

The Alchemy of Asset Securitization

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This article explains asset securitization and shows how companies can use it to gain direct and indirect benefits. More importantly, this article demonstrates that securitization can enable certain companies to achieve a genuine reduction in financing costs by providing access to lower cost capital market funding. This article also explores potential innovative uses of this financing technique.

"[Asset securitization is] becoming one of the dominant means of capital formation in the United States."¹

- Securities and Exchange Commission (1992).

Not only is asset securitization one of the most important financing vehicles in the United States, but its use is rapidly expanding worldwide. What is this innovative approach to financing that has taken the country, and begun to take the world, by storm?

This article explains asset securitization and its unique benefits. The article begins by describing the asset securitization process and then continues to show how companies directly and indirectly benefit from securitization. Most importantly, the article explains why securitization enables many companies to raise funds at a lower cost than through traditional financing. The discussion then turns to the differences between securitization and factoring, an antecedent financing technique.

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¹ Investment Company Act, Release No. 19105, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,062, at 83,500 (Nov. 19, 1992) (provided in connection with the issuance of Rule 3a-7 under the Investment Company Act of 1940). The terms "securitization," "asset securitization," and "structured finance" are used interchangeably. Each refers to a company's use of cash flows from its assets to raise funding. The term "securitization" specifically refers to the issuance of securities backed by such cash flows.

The article then addresses its core question: is the securitization process a zero-sum game or does it truly reduce net financing costs? The short answer is simple: securitization is an alchemy² that really works. In securitization, a company partly "deconstructs" itself by separating certain types of highly liquid assets from the risks generally associated with the company.³ The company can then use these assets to raise funds in the capital markets⁴ at a lower cost than if the company, with its associated risks, could have raised the funds directly by issuing more debt or equity. The company retains the savings generated by these lower costs, while investors in the securitized assets benefit by holding investments with lower risk. The article concludes by describing those areas where securitization opportunities have yet to be fully explored.

This article does not repeat the work of others by attempting to present empirical evidence or a quantitative economic analysis of the efficiency of securitization.⁵ Instead, this article takes an analytical and rather common sense legal approach to understanding asset securitization.

² Alchemy refers to a technique whereby medieval chemists attempted to turn base metals into gold.

³ This raises a threshold question of the propriety of separating a company from its most liquid assets. According to legend, a lawyer, upon learning of securitization, uttered that "it is a perversion of natural law if the jewels of a company could be spirited away by lawyers' trickery." This article will show that securitization ultimately provides benefits, to both the company and its investors, that outweigh any perceived detriments.

⁴ The capital markets are "markets where capital funds—debt and equity—are traded. Included are private placement sources of debt and equity as well as organized markets and exchanges." JOHN DOWNES & JORDAN GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 59 (3d ed. 1991).

⁵ For an excellent quantitative, economic, and empirical analysis of asset securitization, see James A. Rosenthal & Juan M. Ocampo, *Analyzing the Economic Benefits of Securitized Credit*, 1 J. APPLIED CORP. FIN. 32 (1992), to which the author of this article owes a debt of gratitude. Rosenthal and Ocampo analyzed the cost savings that General Motors Acceptance Corporation ("GMAC") realized through securitizing its auto loan receivables over match funded traditional debt financing. They estimated that GMAC may have saved up to 1.3% annually.

But cf. George J. Benston, *The Future of Asset Securitization: The Benefits and Costs of Breaking Up the Bank*, in *THE GLOBAL ASSET BACKED SECURITIES MARKET 3* (Charles Stone et al. eds., 1993). Benston focused on whether securitization is rendering traditional banking obsolete, and his analysis is limited to the costs and benefits of securitizing a bank's own loans to its customers. However, this analysis is misleading when applied to the much broader universe of securitization discussed in this article. This article does not limit its discussion of originators to banks but also discusses unregulated industrial and commercial companies. Moreover, this article does not only analyze bank loans but also includes all generic types of receivables. Furthermore, because the originators discussed by Benston are entities that could directly access the capital markets for funding—as opposed to companies that are non-investment grade and therefore unable to obtain capital market funding directly, Benston virtually ensures his conclusion that the benefits of securitization are indirect or marginal. Nonetheless, Benston still concludes that "securitization is here to stay because it has an important role to play." *Id.* at 14. Part IV of this article addresses Benston's more fundamental argument that securitization can never create wealth.

I. How Securitization Works

A company that wants to obtain financing through securitization begins by identifying assets that can be used to raise funds.⁶ These assets typically represent rights to payments at future dates and are usually referred to as "receivables."⁷ The company that owns the receivables is usually called the "originator." The risk that these payments may not be made on time is an important factor in valuing the receivables. As long as the originator can reasonably predict the aggregate rate of default, however, it can securitize even those receivables that present some risk of uncollectibility. Therefore, a statistically large pool of receivables due from many obligors, for which payment is reasonably predictable, is generally preferable to a pool of a smaller number of receivables due from a few obligors.

After identifying the assets to be used in the securitization, the originator transfers the receivables to a newly formed special purpose corporation, trust, or other legally separate entity—often referred to as a special purpose vehicle, or "SPV." The transfer is intended to separate the receivables from risks associated with the originator. For this reason, the originator will often structure the transfer so that it constitutes a "true sale,"⁸ a sale that is sufficient under bankruptcy law to remove the receivables from the originator's bankruptcy estate.⁹

To raise funds to purchase these receivables, the SPV issues securities in the capital markets. The SPV, however, must be structured as "bankruptcy remote" to gain acceptance as an issuer of capital market securities. Bankruptcy remote in this context means that the SPV is unlikely to be adversely affected by a bankruptcy of the originator.¹⁰

To achieve bankruptcy remoteness, the SPV's organizational structure strictly limits its permitted business activities. The goal is to prevent creditors (other than holders of the SPV's securities) from having claims against the SPV

⁶ For an introduction to the fundamental principles of asset securitization, as well as the underlying legal and business considerations, see STEVEN L. SCHWARCZ, *STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* (Practising Law Inst. 2d ed. 1993).

⁷ Receivables can be short term (typically due in 30 days), such as trade receivables, which represent the right to payment for goods sold or services rendered, or they can be long term, such as payments due over a period of years under loans, leases, licenses, management contracts, etc. See *id.* at 5-15.

⁸ See *id.* at 28-35; *SECURITIZATION OF FINANCIAL ASSETS* § 5.02 (Jason H. P. Kravitt ed., 1988). The term "true sale" sometimes creates confusion because the characterization of a given transfer as a sale could refer to the accounting, usury, tax, or bankruptcy treatment of the transfer, each of which is governed by different criteria. SCHWARCZ, *supra* note 6, at 28.

⁹ 11 U.S.C. § 541 (1988). Securitization is unlikely to create a fraudulent conveyance under § 548 of the Bankruptcy Code (or equivalent state fraudulent transfer law), because the purchase price paid to the originator is normally a reasonable exchange for the receivables sold. See SCHWARCZ, *supra* note 6, at 35-36.

