THE LAW OF CROSS-BORDER SECURITIZATION: FROM LEX JURIS TO CODES OF LAW

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I. Introduction

This article discusses the process by which the law of cross-border securitization has evolved towards uniformity. Securitization is an interesting and useful subject for examining cross-border transactions. Securitized assets are individual financial assets that acquire most features of securities by pooling and distributing.[1] These securities are easily transferred to other countries and continents.[2] Among the issuers, traders, and buyers of these assets are many banks, subject to different national regulations and cultures.[3] Hence, the identity of the regulators and the regulatory rules of the various countries differ as well.[4]

In a former article, I posited the law of cross-border securitization was developed by the lawyers structuring transactions and hence it was named "lex Juris" after its creators.[5] I found "[l]ex Juris may be the forerunner of a new type of lawmaking regulating global activities: law-like rules that escape tight control of domestic laws, but take them into account; rules that are highly flexible for a fast-changing environment, but quickly unified into standards and guidelines of sufficient predict-

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[1] Tamar Frankel, *The Law of Cross-Border Securitization: Lex Juris,* 12 DUKE J. COMP. & INT'L L. 475, 477 (2002) ("Securitization is a process by which illiquid financial assets are converted into securities, to facilitate their sale and trade.").
[2] *Id.* at 477–78.
[3] *Id.* at 478.
[4] *Id.* (citing regulatory differences in tax implications, infrastructure, and political stability).
[5] *Id.*

ability."[6] I suggested the process is cyclical.[7] New forms of cross-border securitization and new legal issues emerge, while old forms and settled issues solidify into rules. The ultimate purpose is the creation of unified system.[8]

This article continues the inquiry in light of new developments that occurred in 2008 and 2009. Parts of the world, including the European Union and the United States, experienced a systemic financial crash.[9] This crash included failure of banks that created and held securitized financial assets.[10] Securitization lost its attraction as well as its benefits. There arose a need for an enhanced and unified regulation in this area. The focus of this article is on this need.

The first part of this article discusses select features of the securitization transactions that apply to banks. Because of the past 2008–2009 developments of enormous losses to the banks, the first part of this article focuses on two features of the securitization transactions that impacted banks. The next part of this article describes the movement from lex Juris to regulation and resolving the differences in the two systems. The last part of this article again addresses a broader question: does the system of lex Juris provide a useful model for other laws in a global context?

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[6] *Id.*

[7] Tamar Frankel, *Cross-Border Securitization: Without Law, but Not Lawless*, 8 DUKE J. COMP. & INT'L L. 255, 257 (1998) (citing Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1683 (1996)).

[8] *Id.* at 275–78 (discussing the "quest for uniformity").

[9] *The Origins of the Financial Crisis: Crash Course*, ECONOMIST (Sept. 7, 2013), www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article [https://perma.cc/KBN8-RPQ5].

[10] Vincenzo Bavoso, *Good Securitisation, Bad Securitisation and the Quest for Sustainable EU Capital Markets*, 4 J. INT'L BANKING & FIN. LAW 221 (2015) (discussing securitization's role in the 2008 financial crisis).

II. The Role and Contribution of Securitization to the Financial Crash[11]

Securitization is deemed one of the causes of the global financial crisis at the beginning of 2008.[12] The market for securitized assets declined after the 2008 crisis, especially in Europe, and, as of April 2015, it "remained in decline."[13] Thus, as of 2012, there was little securitization activity outside the United States and Europe and few cross-border securitizations did not involve the United States and Europe.[14] Among other reasons, securitization contributed to the financial crisis of 2008–2009 due to two factors. One factor was securitizing highly risky borrower's obligations.[15] Lenders were tempted to create short-term loans in the time between lending and selling long-term loans, instead of holding them until the date of payment.[16] Holding short-term, risky loans tempted lending to high-risk borrowers.[17] If risky loans could be quickly packaged and sold profitably, the long-term risk would be transferred to the buyers.[18] Under this system, more loans could be made profitably.[19] A second reason for the banks' losses incurred by securitization was the banks' reduced capital backup.[20] Most of banks' lending money is derived from depositors' money and investors' money.[21] Securitization

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[11] For a description of the purpose and process of creating secured products, how designers of cross-border securitization activities determine in which countries to create secured products, and the process of lex Juris standardization that has already occurred, see Frankel, *supra* note 1.

[12] Bavoso, *supra* note 10, at 221 ("In the aftermath of the global financial crisis, structured finance has been widely identified among its main causes.").

[13] *Id.* ("The securitisation market suffered substantially after 2008, especially in the less developed EU markets, where is has so far remained in decline for two main reasons, namely post-crisis regulation and investors' stigma.").

[14] OICU-IOSCO, GLOBAL DEVELOPMENTS IN SECURITIZATION REGULATION: CONSULTATION REPORT 7 (2012), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD382.pdf [http://perma.cc/WL8T-XPN2].

