

Back to Basics

By Christopher O'Leary and Antony Currie

The recipe for the alphabet soup of all manner of products from SIVs to CPDOs became ever more complex and exotic as the demands of underwriters, managers and investors shifted to accommodate a strong bull market in credit. Now many of these structures look compromised. Can a reversion to a simpler broth help restore confidence?

Matt MacEachern remembers the time a couple of years ago when he was courting some prospective clients who were enamored with the returns offered by collateralized debt obligations (CDOs). MacEachern, a portfolio manager at Emerald Asset Investors, a registered investment adviser that handles investments for high-net-worth clients, wasn't even trying to sell the product — quite the opposite, in fact. It was a tough conversation.

"These guys were throwing out all of these really nice yields and cash flows. It was tough to sell against them," MacEachern recalls of the CDO managers he was competing against. But the prospective clients didn't seem to really understand how the CDOs worked, and didn't seem too concerned about it. "I was trying to tell them: you're not getting that 14% yield for nothing — there's a risk inside them. But honestly, the CDOs were so convoluted I couldn't explain it to the clients either."

Emerald Asset steered clear of CDOs for its own investments. "If I can't understand it, I'm not going to invest in it," MacEachern says. The only CDO investing Emerald has done is indirectly, via high-yield bond funds with CDO holdings, and needless to say, MacEachern has little interest in the deals at present. "I don't think the CDO market is going away, but it needs to clean its act up."

Many share his view. CDOs have run up against the hard realities of a mortgage crisis, an overall credit crunch and a possible recession. For some investors, their once-intoxicating allure has been replaced with a harsher belief that they were hoodwinked by issuers, whose promises of diversification dissolved to nothing. "In hindsight, it all seems insane," says Gabriel Wisdom, managing director of American Money Management, LLC. "There was probably a computer-generated model that showed [the CDO] increased safety and reduced risk, but it didn't — because it eliminated the most important aspect of a bond or a mortgage loan, the collateral."

CDOs are not the only ingredient in the alphabet soup of acronyms that make up structured products that are in trouble. Structured Investment Vehicles (SIVs), until recently one of the most seasoned and successful products, are now floundering. Parts



of the asset-backed commercial paper even took a hit by dint of their association with CDOs and SIVs — though most of the ABCP market remains solid.

Do any of these structures have a viable future? Or has the turmoil of the last few months rendered them too unpalatable for the current generation of investors? While it's probably not hard to imagine one or more of them disappearing from the market, some could survive. But their structurers would need to adapt to learn from their mistakes, as would investors.

Identifying the problem

Let's stick, for now, with CDOs and SIVs — we'll deal with CPDOs later in the Journal (see page 47). Neither product is inherently bad. They both serve useful purposes. One iteration of CDOs — collateralized loan obligations — buys loans from banks, giving them more capital to make more loans. And in general CDOs can offer investors a disparate enough portfolio of assets to diffuse the potential risk of default by any particular issuer or sector and pay a bit of extra yield to boot.

For their part, SIVs were an excellent place to park cash for a short period of time and provide another source of funding for assets. And they were seasoned vehicles: some had been around for as long as 18 years and many had weathered market crises in 1994, 1998 and 2002.

So what went wrong? The most obvious answer is exposure to, and fearful contagion from, the collapsing subprime mortgage market. "The asset-backed CDO market went down not really because of anything to do with the structures, but just because of bad underwriting," says Dan Castro, managing director and chief credit officer at GSC Partners. GSC runs 13 U.S. and international CDO funds, and some have suffered — including one that posted an event of default notice in December, according to Fitch Ratings.

"It was just pure and simple bad underwriting—people were making loans to people that never should have gotten them. No documentation, no down payment — gee whiz, what do you expect would happen?"

Obvious it may be, but it's also not the whole picture. Deteriorating credit quality did indeed set the problem off. But there were also structural problems with CDOs and SIVs, ones both inherent to the products as well as ones that were added in as the bull market in credit chugged along.

