

SYNTHETIC SECURITIZATION

A COMMENT ON BELL & DAWSON

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Ian Bell and Petrina Dawson's article, *Synthetic Securitization: Use of Derivative Technology for Credit Transfers*, describes the benefits of funded, as compared to unfunded, synthetic securitizations, concluding that "unfunded synthetic securitizations fall short of the traditional securitization product in a number of key ways."¹ Notably, unfunded securitizations fail to eliminate credit exposure to the protection seller. From the vantage point of a financial guaranty insurer, however, unfunded transactions have two important benefits as compared to funded transactions. First, funded transactions are more expensive to implement due to the complexity of the documentation, the need to establish and maintain special purpose vehicles, and the underwriting costs associated with placement of credit linked notes. Second, the size of funded transactions is constrained by the capital markets' inability to absorb large (multi-billion dollar) note issuances in this sector.

Instead of relying exclusively upon the capital markets, a material portion of the market for unfunded transactions in this sector has relied upon highly-rated counterparties—often triple-A rated financial guaranty insurers—to provide appropriate credit enhancement on the less risky tranches of certain transactions. The more costly funded protection is employed on the more risky tranches of the transactions that would not otherwise comply with the underwriting requirements of the financial guaranty insurers or other highly-rated protection sellers. In 2001, the financial guaranty insurance sector insured dozens of multi-billion dollar credit default swaps, typically providing coverage to protection buyers for losses in excess of a substantial "deductible," with risk on the deductible portion retained by the protection buyer, covered under other credit default swaps,

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1. Ian Bell & Petrina Dawson, *Synthetic Securitization: Use of Derivative Technology for Credit Transfer*, 12 DUKE J. COMP. & INT'L L. 541, 556 (2002).

and/or covered on a funded basis by credit linked notes. The deductible portion represents a so-called “compressed” risk, which bears the risk of the first dollar of loss, but represents generally ten to twenty percent of the total transaction on a par basis.

A discussion of synthetic transactions is not complete without touching on some of the hazards involved with this methodology. Such hazards include the tendency to hedge exposures with different counterparties while underwriting one’s own risk on the basis of the net exposure (assuming performance by both the initial derivative and the hedged derivative), and the existence of credit cliffs inherent in downgrade triggers or material adverse change clauses that may invoke termination rights on the part of performing derivative counterparties, but not on the part of the party that suffered the downgrade or material adverse change. The interrelationship of these two hazards appears to have contributed to the demise of Enron, where downgrade triggers apparently allowed counterparties to terminate derivatives that were out of the money to Enron, but did not permit Enron to terminate derivatives that were in the money with respect to itself.

Due to the ease of execution of synthetic transactions and the lack of friction costs (i.e., legal fees, underwriting fees, trustee fees, and so forth) associated with funded transactions, it is commercially simpler to assemble an extremely large book of exposures with an apparently small net exposure if opposite-way transactions are allowed to offset each other. The sheer magnitude of these books becomes dangerous if the originator of the book suffers financial distress that allows counterparties to terminate positions that are disadvantageous to the originator, but does not allow the originator to terminate positions advantageous to the originator. In such an event, the originator’s book becomes unhedged and the originator is unable to replace the terminated positions because other counterparties are not prepared to rely upon the originator’s credit.

Further hazards arise in the world of unfunded synthetics transactions because it has evolved without the benefit of securities law disclosure requirements typical even for privately-placed security transactions. Less sophisticated market participants can be unaware of the implications of various provisions or ambiguities in the ISDA forms.² While funded transactions typically involve issuers, trustees,

2. See generally ISDA Master Agreement 1992, available at <http://www.isda.org/publications/1992masterlc.pdf> (last visited Feb. 26, 2002); and 1999 ISDA Credit Derivatives Definitions, available at <http://www.isda.org/c1html#CD> (last visited Apr. 3, 2002).

rating agencies, and underwriters (each represented by counsel), unfunded transactions are often executed over the telephone prior to finalization of “exceptions” to the ISDA forms. As the market evolves, so do the disputes and lawsuits regarding the scope of coverage and the disclosure responsibilities associated with these transactions. While ISDA forms for credit default swaps continue to evolve, sophisticated counterparties negotiate numerous terms in the schedules to the ISDA forms in an attempt to better define the scope of coverage and reduce the potential for abuse.

Still other hazards arise from different performance incentives inherent in synthetic, as opposed to funded, securitizations. In a customary funded securitization transaction, the issuer (more precisely, the residual holder/servicer/manager) of the securities is motivated not to default on its payment obligations. The issuer generally suffers adverse consequences (often bankruptcy) if it does default on a payment obligation. In an unfunded (synthetic) transaction, however, the protection buyer (unlike a customary note issuer) may actually profit from a default in the underlying transaction if it does not have a corresponding opposite-way exposure.

Because of these different incentives, the purchaser of a traditional collateralized bond obligation (CBO) security may bear an appreciably different risk than the credit protection seller or credit linked note purchaser, notwithstanding that the credit exposure of the two risks might bear the same rating from the securities rating agencies. In some cases, credit default swaps are analogous to allowing corporations to buy life insurance policies on other people’s lives as an investment or speculation. This results in a situation where the interests of the policy beneficiary and the insured person are at odds.

Finally, synthetic securitizations are better able to mask arbitrage opportunities because of the relative opaqueness of the credit derivative market as compared to the capital markets. For example, if a funded collateralized debt obligation (CDO) issuer raises \$500 million of proceeds, the issuer will be motivated to invest in securities at the most attractive price available to it, and discounts will be transparent and result in increased credit support (e.g., if the investment portfolio is purchased for 80 cents on the dollar, then the transaction will be backed by \$600 million of bonds). In a synthetic CDO, however, it is difficult to ascertain the protection fees allocable to the referenced securities, either individually or in the aggregate, and the protection buyer may be motivated to include reference securities

with higher credit spreads not reflected by other indicia such as ratings or share prices.