk for the protection seller.<sup>92</sup>

It is worthwhile to recall that tranches are also used in traditional securitization transactions, for a similar purpose.<sup>93</sup> There, as in synthetic securitizations, the tranche indicates the risk that a particular investor bears in relation to other investors who also hold that security (albeit perhaps in different tranches).<sup>94</sup> In a mortgage-backed security transaction, for instance, “default” is the scenario in which homeowners do not make their monthly payments and the return on the security declines.<sup>95</sup> In synthetic securitizations, the different levels of tranches indicate the likelihood that the protection seller will have to pay the protection buyer in case of a default on the underlying assets owned by the protection seller.<sup>96</sup>

A protection buyer might purchase protection for only a certain percentage of the underlying assets’ value.<sup>97</sup> Thus, the protection buyer may enter into an agreement to protect itself against a certain percentage loss that does not cover the total value of the assets that it holds.<sup>98</sup> Additionally, the protection buyer may agree to absorb the first losses, before turning to the protection seller for further coverage.<sup>99</sup> Furthermore, the buyer might also agree to assume the risk of default for its later losses.<sup>100</sup> By way of illustration, a protection buyer might have an underlying asset pool worth \$10 billion and seek coverage for only \$3 billion. The protection buyer might decide to enter into an agreement whereby it bears the risk of default for the first \$2 billion and also the last \$5 billion. As a result, the value that is actually protected by the protection seller is “sandwiched” between the first loss and the last loss that the protection buyer retains. Put another way, in the foregoing example,

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89. See Fontaine, et al., *supra* note 81, at 80 (discussing tranches of risk in synthetic securitization transactions).

90. *Id.*

91. *Id.*

92. See *id.* (discussing seniority of tranches and corresponding risk).

93. See *supra* text accompanying notes 44–46.

94. See *supra* text accompanying notes 44–46.

95. See *supra* text accompanying notes 44–46.

96. Fontaine, et al., *supra* note 81, at 80.

97. *Id.* at 81 (illustrating, by way of a synthetic securitization example, that the protection buyer seeks protection for only a certain percentage of the assets’ value).

98. *Id.*

99. *Id.*

100. *Id.*

the protection buyer bears a total \$7 billion of risk, but is covered for \$3 billion by the protection seller.<sup>101</sup>

Once the protection buyer determines the amount of protection it seeks, the protection seller begins the task of putting together an SPV which will hold the money that is pledged to the protection buyer in case of default.<sup>102</sup> Remember that the SPV is also used in traditional securitization transactions. There, it serves the purpose of holding the pooled assets, portions of which are then sold to investors. Generally, protection sellers in a synthetic securitization transaction hold U.S. Treasuries in the SPV instead of cash, and they pledge those Treasuries to the protection buyer as a means of satisfying their obligations under the credit default swap arrangement. To go back to the example from above, if the protection buyer secures \$3 billion worth of protection in a credit default swap, then the protection seller will place \$3 billion worth of U.S. Treasuries into the SPV and pledge the Treasuries to the protection buyer in case of loss on its assets.<sup>103</sup> In return for the credit protection, the protection sellers receive periodic fees.<sup>104</sup> These fees, as mentioned before, are the primary way that investors make money in a synthetic securitization.

#### B. *The International Use of Synthetic Securitizations for Mortgage Financing*

Synthetic securitizations are a far more common form of mortgage financing in countries outside the United States.<sup>105</sup> There are numerous reasons for preferring synthetic securitization. The reasons can depend on the regulatory climate of the country in question, as well as the goals of the mortgage originator and arranger.<sup>106</sup> Reasons to prefer synthetic securitization might include the complexity and prohibitive cost of a traditional securitization transaction as well its potentially unfavorable tax implications.<sup>107</sup> The important point to remember in a synthetic securitization is that

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101. The foregoing example was based on an illustrative scenario used by Fontaine, et al., *supra* note 81, at 81.

102. *Id.*

103. *Id.*

104. *Id.* at 90 fig.1 (showing a simplified illustration of a synthetic securitization transaction).

105. See Lam, *supra* note 85 (discussing synthetic securitization in Asian countries); Mark Odenbach, *Mortgage Securitization: What Are the Drivers and Constraints from an Originator's Perspective? (Basel I/Basel II)*, HOUSING FIN. INT'L, Sept. 1, 2002, at 52, 55, <http://www.allbusiness.com/personal-finance/real-estate-mortgage-loans/953734-1.html> (stating that traditional securitization developed in the United States in the 1970s).

106. Odenbach, *supra* note 105, at 55.

107. *Id.*



the owner of the assets remains the owner and does not actually pass legal title to other investors, unlike in a traditional securitization.<sup>108</sup>

On a general note, there is fairly little scholarly work to be found on the use of synthetic securitization in other parts of the world. This is in large part due to the fact that although countries outside the United States have been more inclined to use synthetic securitization, securitization of any kind in those countries is still a relatively recent trend.

Germany is one of the countries that recently moved toward making widespread use of securitization in its mortgage markets.<sup>109</sup> Thus, like the United States, Germany relies heavily on capital markets to fund new mortgages, rather than relying simply on deposits at banks and other lending institutions.<sup>110</sup> The German secondary mortgage market appears, in fact, to be a very well developed one, having served the country for close to two hundred years.<sup>111</sup> But there ends the historical similarity with the United States. In Germany, the capital markets have traditionally funded mortgages through bonds known as "Pfandbriefe," which are conceptually distinct from mortgage-backed securities.<sup>112</sup> The Pfandbriefe are covered bonds, which function similarly to securitization *only* in that they help raise money from private investors but differ significantly in their structure.<sup>113</sup> Although covered bonds are not a focal point of this article, a brief introduction to the history of the Pfandbriefe will help bring Germany's more recent experimentation with securitization into clearer relief.

#### i) Pfandbriefe and the History of the German Secondary Mortgage Market

The Pfandbrief is an instrument that German financial institutions have used for close to two centuries as a vehicle for raising money for mortgages in the secondary market.<sup>114</sup> Pfandbriefe were originally issued by the German aristocracy, who had the landholdings necessary to guarantee the repayment of debt on the

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108. *Id.*

109. Green & Wachter, *supra* note 12, at 103–04.

110. *Id.*

111. Peterson, *supra* note 13, at 14–15.

112. *Id.*

113. See Heidi Crebo-Rediker & Douglas Rediker, *Covered Bonds Can Rebuild America*, FORBES, July 28, 2008, available at [http://www.forbes.com/2008/07/28/covered-bonds-infrastructure-oped-cx\\_hcr\\_dr\\_0728bonds.html](http://www.forbes.com/2008/07/28/covered-bonds-infrastructure-oped-cx_hcr_dr_0728bonds.html) (describing covered bonds and their benefits); Peterson, *supra* note 13, at 14–15 (explaining the originator bank's ownership of the pfandbriefe).

