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THE GOOD, THE BAD, AND THE SAVVY: CREDIT RISK TRANSFER GOVERNANCE

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Abstract

Goldman Sachs (Goldman) and AIG on the eve of the 2008 financial crisis were bound together through a web of credit risk transfer (CRT) contracts in the form of credit default swaps (CDSs) and synthetic collateralized debt obligations (CDOs). Synthetic CDOs arranged by Goldman and other investment banks enabled certain hedge funds to profit from the ultimate bursting of the housing bubble due to the funds' savvy in understanding CRT better than their counterparties. This Article examines CRT transactions such as those involving Goldman, AIG, and Paulson's hedge fund. It does so by constructing a novel theory of CRT that extends the insights of creditor governance theory to CRT transactions. Creditor governance theory identifies monitoring, covenants, collateralization, and CRT itself as primary governance mechanisms, but has thus far has been primarily limited to analyzing loans and bonds and not CRT instruments.

By analyzing CDSs and CDOs within the framework of creditor governance, good and bad CRT governance can be distinguished. Good CRT governance requires governance mechanisms to overcome informational asymmetries and incentive misalignments, and doing so enables credit risk sellers and buyers to achieve their risk-adjusted expectations and not cause systemically destabilizing losses. I argue that for unfunded CRT transactions such as CDSs, good governance can be achieved through counterparty governance mechanisms consisting of bilateral monitoring, collateralization, and a robust market infrastructure. Likewise, good governance for funded CRT transactions such as CDOs can be achieved through special purpose vehicle (SPV) governance mechanisms consisting of strong monitoring and substantial ex ante specification of creditors' rights in the form of structured cash flows and other credit enhancements, performance-based covenants, and active SPV management.

Good CRT governance can protect investors (and counterparties) even if the credit risk being transferred is significantly underpriced and eventually leads to unexpected losses. Indeed, a primary cause of the financial crisis of 2008 was not underpriced residential mortgage risk or a lack of regulation, but rather bad governance of nearly every aspect of

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certain types of CDSs and CDOs that transferred the credit risk of subprime residential mortgage-backed securities. Accordingly, this Article challenges much of the conventional and scholarly wisdom regarding CRT, which overemphasizes a lack of regulation as a primary cause of losses and systemic risk from CRT transactions. To the contrary, relatively unregulated CRT transactions are typically well governed in practice and were not a cause of the financial crisis. This observation explains why the CDS market remained generally stable throughout the financial crisis despite the large and relatively unexpected payouts by CDS sellers and the sudden collapse of a major CDS dealer. It also explains why securitizations that transferred the credit risk of assets other than nonprime mortgage-backed securities, such as leveraged loans and commercial real estate, performed relatively well. Policymaking initiatives should thus narrowly target the unique flaws of nonprime residential mortgage-related CRT, but not the CDS or securitization markets more broadly. This Article concludes by identifying important principles and implications of CRT governance for policy makers.