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"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to heaven, we were all going direct the other way – in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only."

CHARLES DICKENS, A TALE OF TWO CITIES

Recent developments and regulatory uncertainties in the US structured finance market

Although Mr Dickens was certainly not writing about the US structured finance market in 1859, his words describe far more eloquently than we could the widely divergent perspectives currently held by market participants, commentators and regulators on the recent resurgence in certain structured finance products and markets.

Some view the recent growth in new issuance of various structured products as a return to the gravy train days of loose and expansive credit and excessive risk-taking, which many believe caused or exacerbated the credit crisis that erupted in 2007. Others, however, view the renewed investor interest in certain structured products as the sensible search for relative value and an acceptance of greater risk for greater reward in the current yield-challenged markets spawned by an environment of low interest rates and accommodative monetary policies.

In this article, we summarise the recent activity in US structured finance markets and offer some evidence on which of the above perspectives on recent trends is more plausible. We also comment on the potential impact of various pending regulatory initiatives that may affect (perhaps significantly) the future prospects for these markets.

Current state of the markets

A significant portion of the structured finance marketplace consists of asset-backed securities (ABS), or securities whose cash flows are collateralised by an underlying pool of assets like bonds, loans or receivables. The most popular types of collateral for ABS have historically included auto, credit card, home equity, mortgage and student loans, as well as certain loans to corporations. ABS

are generally issued through special purpose entities (SPEs) such as Cayman Islands vehicles formed exclusively for the purpose of facilitating the issuance of structured finance securities¹. An SPE issuer finances the acquisition of collateral by issuing ABS whose principal and interest payments are serviced with the principal, interest, and other gains on that collateral.

Structured finance products are often issued in tranchised structures – ie in multiple classes with different levels of seniority and related coupon rates. Investors in relatively more subordinated tranches experience losses on the underlying collateral before any such losses are borne by investors in relatively more senior tranches and thus typically receive a higher interest rate for this greater assumption of risk.

One particular type of ABS – known as a collateralised debt obligation (CDO) – is based on bonds or loans or similar securities or assets as underlying collateral. For example, collateralised loan obligations (CLOs) arose in the late 1980s as a mechanism by which bank originators could manage their credit exposures and finance new loan originations through the capital markets. CLOs based on leveraged loans (ie loans to speculative-grade borrowers often associated with leveraged transactions like LBOs or recapitalisations) have been particularly popular.

After the credit crisis struck global financial markets in August 2007, new issuance of structured finance products plummeted as investors began to reprice known risks and demand significantly higher premiums for holding anything structured². Although CDOs, CLOs and non-agency mortgage-

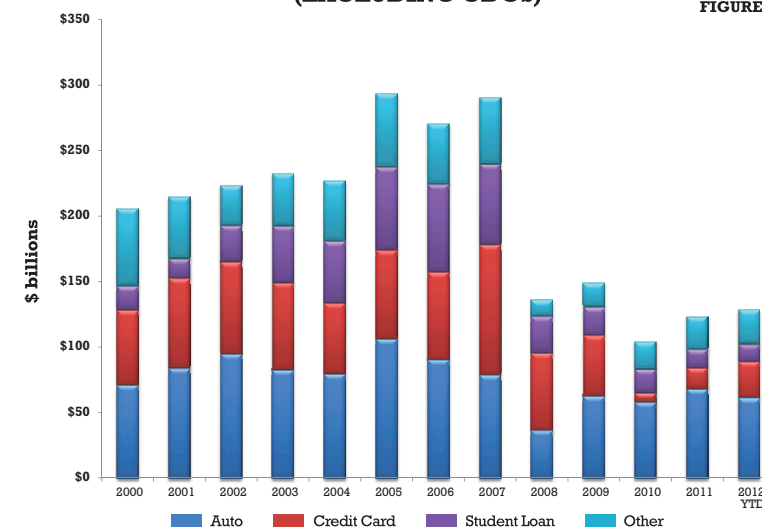
related ABS were especially hard hit, structured finance products with no connection to real estate were also significantly and adversely impacted³.

Recently, certain segments of the structured finance market have rebounded. For example, ABS based on auto loans, credit card receivables and leveraged loans have emerged from post-crisis slumps with robust new issuance and strong secondary market activity (albeit still well below pre-crisis levels). Also indicative of a recovery in ABS markets is heightened investor interest in ABS based on exotic or esoteric collateral such as cell tower leases, franchise fees, timeshare receivables, drug royalties and structured settlements.

As Figure 1 shows, total ABS issuance in the United States for the second quarter of 2012 (2Q12) was \$53.1 billion – an increase of 11.9 per cent and 47.6 per cent over the first quarter and the corresponding period for 2011, respectively. Auto loan-based ABS led new issuance with \$24.1 billion (see Figure 1). Credit card ABS issuance for 2Q12 was also a robust \$12.1 billion, which is more than double total issuance in the prior quarter and nearly four times that for 2Q11. Figure 2 shows the new issuance of ABS by collateral type in 2Q12 in more detail.