The SIV's last stand?

That might sound odd as regards the SIV. "The entire blame for the demise of the SIV should not be laid exclusively at the doors of the SIVs themselves," says Henry Tabe, managing director in Moody's SIV team. "It is the lethal combination of a complete drought of senior funding and the dramatic drop in market val-

ue of high-quality ABS and financial institutions debt, which has been mildly surprising to many, including Moody's."

That's true. And SIVs do also sport a very bank-like structure: they have what is effectively an equity capital base of around 8%. That's actually better than the tier one capital base of a number of U.S. banks. And a SIV has a number of investor-friendly features. First, there are strict limits on what goes into a portfolio: most securities must be rated double-A or higher and, aside from credit card debt, no single class of asset-backed bonds can constitute more than a fifth of the portfolio. Second, there are a couple of triggers designed to protect against severe losses: a restricted investment mode if capital falls below 7% of net asset value; and an enforcement mode — a wind-down, essentially — if capital drops below 5% of assets.

The trouble is, these didn't address the fundamental flaw, one that has plagued other markets before, and hedge funds of all hues time and again: mismatched funding. Its top-notch credit rating allowed it to borrow money virtually for free in short-term money markets, and invest in longer-term paper paying a wider spread.

That left SIVs exposed to market risk, while running portfolios that specialized in credit risk. For 18 years this was the key to its success to such a point that it was pretty

much ignored as a business risk. When the crunch came, none had any back-up funding plans in place to replace the commercial paper and medium-term notes investors were no longer willing to buy.

That quickly undermined the SIV structure's growing reputation for being the next big thing. In 2006 seven new SIVs were launched — the annual average being just two — and more were in the works. CDO managers had even begun to worry about SIVs taking market share, and variations on the SIV concept such as the SIV-Lite — a structure that would combine the attributes of CDOs and SIVs — were percolating. A handful was set up before quickly hitting wind-down mode over the summer.

It was the SIV-Lites and the newer SIVs like Cheyne Finance and Cairn Capital that got into trouble first because of their greater exposure to CDOs and mortgage bonds. It was only to be expected that attention shifted to their older, more diversified brethren. But by the time SIV behemoths like Citigroup and HSBC announced their vehicles' total subprime exposure was negligible — 0.5% and 5% respectively — the damage was already done. Spreads on other asset-backed paper held by SIVs had gapped out in sympathetic contagion, and the fear of broader subprime losses had also whacked spreads on the substantial amounts of financial sector debt they owned.

Instead of growing, the SIV could now potentially be written off as a catastrophic market failure. "The SIV structure as we know it is dead," says Alex Roeber, a fixed-income strategist

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Matt MacEachern, Emerald Asset Investors*

at JPMorgan. “Investors have lost faith in the ability of that structure to pay them back in a timely fashion.”

There was no easy solution to the rout. The U.S. Treasury took a stab, encouraging the banking sector to come up with a plan to provide emergency funding. But the so-called Master Liquidity Enhancement Trust, or SuperSIV, appears to have floundered due to a mix of bureaucracy and skepticism. Its initial target, to raise \$100 billion, represented just one quarter of total assets SIVs held before the summer crisis, and fell to \$50 billion by the time its backers cancelled the plan before Christmas. Arguably, the SuperSIV could have made matters worse by only buying certain assets and thus leaving CP investors in the remaining SIVs with the impression — whether correct or not — they were holding even worse portfolios, which could have created even more of a run on SIV funding.

The inability to set up the SuperSIV, though, did at least put the sponsor banks back on the spot. Most went into partial unwind mode simply to pay off their maturing debt. Whether by selling assets or letting them run off, SIVs shrank by more than \$100 billion in the last few months of 2007.

None can really afford to let investors in the SIVs bear too many losses. “The potential reputational risk that could follow



This used to be a coveted vehicle once, too

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if banks stepped aside and let investors bear the brunt of the crisis would be catastrophic for other areas of the bank,” says one industry observer. “A lot of these SIV investors are large institutional investors and prime clients of the bank — that’s how they became SIV investors in the first place.”

