

PROCESS NOT PRODUCT: THE CDO BEAT GOES ON

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Collateralized Debt Obligations (CDOs) are powerful transactions. They bring additional liquidity, transparency and discipline to the markets for the underlying CDO assets, and allow portfolio investors a greater opportunity to participate in these markets. Employing various structures, encompassing a variety of underlying assets, and using selected eligibility criteria and collateral quality tests, CDOs are not a product, but a rich and complex process.

“*May you live in interesting times*” is a Chinese curse that many CDO market participants feel may apply to them. As with other structured finance, CDOs exist at the confluence of accounting, finance, legal and tax systems, a change in any of which can send the CDO market reeling.

At the time of this writing, such a change is being proposed by the U.S. Financial Accounting Standards Board which has announced that, following the widely publicized “abuses” of special purpose entities (SPEs) by Enron and others, it will issue interpretative guidance for when SPEs should be consolidated in the financial statements of the “primary beneficiary.” This change might result in CDOs being required to have more equity than is currently required and to be consolidated with the party holding a substantial equity interest that is substantially larger than any other party’s equity interest (even if not a majority equity interest). While the impact of the proposed change has caused concern among CDO market participants, one should remember that the CDO market has previously demonstrated its resilience and innovation and is likely to do so again here.

The Rich Variety of CDOs

CDOs are a remarkable success story, and the CDO market is widely admired for its rich and complex character. According to recent Banc of America Securities research, there were over \$209 billion of CDOs in 2001, making CDOs the second largest type of asset-backed securities (ABS) after credit card ABS. Beginning in the late 1980s and early 1990s, with bank loans and bonds as the underlying CDO assets, the market then extended to emerging market bonds, subordinated ABS, MBS and other “multi-sector” collateral and REIT debt, then project finance, distressed debt and trust preferred securities and, most recently, private equity and hedge funds. CDO volume has increased year after year since inception and is forecast to do so again this year. In particular, several CDO market commentators are predicting a resurgence by banks of balance sheet CDOs (which have slowed in recent years in light of the pending revisions to the BIS risk-based capital rules).

CDOs employ a number of “structures.” They can be funded or “synthetic,” utilizing credit derivatives (total return and credit default swaps and credit-linked notes), or a combination thereof.

CDO market participants are similarly varied . Banks, insurance companies and other financial institutions are sponsors of, investors in, and managers for CDOs. Private equity and hedge funds are also investors in, and managers for, CDOs; and last (but by no means least), commercial and investment banks are arrangers and originators of underlying assets for CDOs.

Generally, CDOs are either “balance sheet” CDOs or “arbitrage” CDOs. Balance sheet CDOs are transactions structured as “sales” for accounting and regulatory capital purposes but are “debt” for tax purposes. Commercial banks in particular use balance sheet CDOs primarily for portfolio management and regulatory capital efficiency. By contrast, arbitrage CDOs are structured as sales for all purposes, including tax.

Arbitrage CDOs are either “cash flow” CDOs or “market value” CDOs. They are distinguished by an overcollateralization ratio determined by reference to the par or principal amount of the CDO assets (adjusted for defaulted CDO assets), in the case of a cash flow CDO, or to the market value of the CDO assets, in the case of a market value CDO. Occasionally, CDOs will have a combination of cash flow and market value tests. Obviously, for market value CDOs, there must be transparent and reliable data from which to determine the applicable market values.

Adaptable, Flexible and Dynamic

By tailoring the eligibility criteria and portfolio profile for the underlying assets, a CDO can be structured to reflect a manager’s investment “style” and experience and still provide a sufficiently homogenous pool that can be modelled and analysed by the rating agencies and investors. By further tailoring the collateral quality tests for such pool, a CDO can maximize the respective ratings for the CDO liabilities.

For these reasons, CDOs are better regarded as a “technology” or “process” rather than a “product.” Product implies a static result, and CDOs are anything but static. Over time, CDOs have reflected continual refinement and improvement of their structures and features and, with the continuing expansion of the universe of available CDO assets and the varied combinations thereof, CDOs are highly flexible, complex and subtle transactions. This on-going process of development and innovation is the foundation of the success of CDOs.

In addition, CDOs exist in dynamic markets for the underlying assets and reflect “vintage” and other market-related distinguishing attributes. The relative spreads on CDO assets and liabilities can expand or contract, and may do so faster or slower for such assets or liabilities or vice versa. Due to their success, CDOs have become substantial market participants in the markets for the underlying assets. In 2001, CLOs (Collateralized Loan Obligations) represented over 50% of bank loan syndication and high yield CBOs (Collateralized bond Obligations) represented almost 25% of high yield bonds. The “vintage” issue of many CDOs (especially CBOs) that closed in

1998 and 1999 was dramatically demonstrated when these CDOs suffered a disproportionate number of ratings downgrades last year.

While the vast majority of CDOs have underlying debt assets such as bank loans and bonds, including structured financial assets such as project finance, CMBS, RMBS, ABS and similar securities, there are non-debt CDOs such as trust preferred (a debt/equity hybrid) CDOs and CDOs of CDOs. The CDO market continues to refer to these latter transactions as CDOs even though the underlying assets are not debt. Some CDO market participants prefer SCDO for synthetic CDOs and CFO for private equity and hedge fund CDOs. This article follows the former convention.

