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A way forward for SIVs?

The announcement in June of the restructuring of SIV Portfolio plc (formerly Cheyne Finance) provided some much-needed relief to the structured investment vehicle (SIV) market. Is this restructuring likely to mark the beginning of the end for the SIV industry, or can it act as a catalyst for the product's resurrection? First, let's recap on how the product came into being, the struggles of the last year, and the initial rescue responses from institutions.

SIVs developed through financial institutions seeking to arbitrage the spread between the income that could be earned on long-dated assets and the cost of servicing short and medium-term debt. The vehicles invested in a portfolio of primarily asset-backed securities, usually actively managed by an investment manager. Such investments were funded by the SIV issuing to investors a mix of short-term commercial paper and medium-term notes (MTNs) having a significantly shorter maturity than the underlying assets.

The SIV's funding therefore needed to be continually refinanced throughout the life of the transaction. In contrast to similar structures, such as asset-backed commercial paper programs, SIVs included junior tranches subordinate to the senior debt which obviated the need for a liquidity facility in respect of 100 percent of the portfolio. The liquidity support for a typical SIV was limited to between four to six months of funding obligations.

Until about a year ago, SIVs were heralded as an increasingly vital tool in balance sheet and debt management for financial institutions. As we now know, the fortunes of such vehicles changed almost overnight in the late summer of 2007 with the onset of the credit crunch. The chronic lack of liquidity in the financial markets resulted in most SIVs finding it extremely difficult to refinance their commercial paper funding as it fell due. The nature of the vehicles' liquidity lines meant that SIVs could only cover the shortfall in funding for a limited period of time. In addition, market conditions made it very difficult for SIVs to obtain meaningful valuations for their underlying portfolio, with the consequence that default and unwind mechanisms linked to the net asset value of such portfolios were triggered.

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Consequently, virtually all of the 30 or so SIV or similar SIV-lite structures in existence in 2007 were either brought on balance sheet by the sponsoring financial institution or went into receivership. For those vehicles in receivership, the SIV Portfolio restructuring is an important watershed and is likely to be used as the framework for the restructuring of a number of other transactions. Indeed, similar arrangements were agreed in respect of the Rhinebride SIV during July, and it is likely that others, including Golden Key, Mainsail II and Whistlejacket, will follow later this year.

The SIV Portfolio restructuring involved Goldman Sachs, on behalf of the receivers, auctioning part of the portfolio of underlying assets. The remaining assets were transferred to a new vehicle established by Goldman Sachs. Senior creditors in SIV Portfolio had the option of receiving either cash based on the amount received in the auction, an investment in the new vehicle or direct ownership of a vertical strip of the underlying portfolio. Initial indications are that many investors opted for the cash option, even though it is believed this option results in such investors receiving recovery of a little over 40 percent of the face value of their investment.

Whilst the SPV Portfolio restructuring is seen as an important step forward in restoring some confidence to the structured credit market, it needs to be borne in mind that it essentially provides a way for the underlying investments to be liquidated and for investors to exit the structure in a somewhat orderly fashion. The restructuring is likely to represent a line in the sand, providing some degree of certainty as to the market valuation of the underlying investments in SIVs, and enables investors to move on. However, it does little to indicate whether there may be any future for SIVs or similar vehicles.

Bearing in mind the extreme negative publicity SIVs have received during the course of the last year, it is tempting to assume that they will be consigned to the dustbin of financial instruments, never to be seen again. It is, however, rare for any financial structure to disappear completely. Although the assumptions on which SIVs were modelled have been shown, with the benefit of hindsight, to be flawed, the flexibility and financial advantages that such structures offer are likely to result in future products being developed which have many of the features of SIVs. For this to happen, there are a number of important issues that will need to be addressed.

It is clear that a different liquidity structure will be needed. Of course, part of the attraction of SIVs was the more favourable pricing that could be obtained compared with structures requiring 100 percent liquidity coverage. Future vehicles will, however, need to be designed to survive a liquidity drought of the type recently experienced. It may be that this will require a greater proportion of funding through MTN issuances rather than short term commercial paper. During the credit crisis, a number of vehicles relied on repos of underlying assets to provide liquidity and it is likely that future structures will have similar features built in. Given that the counterparty to the repo takes the asset as collateral, rating agencies and investors are likely to impose limitations on the extent to which such arrangements can be utilised.

The financial uncertainty caused by the credit crunch made it extremely difficult for asset managers to obtain meaningful valuations of the assets underlying SIVs. Consequently, even assets whose credit quality remained fundamentally strong suffered a significant fall in their 'mark to market' valuation. As a result, many SIVs hit unwind or default triggers requiring a liquidation of the underlying portfolio. At that stage, it became inevitable that the vehicle would either need to be acquired by the sponsoring bank or go into receivership.

Senior investors will, of course, require that mechanisms are put in place requiring the unwind of the vehicle when it is in financial difficulty. However, where the underlying credit quality of assets remain strong and their value is suppressed only by a lack of market liquidity, it is unlikely to be in any investor's interest to require an immediate unwind of the structure. It is difficult to conceive that senior investors are likely to accept a move away from triggers based on a mark to market valuation of underlying assets. Nevertheless, it may be possible to build some flexibility into the triggers, with a view to giving more breathing space to the vehicle to seek other solutions, rather than go into immediate receivership.

Consideration needs to be given to the level of disclosure and investor understanding of the products. It seems clear that many investors did not fully appreciate the extent to which the vehicles were exposed to asset-backed securities linked to subprime mortgages, relying principally upon the credit ratings provided to the securities they were purchasing. The regulation of complex structured products is under close scrutiny from a number of quarters at the moment. The recent report by CRMPG III, chaired by Gerald Corrigan and entitled 'Containing Systemic Risk: The Road to Reform' covers many different aspects of the recent financial crisis, including high risk complex instruments. It strongly recommends that such instruments only be sold to sophisticated investors and that investors have the capability and sufficient information at their disposal to understand the risk and return characteristics of the investment and the ability for it to be stress tested. This may well limit the pool of investors to whom such structures are marketed.

Finally, the significant stigma factor now associated with these products as a result of the troubles of the last year must be overcome. Even if products with SIV-like features can be developed successfully in the future, it is unlikely that the name 'SIV' is going to be used in connection with their marketing. Investors are, in the current climate, understandably risk averse and looking to more straightforward products.

As markets improve and investor confidence begins to increase it would be surprising if investors' appetite for vehicles arbitraging spreads between long and short term debt does not return. As highlighted above, there are a number of challenges that product designers will need to overcome before this can become a reality. But we do not expect the technology to be consigned to history forever. ■

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* fund-linked and credit-linked CPPI note issues and other fund-linked repackagings;
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