Abstract

Securitisation is an important financing technique. Following the financial crisis, reform activities in relation to pitfalls of securitisation have been underway. Particularly, a significant debate globally raged following the financial crisis about whether risk retention mechanisms before the crisis were effective. The idea is to align the incentives of originators/securitisers and investors in order to prevent the negative impact caused by the originate-to-distribute model. If the effective risk retention and due diligence goals are achieved, securitisation may continue to serve its benefits to investors and the full implementation of the reforms in the EU and the USA will act as deterrent and inject confidence in the markets.

Keywords: securitisation, risk retention, incentives, IOSCO, Credit Requirements Directive article 122a, SEC Act s.15G.

SECURITISATION, THE FINANCIAL CRISIS AND THE NEED FOR EFFECTIVE RISK RETENTION

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"...greed, for lack of a better word, is good."[♥]

1. Introduction

Securitisation is a product of market needs and commercial practice. It is an innovative financing technique which 'efficiently allocates risk with capital [and] enables companies to access to capital markets directly'.[1] By disintermediation, where banks as intermediaries of funds are removed from the financing cycle,[2] securitisation converts loans or assets that are not normally tradable (such as consumer receivables) into tradable securities which has the ability to raise finance faster than deposits can.[3] Thus the risk inherent in assets that are on loan is efficiently channelled to the financial markets. However, due to its complex and technical nature,[4] securitisation lacks transparency and so often its private law processes that shift the credit risk from originators to investors are misunderstood by the public. The

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♥ The fictional character Gordon Gekko's famous quote in the movie 'Wall Street' 1987.

1 S. Schwarcz, "The Future of Securitization" *Duke Public Law and Legal Theory Research Paper Series No. 223, November 2008,* at 1.

2 S. Schwarcz, (2009) 'Too Big to Fail?: Recasting the Financial Safety Net' *Duke Public Law and Legal Theory Research Paper Series No. 235,* at 2.

3 *See generally* F. J. Fabozzi, and V. Kothari, "Securitization: The Tool of Financial Transformation" *Yale ICF Working Paper No. 07-07*.

4 For the complex nature of the technique *see e.g.* J.C. Hull, *Fundamentals of Futures and Options Markets,* (Pearson, Boston, 7th ed., 2010), 189-202; H. Davies, *The Financial Crisis Who is to Blame?*, 138 *et seq.* (Polity Press, Cambridge, 2010). Long before the financial crisis Professor Roy Goode raised the particular issue of complexity of securitisation and other derivatives transactions and the danger of sliding into illegal areas in financial transactions noting succinctly that '[t]he increasingly abstract nature of markets, in which a variety of complex derivatives can be traded separately from the underlying physical transactions, raises in acute form the question how to distinguish trading and hedging from gambling and speculation.' R. Goode, *Commercial Law in the Next Millennium*, at 7 (Sweet and Maxwell, 1997).

complex nature of securitisation and other structured finance transactions need to be understood along with the fact that that their failure may lead to the Risk Originator's failure.[5] These technicalities have been coupled with risky business and lending decisions which leave narrow or no margin for errors in terms of financial crisis. Although, generally speaking, there seems to be a reckless attribution of liability that securitisation as a financing technique had played a significant role leading to the financial crisis,[6] the IMF Global Financial Stability Report[7] clearly established that

> 'securitization ...was not the problem-it was a combination of lax underwriting standards in the U.S. mortgage market, the concomitant extension of securitisation into increasingly complex and difficult to understand structures, collateralized by increasingly lower quality assets and a favourable financial environment in which risks were insufficiently appreciated.'[8]

Regulation of securitisation and other unregulated financial market products has become the pivotal point of discussion during the financial crisis. As securitisation is a product of financial markets and commercial practice there seems to be no clear statute or regulation that governs the interests, incentives and contractual positions of parties. Party autonomy seems to govern the market participants' financial interests.[9] This has been further encouraged by the deregulation of financial markets. Issues such as transparency (or the adequacy of transparency), investor sophistication and agency costs (whether the incentives of originators

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[5] S. Schwarcz, "The Public Responsibility of Structured Finance Lawyers" (2006) 1 *Capital Markets Law Journal* 6, 6

[6] *See e.g.* "*The Main point about black swans and credit crises"* Financial Times Letters, 17 May 2008 "… As George Soros put it: 'Securitisation had the effect of transferring risk from people who are supposed to know risk and know the borrowers to people who don't.'"; "*Life could yet follow death for the idea of Securitization*" Financial Times Comments, 03 October 2007.

[7] IMF Global Financial Stability Report Containing Systemic Risks and Restoring Financial Soundness (April 2008) ("IMF Report 2008").

[8] *Id.,* at xiii-xiv

[9] For a similar view *see* Goode, *supra* note 4, at 11 arguing that

> [t]he derivatives market has given rise to a wondrous array of contractual and securitisation devices which enable market participants to package financial assets, loans and investments in whatever way best suits their needs to secure such benefits as hedging, arbitrage, reduction of balance sheet assets and the minimisation of tax liabilities.

and investors are misaligned and whether originators should retain risk) are significant in the role that securitisation played during the period leading to financial crisis. However, the particular issue that poses as a pressure point among these, arguably, is whether and how the originators (or securitisers) should retain risk in the securitised receivables. It is believed that a substantive carve out based on the type of securitisation, assets and securities is helpful in aligning, at least to a certain degree, the interests of investors and originators. A number of reform activities have taken place globally and regionally to address the particular issue of risk retention by originators with the intention to align the interests of investors and originators and to make it difficult for originators to remove these securitised assets from their balance sheets. It is argued that these limitations on reckless practices securitisation will lead to more responsibility taking in underwriting, rating and due diligence.

In this article issues related to securitisation that led to loss of investor confidence in the financing technique will be subjected to greater scrutiny. The overarching theme of the article is that securitisation is important and that there is a need for stricter and meaningful regulation, particularly, in risk retention by originators for the purposes of aligning incentives with investors. Part 2 examines securitisation's pitfalls and impact on the financial crisis. Part 3 considers the need to have effective risk retention mechanisms. In this perspective, it looks at risk retention requirements in securitisation as designated under International Organisation of Securities Commissions (IOSCO) Recommendations, EU Capital Requirement Directive and the proposed reforms in the US (entering into force in April 2013). Looking ahead, it suggests that the reform activities in relation to originator's risk retention to align the incentives are, generally speaking, very detailed and take into account of some options in different types of securitisation scenarios. However, it is argued that the more significant amounts of risk is retained, more confidence will be established in the securitisation market. Conclusions will be in part 4.

2. Securitisation: An innocent financing technique?

Securitisation has been developed as an alternative method to raise finance to overcome the undercapitalisation risk of banks[10] which may expose banks to distress. Securitisation has

[10] *See* T. Congdon, *The Debt Threat The Dangers of High Real Interest Rates for the World Economy*, 198 (Blackwell, Oxford, 1988).

the ability, firstly, to increase bank liquidity by reducing bank's undercapitalisation risks and secondly, to spread their credit risk to financial markets to reduce their legal regulatory capital requirements.[11] In the US, from 1930s to 1970s as a result of Glass-Steagall Act commercial banks were tightly regulated and prohibited from speculating on their depositors' savings.[12] This Act effectively separated commercial banking from investment banking and established Federal Deposit Insurance Cooperation (FDIC).[13] Around the world, loans have been traditionally extended through deposits which are guaranteed by governments.[14] Particularly, in the late 1960s with the increased demand for mortgages, banks in the United States developed a model that enabled them to raise finance faster (without the need to limit their funding to deposits) and more balanced than other methods of raising finance according to which banks were pooling portfolios of mortgages the cash flows of which were then securitised and sold on to investors.[15] The significance in this type of raising finance is the United States Government's 'full faith and credit' through the Government National Mortgage Association (GNMA), in the sense that GNMA guarantees investors the payment of principal and interest on mortgages based securities that are insured by qualifying government departments.[16] 1970s and 1980s have seen increased public debt and rise of interest rates which led to the loss of investor and creditor confidence in the market. The complications caused by the increased dollar interest rates have had impact on sovereign

[11] *See generally* Y. Altunbas, L. Gambacorta, D. Marques, 'Securitisation and the Bank Lending Channel' *European Central Bank Working Paper Series* No. 838, at 5 (December 2007); *see also* A. Kokkinis, 'Rethinking Banking Prudential Regulation: Why Corporate Governance Rules Matter', *Journal of Business Law* 611, 622 [2012] noting that '[e]xtensive use of securitisation, …, was widely used before the recent financial crisis to circumvent capital adequacy ratios by removing assets from banks' balance sheets.'

[12] Banking Act of 1933 H.R. 5661. The preamble of the Act states: "An Act to provide for the safer and more effective use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations, and for other purposes."

[13] FDIC provides insurance on deposits and effectively protects depositors against bank runs.

