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Welcome to the Spring 2021 issue of *The Journal of Structured Finance*. It is near the end of March as I write this, but it seems like ages since late December, when I wrote the Editor's Letter for the previous issue. A lot of water has gone over the dam since then. Although the Pfizer and Moderna vaccines received emergency use authorizations from the FDA in mid-December, only about 9 million Americans had received an initial dose by the start of 2021 (Our World in Data 2021). Now, more than 95 million Americans have received at least one vaccine dose, but there many millions that remain "vaccine hesitant." A substantial proportion of them have been influenced by so-called "anti-vaxx" misinformation despite overwhelming scientific evidence of the vaccines' safety and efficacy (Center for Countering Digital Hate 2021; Carroll 2020).

Also, by the end of 2020, President Trump's numerous lawsuits seeking to overturn the results of the Presidential election had failed (McConnell 2021; Horton 2020; Cummings, Garrison, and Sergent 2021) and the Electoral College had formalized President Biden's victory. Despite this evidence, however, Trump supporters who embraced false narratives of election fraud and a stolen election sought to overturn the election results by attacking the US Capitol on January 6.[1] Even after these events, the false narratives persist and continue to be embraced by many (Voter Protection Program 2021).[2]

Misinformation and denialism about Covid-19 and the Presidential election are disappointing but perhaps not surprising. Misinformation is sometimes tenacious. It becomes necessary to occasionally reaffirm basic facts, such as the following: the world is round, the Apollo missions landed on the Moon, the Holocaust happened, smoking cigarettes is dangerous, evolution is real, the 9/11 attacks were not orchestrated by the US government or by Israel, and climate change is real and is influenced by human activity. Each of these *facts* is supported by *overwhelming* evidence. The absence of strong evidence, however, does not necessarily disprove a proposition. Examples include extraterrestrial intelligence and the existence of an afterlife. It is also important to distinguish situations where a fact can be assuredly true in the absence of ordinary evidence. These include facts that are true as a result of pure logic, such as mathematical theorems.[3]

[1] *See*, US Department of Justice, US Attorney's Office for the District of Columbia. 2021. "Capital Breach Cases." Retrieved March 30. https://www.justice.gov/usao-dc/capitol-breach-cases; US Department of Justice, Federal Bureau of Investigation. 2021. "Most Wanted—US Capitol Violence." Retrieved March 30. https://www.fbi.gov/wanted/capitol-violence.

[2] *See*, *US Dominion v. Guiliani*, Case No. 21-cv-00213 (D.D.C., filed Jan. 21, 2021), https://www.courtlistener.com/recap/gov.uscourts.dcd.226485/gov.uscourts.dcd.226485.1.0_4.pdf; *Smartmatic v. Fox Corp.*, Index No. 151136/2021 (N.Y. Sup. Ct., filed February 4, 2021), https://iapps.courts.state.ny.us/nyscef/ViewDocument?docIndex=x16kEpoDU9eTb7qmlaLIYA==.

[3] I put aside, for purposes of this discussion, propositions of moral or political philosophy that claim the weight and force of truths without either factual evidence or antecedents based in pure logic. Alexander Hamilton (1788) offered some compelling observations in that vein in Federalist Paper No. 31. Any more about this, however, would be way beyond the scope of this letter.

One example of a big lie that persisted for decades was that of the "clean *Wehrmacht*." In the aftermath of World War II, the Allied Powers promoted and perpetuated the lie that the *Wehrmacht*—the regular German army, as distinct from the SS—had not participated in the atrocities of the Nazi regime. The lie helped Allied governments achieve popular acceptance for rearming West Germany and integrating it into common defense arrangements for standing against the Soviet Union and the Warsaw Pact. Although some historians challenged the lie as early as the 1960s, it generally persisted until the mid-1990s. Finally, nearly five decades after the end of the war, an exhibit at the Hamburg Institute for Social Research unveiled a trove of material including 1,400 photos showing the truth about the *Wehrmacht's* complicity (Hamburg Institute for Social Research 2004; Wette 2006). It took a long time for the lie to be fully debunked, but ultimately it was.

The remarkable durability and staying power of falsehoods and misinformation should be troubling to securitization professionals. Our models for pricing and evaluating securities cannot tolerate misinformation. They are sensitive to small discrepancies in the variables describing a deal's underlying assets. For example, seemingly small misstatements about concerning a mortgage loan's loan-to-value (LTV) ratio or its delinquency status can translate into material differences in risk. We need information to be true and correct in order to use our preferred tools for portfolio management and trading. The acceptable range for inaccuracy is extremely small. Moreover, the challenge is greatest when dealing with asset classes that claim to possess the strongest credit quality. Those are the cases where deals have the lowest credit enhancement levels. There, misinformation about the riskiness of even a small proportion of a deal's underlying assets can translate into big effects on the credit quality of its securities. This calls for investors to exercise caution.

Exercising caution has always been a good idea, but it is likely more important today than ever before. Among the key lessons from the mortgage meltdown and the financial crisis is that securitization investors receive very little protection under the federal securities laws because of short time limits for bringing claims. A few states offer protection under their blue sky laws, but most do not. Contractual representations and warranties offer some protection, but they are weaker in newer deals and their future effectiveness seems questionable.

