

**COLLATERALIZED DEBT OBLIGATIONS AS THE QUINTESSENTIAL EXPRESSION OF
REGULATORY ARBITRAGE**

I. INTRODUCTION

Diverse legal treatment of structurally similar phenomena is unavoidable, since usually there are sound reasons to regulate differently financial positions¹ that at first glance appear to be similar. In many cases the underlying reasons for regulation to do so are easy to grasp², but in many others cases the different regulatory approach does not seem to be so clearly explained, mainly when considered under the light of the last financial crisis.

In this paper I will attempt to argue that the lack of regulation for some financial products, is an expression of a regulatory perspective focused on the risk taker protection, on its turn based on the paradigm of total segregation between sophisticated and non-sophisticated investors. This approach might seem to place the focus on the isolated risk taker, perhaps neglecting the protection of the financial system as a whole by the origination of vast scope for regulatory arbitrage.³ As an example thereof, I will use the case of the Collateralized Debt Obligations (“CDOs”) structures, which has been appointed responsible for the credit crunch of 2009 amidst widespread discussion about their lack of regulation.

¹ Joanna Benjamin classifies the diverse ways of risk taking (future losses) from the protection buyer with functional notions. “**Simple Positions**” are those in which one party to a contract acts as risk taker or protection provider in exchange for a fee or other return, although individual guarantors often act gratuitously (guarantees, insurance, derivatives, standby credits and performance bonds). “**Funded positions**” in turn, defines positions where there is certain credit risk that is taken by means of a payment: the risk taker is provider of capital. A further development of funded positions, are “**Asset-backed Positions**” in which the credit exposure of the position taker is addressed by identifying and earmarking particular assets to meet its claims. “**Net Positions**” could be either a development of a funded or a simple position: they arise only where the parties have mutual obligations, and this mutuality enables each party to use its claim to discharge its obligation. (Joanna Benjamin, *Financial Law*, Oxford University Press 2007, pages 21, 49, 149 and 331)

² For instance, in the case of the protection provided to an investor in the capital markets and the protection provided to a bank lender, structurally they are both moving money upfront and taking risk.

³ Regulatory arbitrage is the term used to describe the technique used by firms to reduce or avoid compliance of regulation by identifying loopholes in it, whether by using offshore financial services or structuring the same transaction in such a way that remains unregulated (Benjamin, Joanna, pag 505, 23.04).

II. REGULATORY ARBITRAGE

Anecdotally, Gillian Tett reports that the head of a derivatives team in a major firm told his team that they were expected to make at least half of their revenues each year from a product that did not exist before.⁴ That statement, if true, would be the confirmation of what J. Benjamin had argued before: that is that regulatory arbitrage has been historically a driving force in the financial markets. The desire to innovate fuelled to some extent by huge advances in information technology as well as by sheer competitive pressure, continues unabated (even though that last crisis may have tarnished the image of innovation in certain contexts). That drive for innovation has led to the *creation of highly complex financial products*, and Mc Cormick argues that the most striking example of that is precisely the growth and expansion of transactions on structures using derivatives.

Mc Barnett asserts that such complexity arises mainly from the drive of circumventing regulations and creating new products, taking advantage of the regulatory loopholes.

III. COLLATERALIZED DEBT OBLIGATIONS

3.1 Origins of securitization

⁴ Tett Gillian, "Fool's Gold", Abacus, 2010, page 8

There is a clear consensus of what a derivative is⁵. Nevertheless, the use of derivatives gains complexity when not used as a standalone product but as part of a complex structured financial product. The definition of structured finance remains broad and unclear, as shown by a survey research market⁶. Participants do not agree on what it comprises, although some common features are widely recognized⁷. It is widely agreed however, that asset backed securities (ABS) and CDOs are part of the concept of structure finance, particularly securitizations.