[14] For a list and comparability of Deposit insurance/protection schemes *see* www.hmrc.gov.uk/drafts/schemes-comp-fscs.pdf (accessed 5.02.2012)

[15] *See generally* Hull, *supra* note 4, at 189 *et seq.*

[16] http://www.ginniemae.gov/about/about.asp?Section=About (accessed on 23.11. 2011). These include Federal Housing Association and Department of Veteran Affairs. Federal National Mortgage Association (Fannie Mae) established in 1938 and the Federal Home Loan Mortgage Corporation (Freddie Mac) established in 1968 (chartered by Congress in 1970) are other two government sponsored enterprises that securitize or buy mortgage loans originated by lenders. This provides liquidity to lenders so that they can lend more to their borrowers. http://www.fanniemae.com/portal/index.html and http://www.freddiemac.com/ (accessed 5.01.2012).

borrowers particularly in some of the developing Latin American countries where borrowers were mainly commodity producers.[17] This led to different securitisation techniques where securities were created backed by assets without the guarantee provided in mortgage backed securities. However, assets in the asset backed securitisations are different than the collaterals in mortgage based securitisations (*i.e.* immovables). The value of the latter may be volatile depending on the financial markets, political and economic climate. Thus there seems to be more certainty in asset backed securitisations than there is in mortgage backed securitisations. The ratings of mortgage backed securitisations have been based and rated on the similar formulas used in asset backed securitisations, hence the triple-A rating of majority of mortgage backed securities from subprime borrowers. Furthermore, the subprime loans which were converted into securitised bonds and incorporated with other asset backed bonds and were sold to investors who were not necessarily sophisticated enough to realise the risks passing through the financial markets.[18]

2.1 Securitisation's role in the Financial Crisis

The financial crisis takes its roots in the American subprime mortgage crisis. It has proved to have links to a number of interrelated financial, sociological and legal trends.[19] These trends can be summarised as the growth of wealth and its utilisation in investments whether or not in an effective way; the financial sector and individuals' ability to take risk; and deficiencies in the corporate governance and financial supervision.[20] Economists have explained growth and utilisation of wealth from left-wing[21] and conservative perspectives.[22]

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[17] *See* Congdon, *supra* note 10, at 195-198.

[18] *See generally* O. Bar-Gill, "The Law, Economics and Psychology of Subprime Mortgage Contracts" 94 *Cornell L. Rev.* 1073, 1082 *et seq.* (2009).

[19] For a perspective of the roots of the Financial Crisis and measures to limit its damage *see e.g.* F. S. Mishkin, 'Over the Cliff: From the Subprime to the Global Financial Crisis' 25 *J. Economic Perspectives* 49 (2011).

[20] T. Cowen, 'Three Trends and a Train Wreck' *N.Y. Times*, 17 October 2008, available at http://www.nytimes.com/2008/10/19/business/19view.html (accessed 10.11.2011). For the causes of credit boom *see also* A. Wilmarth, 'The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis' 41 *Conn. L. Rev.* 963, 1005 *et seq.* (2009) noting four factors for credit boom as Federal Reserve Board's monetary policies, role played by financial conglomerates, currency exchange rate policies of Asian and oil exporting countries and mass psychology and belief on the potential continuity of credit boom and prices.

[21] *see e.g.* 'Report of the Commission of Experts of the President of the United Nations General Assembly on

According to the former view while globalisation[23] was introduced to reduce the wealth inequality by stabilising financial markets and providing equal opportunities for both developed and developing economies in access to credit, it failed in this mission and caused domino effect in the collapse of economies and financial institutions.[24] Securitisation and other innovative financing techniques have been employed to counterbalance the economic problems affecting consumers and businesses.[25] Counter arguments challenged the income and wealth inequality and the effects of globalisation on the crisis.[26] There are also views about the role of securitisation in the financial crisis. One group of commentators argued that securitisation did not weaken underwriting standards as lending and borrowing decisions were based on FICO scores,[27] while the others suggested that it was the declining house prices that caused the sub-prime crisis and that the originators were retaining risk in the securitisation food chain.[28] The opposing view suggested that securitisation degraded traditional underwriting standards by allowing originate-to-distribute model and reducing the dynamic underwriting standards and replacing them with the statistical analysis and the ability to screen the loans, thereby creating a less transparent market. This, in turn, led banks

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Reforms of the International Monetary and Financial System', available at http://www.un.org/ga/president/63/commission/financial_commission.shtml (accessed 10.11.2011).

[22] *See e.g.* http://www.federalreserve.gov/newsevents/speech/bernanke20070206a.htm (accessed 10.11.2011); J. Parker and A. Vissing-Jorgensen, 'Who bears aggregate Fluctuations and How?' *NBER Working Paper* no. 14665 (2009).

[23] J. Stiglitz, *Globalization and its Discontents,* 9 (Penguin Books, London, 2002).

[24] *Supra* note 21, 14.

[25] *Supra* note 21, 26 where the report states that

> '[t]he negative impact of stagnant real incomes and rising income inequality on aggregate demand was largely offset by financial innovation in risk management and lax monetary policy that increased the ability of households to finance consumption by borrowing, especially in the United States and in some other developed countries such as the United Kingdom. …social protection systems that provided partial compensation for stagnating income in a context of high unemployment were financed through increased public deficits and public debts.'

[26] *See generally* Parker and Vissing-Jorgensen, *supra* note 22.

[27] *E.g.* G. Bhardwaj and R. Sengupta, '*Where's the Smoking Gun? A Study of underwriting standards for US Subprime Mortgages'* (Federal Reserve Bank of St. Louis Working Paper Series No. 2008-036A, 2008). Sub-prime borrowers are those who FICO (Fair Isaac Corporation) scores are below 620. *See* http://www.fico.com/en/Products/Scoring/Pages/FICO-Score.aspx (accessed 12.12.2011).

[28] *E.g.* G. Gorton, 'The Panic of 2007' *Federal Reserve Bank of Kansas City*, 2008, available at http://www.kc.frb.org/publicat/sympos/2008/Gorton.08.04.08.pdf (accessed 11.02.2012). A

to increase their leverage levels and thus thinly capitalised acting as the causal element in the financial crisis.[29]

In the early 2000s the US Federal Reserve reduced the interest rates to facilitate economic growth. Favourable economic conditions during that period, such as low interest rates and lending availability to sub-prime borrowers, led both borrowers and lenders to take more risky financial decisions. This, in turn, led banks to increase their securitisation and originate-to-distribute models which shifted the risk to investors (rather than requiring banks to hold their loans until maturity and concentrate the credit risk in the balance sheets) without the adequate transparency, risk retention or explanation of legal processes.[30] Arguably the rationale for lending subprime borrowers in the pre-crisis period was the appreciation of property prices which allowed more appetite to sell houses and the increased role of private sector in the securitisation process which demonstrated a shift from governmental agencies like Freddie Mac and Fannie Mae to investment banks during which the latter in exchange for higher yields securitised subprime mortgages.[31] This seems to be the root of misaligned incentives (originators are only interested in pooling the receivables and distributing them without retaining risks). Similar arguments equally apply in the UK market, where with the widespread use of securitisation and other unregulated financing techniques, low cost credit has been made available.[32] The G20 Declaration on the Summit of Financial Markets and the World Economy succinctly further identified the causes of the financial crisis as follows:

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[29] *E.g.* K. Eggert, 'The Great Collapse: How Securitization caused the Subprime Meltdown?'41 *Conn. L. Rev*. 1257 (2009); K. Eggert, 'Beyond "Skin in the Game": The Structural Flaws in Private-Label Mortgage Securitization That Caused the Mortgage Meltdown', *Testimony Before the Financial Crisis Inquiry Commission* (23 September 2010); *see also* L. Cox, B. Dorudi *et al.*, 'United KingdomRegulatory Reform: Emergence of the Twin Peaks' *Compliance Officer Bulletin* 1, 4-5 (2012). *See also* R. Tomasic and F. Akinbami, 'Towards a new corporate governance after the global financial crisis' *ICCLR* 237, 239-240 (2011).

[30] *See e.g.* Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, 1 (7 April 2008); *see also* A. Aurora, 'The Global Financial Crisis: A New Global Regulatory Order' *Journal of Business Law* 670, 672 [2010].

[31] B. Keys, T. Mukherjee, A. Seru and V. Vig, 'Did Securitization Lead to Lax Screening? Evidence from Subprime Loans' in R. Kolb (ed.) *Lessons from the Financial Crisis Causes, Consequences and our Economic Future*, 217, 218 (John Wiley & Sons, 2010). For a summary of the system *see e.g.* A. Paolini, 'Lending Sub-prime and advising on financial investments from a D & O Perspective' *Journal of Business Law* 432, 433-4 [2012].