¹⁰ See *SECURITIZATION OF FINANCIAL ASSETS*, *supra* note 8, § 5.01; SCHWARCZ, *supra* note 6, at 16-27.

that would enable them to file an involuntary bankruptcy petition against the SPV.¹¹ Furthermore, an SPV that is owned or controlled by the originator is usually required to have one or more independent directors. The SPV must also attempt to observe all appropriate third party formalities with the originator. These additional steps help to reduce the risk that the originator, if bankrupt, will either cause the SPV to voluntarily file for bankruptcy or persuade a bankruptcy court, in the exercise of its equitable powers, to substantively consolidate the assets and liabilities of the SPV with those of the originator.¹²

II. How Companies Benefit from Securitization

Through the securitization process described above, the SPV raises funds by issuing securities—usually debt or debt-like securities—and uses the receivables purchased from the originator to repay investors in the future. The investors, therefore, are concerned only with the cash flows coming due on these receivables, and care little about the originator's financial condition.¹³

Securitization is most valuable when the cost of funds, reflected in the interest rate that is necessary to entice investors to purchase the SPV's securities, is less than the cost of the originator's other, direct sources of funding. The SPV's lower cost of funds is passed on to the originator through a higher selling price for the originator's receivables. The goal of securitization, therefore, is to obtain low cost capital market funding by separating all or a portion of an originator's receivables from the risks associated with the originator.

The interest rate necessary to entice investors to purchase the SPV's securities is often a function of the "rating" that the SPV's debt securities receive. Such ratings are determined by various independent private companies that have gained widespread investor acceptance as "rating agencies."¹⁴ Given that most investors, except certain institutional investors in private placement transactions (discussed below), have neither the time nor the resources to fully investigate the financial condition of the companies in which they invest, these ratings take on special significance. Investors rely on the assigned ratings to determine the minimum return that they will accept on a given investment.

¹¹ SCHWARCZ, *supra* note 6, at 24.

¹² *Id.* at 16-18, 21-26.

¹³ For an illustration of this idea applied to hospitals, see Gregory R. Salathé, Note, *Reducing Health Care Costs Through Hospital Accounts Receivable Securitization*, 80 VA. L. REV. 549, 554-55 (1994).

¹⁴ The most well-known and widely accepted rating agencies are Standard & Poor's Ratings Group ("S&P") and Moody's Investors Service, Inc. ("Moody's"). Duff and Phelps and Fitch Investors Service, Inc., are also nationally prominent.

Companies whose debt securities are rated "investment grade"¹⁵ can usually issue securities in the capital markets at interest rates competitive with, or even lower than, other generally available sources of funds, such as bank loans.¹⁶ The higher the company's rating within the investment grade categories, the lower the company's cost of funds. This reduced cost is a result of the lower interest rate necessary to induce investors to buy the company's securities.¹⁷

A securitization transaction can provide obvious cost savings by permitting an originator whose debt securities are rated less than investment grade or whose securities are unrated to obtain funding through an SPV whose debt securities have an investment grade rating. Even an originator with an investment grade rating may derive benefit from securitization if the SPV can issue debt securities with a higher investment grade rating and, as a result, significantly decrease the originator's interest costs.

One might expect securitization to be of greatest benefit to riskier companies. This expectation, however, is only partly true. As a company moves toward the extremes of financial instability and towards the brink of bankruptcy, securitization is less of a benefit. At this point, the SPV has a higher than normal risk of being challenged by the originator's trustee in bankruptcy, and risk-averse investors tend to avoid these transactions.

Asset securitization does, however, afford companies with acceptable risk levels the possibility of real cost savings. To determine whether an originator will achieve an overall cost savings from securitization, one must assess the interest savings possible (as discussed above) against the costs of the securitization transaction. A company considering securitization should compare (i) the expected differential between interest payable on non-securitized financing and interest payable on secu-

¹⁵ An investment grade rating typically is BBB- or higher from S&P or Baa3 or higher from Moody's, or the equivalent from the other rating agencies. Such a rating reflects a rating agency's prediction that the securities will be paid on a timely basis. Short term securities, such as commercial paper, are assigned equivalent short term ratings. For a general discussion of ratings see SECURITIZATION OF FINANCIAL ASSETS, *supra* note 8, § 7.01.

¹⁶ For a discussion of the relative costs involved in the different markets, see Steven Pearlstein & Jerry Knight, *Banks Lose Out As Depositors Go Elsewhere; Many Options Available for Saving, Borrowing, Investing*, WASH. POST, Aug. 22, 1993, at A1; Mitchell A. Post, *The Evolution of The U.S. Commercial Paper Market Since 1980*, 78 FED. RES. BULL. 879 (1992). Capital market rates are usually lower because the large number of investors, as well as the free transferability of the securities, act as inherent risk spreaders.

¹⁷ For example, at any point in time, the interest rate on securities rated Aaa (the highest rating) by Moody's will be less than the interest rate needed to attract investors on securities rated Baa by Moody's. This difference is illustrated by the following chart:

Moody's Series	1992	1993	March 25, 1994
Aaa	6.09	5.38	5.35
Baa	6.48	5.82	5.80

Source: 80 FED. RES. BULL., A26, *Domestic Financial Statistics* (June 1994).

rities issued by an applicable SPV with (ii) the expected difference in transaction costs between the alternative funding options.¹⁸ Whether or not the originator will achieve a cost savings partially depends on the way in which the originator structures the securitization because, as will be shown below, transaction costs can vary over a wide range.

A. "One-Off" Securitization Structures

In most securitization transactions, the SPV is created specifically for the particular originator and the particular transaction. The objective of this so-called "one-off" securitization is to provide the originator with significant flexibility to customize the securitization in terms of its particular structure and the types of capital market securities issued. However, because one-off structures are created for a particular transaction, their transaction costs can be high; they can rarely achieve the transaction cost economies of scale realized by multiseller securitization conduits (discussed in the next section).¹⁹ In addition, to avoid subjecting the originator to the liabilities of a thinly capitalized SPV, tax and accounting rules require a minimum level of capital, typically one to three percent of the amount of the securities issued. In contrast, a multiseller securitization conduit needs only nominal capital because the multiplicity of sellers reduces the risk that the SPV will be regarded as the *alter ego* of any one seller. Given these differences, only a case-by-case comparison of costs and other motivations will determine whether a one-off or multiseller structure is more advantageous to a particular originator.

Presently, one-off transactions are structured in a multitude of ways, and new structures are limited only by the creativity of the professionals involved. While it is beyond this article's scope to attempt to categorize all available structures,²⁰ a catalog of approaches would begin by identifying the types of capital market securities to be issued by the SPV.

