FINANCIER WORLDWIDE corporatefinanceintelligence

MORRISON | FOERSTER

BANKING & CORPORATE FINANCING | BY PETER GREEN AND JEREMY JENNINGS-MARES

The structured products market: not drowning but waving

Investment bankers, having spent a summer holiday filled with sun, sand and a vibrating Blackberry, are still adjusting to a market landscape which looks very different to the one they left behind.

Few participants remain unaffected by events which took place during the past few months. Jitters caused by the continued wave of defaults in the US subprime mortgage market have had a knock-on affect on most areas of the industry. In respect to the global structured products market, the immediate impact was felt in the CDO market, particularly in relation to CDOs or CDO-squared transactions (CDOs investing in other CDO vehicles) which had been exposed to subprime loans originated in the US. Given the raft of downgrades of residential mortgage-backed securities, investors holding junior tranches in some of these structures face some serious losses, which have led to high profile failures among hedge funds and other vehicles heavily exposed in this area.

Growing uncertainty as to which financial institutions are most exposed to these losses has led to what has been widely described as a 'liquidity crunch'. It is only now however, with the release of up-to-date financial results, can the actual exposure of these banks be judged.

The effect of the recent liquidity shortages has been particularly acute in the short-term debt (commercial paper) markets. This, in turn, has had an adverse impact on structures relying on continued issuance of commercial paper such as ABCP conduits, SIVs and SIV-lites.

Basel II will introduce a much more sophisticated approach to regulatory capital requirements but will give rise to an increased focus on credit ratings.

Many of these vehicles have had to call on liquidity lines in order to refinance maturing commercial paper. In some cases however, the liquidity banks have had difficulties in accessing the funds necessary to advance the committed facilities. In the most high profile case so far, IKB (which had provided liquidity lines of about US$17.5bn to the Rhineland ABCP conduit and the Rhinebridge SIV) had to be bailed out by KFW, the state-owned German bank. Other vehicles have fallen below 'trigger levels' because underlying asset values have required a liquidation of underlying assets and/or a total unwind. Disaster is not always inevitable however; Cairn High Grade Funding I managed to avoid an unwind by striking a deal between its liquidity providers and junior debt holders.

It would nevertheless be premature to assume that these problems signal a wholesale retreat by investors from the structured finance markets, or that they demonstrates inherent cracks in the foundations of the market. While there is no doubt that the US subprime crisis has given rise to serious consequences in the global financial markets, there is no justification for a general crisis of confidence in asset-backed structures. In the long term, we can expect that CDOs and other structured products will, on the whole, continue to flourish.

Indeed, the structured products market remains an essential tool for banks and other financial institutions looking to manage their risk profile and regulatory capital requirements. It also enables investments to be packaged up in a way which can be tailored to the risk profile of individual investors. It is true to say that market uncertainty has had an effect on deal flows. It has also led to the postponement of some transactions while investors take time to assess market conditions. Nevertheless, many deals, particularly those relating to higher quality assets, remain in the pipeline and a number of smaller issuances are still scheduled to take place before the New Year.

Perhaps even more importantly however, recent events have presented issuers with a number of fundamental questions which need to be addressed.

First, in relation to structures such as SIVs and ABCP conduits, which arbitrage the income from long term investments against the funding costs of short term commercial paper, was the ability of the liquidity banks to meet their commitments, properly stress-tested? In future structures, a wider syndication of such facilities may be advisable.

Second, did investors fully understand the risk profile of the products they were acquiring? There has been an increasing demand for higher yielding investments and the structured product market has been an attractive hunting ground in this respect. However, many of the products are extremely complex and contain several layers of underlying assets. Some investors may not have appreciated fully the risks that they were ▸▸

This article first appeared in Financier Worldwide's *December Issue 2007*.
© 2007 Financier Worldwide Limited. Permission to use this reprint has been granted by the publisher. For further information on Financier Worldwide and its publications, please contact James Lowe on +44 (0)845 345 0456 or by email: james.lowe@financierworldwide.com

taking on; leaving them overexposed to certain asset classes or industry sectors. Consequently there may be an increased focus on proper disclosure and the need for distributors to ensure that the products they are recommending match the risk profile of their clients.

Third, is there an over reliance on credit ratings? Investors are increasingly driven by the ratings of the investments they acquire and this trend is likely to continue as a result of the ratings based approach to regulatory capital calculations introduced by the Basel II accord. Some investors over focus on the rating without properly analysing the risk profile of the investment and whether it is an appropriate investment for them to hold.

Fourth, are the credit rating agencies' models and practices sufficiently robust? Rating agencies are likely to come under considerable scrutiny over coming months. Questions have been raised as to whether their financial modelling has correctly quantified the risks underlying certain assets, particularly complex CDO squared transactions and liquidity risks in relation to the SIV/ABCP conduit sector. It is too early to pass judgement in this regard but, the fact that a number of structures have been downgraded does not, in itself, demonstrate widespread failure on the part of the rating agencies models.

Fifth, are triggers set too tight or too loose? Inevitably triggers and unwind mechanisms will need to be looked at. There is an argument that some triggers are set at too high a level, create the risk of having to fire sale assets into an unfavourable market. Even in circumstances where triggers do require an unwind, there may be sufficient investor interest in finding a restructuring solution, as with the Cairn High Grade I SIV.

As the above questions are addressed and answered, structures are likely to evolve accordingly. In addition, regulators will need to consider whether changes are needed to be made to regulatory framework to address some of the difficulties that have arisen. As already discussed, Basel II will introduce a much more sophisticated approach to regulatory capital requirements but will give rise to an increased focus on credit ratings.

Basel II will also make the provision of liquidity facilities less favourable to banks from a regulatory capital perspective. These changes may encourage issuers to look at other solutions to liquidity support, which could alleviate some of the issues described above. Regulators are also more likely to focus on the extent to which individual banks may have become exposed to a type of asset. Most regulators have 'large exposure' rules limiting banks' exposure to a single entity, which can require the establishment of numerous asset holding companies which are legally unconnected to each other but which are exposed to a pool of similar underlying assets. Again, these rules are likely to come under renewed examination.

Given the reflective, even censorious mood which is currently pervading the financial markets, it is unlikely that this year's Christmas parties will be particularly lavish affairs. Yet, with lessons learnt and more effective safeguards put in place, the investment community may yet still get to enjoy a summer holiday next year – Blackberry's allowing of course. ■

Peter Green and Jeremy Jennings-Mares are partners in the UK Capital Markets Practice of Morrison & Foerster. They can be contacted on +44 (0)207 920 4000 or by email: pgreen@mofo.com or by email: jjenningsmares@mofo.com