[32] The Turner Review A Regulatory Response to the Global Banking Crisis (March 2009), 13-16 and 29-32 available at www.fsa.gov.uk/pubs/other/turner_review.pdf (accessed 20.01.2012)

> 'During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. …weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system.'[33]

During the pre-crisis period originators have excessively exposed themselves to securitisation practices which allowed them 'to off-load part of their credit exposure, thereby lowering regulatory pressures on capital requirements and raising new funds.'[34] Banks were transferring their loans from borrowers to special purpose vehicles and then to financial market investors under the 'originate-to-distribute' model. Thus banks that were excessively relying on securitisation had, seemingly, better capital structures.[35] This is achieved by way of transferring their credit risk to special purpose vehicles and then onto investors rather than being kept on the balance sheet until the borrowers' repayment. That means that securitisation 'removes the loans from the banks' balance sheets and enables the banks to expand their lending faster than they would otherwise be able to.'[36] Subprime borrowers may not have sophisticated financial information which exposes them to predatory lending.[37] It is this feature of securitisation arguably misled investors as well as borrowers. Rising house prices was the fundamental reason why banks lent to people with poor credit histories with the expectation that even if they defaulted in their payments it would be possible to sell these houses without banks having any actual losses. In other words, the idea was to sell and recover any monies before the maturity of these securities arising out of subprime mortgage

[33] *See* G20 Declaration on the Summit of Financial Markets and the World Economy, available at http://www.g20.org/images/stories/docs/eng/washington.pdf (accessed 7.11.2011), at 1. For similar points *see also* Eggert, *supra* note 29.

[34] *See* Y. Altunbas, S. Mangnelli and D. Marques-Ibanez, 'Bank Risk During the Financial Crisis Do Business Models Matter?' *European Central Bank Working Paper Series No 1394 November 2011*, 15; for a similar view *see* A. Van Rixtel and S. Craido, 'The Contribution of Structured Finance to the Financial Crisis' 239, 244, *in* Kold (ed.), *supra* note 31.

[35] *See id.*, Altunbas *et al.*, 15.

[36] Hull, *supra* note 4, 201.

[37] For contractual design features of subprime mortgage contracts and the effects of this on unsophisticated borrowers *see* Bar-Gill, *supra* note 18, 1096 *et seq.*

securitisations. Arguably these were high-risk loans because there was no guarantee whether subprime borrowers could be able to repay. These loans were gathered and sold to investment firms and SPVs. Rating agencies rather traditionally have given high ratings to mortgage backed securities because the default rate on those rates were traditionally lower than the asset backed securities. The underwriting standards in those types of assets were different than the normal securitisation practices. Despite the fact that securities were backed by subprime mortgages, they were continuously highly rated and the lack of liquidity in those highly rated securities due to defaults on the mortgage payments led to the collapse of securitisation market.[38]

It is also argued that the repeal of the Glass-Steagall Act of 1933[39] provisions by the Gramm-Leach-Blilley Act of 1999 thus the removal of the strict separation between investment and commercial banks has a clear significance in this process.[40] Glass-Steagall Act had prohibited the commercial banks to utilise their depositors' money to speculate in risky financial market transactions. Their main duty was to take deposits and lend to borrowers and thus, act as a financial intermediary. Arguably, merging the operations of investment and commercial banks, led to the undercapitalisation of banks as they had built up excessive leverage (*i.e.* they had more borrowed money from the markets in their balance sheets than their own money or deposits).[41] Furthermore, banks also relaxed their lending standards which led to the possibility of lending to uncreditworthy borrowers. Irresponsible

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[38] *See generally* J.J. De Vries Robbé, '*Securitization Law and Practice In the face of the Credit Crunch*' 7-8 (Alphen aan den Rijn: Kluwer, 2008); *see also* A. Sloan, 'House of Junk a close-up one deal shows how subprime mortgages went bad' October 29, 2007 *Fortune* 117-124.

[39] The Act also prohibited floating interest rates thus effectively capping the interest rates (Regulation Q). This was repealed early in the 1980s. For the implications of repealing Glass-Steagall Act and background and criticism of these legislative activities *see e.g.* J. Stiglitz, 'Capitalist Fools' *Vanity Fair*, January 2009

[40] For further information *see e.g.* F. Yeager, N. Seitz, *et al.*, 'US Legislation designed to improve corporate governance: An Exploration' *Company Lawyer* 25, 30-31 (2012); N. Seitz, J. Gilsinan, *et al.*, 'The US Subprime Mortgage Crisis: What have we learned?' *Company Lawyer* 355, 358 *et seq.* (2011).

[41] *See e.g.* Altunbas, Mangnelli and Marques-Ibanez, *supra* note 34, 34 where they state that

> '…the distress experienced during the financial crisis was driven by ex-ante bank size, undercapitalisation, and the degree of credit expansion in the years preceding it. The bank funding structure seems to be of significance, with those banks relying on large deposit base suffering less than those more dependent on market funding.'

As part of a regulatory approach to systemic risk *reducing leverage* can have the potential. For further information *see* S. Schwarcz, 'Systemic Risk' 97 *Georgetown L. J.* 193, 223 *et seq* (2008).

lending and further leveraging increased the risk levels of banks, because they have misaligned their incentives with investors. The liquidity squeeze became the significant problem for banks during the period leading up to financial crisis.[42] The trend of reckless risk taking continued by the deregulation of financial products which began by the enactment of Commodity Futures Modernization Act 2000 which declared regulation attempts of futures and derivatives as illegal (s.103), thus allowing risk increasing self-regulation.[43] With this amendment the Commodity Futures Trading Commission has been, somewhat, excluded from any regulatory attempts it may have over the credit default swaps[44] as the amendment allowed eligible parties to slip outside the net of Commodities Exchange Act (CEA). However, ironically, this was presented as 'Legal Certainty'.[45] The significance of this point

[42] *See* Davies, *supra* note 4, 50-53. It was argued that the liquidity squeeze was a result of neglect of liquidity regulation because central banks would help banks if there was need for liquidity and thus, in fact, putting the risk onto central banks.

[43] On self-regulation *see e.g.* J. Black, 'Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a 'Post-Regulatory' World' 54 *Current Legal Problems* 103 (2001).

[44] For the legal nature of credit default swaps *see e.g.* M. Smith, 'The Legal Nature of Credit Default Swaps' *LMCLQ* 386 (2010). A credit default swap (CDS) is an insurance contract which protects an investor who owns bonds of a company and purchases an insurance policy to protect it from the default of these bonds. They are useful products to manage credit risks that banks may experience. The risk of default is assumed by an insurance company. If the default occurs, the buyer of the insurance policy may sell the bonds issued by the company, at the amount that would have been payable if there was no default, to the seller of the insurance. The CDS are regulated through clearinghouses which require banks to deposit their trades as well as their future contracts but no further regulation in the sense that prevents systemic risks are in place. It has been argued that '[b]anks bought them to reduce the amount of capital they were required to hold against investments …[*i.e.*] to avoid regulation. Because they owned the swap, banks claimed they no longer had the risk of a default of the bond.' *See* E. Dinallo, 'We modernised ourselves into this ice age' *Financial Times* 30 March 2009. On CDSs *see e.g.* Hull, *supra* note 4, 497-507; E. Andrews, M. De la Merced and M. Walsh '*Fed's $85 Billion Loan Rescues Insurer*' NY Times 16 September 2008.

[45] S.103 Legal Certainty for Excluded Transactions. The CFMA also inserted a provision (s.118) in the CEA with the effect that the CEA will supersede and pre-empt any state law that prohibits or regulates 'bucket shops'. The term was defined in a number of early 20th century decisions most notably in *Gatewood v North Carolina* 27 S. Ct. 167, 168 (1906) as follows:

> 'an establishment, nominally for the transaction of a stock exchange business, or business of a similar character, but really for the registration of bets or wagers, usually for small amounts, on the rise or fall of the prices of stocks, grain, oil, etc., there being no transfer or delivery of the stock or commodities nominally dealt in.'

see also e.g. State v McGinnis 51 S.E. 50 N.C. 1905; *Board of Trade of Chicago v Odell Commission Co. (C.C.)*

is that without a meaningful regulation of innovative financial transactions, the market may grow unregulated to the detriment of the global economy.[46] It has been argued that deregulation has affected the banks' dependency on financial markets which may lead to loss of confidence and run on banks when market funding becomes sparse in which case those financial institutions that are funded mainly through deposits will be preferable. This is because deposits provide more predictable funding alternative and are guaranteed by governments as opposed to market funding from volatile and deregulated financial markets.[47] Recently proposals have been made to prohibit banks from certain types of risk taking activities. The most significant one is the Volcker Rule, which prohibits banks from entering into proprietary trading and acquiring an ownership interest in a hedge fund or private equity fund.[48] However, there are also other views that oppose Volcker rule and suggest that universal banking was not the main problem but rather it was the quality of securities issued by the banks during the period leading to the crisis.[49]

2.2 Pitfalls of Securitisation

The main pitfalls of securitisation are insufficiency of transparency and disclosure, difficulties in determining investor suitability in appreciating the risks and the inadequacy of risk retention by originators. Additionally, the financial crisis has justified the fact that investors have over relied on the credit agencies' ratings who applied the same criteria for

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115 Fed. 574; *Smith v Tel. Co.* 84 Ky. 664, 2 S.W. 483.

