Chapter 10

Cross-Border Securitization
Innovative Regulation and Transfer of Financial Innovations

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Abstract: Cross-border securitization represents an example of a financial innovation to which the law responds with its own brand of innovation. This chapter describes the structure and nature of securitization, and the process by which legal change strives for a balance between flexibility and expressiveness, and uniformity and predictability. The chapter explains why the balance in the law governing securitization and its spilling cross-border activities is tilted towards flexibility at the price of predictability.

1. INTRODUCTION

This chapter addresses the interaction between innovative regulation and the transfer of financial innovation across national borders. It focuses on securitization, which is a fairly recent financial innovation. Securitization is a form of intermediation uniquely suited for global design and implementation because one of its main innovative features is the "unbundling" of traditional forms of intermediation. Like a child's Lego game, securitization consists of several discrete stages that can be executed by different actors in different countries and then linked to form a desired intermediation scheme. While


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International transactions are usually completed in one country and then transported to others, separate parts of cross-border securitization can be completed in more than one country and then combined. Domestic regulation of securitization can drive its migration across borders for a number of reasons. From the perspective of an innovator in the securitization field, domestic regulation and environment may be too burdensome, risky or corrupt; local taxes may be too high; and bureaucracy may be too rigid and slow. Domestic regulation may simply lack the requisite legal infrastructure for securitization. For example, mortgage securitization may not be impractical where land registration is dispersed in thousands of small villages and no realistic foreclosure of mortgages is available. Absence of clear laws regarding transfer of financial assets renders securitization impossible. Because these factors raise investors’ costs and risks, investors may demand higher returns, raising the cost of capital to unprofitable levels. The process by which the law of cross-border securitization is created helps meet these challenges. The design of securitization law is open. Innovators share their creations rather than "proprieties" and shelter them under intellectual property laws of trademarks, copyright or patents. Thus, lawyers can adjust the designs of others to suit investors and borrowers under different conditions and at different places. Section 2 of this chapter introduces securitization and discusses the conditions and incentives that drive securitization across borders. Section 2 offers an explanation on why legal innovators have taken the open design route and what motivates them to "give away" their innovations. Section 3 discusses the nature of securitization law as a fertile ground for legal innovation. The development of the law strikes a balance between flexibility and ease of change, on the one hand, and stability, uniformity and predictability, on the other hand. Both are necessary for securitization to succeed. The balance determines whether innovations will flourish. By definition, cross-border securitization is subject to many legal systems, yet, market and institutional intermediation are unlikely to arise, let alone flourish, without a legal infrastructure that provides uniform, predictable, stable rules of behavior. Securitization requires a legally binding assignment of financial assets to a bankruptcy-remote special purpose vehicle; a developed securities market and a regulatory system to support it, as well as regulated and trusted intermediaries. Predictable laws are especially important in securitization because the process involves several independent parties. Section 3 explains how cross-border securitization arose in the first place, without a uniform governing law and why it is spreading quickly to so many countries, including those without the necessary financial and legal infrastructures. This explanation is based on the nature of securitization as a combination of discrete activities, and on the theory of decentralized Cross-Border Securitization.
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area of action is the globe. Yet they need predictable rules and standards in order to operate efficiently. The actors can usually utilize existing legal forms and apply them to any one of the discrete components of securitization without necessarily affecting the laws applicable to other components in the process. Therefore, the evolution of securitization law may provide insights into legal innovations and transfer in other areas.

2. INTRODUCING CROSS-BORDER SECURITIZATION

This section of the chapter discusses the main characteristics of securitization and its cross-border aspects, focusing on the main reasons for the emergence of cross-border securitization.

2.1 Securitization

Securitization is a new system of intermediation among savers/investors and borrowers/issuers, merging traditional intermediation systems of markets and institutions. Securitization can arise when institutional intermediaries, e.g., banks, insurance companies, are inadequately performing their functions and bypass these traditional institutions. Thus, the US developed securitization in the 1970s when banks and savings and loan associations did not perform the functions of intermediation effectively.