[15] Aron M. Zuckerman, *Securitization Reform: A Coasean Cost Analysis*, 1 HARV. BUS. L. Rev. 303, 309 (2011).

[16] *Id.*

[17] *Id.*

[18] *Id.* at 307.

[19] *Id.* ("Securitization . . . incentivizes banks to make more loans. . . .").

[20] John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 956 (2015) ("Even the 'best' performing U.S. banks during the crisis lost significant amounts of money, [and] needed to raise capital on terms suggesting pre-crisis undercapitalization. . . .").

[21] Zuckerman, *supra* note 15, at 305.

enabled banks to sell the loans they made and collect the lending money after a relatively shorter period compared to the loan periods.[22] After all, intermediation is the banks' main function. Securitization enabled banks to reduce their backup capital.[23] Instead of low-risk backup capital (which produced low return), the ability to sell the loans and collect their profit seemed to be a substitute for back-up capital, at least in part.[24]

In the 2008–2009 financial crisis, it was found that many banks, which engaged in securitization were undercapitalized.[25] Notably, while banks in the U.K., France, Germany, and Belgium were undercapitalized, the banks in Canada and Australia were not. In part, their healthier position was due to stricter capital requirements.[26] Also, problems of private individual transactions became systemic problems.[27] These findings led to a regulatory response.[28] Regulators proposed stricter capital requirements,[29] as well as stricter guidelines for securitizations.[30] According to a 2014 discussion paper prepared by the Bank of England (BoE) and European Central Bank (ECB) staff, regulatory initiatives were proposed or enacted after the crisis to "address the fragilities exposed during the crisis."[31] These 2010 proposals were designed to be implemented between 2013 and 2019.[32]

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[22] *Id.* at 306.
[23] *Id*. at 308 (explaining how securitization allowed banks to move loans off their balance sheets and reduce their reserve requirements).
[24] *Id.* at 307.
[25] Coates, *supra* note 20, at 955–56 ("[B]anks were revealed to be grossly undercapitalized for the risks they had been running.").
[26] *Id.* at 956 (explaining how countries with stricter capital requirements had banks fair better during the financial crisis).
[27] *Id*.
[28] *Id*. at 957.
[29] *Id.*
[30] *Id.* at 958 ("Other requirements in the guidelines included more common equity; tougher treatment for credit default swaps and counterparty risk; securitizations; and risk management; and a surcharge for the very largest, most complex, and interconnected banks, known as 'systemically important financial institutions,' or SIFIs.").
[31] BANK OF ENG., EUROPEAN CENT. BANK, THE CASE FOR A BETTER FUNCTIONING SECURITISATION MARKET IN THE EUROPEAN UNION 13 (2014), http://www.ecb.europa.eu/pub/pdf/other/ecb-boe_case_better_functioning_securitisation_marketen.pdf [https://perma.cc/TYF2-4JTX] [hereinafter BOE/ECB Report].
[32] Arie C. Eernisse, *Banking on Cooperation: The Role of the G-20 in Improving the International Financial Architecture,* 22 DUKE J. COMP. & INT'L L. 239, 254–55 (2012).

The BoE/ECB favored regulation, which would not cause systemic risks, because it would lead to a distribution of risk.[33] The BoE and ECB established principles of "qualifying securitisation," which would enable investors to assess the risks involved in securitization and set strict underwriting standards in distributing the product securities.[34] Pursuant to these principles, regulators would certify qualified transactions by: (1) standardized disclosure of information; (2) transparency of credit ratings, and (3) design of ancillary facilities.[35] "[I]nstitutions acting as swap counterparties and/or providing . . . liquidity/credit facilities" would be required to "meet certain rating requirements."[36] The BoE/ECB principles govern: (1) the nature of the assets, (2) the underlying assets' performance history, (3) primary obligors, in a method designed to ensure that the securitization system and its investors would have recourse to the obligors for receivables, (4) originators, requiring that they show that the issued securities are based on receivables, that their asset type is homogeneous, and that the expected payments are realistic, and (5) payment priorities, among others things.[37]

In addition, in September of 2015, the European Commission "proposed a regulatory framework for securitisation, which is simple, transparent and standardised [STS] and subject to adequate supervisory control."[38] "The new EU legal framework provides a clear set of rules to ensure that STS benefits the real economy."[39] However, raising the banks' capital requirements may reduce investor incentives to invest in bank holding companies,[40] and the requirement imposed on issuers to retain backup capital as well as the regulatory uncertainty over possible