Originators desiring medium or long term financing can often access the capital markets through "securitized private placement transactions." In these transactions, an SPV is created for a specific deal and issues medium term or long term notes, usually to sophisticated institutional investors such as insurance companies. A private placement takes advantage of the one-off structure because the private placement's requirements are determined primarily by the investors, who actively

¹⁸ If, however, the securitization transaction is off balance sheet, a strict debt-to-debt comparison may understate securitization's benefits. Off balance sheet securitization has its own inherent advantages because it does not put pressure on the originator to raise additional equity capital. See Rosenthal & Ocampo, *supra* note 5, at 33.

¹⁹ Significant economies of scale can be obtained, however, by originators such as GMAC, Citibank, and Chrysler that frequently use an SPV to issue capital market securities.

²⁰ For a representative catalog of structures, see SECURITIZATION OF FINANCIAL ASSETS, *supra* note 8, § 4.

participate in analyzing the receivables and negotiating the structure of the deal with the originator. In addition, the investors' sophistication allows for a great deal of creativity in both the structure and type of receivables used. The SPV's securities only need to be rated if the investors so require. Investors, particularly in the case of insurance companies, often use the rating to avoid placing the purchased securities in the so-called "basket" of non-eligible investments.²¹ The interest rate on such securities may, however, be higher than normal because privately placed securities cannot be freely traded.²²

Investment grade originators that have highly predictable receivables, or that obtain investment grade credit enhancement, may be able to offer long term securities publicly through an SPV to investors in the capital markets. Because of the demand for publicly traded securities, this type of transaction would provide long term financing with the lowest interest rate cost to the originator. The transaction costs of a public offering, however, are high. Not only must an SPV be created specifically for the financing, but it also must prepare and file a registration statement with the Securities and Exchange Commission ("SEC"). In contrast to a private placement transaction, which can be accomplished in a period of weeks, a filing with the SEC can take months to accomplish. In addition, the level of due diligence required to satisfy the disclosure requirements of the federal securities laws can be daunting.²³ For this reason, public securitization is rarely cost effective for transactions of less than \$50 million and is more common for transactions in the \$100 million or higher range.²⁴

The repayment of securities issued in one-off securitization structures is often guaranteed in whole or in part by creditworthy third parties in the business of assessing this kind of risk, such as banks (through the issuance of letters of credit) or surety companies (through surety bonds). The providers of these guarantees, often referred to as credit enhancement facilities, make independent decisions whether to extend such enhancement and how much to charge for it. Although obtaining credit

²¹ Insurance companies are limited, for example, in the amount of new insurance policies they may issue by the amount of their eligible investments, which are usually defined as securities rated at least investment grade, and other eligible assets. For the "basket" provision of the NY Insurance Code, see N.Y. INS. LAW § 1404 (b) (Consol. 1993).

²² See SCHWARCZ, *supra* note 6, at 62-63. In an attempt to increase the efficiency and liquidity of the private placement market, the SEC has issued Rule 144A. This rule permits the relatively free trading of privately placed securities to buyers (referred to as "qualified institutional buyers," or "QIBs") who have more than \$100 million in the aggregate owned and invested in securities on a discretionary basis (or \$10 million in securities with respect to dealers). See 17 C.F.R. § 230.144A (1993).

²³ See, e.g., Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1988); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1988). State securities, or so-called "blue-sky," laws may also be applicable.

²⁴ Recently, however, the SEC revised its forms to provide the benefit of shelf registration to securitized public offerings of investment grade securities. See SCHWARCZ, *supra* note 6, at 62 n.156; SECURITIZATION OF FINANCIAL ASSETS, *supra* note 8, § 10.01.

enhancement adds to transaction costs, the net effect may reduce total costs because securities supported by credit enhancement obtain higher credit ratings. As a result, the interest rate payable on such securities will be lower.

B. Multiseller Securitization Conduits

A "multiseller securitization conduit" offers originators the opportunity to minimize their transaction costs by utilizing a common SPV. These conduits are typically administered by commercial or investment banks and are able to achieve a transaction cost economy of scale by allowing multiple originators to sell receivables to a single pre-existing SPV.²⁵

To date, most multiseller securitization conduits have accommodated only investment grade originators. This selectivity minimizes the risk—already rendered unlikely because of the bankruptcy remote structure—that a single originator's bankruptcy might adversely impact a conduit engaged in transactions with many originators.²⁶ However, a limited number of multiseller securitization conduits have recently begun to serve originators whose debt securities are rated less than investment grade. As a result, more originators are now able to take advantage of the transaction cost economy of scale.

Multiseller securitization conduits, like one-off structures, may benefit from credit enhancement. However, multiseller conduits usually issue short term securities, such as commercial paper. Rating agencies will determine the ratings of such short term securities based not only on the ultimate risk of default but also on the probability of timeliness of payment. As a result, rating agencies often insist that creditworthy third parties ensure timely payment. "Liquidity" facilities, usually provided by banks, help to assure that the multiseller conduit will have the liquidity available to meet short term financial obligations in the event that cash flow from collections is temporarily insufficient. Providers of liquidity facilities are then repaid by collections on receivables when received. In most instances, the conduit will be able to pay maturing short term debt securities through its collections on purchased receivables or by re-issuing commercial paper. Only when these sources

²⁵ Multiseller securitization conduits typically issue short term commercial paper or medium term notes in the capital markets to fund their purchases of receivables from originators. See, e.g., *Corporate Asset Funding Co., Inc.*, FITCH INVESTORS SERVICE, STRUCTURED FINANCE, NEW ISSUE, June 15, 1992, at 81 (discussing Corporate Asset Funding Co., Inc.'s \$7 billion commercial paper and medium term note program); Mark H. Adelson, *Asset-Backed Commercial Paper: Understanding the Risks*, MOODY'S INVESTORS SERVICE, STRUCTURED FINANCE, SPECIAL REPORT, Apr. 1993.

²⁶ Furthermore, by limiting a conduit to serving investment grade originators, transaction costs can be reduced because the transfer of receivables from the originator to the conduit need not be structured as a true sale. See *infra* note 33; SCHWARCZ, *supra* note 6, at 35; SECURITIZATION OF FINANCIAL ASSETS, *supra* note 8, § 5.03.

are not sufficient to meet the conduit's short term financial obligations will liquidity facilities need to be funded to assure the conduit of the necessary cash flow.²⁷

The result is that multiseller securitization conduits typically utilize both liquidity facilities and credit enhancement. Providers of liquidity facilities often insist that conduits obtain credit enhancement as well to emphasize that the liquidity facilities providers are ensuring only timeliness of payment and not guaranteeing against ultimate loss. They also may require credit enhancement if they are uncomfortable with the structure or the level of security of a given transaction.

