THE CONFLICTS OF INTERESTS IN SECURITIZATION

Alain NOUJAIM

July 2013

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71, Pierre Gemayel Street - Kallas Building - 1st floor – Bouchrieh - Beirut – Lebanon
Tel. : +(961) 1 256 883; +(961) 1 254 663; Fax :+(961) 1 254 663 (ext. 103)
Email : info@noujaimlaw.com - Website :www.noujaimlaw.com

I- Introduction

After the 2007 massive financial American and global crises, which we are living its consequences till now, every investor, regulator, CEO etc… pointed out securitization and blamed the systemic effect of the crisis on securitization, if not the origin of the financial crisis. Although some have predestined the securitization transaction to disappear, the majority of authors predict that securitization market, at least on the long term horizon, is expected to recover[1].

Securitization is a financing technique in which assets, generally illiquid, and which generate constant stream of cash flows, are pooled and converted into instruments that are offered and sold in the capital markets as securities. This technique usually involves an Arranger which designs the operation, an Originator which provides the assets to be securitized, an SPV (Special Purpose Vehicle) to which the assets are transferred and which issues securities representing the pool of assets to be securitized, Investors which buy the securities issued by the SPV and a rating agency which rates the riskiness and credit worthiness of the security issued by the SPV.

In other words, the originator contacts the arranger to set up a securitization of some of its assets. An SPV is then constituted to acquire these assets. The arranger creates, based on the combined and pooled assets, the financial product to be offered to investors on the

[1] Blommestein, keskinler, lucas, outlook for the securitization market, OECD journal: financial market trends, volume 1, issue 1, 2011.

markets. Securities are then issued by the SPV representing the pool of assets acquired. These securities would be divided to different categories depending on their seniority, riskiness, return…

Every author blamed securitization as if it were the main cause of the financial crises, combining it with predatory lending from banks and the loosening on conditions for house loans and mortgages. Following these accusations, some authors mourned securitization and declared its end.

There is no denial that securitization has affected, one way or the other, the cataclysm of the global financial crisis, whether by creating the systemic risk and spreading the risk of decrease of US home prices to the world, or by being an indirect reason for the loosening of the standards of the banks for giving loans. But will this lead to the vanishing of the securitization on the financial world[2]?

We do not think so and as Bernanke says in his speech At the UC Berkeley/UCLA Symposium: The Mortgage Meltdown, the Economy, and Public Policy, Berkeley, California October 31, 2008: "Developing an effective securitization model is not easy--according to one economic historian, mortgage securitization schemes were tried and abandoned at least six times between 1870 and 1940".[3]

[2] Benjamin J. Keys, Tanmoy Mukherjee, Amit Seru, Vikrant Vig (December 2008): Did Securitization Lead to Lax Screening? Evidence From Subprime Loans

[3] See Kenneth Snowden (1995), "Mortgage Securitization in the United States: Twentieth Century Developments in Historical Perspective," in Michael D. Bordo and Richard Sylla, eds., *Anglo-American Financial Systems: Institutions and Markets in the Twentieth Century* (New York: McGraw-Hill).

Securitization will be used again on the financial market, and the global crisis will allow financiers to create a better version of securitization.

From this point, we find that securitization as used in the financial markets, was flawed. One of the flaws of the securitization as it has been used is the conflicts of interest in this operation.

As we can notice, lots of persons are involved in this process and some of the relations between the parties to this transaction could be interpreted as principal-agent relationship: between the originator and the arranger, between the investors and the SPV,… Therefore, it is inevitable that problems of conflict of interests would arise from such transaction.

Unfortunately, the problems of conflicts of interest created by securitization were not addressed in due time, and therefore, these conflicts of interests were exploited perversely in securitization schemes, adding an element of non-transparency, which was one of the indirect causes of the financial crisis the mispricing of the securities issued by SPVs in securitization.

One of the reasons which made the securitization acquire such negative notoriety after the 2008 crisis is the unclear relations between the parties involved in such transaction and their opacity to the markets.

Consequently, the questions which need to be treated: what is securitization and what parties are involved in such transaction? What are the conflicts of interests which may

arise from this transaction between the parties involved? How can we mitigate and try to eliminate these conflicts of interests without affecting the market of securitization?

In times of crisis, the intervention of the regulator is generally welcomed and even required[4], whereas in times of prosperity, the intervention of the regulator is seen as an impediment to the growth of the market. In fact, "the immutability of regulation can transform protectionism into strangulation"[5], therefore, an equilibrium should be found between the intervention of the regulator and the freedom of the market. Indeed, some authors believe that "additional legislation and regulations cannot and should not try to prevent subprime lending (or innovation in the mortgage markets more generally), because that will simply shut off credit to less creditworthy individuals who want to become home owners. Instead, actions should focus on better educating consumers on complex loan products and simplifying the documents necessary for informed decision-making."[6]

We will try, through this thesis, to define the conflicts of interest of the different parties of a securitization (section II), after defining briefly securitization and determining the parties involved in such a transaction (section I), to conclude with solutions to these conflicts of interest, first through changes in the structure of the operation of securitization (section IV) and finally through the intervention of the regulators (section

[4] Mccoy, Pavlov, Wachter; Systemic risk through securitization: The result of deregulation and regulatory failure, Connecticut law review, volume 41, number 4, may 2009.
[5] Joskow and Rose; the effects of economic regulation; April 1987, Massachusetts Institute of Technology.
[6] Barth, Li, Phumiwasana, Yago, a short history of the subprime mortgage market meltdown, Milken institute, January 2008.

V), where there is no room for the removal of such conflicts of interests through the market.

II- The securitization process

In this section, we will start by defining the securitization (A) and then determine the different parties and their roles in this transaction (B).

A- A brief history of securitization

Before 1980, residential home mortgage loans were made essentially by savings and loans. The institutions providing loans originated, serviced, and held them in their portfolios. However, starting from the 1970, residential home mortgage loans were increasingly securitized and the combining of these three functions by a single institution began to change. Ginnie Mae (Government National Mortgage Association GNMA), Fannie Mae (Federal National Mortgage Association FNMA), and Freddie Mac (Federal Home Loan Mortgage Corporation FHLMC) developed into the main securitizers of home mortgages.

The securitization process contributed to the unbundling of the home mortgage practice: savings and loans no longer had to hold these mortgages in their portfolios. Moreover, the

origination and servicing of mortgages became separate functions not entirely performed by savings and loans. The unbundling of the home mortgage process into these three separate functions (funding, origination, and servicing) meant there were also three separate sources of revenue to be earned. Unlike the savings and loans, investors who ultimately purchased securities based upon pools of home mortgage loans became more detached from the homes serving as collateral, and consequently were relying excessively on rating agencies for the assessment of the credit quality of these securities.

The financial innovations of securitization helped the development of the mortgage markets in the US. Beginning in the second half of the 1990s, subprime mortgage loans (loans issued to higher-risk borrowers) increased rapidly. Ginnie Mae, Freddie Mac, and Fannie Mae were no longer dominating the security issuance. Home mortgage loans securitized by non-agency entities grew quickly.

Low interest rates and considerable raises in home prices in the US fueled important optimism on the part of lenders, borrowers, and investors. Furthermore, mortgage brokers also found subprime loans attractive since they could get fees while passing along any credit risk.

Significant problems began to surface in the subprime loan market, in 2007, when some of the subprime mortgage lenders filed for bankruptcy with several financial firms

suffering serious losses on subprime securities. This troublesome situation has led to many condemnations of subprime mortgage loans and securitization[7].

B- The definition of securitization

No uniform definition was given to the process of asset securitization. However, many authors defined securitization.

Schenker and Coletta defined securitization as "the sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets"[8].

Ronald Borod has defined securitization in a broader and simpler manner: "the aggregation and pooling of assets with similar characteristics in such a way that investors may purchase interest or securities backed by those assets"[9].

In fact, Asset securitization transactions are structured in different methods. Nevertheless, we can determine five criteria required in all asset securitization transactions. In fact, in a

[7] Barth, Li, Phumiwasana, Yago, a short history of the subprime mortgage market meltdown, Milken institute, January 2008.

[8] Joseph C. Shenker & Anthony J. Colletta, Asset Securitization: Evolution, Current Issues and New Frontiers, 69
Tex. Law. Rev. 1369, 1374-75 (1991)

[9] Ronald S. Borod, Securitization, Asset Backed and Mortgage Backed Securities, 1-7 (3d ed. 1991).

classic securitization transaction, an entity typically called the "originator" transfers rights to payment from income producing assets (loans, lease rentals, accounts receivable or commonly undivided interests in such rights) to a special entity: the special purpose vehicle ("SPV"). The SPV, then, issues securities to capital market investors and utilizes the proceeds of the issuance to pay for the receivables. The investors, repaid from the collections of the receivables, purchase the securities relying on their assessments of the value of the receivables[10].

The five criteria would then be:

1- The beginning of the asset securitization with the "Originator" which identifies a pool of assets to be securitized.
2- The Originator forms a Special Purpose Vehicle ("SPV") which would be owned as a subsidiary and designed specifically for the asset securitization.
3- While creating the SPV, the Originator try to make the SPV "bankruptcy remote" by utilizing several "bankruptcy proofing" techniques.
4- The Originator sells the identified pool of assets to the SPV a "true sale".