That is no doubt one of the reasons why so many banks have stepped in to take some or all the SIV assets onto their own balance sheets. It should be no surprise the European banks were the first to do so. The Basel II capital adequacy rules they adopted at the start of this year make it much more capital efficient than before to hold highly rated assets on balance sheet.

U.S. banks won’t comply with Basel II until 2009. That’s one reason why Citigroup was so adamant for months that it would not consolidate its seven vehicles. But even this progenitor of the SIV industry had to concede in the end. It helped that asset sales had halved the combined portfolios to \$49 billion, making it less hard to digest them. The prospect of rat-

ings downgrades making capital raising for SIVs even tougher in the months ahead must have made the decision easier. The knowledge that the move would probably prevent damaging relationships with clients was a comfort. And it allowed new chief Vikram Pandit to chalk up his first policy departure from previous management

The two largest bank sponsors have thus effectively exited the business — HSBC had already shouldered its two SIVs’ combined \$45 billion in assets. Elsewhere Société Générale has done the same for its \$4.5 billion structure, Pace. Standard Chartered has bought some assets from its SIV, as well as taken a vertical slice — swapping its capital notes for assets. WestLB has propped up one of the SIVs it co-sponsors.

Others are just calling it a day. MBIA gutted its SIV after finding essentially no buyers for its debt since August, according to Chief Financial Officer Chuck Chaplin. MBIA’s Hudson Thames Capital SIV has shrunk to about \$400 million from \$2 billion.

Part of what did in the SIVs was their own rapid growth in 2005 and 2006. HSBC’s Asscher SIV, for example, launched in 2006 and quickly amassed \$8 billion in assets before the UK bank announced plans to bring it on to its balance sheet last November. By mid-2007 the sector as a whole had doubled in size to \$400 billion of assets — in just 18 months.

Because the market had so much liquidity at the time, there was almost no differentiation in the market between a SIV, a SIV-Lite, or a bank-backed CP vehicle — they were all trading at roughly the same spreads. So new SIVs often either leveraged up to increase returns or in some cases bought riskier assets.

Now that the sector is crumbling, it’s having much broader effects. Fire sales of SIV assets have already contributed to spreads widening in the assets they’re shedding. And just under half of that is in bank and finance company debt. As those spreads deteriorate, borrowing costs for new bank debt will spike. That in turn would likely force banks to tighten their own lending, charge more, or both. And the loss of SIVs as buyers of all assets is also worrisome: “The SIVs and other forms of conduits were buying 50% of highly rated structured finance assets in the market. That’s now gone away,” says Dr Doug Long, EVP of business strategy for Principia Partners. That creates problems of its own [see article, page 56].

When is a SIV not a SIV?

It would take a Herculean effort for the SIV model to dig itself out of this mess. More transparency would be crucial. “It is now too late for SIVs, but if the sector carries on in any form, then increased transparency would be a minimum from the investors’ perspective,” Taber says. For example, SIV managers could release more detailed market performance information on a monthly or weekly basis, offering the sort of perspective to investors that they now only grant to ratings agencies. But CUSIP-level trading information could be a competitive disadvantage, as would a complete breakdown of portfolio holdings. And many investors may not have the capacity to analyze the data — after all, the reason they jumped in at all was because SIVs were meant

to be ultra-safe investments that didn't necessarily require large amounts of continual due diligence.

But, as Long says: "The flaws of the SIV are too widely identified in the market. The SIV name is a very bad name at the moment. No one is going to call a structure 'SIV 2'."

Anything that could rescue it in any way would involve altering it beyond recognition and ditching the one thing that makes a SIV a SIV: the lack of a liquidity backstop. Tabe says a change in funding is essential, along with SIV managers having to set aside more cash, or access to cash, so they could endure a similar credit crunch in the future without having to have hold a fire sale on assets.