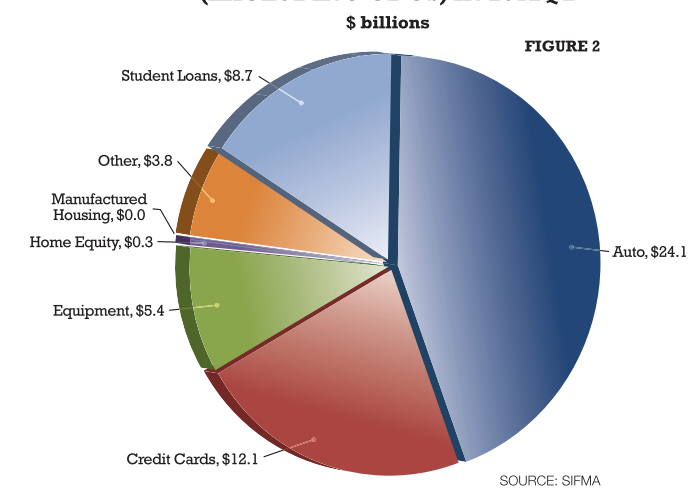
Investor demand for CLO securities has also resurged. Net outstanding CLO securities balances have risen, and new US/Cayman CLO issuance in 2Q12 was \$6.5 billion, representing an increase of 48.2 per cent from the prior quarter and a substantial 232.4 per cent increase from 2Q11 (see Figure 3). US and Cayman issuance of CLOs picked up substantially in 2012, with year-to-date issuance of about \$25 billion and estimates for total 2012 issuance of \$35 billion or more, which is almost double 2011 CLO is-

US NON-MORTGAGE ABS ISSUANCE (EXCLUDING CDOs)



SOURCE: SIFMA NOTE: 2012 data is as of August 2012

ABS ISSUANCE BY TYPE (EXCLUDING CDOs) IN 2012Q2



SOURCE: SIFMA

suance. This growth in CLOs is particularly noteworthy given that many pre-crisis CLOs have entered the final stages of their life cycles in which new collateral cannot be purchased⁴. Strong primary market issuance of new CLOs thus has more than offset the required amortisation of pre-crisis legacy CLOs.

Not all segments of the ABS market, however, have recovered from the effects of the credit crisis. In particular, new issuance of private-label non-Agency mortgage-related securities – including both residential mortgage-backed securities (RMBS) and ABS based on home equity loans – is essentially moribund (see Figure 4) and shows no sign of significant improvement any time soon. This is particularly striking given that these products accounted for a significant amount of total ABS issuance in the decade preceding the crisis. In addition, CDOs (excluding CLOs) have also failed to re-emerge as a product of interest to investors in the current environment, as indicated in Figure 3.

Insurance-Linked Securities

Insurance-linked securities (ILS) are close cousins of ABS and CDOs and comprise another important component of the structured product marketplace⁵. In a typical ILS deal, a SPE issues securities and invests the proceeds in low-risk assets, which serve as collateral for insurance protection provided by the SPE (often domiciled in Bermuda or Cayman) to an insurance or reinsurance company "sponsor" of the deal. Investors in the ILS receive the interest earned on the collateral plus the insurance premium paid to the SPE by the sponsor, less any insurance claims paid by the SPE to the insurance company.

The ILS market has exhibited considerable vitality in 2012 to date⁶. New ILS issuance for the 12 months ending in June 2012 was a record \$6.4 billion (see Figure 5), which was more than \$2 billion higher than in the previous year. Similarly, total ILS outstanding in June 2012 was \$14.9 billion, or \$3.4 billion above the prior year's end (see Figure 5)⁷. Notably, this solid performance followed declines in ILS outstanding amounts resulting from the maturation of legacy ILS issues and subdued new issuance in the wake of the credit crisis and the failure of Lehman Brothers⁸.

One interesting segment of recent ILS activity has involved the sponsorship of new ILS by government-owned or sponsored insurers, including the California Earthquake Authority (CEA) and Florida's Citizens Property Insurance Corporation (Citizens)⁹. Since August 2011, the CEA has sponsored three separate ILS issuances under its Embarcadero Re program – an initial issuance of \$150 million, followed by a second issue in January 2012 of \$150 million and a recent July 2012 issue of \$300 million.

Similarly, in May 2012 Citizens sponsored the largest single ILS issue to date under its Everglades Re program. Demand for the Everglades Re offering was so strong that the initial planned transaction size of \$200 million was substantially increased to \$750 million. Whereas earlier ILS structures have typically provided sponsors with only a small portion of their total reinsurance cover requirements, moreover, the Everglades Re issue secured 75 per cent of Citizens' projected total reinsurance cover budget.

Another positive development in the ILS market has been the influx of new ILS investors. ILS have always been appealing to certain investors as

a result of the low observed correlations between ILS returns and returns on other major asset classes. But in the aftermath of the credit crisis, ILS also have attracted new interest from investors seeking diversification and higher yields through structured products that are not based on credit instruments.

Resurgence of demand or recurrence of a problem?