The main character in HBO's 2019 mini-series, *Chernobyl*, had a great line near the end of the story: "Every lie we tell incurs a debt to the truth. Sooner or later that debt is paid." That's powerful stuff. Unfortunately, however, for structured finance investors, "later" is much more common than "sooner." Accordingly, investors are well served by applying extra vigilance up-front, and embracing a willingness to walk away from an offering when something seems wrong. Also, they would likely benefit from redoubling their efforts toward ongoing surveillance, so that they can exit deteriorating positions quickly. For some investors, these considerations will tip the balance toward favoring agency MBS over private-label securitizations.

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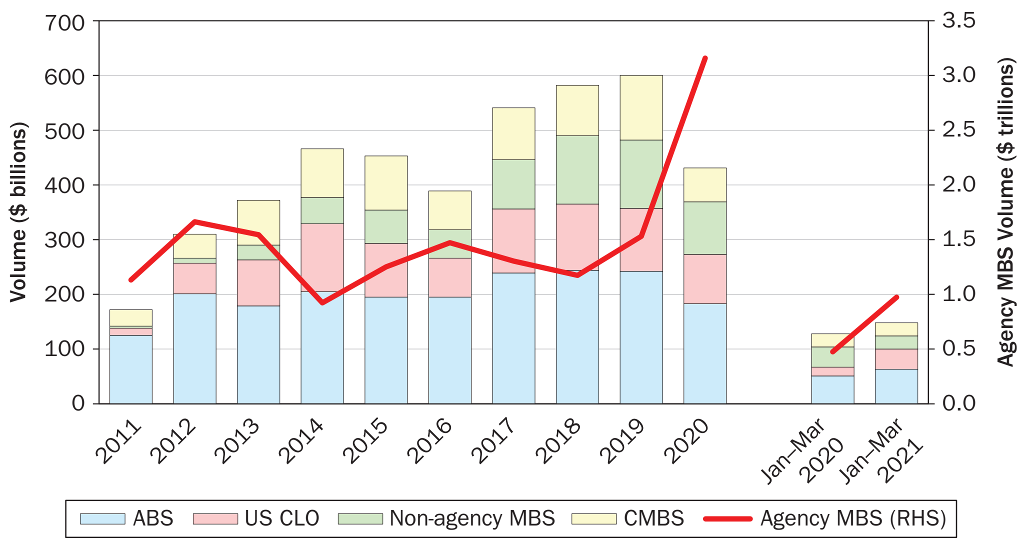
US securitization issuance volume is off to a stronger start this year than last (Exhibit 1). The same appears to be true of issuance activity in Europe and the Asia-Pacific region. The regulatory climate appears reasonably benign, at least for the

EXHIBIT 1

US Securitization Issuance Volume



NOTE: Non-agency MBS includes jumbo, non-QM, non-performing and re-performing loans, single-family rental, and agency credit-risk transfer transactions.

SOURCE: Bank of America Global Research.

near term. Recent New York legislation addressing the discontinuance of LIBOR will certainly help to minimize disruption. Clouds on the intermediate horizon include the potential for reduced demand for office space and the resolution of loan forbearances scheduled to expire later in the year. Longer term, the greater challenges may be inflation and the expansion of government debt.

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This issue opens with “Why We Tend to Be Unprepared for the Inevitable Next Disaster” by Martin Goldberg, a quantitative risk analyst at Bloomberg. He discusses how various factors, including psychological ones, often cause people to be unprepared for disasters (such as the Coronavirus pandemic), even though many similar events have happened in the past. He addresses eight specific factors and describes how each one bears on judgment and decision making.

In “Financing Correlated Drug Development Projects,” Andrew Lo and Kinn Wei Siah (both of MIT) extend earlier research on proposed biomedical mega-funds for financing drug development. They introduce correlations between phase transitions in the drug development process and find that the correlations somewhat reduce the attractiveness of the structure. However, they also find that the structure still outperforms equity-only financing under a wide range of scenarios.

Steffen Hundt (University of Paderborn), Johanna Jahnel (University of Freiberg), and Andreas Horsch (University of Freiberg) discuss using the cash flows from power purchase agreements (PPAs) as the basis for financing renewable energy projects.

In "Power Purchase Agreements and Financing Renewables: An Interdependency," they find strong connections between the amount of debt that can be raised and both PPA pricing and the credit quality of the PPA counterparties.

In "Antecedents of Financial Instrument Choice by VC/PE Funds: Using the Theory of Adverse Selection," Smita Tripathi (Doon University) examines the use of equity, preferred shares, warrants, debt, and convertible securities when venture capital/private equity (VC/PE) funds invest in the Indian infrastructure sector. She finds that equity is the most common type of instrument, though VC/PE investors often use convertible securities for mitigating information asymmetry.

Dirk Dreyer and Ilja Schaab (both of the FOM University of Applied Sciences) consider the diversification benefits that investors can achieve from investing in leveraged loans. They find that leveraged loans display low correlation with most asset classes in both US and European markets, though correlation with high-yield bonds is somewhat higher. The correlation is lower in Europe than in the US, allowing for greater diversification benefit in Europe.

As usual, this issue includes highlights from *GlobalCapital* and a selection of industry news items from the Structured Finance Association, in both cases covering Q1 2021.

We welcome your submissions. Please encourage those you know who have good papers or who have made good presentations on structured finance- or project finance-related subjects to submit them to us.

Submission guidelines can be found at https://jsf.pm-research.com/authors. If you have comments or suggestions, you can e-mail me directly at M.Adelson@PageantMedia.com.

Mark Adelson
Editor and Content Director

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