That might involve, says Long, reorganizing the funding basis of the SIV to move from a market value structure into a cash flow structure. In essence, that would create either an ABS CDO-type structure, or a conduit. But "the whole point of the SIV structure is to get away from having to have bank backstop liquidity," says Roever. "So I don't think that kind of innovation is likely to occur. It would push up the costs of running the vehicle, as liquidity is not without cost, and that cost would have to come out of the cash flow produced by the portfolio."

The irony is that if a SIV could somehow form now, it could take advantage of some of the most favorable market conditions in years. "If you could set up a SIV now, you could get high-quality assets and would have to be nowhere near as leveraged and there would be no need to grow to such volumes," Long says. Scant chance of that happening.

Rescuing the CDO

The tragedy of many SIVs, especially the more established ones, is that the actual credit quality of their portfolios may turn out to be just fine. But the evaporation of short-term funding means SIVs may not exist in any recognizable form to find out. It's almost the opposite for CDOs, or at least for those asset-backed CDOs constructed with subprime mortgages.

The quality of those loans has deteriorated fast. But CDOs have their funding locked in; barring ratings downgrades, or collateral or event of default triggers, their managers won't be forced to sell any assets.

Of course, that's no comfort to investors. But unlike SIVs, they arguably had many more warnings about the perils of CDOs: this is not the first time the structure has gotten into trouble in a hot market. Exuberance for both manufactured housing debt and high-yield bonds in the latter half of the last decade worked fine for a couple of years, before complaints

about bad structures, overselling and multiple downgrades marked the end of the love affair. Sound familiar?

Each time, the structure is tweaked and investors are assured that next time, with a new asset class, things will be different. But the fundamental tragedy for CDOs of almost any description is that they are so wonderfully suited to snapping up assets in a bear market, but seem only to capture investors' attention at the height of bull markets when their structure will be put under the most stress.



More? Are you sure you know what's in it?

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How so? First, there are the assets themselves. This latest iteration was first dubbed a structured finance CDO, and from its inception at the start of the decade until perhaps 2004 or 2005 stayed true to its name. Those created during that time held all manner of asset-backed debt, whether mortgages, credit cards, student loans or auto loans.

This is the diversification benefit that CDOs are supposed to strive for. Then came the bull market for credit. Spreads on all these assets tightened — we can lay some of the blame for that on the SIVs, of course — and suddenly very few ABS deals fit the CDO profile. "We didn't have much of a choice," says one CDO manager. "The spreads on EETCs and man-

ufactured housing were wide enough to work, but they weren't desirable credits." Diversification thus became, to coin a phrase, "diworsification." Much better to concentrate on better-looking credits that still had enough spread. "That left us with just two: subprime mortgages, and other CDOs. Of course, you don't want CDOs in there if you can help it. They're harder to risk manage," says the CDO manager, with no hint of recognizing the damning irony of his own words.

Why would investors put up with this shift over the years to a concentrated portfolio? In part, because many assumed there was a degree of diversification built into U.S. housing. In the past, perhaps, there was. But not now. The one lesson the current mess should teach investors, and one that will likely be applied to CDOs in the future, is that diversification of collateral can only go so far. "The one thing I find astounding is that there was a high correlation of bad assets in the same structures," says GSC's Castro. "People said, 'I've got bonds focused on that part of the country, from this issuer and that issuer,' but when the whole subprime market goes down, you're basically invested in the whole subprime market."

But also, investors were looking for higher yields as spreads on underlying assets kept on getting tighter. That's what so enticed the clients Emerald Asset's MacEachern talked to. Likewise the \$3.2 billion Dallas Police and Fire pension fund,

according to a Bloomberg report. Administrator Richard Tetrament reckoned its CDO investments returned more than 20% in 2006 — but he wasn't sure what the collateral was.