Because liquidity facilities and credit enhancement significantly reduce risk on securities issued by a multiseller conduit,²⁸ rating agencies base their evaluations of such securities primarily on the liquidity and credit enhancement facilities that the conduit obtains.²⁹ Obtaining these facilities will, however, add to transaction costs, and their value in reducing interest costs must be adjusted accordingly.³⁰

C. Indirect Costs and Benefits

The preceding sections discussed how variations in securitization structures can affect direct transaction costs and flexibility. Each structure is also associated with certain indirect costs and benefits. For example, transaction costs are not limited to direct expenses, such as fees for lawyers, investment bankers, and liquidity or credit enhancement facilities. They also arise from the true sale requirement.³¹

To achieve a true sale, an originator must limit, if not forego, its right to the residual value of the receivables sold to the SPV. This residual value can often be significant since the SPV must obtain a level of receivables well in excess of the amount necessary to pay the securities issued by the SPV. Such "overcollateralization" is needed to assure investors and providers of liquidity and credit enhancement that they will not suffer losses from delayed collection or defaults. Conflict may develop over the amount of overcollateralization necessary for the SPV: originators want the level of overcollateralization to be low, while investors and credit enhancers want it to be high. Because the amount of receivables

²⁷ Rating agencies usually require, however, that entities providing liquidity facilities have short term debt ratings at least equal to the ratings of the conduit's commercial paper.

²⁸ For a discussion of the types of liquidity facilities and credit enhancement available in different settings, see SCHWARCZ, *supra* note 6, at 13-15; Salathé, *supra* note 13, at 552.

²⁹ The rating agencies also consider the strength of the originator, the bankruptcy remoteness of the structure, and the experience and capability of the conduit's administrator and servicer.

³⁰ In the author's experience, the cost of credit enhancement ranges between 0.40% and 0.75% of the amount of credit extended, and the cost of liquidity ranges between 0.15% and 0.35% of the amount of the commitment made available. These amounts fluctuate depending on the particular transaction and the supply of suitable parties willing to provide such enhancement or liquidity.

³¹ See SCHWARCZ, *supra* note 6, at 28-29; SECURITIZATION OF FINANCIAL ASSETS, *supra* note 8, § 5.03.

sold may turn out to be greater than what was needed to pay the SPV's securities, the overpayment represents an indirect, but real, cost to the originator.

The cost of overcollateralization can be managed in several ways. If the originator's rating is investment grade, it often can structure the transfer of receivables to the SPV as a sale for accounting but not necessarily bankruptcy purposes. After the SPV pays off its securities, the excess receivables and collections can be returned to the originator without altering the original accounting characterization of the transaction as a sale.³²

If the originator is not investment grade, a sale for bankruptcy purposes will be required to protect investors from the risks associated with the originator's possible bankruptcy. This bankruptcy risk can be avoided, while minimizing the cost of overcollateralization, by structuring the securitization transaction with two SPVs in a two tier structure, also known as a "FINCO" (finance company) structure.³³ Under this method, the originator first sells receivables to a wholly owned SPV in a transaction that constitutes a true sale for bankruptcy purposes and thus achieves bankruptcy protection. The wholly owned SPV then transfers its receivables to an independent SPV in a transaction that constitutes a sale for accounting purposes but not necessarily for bankruptcy purposes. The independent SPV issues securities in the capital markets to fund the transfer. After the independent SPV pays off the securities, it can reconvey the remaining receivables and collections to the wholly owned SPV without impairing the accounting characterization as a sale. The wholly owned SPV is then merged into the originator, or alternatively, the remaining receivables and collections are transferred back to the originator, as dividends. This structure thus allows the originator to realize the value of any excess receivables and collections created by the original overcollateralization.³⁴

The indirect benefits of securitization will often more than compensate for its indirect costs. One of the most important indirect benefits is that asset securitization provides a source of off balance sheet funding. Because a securitization is usually viewed, for accounting purposes, as a sale of assets and not as financing, the originator does not record the transaction as a liability on its balance sheet. Such

³² See SCHWARCZ, *supra* note 6, at 28-29.

³³ See *id.* at 21-22.

³⁴ A recent theory of "binary recourse" may permit a bankruptcy true sale directly from the originator to the SPV while permitting the SPV to reconvey a significant portion of excess collections back to the originator. See Steven L. Schwarcz, *A New Theory of Recourse*, ASSET SALES REP., Feb. 14, 1994, at 8; Steven L. Schwarcz, *The Parts are Greater Than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open The Capital Markets to Middle-Market Companies*, 1993 COLUM. BUS. L. REV. 139 (1993) [hereinafter Schwarcz, *Divisible Interests*].

off balance sheet funding thus raises capital without increasing the originator's leverage or debt-to-equity ratio on its financial statements.³⁵

Another benefit of asset securitization is that it may represent an additional and untapped source of financing for an originator. Sometimes originators will find that investor appetite for their securities has become temporarily sated. In other words, the amount of originator risk exposure that the capital markets are prepared to accept may be less than the amount of capital market financing desired by the originator. In these cases, securitization permits the originator to obtain additional capital market funding through an SPV. This change in form is not an attempt to mislead investors. Investors are often prepared to accept the more limited risks associated with the SPV, namely the default risk of the receivables, as compared to the greater risk associated with the originator as a whole. As a result, by providing an additional source of capital market funding, securitization can be beneficial even to investment grade originators.

Certain securitizations may also result in a lower weighted average interest rate to the originator through the use of a "senior/subordinate" securities structure at the SPV level. Sophisticated investors provide the equivalent of "credit enhancement" to the SPV by purchasing subordinated securities. The originator thereby allocates certain repayment risks to these investors, who are in the business of assessing and accepting such risks and who consequently are willing to accept a higher level of risk than the average investor. The interest rate on these subordinated securities would be higher than the interest rate on the non-subordinated (or senior) securities to compensate for the greater risk. Nonetheless, this combination of senior and subordinated securities will still be of benefit to the originator if, as is usually the case, the resulting blended interest rate on the combined securities is lower than the rate that would have been applicable if only one class of securities had been issued.

The senior/subordinate structure can also be used to expand the universe of parties available to provide credit enhancement. An entity providing external credit enhancement in the form of a guarantee or its equivalent is usually required to have a credit rating at least equal to that of the securities being guaranteed. However, the number of highly rated credit enhancers—including banks—is relatively small. Moreover, because of high capital reserve requirements,³⁶ third party credit enhancement provided by regulated institutions such as banks has become very expensive. But investors in subordinated securities have no rating requirement. The

³⁵ Investors would view securitization in the same light as accountants do under generally accepted accounting principles. See FIN. ACCT. STANDARDS BD., FIN. STATEMENT OF ACCT. STANDARDS NO. 77 (1983). See SCHWARCZ, *supra* note 6, at 2-3; SECURITIZATION OF FINANCIAL ASSETS, *supra* note 8, § 3.02. However, others, such as rating agencies, may adopt different views.

³⁶ See SCHWARCZ, *supra* note 6, at 68-70, 73-75.

credit enhancement comes from their initial cash investment in the SPV's subordinated securities. Because the proceeds of the SPV's subordinated securities are used to purchase receivables and thereby further overcollateralize the SPV's senior securities, the subordinated securities supplement the means by which the senior securities are paid.