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[33] BOE/ECB Report, *supra* note 31, at 19 ("It would therefore be desirable to achieve a distribution of risk across the financial sector that is transparent and diverse, with ABS ultimately being held by less leveraged investors.").
[34] *Id.* ("It may be beneficial for the authorities to support the development of high-level principles that identify 'qualifying securitisations'. Such securitisations should be simpler, more structurally robust and transparent, enabling investors to model and understand with confidence the risks incurred. They could also potentially be less risky, due to higher quality of underwriting standards.").
[35] *Id.* at 20–21.
[36] *Id.* at 21.
[37] *Id.* at 23–24.
[38] European Comm'n, Press Release, Capital Markets Union: EU Reaches Agreement on Reviving Securitisation Market (May 30, 2017), http://europa.eu/rapid/press-release_IP-17-1480_en.htm?locale=en [https://perma.cc/ YBP6-SHZ4].
[39] *Id.*
[40] BOE/ECB Report, *supra* note 31, at 15.

relief from the bank capital requirements may impede issuers from securitizing.[41] Thus, the medicine might kill, rather than rehabilitate, the patient.

III. The Compromise

Counter-proposals have been offered.[42] The European Union agreed to a compromise and amended its earlier proposals. Arguably, the new compromised proposals may lead to "a regime that is much more supportive of the European securitisation market."[43] Thus, in May 2017, the European Parliament, the Council, and the Commission approved a regulatory framework for securitization.[44] The new framework was intended to provide "a risk-sensitive, transparent and prudential treatment of securitization," as well as "restore an important funding channel for the EU economy without endangering financial stability."[45] In other words, the proposed rules addressed the problems that led to the 2008 market crash yet encouraged securitization.

The critics still raised concerns that the requirements imposed on issuers of securitized loans a duty to retain backups (for failed loans) and posed a regulatory uncertainty over possible relief from the bank capital requirements.[46] Therefore, these rules may discourage lenders and issuers from securitizing unequal small obligations by diverse debtors.[47] In both cases, presumably profits will be reduced, although the risks will be lowered as well. It seems that one basis of the criticisms of the proposals was the micro-management of the regulations and regulators.[48] Lex Juris

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[41] *Id.* at 16.
[42] *Id.* at 19.
[43] Memorandum from Cadwalader, Wickersham & Taft LLP, Stephen Day et al., European Union: Agreement Reached on Form of New EU Securitisation Regulation and On Amendments to the Capital Requirements Regulation (June 27, 2017), https://www.cadwalader.com/uploads/cfmemos/70faf99cbd49ba300b24ad55a65a9332.pdf.
[44] *Id*.
[45] *Id.*
[46] *Id.* at 4 ("The Council also expressed serious reservations regarding the proposals to revisit the rates every two years in the future, which the Council noted would introduce excessive uncertainly into the securitisation market.").
[47] *Id.* at 8.
[48] *See id.* at 8 (explaining the Council of the European union disfavored "a complete ban on re-securitisation and suggested carving out certain transactions that might be inadvertently affected").

and negotiated deals were giving too limited a space to the intermediaries.[49]

IV. Conclusion

Important lessons can be derived from the history of securitization regulation—the process is valuable. It contributes to the investors, borrowers, lenders, and intermediaries. Yet, the process poses risks to all participants, especially failing borrowers, and to the financial system as a whole. Their possible failure may be initially established, and they may be disqualified, but some may fall on hard times through no fault of their own. That is why an institution, such as a bank, as well as underwriters and other lenders, must bear at least some of the burden of assurance by back up funds and ensure reasonably conservative lending.

Who should determine the measures of risk, and who should enforce assured distribution of the borrowers' obligations? The 2008 crash demonstrated the short-term incentives of institutions that hold other people's money.[50] That is why regulations were instituted.[51] On the other hand, regulators cannot and should not micromanage the financial system. This is especially problematic when the lenders and intermediaries are not necessarily similar. Some require more government supervision while others require far less supervision because they can self-impose rules. Securitization offers a balance. As we view the private rules and rule maker—the lex Juris—and the evolution of the rules to government regulation and enforcement, we may not find a uniform answer. Instead we may list a number of the issues and problems and approaches to a balancing system.

In this article the issue was who should regulate and the answer seems to be the government on a higher scale and the lawyers on lower individual cases. We may find others, within the institutions, who must play the role of rule-designers enforcers. We know the problems. Now we must seek to find and educate those who would be best suited to

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[49] *See id.* at 7 ("However, the failure to include a third country equivalence regime in the Securitisation Regulation itself is likely to result in the exclusion from the STS securitisation regime of securitisations that otherwise would be classified as STS securitisations.").

[50] *See* Zuckerman, *supra* note 15, at 308 (discussing banks' incentives to securitize loans in the period leading up to the financial crisis).

[51] *See id.* at 310–13 (discussing regulations implemented in the wake of the 2008–2009 financial crisis).

reduce the problems, and balance the conflicting entitlements, if not eliminate them altogether.