[46] For the background of the dispute and a criticism of non-regulation of complex financial derivatives *see e.g.* Davies, *supra* note 4, 71-75.

[47] On these points *see* Altunbas, Manganelli and Marques-Ibanez, *supra* note 34, at 15-16.

[48] For further information *see* Davies, *supra* note 4, at 80-81; D. Tarullo, 'The Volcker Rule' *Testimony By Mr. Daniel K. Tarullo before the subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, US House of Representatives, Washington DC, 18 January 2012.* The Conservative Party banking reform paper suggested similar solutions. *See generally* 'From Crisis to Confidence: Plan for Sound Banking' Policy White Paper (July 2009). In October 2009, the Bank of England Governor Mervyn King suggested restructuring of banks in addition to regulating them and discussed the impracticality of arguments against the separation of commercial and investment banks. *See* Speech by Mervyn King, Governor of the Bank of England to Scottish Business Organizations, Edinburgh (20 October 2009) available at www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf (accessed 10.11.2011).

[49] *See e.g.* http://www2.lse.ac.uk/fmg/events/conferences/2012/Basel_Conference/Eugeneper cent20White.pdf, at 11ff (accessed 5.4.2012).

rating asset backed securities to mortgage backed securitisations. Credit rating agencies provided AAA rating for most products even though they were from subprime borrowers.[50] Complex nature of financial markets and transactions arguably were created 'due to demand by investors for securities that meet their investment criteria and their appetite for ever higher yields.'[51] However, the significant risk that securitisation involved was the transfer of risk with little due diligence from the originator to investors as a result of which there was reduced incentives to screen the quality of loans securitised and failure to adequately retain the risk in those securitised loans.[52]

As securitisation has an extremely complex and technical structure and involves certain risks (such as interest rate and prepayment risks), it lacks the desired level of transparency according to which the quality of loans and the level of risks are determinable by investors. Professor Schwarcz argues that despite the disclosure of risks involved in mortgage backed securities, this has proved to be insufficient and the complex nature of securitisation as well as the length of documentation in the offering of these securities has had an impact on the insufficiency of information in this market.[53] Ideally, the information on the products should be openly available to investors. Investors rely on ratings by credit rating agencies and the agencies are paid by originators. Insufficiency of transparency has occurred in different levels and dimensions of securitisation which creates a conflict of interest. These include valuation, pricing and concentration of risk.[54] The complex nature of mortgage backed securitisation has led to the insufficiency of disclosure, as investors were not certain in relation to the value of the securities that they have invested on and exposed them to credit risk. This is also called as the 'concentration of risk' according to which lack of detailed reporting of exposures caused the market participants to be non-informed of the risks which then 'led to a reluctance to

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[50] T. Hurst. 'The Role of Credit Rating Agencies in the current worldwide financial crisis' 30 *Comp. Law.* 61 (2009).

[51] P. Green and J. Jennings-Mares, '*Demand that gave rise to complexity'* Financial Times 4 July 2008.

[52] *See* G. Caprio, Jr, A. Demirguc-Kunt, E. J. Kane, 'The 2007 Meltdown in Structured Securitization: Searching for Lessons not Scapegoats' *Policy Research Working Paper 4756* (September 2008), 15 *et seq.*

[53] S. Schwarcz, "Disclosure's Failure in the Subprime Mortgage Crisis" (2008) 3 *Utah L. Rev.* 1109, 1110; S. Schwarcz, 'Information Asymmetry and Information Failure: disclosure problems in complex financial markets' *in Corporate Governance and the Global Financial Crisis,* W. Sun, J. Stewart and D. Pollard (eds), 95, 98-99 (Cambridge University Press, 2011).

[54] W. Dudley, "Lessons learned from the Financial Crisis" (2009) *Remarks at the Eighth Annual BIS Conference*, 3.

engage with counterparties [and] pushed up spreads and reduced liquidity further.'[55] It has been argued that disclosure in complex securitisation transactions cannot be a decisive solution as 'complexity increases the amount of information that must be analysed in order to value the investment with a degree of certainty.'[56] Furthermore, it was also argued that in those complex transactions and structuring models investors who review those documents might not realise the legal consequences of the transactions.[57] In the absence of adequate transparency, investors have generally relied on the credit agencies' ratings in their investment decisions.[58] However, these ratings, which were generally and generously attributed to bonds at the highest possible value, did not consider the fact that receivables from subprime mortgages were incorporated to the receivables from asset securitisations, thus in the event of originator's bankruptcy created a package deal in which the toxic portfolios could not be separated from the non-toxic ones. Additionally, the IMF report has pointed out that the Off-Balance-Sheet entities (such as commercial paper conduits or special investment vehicles) have not been transparent to regulators.[59]

In relation to the transparency and disclosure arguments, the private law processes of securitisation may have a negative impact on third parties (*i.e.* unsecured creditors of the originator) by reducing the assets available to unsecured creditors. As unsecured creditors, unlike the secured creditors, will be subject to the *pari passu* principle according to which in the event of bankruptcy of the originator the distribution will be made on an equal footing, unsecured creditors' proportion of claims will be reduced. This is because the originator will transfer those assets and receivables that have the ability to attract higher rates to the SPV. The unsecured creditor may not have the monitoring ability, unlike secured creditors, to be able to assess the credit risk of the originator (debtor) even though they charge a higher interest rate[60] to compensate their monitoring costs. Thus the unsecured creditors will be left

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[55] Dudley, *id.*, 3.

[56] Schwarcz, *supra* note 53, 99.

[57] Schwarcz, *supra* note 53, 99.

[58] *See* H. McVea, 'Credit Rating Agencies, the Subprime Mortgage Debacle and Global Governance: The EU Strikes Back' 59 *ICLQ* 701, 706 *et seq.* (2010).

[59] IMF Report 2008, *supra* note 7, 69.

[60] On the efficiency of secured credit and monitoring issues *see e.g.* T.H. Jackson and A.T. Kronman, 'Secured Financing and Priorities Among Creditors' 88 *Yale L. J.* 1143 (1979); A. Schwartz, 'Security Interests and Bankruptcy Priorities: A Review of Current Theories' 10 *J. Legal Stud.* 1 (1981). For unsecured creditors'

with higher credit risk.[61]

Investors' sophistication or suitability is part of the problem. Investors expect a number of characteristics in securitised products. These include the strength of the origin of the securitised receivables (the larger the pool, the lower the risk of non-payment), the quality of assets and low credit risk (risk retention by the originator), the stability of the interest rates applicable to debtors of the underlying assets, credit enhancement by the originator where the originator creates distinct classes of securities with distinct risks and short maturity.[62] It was established that, in the pre-financial crisis period, investors were not scrutinizing the products they were purchasing, but rather trusting the seller or the originator.[63] The IMF Report in 2009 pointed out that issuers of securities 'relied on originator representations and warranties regarding the quality of the loans and the underwriting process that turned out to be inadequate [as occasionally] the originators lacked the capital and liquidity to make good on their warranties.'[64] Therefore, in order to have diligent loan underwriting and monitoring it is necessary to have a workable policy on risk retention.

3 Risk retention by originators and securitisers

Following the financial crisis, suggestions have been made to reduce the risks involved in securitisation. The most significant is the originators' credit risk retention requirement in the securitisation deal. Risk retention is 'the meaningful exposure to the credit risk of a securitization's underlying assets that cannot be removed, sold, or hedged for a specified

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carve-out proposals *see e.g.* E. Warren, 'Making Policy with Imperfect Information: The Article 9 Full Priority Debates' 82 *Cornell L. Rev*. 1373 (1997).

[61] L.R. Lupica, 'Asset Securitization: The Unsecured Creditor's Perspective' 76 *Tex. L. Rev.* 595, 627 *et seq.* (1998).

[62] S. Scott and P.A. Wellons *International Finance Transactions, Policy and Regulation,* 771-772 (New York: Foundation Press, 4th ed., 1997) noting that '[n]ot all assets have these features, … [and] [m]ortgages most readily fit the criteria.'

[63] *See* R. G. Rajan, 'The Past and Future of Commercial Banking viewed through an Incomplete Contract Lens'30 *Journal of Money, Credit & Banking* 524, 540 (1998) noting that the

> …reasons they can do so is that the greater integration of markets has increased the frequency of transactions any single player undertakes. Reputation not only becomes easier to build, but also more important to maintain as banks fund loans through their placing power rather than their balance sheets.