One of the most essential issues in a securitization is if the SPV's investors will continue to be repaid in case of the originator's bankruptcy. If the SPV owns the receivables, its investors will continue to be repaid; if not, their right to be repaid will be suspended and subject to possible impairment. The SPV will own the receivables only if the transfer of

[10] Schwarcz, the impact of bankruptcy reform on "True Sale" determination in securitization transactions, Fordham journal of corporate and financial law, volume 7, issue 2, article 5, 2002.

those receivables from the originator to the SPV constitutes a sale under applicable bankruptcy law - usually referred to as a "true sale"[11].

5- The SPV issues asset-backed securities and/or debt instruments to pay the Originator for the purchase of the assets[12].

In our thesis, we will limit the assets to loans backed by mortgages delivered by the banks, or any other institution capable of contracting mortgaged loans, by law.

C- The parties involved in a securitization and their respective roles

The asset securitization transaction begins with the Originator, which, as previously mentioned, indentifies a pool of assets to be securitized. Different types of loans and receivables have been identified as assets for securitization transactions, including car loans, car leases, credit card receivables, trade receivables and franchise fees.

Usually, the assets must have a steady, predictable income stream in order to service principal and interest payments. A large pool of assets is typically used to ensure that the risk of non-payment is diversified.

Once an appropriate asset pool having these specifications is identified, the Originator will isolate it and transfer it to the SPV in the form of a "true sale".

[11] Schwarcz, the impact of bankruptcy reform on "True Sale" determination in securitization transactions, Fordham journal of corporate and financial law, volume 7, issue 2, article 5, 2002.

[12] Klee, Butler, Asset-backed securitization, special purpose vehicles and other securitization issues, UCC law journal, Vol.35, number 2, fall 2002.

The Originator will create a subsidiary—the SPV—that serves as the purchaser of the mentioned identified assets to be securitized. The SPV will be a separate legal entity from the Originator.

The SPV serves three principal functions: (i) it is a pass-through vehicle allowing the transformation of the Originator's assets into liquid securities which will be sold to investors; (ii) it protects the investors of the securitized assets from the SPV going bankrupt; and (iii) it protects the securitized assets from the Originator's creditors, in case the latter files for bankruptcy. Different legal forms can be taken by the SPV: a corporation, trust, partnership or a limited liability company or partnership[13].

A good deal of securitization transactions are structured with the Originator acting as servicer of the cash flow produced by the securitized assets. The role of the servicer is to monitor the assets and administer the income. It is logical that the Originator acts as the servicer, because the Originator initially generated or held the assets, therefore it would be in the best position to understand the nature of the assets and how to best service them. The designation of a new servicer could lead to an increase in the expenses and in inefficiency. However, when the Originator acts as the servicer, some problems may arise, especially regarding the qualification of the transfer of the assets as a "true sale", since the Originator would maintain some control over the assets and their proceeds, even after their transfer to the SPV. Also, the probability of substantive consolidation between the Originator and the SPV would be increased.

[13] Klee, Butler, Asset-backed securitization, special purpose vehicles and other securitization issues, UCC law journal, Vol.35, number 2, fall 2002.

Due to the intrinsic risk that that the SPV will have insufficient funds to pay the asset-backed securities, credit enhancement methods are usually employed to secure a high credit rating for the SPV and for the asset-backed securities it issues. The commonly used techniques for credit enhancement are over-collateralization and subordination.

Over-collateralization is where the principal amount of the assets backing the SPV's securities is greater than the principal amount of securities issued under the securitization transaction. This technique protects the investors of asset-backed securities against the risk of non-payment or late payment. It also increases the chances that foreclosure on the assets will yield enough funds to compensate investors. On another level, over-collateralization increases the risk that the securitization transaction will be attacked as a fraudulent transfer and not as a "true sale". The securities may also be backed by a letter of credit issued by a bank, a surety bond issued by an insurance company, or a guarantee issued by a financial company.

Another frequently used credit enhancement device is the senior debt/subordinated debt structure, or subordination. This method of credit enhancement split the issued securities of the SPV into senior and junior securities. The junior shares would be subordinated to the senior ones. The subordinated holders do not receive scheduled principal and payments unless the senior holders have received all of their principal and interest payments.

The most subordinated securities in the assets of the SPV are usually acquired by either an independent third party, affiliate of the Originator, or the Originator itself in exchange for the transfer of the assets.

The subordinated securities provide the SPV with an extra layer of capital protection because the subordinated debt absorbs losses on the underlying receivables[14].

The issuance of asset-backed securities has taken three principal forms: (i) debt (of varying classes); (ii) preferred stock; and (iii) certificates of beneficial interest[15]. Asset-backed securities in a single structure can provide a variety of priorities, maturities and rates of return to investors.

These entire credit enhancement methods are used in one purpose, as stated above, to ensure the high credit rating of the SPV and the issued securities. In fact, due to the complexity of the securitization transaction and its reliance on a large pool of relatively small assets, a due diligence is difficult to make and therefore the pricing of the securities and the assessment of their risk is very difficult. Therefore, the investors in securities issued due to a securitization would over-rely on credit rating agencies to assess the risk of the securities. Indeed, Credit rating is essentially an assessment of credit risk of the SPV and its assets.

[14] Klee, Butler, Asset-backed securitization, special purpose vehicles and other securitization issues, UCC law journal, Vol.35, number 2, fall 2002.

[15] Klee, Butler, Asset-backed securitization, special purpose vehicles and other securitization issues, UCC law journal, Vol.35, number 2, fall 2002.

Credit ratings by one or more of the prominent rating agencies are invariably required in order to sell asset-backed securities[16]. These agencies study and examine the quality of the assets and publish credit ratings. The credit rating depends on a variety of factors including the quality of the assets and the level of over-collateralization and credit enhancement.

All of the above mentioned parties and operations in the securitization transaction are monitored and guided by the Arranger. The Arranger acts as the "maestro" of the securitization transaction. It will be generally responsible for the financial structuring and insuring the investments of shares to investors.

The arranger takes overall responsibility for the overall structure of the securitization and offers the substantial knowledge and administrative functions to create the securitization framework and implement it. This task includes liaison between the originator, investors, lenders and other related parties. The arranger has to be able to accurately understand the needs of each party of the transaction as well as have the skill for the coordination of the logistics of the securitization and specialist knowledge to negotiate effectively with lawyers, tax attorneys and accountants when necessary[17].

In addition to the due diligence on the assets purchased from the Originator, the Arranger is responsible for bringing together all the elements for the deal to close. In particular, the Arranger creates an SPV that will purchase the assets, consults with the credit rating

[16] Klee, Butler, Asset-backed securitization, special purpose vehicles and other securitization issues, UCC law journal, Vol.35, number 2, fall 2002.

[17] Real estate securitization handbook, p.18

agencies in order to finalize the details about deal structure, makes necessary filings with the SEC, and underwrites the issuance of securities by the SPV to investors[18].

After the asset is in the securitization vehicle the Arranger may select the underwriter for the sale of public securities, if applicable, as well as the financing counterpart who will provide the non-recourse loan.

Generally, Arrangers are securities firms, city banks, trust banks, other financial institutions and consultants.

We have defined the securitization transaction after giving a brief historical review of the transaction and determined the parties to a securitization transaction, the Originator, the Arranger, the servicer, the credit rating agencies, and the investors and we defined their respective roles.

In the next section, we will define the conflicts of interests created by each party to the securitization transaction due to their roles and their interactions with each other, before trying to give some solutions to these problems of conflicts of interests.

III- The conflicts of interests in securitization

[18] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

In a securitization transaction, many relationships can be described as principal-agent relationships. The principal-agent model deals with the difficulties arising from conditions of incomplete and asymmetric information. This occurs when a person (principal) engages another person (agent) to perform some service on his behalf involving the delegation of some decision-making authority to the agent. In such a case the principal undergoes the risk that the agent takes advantage of his superior knowledge of this precise matter to the disadvantage of the principal.

This issue seems to have been a significant cause of the financial crisis and was due to the materialization of conflicts of interest that had developed in about every phase of the securitization transaction[19].

A- The Originator and the Borrower

Since we limited the assets of a securitization transaction to mortgaged loans, the process of securitization starts with the originator (to be) selling a mortgaged loan to its clients (the borrower). In this relationship, the Originator is more informed about the loan and means of financing than the borrower, the borrower is usually financially unsophisticated[20].

[19] Kumpan, conflicts of interest in securitization: adjusting incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.

[20] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

In addition to that, the Originator is usually paid depending on the loan volume they contract, not on long-term loan performance. They receive a commission, once their loans are booked, and the credit risk is quickly transferred to other market participants through the securitization of the loans[21]. Therefore, The Originator is incentivized to increase the volume of its loans without focusing on their quality, to generate higher profits.

This lead to what was called "predatory lending", defined by Morgan (2005) as the "welfare-reducing provision of credit". This predatory lending practice, due to the structure of the securitization transaction, caused a lax in the standards of the Originator to give loans to borrowers, as it was justified by several studies, linking the ease of securitization to the lax of screening[22].

