Bank Regulation Spawns a New Security

In the years running up to the financial crisis of 2007-2009, banks sold large parts of their loan portfolios. This commonly involved the bank setting up a special-purpose company that then bought a package of loans from the bank. The company raised the cash to buy the loans by selling *asset-backed securities* to investors. All being well, the cash from the package of loans would be more than sufficient to service the asset-backed securities. Frequently, these asset-backed securities were sold in several tranches, known as *collateralized debt obligations,* or *CDO*s. If the cash flows from the package of loans proved insufficient to service all the debt, the junior tranche took the first hit.

There were a variety of motives for creating these securities, but one was undoubtedly provided by bank regulation. Regulators require banks to hold a minimum amount of capital to protect against a fall in the value of their assets. By securitizing parts of their loan portfolio, banks were able to reduce the amount of capital that they were obliged to hold. But that answers only part of the question. Regulation may explain why banks chose to sell part of their loan portfolio, but it does not explain why they packaged the loans and then sliced up the package. Were the banks able to create extra value by appealing to an untapped clientele of investors?[1]

CDOs earned a bad reputation for the part that they played in the financial crisis and have (for the moment at least) almost entirely disappeared. It seems that, if banks had uncovered a violation of MM's proposition I, it was not a lasting violation.

[1] One possibility is that the ratings agencies were mistakenly prepared to assign a triple-A rating to the senior tranches, which made them eligible investments for money market funds.