The hunger for yield affected all parts of the capital structure. But returns on the all-important equity tranche of CDOs also had to remain competitive with the improving performance of stock markets, and the often stellar returns of hedge funds. A similar dynamic helped undo high-yield bond CDOs. The dynamic was self-reinforcing: as investors in each part of the capital structure pushed for more yield, the choice of assets available to managers continued to shrink.

Eventually, arrangers and managers even thought they had found a way to milk a bit more from the structure: they created commercial-paper programs to fund the super-senior tranches of ABS CDOs. The lower funding costs released more cash flow, which flowed through to investors as extra returns. What's more, it seems apparent that much of the CP was itself funded with leverage.

And the CDOs didn't even carry the risk. In the case of auction-rate CP programs used by the likes of Merrill Lynch, whoever holds the CP when the auction fails termed out. Bank of America and Citigroup actually agreed to backstop the CP themselves — they called it a liquidity put — which is where a combined \$40 billion of their exposure to the market stemmed from.

Bubble market excess

That all seemed fine and reasonable before the crash. But now it smacks of the kind of excess one so often sees in bubble-like markets.

For all that, though, there is still a role for CDOs. But much will have to change. The multi-billions of dollars in write-downs and losses will help enforce that. "There are perhaps four key elements to refocusing the market," says Kareem Serageldin, Credit Suisse's global head of CDOs. "Structures are likely to be simpler. We'll also see new asset classes like foreign exchange and even equity default swaps. There will be more multiple asset deals again. And there's likely to be a shift away from bespoke transactions back to syndicating deals."

Greater transparency and stronger underwriting standards are a given, as is a decrease in the use of subprime mortgages as collateral. It's likely investors might insist underwriters commit to make markets in secondary trades. And with the promise of diversification a bust, the tide may turn in the other direction — AAM's Wisdom, for one, said he would welcome much more specific deals backed by very tight geographic and sector-based collateral, so as to better measure potential risk.

Issuers might need to stump up as well. Martin Fridson, head of credit research firm Fridson Vision, says that European investors who had been regular buyers of the equity pieces of CDOs, the riskiest slices, "are burned so badly that I don't

think they will be back any time soon." To find replacements for such buyers "may require originators to retain the equity piece, to accept a loss on the equity piece in order to earn fees on the origination of the deal—it's still an economically viable position."

A longer-term solution, he says, "could be to have the equity pieces sold in a bona fide auction market with no hidden bids — price it properly and the rest will hopefully take care of itself."

Trigger and cash flow dynamics may also change. At times

that will require resolving all manner of legal quandaries. GSC's Castro says that in a great number of outstanding synthetic deals, there is a heap of contradictory documentation. For example, one clause of a CDO will have that, in the

event of a default, all cash flow will be diverted to pay the senior notes, yet at the same time the CDO also contains a clause mandating that interest cannot be diverted from lower tranches to pay principal, a situation which would occur if the senior notes were paid off.

"It's pretty clear that lawyers were asleep at the switch," in drafting many CDOs, Castro says. "For a lot of synthetic deals out there, the documents are inconsistent and often say conflicting things, so that if you're the trustee, you've got a real problem—if you take one course, one group of investors are going to sue you, and if you take the other, another group will sue you. We're going to have to see how that works out. There are lots of lawsuits waiting to happen."

Needless to say, any mortgages backing the next generation of ABS CDOs are going to have to be of a higher caliber. "Mortgages will be written more like they used to be. That's what's most likely to change. It might be a long while for people to get comfortable with the notion these are good loans again," he says. As with SIVs, now might just be the time to go on the hunt for good assets at wide spreads. Some good asset picking, unaggressive structures and careful husbanding of portfolios could go a long way to restoring the viability of CDOs.

They certainly have a better chance than SIVs of overcoming the fate of all market manias — ending with a bang, accompanied by short-term pain and long-term uncertainty. But you have to admit, it was nice while it lasted. "Investors were dazzled by the lure of super-high yields. As long as you're handing risk off to someone else, it's a goldmine," Fridson says. "That game is over for a while." ▼

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Dan Castro, GSC

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