114. Louis Hagen, *A Safe Haven From the Subprime Crisis: Pfandbriefe Have Defied Difficult Times*, ATLANTIC TIMES (Germany), Jan. 2008, available at [http://www.atlantic-times.com/archive\\_detail.php?recordID=1148](http://www.atlantic-times.com/archive_detail.php?recordID=1148).

bond.<sup>115</sup> As German society modernized, so did the institutions that could issue Pfandbriefe—in other words, the privilege began to extend to issuers other than the aristocracy.<sup>116</sup> Fundamentally, however, the idea and the mechanism behind the Pfandbrief as a covered bond has endured.<sup>117</sup>

A covered bond is a security that is sold to investors in return for money. In this way, it is exactly like any other bond that issuers such as governmental entities and private corporations issue on a regular basis. Investors give the covered bond-issuing entity money in return for a promise by the issuer to repay the investor at a later date. The appeal of covered bonds is the fact that they are collateralized by the issuing institution.<sup>118</sup> Put simply, this means that the issuer has assets on its balance sheet that the investors can go after in case of a default by the issuer on the covered bonds.<sup>119</sup> The very low risk of default means that these securities are highly desirable to investors with a low risk tolerance.<sup>120</sup> Pfandbriefe, being covered bonds, have been used in the German mortgage market as a way to raise money, which banks can then use to originate loans.<sup>121</sup> Banks use the capital they raise through the sale of Pfandbriefe to make loans to consumers, and they hold the loans to collateralize the bonds and provide relief for creditors in case of default.<sup>122</sup> This setup gives Pfandbriefe investors easy recourse to the loans that their money effectively helped to originate.<sup>123</sup>

The structure of the Pfandbriefe has provided German investors with security<sup>124</sup> while at the same time providing a steady source of funding for the German mortgage markets. Indeed, the theoretical reliability of the Pfandbriefe has been empirically verified: no Pfandbrief has defaulted on its payment obligations in the past one hundred years.<sup>125</sup> The integrity of the covered bond market for residential finance in Germany is due also in part to the stringent oversight that the German financial regulator BaFin provides for the Pfandbrief market.<sup>126</sup> In addition to periodic reporting requirements about the state of the collateral assets securing the bonds, BaFin

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115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

120. See Norton Rose Group, *German Pfandbriefe: A Modern Financing Tool in Demand*, Dec. 2008, <http://www.nortonrose.com/knowledge/publications/2008/pub18574.aspx?lang=en-gb> (“[N]o Pfandbrief has ever defaulted for a period which now goes back for more than 100 years.”).

121. Hagen, *supra* note 114.

122. *Id.*

123. *Id.*

124. Norton Rose Group, *supra* note 120.

125. *Id.*

126. Hagen, *supra* note 114.

appoints a fiduciary agent to oversee each Pfandbrief-issuing bank, whose job it is to represent the interests of the bond holders.<sup>127</sup> Furthermore, BaFin requires that the value of the collateral loans used to secure the bond be equal to the value of the bond itself.<sup>128</sup>

The Pfandbriefe have been a crucial mainstay of German real estate finance for decades. These bonds are a feature of the German financial landscape in which investors, financiers, and the country at large have put great faith and of which they are, generally speaking, very proud.<sup>129</sup> Recently, the German Parliament passed the Pfandbrief Act, which aims to give even higher protection to investors and in general consolidate regulation of the Pfandbriefe into a single, comprehensive law.<sup>130</sup> One of the principal reasons behind this legislation, according to German commentators, is the recognition that the Pfandbriefe are a vital part of German finance and that they provide investment opportunities for individuals and companies that German financial institutions are eager to capitalize on.<sup>131</sup> Given that German institutions place such confidence in the Pfandbriefe, it is unlikely that they will disappear from the German real estate financing markets anytime soon.

## ii) Pfandbriefe and the Emerging Securitization Market in Germany

If the Pfandbrief is a well-developed financial instrument in Germany, a mortgage-backed security is anything but. As the Bundesbank (the German Central Bank) itself stated in 2006, “there is no legal or market definition for securitization in Germany.”<sup>132</sup> Nonetheless, the Bundesbank recognizes that securitization (both traditional securitization and synthetic securitization) has taken off in Germany in the past few years and has begun to be used for the purpose of raising capital for mortgages.<sup>133</sup> Growth of securitization

127. Norton Rose Group, *supra* note 120.

128. *Id.*

129. *See, e.g.*, ASS'N OF GERMAN PFANDBRIEF BANKS, THE PFANDBRIEF: A SAFE INVESTMENT, available at [http://www.pfandbrief.de/cms/\\_internet.nsf/0/931B8415065095FEC12576A900424BCB/\\$FILE/EN\\_Pfandbrief\\_Flyer\\_02\\_2009.pdf?OpenElement](http://www.pfandbrief.de/cms/_internet.nsf/0/931B8415065095FEC12576A900424BCB/$FILE/EN_Pfandbrief_Flyer_02_2009.pdf?OpenElement) (discussing why the Pfandbrief is a safe investment).

130. BUNDESVERBAND ÖFFENTLICHER BANKEN DEUTSCHLANDS & ALLEN & OVERY, THE NEW GERMAN PFANDBRIEF ACT: STRENGTHENING GERMANY AS A FINANCIAL CENTER 4–5 (2005), available at [www.voeb.de/download/publikation\\_pfandbriefgesetz-allenoverly.pdf](http://www.voeb.de/download/publikation_pfandbriefgesetz-allenoverly.pdf).

131. *Id.* at 5.

132. *New Legal and Regulatory Framework for the German Securitisation and Pfandbrief Market*, 58 DEUTSCHE BUNDESBANK MONTHLY REP. 37, 39 (Mar. 2006), available at [http://www.bundesbank.de/download/volkswirtschaft/mba/2006/200603mba\\_en\\_german\\_securingisation\\_pfandbrief\\_market.pdf](http://www.bundesbank.de/download/volkswirtschaft/mba/2006/200603mba_en_german_securingisation_pfandbrief_market.pdf) [hereinafter *New Legal and Regulatory Framework*].

133. *Id.* at 38–39.

has been slow, however, due in large part to the existence of the Pfandbriefe, which provide German financial institutions a trusted and reliable avenue to capital markets.<sup>134</sup> Colloquially speaking, securitization has had a relatively hard time taking root in the shadow of the venerable Pfandbrief. Nevertheless, the demand for securitized transactions in Germany (including mortgage-backed securities) is present. Why? What explains Germany's appetite for securitization given the long history of the Pfandbriefe?

The most significant explanation is perhaps that securitization holds the promise of higher returns for investors.<sup>135</sup> A general rule of finance is that higher risk creates higher return and correlatively that lower risk tends to create lower return. This simple axiom holds true in a comparison of Pfandbriefe with securitization; Pfandbriefe tend to give investors much lower returns (due to their conservative nature) than do mortgage-backed securities.<sup>136</sup> Securitization, therefore, responds to an increased appetite for risk and return for certain investors; it can perhaps be best seen as complementing Pfandbriefe, rather than displacing them.<sup>137</sup>

Having considered the historical context of real estate finance in Germany, we are in a better position to examine why Germany has used synthetic securitization more extensively than traditional securitization. Unlike the United States, where traditional securitization is dominant, synthetic securitization made up the majority of Germany's securitization market prior to 2005.<sup>138</sup> This is due in large part to Germany's regulatory and legal climates which—until 2005—had not been accommodating to traditional securitization.<sup>139</sup>

The fact that German law historically did not recognize the existence of SPVs is perhaps the most likely culprit for the failure of traditional securitization to take deep root in Germany.<sup>140</sup> Because German originators cannot create SPVs to hold the assets in which investors could buy interests, a key component of the traditional

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134. *Id.* at 39.

