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Counterfeit Collateral: Lehman and the ECB

Lehman Brothers in 2008 and the European Central Bank (ECB) in 2012 share a common connection to "counterfeit collateral" from opposite perspectives. Lehman acted in bad faith in pledging defective collateral to unsuspecting lenders prior to its bankruptcy. The ECB today accepts arguably tainted collateral in its massive lending to European banks - though our conjecture is that the ECB is fully aware of the risk of its "secured" lending.

Beginning in April 2008, Lehman sought to generate liquidity by creating balance sheet CLOs from its own corporate and commercial real estate loan books. The CLOs, with names such as Freedom, Pine, Spruce, and Verano, consisted of large senior tranches rated single-**A** and unrated subordinate tranches. Had Lehman sold the CLO senior tranches to the market, this securitization strategy would genuinely have boosted liquidity. Instead, Lehman pledged these tranches as collateral in short-term repo (repurchase) transactions to lenders willing to accept collateral in the form of investment-grade structured products. The fatal defect in these transactions was the deliberate absence of bankruptcy remoteness in the transfer of loan risk to the CLO special purpose vehicles (SPVs). Instead of selling or assigning loans to the SPVs, Lehman issued loan participations.

With loan participations, it was entirely foreseeable that Lehman's default would disrupt principal and interest cash flows of the loan collateral to the SPVs. Custom and practice in the repo market dictated that borrowers not pledge assets – such as their own debt or equity – that will fall in value upon borrower default. Repo lenders, for their part, apparently did not read transaction documents or otherwise study carefully the Lehman collateral they accepted. Lehman's bankruptcy filing in September 2008 saddled these lenders with highly illiquid and impaired CLO collateral.

The ECB today is the dominant lender to European banks. One traditional central bank function is to serve as "lender of last resort" to banks against high-quality, discounted collateral at a punitive interest rate.

Regarding quality and discount of collateral, the ECB's own description states that these parameters must be such that "it is highly probable that the Eurosystem would be able to recover the full amount of its claim" upon selling such collateral to the market after a borrower default (see http://www.ecb.int/paym/coll/risk/html/index.en.html).

Yet, reminiscent of Lehman's counterfeit collateral, the ECB permits banks to pledge investment-grade ABS transactions they have created. Instead of the Lehman "absence of bankruptcy remoteness" defect, the ABS collateral is weak in that it will be immediately distressed upon the borrower's default due to the many typical roles of the borrower as sponsor to the securitization: seller; servicer; account bank; and swap counterparty. There exist, in theory, replacement rules pertaining to the impact of sponsor bank default on its securitizations that, in practice, are almost certain to prove inadequate in maintaining the market value of the ECB collateral.

Performance of this collateral is highly correlated to the solvency of the (sponsor bank) borrower. Thus, the same principle that forbids a borrower from pledging its own debt as collateral for a secured loan should prohibit a bank from pledging its own ABS. The ECB may believe it understands the elevated risk it takes in accepting borrower-sponsored ABS collateral, but failure of the highly leveraged ECB itself is an immediate threat to the Eurozone.

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