By merging institutional, in particular banking, and market intermediation, securitization offers many of their advantages while reducing their disadvantages to the parties. Like markets, securitization offers investors liquid securities; but unlike markets, borrowers may issue few unique obligations that are not marketable; they can borrow from institutions that then securitize the loans.

Like banking, securitization bridges the gap between the terms acceptable to borrowers and those acceptable to savers. For example, credit enhancement and diversification of borrowers’ loan portfolios can lower the risks to investors from borrowers’ failures. Further, while banks provide "bundled" services (raising funds, usually through deposits, originating and servicing loans, and holding them to maturity), securitization has "unbundled" these functions, enabling separate actors to perform one or more of these functions and linking the actors through a sponsor rather than one super-intermediary.

Securitization is not without its critics. While, arguably, the process offers global benefits because capital flows to the most productive uses around the globe, and provides higher returns for investors the process can produce a significant number of losers, especially in those countries that lose funding support. Further, cross-border transactions may facilitate money laundering, tax avoidance, and circumvention of regulatory requirements of particular countries. However, the debate about the merits of securitization, and to whom, is beyond the scope of this chapter.

The process of securitization is divided into discrete stages, each of which can be performed by a different entity and in different jurisdictions: loans are made; the loans are transferred to a special purpose vehicle in the form of a corporation, a trust or another entity; the special purpose vehicle issues securities to investors; the credit, markets, currency, country, and other risks to which the portfolio of the vehicle are exposed are reduced through various mechanisms including rating, guarantees, insurance, appraisals; and the portfolio is serviced by collecting the borrowers’ payments and distributing the proceeds to investors after covering costs.

2.2 Cross-Border Securitization: Not Only International and Multinational but Without Borders

The segmented nature of securitization allows for cross-border design that can optimize efficiency through expertise and cost avoidance. Securitization offers actors opportunities to develop expertise in parts of the process, and draw on expertise available in the global markets. Similarly, actors can structure parts of the process in different locations around the globe that provide a receptive environment, and avoid those with a less welcoming and a more costly environment. Further, cross-border securitization allows for efficient and cost-reducing credit enhancement mechanisms to lower the cost of capital. For example, foreign investors’ cost of evaluating domestic borrowers is higher than the cost of utilizing a credible domestic institution that can provide credit enhancement to investors.

Even if large institutions could perform all parts of the securitization process internally, they may still take advantage of the environment or expertise that is offered elsewhere. Although there are many combinations of in-house and out-sourced services in both cases, securitization does not require a guiding or governing hand throughout the process. In that sense it is more market than institution oriented. Securitization leaves more freedom to entrepreneurs and initiatives than institutional planning would.

Cross-border securitization parallels the development of multinational corporations. For example, United States corporations have long exported their products to foreign countries. In that sense the corporations were engaged in international business. At some point, however, managers in these corporations began to view the whole globe as their marketplace.
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They no longer assumed that their manufacturing, marketing, or transportation operations were entirely separate from the rest of their operations in different countries. The global reach of companies and their financial systems has made these cross-border operations integral parts of their overall strategies. The global view has also changed the strategic aspirations of companies in a fundamental way. The starting point for companies is no longer the individual countries, but the single company. It is the company’s strategy that changes as it interacts with the individual businesses in different countries. The global view means that companies now see themselves as having to think in terms of the entire world rather than just their individual countries.

Cross-border securitization reflects a similar method and view. A company is no longer restricted to issuing securities in a single country. By employing cross-border securitization, a company can issue securities in multiple countries, making it easier to distribute risk and spread the risk. In effect, this is the same as if the company had issued securities in the single country. The company would now have to think about the entire world. The company’s strategy becomes the basis for issuing securities.

2.3 Innovators in the Area of Cross-Border Securitization

"Seem to Give Away Their Innovations Instead of Creating Property Rights in Them."