135. *Id.* at 41.

136. *Id.*

137. *Id.* at 53.

138. *Id.* at 38.

139. Peterson, *supra* note 13, at 15.

140. *See id.* (explaining the effect that the legal and regulatory climate has had on the development of both traditional and synthetic securitization). For an in-depth analysis of Germany's position on SPVs in comparison with other civil law countries, see generally Line Aleknaitė, *Why the Fruits of Capital Markets Are Less Accessible in Civil Law Jurisdictions or How France and Germany Try to Benefit from Asset Securitization*, 5 DEPAUL BUS. & COMM. L.J. 191 (2006–2007) (describing why certain elements of German and French law impede the development of securitization markets in those countries).

securitization model is essentially precluded.<sup>141</sup> German originators, faced with this reality, had two options. For a while, they attempted to get around the prohibition on German SPVs by doing business with SPVs in foreign countries through cross-border transactions.<sup>142</sup> Other originators, however, sensed the transaction cost savings that synthetic securitization could bring and used that method instead.<sup>143</sup> Predictably, German originators with synthetic securities purchase credit default protection in the form of credit default swaps, for instance, from protection sellers, thus fitting with our overall understanding of synthetic securities transactions.<sup>144</sup> Shifts in German practice are emerging, however. Prior to 2003, for instance, the German government made changes in tax law to alleviate the costs of setting up SPVs, which might portend greater use of traditional securitization in the future.<sup>145</sup>

Although Germany provides a relatively useful case study of synthetic securitization, it is by no means the only country which uses this method extensively. Some recent anecdotal evidence can help shed light on the size of synthetic securitization transactions which have emerged in the global market outside of Germany:

- More than \$47 billion worth of European residential mortgage-backed securities were marketed in 2005.<sup>146</sup> Following the offerings, an expert commented: "You have to ask why there have been so many synthetic RMBS deals in the past week. Is it merely a year-end balance sheet cleaning exercise, or the start of something bigger?"<sup>147</sup>
- Synthetic securitization in Italy is becoming increasingly popular even at a time when the regulatory climate has become much friendlier to traditional securitizations.<sup>148</sup> Commentators note that the relatively high transaction costs of traditional securitization account for this trend in part.<sup>149</sup> Most of these transactions have been done in connection with consumer loans in general, not just home mortgages.<sup>150</sup> Moreover, Italy's pace of

141. Peterson, *supra* note 13, at 15–16. For a discussion of SPVs and their use in traditional securitization, see *supra* text accompanying notes 38–46.

142. Peterson, *supra* note 13, at 16.

143. *Id.* (explaining that, by using synthetic securitization, these originators saved the transaction costs associated with setting up and maintaining a foreign SPV).

144. *Id.*

145. *New Legal and Regulatory Framework*, *supra* note 132, at 43.

146. Hugh Leask, *Synthetic RMBS Floods European Market*, TOTAL SECURITIZATION, Dec. 9, 2005.

147. *Id.* (quoting Ganesh Rajendra, head of European securitization research, Deutsche Bank).

148. Simonetta Andrioli & Luca Dezzani, *Italy: Synthetic Securitization: A Growing Funding Technique*, 21 INT'L FIN. L. REV. 10, 83–84 (2002).

149. *Id.*

150. *See, e.g., id.* (noting the Banca Finconsumo SpA's synthetic transaction involving consumer loans).

securitization has also picked up in the past decade, accelerating at virtually breakneck rates.<sup>151</sup>

- Synthetic securitization transactions involving real estate mortgage-backed securities in Taiwan offered some of the best opportunities for synthetic securitizations in Asia during the middle of this decade, at a time when the slow rise in value of consumer financial assets painted a bleak picture for securitization in general.<sup>152</sup>

### C. Shortcomings of Synthetic Securitizations

Perhaps the greatest shortcoming of synthetic securitization is the fact that it uses credit default swaps in order to give the protection buyer the coverage it is looking for. Credit default swaps are a type of financial instrument known as a “derivative.” As financial instruments, derivatives have a long history—we can trace their use back as far as the seventeenth century.<sup>153</sup> Their use has also been far from isolated; countries such as Holland and Japan both used derivatives historically for trade in various products, such as rice in Japan and tulip bulbs in the Netherlands.<sup>154</sup> The number and complexity of derivatives soared, however, in the 1970s when increasing uncertainty in the global financial markets, coupled with decreased regulation of financial instruments, created a climate favorable for their use.<sup>155</sup> Traditionally, a large variety of businesses have used derivatives for various purposes, including:

1. *Companies buying and selling in foreign markets:* Using foreign currency derivatives to reduce the risk of an adverse effect due to changes in international exchange rates.<sup>156</sup>
2. *Companies with high leverage (debt):* Derivatives can help reduce the risk of default that companies with high levels of debt face.<sup>157</sup>
3. *Various other factors:* Companies also use derivatives to reduce “accounting earnings volatility” and to reduce the “present value of their tax liabilities.”<sup>158</sup>

Derivatives have, in recent times, earned a poor reputation at best.<sup>159</sup> Legendary investor Warren Buffet described derivatives in

151. *Id.*

152. Lam, *supra* note 85, at 1.

153. Rene M. Stulz, *Should We Fear Derivatives?*, 18 J. ECON. PERSP. 173, 177 (2004).

154. *Id.*

155. *Id.*

156. *Id.* at 181.

157. *Id.*

158. *Id.* at 181–82.

159. See, e.g., *Are Derivatives Dangerous?*, BUS. WK., Mar. 31, 2003, available at [http://www.businessweek.com/magazine/content/03\\_13/b3826070\\_mz020.htm](http://www.businessweek.com/magazine/content/03_13/b3826070_mz020.htm) (explaining the risks of derivatives); Cris Sholto Heaton, *The Dangers of Derivatives*, MONEY WK., Sept. 27, 2006, available at <http://www.moneyweek.com/investments/>

general (of which credit default swaps are a subset) as “financial weapons of mass destruction,” warning that it was only a matter of time before they would cause great damage to the world economy.<sup>160</sup> When one considers that the derivatives market is worth potentially up to \$85 trillion, Buffet’s warning comes into much clearer relief.<sup>161</sup> Buffet’s criticisms of derivatives come in two flavors. First, he claims that derivatives have the potential to force companies into a “meltdown” from which there is little or no escape.<sup>162</sup> Second, he says that derivatives have the potential to distort accounting statements because of the often delayed nature of their effect on a company’s actual value.<sup>163</sup>

On a broader scale, derivatives face criticism for the following reasons:

1. *Derivatives are hard to value accurately:* Because of the sometimes limited amount of information that exists about the parties involved in a derivative transaction, there is a substantial risk that a derivative will be mispriced. This problem is either greater or smaller depending on which of two methods parties use to buy and sell derivatives:<sup>164</sup>
  - a. Derivatives can be traded on the so-called “over the counter” or OTC market. In this kind of transaction the buyer and the seller of the derivative negotiate a price without relying on an exchange. The parties use the best information that they have to try and price the derivative accurately. The potentially limited sphere of information, however, means that the risk underlying the derivative contract may actually be higher or lower than the parties believe, resulting in the mispricing of the derivative itself.<sup>165</sup>
  - b. Some derivatives can be traded on an exchange such as the Chicago Mercantile Exchange.<sup>166</sup> The advantage of this mechanism—at least theoretically—is that individuals wishing to buy or sell derivatives bring more information to the table, resulting in a more accurate pricing of the derivative.
2. *Lack of transparency in accounting:* Investors seeking information on the value of derivatives found on a company’s balance sheet may find it hard to find such information because (1) no hard and fast accounting rules exist as to how these derivatives should be

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stock-markets/the-dangers-of-derivatives.aspx (“Many pundits have gone as far as to warn that these instruments could bring down the financial system.”).

160. *Buffet Warns on Investment ‘Time Bomb,’* BBC NEWS, Mar. 4, 2003, available at <http://news.bbc.co.uk/2/hi/business/2817995.stm>.

161. *Id.*

162. *Id.*

163. *Id.*

164. Stulz, *supra* note 153, at 177.

165. *Id.* at 183 (citing studies showing the mispricing that results when derivatives are particularly complex or when there is little available information about them).

166. *Id.* at 177.

represented on a balance sheet; and (2) the greater the complexity and interconnectedness of derivatives, the harder they are to separate from one another and value accurately.<sup>167</sup> As a result, companies holding derivatives may be exposed to more risk than their balance sheets indicate.<sup>168</sup> To ensure that they have valued their derivatives-related risk accurately, firms commonly use two techniques:

- a. Value at risk (VaR): this measurement indicates the percentage risk that the company to which it is applied will lose a certain amount of money in a given day. For example, "a 5 percent value-at-risk of \$100 million for a bank means that there is a 5 percent risk that the bank will lose \$100 million or more."<sup>169</sup> Generally, the VaR is an expression of risk premised on not one, but multiple models that are then expressed as one number.<sup>170</sup>
- b. Stress test: these models aim to show how certain simulated events in global financial markets (especially those that are generally considered adverse, such as a currency crisis) would affect the risk that the company bears with regard to its derivatives.

The preceding discussion attempted to highlight the perceived shortcomings and dangers of using derivatives in business transactions to manage risk, of which credit default swaps (the key ingredient of a synthetic securitization transaction) are a subset. Given that people see derivatives as potentially problematic and dangerous, are synthetic securitizations doomed? In particular, does the ongoing financial crisis suggest that banks and businesses will forswear derivatives and other complex, high-risk financial instruments in the future and seek to reduce risk in other ways?

#### D. *Rescuing Derivatives from Becoming the Bogey-Men of the Financial World*

While it is impossible to say with certainty the extent to which businesses will use derivatives in the future, there is reason to believe that the financial world has not abandoned them altogether.

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167. *Id.* at 185–86.

168. *Id.* at 186.

169. *Id.* For an easy-to-understand discussion of VaR, see Joe Nocera, *Risk Mismanagement*, TIMES, Jan. 2, 2009 (Magazine) available at <http://www.nytimes.com/2009/01/04/magazine/04risk-t.html>. The reliability of VaR has come under fire in recent months as the global financial crisis has continued to unravel;

Given the calamity that has since occurred, there has been a great deal of talk, even in quant circles, that this widespread institutional reliance on VaR was a terrible mistake. At the very least, the risks that VaR measured did not include the biggest risk of all: the possibility of a financial meltdown.

*Id.*

170. Nocera, *supra* note 169.



Lawmakers and regulators around the world are considering making derivatives transactions much more transparent than they currently are.<sup>171</sup> The target of the new plans is the less than transparent OTC market.<sup>172</sup> As mentioned before, the basic premise of an OTC market is that private parties consummate a transaction, generally without the use of an exchange intermediary.<sup>173</sup> Usually, however, a party wishing to enter into an OTC transaction does use a broker-dealer or investment banker to help find the other party.<sup>174</sup> This is often the case for complex financial instruments, of which derivatives in general,<sup>175</sup> and credit default swaps in particular, are a good example. Parties engaged in OTC transactions—even when using a broker-dealer or investment banker to consummate the transaction—therefore operate in a much more “private” way than parties buying and selling on an exchange such as the NYSE.<sup>176</sup> On an exchange, the number of buyers and sellers is generally much higher and the amount of information available about the parties is also more plentiful and easy to come by.

Opening up the trading of derivatives has two potential effects. First, it would make information about the parties involved in the transaction more readily available.<sup>177</sup> This would help investors and the broader business community gain a stronger sense of what the derivatives are actually worth and the underlying risk that these derivative transactions implicate.<sup>178</sup> Second, having a centralizing trading medium would help to reduce the systemic risk that a collapse in derivatives might precipitate.<sup>179</sup> Such a centralized medium might be a central clearing counterparty (CCP) that could eventually evolve into a formal exchange<sup>180</sup> where parties could trade derivatives in a manner analogous to parties trading on the better-known exchanges such as the Chicago Mercantile Exchange today. The notion here is that a centralized process would allow for the absorption of individual shocks and not let those dislocations disrupt the broader market.<sup>181</sup> The primary proposed mechanism for this

171. Michelle Price, *Clearing Up*, BANKER, Feb. 2, 2009, available at [http://www.thebanker.com/news/fullstory.php/aid/6423/Clearing\\_up\\_.html](http://www.thebanker.com/news/fullstory.php/aid/6423/Clearing_up_.html).

172. *Id.*; see *OTC Oversight and Infrastructure to Be Strengthened*, 28 BANKING & FIN. SERVICE POL'Y REP. 23, 24 (2009) (describing similar efforts to build a more transparent exchange medium for derivatives).

173. Investopedia, Entry for “Over-the-Counter (OTC)”, <http://www.investopedia.com/terms/o/otc.asp> (last visited Mar. 30, 2009).