[64] IMF Global Financial Stability Report October 2009 ("IMF Report 2009"), 100.

period of time.'[65] Risk retention should be understood as to who should take responsibility of defaults and non-payment against investors. The main interest of an investor is to maximise its wealth and credit agencies' rating has played significant role in the purchase decision. Once the originator originates and distributes the receivables, it retains little interest in the quality of securitised receivables. As the originator's credit risk is effectively distributed to the financial markets, his incentive to monitor the quality of receivables or the creditworthiness of his borrowers reduces. Risk retention by the originator improves loan quality by having better underwriting standards, provides by diligent origination and 'reduces risks to financial stability arising from incentive and informational asymmetries between the investor and earlier securitization chain participants.'[66] This process is often known as the 'skin in the game'.

Risk retention prevents originators to originate and distribute high risk and poor quality loans under the securitisation method without retaining economic risk until the relevant securitisation is concluded.[67] The ability to raise finance in securitisation, like in factoring,[68] depends on the quality of the assets rather than the creditworthiness of the originator. Credit risk retention thus has more relevance at the origination. If the originator's loan is good risk retention will provide an additional security for investors. The loss of investors' confidence during the pre-financial crisis period has been attributed to the peculiar link between securitisation and incentives. There was competition among loan originators and securitisers in subprime lending practices and their securitisations.[69] Originators transferred their credit

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[65] 'Macroeconomic Effects of Risk Retention Requirements' Timothy F. Geithner, Chairman, Financial Stability Oversight Council, 18 January 2011, at 16.

[66] *Id.*, 16.

[67] For an analysis of market collapse, causes and recommendations *see* 'Wall Street and the Financial Crisis: Anatomy of a Financial Collapse' *Majority and Minority Staff Report United States Senate Permanent Subcommittee on Investigations Committee on Homeland Security and Governmental Affairs*, (13 April 2011), at 158-159.

[68] *See* L. Klapper, 'The Role of Factoring for Financing Small and Medium Enterprises' *World Bank Policy Research Working Paper 3593* (2005).

[69] As early as 2001, FDIC released extended guidance in relation to subprime lending practices and indicated a non-exhaustive list of credit risk characteristics posed by subprime borrowers. These include two or more 30-day delinquencies in the last 12 months, judgment, foreclosure or repossession in the last 24 months, bankruptcy in the last 5 years, relatively high default probability evidenced by credit history score and imbalanced debt service-to-income ratio. Available at http://www.fdic.gov/news/news/press/2001/pr0901a.html (accessed

risks without appropriately screening the quality of the loans. As securitisation food chain became more complex[70] the link between originators and investors became too weak or too remote which had negative impact on 'incentives for proper screening and due diligence along the chain ... [which could] contribute to a lowering of lending standards and a gradual deterioration in the credit quality of assets included in the collateral pools of securitised instruments.'[71] However, during that period originators lose the interest to protect the integrity of the overall financial market and rather protect their economic interest, creating misaligned incentives.

The originator essentially prefers to hold the assets off the balance sheet (or isolate their credit risk by assigning their assets) in order to reduce its vulnerabilities that may be created by the difference between capital requirements and trading books. When the difference between capital requirements and trading books is high, that will be the sign of inadequate capital. Thus in order to avoid capital charges which may be imposed upon banks due to inadequate capital levels, banks sell these book debts (keep them off their balance sheet) in the form of true sale to SPVs.[72] However, Turner Review observed that

> '[a]t the individual bank level, the classification of these as off-balance sheet proved inaccurate as a reflection of the true economic risk, with liquidity provision commitments and reputational concerns requiring many banks to take the assets back on balance sheet as the crisis grew, driving a significant one-off increase in measured leverage.'[73]

11.12.2011). For an interesting discussion *see* Bar-Gill, *supra* note 37, 1087 *et seq.*

[70] *E.g.* in order to make mezzanine tranches (which are rather difficult to be marketed compared to equity and senior tranches) more marketable, financiers repackaged mezzanine tranches, and risks associated with them have been re-securitised in order to receive higher yields. These are called asset backed securities collateralised debt obligations (ABS CDOs). Arguably these types of risk structuring made securitisations more complex. For further information *see e.g.* Hull, *supra* note 4, 192 *et seq.*

[71] *See e.g.* I. Fender and J. Mitchell, 'Incentives and Tranche Retention in Securitisation: A Screening Model' *BIS Working Paper* No. 289, 2 (September 2009). *See also* R.G. Rajan, 'Has Financial Development made the World riskier?' *NBER Working Paper Series* Working Paper 11728 (Washington DC, 2005) where it is argued that market-friendly regulation to reduce incentives in order to prevent excessive risk taking is necessary.

[72] Davies, *supra* note 4, at 47-8.

[73] *See supra* note 32, 20.

On the other hand, investors prefer to increase their profit either through short term investment products (commercial paper)[74] or bonds that are products of securitisation. Studies have established that during the period leading up to the financial crisis 'there may have been insufficient 'skin in the game' for some lenders.'[75] That is as originators distributed their credit risk through securitisation they did not have the incentive to monitor the quality of the receivables or the creditworthiness of the borrowers. Some economists[76] seem to blame securitisation itself without looking at the human input or errors in the process,[77] while others acknowledged the significance of securitisation and pointed out the importance of risk retention to reduce financial risk and that before the financial crisis in a securitisation transaction the originator did not have any responsibility, this reduced the incentives to screen the creditworthiness of borrowers thus led to irresponsible lending practices.[78]

There are compelling reasons why originators should be strictly required to retain credit risk in the securitisation chain. Firstly, it is a quality control mechanism that originators will keep in mind that their products have the necessary quality that match the stated value claimed by the originators and do not contain any toxic assets.[79] This may also serve as an

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[74] Commercial paper is a short term mechanism that provides funding to banks. Banks sell commercial paper with short maturities to investors (who are, in a sense, lenders to banks), and banks provide investors with guarantees that they will be paid by the maturity date.

[75] B. Keys, T. Mukherjee, A. Seru and V. Vig, 'Did Securitization Lead to Lax Screening? Evidence from Subprime Loans' 125 *The Quarterly Journal of Economics* 307, 355 (2010).

[76] *see e.g.* J. Stiglitz, *'Houses of Cards'* Guardian 9 October 2007 noting that '…securitisation contributed to bad lending: in the old days, banks that originated bad loans bore the consequences; in the new world of securitisation, the originators could pass the loans onto others…' While one agrees with the criticism against the banks' irresponsible lending practices, securitisation as a financing technique has no contribution because the above criticism involves human input/greed in the problems investors facing with.

[77] For human greed or input *see e.g.* R. Lastra and G. Wood, 'Responses to the Financial Crisis' JIBLR 307, 308 (2011). For earlier indications of corporate greed *see* T. Frankel, '*Trust and Honesty America's Business Culture at a Crossroad'* 92 *et seq.* (OUP, 2006).

[78] *See e.g.* A. S. Blinder, 'Six Fingers of Blame in the Mortgage Mess' 30 September 2007 *NY Times* where it is pointed that

> [securitization] has lubricated the market and made mortgages more affordable. We certainly don't want to end it. But securitization sharply reduces the originator's incentive to scrutinize the creditworthiness of borrowers. After all, if the loan goes sour, someone else will be holding the bag. We need to find ways to restore that incentive, perhaps by requiring loan originators to retain a share of each mortgage.

[79] For a similar view *see e.g.* D.L. Batty, 'Dodd-Frank's Requirement of "Skin in the game" for Asset-Backed

approval for credit enhancement where the stronger risk retention demonstrates the strength of the underlying assets. However, the significant problem which originators may wish to prevent is that as securitisation requires a true sale nature of transfer from the originator to the SPV, in the case of bankruptcy of the originator or where the balance sheet shows certain high percentage of retained securitised assets, this may be considered as charge disguised as sale. The main problem is that the retained amount may not be high enough to provide relief for investors. From another point, although banks transfer loans and risks from their balance sheets thus increase their capital ratios against trade books for capital adequacy purposes,[80] these transactions for accountancy reasons, however, may be required to be kept in the balance sheet to demonstrate the true nature of the transfer.[81] Nevertheless, it is important to retain acceptable levels of risk in the products to demonstrate the strength of and confidence to the products sold to investors. Secondly, risk retention may lead to responsible lending in the sense that the originators will employ the same moral values (*i.e.* investment and expansion of business within the limits of the rule of law and ethical values) as investors do. In other words, if the originators retain risk in the tranches sold to investors 'this encourages them to make the same lending decisions that the investors would make.'[82] Arguably, this approach also has the potential to prevent gambling and or the so-called 'casino banking'.

Securities may scalp Corporate Loan Liquidity' 15 *N.C. Banking Inst.* 13, 41 (2011) noting that '[risk retention] requirements are based on the idea that the "securitizer" is selling assets that it would never buy itself to a market that lacks the securitizer's knowledge about the quality of the underlying asset backing the security.'