III. Securitization Distinguished from Factoring

Traditionally used in the textile and apparel industries, factoring, like securitization, entails a sale of receivables to generate cash. Given the superficial similarities between the two financing techniques, it is useful to compare them and consider when each applies.

Factoring, in its purest form . . . involves only the purchase of accounts receivable (or "receivables") by the factor from the party (called the "client") with whom it has a factoring contract. The client assumes all risks of nonpayment of the receivable except the "financial inability of the account debtor (customer) to pay." . . . The factor agrees to pay on a monthly basis for purchased receivables at a date computed under the contract, usually called the "average maturity date" or adjusted average maturity date. The customer is immediately notified of the sale of the receivable to the factor and is instructed to make all payments directly to the factor.³⁷

In a factoring transaction the factor is typically a pre-existing finance company which realizes its profits by buying receivables from clients at a discount. Securitization, in contrast, usually involves the creation of a bankruptcy remote SPV which purchases receivables from the originator and issues asset-backed securities into the capital markets. Whereas factors rely on their expertise in collection to reduce their risk of loss, the SPV minimizes its risk through the purchase of quality receivables with predictable rates of default.³⁸ The differences between securitization and factoring, however, are not rigid and begin to blur in certain instances. For example, there are fewer differences between securitization and factoring in transactions where an SPV borrows funds from non-capital market sources instead of issuing securities, or where a factor funds itself through the issuance of capital market securities.

Nonetheless, traditional factoring is not obsolete. For many small and medium size companies, the costs associated with creating an SPV or registering debt

³⁷ PETER H. WEIL, FACTORING IN ASSET BASED FINANCING: A TRANSACTIONAL GUIDE § 27.01 [1] (Matthew Bender ed., 1985).

³⁸ Salathé, *supra* note 13, at 562.

securities prohibit them from securitizing. In these cases, factoring may provide a lower cost financing technique.

Hospitals currently face a choice between factoring and securitization techniques. Health care receivables are a large and relatively untapped source of assets which hospitals can use to meet their financing needs. Which is more efficient—factoring or securitizing these receivables?

A 1991 study compared the advantages and disadvantages presented by securitization for the health care field.³⁹ The authors pointed out that an “old line” factor often buys receivables at a discount of five to ten percent, while at the same time charging a factoring fee that may be as high as fifteen to twenty percent of the value of the receivables sold.⁴⁰ In addition, a factor will not advance all of the funds up front. As a result, the authors estimated that securitization would provide between thirty and forty percent more funds in advance than would old line factoring.⁴¹ The funding differential may be attributed primarily to the deep discount taken by the factor to protect itself and insure its profits. The SPV, on the other hand, funds itself through the capital markets, which act as a natural risk spreader by distributing the securities over many investors.

In certain circumstances, the principles used in securitization and factoring may be combined to obtain even lower cost funding than through either conventional securitization or old line factoring. For example, hospitals as well as small and medium size companies may be able to benefit from structures, such as the “divisible interest” structure,⁴² that provide capital market funding without the extra cost of creating an intermediary SPV.

In the divisible interest structure, an originator would sell, for a negotiated fixed price, its rights in a pool of receivables equal to one hundred percent of all collections up to a “trigger point” (and possibly also a fixed percentage of collections above the trigger point). Once fixed, there is no adjustment to the purchase price, irrespective of actual collections, and because the transfer is directly from the originator of the receivables to the issuer of the securities, there is no need to create an intermediary SPV, as in the two-tier structure.⁴³ Thus, the divisible interest struc-

³⁹ Sandra Ferconio & Michael Lane, *Financing Maneuvers: Two Opportunities to Boost a Hospital's Working Capital*, HEALTHCARE FIN. MGMT., Oct. 1991, at 74.

⁴⁰ See *id.* at 76.

⁴¹ See *id.* at 80.

⁴² See Schwarcz, *Divisible Interests*, *supra* note 34, at 149. The divisible interest structure eliminates the need for a bankruptcy remote subsidiary, and thereby permits multiple originators to obtain economies of scale by pooling their receivables in a single securitization transaction. As a practical matter, however, the use of these innovative structures, which raise issues of first impression in the absence of case law directly on point, may be limited to private placements with sophisticated investors until there are sufficient precedents decided or until a sufficient number of transactions are done so as to create investor and rating agency comfort.

⁴³ *Id.* at 155-60.

ture permits multiple originators to pool their receivables in a single securitization and thereby achieve economies of scale.⁴⁴ It also reduces the transaction costs (e.g., double set of documentation, creation, and capitalization of an intermediary SPV, and appointment of independent directors) of a two-tier structure. Therefore, the combination of concepts from securitization and factoring can lead to innovative and synergistic structures and approaches.⁴⁵

IV. Does Securitization Reduce Net Financing Costs?

A "zero-sum game" is one in which one person's benefit exactly offsets another person's loss, so that the net payoff of the entire game is zero. Is securitization a zero-sum game, or does it create a genuine cost reduction for parties?

Only an empirical study would fully answer this question. Such a study is not only beyond the scope of this article, but difficult to envision given that the corporate finance world rarely lends itself to controlled experiments. Nonetheless, a common sense analysis indicates that securitization can create a net cost savings.

This article has shown that, despite its transaction costs, securitization can be less expensive than alternative funding sources because it enables originators to obtain low cost capital market funding. Even investment grade originators who already have direct access to capital market funding may prefer securitization because of its indirect benefits, such as the provision of off balance sheet funding. Although indirect benefits are harder to quantify, many companies that use securitization are investment grade. This fact is significant when one considers that profit maximizing companies generally do not engage in activities whose benefits are illusory.

These observations leave unanswered, however, the question whether securitization enables originators to realize a gain at the expense of others, such as the originator's unsecured general creditors. For example, some critics have argued that unsecured creditors are harmed by securitization because it reduces the amount of the originator's unencumbered assets available for debt repayment.⁴⁶ This argument is flawed, however; securitization merely replaces one type of asset, receivables, with another type, cash. The unsecured creditor has the same amount of unencumbered assets to levy against after the securitization as it did before the securitization.

Other critics have argued that securitization could hurt creditors because the cash received is unlikely to stay within the originator.⁴⁷ The originator, they

⁴⁴ *Id.* at 154-55.

⁴⁵ See Schwarcz, *A New Theory of Recourse*, *supra* note 34, at 9.

⁴⁶ Cf. Paul M. Shupack, *Boundaries and Definitions: A Commentary on Dean Baird*, 80 VA. L. REV. (forthcoming Nov. 1994).

⁴⁷ Chase W. Ashley, *Comment: When a Company Securitizes, Its Creditors Face Higher Risks*, AM. BANKER, May 7, 1993, at 4.

say, may speculate or fraudulently transfer the cash. Given that the originator will have already sold its receivables, the originator will have to wait until new receivables are created and mature for its cash flow to regenerate.⁴⁸ This dissipation of cash may eventually result in a liquidity crisis unless the securitization can be repeated or refinanced.