These factors also created moral hazard in the origination of loans. In fact, it has been proven that an important part of early payment defaults in subprime loans contained clear signs of fraud in the loan files[23]. In fact, a report of the United States Financial Crimes Enforcement Network (2006) shows that mortgage fraud has increased dramatically, over the past decade, (1318 reported instances in 1996 to 25,989 reported instances in 2005)[24].

[21] Kumpan, conflicts of interest in securitization: adjusting incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.

[22] Keys, Mukherjee, Seru, Vig, did securitization lead to lax screening?evidence from subprime loans. Electronic copy available at: http://ssrn.com/abstract=1093137.

[23] Kumpan, conflicts of interest in securitization: adjusting incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.

[24] Financial Crimes Enforcement Network, "Mortgage Loan Fraud, An Industry Assessment based upon

B- The Originator and the Arranger

In addition to the conflict of interest between the Originator and the Borrower, a conflict of interest appeared between the Originator and the Arranger. This conflict of interest is due to the information asymmetry between the Originator and the Arranger. In fact, the Originator knows more about the loans it is originating than the Arranger. This created an adverse selection situation between the Originator and the Arranger. The adverse selection refers to "a market process in which – due to asymmetric information – competition leads to such results that "bad" products, customers, or agents – so-called lemons – are more likely to be selected then "good" ones"[25].

Therefore, the Originator would retain the good subprime mortgages and securitize bad (riskier) ones (the lemons). This unbalanced expansion also had lead to a loosening of lending standards and excesses in lending[26].

In this case, the Arranger has the same motivations for not doing a thorough due diligence, since the Arranger also did not care about the good or bad subprime loans, due to the nature of its remuneration. The Arranger would typically structure the securitization to get the best credit rating and sell the issued securities to investors.

Suspicious Activity Report Analysis" (November 2006)

[25] Akerlof, The Market for Lemons: Quality Uncertainty and the Market Mechanism" (1970) 84 *The Quarterly Journal of Economics* 488.

[26] Kumpan, conflicts of interest in securitization: adjusting incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.

Indeed, we will see through this thesis that, the Arranger in this case would benefit of an information asymmetry between him on one hand, and the credit rating agencies and the investors, on the other.

In fact, the Arranger usually purchases the pool of mortgage loans from the originator. The responsibilities of the arranger include conducting due diligence on the originator. This due diligence consists of but is not limited to financial statements, underwriting guidelines, discussions with senior management, and background checks.

In addition to institutions which both originate and issue on their own, the list of issuers also includes investment banks that purchase mortgages from originators and issue their own securities.

The Arranger is generally compensated through fees charged to investors and through any premium that investors pay on the issued securities over their par value[27].

This conflict of interest involves an information assymetry problem between the Originator and Arranger. In fact, the Originator has an information advantage over the Arranger regarding the quality and credit worthiness of the Borrower. This situation might lead to predatory lending (the lender convinces the borrower to borrow "too much") or predatory borrowing (the borrower convinces the lender to lend "too much")[28].

C- The Arranger and third parties

[27] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

[28] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

As we mentioned earlier in the section related to the conflict of interest between the Aranger and the Originator, it appears that a conflict of interest concretizes between the Arranger and Credit rating agencies as well as between the arranger and the SPV.

1- The Arranger and credit rating agencies

Before assessing the conflict of interest between the Arranger and a credit rating agency in a securitization transaction, we will start by a brief definition of a credit rating agency. "A credit rating by a Credit Rating Agency represents an overall assessment and opinion of a debt obligor's creditworthiness and is thus meant to reflect only credit or default risk. To be sure, it is not the obligor but the instrument issued by the obligor which receives a credit rating. The distinction is not that relevant for corporate bonds, where the obligor rating is commensurate with the rating on a senior unsecured instrument, but is quite relevant for structured credit products such as asset-backed securities (ABS)".[29]

Moody's defined rating as "the comparability of these opinions holds regardless of the country of the issuer, is industry, asset class, or type of fixed-income debt" (Moody's 2004). Whereas Standard and Poors stated that "our ratings represent a uniform measure of credit quality globally and across all types of debt instruments. In other words, an 'AAA' rated corporate bond should exhibit the same degree of credit quality as an 'AAA' rated securitized issue" (S&P 2007, p.4).

As we have stated above, the complexity of the securitization transaction, in its execution and not in its fundamentals, and the lack of transparency regarding the information

[29] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

regarding the securitized assets, in addition to conflicts of interest between the different parties in this transaction, lead to an excessive reliance over the ratings of a credit rating agency to assess the risk of securities issued through securitization transactions, by investors and regulators[30][31]. The three most important credit rating agencies are Moody's, Standard and Poors and Fitch. Indeed, a favorable rating from the three major credit rating agencies was essential for the sales of the issued securities of a securitization transaction[32].

Since the volume of securitization increased immensely over the last decade, the credit rating agencies were "very interested" in rating securitization. In fact, a study shows that rating mistakes were systematically correlated with issuer size and market conditions[33].

These facts helped the creation of a conflict of interest situation between the Arranger and the credit rating agencies, but the most important two factors that lead to the conflict of interest situation are the remuneration of the credit rating agency by the Arranger[34] and the asymmetry of information between the Arranger and the credit rating agency[35].

The credit rating agencies, in the early 70's, changed their payment model from "investor pays" to "issuer pays". In fact, the system before the 70's was that the investor would pay the credit rating agencies to rate securities in order to allow the investor to assess the

[30] Fons, white paper on rating competition and structured finance, January 10, 2008.
[31] Kumpan, conflicts of interest in securitization: adjusting incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.
[32] White, the credit rating agencies, journal of economic perspectives, volume 24, number 2, Spring 2010, pages 216-226.
[33] Jie He, Jun Qian, Philip Strahan, credit ratings and the evolution of the mortgage-backed securities market, December 2010.
[34] Kumpan, conflicts of interest in securitization: adjusting incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.
[35] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

credit worthiness and the risk of the security. Due to different causes[36], the system changed in early 70's and the issuer started to pay the credit rating agencies to rate the securities issued by this issuer.

Regardless of the reason, "the change to the "issuer pays" business model opened the door to potential conflicts of interest: A rating agency might shade its rating upward so as to keep the issuer happy and forestall the issuer's taking its rating business to a different rating agency"[37]. It has been proven that this situation lead the Issuer (in our case the Arranger) to "shop for ratings", especially regarding complex securities, and consequently took the best rating made available by the credit rating agencies[38].

Therefore, the Arranger, in the case of a securitization transaction, would select the rater that creates a conflict of interest.

The asymmetry of information is another important cause to the conflict of interest between the arranger and the credit rating agencies. The opinion of the rating agencies is vulnerable to the lemons problem[39] (the arranger likely still knows more) because they only conduct limited due diligence on the arranger and originator[40].

[36] White, the credit rating agencies, journal of economic perspectives, volume 24, number 2, spring 2010, pages 216-226.

[37] White, the credit rating agencies, journal of economic perspectives, volume 24, number 2, spring 2010, pages 216-226.

[38] Skreta, Veldkamp, rating shopping and asset complexity: a theory of ratings inflation, New York University, stern school of business, October 24, 2008.

[39] Named after 2001 Nobel Laureate George Akerlof's 1970 paper "The Market for Lemons". His original example had to do with used cars. Why does the seller want to get rid of the car? It might be a lemon. The buyer and seller have asymmetric information. Hence, the buyer will demand a deep discount on the car because of the possibility it is a lemon.
source: http://www.nasdaq.com/investing/glossary/l/lemon#ixzz2ZlWLNrtt

[40] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

In addition to the mentioned above, the incentive of a credit rating agency to do a strict due diligence over the securities issued through a securitization transaction is mitigated by the "Issuer Pays" problem.

Hence, we find that a conflict of interest situation do exist between the Arranger and the credit rating agencies, creating a situation where the credit rating agencies ratings are unreliable whereas the vast majority of the players on the securitization market are over-reliant on these ratings.

While this situation creates a conflict of interest "in favor" of the Arranger on one hand, on the other hand, it creates a conflict of interest between the credit rating agencies and the investors[41]. In fact, whereas the rating for the securities issued through securitization should be done to allow investors, to mitigate the informational asymmetry between them and the arranger, and give them a better assessment of the risk and the credit worthiness of the securities issued through securitization, it has become an instrument used by the Arranger to promote and to sell these securities, to misinformed investors.

After demonstrating the conflict of interest between the Arranger and credit rating agencies, we will show below, the conflict of interest between the Arranger and the SPV of a securitization transaction.

2- <u>The Arranger and the SPV</u>

[41] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

As mentioned here above, the Arranger gets compensated through investors in the SPV and the premium these investors pay. Therefore, the Arranger has limited incentives to execute its tasks, especially regarding due diligence, since it would not bear the risk of default of the loans.

Moreover, the Arranger would be incentivized to turn a blind eye concerning the quality of the loans to be securitized because, in case the quality turns out to be lesser than expected, it would affect the cost of establishing the securitization and the remuneration of the arranger.

Consequently, the asymmetry of information in this case, between the SPV and the Arranger, created also a conflict of interest situation, where the Arranger abuses of his superiority regarding information related to the assets to be securitized vis-à-vis the SPV.