[80] Lenders need to hold total Basel Capital Adequacy Ratio capital of 8per cent of risk-weighted assets and Tier 1 [equity capital and disclosed reserves] capital of 4 per cent of risk-weighted assets *see* IMF Report 2009, *supra* note 64, 12. Under Basel III requirements banks have to establish 7 per cent ratio of core capital (Tier 1) to risk weighted assets (and not the total assets thus safe securities are not considered as assets) by 2019. Currently this ratio is 4 per cent. *See also* V.V. Acharya and M. Richardson, 'Causes of the Financial Crisis' 21 *Critical Review* 195 (2009); Rajan, *supra* note 63, at 541 noting that

> [a] bank that wants to profitably lend to high-quality credits has to either bolster its capital so that its own credit quality improves, or find a convincing way to commit to the market that it will keep only high-quality loans on its balance sheet. ... Rather than lending to a firm and keeping the loan at high cost on its balance sheet, it makes sense for the bank to lend only on a contingent basis-when all other sources of funds dry up and the firm is a high risk.

[81] Financial Reporting Standard 5 (FRS5) Reporting the Substance of Transactions requires that

> 'the substance of an entity's transactions is reported in its financial statements. This requires that the commercial effect of a transaction and any resulting assets, liabilities, gains and losses are shown and that the accounts do not merely report the legal form of a transaction.'

Available at http://www.frc.org.uk/asb/technical/standards/pub0100.html (accessed 10.01.2012)

[82] Hull, *supra* note 4, 198.

Thirdly, risk retention may also lead to the point where originators become the 'administrators of the mortgages (collecting interests, making foreclosure decisions etc.) … [and that] their decisions as administrators are in the best interests of investors.'[83] The position of secured creditor and the debtor may be used as a metaphor to illustrate the administration argument. The power granted to the secured creditor by the security interest over the collateral grants the secured creditor the ability to control the business decisions of the debtor. The debtor has the obligation to protect the value of the assets during the time when there is a security over the assets and should refrain from entering into wealth reducing transactions.[84] Thus, retaining risk and becoming administrators of the mortgages may lead originators to take prudent business decisions for the best interests of investors that will prevent wealth reduction. Similar arguments have been made that originators in complex securitisation deals may be required to retain risk by retaining for example the equity tranche (which is the lowest ranked tranche of securities and retained in non-mortgage securitisations).[85] In relation to the final point, although originators had retained some risk in the equity tranche before the financial crisis period,[86] the insignificance of holding equity tranche compared to mezzanine and senior tranches make these earlier examples of risk retention somewhat symbolic. This is because equity tranches are unrated tranches which absorb losses when the portfolio of receivables they belong to underperforms. Thus, returns that may be expected from equity tranche are not guaranteed.[87] Furthermore, as the originators used to sell or hedge the risk in equity tranches, risk retention in equity tranches did not provide effective alignment of incentives.[88] For successful risk retention in equity

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[83] Hull, *supra* note 4, 198.

[84] On the nature of security affording control and expansion of business *see e.g.* A. Schwartz, 'Priority Contracts and Priority in Bankruptcy' 82 *Cornell L. Rev.* 1396 (1997); R.J. Mann, 'Explaining the Pattern of Secured Credit' 110 *Harvard L. Rev.* 625, 683 (1997); G. Triantis, 'Secured Debt Under Conditions of Imperfect Information' 21 *J. Legal Studies* 225 (1992); J. Armour, 'The Law and Economics Debate About Secured Lending: Lessons For European Lawmaking?' in H. Eidenmüller and E.M. Kieninger (eds) *The Future of Secured Credit in Europe* E.C.F.L.R, (Munich: De Gruyter Recht, 2008) 3, 8.

[85] Schwarcz, *supra* note 53, 104.

[86] I. Fender and J. Mitchell, 'The Future of Securitisation: How to align incentives?' *BIS Quarterly Review,* 27, 36 (September 2009).

[87] S.L. Schwarcz, 'Private Ordering of Public Markets: The Rating Agency Paradox' University of Illinois Law Review 1, 6 (2002) arguing that equity securities 'have neither a specified maturity date nor a contractually fixed principal amount.'

[88] Fender and Mitchell, *supra* note 86, at 36-37.

tranche it is necessary to have high quality loans (*i.e.* loans lent to creditworthy borrowers) and positive economic conditions.[89] In the absence of these factors originators have less desire to monitor the loans provided to borrowers. Equity tranches used to be purchased by hedge funds and securitisers of collateral debt obligations which reduced the significance of risk retention by originators.[90] Arguably originators may hold mezzanine tranche and in the event of its exhaustion, vertical risk retention method where the originator retains a certain percentage in each tranche, may be employed.[91] The significance of vertical risk retention is that financial institutions do not need to have high capital requirement, as may be the case under horizontal retention, but hold certain levels of capital for each tranche without the ability to consolidate the securitisation. Whereas under horizontal retention they have to hold higher rate of capital and consolidate the securitisation transactions. Senior and mezzanine tranches provide substantive compensation to originators. This situation is explained in the House of Commons Financial Stability and Transparency Report as follows:

> ...the least risky, or 'senior', tranche has the first claim on payments from the pooled mortgages. The 'senior' tranche has the highest credit rating, often triple–A investment grade, but receives a lower rate of interest than the other tranches. After the senior claims are paid, the middle or mezzanine tranche receives its payments. Mezzanine represents greater risk and usually receives below-investment grade credit ratings and a higher rate of return. The lowest, or equity, tranche receives payments only if the senior and mezzanine tranches are paid in full. The equity/first-loss tranche absorbs initial losses. Equity tranches are therefore the most risky tranche and consequently often unrated, but as a consequence offer the highest rate of return. This process, whereby losses are applied to more 'junior' tranches before they are applied to more 'senior' tranches, is known as subordination and is one, albeit important, form of credit enhancement.[92]

Amendments to the current incentivisation system have been proposed by the IOSCO, the EU and the USA. These include retaining credit risk in the equity tranche, a vertical risk retention structure in all tranches or a percentage share. In the early stages of the financial

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[89] IMF Report 2009, *supra* note 64, 101.

[90] Eggert, *supra* note 29, 1292-93.

[91] *See generally* Fender and Mitchell, *supra* note 71.

[92] House of Commons, Financial Stability and Transparency (Sixth Report) HC 371 2007-2008, para. 60.

crisis the amendments to the current incentivisation scheme in the EU and the USA were criticised by being unsophisticated or too flexible that the choice of amount and form have been left to the originator which might not lead to best results.[93]

3.1 Reform efforts on unregulated financial markets and products by IOSCO

IOSCO Task Force on Unregulated Financial Markets and Products ('Task Force') was set up in response to the reform and as part of the medium term action for enhancing sound regulation which required the 'review of the scope of financial regulation, with special emphasis on institutions, instruments, and markets that are currently unregulated, along with ensuring that all systemically-important institutions are appropriately regulated.'[94] The action plan was set by the Group of Twenty (G20) during its meeting[95] in Washington, DC on 15 November 2008. The Action Plan to Implement Principles for Reform[96] set out a comprehensive road map for the implementation of principles for reform in financial markets. These principles include strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets, reinforcing international cooperation, and reforming international financial institutions. In September 2009, the Task Force issued final regulatory report on transparency and oversight in unregulated markets and products with particular emphasis on securitisation and credit default swaps.[97] The essence of recommendations articulated in the Final Report is, mainly, to improve investor confidence in the post-financial crisis period by introducing greater transparency in securitisation transactions and similar unregulated financial market products. The Task Force focused on mainly, among others, securitisation due to its significant contribution to credit availability, systemic risk and restoration of international capital flow as well as its role in the global financial crisis.[98] The review for implementation of securitisation recommendations was published in March 2011 where it was established that most measures articulated in the recommendations would be implemented. These recommendations articulate the introduction

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[93] *E.g.* Fender and Mitchell, *supra* note 71, 32.

[94] G20 Declaration on the Summit of Financial Markets and the World Economy, available at http://www.g20.org/images/stories/docs/eng/washington.pdf (accessed 7.11.2011) at 2.

[95] *See id.*

[96] *See id,* 6 *et seq.*

[97] 'Unregulated Financial Markets and Products–Final Report', *Technical Committee of the International Organization of Securities Commissions* (September 2009).