Valdez & Molyneux have stated that the boom of these complex financial products is directly related with the way in which banks structure their finance. Before securitization banks could only make a limited number of loans based on the size of their balance sheets; however, the new form of financing allowed banks to sell off their loans to other banks or investors and the funds raised could be used to grant more loans⁸. Under the *traditional approach*, lenders (banks) find borrowers, originate loans and then hold these on balance sheet until maturity. Under the *securitization approach*, lenders (banks) find borrowers, originate loans and then sell the loans (repackaged as securities) onto investors. Under this approach Banks no longer rely on deposits to make loans; they can make loans and then sell them on to investors in the form of securities that in turn finance their lending activity.⁹

⁵ Its standardized Master Agreement (ISDA) “*is one of the most widely used forms of agreement in the world*” (Justice Briggs in *Lomas and others v JFB Firth Rixson, Inc and others*, [2010] EWHC 3372 (Ch))

⁶ Henry Davis, “*The Definition of Structured Finance, results from a survey*”, The Journal of Structured Finance, Fall 2002, page 5.

⁷ The Bank for International Settlements recognizes three key characteristics: 1) pooling of assets; 2) trenching of liabilities that are backed by the asset pool; 3) delinking of the credit risk of the collateral asset pool from the credit risk of the originator, usually through use of a special purpose vehicle. (“*New Developments in Structured Finance*,” Report 56, Business Lawyer 95, 2000-200, cited by H Davis, page 5).

⁸ Stephen Valdez & Philip Molyneux, *An Introduction to Global Financial Markets*, Sixth Edition.

⁹ Joanna Benjamin attributes the development of asset-backed securities to the introduction of the regulatory capital requirements (in the original Basel Accord of 1988), which they helped to avoid.

In Mc Barnet words, circumventing capital adequacy regulation was a crucial driver behind most structured finance¹⁰. J. Benjamin is of the same opinion.¹¹

3.2 Economic or accounting purposes?

The growth¹² in securitization activity has increased the interdependencies between banks and markets. From a positive perspective, securitization offers the potential for banks to manage their balance sheets more effectively and to move the risks to those most willing to bear it. This can result in a more efficient use of capital resources and better allocation of risks in the system overall. It also enabled banks and other financial institutions to generate extra revenue and therefore helped boost financial performance.

However, it is an open discussion whether the deals can stand on their economic merits or whether they depend exclusively on favourable accounting. Some market participants argue that the fundamental rationale for structured financing is the value it creates by unlocking otherwise inaccessible capital. Lynn Turner, former chief accountant at the SEC is of that opinion: "*structured finance allows people to raise money they may not otherwise be able to raise, and that access to capital contributes to productivity*".

¹⁰ D. Mc Barnet, "Financial Engineering or Legal Engineering? Legal work, Legal Integrity and the Banking Crisis" in The Future of Financial Regulation, edited by Mc Neil and O'Brien, 2010, page 68.

¹¹ J. Benjamin, supra note 1, Page 506.

¹² In 2005 structured finance transactions amounted to some 43 per cent of the global amount of debt instruments in issue in the capital markets, and USD 2,524 billion in volume.

However, with the development and spring of *synthetic structures* as the one that will be described below (3.3), others contended that it is accounting (taking the loan off their balance sheet), and not economics (raising capital) the driver of structured finance transactions.¹³

3.3 A case study: Lehman Brother's Saphir.

Stripped to its essentials, a '*synthetic collateralised debt obligation*' has been described by market participants as "*the transfer of economic or credit risk associated with assets without transferring the assets*"¹⁴. It is a device of financial engineering that is credited for being helpful in the face of anti-assignment clauses, transfer restrictions under the laws or jurisdictions where the assets are located, restrictions in securities laws, registration issues, etc. (in the relevant assets to be transferred).

Considering the lack of consensus among the markets participants about the precise concept of what constitutes a CDO and in order to exemplify synthetic securitizations, I will use the infamous deal Saphir I, structured by Lehman Brothers that after its collapse arouse litigation with primarily clashing results in UK and US.¹⁵ An explanatory chart¹⁶ is included as an Appendix.