This situation is worsened by the fact that the Arranger also abuses of conflict of interest between him and the rating agencies, as shown above. Hence, the investors of a SPV, which "only" way to investigate the quality of the assets of a securitization transaction is through the reliance on the credit rating agencies, lose this element, which was supposedly there in their favor, due to the structure of the securitization, which do not take into consideration, the different conflict of interest situation it creates.

After, the probing of the conflict of interest situations involving the Originator and the Arranger, we will concentrate on the conflict of interest relating to the Servicer.

D- The servicer and the SPV

One may underestimate the influence of the servicer in a securitization transaction, but Moody's estimates show that servicer quality may affect the realized level of losses by +/- 10%.

Before focusing on the conflict of interest situation between the service and the SPV, let us start by defining the role of a service in general, and particularly in securitization.

In a traditional mortgage lending relationship, a lender makes a loan, retains the loan in its portfolio, and services the loan itself. The lender sends out monthly billing statements and collects the payments. If the loan defaults, the lender will deal with the default aiming to maximize the loan's net present value. Therefore, the lender, in a traditional portfolio, has an entire economic interest in the loan's performance. Hence, its decision whether to restructure or foreclose a defaulted loan will practically always be aligned with his interest[42].

In a securitization transaction, the lender which makes the loan is no longer the servicer. In fact, the securitization transaction distributes the different roles of a traditional mortgage lending on different parties. The servicer would be a third party, appointed by the SPV.

The role of a servicer within a securitization transaction would be to perform all the day-to-day activities regarding the mortgages transferred to the SPV. It will be in charge of

[42] Levitin, Twomey, Mortgage servicing, Yale journal on regulation, volume 28.1, 2011.

the account maintenance activities: sending monthly statements to mortgagors, collecting payments from mortgagors, keeping track of account balances, handling escrow accounts, calculating interest-rate adjustments on adjustable-rate mortgages, reporting to national credit bureaus, and remitting funds collected from mortgagors to the trust. Servicers also are in charge of handling defaulted loans and prosecuting foreclosures and try to diminish the losses of the SPV.

Hence, Servicers are responsible of ensuring that the mortgage loans are repaid to the SPV[43].

The conflict of interest arising between the servicer and the SPV is mainly the consequence of the remuneration scheme of the servicer by the SPV. This compensation method, which we will detail below, along with the system in which the servicer works, lead to a conflict of interest between the SPV and the servicer.

The compensation of a servicer in a securitization transaction is based on four types of compensation: servicing fees; float income; ancillary fees and a retained interest in securitization[44].

We will not enter in the details of the remuneration of the servicer but the important points of this remuneration, which affect the situation of conflict of interest with the SPV are:

[43] Levitin, Twomey, Mortgage servicing, Yale journal on regulation, volume 28.1, 2011.
[44] Levitin, Twomey, Mortgage servicing, Yale journal on regulation, volume 28.1, 2011.

i. The servicing fee is a flat percentage of the outstanding principal balance of the mortgage loans[45].

ii. The servicer in a securitization is paid each month before any funds are advanced to investors[46].

iii. The servicer also receive late fees resulting of the advances paid by the servicer to the SPV for a delinquent loan, including insurance on the mortgage, foreclosure expenses etc…but servicers are not paid for expenses related to the restructuring of the loan[47].

iv. We will address the retained interest in securitization further in the thesis, since this type of compensation mitigates the conflict of interest in some cases.

The consequences of the compensation plan of the servicer are that the servicer in more inclined to keep the loans on his books for as long as possible. Also, the servicer will not decide to restructure the loan or go for the foreclosure depending on the interest of the SPV, but depending on the cost of the restructuring versus the foreclosure on his income. Moreover, the servicer will inflate the late fees to gain the maximum out of the foreclosure.

[45] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.
[46] Kumpan, conflicts of interest in securitization: adjusting incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.
[47] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

Firstly, the servicer is more inclined to keep the loans on his book for the maximum period because the servicing fee is a flat percentage of the outstanding balance of the mortgage loans, as we have mentioned. Therefore, the more the loans are on his books, the bigger his remuneration. Hence, the servicer would strongly prefer to delay the foreclosure and restructure the loan irrespective of the interest of the SPV[48].

Also, since the servicer is paid usually in the beginning of the month, before the SPV, and the SPV receives the payments at the end of the month; the servicer would prefer to keep the loans on his books to earn the interest on float[49].

Secondly, the fact that the servicer has to make advances to the SPV, in case of delinquent loans, and then receive the late fees, would incentivize the servicer to directly go to foreclosure for the delinquent loans, and not for the restructuring of these loans[50]; since it may affect its liquidity and bear the risk of being unpaid by the SPV. In this case, the servicer must advance unpaid interest (and sometimes principal) to the SPV as long as it is deemed collectable, which typically means that the loan is less than 90 days delinquent. In addition to advancing unpaid interest, the servicer must also keep paying property taxes and insurance premiums as long as it has a mortgage on the property[51].

[48] Kumpan, conflicts of interest in securitization: adjusting incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.
[49] Kumpan, conflicts of interest in securitization: adjusting incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.
[50] Kumpan, conflicts of interest in securitization: adjusting incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.
[51] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

Consequently, and based on what we mentioned in the above paragraph, the decision of the servicer to restructure the loan or to go to foreclosure, is not related to the interest of the SPV but directly to the sole interest of the servicer's compensation.

Finally, in case of foreclosure, the servicer will have to pay all the expenses until the property is liquidated and will naturally tend to inflate the costs of the foreclosure[52], especially that no party can control the adequacy of these costs.

It is important to mention that a conflict of interest situation arises between the servicer and the borrower. In fact, the borrower-mortgagor would not have the incentive to provide efforts or resources in order to maintain a property which is close to foreclosure[53]. However, we will not develop on this conflict of interest since we do not find that its effect is as important as other conflict of interests in securitization.

The conflicts of interests do not appear on the "selling side" of the securitization transaction, but also, as we will see below, on the "buying side".

E- The managers and the investors

[52] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

[53] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

The conflicts of interest appear also from the side of the investors. Typically, the investors would invest in an entity managed by a manger. The latter would then invest the funds of the investors in securities issued through securitizations[54].

The hunt for yield, created by the completion between managers relatively to their peers or to a benchmark, created a conflict of interest between the managers and the investors: a principal-agent conflict of interest.

Indeed, it appears that managers were attracted by the combination of high rating/high return of the securities issued through securitization and hence were willingly loosening their supervision and due diligence with respect to the securities issued through securitization, and even if, in some cases, they knew these securities were improperly rated[55].

While bearing in mind that a typical investor is generally unsophisticated financially and therefore would not be able to understand the investment strategy of the manager or to monitor the latter[56], it becomes clear why the principal-agent problem occurred between the investors and the managers.

[54] Kumpan, conflicts of interest in securitization: adjusting incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.
[55] Kumpan, conflicts of interest in securitization: adjusting incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.
[56] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

Now that we have developed and defined the important situations of conflicts of interest in a securitization transaction, we will try to find solutions to these conflicts of interest. Since we believe that over-regulation of the securitization will kill the transaction on the long run, and since we believe that the market can, in most cases, correct its flaws, we will start by trying to find solutions to the conflict of interest situations by "remodeling" the structure of the transaction.

As for the conflict of interest problems which cannot be solved by the market, we will try to find regulatory solutions, which would mitigate or eliminate the conflict of interest, without affecting the market of the securitization transaction.

IV- The conflicts of interests which can be solved by changes in the structure of the operation

Many of the conflicts of interests situations appearing in a securitization transaction can be solved or, at least, mitigated without the interference of regulators. In fact, a change in some details in the securitization transaction procedure might eliminate the conflict of interest between two parties of the securitization transaction. These details can include having a stake in securitization, changing the compensation scheme of a party, putting another party in the transaction etc…

The conflicts of interest which can be solved or mitigated without intervention of the regulators are the conflicts of interest of: Arranger-Originator; Arranger-Credit Rating Agencies; Arranger-SPV; Servicer-SPV and Managers-Investors.

We will detail below how some changes in the mechanism of a securitization transaction can eliminate or diminish the conflict of interest situation.

IV- The conflicts of interests which can be solved by changes in the structure of the operation

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The conflicts of interest which can be solved or mitigated without intervention of the regulators are the conflicts of interest of: Arranger-Originator; Arranger-Credit Rating Agencies; Arranger-SPV; Servicer-SPV and Managers-Investors.

In fact, history shows us many examples of regulatory overreaction after a financial crisis like Sarbanes-Oxley. The problem is in fact based in the misaligned incentives, they tend

to lower the quality of a financial product and destabilizing valuation and to raise the leverage of financial intermediaries[57].

Moreover, a regulation of the financial system which is too restrictive, while hailed in times of crisis, would stifle growth and innovation and thus ultimately damage the very institution it is meant to protect[58].

We will detail below how some changes in the mechanism of a securitization transaction can elimitnate or diminish the conflict of interest situation.

A- Arranger – Originator

The conflict of interest between the Arranger and Originator, as we have mentioned above, is based on an information asymmetry regarding the assets to be securitized. Indeed, the Originator has most probably more information about its assets than the Arranger who will be acquiring them.