Core Concept

The core concept of CDOs is that – given default rates, loss severity/recovery amounts and recovery periods that can be reliably forecast -- a defined pool of financial assets will perform in a predictable manner. Furthermore, by applying appropriate levels of credit enhancement, the asset pool can be financed in a cost-efficient fashion that captures the arbitrage between the interest and yield return received on the CDO's assets, and the interest and yield expense of the CDO securities issued to finance them.

Each of the recognized rating agencies (Fitch, Moody's and Standard & Poor's) have developed various CDO criteria, statistical methodologies and analyses to "stress" a pool of specified CDO assets. This enables them to determine the level of credit enhancement required to assign respective credit ratings to the CDO securities used to finance such pools. Of course, rating offerings is easier when available and reliable historic default/loss data exists; and absence of such data can make the extension of CDOs to new assets more difficult.

Typically, CDOs require the CDO assets to meet certain eligibility criteria including, in the case of bank loans and bonds, diversity, weighted average rating, weighted average maturity, and weighted average spread/coupon. Eligibility criteria will be adjusted to "fit" the underlying CDO assets. For example, in the case of private equity and hedge fund CDOs, diversity will apply to the approved general partners, the fund "style," and the "vintage" of the original commitment/investment.

A CDO will allocate on periodic distribution dates the interest and principal proceeds of such assets according to certain collateral quality tests. In the case of a cash flow CDO, this would include an overcollateralization ratio and an interest coverage ratio. CDO securities are usually issued in several tranches. Each tranche (other than the most junior tranche) has a seniority or priority over one or more other tranches. "Tighter" collateral quality tests are set to trigger a diversion of interest and principal proceeds that would otherwise be allocable to more junior tranches, with the proceeds then used to redeem or otherwise retire more senior tranches.

The junior-most CDO securities are effectively "equity" (and for accounting reasons are often preferred shares) and receive the residual cash flows from the CDO assets after all senior payments and distributions. The resulting subordination of such junior tranches constitutes the required credit enhancement for the more senior tranches and allows the CDO securities of such

senior tranches to receive a credit rating that reflects such seniority or priority. Some CDOs use insurance “wraps” for the same effect.

CDOs often will allow principal proceeds to be reinvested in additional eligible CDO assets during a specified reinvestment period, although in “static” CDOs, all principal proceeds are used to retire the CDO liabilities sequentially according to their relative priorities. In addition, in a “managed” CDO there will be a collateral manager, who must identify eligible CDO assets and monitor them for the CDO. Most managed CDOs allow a portion of the CDO assets to be traded annually, which allows an adept collateral manager to enhance the arbitrage opportunity of the CDO.

In most cases, a market value CDO will require more equity than a cash flow CDO, but will allow a greater degree of trading by the collateral manager. To facilitate such trading, the capital structure of a market value CDO will usually include a substantial revolving credit facility. This allows the collateral manager to efficiently manage the capital of the CDO and to trade CDO assets more easily. However, as one would expect, market value CDOs require timely and reliable price reporting to establish market values of the underlying CDO assets. Where the cash flow of the CDO assets has greater variability (for example, distressed debt, private equity and hedge funds), a CDO will include reserves or liquidity arrangements to ensure available funds for scheduled payment of the related CDO liabilities.

Increased Foreign Investment

Recent growth of the CDO market has been due in part to the significant participation of non-US investors (especially foreign insurance companies) seeking exposure to US assets to which they are underweighted. These foreign investors are attracted to the professional management of CDOs and the ability, through an investment in the junior CDO tranches, to gain leveraged exposure and an opportunity for enhanced returns.

To facilitate non-US investors in CDO equity, the CDO issuer for most CDO assets is most often established outside of the US (for example, the Cayman Islands) and usually must not be engaged in trade or business in the US in order to avoid US taxation. This often requires that the activities of the CDO issuer (and the collateral manager on its behalf) be restricted to ensure this result.

However, for some CDOs not able or willing to be so restricted, the CDO issuer will probably be a domestic LP or LLC, since the underlying CDO assets may include assets for which it will be impractical to avoid a US trade or business. For example, if partnership interests in US partnerships are the CDO assets, in the case of private equity CDOs, foreign CDO equity investors may decide to invest “synthetically” (e.g., through a credit-linked note or total return swap) or through a separate offshore “conduit” entity.

The offering of CDO securities must be carefully structured to satisfy other applicable legal requirements, including, but not limited to:

- the perfection of the collateral lien on, and security interest in, the CDO assets;

- the exemption of such offering from registration requirements under applicable US securities laws and similar laws of other jurisdictions in which such CDO securities are offered;
- the avoidance of registration under the US Investment Company Act; and
- the exemption from adverse consequences under ERISA.

These requirements, together with a description of the innumerable variations of and refinements to the CDO structures described here, are beyond the scope of this article.

Conclusion

As the foregoing illustrates, CDOs are a successful application of securitization technology to an expanding universe of underlying assets. Through continual development and innovation, CDOs represent a rich and complex market that allows portfolio investors a greater opportunity to participate in markets for the underlying assets and brings liquidity, transparency and discipline to such markets.

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