174. *Id.*

175. *Id.*

176. *Id.*

177. Price, *supra* note 171.

178. See *id.* (discussing the salutary effects of a more transparent medium of exchange for credit default swaps).

179. *Id.*

180. *Id.*

181. *Id.*

would be the creation of a “default fund” that could be used to shore up companies facing default.<sup>182</sup>

International support for revamping the trading infrastructure for credit default swaps appears to be growing:

Persuaded by this paradigm, the US authorities, led by the New York Federal Reserve, have vigorously campaigned for the creation of a CDS CCP facility, while Senator Tom Harkin, chairman of the Senate Agricultural Committee, has introduced a bill requiring OTC derivatives to be traded only on exchanges. In Europe too, plans are now afoot to set up a CCP infrastructure, in what has been presented as an open-and-shut case in favour of the long-lived model.<sup>183</sup>

Disagreement exists, however, as to what such a trading system should like, which firms and organizations should receive regulatory approval, and even where (geographically) such a CCP should be located.<sup>184</sup> The plan also faces opposition from broker-dealers who see the proposed growth of these new exchange intermediaries as endangering their livelihood.<sup>185</sup> Additionally, some fear that a CCP would force the standardization of derivatives transactions, which would have the perverse effect of reducing parties’ ability to structure their transactions according to their individualized needs.<sup>186</sup>

The foregoing discussion of proposed alternatives to the current OTC trading of credit default swaps is offered not primarily for the purpose of illustrating the specifics of any particular plan, but rather to suggest that there is broad international consensus that derivatives markets ought to be kept open and strengthened through mandated transparency. This observation is important, because it suggests that derivatives trading is here to stay. And this is good news. As long as derivatives markets are made stronger, more efficient, and more transparent, they have the potential to provide investors with valuable information regarding risk that can and should be harnessed for use in American mortgage-backed securitization.

#### IV. USING SYNTHETIC SECURITIZATION IN TRADITIONAL SECURITIZATION TRANSACTIONS TO PROMOTE TRANSPARENCY

Having explored the major characteristics, advantages, and shortcomings of both traditional and synthetic securitization, this Note will now propose that regulators consider requiring a

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182. *Id.*

183. Price, *supra* note 171.

184. *Id.*

185. *Id.*

186. *Id.*

combination of the two methods in all mortgage-backed securities transactions done in the United States. The following paragraphs discuss what such a suggestion would look like and, more importantly, why it would be useful for investors.

It may be worthwhile to pause at this point to recall the important role that securitization plays in the American mortgage market.<sup>187</sup> In the past couple of decades securitization has unquestionably become one of the primary driving forces of the growth in home ownership across the United States.<sup>188</sup> Securitization has, therefore, been directly responsible for expanding individual Americans' ability to purchase and pay for a home of their own.<sup>189</sup> This is arguably a positive development for the country. Owning a house is not only commonly thought of in the United States as a pillar of the "American Dream," but it also means—from a more pragmatic, economic standpoint—the ownership of a significant asset, against which people can borrow or from which people can withdraw equity.<sup>190</sup>

Home ownership, therefore, has both a sentimental and an economic autonomy aspect to it. Although it is uncertain what the American housing market of the future will look like, it is highly likely that these twin characteristics of homeownership will remain coveted by Americans. If securitization has helped secure homeownership for more and more Americans by making more money available for mortgages, there is every reason to hold on to it and harness its power in the future. There is, to be sure, broad consensus that both traditional and synthetic securitizations have significant drawbacks, which have come into sharp relief during the ongoing financial crisis and especially the collapse of the market for mortgage-backed securities.<sup>191</sup> Securitization's shortcomings should not be taken, however, to mean that they are fundamentally flawed and do not serve an important purpose—they do. What is needed now is strengthening, rather than abandonment.

#### A. *What is the Problem We Need to Address?*

Proposals for strengthening securitization must be based on the fundamental problems that people associate with securitization itself. One of these problems is that securitization creates a perverse incentive for mortgage originators to sell high-interest, high-risk

187. See *supra* Part II.C (discussing the role of securitization in the secondary mortgage market).

188. See discussion *supra* Part II.C.

189. See discussion *supra* Part II.C.

190. Bankrate.com, What Home Equity Debt Is, <http://www.bankrate.com/brm/green/loan/basics1-1a.asp> (last visited Mar. 30, 2010).

191. See discussion *supra* Part I.

mortgages that then yield greater returns for investors who purchase the bundled mortgages in the form of mortgage-backed securities.<sup>192</sup> This is a significant problem that merits attention. It is also perhaps the problem that is the hardest to solve. At root, the issue here is that the actors involved in the securitization process (mortgage originators, investment banks, investors) were blind to the risks of default in the underlying mortgages and focused instead on the lure of ever higher returns.<sup>193</sup> One may describe this behavior as speculation, or even—to use Alan Greenspan’s famous words—irrational exuberance.<sup>194</sup> What makes these problems difficult to solve is that they are inherent in the world of investing and have plagued financial markets for centuries.<sup>195</sup> It is difficult to conceive of effective policies short of limiting individual investment that have the effect of arresting asset bubbles before they cause chaos in the broader economy. Stopping investors from making irrational decisions—assuming accurate information is available—necessarily involves imposing restraints that might strike many as too paternalistic or overly meddlesome in private enterprise. It is not the goal of this Note to propose a solution to this problem. Rather, the Note seeks to make a more modest contribution by examining another problem associated with mortgage-backed securities, namely, the accuracy of information concerning risk that the market and investors can rely on.

Information inadequacy appears to have been a significant problem for many of the mortgage-backed securities sold over the past decade or so.<sup>196</sup> The primary reason for this is that the critical information about mortgage-backed securities (the default risk that they carried) came from the credit ratings agencies and not the broader market.<sup>197</sup> As discussed before, these credit ratings agencies were responsible for assimilating information regarding the mortgage-backed securities and then issuing ratings on them based on the risk that the securities appeared to carry.<sup>198</sup> The particular rating that an agency gave a mortgage-backed security was therefore

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192. See *supra* Part II.E (discussing the misalignment of originator incentives in traditional securitization).

193. See discussion *supra* Part II.E.

194. Alan Greenspan, Chairman, Fed. Reserve Bank, Remarks to the Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research (Dec. 5, 1996), available at <http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm>.

195. See, e.g., Investopedia, Dutch Tulip Bulb Market Bubble, [http://www.investopedia.com/terms/d/dutch\\_tulip\\_bulb\\_market\\_bubble.asp](http://www.investopedia.com/terms/d/dutch_tulip_bulb_market_bubble.asp) (last visited Mar. 30, 2010) (describing the unsustainable rise in the price of tulip bulbs in seventeenth century Holland and the resulting crash).

196. See discussion *supra* Part II.D (describing the role of credit rating agencies in the securitization process).

197. See discussion *supra* Part II.D.

198. See discussion *supra* Part II.D.

often the main—if not the only—information that investors could rely on to make their decisions. The most serious problem goes to the fact that credit rating agencies appear to have had serious conflicts of interest in rating the securities that were assigned to them.<sup>199</sup> These two factors, in combination, opened the door to serious flaws in information flow that many investors may have relied on to their detriment.<sup>200</sup> In other words, the information problem—again, as old as investing itself—can be seen in the mortgage-backed securities context as well.

### B. *Current Legislative and Regulatory Proposals—On the Right Track?*

The U.S. government has responded vigorously to the ongoing crisis in the housing market and will likely continue to do so for the foreseeable future. Perhaps most significantly, Congress has passed or attempted to pass a number of new laws that aim to ensure that a subprime debacle like the one the United States is currently experiencing does not happen again.<sup>201</sup> Additionally, the SEC has sought to do what it can to restore market integrity through rulemaking.<sup>202</sup> While some of the current proposals aim to enhance the quality of information available to investors, they nonetheless do so in a shortsighted and inadequate way.<sup>203</sup> These proposals focus on front-end regulation of behavior, whether for mortgage originators or credit ratings agencies.<sup>204</sup> An overview of some of recent legislative and regulatory activity illustrates the focus that Congress and the SEC's initiatives have adopted.