To dissuade the Originator from abusing of his information advantage the initial securitization scheme would include a due diligence by the Arranger and representations and warranties from the Originator to the arranger, regarding the "Lemons" or the bad loans. The originator would then repurchase the problem loan. But the consequence here

[57] Franke, Krahnen, The Future Of Securutization, Center Of Financial Studies, Econstor, October 11, 2008, Working paper n.2008/31, Version is available at: http://hdl.handle.net/10419/43196

[58] Kumpan, Conflicts Of Interest In Securitization: Adjusting Incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.

is that the originator must have adequate capital to buy back these loans and so that these representations and warranties have an effect on the conflict of interest between arranger and originator[59]. Indeed, in some cases, originators did not have enough capital to repurchase the bad loans in application of their representations and warranties[60].

Obviously, these techniques did not deter the originator from abusing of his information advantage at the expense of the Arranger. On another note, the arranger was also not incentivized to effectuate a strict due diligence, as we have already explained. We will deal the conflict of interest Arranger – SPV in another section.

From the Originator side, studies have shown that excessive securitization, in the way it was executed, did adversely affect the screening incentives of originators[61], one of the consequences of the disintermediation effect of securitization[62]. In fact, this lax screening would not have happened if there was no information asymmetry between the originator and the arranger since the latter would have not accepted to purchase bad loans from the originator.

[59] Ashcraft, Schuermann, Understanding The Securitization Of Subprime Mortgage Credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.
[60] Kumpan, Conflicts Of Interest In Securitization: Adjusting Incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.
[61] Keys, Mukherjee, Seru, Vig, Did Securitization Lead To Lax Screening? Evidence From Subprime Loans, December 2008, Electronic copy available at: http://ssrn.com/abstract=1093137.
[62] Wang, Xia, Bank Monitoring And Corporate Loan Securitization, Hong Kong Research Council, January 2012.

To deter the originator from exploiting his information advantage to securitize bad loans, the most commonly proposed solution is the retention of the equity tranche (which suffers the first loss) by the Originator to have some "skin in the game"[63].

In fact, studies have shown that the Originator's retained share and reputation are the key mechanisms for reducing information asymmetry between the Originator and other parties of a securitization[64]. Also, agency theory tells us that the party affecting the level of default losses through its activities should bear a substantial portion of these losses. Hence the originating bank should retain a substantial part of the first loss piece[65].

Ceteris paribus, from standard agency theory, the stronger is the influence of some party on the overall risk, the more risk it should bear.

The originator has a strong influence through its screening activities; therefore it should bear a relatively higher stake of the risk in the securitization transaction.

Two factors may diminish this share of risk: firstly, the originator has limited control over the other parties in securitization and secondly, the Originator is involved only in the first phase of the securitization transaction (the part where the assets are transferred to the arranger).

[63] BIS (Bank for International Settlements), International Banking And Financial Market Developments, BIS quarterly review, September 2009.
[64] Benmelech, Dlugosz, Ivashina, Securitization Without Adverse Selection: The Case Of CLOs, Journal of financial economics, 106 (2012) 91-213
[65] Franke, Krahnen, The Future Of Securutization, Center Of Financial Studies, Econstor, October 11, 2008, Working paper n.2008/31, Version is available at: http://hdl.handle.net/10419/43196

Consequently the Originator would ask to be compensated for these risks. Hence, the effect of the Originator on the assets performance should be measured and the stake of the Originator in the equity part should be calculated according to this risk. Depending on the assets, the Originator influence may show in different phases through the securitization transaction and its part of equity should vary, during the lifetime of the securitization transaction, depending on its influence, in any stage of the securitization[66].

In fact, the consequence of having a stake in the equity part could lose its effectiveness in mitigating the impact of the conflict of interest between parties if the stake does not cover the risk held by the Originator. If losses are high enough, the Originator's tranche would be out of the money. This is shown by a study on the effect of holding an equity tranche by a servicer but could be transposed to the case of the Originator holding an equity tranche as well[67].

The above mentioned arguments lead us to two conclusions: first, the Originator should have a stake in the equity share to mitigate the risk of the conflict of interest; second, the share of the part of the Originator should not be strictly defined, because it will lose its

[66] Franke, Krahnen, The Future Of Securutization, Center Of Financial Studies, Econstor, October 11, 2008, Working paper n.2008/31, Version is available at: http://hdl.handle.net/10419/43196
[67] Levitin, Twomney, Mortgage Servicing, Yale Journal On Regulation, Volume 28.1, 2011

consequences; it should be defined ona case by case basis, by the parties in the securitization transaction.

We mentioned the consequences because we noticed when the subprime financial crisis hit; the reaction of the regulators was to make sure that Originators had a stake in the equity tranche of a securitization[68][69]. These regulations were led by the EU and the US: In the European Union, the new article 122(a) of the Capital Requirements Directive (CRD II) includes a minimum risk retention rate, according to which a credit institution shall be exposed to the credit risk of a securitization position only if the originator, sponsor or original lender has explicitly disclosed to the credit institution that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5 per cent of the total issuance of securitization products. This new requirement came into force on 31 December 2010.

In the United States, section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) requires a securitizer to retain at least 5 per cent of the credit risk of any asset that the securitizer, through the issuance of an ABS, transfers, sells, or conveys to a third party[70].

[68] Basel Committee On Bank Supervision, The Joint Forum, Report On Asset Securitization Incentives, July 2011.
[69] Global Developments In Securitization Regulation, Final Report, The Board Of The International Securities Commission, 16 November 2012.
[70] Basel Committee On Bank Supervision, The Joint Forum, Report On Asset Securitization Incentives, July 2011.

We believe that through the financial crisis of 2008 and the studies that were made after this crisis to determine its causes, and especially those related to the issues of conflict of interests, the players on the market of asset securitization are now aware of the risks of conflict interest. This holds true especially regarding Originators and Arrangers, since they would be considered the financially sophisticated parties of the securitization. These findings would lead necessarily to the pressure, by the market, on the originator to have a stake in the equity tranche. Based upon this fact, the determination of this tranche should not be determined by the regulator since this tranche would depend on different criteria related to different securitization transactions.

After discussing the Originator-Arranger conflict of interest, we will focus on another conflict of interest in securitization. This conflict of interest was attacked the most after the financial crisis: the Arranger-Credit Rating Agencies conflict of interest.

B- Arranger – Credit Rating Agencies

Credit rating agencies play an essential role in securitization. In fact securitization creates intermediaries from the origination of the loan by the originator, to the distribution of the payments to investors, passing by the arranger, the SPV, the servicer etc…

Therefore, an asymmetry of information is likely going to be incepted through this transaction[71]. Thus, the importance of the rating agencies is certain since these rating agencies will have to mitigate the informational asymmetry by rating the securitized assets and acting as intermediaries[72].

As argued before, the main problem created by securitization regarding the relationship between the Arranger and Credit rating Agencies is that the situation led to a credit rating shopping by the Arranger.

We detailed the problem earlier in our paper, and now we will list some solutions that might eliminate or mitigate this problem of conflict of interest.

The main issue that created this conflict of interest is that the Credit rating Agencies were remunerated by the Arranger. Therefore, the Arranger would impose his terms on credit rating agencies, which were interested in rating its securities and growing their business.

Knowing the cause would allow us to propose a comeback to the rule of "investor pays" where the investors in the securities issued through a securitization transaction pay for the rating of these securities.

[71] Iacobucci, Winter, Asset Securitization And Asymmetric Information, Journal Of Legal Studies, Volume 34, The University Of Chicago, January 2005.
[72] Iacobucci, Winter, Asset Securitization And Asymmetric Information, Journal Of Legal Studies, Volume 34, The University Of Chicago, January 2005.

Some authors proposed the return to an "investor pays" system and did find that although it might have some drawbacks, but these consequences would be mitigated by the market[73].

This measure do not necessitate the intervention of the regulator, because the market will readapt to this condition and securities rated by Credit rating Agencies paid by the issuer would be less credible and therefore less valuable than securities rated by Credit rating Agencies paid by the investors.

In addition to the aforementioned, the credibility (and therefore the value) of a rating presumably derives from the reputation of the issuing agency. Any agency suspected of selling high ratings would, in a free market, see its business deteriorate as such ratings would not influence bond pricing decisions. The market would discount or ignore ratings of agencies whose reputation is tarnished[74].

However, the intervention of the regulator seems necessary in some way. In fact, and despite the fact that the market can, now that the reasons are clear, "punish" a securitization which include an inherent conflict of interest, this consequence of the market require that the latter is informed about the securitization transaction. In fact, regulations related to the transparency and information to the investors needs to be

[73] Skreta, Vedkamp, ratings shopping and asset complexity: a theory of ratings inflation, New York university, Stern School of business, October 24, 2008.
[74] Fons, white paper on rating competition and structured finance, January 10, 2008.

enforced, forcing the Credit rating Agencies to disclose information about the securitization transaction.

Also, rating methodologies made publicly available and providing sufficient detail to guide a non-professional towards plausible rating outcomes are one of the most important tools to counteract the issuer-pays conflict. A transparent methodology makes it difficult to justify a higher-than-warranted rating outcome. Moreover, an issuer with publicly available financial data is open to scrutiny by a wide range of market participants. When there is financial transparency, it would be easier for investors to apply rating criteria and to compare with published ratings. Also, as a defense against “rating shopping,” any rating agency can (in principle) assign a rating to an issuer with transparent financial reports, which may reduce potential shopping of rating[75].