¹³ "Reporting: See-through Finance", CFO Magazine, October 2002, available at http://www.cfo.com/article.cfm/3006578/c_3046581?f=magazine_featured

¹⁴ D. Mc Barnett, "*Financial Engineering or Legal Engineering? Legal work, Legal Integrity and the Banking Crisis*" in *The Future of Financial Regulation*, edited by Mc Neil and O'Brien, 2010, page 71.

¹⁵ *Belmont Park Investments Pty Ltd and ors v BNY Corporate Trustee Services Ltd and anr*, [2011] UKSC 38.

¹⁶ The chart is based on a similar one provided by Dr Jo. Braithwaite as a resource for her lecture of "The Law and Practice of International Finance" course in London School of Economics during 2012.

In this particular deal, Lehman Bros, incorporated a Special Purpose Vehicle (“**Issuer**”), which in turn issued *credit linked synthetic notes* (“**Notes**”) to investors of capital, such as Perpetual Trustee (“**Investors**”). The note-holders would receive a steady stream of income (interests) plus the return of capital at the end of the fixed term investment. The Issuer used the capital raised by the Notes to make a presumably safe triple-A investment through a Trustee company¹⁷, which produced an income. The Issuer’s obligations towards the note-holders were secured by a charge (proprietary right) over the investment held by the Trustee.

To even up the *mismatch* between the income produced by the investment and the payments due to Investors under the notes, the Issuer entered into a *credit default swap agreement* (“**Swap**”) with LBSF, a Lehman’ Bros subsidiary, under which LBSF made payments to the Issuer equal to the payments due under the Notes, and in return Issuer paid LBSF the amount received from the collateral.

LBSF’s obligations towards Issuer were guaranteed by LBSF’s parent company (LBHI), and LBSF benefited from a charge (proprietary right) over the safe investment held by the Trustee in order to secure their right to the income it produced. On maturity of the Notes, the amount payable by LBSF to the Issuer was to be calculated by reference to certain Credit Events (as defined therein) by reference to one or more reference entities (hereinafter “**Underlying Pool**”).

There was no requirement for LBSF to have any *direct exposure to the reference portfolio*; it was expressly provided that the Swap did not constitute a contract of insurance and that payments would be due in the event of the referred Credit Events without proof of economic

¹⁷ BNY Corporate Trustee Services

loss to LBSF.¹⁸ *If the Credit Events did not occur* the Note-holders were due to receive the full amount of the Notes, and LBSF would put the Issuer “on the money” (provide the funds) to redeem the Notes. *If the Credit Events occurred*, the amounts payable by LBSF and the principal amount due on the Notes were to be reduced from time to time as and when such Credit Events occurred. Consequently the *performance of the Notes was linked to the performance of the obligations of the reference entities*: LBSF was speculating that sufficient Credit Events would occur and Note-holders were assuming that the credit reference portfolio was safe.

IV. RISK AD INFINITUM.

4.1 Creating risk regardless of the economic logic of the assets.

Particularly in the synthetic securitization transaction explained above, there is a **credit derivative** (swap) that is necessary to achieve the economic result obtained in an asset-backed structure (non synthetic), where the result would be achieved through the *purchase* by the Issuer of the Underlying Pool from the originator, i.e. the obligations of the Issuer under the notes would be *directly backed* by the portfolio. In synthetic transactions the portfolio of assets (Underlying Pool) **needs not to be transferred**, since it is only *referenced* as the underlying asset in the credit default swap.

¹⁸ That being precisely the intention of a credit derivatives contract: that the other party will pay out on the occurrence of the relevant event, even though the recipient may have suffered no loss at all or may even have made a profit (A. Mc Knight, Andrew Mc Knight, *The Law of International Finance*, Oxford University Press, 2008, page 592), which differentiates them with insurances and evidences their speculative nature.