In 2007, the U.S. House of Representatives passed the "Mortgage Reform and Anti-Predatory Lending Act," which sought to extensively regulate the lending practices of mortgage originators around the

199. See discussion *supra* Part II.D.

200. See discussion *supra* Part II.D.

201. See, e.g., Mortgage-Reform and Anti Predatory Lending Act of 2007, H.R. 3915, 110th Cong. (2007) ("[The purpose of this act is] to reform consumer mortgage practices and provide accountability for such practices, to establish licensing and registration requirements for residential mortgage originators, to provide certain minimum standards for consumer mortgage loans, and for other purposes.").

202. See, e.g., Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 17 C.F.R. pts. 240, 249b (2009) (imposing additional requirements on nationally recognized statistical rating organizations).

203. See, e.g., Credit Rating Transparency and Disclosure Act, H.R. 6230, 110th Cong. (2008) (requiring nationally registered statistical rating organizations to provide additional disclosures); Fair Mortgage Practices Act of 2007, H.R. 3012, 110th Cong. (2007) (providing for the establishment of fair mortgage practices and subprime mortgages, and a national system for licensing or registering residential mortgage loan originators).

204. H.R. 6230; H.R. 3012.

country.<sup>205</sup> Among other things, the law required that mortgage originators provide customers with a range of mortgage financing options that are suitable to the financial situation of the borrower,<sup>206</sup> that originators make clear any conflicts of interest that they may have with regard to the borrower and another party,<sup>207</sup> and that originators certify to the creditors that they are in fact in compliance with all applicable rules and regulations.<sup>208</sup> Additionally, the law prohibited originators from receiving monetary incentives to sell mortgages with a higher risk and therefore higher corresponding interest rate.<sup>209</sup> Furthermore, the law required that originators not affiliated with a depository institution register with a national database.<sup>210</sup>

Following passage in the House, however, the bill failed in the Senate, except for the provision that creates a federal database for mortgage originators.<sup>211</sup> That particular provision was signed into law.<sup>212</sup> The above-outlined attempt at reform shows that Congress has focused a significant portion of its attention on reforming the lending practices of originators on the front end. Laws that attempt to regulate originator behavior—as did this law—can be hard to police and enforce. More importantly, however, they wrestle with the structural incentives that investors on the back-end have to pour increasing amounts of money into mortgage-backed securities in the hope of high returns through risky mortgages. Given that these incentives were what led originators to become reckless in the first place, it seems that legislation which ignores the *underlying* incentives that securitization creates fails to address the problem in a fundamental way. By not addressing the issue of better disclosure and more reliable risk-related information, Congress has failed to take the initiative on giving investors the tools they need to make better-informed decisions in the future. Absent these tools, investors will likely be drawn once more to the high returns of high interest rate mortgages, underestimating the true risk that they carry. Such investor interest will only serve to undercut—from a structural point of view—the behavioral template that Congress has attempted to

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205. H.R. 3915.

206. *Id.* § 102.

207. *Id.* § 122.

208. *Id.*

209. *Id.* § 123.

210. *Id.* § 104.

211. Diana Golobay, *Industry Players Vie for a Piece of Mortgage Lending Reform*, HOUSING WIRE, Mar. 12, 2009, available at <http://www.housingwire.com/2009/03/12/industry-players-vie-for-a-piece-of-mortgage-lending-reform/>.

212. *Id.* The requirements of the federal database of mortgage originators and the federal-state obligations that such a database gives rise to are more fully fleshed out in the Secure and Fair Enforcement for Mortgage Licensing Act [S.A.F.E. Mortgage Licensing Act] of 2008, 12 U.S.C. § 5101 (2008).

foist on the mortgage originators. This is not to say, however, that lawmakers have not recognized the important role that issuers of mortgage-backed securities play in the process. Section 204 of the Mortgage Reform and Anti-Predatory Lending Act would have extended liability for violations of the law with regard to origination standards to the securitizers themselves. Congress's recognition that issuers are a vital part of the puzzle is a good beginning, but it should not be the end.

While Congress has focused its legislative efforts on reforming the lending practices of mortgage originators, the SEC has taken aim at credit rating agencies, which the SEC sees as having contributed to the crisis by providing misleading information about mortgage-backed security risk.<sup>213</sup> In general, one of the new SEC rules requires that: (1) credit ratings agencies provide better information about the methods they use to rate securities; (2) they make available to investors a random sample of how they rated a particular issuer's securities; and (3) the agencies must provide the SEC with an annual report.<sup>214</sup>

While this is a good beginning, the SEC's focus on improving credit rating agencies as the major source of information for investors seems somewhat myopic. It is not readily apparent how the above-outlined requirements will reduce conflicts of interest for credit ratings agencies and how, in turn, the agencies will be able to provide more accurate and objective information about risk to investors. It seems, therefore, that although the SEC recognizes the need for better information, it is still looking to only one source for that information (the rating agencies), rather than making available other sources which are perhaps less susceptible to bias.

In terms of future regulatory development, the SEC will likely not limit its action to the previously-mentioned Rule. Moving forward, the Chairwoman of the SEC, Mary Shapiro, has signaled that the SEC's priorities will include further defining appropriate SEC oversight of credit rating agencies, instituting more flexible internal protocols for more efficient prosecution of securities fraud, and the regulation of credit default swaps.<sup>215</sup> These broad priorities suggest that perhaps the SEC will be open to exploring new,

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213. See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 17 C.F.R. pts. 240, 249(b) (2009). For a discussion of credit ratings agencies and their role in assessing mortgage-backed securities risk, see *supra* Part II.D.

214. 17 C.F.R. pts. 240, 249(b).

215. *Securities and Exchange Commission's Actions Relating to the Financial Crisis: Hearing Before H. Subcomm. on Financial Services and General Government of the H. Appropriations Comm.*, 111th Cong. 1-3 (2009) (testimony of Mary Schapiro, Chairman, U.S. Sec. & Exch. Comm'n) available at <http://www.sec.gov/news/testimony/2009/ts031109mls.htm>.

nontraditional informational conduits for the protection of investors especially in the mortgage-backed securities markets.