This disclosure would have to be regulated and systematized to be efficient for investors. In fact, in order to improve transparency and disclosure related to credit ratings used for securitization, rating agencies are required to publish information that may be considered important in an assessment by a third party of the correctness of the credit rating; and Stakeholders are encouraged to implement measures to enable a third party to verify the correctness of the credit rating[76].

[75] Fons, white paper on rating competition and structured finance, January 10, 2008.
[76] Basel committee on bank supervision, the joint forum, report on asset securitization incentives, July 2011.

We will be developing the role of the regulator in this type of conflict of interest later in our thesis.

We will be reviewing now the conflict of interest between the Arranger and the SPV in a securitization.

C- Arranger – SPV

We have detailed above the nature of the conflict of interest between the Arranger and the SPV. In fact, the conflict of interest arising in this situation is due to an information asymmetry between the Arranger and the SPV. Indeed, the Arranger is more informed of the quality of the underlying asset of the securitization than the SPV. Moreover, by adding the conflict of interest existing between the Arranger and credit rating agencies, which influence the conflict of interest between the Arranger and the SPV, as previously mentioned, the consequence of the Arranger-SPV conflict of interest is aggravated.

Since the credit rating agencies – arranger conflict of interest might be eliminated or mitigated, as previously stated, the credit rating agency, paid now by investors, and required to disclose information about its methodology, would give a rating to investors in the SPV by conducting a thorough due diligence on the arranger. Therefore, the margin of the Arranger would be *de facto* limited.

But since there is always an information asymmetry between the Originator and the credit rating agencies, this limitation might not be sufficient.

On another note, we have previously noted that the Arranger is one of the parties of the securitization transaction which is involved through the whole securitization. Therefore, it would make sense that the Originator holds a stake in the securitization after the Originator.

In addition what we mentioned, the reputation of the arranger, the credit enhancements provided by the arranger and a thorough due diligence conducted by the SPV appear to be important elements in mitigating or eliminating the conflict of interest between the Arranger and the SPV[77].

These measures do not require the intervention of the regulator and can be easily applied by the players on the market of securitization.

Another conflict of interest we have underlined, and which influence significantly on the securitization transaction is the Servicer-SPV conflict of interest which we will be treating below.

D- Servicer – SPV

[77] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.

As we mentioned earlier, the conflict of interest between the servicer and the SPV can have an important impact on the return of a securitization which can vary +/- 10%, depending on the quality of the servicer.

The conflict of interest between the Servicer and the SPV is mainly the consequence of a remuneration scheme that is not adapted to the securitization and which creates a conflict of interest.

Since the main cause of this conflict of interest is remuneration, we have to focus on a remuneration scheme that would be suitable for the securitization transaction without creating a situation of conflict of interest.

Some authors suggested the existence of a master servicer which would be in charge of monitoring and supervising the servicer[78]. We do not find this approach suitable since it would complicate more the securitization transaction. Moreover, it would add another party to the transaction which is likely to create another situation of conflict of interest, in addition to all these conflict of interests and would make the securitization even more vulnerable. Finally, this solution would add another cost to an already costly transaction which is not available but to a small minority of big originators which have enough assets to securitize to make the transaction work[79].

[78] Ashcraft, Schuermann, understanding the securitization of subprime mortgage credit, Federal Reserve Bank of New York staff reports, staff report n. 318, March 2008.
[79] Levitin, Twomney, Mortgage servicing, Yale journal on regulation, volume 28.1, 2011

Some authors suggested that the servicer holds a stake in the securitization[80]. However, the servicer has no influence on the choice of the originator and therefore would not accept being compensated depending on the originator assets quality[81]: servicers do not want to incur credit risk because it is not their business[82].

Also, studies have shown that the structure where the servicer holds a stake in securitization alleviates conflict of interest only when delinquency rates in a pool are relatively low[83], meaning that this structure would only work, regarding conflicts of interest, when the market is strong and the losses are low.

Another category of authors studied the possibility of separating the servicing into two parts: a servicer would be responsible for the collections of loans and once the borrower is delinquent or needs a restructuring of his loan, the loan is serviced then by a special servicer which would specialize in delinquent loans. Each servicer would be paid differently[84]. However, some studies show that splitting servicer's role has secondary effects, regarding the decision for foreclosing a loan or not, irrelevant of the interest of the SPV[85].

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[80] Hila Gan, Mayer, agency conflicts, asset substitution, and securitization, National bureau of economic research, July 2006, Working Paper 12359, http://www.nber.org/papers/w12359.
[81] Franke, Krahnen, the future of securutization, center of financial studies, econstor, October 11, 2008, Working paper n.2008/31, Version is available at: http://hdl.handle.net/10419/43196.
[82] Levitin, Twomney, Mortgage servicing, Yale journal on regulation, volume 28.1, 2011.
[83] Hila Gan, Mayer, agency conflicts, asset substitution, and securitization, National bureau of economic research, July 2006, Working Paper 12359, http://www.nber.org/papers/w12359.
[84] Levitin, Twomney, Mortgage servicing, Yale journal on regulation, volume 28.1, 2011
[85] Ambrose, Sanders, Yavas, special servicers and adverse selection in informed intermediation: theory and evidence,

We would think of a solution based on a logical compensation scheme which would reflect the risk created by the servicer for the other parties in a securitization transaction.

In fact, compensation systems based on immediate, rather than on longer-term, financial results contributed to the misalignment of interests. The compensation of those involved at the inception of the securitization, and who would otherwise no longer be engaged after creation, could be disbursed over time in accordance with product performance[86].

We have to take into consideration two structures of securitization. In some cases, the servicer is also the Originator. In fact, it makes sense that the Originator would be appointed as the servicer. The Originator would have all the information needed to service the loan and to take the best decision whether to restructure the loan or go to foreclosure. In addition to that, the fact that, in our structure, the originator has a stake in the securitization, it would be in his best interest to maximize the value of the loans. Moreover, the argument of the servicer that it would not bear the risk of retaining a stake in the securitization because the origination of the loan is out of his control, and that it has no power or influence over other parties in the securitization transaction, would be solved.

[86] Basel committee on bank supervision, the joint forum, report on asset securitization incentives, July 2011.

We have to clarify here that this case does not exclude the fact that the remuneration scheme if the servicer should be reviewed. Even in the case the servicer is the originator, a conflict of interest may appear due to the compensation scheme of the servicer and the originator might prefer to get paid through his duty as a servicer and sacrifice his stake in the securitization, if it deems that it is more profitable to it.

The other case is where the servicer is a third party. In this scenario, the servicer would not accept to take a stake in securitization since, as we argued, he has no control over the inception of the assets. And even if the servicer would accept, the cost of such a stake would be high because the servicer would want to be compensated for the extra risk it is holding.

Consequently, our main instrument to try and eliminate or mitigate the conflict of interest between the SPV and the Servicer is to find a suitable remuneration scheme which would take into consideration the SPV-servicer conflict of interest.

First, the servicing fee should not be related to the outstanding amount of mortgages on the balance of the servicer. We have seen how this incentivizes the servicer to keep the loan on his books for as long as possible.

Second, the fees related to the restructuring of the loan of the borrower in case it is delinquent should be paid to the servicer. These fees have to be specified in advance and

each modification should be paid for by the SPV. In fact, we saw that this issue made the servicer more inclined to go to foreclosure, even if it is not in the best interest of the SPV, to avoid not being paid for the modifications he made to a loan.

Third, a stake in the securitization would only work if the Originator is the designated servicer in a securitization. Therefore, a regulation of this kind would not be suitable for the servicer nor for the readjustment of the securitization transaction.

Fourth, the late fees, in case the SPV pays for the modifications, would not affect the conflict of interest. In fact, equilibrium would be created and the servicer would not be more inclined to foreclosure nor to modify the loan.

All these steps that we mentioned ahead would not incentivize the servicer to work in the best interest of the SPV, but merely neutralized the servicer regarding the relationship between his work for the SPV and its remuneration.

In order to incentivize the servicer work in the best interest of the SPV, another incentive should be added to the compensation scheme of the servicer. This additional fee can be a bonus in case the servicer performed well.

The question would be now: how to know if the servicer performed well, since it is agreed upon that the work of the servicer depends on the quality of the loans and on the sectors in which the assets are in?

In response to this question, we believe that regarding the sectors in which assets are involved (ex: real estate mortgages), and since, typically, the pool of assets in a securitization is formed of similar assets in the same category (real estate mortgages, credit cards loans, car loans…); the impact of the market regarding servicing these loans can be compared to the servicer's peers performance.

The second part of this question would be related to the quality of the assets. We will discuss later that for the conflict of interest between the Originator and the borrower (regarding predatory lending and lax screening), the intervention of the regulator should be necessary. This intervention would be axed on preventing predatory lending and creating standardization of these borrowing and of the conditions required for these borrowings.

Once this issue is solved, the difference of quality between the different loans of different originators would be negligible. In addition to the mentioned, the reputational risk of the Originator, in competition with other originators, and to maintain its reputation to sell its portfolio of loans, would be additional incentives for the Originator to verify the quality of its loans.