That is precisely the distinction between asset-backed securitization and synthetic securitization. In an asset-backed securitization the assets are physically removed from the balance sheet of the originator, unlike *the "synthetic" deals*, where through the use of derivatives the *risk correlative to the original funded position¹⁹ is transferred without actually transferring the assets themselves²⁰*. Similarly, in our case study, the Investor's potential risk is dependent upon the performance of the Underlying Pool, being the exposure transferred to them through the use of the Swap. Under the Swap the seller of protection (LBSF) agrees to pay the buyer of protection (Issuer) an amount if during an agreed period a prescribed credit event occurs signifying a problem, such as non-payment in relation to a reference obligation of a reference entity (i.e. if debtor of the loans or the issuer of the bonds of the Underlying Pool defaults). That means that in a **synthetic securitization the Swap enables the diversion between the risk itself and the assets.**²¹ Consequently, the risk can be replicated indefinitely since the same Underlying Pool is used as reference in every transaction.

4.2 **The crush: widespread credit risk.**

The growth of the CDOs and ABSs resulted in enormous and widespread credit risk.²² As we now know ²³ with the use of CDOs risk was being accumulated not dispersed, and the

¹⁹ For instance if the Underlying Pool consisted in loans and the 'Credit Events' consisted of 'default', then the risk of default.

²⁰ In the case of a loan, the creditor position inherent to a loan transaction would not be transferred.

²¹ Valdez & Molyneux, *supra* note 8, page 430.

²² Roger Mc Cormick, *Legal Risks in the financial Markets*, Oxford University Press, 2010. Page 295.

²³ Opposite of what it had foreseen in April 2006, when the IMF noted: "*There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risks on their balance sheets, has **helped** to make the banking and overall financial system more resilient*" (International Monetary Fund, 2006. "Global Financial Stability Report: Market Developments and Issues",

financial system became more fragile, not more resilient. With the advent of the subprime crisis and the credit crunch, which burst in 2008, we learnt that there is a serious negative downside to such activity.²⁴

The use of credit derivatives and its potential for transferring credit risk from banks to insurance companies and other non-bank investors in the capital markets, and the consequent accumulation of credit risk in the hands of parties without the necessary expertise to properly monitor and manage the risk being assumed, was shown to its all extent in the last crisis.²⁵

VI. THE REGULATORY CHASE.

6.1. Framing complex financial products into legal categories as an obstacle.

The constant innovation increases the spectrum of products available and makes it difficult to be definite or categorical about the characteristics of these types of transactions.²⁶ Many of them share common features but the differences are not clear-cut, concepts or definitions that were drawn based on functional notions become blurry: are CDOs asset-backed positions? Can preferential shares and convertible bonds be classified as equity and debt respectively?

page 51, cited by Donald MacKenzie, “*The Credit Crisis as a Problem in the Sociology of Knowledge*” in *American Journal of Sociology*, Vol. 116, No. 6 (May 2011), pp. 1778-1841 Published by: The University of Chicago Press).

²⁴ Valdez & Molyneux, supra note 8, Page 273, 274, 282

²⁵ Timothy F. Geithner, US Treasury secretary, before the House Financial Services Committee on 23 July 2009, summarized what went wrong “*Loan originators failed to require sufficient documentation of income and ability to pay. Securitizers failed to set high standards for the loans they were willing to buy (...) Investors were overly reliant on credit rating agencies, whose procedures proved no match for the complexity of the instruments they were rating. In each case, lack of transparency prevented markets participants from understanding the full nature of the risk they were taking (...)*” (Valdez & Molyneux, supra note 8, Page 282)

²⁶ Andrew Mc Knight, *The Law of International Finance*, Oxford University Press, 2008, page 566.

Does a Credit Linked Note constitute a way of raising funds or is it a risk transfer procedure?

