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Securitization Law and Practice

In the Face of the Credit Crunch

Jan Job de Vries Robbé



Wolters Kluwer

Law & Business

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NY 10011, United States of America. E-mail: permissions@kluwerlaw.com.

List of Abbreviations

ABS	Asset-Backed Security
BBA	British Bankers' Association
BIS	Bank for International Settlements
CAD	Capital Adequacy Directive
CCO	Commodity Collateralized Obligation
CDO	Collateralized Debt Obligation
CDS	Credit Default Swap
CFXO	Collateralized Foreign Exchange Obligation
CLO	Collateralized Loan Obligation
CMBS	Commercial Mortgage-Backed Security
CMCDS	Constant Maturity Credit Default Swap
CPDO	Constant Proportion Debt Obligation
CRE	Commercial Real Estate
CRM	Credit Risk Management
CRT	Credit Risk Transfer
CSA	Credit Support Annex
CSO	Collateralized Swap Obligation
CTS	Commodity Trigger Swap
DFI	Development Finance Institution
EBRD	European Bank for Reconstruction and Development
ECAI	External-Based Assessment Institution
ECO	Equity Collateralized Obligation
EDO	Equity Debt Obligation
EEA	European Economic Area
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FSA	Financial Services Authority

FSMA	Financial Services Markets Act
FX	Foreign Exchange
GDP	Gross Domestic Product
GIC	Guaranteed Investment Contract
HY	High Yield
IC	Interest Coverage
IFC	International Financial Corporation
IFRS	(International Financial Reporting Standards)
IRB	Internal Ratings Based
IRR	Internal Rate of Return
IRS	Interest Rate Swap
ISDA	International Swap and Derivatives Association
LCDS	Loan Only Credit Default Swap
LIBOR	London Inter-Bank Offered Rate
LMA	Loan Market Association
LSS	Leveraged Super Senior Swap
LSTA	Loan Syndications and Trading Association
LTV	Loan to Value
MBS	Mortgage-Backed Security
MFI	Microfinance Institution
NGO	Non-governmental Organization
OC	Over Collateralization
OTC	Over the Counter
PAI	Publicly Available Information
PFI	Public Finance Initiative
PIK	Payment in Kind
PPP	Public-Private Partnerships
RBA	Ratings-Based Approach
RED	Reference Entity Database
RMBS	Residential Mortgage-Backed Security
SFCDO	Structured Finance Collateralized Debt Obligation
SME	Small and Medium Enterprise
SPE	Special Purpose Entity
SPV	Special Purpose Vehicle
STCDO	Single Tranche Collateralized Debt Obligation
TRS	Total Return Swap
UCITIS	Undertakings for Collective Investments in Transferable Securities

About the Author

Jan Job de Vries Robbé (J.J.) is a solicitor and structured finance counsel at FMO, the Dutch Development Bank. He specializes in securitization and derivatives. J.J. has extensive experience in structured finance, gained both in private practice (at De Brauw Blackstone Westbroek and Minter Ellison) and in-house (at NIBC and ANZ) in Europe and overseas. He is a visiting scholar at (among others) the University of Melbourne, where he lectures on securitization and derivatives. With Paul Ali, J.J. has authored and edited various books on structured finance, including *Synthetic, Insurance and Hedge Fund Securitisation* and *Opportunities and Challenges in Credit Derivatives and Synthetic Securitisation*, as well as three yearbooks: *Securitisation of Derivatives and Alternative Asset Classes* (2005), *Innovations in Securitisation* (2006) and *Expansion and Diversification in Securitisation* (2007).

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Foreword

Steven L. Schwarcz¹

I am pleased to introduce this book by Mr de Vries Robbé on the legal aspects of securitization transactions. This is the fourth volume in Kluwer Law International's series of annual publications dealing with securitization. This particular volume distills the common legal attributes of the transactions encountered in the first three volumes, encompassing not only conventional mortgage-backed securitizations but also other "true sale" securitizations as well as synthetic, insurance, managed fund-style, microfinance, and whole business securitizations.

This volume comes at a timely juncture when the "language" of securitization has begun to enter the mainstream, due to the downturn in the United States housing sector and resulting highly-publicized subprime mortgage crisis and write-downs of securitization assets backed directly or indirectly by subprime mortgages. This volume should be of considerable interest to law practitioners, academics, and researchers seeking a practical explanation of the legal structure of securitization transactions, particularly in the forms encountered in Europe and Asia, and the legal issues encountered by the participants in these transactions.

Despite its detractors, securitization remains an established tool of corporate finance, enabling companies to obtain lower-cost funding than more traditional funding sources, such as bank loans and corporate bonds. Financial institutions, too, use securitization to manage their balance sheets and allocate risk capital more efficiently. The problems that led to the subprime crisis – including the complacency of investors that allowed the inclusion of increasingly risky but underpriced

1. Stanley A. Star Professor of Law and Business, Duke University School of Law; Founding Director, Duke Global Capital Markets Center. Contact: Schwarcz@law.duke.edu.

assets in securitization pools, the willingness to accept potentially inappropriate conflicts of interest, and misconceptions about the role of the rating agencies, all exacerbated by a drop in housing values unprecedented since the Great Depression – are not indicative of fundamental flaws in the securitization model.²

Mr de Vries Robbé is to be commended for producing this volume on securitization at a time when it has become critically important that those entrusted with the oversight of financial markets and the stakeholders in those markets have a nuanced understanding of how securitization operates.

Duke University
Durham, North Carolina
April 2008

2. For a detailed examination of these problems, see Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, forthcoming 93 MINNESOTA LAW REVIEW issue no. 2 (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1107444.

Introduction

There are many books on securitization. But many focus on a single aspect, or are theoretical rather than practical. But in a market so fluid, so dynamic, new deals are the key to the next innovation. Securitization continues to be bolstered by the exponential growth of the derivatives market. Every year sees new asset classes becoming capable of being securitized. Commodity risk? Microfinance exposure? Project finance risk? This first edition of *Securitization Law and Practice* brings these deals together and analyzes them.

The purpose of the first and second chapter is to provide an in-depth discussion of the framework and guiding legal principles and risks in securitization transactions. If you will, it is back to the drawing board when structuring a transaction on the back of an envelope. Key risks and building blocks are addressed, from counterparty risk to the super senior swaps. The third chapter focuses on credit derivatives, the essential building block of synthetic transactions. It tries to demonstrate the inherent flexibility in this financial instrument, which seems to generate a new off-shoot product every month to tailor some investors' requirements. This is followed by a chapter with a practical focus, one on both CLOs and CDOs. While their current popularity may be distinctly different, there is a lot of overlap between the two structures. The various sub-classes are discussed, and the different characteristics and common denominators identified. The final chapter in this sub-book on synthetics explores how the synthetic technique is extrapolated to transfer other types of non-credit risk, such as commodity, equity and FX risk.

The following chapters focus on niche products, including the improbable combination of microfinance and securitization, fund and insurance securitization and whole business securitization (a hybrid of corporate finance and securitization).

The final two chapters are devoted to the rules of the securitization game, the perimeter fences. These are laid down in the Basel II accord with respect to regulatory capital, and on IFRS (International Financial Reporting Standards) for accountancy treatment.

Welcome to the first edition. The way the securitization market develops, there will be many more innovations and further iterations.

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This work would not have been possible without the generous support of many. First among them is Paul Ali, with whom I have worked together on so many publication projects in this area. Thank you, Paul, for your continued support and encouragement to lecture. Thanks also to Tim Coyne, a loyal contributor and lecturer from the start.

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