Therefore, a bonus should be granted for the servicer based on its performance. His performance, by taking the factor of the quality of the loans off, would be benchmarked to his peers. In case it performs better than its peers, a bonus is granted. In the other cases, it will receive the determined servicing fees, in addition to modification and foreclosure fees.

We notice, in this case also, that there is no need for regulators to intervene. The players in the market of securitization can confront this conflict of interest by restructuring the securitization.

We have tried, in this section, to provide a solution for the SPV-servicer conflict of interest, which would, in our opinion, be the best solution for such a conflict. We will finally, in the below section, see through the conflict of interest between the managers

V- The conflict of interest which need the intervention of the regulator

We have mentioned earlier in our thesis that some of the conflicts of interest have to be solved through the intervention of the regulators.

In fact, the main conflict of interest, and the most important one, the conflict between the Originator and the Borrower cannot be solved by financial innovations or restructuring.

This is due to the fact that the Originator is the most informed about the loan comparing to the parties of the securitization. This information asymmetry cannot be eliminated through incentives or other financial scheme. Indeed, the Originator cannot be incentivized enough to provide all the information about its portfolio of loan because it would affect the selling price of the portfolio to the Arranger and because, in all cases, there is no way of knowing all the information regarding the loans in a pool of assets without passing through the Originator which has created the loan.

Therefore, we need the intervention of the regulator to monitor the practices of originators and to put some rules which would prevent originators from predatory lending[87].

On another note, we have noted the need for regulations regarding the conflict of interest between the Arranger and Credit Rating Agencies, earlier in our thesis.

We will begin by addressing the conflict of interest between the Originator and the Borrower before getting into the role of the regulator in the conflict of interest between the Arranger and Credit Rating Agencies.

A- Originator - Borrower

Let us start by trying to define predatory lending. Predatory lending is not easy to define. In fact, the opponents of a reform regarding predatory lending used the argument that you cannot remedy in absence of a defined problem, whereas the answer of some activists

[87] Engel, McCoy, a tale of three markets: the law and economics of predatory lending. September 1, 2001.

with the reform would be "you know predatory lending when you see it"[88]. It appears from the mentioned the importance of the definition of predatory lending.

The main issue with the definition of predatory lending is that it is formed of different practices which, as they appear, are categorized as predatory lending. Some authors have been categorizing practices which are perceived as predatory lending[89]. These practices are:

- Racial targeting in advertising and loan solicitations
- Loans in connection with home improvement scams
- Kickbacks in the form of yield spread premiums
- Steering to high-cost lenders
- Loan payments in excess of the borrowers' ability to repay, resulting in foreclosure (equity skimming)
- Fraud on borrowers and on secondary market buyers via falsified loan applications, forged signatures,

  Inflated appraisals and the like
- High annual interest rates
- High points
- Balloon payments
- Negative amortization
- Padded or duplicative closing costs and fees

[88] Engel, McCoy, a tale of three markets: the law and economics of predatory lending. September 1, 2001.
[89] Sturdevant, Brennan, Jr., A Catalogue of Predatory Lending Practices, 5 the consumer advocate 4 , 1999.

- Insurance packing and single premium credit life insurance

- Excessive prepayment penalties

- Mandatory arbitration clauses

- Loan flipping (repeated refinancing by the same lender)

- Refinancing of low- or no-interest mortgages at higher rates

- Shifting unsecured debt into mortgages

- Making loans in excess of 100 percent of the loan-to-value ratio of the underlying collateral

- Abusive collection practices

- Foreclosure abuses[90]

However, there is no consensus on either the definition of predatory lending or on how widespread is the problem[91].

The problem in defining predatory lending by practices would only protect the Borrower from predatory lending practices used in the past and not from new predatory lending practices. Moreover, predatory lending is divided in to two categories: the practices that are either clearly illegal or unconscionable by their nature (for example: misrepresenting the terms of the loans and forging the signatures of borrowers on loan documents).

On the other hand, some practices are legal but, when misused by unprincipled lenders, cause borrowers to pay interest rates and fees higher than the market and the borrowers' credit rating would justify. In fact, practices such as adjustable rate mortgages, rapid

[90] Sturdevant, Brennan, Jr., A Catalogue of Predatory Lending Practices, 5 the consumer advocate 4 , 1999.
[91] Eggert, held up in due course: predatory lending, securitization, and the holder in due course doctrine, Creighton law review, April 2002.

refinancing of existing loans, and even high interest rates and fees could be used in non-predatory loans[92].

In fact, securitization causes secondary effects for the borrowers. There are mainly four different negative consequences of the securitization transaction for the borrower. First, originators are more prone to commit loan abuses because they are less heavily regulated, have reduced reputational risk, and operate with low capital, helping to make them judgment-proof. Second, securitization dilutes incentives by lenders and brokers to avoid making loans with excessive default risk by allowing them to shift that risk to the secondary market, which has other ways to protect itself. Third, securitization denies injured borrowers legal recourse against assignees by triggering the holder-in-due-course rule[93] and impeding work-outs. Lastly, securitization drives up the price of subprime loans because investors demand a lemons premium for investing in subprime mortgage-backed securities[94].

[92] Eggert, held up in due course: predatory lending, securitization, and the holder in due course doctrine, Creighton law review, April 2002.
[93] The Uniform Commercial Code (UCC) defines a holder in due course as one who takes an instrument for value in good faith absent any notice that it is overdue, has been dishonored, or is subject to any defense against it or claim to it by any other person.
[94] Engel, McCoy, turning a blind eye: Wall Street finance of predatory lending, Connecticut school of law articles and working papers, 19-3-2007.

Therefore, we will start by describing the operation of predatory lending. In simple terms, predatory lending is exploitive high-cost loans to naïve borrowers, resulting in soaring rates of foreclosures[95].

Daniel S. Ehrenberg provided a rough definition of predatory lending. He defined it as "a mismatch between the needs and capacity of the borrower. In essence, the loan does not fit the borrower, either because the borrower's underlying needs for the loan are not being met or the terms of the loan are so disadvantageous to that particular borrower that there is little likelihood that the borrower has the capability to repay the loan".

However, with can find similar characteristics that fit in all predatory lending practices. In fact, most, if not all, predatory lending practices include one or more of the below problems:

1- Loans structured to result in seriously disproportionate net harm to borrowers;
2- Harmful rent seeking;
3- Loans involving fraud or deceptive practices;
4- Other forms of lack of transparency in loans that are not actionable as fraud; and
5- Loans that require borrowers to waive meaningful legal redress[96].

[95] Engel, McCoy, a tale of three markets: the law and economics of predatory lending. September 1, 2001.
[96] Engel, McCoy, a tale of three markets: the law and economics of predatory lending. September 1, 2001.

After defining predatory lending and its consequences on the borrower, it is clear why this practice would harm a securitization transaction. The problem would now be to resolve this issue. As we argued, this issue would be solved, in our opinion, through the intervention of the regulators.

The regulators intervened indeed after the 2007 financial crisis, in order to clean the mess created by the malpractices of the financial sector, and indeed, one of the issues that the regulators tried to focus on was predatory lending.

In the US the laws on predatory lending are mainly issued on the different states level. Indeed, In response to concerns about the growth of predatory lending and the limitations of existing laws, 25 states, the District of Columbia, and 11 localities have passed their own laws addressing predatory lending practices, according to a database that tracks such laws[97].

Although there is no consensus as to what would be better: a federal single uniform set of national regulations or a protection on a state basis[98], from a securitization point of view, this would already cause a problem. In fact, the problem would be that there is no same law applicable to all loans and predatory lending can vary from one state to the other. This would mean that every loan could, or could not, be the result of a predatory lending practice, depending on the state in which it was originated, which would make the due diligence in a securitization transaction very hard.

[97] United States General Accounting Office, consumer protection, federal and state agencies face challenges in combating predatory lending January 2004.

[98] United States General Accounting Office, consumer protection, federal and state agencies face challenges in combating predatory lending January 2004.

However, some laws have been issued on the federal level. Federal agencies and regulators have used a number of federal laws to combat predatory lending practices. Among the most frequently used laws—HOEPA[99], the FTC[100] Act, TILA[101], and RESPA[102]—only HOEPA was specifically designed to address predatory lending. Enacted in 1994, HOEPA places restrictions on certain high-cost loans, including limits on prepayment penalties and balloon payments and prohibitions against negative amortization. However, HOEPA covers only loans that exceed certain rate or fee triggers, and although comprehensive data are lacking, it appears that HOEPA covers only a limited portion of all subprime loans.

The FTC Act, enacted in 1914 and amended on numerous occasions, authorizes FTC to prohibit and take action against unfair or deceptive acts or practices in or affecting commerce. TILA and RESPA are designed in part to provide consumers with accurate information about the cost of credit[103].

TILA, RESPA and HOEPA all have major weaknesses in what activities they prohibit and the relief that they provide. TILA has not lived up to its goal of standardizing disclosures on the total cost of credit because a long list of closing costs are currently excluded when computing finance charges and annual percentage rates. These omissions are exacerbated when lenders pad closing fees and engage in insurance packing.

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[99] Home Ownership and Equity Protection Act.
[100] Federal Trade Commission.
[101] Truth In Lending Act.
[102] Real Estate Settlement Procedure Act.
[103] United States General Accounting Office, consumer protection, federal and state agencies face challenges in combating Predatory lending January 2004.

