Securitisation of Derivatives and Alternative Asset Classes

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# Securitisation of Derivatives and Alternative Asset Classes

## Yearbook 2005

*by*

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# Foreword

*Steven L. Schwarcz*[1]

This inaugural volume of a series of Yearbooks on securitization focuses on innovative securitizations and recent developments in the accounting and regulatory treatment of securitization. Securitization remains one of the most important means by which corporations can raise funds, despite the questions raised about its probity following the collapse of Enron.[2] The transactions examined in this volume, which range from the securitization of new classes of receivables to the 'synthetic' securitization of derivatives, well exemplify both the robustness and the continuing evolution of the global securitization markets.

The editors, Jan Job de Vries Robbé and Paul Ali, have selected contributors with considerable legal and financial expertise in securitization, including some of the leading participants in the securitization markets. The editors have divided their contributions into three groups, each group being concerned with a critical feature of contemporary securitizations.

The first group of contributions deals with the rapidly growing class of synthetic securitizations. These securitizations involve the use of de-

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

2 Enron's use of special-purpose entities and other structured-finance techniques bears only superficial similarities to, and are fundamentally different from, securitization. See S. L. Schwarcz, 'Securitization Post-Enron' (2004) 25 *Cardozo L Rev* 1539; S. L. Schwarcz, 'Enron, and the Use and Abuse of Special Purpose Entities in Corporate Structures' (2002) 70 *University of Cincinnati L Rev* 1309.

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rivatives to isolate a specific risk, in particular credit risk, from designated financial assets, and the issuance of securities to investors incorporating only that risk. This is in marked contrast to 'true-sale' securitizations in which the securities issued to investors are backed by receivables and thus incorporate the multiple risks associated with those receivables. Chapters 1 to 5 examine new developments in the securitization of credit derivatives and also look at the securitization of more 'exotic' weather derivatives and equity-default swaps.

The second group (Chapters 6 to 17) is concerned with innovation in true-sale securitizations, including the issue of securities backed by new classes of receivables (for instance, residential pre-sale receivables, private equity investments, and taxation receivables) and the development of new markets (primarily in Europe, Japan, and Islamic countries). Also included in this group is a discussion of certain securitizations – covered bonds and whole business securitizations – in which the true sale of receivables has been replaced by a security interest in receivables or in an entire business enterprise.

The final group of contributions (Chapters 18 to 20) contains a comprehensive discussion of the implications of the International Financial Reporting Standards (which are currently being adopted in Europe and Australia) and the Basel II Capital Accord for securitizations.

The practical perspective of the contributions, combined with the extensive use of case studies of key transactions, should make this volume an invaluable resource for lawyers, as well as legal and business academics, interested in the very latest developments in the global securitization markets.

*Duke University*
*Durham, North Carolina*
*February 2005*

# Preface

This Yearbook focuses on the latest innovations in securitisation, including the securitisation of derivatives and alternative asset classes, and also exotic variations on the securitisation of well-established asset classes. The Yearbook is designed primarily to provide legal advisers with detailed information on the legal structure of these innovative securitisations as well as recent developments in the accounting and regulatory treatment of securitisations. The contributors to this Yearbook are representative of the wide range of participants – advisers, structurers, facilitators and regulators – in the global securitisation markets.

The global securitisation markets have continued to go from strength to strength, particularly as regards the evolution of new synthetic structures and the application of securitisation technology to fresh asset classes. The threats to securitisation that emerged in the aftermath of the collapses of Enron, WorldCom and Parmalat have proved to be over-stated and, as a leading US commentator has noted, '[t]he future of securitisation is secure'.[1] Admittedly, the free-wheeling days of securitisation arbitrage and capital relief have now come to an end, due to ever-tightening credit spreads and the new Basel Capital Accord. Yet for market participants, there remain ample opportunities for 'premium work' as demonstrated by the innovative transactions discussed in this Yearbook.