It is important to realize that the potential benefits of cross-border securitization are not limited to the countries in which the securities are issued. The potential benefits can be realized in all countries, irrespective of whether the securities are issued in one country or several.

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creative structures voluntarily by advertising in law review articles and on the Internet. They compete for a chance to speak at conferences attended by lawyers. They work with peers on uniform contracts and model laws in trade and professional associations, United Nations projects, and other international organizations. Presumably, advertising their innovation and participating in leading movements to design and promote innovations enhances their prestige and expands their reputation. Standardization and publication of a proven innovation gives innovators the fruits of their labors, at least for a while. It allows other innovators and their peers and competitors to learn from them. There are a great satisfaction in having an impact on the law of countries and the work and life of many persons. However, these activities generate costs rather than monetary rewards for work done.

The answer to this puzzle seems to be based both on the negative aspects of attempting to create enforceable copyright, patent, and trademark rights, and on the far more fruitful and profitable results of giving the innovation for free. In the area of financial services, recapturing the costs and reaping the monetary rewards of innovative structure through trademark, copyrights and patents has been unsuccessful. First, the name of the product is rare and unique, and other descriptive names are abundant. For example, the creators of the "hub and spoke" structure for mutual funds have taken a trademark and patent on the name and structure. However, other lawyers and the regulators chose "master-feeder funds" to describe essentially the same structure, thus passing the trademark issue. Later, the patent was not recognized. Today, computerized investment management systems are "of suspect value.

Second, the innovative structure itself can be used with sufficient variations that would distinguish it from the original. Thus, it is very difficult to shelter financial innovations under existing laws. Third, financial and legal innovators' protections are unjustified even though innovators incur substantial costs in creating new products and bear the risk of a nonenforceable name if these innovations can be easily and quickly copied by others. Although current laws may provide some protection for such innovations it seems that financial and legal innovations, abundant, suggesting that there is little need to provide innovators more incentives to produce novel products. Fourth, copyright protects software code, but not the ideas underlying the code, allowing competitors to duplicate the idea by designing different codes that achieve the same result.

In contrast, and perhaps paradoxically, "giving away" an innovation provides many monetary benefits. To begin with, these giveaways may not be complete. Unlike disclosure in applications for patents, disclosures of innovations in advertising, presentations or professional publications are not as complete and detailed. Certain experiences, drawbacks and danger points are likely to be omitted. Some say that following cookbooks of famous chefs rarely seems to produce dishes that taste as the chefs' dishes do. That is not necessarily done by intentionally avoiding an important ingredient from the recipe (although some cooks would be tempted to do so). In a complex area with different actors, it is difficult to transfer fully information in such publications so that the reader can replicate the activity without hands on guidance. Just as the water, cooking utensils, and ingredients may not be identical to those used by the author-chefs, so may the quality of the financial assets, the type of clients and the legal environment of the transactor differ from those of the innovators. These differences may produce difficulties for the services.

Second, to be valuable, innovations must be recognized and followed. Innovation is risky for users because there is less information about their effects; their novelty produces uncertainty that may result in failure and losses. Greater experience in using the innovation lowers the users' risks, and induces them to adopt the innovation. A broad adoption of an innovation verifies and enhances its value, thus proving the success of the innovation. Therefore, innovators may initially give away their innovations to produce a more widespread adoption. Third, if potential clients are convinced of the value of the innovation, they seek the innovators' services. Repeat performance is far less costly to the innovators than to their competitors. Even as compared to peers, innovators have an advantage during the learning period of their competitors. Some service providers would be happy to resort to the innovators because their cost of learning outweighs benefits if their clients seldom seek these services. Thus, innovators benefit from peers' referrals.

Fourth, innovators reap the rewards of prestige and enhancing their reputation. For some people, these rewards may be the main driver. Some of the advantages described above are not available except under certain conditions. First, the innovation must be complex. Otherwise the innovation can be easily replicated, and novices will be less eager to pay innovators for guidance. Second, the recipients of the innovators' services must be peers, colleagues, and clients. They have an interest in maintaining this system and would support one actor to obtain reciprocal support later. Third, the system will work best in a specialized industry. Repeated transactions tend to produce efficient industry norms, and, as the discussion in the following section demonstrates, in a specialized business, the maintenance of these norms is valuable to all members.