[98] *Id.*, 5 and 13, paras 15 and 38.

of greater transparency through regulatory actions to assist financial market regulators and financial services authorities thereby aim to improve investor confidence in post-financial crisis period. Recommendations include requirement of originators to retain long term economic exposure to the securitisation to balance the interests of originators and investors; enhanced transparency through disclosure by issuers; independence of service providers from issuers in order to ensure that service providers do not influence an investor's decision to purchase securitised products; updating investors about initial and ongoing information on underlying asset pool performance and strengthening investor suitability. Recommendation 1.1 states 'originators and/or sponsors to retain a long-term economic exposure to the securitisation in order to … align interests in the securitisation value chain.'[99] This is supported by three principles which establish that any retention requirement must be considered taking into account of the impact of the reform in domestic securitisation markets that this implementation needs to regard the quality of the underlying collateral backing the securities and that it should consider the legal processes of securitisation in the relevant jurisdiction. The Implementation Report pointed out that there was no clarity with regards to the form of risk retention (*i.e.* whether a fixed percentage or a risk-based approach for risky assets).[100]

3.2 Reforms on risk retention in the EU

The amendments in the EU to the Credit Requirements Directive (CRD)[101] introduced a minimum 5 per cent originator risk retention requirement (article 122a) to align the interests of originators and investors.[102] Article 122a stipulates credit institutions in the EU to act with due diligence in their investment decisions in securitisations only where originators have the acted with diligent underwriting.[103] The article requires investors to conduct due diligence,

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[99] 'Task Force on Unregulated Financial Markets and Products Implementation Report', *Technical Committee of the International Organization of Securities Commissions* (March 2011), 7.

[100] *See id.,* 7-8.

[101] Art. 122a Directive 2006/48/EC.

[102] For a criticism of the fixed percentage approach *see e.g.* H. Scott, *International Finance: Transactions, Policy and Regulation*, 240 *et seq.* (Foundation Press, 16th ed., 2009) arguing that 'the fixed percentage approach applicable to all or a broad range of securitisation transactions ...cannot adequately account for the distinct nature of securitisation markets...'

[103] Report from the Commission to the Council and the European Parliament 'Expected impact of article 122a of Directive 2006/48/EC (COM (2010)262 final (28.5.2010)), 2.

originators to disclose the relevant information to investors for the purposes of due diligence and issuers and originators to retain the credit risk. The significance of the minimum level of risk retention (5 per cent), which may be higher depending on the risks associated with underlying assets and transparency level, rather than a specific form is that misalignment of incentives differ in different securitisations and that the crucial point is the ability of the investor to appreciate the risk in that securitisation.[104] The EU impact report noted that

> a regulatory minimum retention level appears very relevant as a regulatory backstop mechanism to improve market resilience in time when bubbles build up [and] such regulatory backstop should not be set too high. For relatively transparent securitisations where the information disadvantage of investors is small, the moderate 5% minimum may actually constitute the adequate level….a higher than necessary retention requirement could potentially imply that certain non-bank issuers would find securitisations not an attractive business model anymore, meaning that they leave the markets and thereby reduce competition among lenders.[105]

The amendment to the CRD highlights problems with weak underwriting standards caused by the originate-to-distribute model which does not allow credit risk retention. Article 122a requires that for exposure to the credit risk the originator must disclose explicitly to the credit institution that it will retain net economic interest of which cannot be less than 5 per cent. The amendment requires originators to disclose the level of retention and ensure that investors have the necessary access to the relevant data and employ the same standard to the loans securitised and exposures on their trading books. These amendments aim to strengthen the quality of origination and disclosure. The disclosure requirements of originators, in addition to risk retention requirements as specified above, require them to disclose the amount and details of the retained exposures. This will establish flexibility and investors are able to determine the size and form of risk retention by originators. Accordingly, a credit institution when investing in securitisation as a securitiser is required to get confirmation from the originator, sponsor or the original lender that minimum 5 per cent risk has been retained. The credit institution, as a securitiser, is also required to provide the relevant information, while investing in securitisation, to the regulators that it has thorough understanding of the risks and securitisation positions, thus it has complied with the due diligence requirements. If the credit

[104] *Id.*, 5-6.

[105] *Id.*, 6.

institution is acting as sponsor or originator, it has to apply the same credit criteria to exposure to be securitised as they apply to exposures to be held in their book. Along the same lines, the credit institution as sponsor or originator has to disclose to investors the level of its retention commitment to maintain a net economic interest in the securitisation, thus, will fulfil the disclosure requirement.

The retention of net economic interest, providing different options, has been defined under article 122a(1) as vertical slice retention (retaining risk in each of the tranches until loans have been paid); securitisation of revolving exposures[106] where originator's interest of no less than 5 per cent retained; retention of randomly selected exposures (this corresponds to the US Securities Exchange Act equivalent of equivalent exposures) and horizontal retention of first loss (equity) tranche or other similar tranches with similar severe risk profiles.[107] The latter two options, particularly, have been criticised on the basis that they require the retention on the basis of nominal value rather than risk weighted exposure.[108] It is clear that equity tranche draws more risk weight than the mezzanine tranche and requiring a higher percentage of risk retention based on risk weighted exposures rather than nominal values would have been better.[109] This would also have aligned the amendments with the Basel II requirements terminology which uses the term 'risk weight'. The amendment, by having various options, takes into account of different types of securitisation transactions and thus effectuates the significance of risk retention by originators. Article 122a will affect any EU credit institution that has securitised products in its banking or trading books and has long arm applicability in that it applies to non-EU institutions selling securitisation tranches to EU credit institutions. An originator or a sponsor cannot hedge the retained economic interest[110] but may enter into

[106] Securitisation of revolving exposures is the securitisation of receivables where investors agree to purchase receivables payable to the originator (e.g. credit card receivables, or trade receivables) in the future through a forward agreement and the yields previously collected are distributed to the investors after end of the revolving period. This is a valuable method of securitising non-liquid receivables, as without this method, pool will mature before the investors able to purchase.

[107] Art. 122a (1)

[108] *E.g.* K. Hawken and M. Baker, 'Welcome Flexibility' *IFLR* 43 (June 2009).

[109] *See also* IMF Report 2009, *supra* note 64, 105.

[110] Art. 122a(1) where it is stated that the sponsor's, originator's or original lender's retained economic interest 'shall not be subject to any credit risk mitigation or any short positions or any other hedge.' *But cf.* Under the Securities Exchange Act 15G the originator may hedge against its share of the credit risk. *See infra* note 121 and the accompanying note.

risk management hedging and keep themselves exposed to credit risk. Article 122a aims

> to disallow hedging that eliminates a sponsor's, originator's or original lender's exposure to the credit quality of the specific exposures that have been securitised and to seek to balance this objective with another, of ensuring that sponsors, originators and original lenders still have sufficient flexibility to risk-manage their exposure to broader changes in the credit quality of the asset classes, collateral, or macroeconomic variables to which they are exposed via their lending activities, securitisation activities, or otherwise.[111]

Therefore, article 122a does not allow the originator, sponsor or original lender to purchase credit default swaps (insurance) to protect themselves from this credit risk when they retain credit risk under vertical slice risk retention, revolving exposures risk retention and horizontal (first loss) risk retention, and when credit risk retained under randomly selected exposures originator, sponsor or original lender are not allowed to hedge the credit risk. It is believed that this is a significantly effective method to prevent overriding of the effectiveness of credit risk retention arrangements.

Article 122a contains certain exemptions[112] according to which the retention requirement will not apply where the claims have been guaranteed by governments, central banks, institutions with a risk weight of 50 per cent, multilateral development banks (as these are deemed as low risk)[113] and where the transactions have been based on transparent index and to syndicated loans, CDS and purchased receivables (as these do not constitute securitisation). It is arguable that the exemption of governmental or other claims should not have been included in the legislative text. Because in the absence of clear evidence in terms of the quality of rating agencies' ratings of these claims and the recent sovereign debt crisis have shown that even though a claim is guaranteed by a government or other entity, it may still be considered as credit risk. However, the Committee of European Banking Supervisors (CEBS)[114] considers these exemptions not to be a circumvention of risk retention

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[111] Guidelines to Article 122a of the Capital Requirements Directive, Para. 39 (31 December 2010).

[112] Art. 122a(3)

[113] *Supra* note 103, 8.

[114] http://www.c-ebs.org/documents/Publications/Advice/2009/article-122a/Advice.aspx (accessed 27.3.2012).

requirements in the CRD.[115]

3.3 Reforms on risk retention in the USA

Similar amendments are in the process of being made to the Securities Exchange Act of 1934 ('SEA') in the USA as part of Dodd-Frank Wall Street Reform and Consumer Protection Act section 941(b) which added section 15G to the SEA. The proposed reform in the USA will enter into force in April 2013. A report prepared in January 2011,[116] under section 946 of the Dodd-Frank Act, discussed a number of factors need to be considered as part of the reform in risk retention. The paper concluded that securitisation was an important source of raising finance and within the securitisation food chain it was important to retain risks by originators or securitisers in order to have ongoing exposure and that risk retention could lead to better lending decisions.[117] The Report further suggested a number of objectives that should be incorporated into a risk retention framework which include aligning incentives without distorting the basic structure of securitisation, promotion of greater certainty, efficiency of capital allocation, flexibility in the framework and encompassing broad range of participants in the lending activities. As to the form of risk retention the report noted three options as 5 per cent vertical risk retention, 5 per cent equity tranche retention (horizontal first loss) and 5 per cent retention (equivalent exposures) of 'representative sample of all the assets that are transferred to the issuing entity'.[118]

The rule, provided by section 941b, in SEA 15G[119] requires that minimum 5 per cent credit risk will be retained by the securitiser for any asset that is not a qualified residential mortgage that is sold through the issuance of an asset-backed security or that is a qualified residential mortgage that is sold through the issuance of asset-backed security if one or more of the

[115] *Supra* note 103, 8-9.