### C. Possible Alternatives

#### i) Public Benchmarks for Securities Prices

What, then, are possible alternatives to the status quo? How might we make information available to investors that is at once more objective and also more reliable than the information investors have received based on agency ratings of individual mortgage-backed securities? A possible option is to look for information from other sources in the market at large. What might one of these sources look like? In particular, what sources might there be which would give investors greater information on the risks inherent in mortgage-backed securities and thereby help them value the securities more accurately? There exist already, to be sure, certain sources of public information which the investing community can turn to for guidance.<sup>216</sup>

Benchmarks are set by daily reports of the price of mortgage-backed securities that investors can then use to price other issues.<sup>217</sup> While these are certainly helpful, they are generally available only for the more straightforward, uncomplicated types of mortgage-backed securities. The more complex ones—those sold by private label issuers and a large portion of which constituted subprime mortgages—are generally left out of these reports and their value therefore remains somewhat inscrutable.<sup>218</sup> This issue was elegantly illustrated at the end of last year, when commentators speculated as to how the U.S. government would value troubled assets (some of them mortgage-backed securities) that it proposed to buy from banks as part of its Troubled Asset Relief Program (TARP).<sup>219</sup> A further shortcoming of these benchmark reports is that they provide little background information on the securities before they are sold. Investors, therefore, may have a fairly good sense of what price range a particular mortgage-backed security might fall into, but they may still lack information about the individual securities themselves. What is needed, therefore, is an information mechanism which helps expose more details of the *particular transaction* that investors can then rely on to make reasoned and informed decisions regarding purchase. A potential way to do this would be to require that each

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216. John Waggoner & Matt Krantz, *Pricing Mortgage-Backed Securities Will Be Tough*, USA TODAY, Oct. 7, 2008.

217. *Id.*

218. *Id.*

219. *See id.* (referring to the Treasury's dilemma over how to value assets in the implicit context of TARP).



traditional securitization also contain an element of a synthetic securitization for the purpose of shedding more information on the specifics of the transaction. What, precisely, would this look like and how, specifically, would it serve the information function?

## ii) Combining Synthetic and Traditional Securitization

In a synthetic securitization, an institution owns a particular group of assets and then buys default protection from a third party in the form of a credit default swap (derivative).<sup>220</sup> In the course of buying the default protection, the institution holding the asset (protection buyer) and the party providing the protection (protection seller) typically enter into a derivative transaction through an intermediary such as a broker-dealer in a closed, over-the-counter market.<sup>221</sup> Entering into a default protection agreement requires both sides to negotiate the precise contours of the deal in order to determine (1) the risk of default for the underlying asset and (2) the amount that the protection buyer will pay on a regular basis to the protection seller for the risk of default that the seller is assuming. The point about this information is that it is valuable. The parties entering into a derivatives transaction have an incentive to discover as much information about the underlying asset in question as possible. It is based on this information that they either under- or over-price the protection that they are buying and selling. If this information can be harnessed and then used by other investors in the broader, traditional securitization, then the investors participating in that transaction would have an alternative source of information to rely on other than the credit ratings agencies. The information gleaned from parties engaged in the derivative transaction of the synthetic securitization would be arguably more objective and less prone to bias than the ratings that the agencies issue. The development of an exchange medium for credit default swaps would likely help facilitate this process by making the transaction even more transparent than it is now.<sup>222</sup>

How, practically speaking, could such an information-enhancing mechanism be joined together? In particular, how would investors in a traditional securitization transaction gain access to the information that emerged from the negotiations between the protection seller and the protection buyer in the derivative transaction of the synthetic securitization? The basic mechanics of this proposed arrangement

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220. See *supra* Part III.A (describing the securitization process).

221. See *supra* Part III.A.

222. For a discussion of a proposed Central Clearing Counterparty, see *supra* Part III.D.

are relatively straightforward and can be broken down into a few essential steps:

1. When an institution (such as an investment bank) receives mortgages from originators, the investment bank should set aside a certain percentage of the total pool size (perhaps two to three percent) that will be used for the synthetic securitization transaction. In other words, these mortgages will not be sold to investors; rather, they will remain on the balance sheet of the bank, but be protected by credit default swaps.
2. The information regarding the price of the credit default arrangements must be made public to investors who are considering participating in the traditional securitization transaction. This is the crucial part. By making the price and terms of the derivatives transaction available, future investors will have access to one more source of information regarding the risk of the mortgages. In theory, therefore, investors looking to enter into the traditional securitization transaction will have the benefit of information gleaned through the negotiations between the bank and the protection seller.

The rest of the mortgages that the investment bank receives from originators will be bundled and sold to investors, precisely as in a traditional securitization. The overall result, therefore, is that 97–98% of the mortgages received from the originator are bundled and sold as traditional mortgage-backed securities, whereas the remaining 2–3% remain on the balance sheet of the mortgage-backed securities issuer. Assuming that the process outlined above functions properly, investors wishing to buy mortgage-backed securities in a traditional offering will be able to rely on another source of information that they did not have before. Ideally, the information will not only be more readily available, but also more accurate and more indicative of the true value and risk of the underlying mortgages. In addition, there may be other useful byproducts of such a framework:

1. Banks would be forced to internalize—to some extent—the risk of some of these mortgages by holding them on their balance sheets. Although banks may purchase default protection for them, there still remains a risk that the protection seller will not fulfill its promise. As a result, highly risky investments may be shut out of the market because banks will be reluctant to keep such dangerous mortgages on their balance sheets as a result of the synthetic securitization component. Practically, therefore, the highest risk mortgage-backed securities may never make it into the hands of investors.

Even if banks are willing to buy the assets and hold them on their balance sheets, evidence of a lack of willingness on the part of protection sellers to enter into derivatives agreements with the banks will signal to investors that the mortgages are too risky. Although this is a relatively unlikely scenario since, given the right price, protection can almost always be found, it may nevertheless help investors identify certain rare instances in which unusually risky

mortgages are being bundled. There appear to be two basic approaches that firms could take with regard to implementation of the above-outlined strategy. First, firms could voluntarily choose to make synthetic securitizations a component of their traditional securitization transactions. Although this may sound unlikely at first blush, it would have certain merits for banks. Investors may very well prefer to buy mortgage-backed securities from a bank which makes available the price and terms of the credit default swaps that it has entered into in order to give potential investors more information. Alternatively, the above-outlined approach might be mandated by legislation or regulation. Given that the current climate favors greater regulation of asset-backed securities in general, it is likely that such a proposal would receive support from at least some quarters.

### iii) Shortcomings of This Approach

Concededly, the approach also has a number of drawbacks and reasons why it may fall short of what it is supposed to achieve. Most importantly, there is no guarantee that the information gleaned by investors from the price and terms of the credit default swap is itself accurate. The protection buyer and seller have information asymmetries that they themselves have to overcome but may not be able to overcome. Furthermore, the parties may not negotiate in good faith, as a result of which the price and terms of the default protection will inaccurately reflect the default risk that the underlying mortgages carry.

A further, though related, concern might be that despite the seemingly "objective" nature of the information that emerges from negotiations over buying and selling credit default swaps, this information will actually be anything but objective. Banks might, for instance, try to put pressure on the protection seller to accept a lower payment for default protection (and thereby indicate smaller risk). In return, the bank may compensate the protection seller in other ways, for instance, by reducing the cost of services that the bank provides for the protection seller in other areas. Since financial institutions of the size discussed here very often cross paths in various domains, such a conflict of interest is not only probable, but also fairly likely. A draconian and unrealistic response might be to limit the other activities that a bank and a protection seller can engage in while in an existing credit protection relationship. Such a proposal would likely place an undue damper on business and would be fairly unlikely to succeed.

Parties entering into a default protection arrangement may also object to the disclosure of the price and terms of their arrangement. They may see such a requirement as violating confidentiality and thereby hampering their ability to negotiate openly and with the

greatest amount of flexibility. Such a perception would have a negative impact on the securitization process in general, with parties being potentially less willing to enter into securities transactions altogether.

