
Complex Debt

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This week, the Financial Stability Forum initiated discussions that could decrease banks' ability to hold complex debt instruments on their trading books. At issue is banks' holdings of securities related to securitizations, in which the senior portions have already been sold but the junior portions have not. Sometimes, those junior portions were being aggregated in order to assemble CDOs, which would provide knock-on financing vehicles for the junior pieces of the securitization. CDOs-squared and subsequent dealings involved similar aggregations.

But such practices were not isolated nor uncommon. In fact, the practices created a way in which banks could hold on to the essential risk in the securitization by maintaining that it was really "for sale," while profiting in the meantime if the deal did well and – as we now know – losing if the deal did not.

The problem, in fact, goes much deeper. The practice also allowed banks to hold non-investment grade assets on its books for significant periods of time. In some cases, those assets were not eligible for fiduciary investment because they did not have investment-grade ratings. In other cases, they were unrated, largely because they fell outside the (already overly broad) category of asset-backed securities that could be rated by an NRSRO.

But bank regulators were already allowing investment in similar complex securities for purposes of capital relief. As late as 2005, ISDA was seeking to broaden the classes of securities that could be rated by NRSROs to synthetic securities, a class of securities that includes credit default swaps. ISDA justified its approach, in part, by reasoning that, "...both the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency have issued prescriptive guidelines for credit derivatives allowing financial institutions to benefit from regulatory capital relief assuming certain conditions are met."

So, whether we like it or not we already have a world where banks have lowered their capital requirements not only through securitizations, but also using complex hybrid and synthetic debt instruments. It is no wonder, then, that the Federal Reserve had to bail out Bear Stearns, who was one of several major counterparties to such instruments.

In summary, the fundamental problem with securitization is that there is no natural home for junior and equity residuals created in securitizations. Hence, those portions were securitized and re-securitized and re-re-securitized like a

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game of hot potato: whoever was left holding them in the end got burned. As a result, banks hedged the exposures with even more complex hybrid and synthetic securities, even though the investment characteristics of those securities have not been tested.

Hence, as I have said in the press since early last year, the present market difficulties are a crisis of structured finance, not just subprime mortgages. Regulators therefore have before them the task of catching up with roughly thirty years of financial industry development before fostering liquidity and stability in all manner of complex debt that has come to dominate the system. Until they do so, the industry will be subject to some \$60 trillion of unreported illiquid counterparty risk, an amount far too vast to be resolved by bailouts. I hope we see some movement soon.