Securitisations can, in general, be divided into three classes. The first class, which is variously known as 'cash' or 'true sale' securitisations, involves the issue to investors in the capital markets of debt securities serviced by a sequestered pool of income-producing assets. Indeed, it appears that virtually any income-producing asset is capable of being securitised, from auto loans and commercial mortgages to Islamic law-

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1 T. E. Plank, 'The Security of Securitization and the Future of Security' (2004) 25 Cardozo L Rev 1655, p. 1730.

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compliant financial instruments, private equity investments, residential pre-sales contracts and tax receivables.

The second class of securitisations goes by the name of 'synthetic securitisations'. These securitisations involve the issue of debt securities backed by collateralised derivatives. At the core of these transactions is the disassembling of income-producing assets or entire businesses into their component risks, with discrete risks being laid off to investors in the capital markets. Synthetic securitisations have been dominated by the transfer of static credit risk (synthetic collateralised debt obligations (CDOs)) and peak-peril risk (catastrophe bonds). More recently, however, this technology has been extended to securitise dynamic credit risk (managed arbitrage synthetic CDOs) and equity risk (equity collateralised obligations), and to repackage other synthetic securitisations (synthetic squares). There has also been a revival of interest in the securitisation of weather risk.

Both the above classes of securitisation are constructed around the overt transfer of assets or discrete risks. There is, however, a third class of securitisation that utilises security interests, rather than asset sales or risk-transfer instruments. This is well exemplified by 'whole business' securitisations where the debt securities issued to investors are backed by loans secured over entire businesses and 'covered bonds' which are debt securities backed by security interests over pools of residential mortgages.

This yearbook is divided into three parts.

The first one focuses on the securitisation of derivatives. JJ de Vries Robbé's (FMO, The Hague) chapter provides a broad overview of the market for synthetic squares, which, at least in Europe, has become one of the major means for arbitrage securitisation. JJ has gained securitisation experience in both Europe and Australia. The complexities of these transactions from a ratings perspective are effectively highlighted in Kai Gilkes' (Standard & Poor's, London) contribution on the modelling of credit risk. His chapter may be particularly valuable for those involved in structuring a CDO of CDOs or CDO of ABS.

Stefan Krauss (partner, Hengeler Mueller in Frankfurt) explains the use of synthetic securitisation in Germany through KfW. Stefan has been at the forefront of developing and documenting many transactions on the renowned Provide and Promise platforms. Giuseppe Schiavello (partner, Macchi Gangemi in Rome) details the potential for (among others) synthetic CMBS in Italy, outlining the recent changes in Italian legislation. His chapter should also be worthwhile for international practitioners, given his involvement in pan-European transactions.

The next two chapters relate to derivatives, which at the time of writing, were still classified as emerging asset classes. Paul Ali's contribution focuses on weather derivatives and its potential to become an entirely new asset class. He discusses one of the most innovative transactions executed in this area. Michael Logie and John-Peter Castagnino (partner and solicitor respectively at Ashurst in London) have gone to great lengths to provide readers with an excellent bird's eye view of the use of equity derivatives to securitise equity risk as an alternative – and, to some, a substitute – for credit risk. They outline the potential of this new asset class, as well as the inherent documentation issues.

The second part of the book is devoted to the securitisation of alternative asset classes. It combines perspectives from the market, academia and legal points of view. Peter Kilner (partner, Clifford Chance, Tokyo) discusses in clear terms the development of the Japanese securitisation market (demystifying some of the dealings of this important market in the process). His chapter combines a discussion of key structures with changes in the legislative arena relevant to securitisation practitioners. Miroslav Visic (Deutsche Bank, New York) provides an overview of the opportunities for relative value in the US CDO market. His contribution, a real snapshot, gives valuable market insight into the asset classes that may specifically grow this year, both in the US and abroad.

The development of covered bonds is undoubtedly one of the key trends in the European market. Sergio Nasarre-Aznar (University Rovira i Virgili, Tarragona) and Otmar Stöcker (Association of German Mortgage Banks, Berlin) have provided a very useful comparison of covered bonds in a variety of European jurisdictions. Their contribution is a very valuable guide to where covered bonds have come, as well as where further development may lead to.