In J. Benjamin's words: "*the traditional connotation of the legal categories are no longer informative*"²⁷

The complexity of the transactions together with the opaque jargon and the lack of transparency have made the systems hard to penetrate not only for non-markets participants but also for the very own participants themselves.²⁸

Therefore, conceptualizing financial positions assumed in those complex transactions in order to regulate them, fitting those constantly changing and evolving products into one legal category is challenging. The traditional conceptual approach is insufficient to analyse and assess the different ways in which regulation addresses these complex transactions. That, coupled with the fact that regulation is necessarily ex post facto and generally slow, turns the efforts to elude regulatory arbitrage into a real chase of the ultimate inventions (that very few people actually know and understand).

6.2 Shifting the focus from a risk taker perspective to a systemic perspective.

The regulatory regimen generally differentiates between *sophisticated* and *unsophisticated* investors, protecting the latter. Indeed, it is considered over burdensome and paternalist to

²⁷ J. Benjamin, supra note 4, page 588.

²⁸ Even sophisticated financial companies have admitted that they had trouble understanding the complex instruments marketed by Wall Street. Pretznick and Silverman report that American Express disclosed that it had lost money on CDO investments it did not fully understand. Pretznick and Silverman, "What goes around" Financial Times editorial 31, January 2002.

attempt to protect business investors in all fields.²⁹ The regulation of financial positions is crafted considering the degree of protection to be given to the risk taker, since it is the one most directly affected. However, sophisticated risk takers are the ones who will eventually try to engage in regulatory arbitrage, precisely because they seek their positions to be the least possible regulated and are less adverse to risk.

As shown with the CDOs in the last crisis, the non-regulation of those products led to a major credit crush rapidly propagated by the current *interconnectedness of the system*³⁰: mutual exposure quickly made the unregulated positions affect those that were regulated as well.

Perhaps the recent financial crisis and the impact that the those unregulated financial innovations have had in the community as a whole, *makes the focus of the analysis shift from the perspective of protecting the single risk taker who incurs in a financial position to consider the system as a whole*; and to reassess the consequences of allowing the freedom of contract to be the sole regulator of the sophisticated financial firm's innovations.

VII. CONCLUSION.

Credit derivatives are controversially discussed. On one hand the detractors affirm they are “time bombs” (Warren Buffet) or as Phillip Wood puts it, “toxic weapons of financial mass

²⁹ This approach is evidenced by the classification made by the “Markets in Financial Instruments Directive 2004” (MIFID), which also differentiates between *professional* and *retail* clients.

³⁰ Rosa Maria Lastra argues that what makes a crisis of a systemic nature is not so much the trigger event (*causa proxima*) but the transmission mechanisms, the cannels of propagation of the crisis. *The stronger the linkages are, the greater the potential for systemic instability will be.* (Rosa Maria Lastra, “Systemic risk, SIFIs and financial stability” in Capital Markets Law Journal V 6, N 2).

destruction” because of the extreme risks they entail.³¹ On the other hand, it is reported that the former chief executive of the Financial Services Authority, said that credit derivatives bring speculators and hedgers into the market and that means information into the market which makes markets more transparent and is good for all players.³²

The growing interconnectedness of the market implies that the lack of regulation ceased to be a problem for the sole risk taker in an event of default: it rather entails a problem for the entire financial system. Consequently the question that arises is whether the sole “*risk taker perspective*” to regulate financial positions is truly a stance that takes into account the systemic risk generated by the said interconnectedness. Under a systemic perspective, the paradigm that sophisticated investors do not need protection and can protect themselves through self-regulation might be worth being rethought.

The risk taker perspective could be said to be micro-prudential supervision. Macro-prudential supervision is analogous to the oversight of the forest, whereas micro-prudential supervision is analogous to the oversight of individual trees. In some cases, the well-being of the forest may require the trimming of individual trees.

³¹ Philip Wood, *The Law and Practice of International Finance*, University Edition, 2008, page 425

³² Valdez & Molyneux, *supra* note 8, page 432.

APPENDIX