In some cases, if an innovation is prepared for a client that values the advantage of being "the first" or of the transaction is very large, the client is...
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3. HOW CAN CROSS-BORDER SECURITIZATION EXIST WITHOUT A UNIFORM LAW?

By definition, cross-border securitization is not regulated by one legal system. The securitization participants are generally located in different jurisdictions, and the transactions cross borders. This creates a need for the securitization participants to comply with the laws and regulations of the jurisdictions in which they operate. A common characteristic of most cross-border securitizations is that they are conducted in a jurisdiction that is well-known for its financial regulations, such as the United States or the United Kingdom. This allows the securitization participants to benefit from the availability of capital and the stability of the financial markets in these jurisdictions.

3.1 Creating Cross-Border Securitization

3.1.1 Uniform Law: The Parties Choose Privatized Markets

The issue of cross-border securitization is closely related to the issue of the interaction between national authorities and international standards. National authorities often have the power to regulate the securitization market and to ensure the protection of investors. However, as cross-border securitization becomes more prevalent, national authorities may face challenges in enforcing regulations and ensuring compliance. To address this issue, the use of international standards and regulations, such as those provided by the International Organization of Securities Commissions (IOSCO), has become more common.

3.1.2 The Quest For Uniformity

While securitization continues to evolve, it is clear that uniformity is essential for the growth and development of the market. Uniformity is achieved through the adoption of international standards and regulations, which provide a common framework for securitization activities. This allows securitization participants to conduct transactions in a transparent and efficient manner, thereby increasing the accessibility and liquidity of the market.

The quest for uniformity is driven by the need to ensure that securitization transactions are conducted in a manner that is consistent with international standards. This involves the development of common rules and procedures that are applied in all jurisdictions where securitization is conducted. Uniformity is achieved through the adoption of international standards and regulations, which provide a common framework for securitization activities. This allows securitization participants to conduct transactions in a transparent and efficient manner, thereby increasing the accessibility and liquidity of the market.

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4. CONCLUSION

Arguably, this method allows markets to develop the securitization process, and the government to intervene whenever a problem arises. Yet, this system

3.3.1 Enforcement of Securitization Law

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Financial innovations in the shadow of advances in the theory and practice of cross-border securitization

The advent of securitization has created new opportunities for financial institutions to raise capital efficiently and to manage risk. However, the growth of securitization has also raised concerns about the potential for new forms of financial innovation that could lead to increased market volatility and systemic risk. In response, regulators around the world have been developing new policies and regulations to address these concerns.

One of the most significant challenges posed by cross-border securitization is the need to ensure that securitization activities are subject to appropriate regulatory oversight. In many countries, securitization transactions are subject to specific regulatory frameworks that may be inadequate or insufficient to address the risks associated with cross-border transactions. As a result, there has been a growing call for a comprehensive, coordinated approach to regulation that can effectively address the risks associated with cross-border securitization.

To address these concerns, a number of countries have implemented new regulatory frameworks that are designed to provide greater transparency and accountability in securitization markets. These frameworks typically involve the development of new disclosure requirements, increased transparency in the securitization process, and more rigorous due diligence and risk management practices.

In addition to regulatory developments, there has been a growing focus on the role of international cooperation in the regulation of cross-border securitization. This has led to the development of new frameworks for international cooperation, including the establishment of New Arrangements for Financial Market Infrastructures and the development of new cooperative arrangements to address regulatory challenges.

Overall, the development of new regulatory frameworks and international cooperation is crucial to ensuring the safety and soundness of cross-border securitization markets. As securitization continues to evolve, it is important that regulators and policymakers remain vigilant to ensure that new financial innovations are subject to appropriate regulatory oversight and that the risks associated with cross-border securitization are effectively managed.
REFERENCES