One cannot assume wasteful behavior simply because an originator sells its receivables for cash. In fact, given the scrutiny imposed by rating agencies and other independent parties such as credit enhancers, securitization may present fewer opportunities for self-dealing than other financing methods. Nonetheless, securitization, just like any other sale of assets by an originator, may become suspect if implemented when an originator is on the brink of bankruptcy. An originator, for example, may be seeking to convert receivables into cash to make preferential payments to certain creditors or even to fraudulently hide assets. The potential for such suspect actions, however, is not unique to securitization transactions. The same issues would arise, for example, if on the eve of bankruptcy an originator sold, or borrowed money by encumbering, a factory or equipment and similarly sought to dissipate the sale or loan proceeds. Such questionable uses of proceeds are more appropriately addressed by preference⁴⁹ and fraudulent conveyance laws,⁵⁰ which seek to ensure equality of distribution of a debtor's estate.

The Delaware Supreme Court recently put debtors on notice that near-bankrupt corporations must be mindful of their responsibilities to act in their creditors' interests and not to their detriment. In *Credit Lyonnais Bank v. Pathe Communications*,⁵¹ the court noted that a board of directors of a corporation in the "vicinity of insolvency" owes a fiduciary duty not only to its shareholders but also to its

⁴⁸ *Id.*

⁴⁹ 11 U.S.C. § 547 (1988). Shupack contends that:

any sale of an asset has the consequence of turning a less liquid asset into cash. *The risk to creditors of the debtor resulting from any sale is not the sale transaction itself, but the subsequent dissipation by the debtor of the cash realized.* All sales and security interests in the debtor's assets carry with them the same risk of removing an asset from the debtor's estate and the attendant risk of dissipation.

Shupack, *supra* note 46 (emphasis added). Also, as stated previously, securitization is of least benefit when the originator is on the verge of bankruptcy, because of the increased likelihood that such securitization will be challenged by the originator's creditors. Therefore, the risk of the dissipation of funds raised by a near insolvent originator may only have limited practical importance for securitization.

⁵⁰ 11 U.S.C. § 548 (1988) and applicable state laws. For a discussion of fraudulent conveyance law, see Steven L. Schwarcz, *The Impact of Fraudulent Conveyance Law on Future Advances Supported by Upstream Guaranties and Security Interests*, 9 CARDOZO L. REV. 729 (1987); SCHWARCZ, *supra* note 6, at 35-36.

⁵¹ No. 12150, 1991 LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991).

creditors. This ruling gives greater assurance that a troubled corporation will not speculate with the cash received from a securitization to the detriment of creditors.

The question nonetheless remains: does securitization genuinely reduce net financing costs? A possible method of testing this hypothesis is to examine it in light of the principle of "exposure conservation." This principle states that:

Secured creditors will charge lower interest rates because security reduces their risks, but unsecured creditors will raise their interest rates in response because security reduces the assets on which they can levy, and so increases their risks.⁵² The interest rate reductions are precisely matched by interest rate increases; hence, the firm makes no net gain from granting security.⁵³

If one assumes, *arguendo*, that the principle of exposure conservation means that unsecured creditors will raise their rates in response to a debtor's securitization, just as they would in response to a debtor's secured financing, the principle would indicate that the rise in unsecured interest rates should precisely match the rate reduction granted by the secured creditor in return for taking collateral. As a result, the originator would realize no net gain.

The principle of exposure conservation assumes that interest rates do not vary with the source of financing. A securitization, however, provides a new source of financing—the capital markets, whose rates are systematically lower than the rates at which small or medium size firms commonly borrow. Prior to engaging in a securitization, an originator is financing itself through secured and unsecured loans. After the securitization, the originator raises funds by accessing the capital markets through the SPV.

⁵² Where pre-existing creditors receive security for their antecedent debt, the granting of security reduces the assets on which the remaining unsecured creditors can levy and thereby increases the risk for such unsecured creditors. The preference laws address such potential inequality. See 11 U.S.C. § 547 (1988). To the extent that creditors offer new money at lower interest rates in return for security, the analysis of whether there is increased risk to unsecured creditors would appear to be similar to that previously set forth in this article. However, the analysis of whether the granting of security increases risk is beyond the scope of this article. Compare Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtor's Choices Seriously*, 80 VA. L. REV. (forthcoming Nov. 1994) with Alan Schwartz, *Taking the Analysis of Security Seriously*, 80 VA. L. REV. (forthcoming Nov. 1994).

⁵³ Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1054 (1984) (emphasis deleted); cf. Franco Modigliani & Merton Miller, *The Cost of Capital Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). In a perfect universe, every savings achieved by changing one part of a company's capital structure will result in offsetting costs to other parts of the capital structure, including by taking advantage of third parties. Securitization achieves a net cost savings because the universe is imperfect.

The transformation from secured financing to capital market funding with its comparatively lower interest rate thus can reduce net financing costs.⁵⁴ So long as the added transaction costs are less than the interest saved by using securitization instead of secured financing, the principle of exposure conservation supports the proposition that securitization creates a net gain. The following examples help to illustrate this point.

An originator with \$100 million of unsecured debt, bearing an interest rate of X percent, plans to repay \$50 million of this unsecured debt with the proceeds of a new \$50 million issuance of secured debt. The principle of exposure conservation states that the interest rate on the secured debt will be reduced to X-Y percent, but this reduction in rate will be matched by an interest rate increase on the remaining unsecured debt to X+Y percent. This analysis assumes that the unsecured creditors are free to adjust to a market rate. Therefore, according to the theory, the originator makes no net gain from granting security.

If this originator repaid the \$50 million of the unsecured debt from the proceeds of a securitization, instead of from the issuance of secured debt, the interest rate on the remaining unsecured debt would again rise to X+Y percent.⁵⁵ However,

⁵⁴ As illustrated by the following chart, the interest rate on commercial paper was consistently lower than that of the bank prime loan rate over the last 3 years.

	1992	1993	August, 1994
Commercial Paper 1 - Month	3.71	3.17	4.65
Commercial Paper 3 - Month	3.75	3.22	4.84
Commercial Paper 6 - Month	3.80	3.30	5.19
Prime Rate	6.25	6.00	7.51

Source: 80 FED. RES. BULL., A25, A26, *Domestic Financial Statistics* (Nov. 1994).

⁵⁵ The increase in the unsecured borrowing rate is assumed to be the same whether triggered by secured financing or securitization. In practice, however, such rate increase will be less for securitization because, as previously discussed, securitization merely replaces receivables with cash and therefore does not reduce the assets on which unsecured creditors can levy. Furthermore, securitization does not affect a company's leverage ratio for financial reporting purposes. A precise comparison of the differences that may affect unsecured creditors between securitization and secured financing is subtle and depends on the structure of the transaction. For example, in a securitization, any excess receivables sold may or may not be available to repay unsecured creditors once the securitized debt is paid, while in a secured financing excess collateral may be used to repay unsecured creditors once the secured debt is paid. On the other hand, in a securitization if the receivables sold are insufficient to pay the securitized debt the holders of such debt will have no claim against the originator's remaining

because capital market rates are generally lower than secured financing rates (as shown in note 51), the interest rate on the securitized debt will reduce to $X-Y-\Delta$ percent (where Δ percent represents the rate differential between capital market and secured financing rates).