More generally, the current financial climate might make banks hostile to the idea of keeping a collection of mortgages on their balance sheets as synthetic securities for which they have to purchase credit default swaps. Essentially, it was this precise scenario that seems to have clogged banks with toxic assets in the first place, leading to the credit crunch and the resulting recession that the United States is currently experiencing. Requiring banks to do what now appears disastrous may well seem odd. A candid response to this objection should recognize that at present the derivatives markets are most likely not well enough developed to handle such a regulatory requirement. This is not to say, however, that derivatives markets in the future will lack robustness in the same way that they do today. On the contrary: as this paper has argued, derivatives markets are already in the process of reform and will likely emerge stronger than they were previously.<sup>223</sup> The successful implementation of the proposed policy may well be a question of “when” rather than “if.”

## V. IMPLEMENTING THE PROPOSAL UNDER THE U.S. SECURITIES LAWS

### A. *Regulation of Mortgage-Backed Securities Today*

In the United States, the SEC regulates the issuance of residential mortgage-backed securities through Regulation AB, which the SEC promulgated in 2005.<sup>224</sup> Like the securities laws in general, Regulation AB attempts to provide a framework for residential mortgage-backed security issuance that helps protect investors by mandating disclosure of important information by the issuer.<sup>225</sup> At the same time, however, Regulation AB also attempts to encourage capital formation by not requiring so much information from the issuer that the issuer will be discouraged from offering mortgage-backed securities.<sup>226</sup> Overall, Regulation AB represents a consolidation of rules and regulations of mortgage-backed securities issuance into one comprehensive framework.<sup>227</sup>

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223. See *supra* Part III.D.

224. Asset Backed Securities, 70 Fed. Reg. 1506 (Jan. 7, 2005) (to be codified at 17 C.F.R. pts. 210, 228, 229, 230, 232, 239–40, 242, 245, 249).

225. See, for example, the table of contents of Regulation AB describing the various disclosure requirements. *Id.* at 1506.

226. See *id.* at 1509 (detailing places in which the SEC has decided—for the sake of efficiency—that extensive disclosure is not warranted).

227. *Id.* at 1506.

Regulation AB applies, however, only to traditional mortgage-backed securities transactions. As stated explicitly by the Rules own terms, however, it does not apply to synthetic securitizations.<sup>228</sup> The SEC views synthetic securitization as being conceptually different from asset-backed securitization and therefore not within the purview of the Rule.<sup>229</sup> The primary reason for this is that the money generated in a synthetic securitization transaction does not come from the cash flow of a discrete pool of assets, but rather from the credit protection that counterparties sell to the issuer who keeps the assets on its balance sheet.<sup>230</sup>

### B. *Regulation of Mortgage-Backed Securities Going Forward*

The existence of Regulation AB suggests that requiring issuers to use synthetic securitization as part of their traditional securitization transactions to promote greater transparency might not be difficult to do. Indeed, given the comprehensive character that the SEC has given Regulation AB, it seems that this would be the most logical place to have such a requirement. Reading the text of Regulation AB, it becomes apparent that the SEC has—at least to some extent—considered and validated some elements of this Note’s proposal regarding the availability of a credit derivative agreement.<sup>231</sup> In the text of the Rule, the SEC states that “any derivative whose primary purpose is to provide credit enhancement related to pool assets or the asset-backed securities” must be disclosed, to the extent that it is material.<sup>232</sup> Additionally, Regulation AB provides that:

Disclosure of the material terms of the agreement to provide such enhancement or support is required, including any limits on the timing or amount of the enhancement or any conditions that must be met before the enhancement can be accessed. Provisions regarding substitution of enhancement also must be disclosed. The agreement relating to the material enhancement or support must be filed as an exhibit to the filing.<sup>233</sup>

These requirements are only one part of a broader effort by the SEC to make available to investors information connected to “enhancement and support,” which the SEC believes can be seen as an integral part of the asset-backed security itself.<sup>234</sup>

228. *Id.* at 1514.

229. *Id.*

230. Asset Backed Securities, 70 Fed. Reg. at 1514.

231. *See id.* at 1549 (stating that the final item will provide for disclosure of certain information).

232. *Id.*

233. *Id.* at 1548.

234. *Id.*

These disclosure requirements by the SEC suggest two important elements of the SEC's thinking in this field. First, requiring disclosure of the existence and terms of a credit default swap arrangement or other enhancement suggests that the SEC believes this information can be of value to an investor making a decision about purchasing mortgage-backed securities. Indeed, the major goal of the securities laws is to make reliable and material information available to investors so that they can make accurate judgments about where and how to invest their money.<sup>235</sup> Second, by stating that credit enhancements can properly be seen as constituting a part of the asset-backed security itself, the SEC seems to leave open the door to including other financial instruments in an asset-backed security. This latter point suggests that a traditional mortgage-backed security might well contain a synthetic securitization component without losing its general asset-backed security quality as understood by the SEC. Furthermore, it appears that most commentators who wrote to the SEC during the notice and comment process available for Regulation AB seemed to be in favor of the disclosure requirements for credit enhancement instruments.<sup>236</sup>

Given that the SEC requires disclosure of existing credit enhancement transactions under Regulation AB, implementing the recommendations as outlined in section IV of this Note should be seen as a logical next step, rather than a fundamental rethinking of how mortgage-backed securities issuance should be regulated. Fundamentally, this Note proposes that the SEC make mandatory something that it already recognizes the informational importance of when done voluntarily—entering into credit default swaps. How could the SEC do this? It could simply require synthetic securitization as an element in traditional mortgage-backed securitization. Requiring this will almost certainly push the issuer to enter into credit default swaps which will then be made public thanks to the disclosure requirements of Regulation AB. In addition, requiring synthetic securitization, by which issuers keep a portion of the assets on their own balance sheets, serves as an additional check on issuers by providing a disincentive to package loans that have very high risk. The current language of Regulation AB, mandating disclosure of credit enhancement agreements and seeing those agreements as an integral part of an asset-backed security, suggests that this Note's proposal would merely extend the Commission's current thinking, rather than break significant new ground.

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235. JAMES COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 1 (5th ed. 2006).

236. *Asset Backed Securities*, 70 Fed. Reg. at 1548.

## VI. CONCLUSION

Although not without flaws, this Note has tried to address the problem of potentially inaccurate information that investors face when considering whether to buy traditional mortgage-backed securities in U.S. markets. The Note has focused on the mechanics and dynamics of traditional securitization and identified conflicts of interest at credit rating agencies as one of the principal reasons for poor information. Compared with traditional securitization, however, synthetic securitization has an important component—credit default protection—that can potentially help investors gain more information about mortgages underlying securities as a useful byproduct of the negotiations that take place between the protection buyer and seller when trying to determine the price and terms of the default protection. As a solution to the identified problem, this Note has suggested combining the two methods of securitization. While not without shortcomings and risks, there is a strong likelihood that implementing such an approach would give investors more objective and hopefully more accurate information that they could then rely upon to make more informed investment decisions.

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