In Australia, a new asset class has emerged in the form of securitisation of pre-sales. Larry Mahaffy (ANZ Investment Bank, Melbourne) uses his experience in the first deal of this kind to guide readers through the opportunities and pitfalls of this new area. His contribution may be of particular interest for arrangers and practitioners in the property market. The same is true for the contributions from Sarah Smith (partner, Sidley, Austin, Brown & Wood, London) and Sander Beekwilder (NIBCapital, The Hague). Both address the growth and potential in the CMBS market in Europe. Sarah's excellent article builds on the legal considerations of CMBS, with an emphasis on cross-border elements. It also draws on her experience in similar transactions for major houses. Sander's chapter nicely complements the first chapter. It puts CMBS transactions in a broader perspective, and adds the investor perspective by explaining many structural elements and recent transactions.

Olav Koenig (Capital Dynamics, Zug) explains the emergence and value of private equity securitisations. His focus is on the structuring and demystifying of these innovative deals, as well as an extensive case study. In a transaction which arguably skirts the limits of securitisation, Pedro Cassiano Santos (partner, Vieira de Almeida, Lisbon) and his team discuss the securitisation of non-performing tax receivables in Portugal in the Explorer transaction. Pedro brilliantly unlocks the potential for public sector securitisation, not just in Portugal, but abroad as well.

Mariëtte van't Westeinde's (partner, Loyens Loeff, Amsterdam) discussion of securitisation of auto leases in the Netherlands proves securitisation is not solely about new asset classes, but also about legal ingenuity to allow market participants to draw the benefits from securitisation of existing asset classes which hitherto were thought not to be available due to legal constraints. Tamara Box and Mohammed Asaria (partner and associate, Lovells, London) unlock yet another securitisation market in their discussion of securitisation in an Islamic regulatory and legal framework. Their analysis proves elements of both worlds can be combined in securitisation structures, which many readers may have not thought possible.

Patrice Doat and Philippe Nugue (partner and associate respectively, Gide Loyrette Nouel, Paris) arguably put the long ranging debate on the feasibility of whole business securitisations in civil law countries to rest. Their discussion of two recent French securitisations elegantly makes the point that corporate securitisations are not just available to English corporates.

The third and concluding part of the Yearbook centres on accountancy and regulatory aspects of securitisation. It endeavours to outline the limitations or parameters of the securitisation market going forward. Two developments stand out: the current changes in the accountancy arena, fuelled largely by Enron's demise and the perceived abuse of existing regulations, and the publication of the revised framework for capital adequacy by the Basel Committee, also known as Basel II.

On the former, Tim Coyne (partner, Ernst & Young's Melbourne office) has collaborated with his colleagues in the UK and the US to provide a global and user-friendly overview of the dynamic in accountancy, and its impact on specific securitisation transactions globally. Regarding the latter, Eric Elvers (Dutch Central Bank) has provided a detailed overview of Basel II. His contribution is particularly valuable as he himself has been involved in the negotiations leading up Basel II. His chapter discusses the applications of Basel II in practice, among others to synthetic securitisations. Stefan Hohl (Bank for International Settlements in Hong Kong) focuses on the consequences of Basel II for the Asia-Pacific market. Both provide indispensable insight into the economics of securitisation today and tomorrow.

This publication would not have been possible without the support of many. The editors take the opportunity to thank all, and some in particular.

JJ de Vries Robbé would like to thank Ralph Ayling and Fred Tinsley (Minter Ellison), Frédérique van Dunné (Royal Women's Hospital), and Pieter, Mathijs and Elenora, for their continuous support and patience in fostering an environment in which ideas can come to fruition.

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It has been a pleasure to work with Professor Ross Buckley (Editor, Global Trade and Finance Series) and Ms Sian O'Neill (KLI, London) in producing this Yearbook.

**J.J. de Vries Robbé**
**P.A.U. Ali**

*Melbourne, March 2005*

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