If securitization bore no transaction costs, the originator would save exactly Δ percent of \$50 million in annual interest costs by refinancing through a securitization rather than secured financing. The originator's actual cost saving, however, would be at least partially offset by transaction costs. But as long as an originator's interest and transaction costs for a securitization are less than the costs of a secured financing, securitization will create a net cost savings by providing access to lower cost capital market funding.

But why should the capital markets be prepared to fund securitization transactions at a lower rate than secured financing? At least one explanation is that securitization serves as a means of reducing "monitoring costs," a theory originally presented by Jackson and Kronman in the secured financing arena.⁵⁶ Because the interest rate on the loan is determined when the loan is made, a borrower may take actions that increase the loan's riskiness after the loan is made. Jackson and Kronman argue that a creditor will incur certain monitoring costs as a result to ensure that the borrower's actions do not increase the riskiness of the loan.⁵⁷ In this regard, a secured creditor should have lower monitoring costs than an unsecured creditor because the secured creditor needs to monitor the borrower's actions only in regard to the collateral backing its loan and can disregard how the borrower acts generally.⁵⁸

Subsequent commentators have argued, however, that secured financing may not reduce, and indeed may increase, the need to monitor the borrower's financial condition. The reason is that if the borrower enters bankruptcy, an automatic stay will freeze the secured creditor's ability to exercise remedies against the collateral and thereby impair the secured creditor's collateral position.⁵⁹ As a result, the secured creditor has a significant interest in ensuring the continued viability of the borrower and will incur monitoring costs to further that interest in addition to the costs of monitoring the collateral.

assets. In a secured financing if the collateral is insufficient to pay the secured debt, the holders of such debt generally may assert an unsecured claim against the originator's remaining assets, and such unsecured claim will be *pari passu* with the originator's other unsecured claims. See 11 U.S.C. § 506(a) (1988). Accordingly, the author believes that the assumption used in this article as to the increase in the unsecured borrowing rate may be overly conservative; therefore, the actual net cost saving enjoyed by the originator may be even greater than portrayed.

⁵⁶ Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L. J. 1143 (1979).

⁵⁷ *Id.* at 1149.

⁵⁸ *Id.* at 1153.

⁵⁹ 11 U.S.C. § 362(a)(5); see also SCHWARCZ, *supra* note 6, at 29-30; SECURITIZATION OF FINANCIAL ASSETS, *supra* note 8, § 5.05.

In a securitization, on the other hand, the originator's receivables are sold to a bankruptcy remote SPV in a "true sale." Consequently, a bankruptcy of the originator would not adversely affect the ability of investors to receive payment on their asset-backed securities.⁶⁰ Because a bankruptcy remote structure separates the source of payment of the SPV's securities from the risks associated with the originator, the need to monitor the originator's financial condition is largely eliminated. Although the risks associated with servicing and collecting the receivables still necessitate some monitoring,⁶¹ these risks can be borne by providers of credit enhancement or investors in subordinated securities, parties who are in the business of precisely assessing and absorbing such risks.⁶²

Securitization, thus, creates genuine cost reductions. By eliminating the risk of bankruptcy to investors, many different types of companies can better utilize their most valuable asset, their receivables, by accessing low cost capital market funding.

V. Untapped Opportunities

The greatest benefit of securitization is its potential for bringing low cost capital market financing to companies that would otherwise be unable to access the capital markets. Yet some of the most promising candidates for securitization, such as hospitals and middle market companies, have yet to capitalize on its advantages. These types of originators are generally unrated or rated less than invest-

⁶⁰ The SPV's receivables, for example, cannot be claimed by unsecured creditors of the originator except through the originator's equity interest in the SPV. See *supra* note 52. However, as previously discussed in Part I, to the extent that the receivables sold in a securitization might be adversely affected by the originator's bankruptcy, such as is the case with franchise fees, the process of securitization is made more difficult. See SCHWARCZ, *supra* note 6, at 7-9, 11-13.

⁶¹ For an example of the need for monitoring in securitization cases, see Mark H. Adelson, *Seller/Service Fraud and the Towers Situation*, MOODY'S INVESTORS SERVICE, STRUCTURED FINANCE, SPECIAL REPORT, June 1993.

⁶² As previously discussed in Part II, some originators use a senior/subordinate structure to create a specialized assumption of risk. By causing the SPV to issue a combination of senior securities to ordinary capital market investors and subordinated securities to sophisticated investors, an originator can minimize the effect of asymmetric information among investors and thereby obtain a lower blended interest rate and therefore lower credit costs. Credit enhancement minimizes the effect of asymmetric information among investors through the use of highly rated institutions that wish to profit by guaranteeing all or a portion of the securities issued to investors. This discussion of monitoring costs assumes that the reduction of monitoring costs in a securitization does not increase the monitoring costs of unsecured creditors. In the author's experience, companies that engage in securitizations also have contractual unsecured creditors, such as banks and insurance company lenders, with covenants that enable them to monitor the debtor with at least the care performed by secured lenders. As a result, the author believes that this assumption is correct and that there is not a strict law of conservation of monitoring costs.

ment grade⁶³ and therefore do not have direct access to low cost capital market financing. Because of their relatively small size and limited financing requirements, transaction costs have for the most part prevented hospitals and middle market companies from using securitization. Innovative approaches, such as the recently advanced concept of "divisible interests,"⁶⁴ however, may permit middle market companies and hospitals to pool their receivables in ways that reduce transaction costs and make securitization far more feasible and attractive.

Companies in bankruptcy represent yet another potentially significant but undeveloped resource for securitization.⁶⁵ Although securitization has resulted in significant cost savings for a limited number of large bankrupt companies,⁶⁶ it has yet to be applied to small or medium size companies. One potential tool for the expansion of securitization to such smaller companies would be the creation of a multi-seller securitization conduit to handle debtor-in-possession financing.⁶⁷ So long as the receivable streams of a bankrupt company remain consistent, they too can be used for securitization.⁶⁸

Securitization opportunities are no longer limited to the financing of receivables. Securitization techniques have recently been applied to inventories and other assets that do not themselves constitute rights to payment but may nonetheless give rise to such rights over time. The potential application of securitization to these "future rights" is nearly limitless. Examples of its potential uses range from the issuing of capital market securities to finance mineral production payments to the securitization of future revenues generated from the environmentally-safe harvesting and sale of timber in South American rain forests. Securitization can also be applied to "project-finance" transactions to help meet the current demand for infrastructure development and improvement.⁶⁹ Kravitt, Forrester, and Rosenberg argue for the application of securitization to assist in the refinancing of previously con-

⁶³ The term "investment grade" technically refers to the rating on a company's long term debt securities given by independent rating agencies. An investment grade rating reflects a rating agency's prediction that the debt securities will be paid on a timely basis. At the end of 1992, most medium size or "middle market" companies either did not have ratings or were rated less than investment grade. At that time, even some larger companies, including virtually all airlines and department stores, did not have investment grade ratings. See Schwarcz, *Divisible Interests*, *supra* note 34, at 141 n.8; *S & P Lowers the Bond Ratings of 3 Big Airlines to Junk*, N.Y. TIMES, Mar. 12, 1993, at D1;

⁶⁴ See *supra* notes 34 & 42-45.