[116] *Supra* note 65.

[117] *Supra* note 65, at 30.

[118] *Supra* note 65, at 20-21. However, the risk retention requirement under Dodd-Frank Act has been criticised as an attempt to prevent further financial crisis with unintended consequences on syndicated loans where administrative agents of those loans may be treated as originators and come under the scope of the Act's risk retention requirement. For those criticisms *see e.g.* C. Vitello, 'The Wall Street Reform Act of 2010 and what it means for Joe & Jane Consumer' 23 *Loy. Consumer L. Rev.* 99 (2010); Batty, *supra* note 79, 18 *et seq.*; S. Vydyula, 'Raising the Blinds: Effects of the Dodd-Frank Act's Risk Retention Requirement on International Firms seeking Financing through U.S. Markets' 10 *J. Int'l & Bus. L.* 413, 415 *et seq.* (2011).

[119] Securities Exchange Act of 1934 [As amended through P.L. 112-90, Approved January 3, 2012].

assets that collateralise the assets are not qualified residential mortgage or less than 5 per cent of the credit risk for an asset that is not a qualified residential mortgage that is sold through the issuance of an asset-backed security by the securitiser if the originator of the asset meets the underwriting standards stipulated in the Act. The rule exempts 'qualified residential mortgages' as the securities collateralised by these types of mortgages are less likely to default because these loans have been subjected to higher degree of conditions and verification (Section 15G(e)(4)) including documentation of borrower's income and the ratio of income to debt. The securitiser will not be required to retain credit risk if all the assets that collateralise the securities are qualified residential mortgages. However, concerns have been raised in terms of the narrow definition of qualified residential mortgages as well as the amount that needs to be set aside by the securitizers.[120] There are other exemptions where the Federal banking agencies (*i.e.* FDIC, Federal Reserve, Office of the Comptroller of the Currency) and the Securities Exchange Commission may jointly adopt provided the underwriting standards for the securitisers and originators are of high quality and that consumers' and businesses' access to credit is encouraged through appropriate risk management practices by the securitisers and originators. These exceptions include financial assets or loans made by the Farm Credit Administration and to residential, multifamily or health care facility mortgage loan asset guaranteed by the United States or the agencies of the United States except the Federal Mortgage Association, the Federal Home Loan Mortgage Corporation (*i.e.* Fannie Mae and Freddie Mac). In relation to commercial mortgages risk retention may include either a specified amount or percentage, or retention of the first loss (equity tranche). Another significant reform in section 15G is the allocation of risk between the originators and securitisers. The Federal Banking agencies and the Securities Exchange Commission shall have the authority to reduce the percentage of risk retention obligation required of the securitiser by the risk percentage required of the originator. In doing that the Securities Exchange Commission will consider the fact that whether the assets sold by the originator to the securitiser have low credit risk and whether there is misaligned incentives where the originator employed imprudent origination and whether the risk retention obligations have any impact on consumers' and businesses' access to credit in reasonable terms.

[120] *E.g.* 2 August 2011 dated letter from Representatives Spencer Bachus and Barney Frank to Secretary of Housing and Urban Development Chairman of FDIC, Chairman of SEC, Chairman of Fed, *et al.*

Although this reform somewhat presents certainty and protection for investors by, to a certain extent, aligning the interests of originators, securitisers and investors, it is, arguably, a compromise. This is because the roots of the financial crisis can be found in the mortgage based securitisation where the incentives were misaligned and residential mortgages that were sold to subprime borrowers were securitised and mixed with asset based securities. It is a compromise in the sense that residential mortgages have been exempted from the risk retention requirements through detailed regulations that will be enacted to supplement the Securities Exchange Act of 1934. The form and portion of risk retention (*e.g.* whether base risk retention, vertical or horizontal risk retention by sponsor L-shaped risk retention or retention by sponsor of representative sample) has not been clarified in the Act and it has been left to the discretion of the federal banking agencies and the Securities Exchange Commission. This will be achieved through regulations which will be prescribed by the federal banking agencies and the Securities Exchange Commission. Furthermore, retention of less than 5 per cent of the credit risk for an asset that is not a qualified residential mortgage if the originator meets the underwriting standards (section 15G(c)) seems to be vague. Because the underwriting standards of these assets, which could be commercial loans, auto-loans or commercial mortgages, could be different and the portion of risk retention might vary. Moreover, allocating risk between originators and securitisers has the danger of financial institutions purchasing assets from other originators and securitising them because they can share risk with those originators where their risk percentage is reduced to the extent of the originator's percentage. This is more advantageous for securitisers because they do not have to securitise their own in-house assets (in which they are originators and securitisers and cannot share the risk). It has been argued that '[a]ggregate risk retention could be significantly diluted if securitizers reduce their credit risk by sharing it with originators, and originators evade much of their risk by hedging against it.'[121] Section 15G(c)(1) do not allow securitisers to hedge the credit risk. Thus, it has been argued that the regulatory attempts of the Act are not forceful enough to respond to the issues that may arise from ever changing financial innovation.[122]

[121] 'Developments in Banking and Financial Law: 2010-2011' 30 *Rev. Banking & Fin. Law* 1, 49 (2010-2011). It was noted that '...the higher the percentage of risk assigned to originators, the less effective retention requirements will be at eliminating the same morel hazards that previously prompted irresponsible lending and the issuance of risky loan-backed securities.' *See also* R.M. Hynes, 'Securitization, Agency Costs, and the Subprime Crisis' *4 Va. L. & Bus. Rev.* 231, 243 (2009).

[122] For shortcomings of Dodd-Frank Act in terms of regulation *see* D. Awrey, 'Regulating Financial Innovation:

4 Conclusions

Securitisation offers a low cost funding ability for the originator and provides improved liquidity. It also offers the flexibility to the originator to remove the securitised asset from the balance sheet so that these assets (loans and receivables owed to the originator) do not weigh down the balance sheet thus capital adequacy versus trade books ratio of the originator is improved. Securitisation diversifies credit risk for the originator and enables the originator to use different sources of funding whereby increasing their liquidity levels; banks are able to provide further loans depending on the business cycle conditions and their credit risk.

The excessive usage of originate-to-distribute model in securitisation without meaningful credit risk retention helped increase house prices and led to the decline of underwriting standards. This process illustrated the distinct incentives of originators, securitisers and investors. Securitisation, when used properly, is a significant method of raising finance. However, more coherent and transparent system of securitisation and better understanding of its limits may help prevent further crisis based on securitisation. Reforms in the EU and USA provide resemblances. Both reform activities provide exemptions, although these exemptions, arguably, do not help align incentives. The EU reform clearly sets out the form and portion of retention of net economic interests, whereas the same cannot be argued for the US reform. Studies have revealed that 'performance is better when the originator retains skin in the game as a result of affiliation with the deal sponsor or the loan servicer."[123] However, it is also clear that before the financial crisis originators and lenders voluntarily had kept some of the credit risk in their portfolios and that did not prevent the collapse of markets. It would have been more persuasive, had both the EU and US reforms, which require compulsory credit risk retention, provided variable risk retention percentages.[124]

A More Principles-based Proposal?' 5 *Brook. J. Corp. Fin. & Com. L*. 273, 273 (2011); A. Wilmarth, 'The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem' 89 *Oregon L. Rev.* 951 (2011); S. Block-Lieb and E. J. Janger, 'Reforming Regulation in the Markets for Home Loans' 38 *Fordham Urb. L. J.* 681 (2011); Batty, *supra* note 79;

[123] *See e.g.* C. Demiroglu and C.M. James, 'How important is having Skin-in-the-Game? Originator-Sponsor Affiliation and Losses on Mortgage-Backed Securities' *AFA 2012 Chicago Meetings*, at 26 (January 2012).

[124] *Supra* note 121, at 49-50.

It is clear that the IOSCO's recommendations provide general framework for legislators by providing a principle that originators must retain economic interest in the securities sold to investors. Reforms in the EU and the USA as well as the IOSCO recommendations will, arguably, align the incentives of originators, securitisers and investors and implementation of those reforms will act as deterrent and inject confidence in the markets. It is believed that no concrete regulation will ever be effective against the innovativeness of financial markets. However, if the effective risk retention and due diligence goals are achieved, securitisation may continue to serve its benefits to investors.