As previously discussed, in addition to deficient private enforcement, RESPA suffers from poorly thought-out timing provisions. The result is lengthy and confusing GFEs and HUD-1 settlement statements that are too late and too unreliable to be meaningful to the consumers they are meant to serve.

This state of affairs puts unsophisticated loan applicants at risk of high-pressure tactics at closing. At closing, borrowers may learn for the first time that they will be paying higher interest, points and/or fees. Confronted by surprise disclosures, they need financial or legal advice at the exact moment that they have to commit. Without that advice, fearful that they will lose their loans and desperate for funds, most borrowers sign the closing documents. These and other related problems caused Congress to enact the advance disclosure requirements in HOEPA. Although HOEPA is an improvement over TILA and RESPA, HOEPA is easy to evade because of its narrow coverage. To begin with, HOEPA does not apply to purchase money mortgages, reverse mortgages or open-end credit lines of any kind.220 Furthermore, for home mortgages within its coverage; HOEPA only applies if at least one of the following triggers is satisfied:

· The annual percentage rate at consummation exceeds the yield on Treasury securities of comparable maturity plus ten percent; or

· The total points and fees exceed eight percent of the total loan amount or $400 (subject to annual indexing), whichever is greater.

Accordingly, to evade HOEPA, a lender can either style a loan as an open-end extension of credit or keep the interest or total points and fees below the respective ten and eight percent triggers. HOEPA's triggers are so high that most lenders, including predatory

lenders, are able to price their loans below the triggers.223 Subprime lenders have compensated for the lower resulting interest rates by raising the charges for items excluded from total points and fees[104].

Hence, the laws which supposedly are enacted to protect borrowers against predatory lending do not cover all the area, or at least the majority of the area, of predatory lending practices. In fact, these laws are protecting borrowers against predatory lending in case the practice or activity of the lender is clearly illegal or by defining some rules regarding a certain limit for certain rate or fee.

Concerning the illegal practices *per se*, a uniform national regulation seems to be indispensable for the health of the financial system.

However, regarding the second category, which we mentioned earlier, including the legal practices which might, if used perversely, lead to predatory lending, the problem is more complex.

Firstly, and as we mentioned, from a securitization transaction point of view, a uniform national regulation for this case is also crucial.

The main problem however, would be to enact a body of laws which would prevent future predatory lending practices. We will not enter in the details of the procedure of enacting a law, but since we defined predatory lending earlier in this thesis, enacting a law protecting borrowers against predatory lending would not be too complicated. In all

[104] Engel, McCoy, a tale of three markets: the law and economics of predatory lending. September 1, 2001.

cases, the procedure should be focused on having a definition of predatory lending, and enacting a law based on that definition.

Also, to be effective, a regulatory body should be created which function would be to monitor lenders and check if they are abiding by the laws to prevent predatory lending. This is important because the predatory lending perversely using legal activities, which is the hardest to detect also, is based on technical knowledge of the banking and lending system. Therefore, monitoring this kind of predatory lending should be delegated to a body formed of specialists who would be able to detect predatory lending practices.

B- Arranger – Credit Rating Agencies

We will now assess the intervention of the regulators in the conflict of interest between Credit Rating Agencies and Arrangers.

In both the United States and Europe, rating agencies are subject to augmented disclosure requirements, designed to enhance transparency in connection with structured finance ratings. The rating agencies themselves note that they have restructured their ratings processes to allow for more oversight and examination of decisions, and to improve the comparability of ratings across different investments. At the same time, while market participants have expressed skepticism of ratings, there are still instances of rating

reliance and shopping[105]. Credit ratings are expected to keep on providing an significant role in the market given the considerable existing information and analytical capacity asymmetries, especially for small investors and illiquid instruments[106].

In Japan, in order to enhance transparency and disclosure related to credit ratings used for securitization, rating agencies are required to publish information that may be deemed valuable in an assessment by a third party of the appropriateness of the credit rating; and stakeholders are encouraged to implement measures to enable a third party to verify the appropriateness of the credit rating in line with IOSCO's revised code of conduct (2008)[107].

The enacted or proposed regulations in the US and the EU seem to be insufficient and, at best, only partly convincing. On one hand, they are very detailed and rather restrictive. On the other, they lack mechanisms for incentivizing rating organizations and their analysts, and for effectively, but also adequately, sanctioning poor performance or having caved in to conflicts of interest.

Instead of drafting comprehensive and detailed disclosure and governance rules, it would have been more target-oriented to focus on an incentive-oriented regulation of rating

[105] As in the case of US Re-REMICs, which are transactions that involve repackaging downgraded tranches of securitizations into new portfolios for securitization.
[106] Basel committee on bank supervision, the joint forum, report on asset securitization incentives, July 2011.
[107] Basel committee on bank supervision, the joint forum, report on asset securitization incentives, July 2011.

organizations. This approach would possibly realize the overall aim of regulating rating agencies, namely to ensure the quality of the ratings, better than the current approaches.

Additionally, requiring rating organizations to disclose their methodology to the public – as in the US[108] or the EU[109] – would probably asphyxiate their business since other organizations will be able to take advantage of this information and consequently market incentives for innovation will be reduced.

The system would be that a certain amount of the analyst's of a rating agency monthly compensation – the bonus part – would be determined by the constant adequacy of his initial assessment. In case rating alteration is necessary it should influence the bonus payment depending on whether they could have been avoided at the time of the initial rating or were unpredictable at that time. Moreover, it would incentivize the analyst to do a thorough first analysis to make sure that he does not miss any essential information.

Another analyst should conduct the monitoring of the analyst regarding his reviewing of the first rating. This monitoring analyst should be paid a bonus depending on the timeliness and appropriateness of suggested adjustments to the first rating and where flaws in the first analysis are discovered.

In all cases the reception of all information by the monitoring analyst from the analyst has to be ensured. Also, analysts must not have any relationship, financial or otherwise,

[108] 15E (a)(1)(B)(ii) Securities Exchange Act and SEC, Form NRSRO, Application for Registration as a Nationally Recognized Statistical Rating Organization (NRSRO), item 9 exhibit 2.
[109] Art 8 (1) and Annex I Section E Part I No 5 of the Regulation on Credit Rating Agencies.

to the issuer and its securities, to prevent their obtaining compensation for forfeited bonuses.

Moreover, Credit rating agencies should be compensated based on the adequacy of their ratings. A middleman has to be instituted and would hold the funds in a fashion of escrow and thus act as a clearing institution. In such a system, investors would pay the fees that they have negotiated with the Credit rating agency to the middleman, who in turn would pay the Credit rating agency.

A predetermined portion of these fees, however, would be held back by the middleman and paid in monthly installments according to the continued adequacy of the ratings. alterations of ratings by the Credit rating agency should be assessed according to their impact, whether they are made in a timely fashion and why they are made. If changing conditions necessitate an unpredictable adjustment, such an adjustment should not affect the Credit rating agency compensation. If, however, the initial assessment was flawed from the beginning, it should be assessed whether the Credit rating agency itself brought it to light or whether someone else (a competing Credit rating agency or the middleman) found the flaw. While in the latter case future payments with regard to that rating should be forfeited (and a reward paid to the individual or organization who found the problem), Credit rating agencies should receive at least some part of the pending installments under the first scenario to encourage their self-monitoring.

The middleman could be a supervisory authority or another institution established for that purpose. The task of middleman is not to rate the securities, but to monitor the market

and the appropriateness of the ratings at issue, as well as the ratings of competitors. Consequently, the findings would be disclosed to the public to better enable investors to assess the ratings[110].

VI- <u>Conclusion</u>

Securitization is as necessary to any economy as organized financial markets. In fact, securitization outcome is the creation of tradable securities with better liquidity from financial claims that would otherwise have remained bilateral deals and been highly illiquid[111].

Therefore, before overreacting to or overstating the current problems in the subprime loan market, and start blaming securitization for every financial crisis from 2007, it is important to realize that the growth in this market reflected a combination of factors, including the extension of credit to less creditworthy individuals, increasing first-time homeownership[112].

This said, we tried, through our thesis, to focus on the conflict of interest in securitization transactions which appeared after the financial crisis of 2007.

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[110] Kumpan, Conflicts Of Interest In Securitization: Adjusting Incentives, Electronic copy available at: http://ssrn.com/abstract=1503429.

[111] Fabozzi, Kothari, Securitization, the tool of financial transformation, Yale international center for finance, 2007, http://ssrn.com/abstract=997079.

[112] Barth, Li, Phumiwasana, Yago, a short history of the subprime mortgage market meltdown, Milken institute, January 2008.

We have defined the major conflict s of interest which, in our opinion, influenced and catalyzed the role of the securitization in the financial crisis of 2007.

After determining these conflicts of interest, we tried to find solutions in the structure of the securitization operation, before trying to find solutions in regulations. In fact, we think that markets should use minimum interference of the regulators because laws, generally, are rigid, slow to be enacted, and cannot cover all the possible scenarios, whether the financial markets are malleable, need fast solutions, and comprise, each day, a new instrument.

The consequence would be to find solutions on the market because each transaction has its own structure, its own goals and its own challenges and conflicts of interest, and, in case no solution could be found, the regulator should intervene at that time.

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