⁶⁵ Potential investors would want to obtain assurances with respect to the types of issues that make a securitization with a company on the brink of bankruptcy risky, because a securitization of a company in bankruptcy requires court approval to be consummated.

⁶⁶ See SCHWARCZ, *supra* note 6, at 40-45.

⁶⁷ Such conduits have been given the term debtor-in-possession company, or "DIPCO."

⁶⁸ Debtor-in-possession securitization transactions have occurred with and without third-party credit support. See SCHWARCZ, *supra* note 6, at 44.

⁶⁹ See J. Paul Forrester, et al., *Securitization of Project Finance Loans and Other Private Sector Infrastructure Loans*, THE FINANCIER: ACMT, 1994, at 7.

structed and operational infrastructure projects. Waiting until after the completion of the project, they note, would enable investors to more accurately predict the rate of default⁷⁰ and therefore result in lower rates.⁷¹

Securitization might also be used to finance infrastructure projects from their inception. Such a transaction would presumably involve the present sale of future revenues to be generated by the completed project. The major obstacles to this type of transaction would be the difficulty inherent in evaluating the riskiness associated with the project's completion,⁷² as well as the risk associated with the securitization of future income not arising from an existing contract.⁷³ While such transactions would have uncertainties regarding the generation of future revenues and the creation of bankruptcy remote structures, the techniques and methods of securitization may well prove a useful starting point in considering how to structure the transactions.

Another almost unlimited opportunity to use securitization is provided by the growing desire to bring low cost U.S. capital market financing to foreign originators. As with other areas in which securitization is not yet widely utilized, certain risks may make such cross-border transactions less feasible. These risks include uncertainties concerning foreign currency exchange, tax, and sovereignty as well as problems related to dealing with legal systems that may be unsophisticated in asset based finance. Nevertheless, given the potential size and scope of this undeveloped area, the rewards for pursuing cross-border securitization may be great.

Other opportunities for securitization may be politically influenced. While the House of Representatives adopted Representative Paul Kanjorski's bill promoting the securitization of commercial loans in 1994,⁷⁴ the Senate incorporated provisions⁷⁵ into its version of the Community Development Banking bill that attempt to create a favorable legal framework for banks wishing to securitize their

⁷⁰ The rate of default of infrastructure projects which depend on future customers, such as power plants, can generally be determined through the use of demographic studies. For example, the default rates of power projects can be evaluated based on the project's capacity and energy sale agreement. *See id.* at 10.

⁷¹ *Id.* at 18.

⁷² Aside from the underlying business risks, licensing problems and community opposition sometimes can interfere with the completion of certain projects. For example, examine the circumstances surrounding the Von Roll hazardous waste incinerator in Ohio which was temporarily enjoined by the EPA due to the actions of Vice President Gore, and the circumstances surrounding the closing of the Shoreham Wading River Nuclear Power Plant in New York.

⁷³ Section 552(a) of the Bankruptcy Code states that assets acquired by a debtor after the filing of a bankruptcy petition may not be subject to a pre-bankruptcy security interest. 11 U.S.C. § 552(a) (1988). Even though an SPV may have acquired the future rights to a project's income, § 552(a) may cut off those rights in income generated after the project becomes subject to a bankruptcy case unless, for example, the future income arises under a presently existing contract. *See* Schwarcz, *Divisible Interests*, *supra* note 34, at 149 n.36.

⁷⁴ H.R. 2600, 103d Cong., 2d Sess. (1994).

⁷⁵ These provisions were referred to as the Small Business Loan Securitization and Secondary Market Enhancement Act of 1993, S. 384, 103d Cong., 1st Sess. (1993).

small business loans.⁷⁶ The Reigle Community Development and Regulatory Improvement Act of 1994,⁷⁷ as enacted, generally adopted the Senate's approach, thereby permitting investors that presently do not lend directly to small businesses to invest in capital market securities backed by these loans. Therefore, banks will be able to replace the loans presently on their books with cash and, in turn, make new loans to small businesses.⁷⁸

VI. Conclusion

In many cases, securitization not only reduces an originator's direct financing costs but also provides significant indirect benefits. Securitization entails real costs, however, and therefore should only be used after comparison with alternative sources of funding. Because securitization has only been applied to a portion of its potential market opportunities, it promises to be a financing technique that will continue to grow.⁷⁹ Securitization, in short, brings to financial technology what the sought-after philosopher's stone promised to bring to base metals—the ability to turn them into gold!⁸⁰

⁷⁶ Provisions of S. 384 were incorporated into an amendment in the nature of a substitute to the Community Development Banking and Financial Institutions Act of 1993, S. 1275, 103d Cong., 1st Sess. (1993), by the Senate Committee on Banking, Housing, and Urban Affairs on September 21, 1993.

⁷⁷ Pub. L. No. 103-325 (Sept. 23, 1994). The Act also amends the Secondary Mortgage Enhancement Act of 1984 to add commercial real estate related securities to the types of mortgage related securities that are accorded relief from certain trading and investment restrictions.

⁷⁸ *Hearings on S. 384 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 103d Cong., 1st Sess. 41 (1993) (Statement of the Honorable Frank N. Newman, Under Secretary of the Treasury).

⁷⁹ According to data compiled by the Securities Data Corporation and estimates performed by Citicorp, the annual issuance of asset-backed securities, exclusive of mortgage-backed securities, grew from over \$60 billion in 1989 to over \$130 billion in 1993, and the total asset-backed securities currently outstanding exceeds \$300 billion. Telephone Interview with Frank J. Cavallo, Vice President of Securitization at Citicorp Securities, Inc. (June 15, 1994). The mortgage-backed securities market presently has \$2.45 trillion of securities outstanding, representing a combination of \$2.3 trillion in government guaranteed securities (Ginnie-Mae, Fannie-Mae, and Freddie-Mac) and \$150 billion non-government guaranteed. See *INSIDE MORTGAGE SECURITIES*, June 10, 1994, at 2.

⁸⁰ The philosopher's stone was an imagined substance which allegedly had the power to transform base metals into gold. WEBSTER'S II NEW RIVERSIDE UNIVERSITY DICTIONARY 882 (1984).