Some view the renewed investor interest in certain structured products as the sensible search for relative value and an acceptance of greater risk for greater reward in the current yield-challenged markets spawned by an environment of low interest rates and accommodative monetary policies. Others, however, fear that the flourishing investor interest in non-mortgage ABS presages another credit crisis. Those critics contend that the current environment of loose monetary policy and low interest rates is the same situation that lured investors into structured products and got us into trouble in 2007. Loose monetary policies, low interest rates and low credit spreads clearly were a significant cause of the crisis in 2007¹⁰, but critics of the recent resurgence in some ABS sectors also believe that irrational and inadequately informed investors blindly chasing yields did and will again fuel an asset price bubble and its inevitable bursting in an abrupt correction.

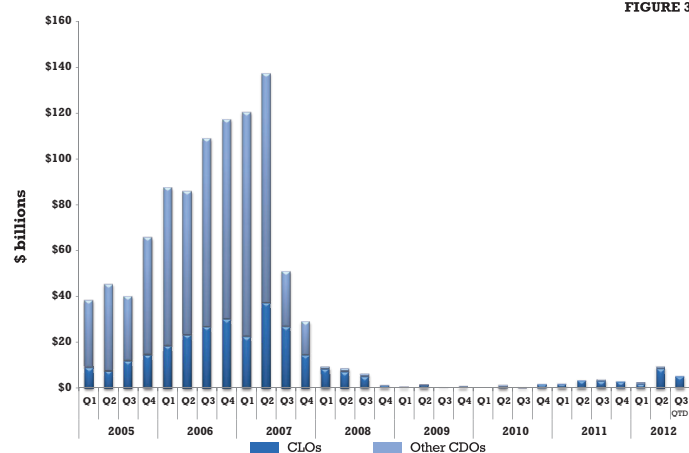
Several aspects of post-crisis ABS (as compared to their pre-crisis counterparts), however, suggest to us that the recent revitalised interest in structured finance is more consistent with informed risk-taking than irrational exuberance on the part of investors. Perhaps most importantly, investors

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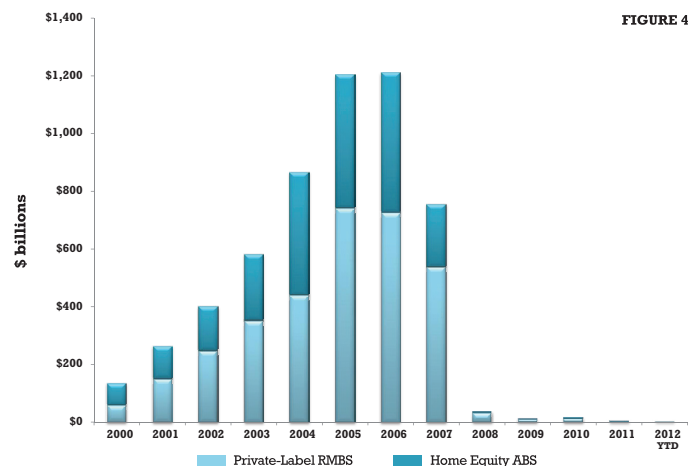
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US/CAYMAN CDO & CLO ISSUANCE



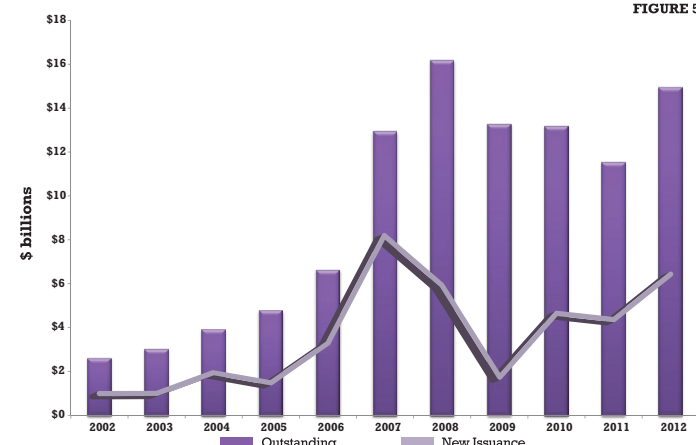
SOURCE: Thomson Reuters NOTE: 2012Q3 QTD is Quarter to Date, and includes issuance through 7 September 2012.

US NON AGENCY MORTGAGE RELATED SECURITIES ISSUANCE



SOURCE: SIFMA NOTE: 2012 data is as of August 2012

ILS OUTSTANDING AMOUNTS AND NEW ISSUANCE (YEARS ENDING JUNE 30TH)



SOURCE: Aon Benfield Securities

seem much more cognisant post-crisis of the need to evaluate the risks of structured products relative to expected returns. The information available to such investors, moreover, is often more transparent and detailed now than in many pre-crisis offerings (which were sometimes extremely opaque)¹¹. Recent ABS have also frequently involved less leverage and a greater retention of risk by the equity holders, sponsors or originators than comparable pre-crisis products.

The crisis also highlighted some deficiencies in the documentation and contractual aspects of certain ABS that market participants have now addressed. Consider, for example, how recent CLOs reflect shortcomings in earlier deals and documents exposed by the crisis:

Provisions have been included in recent deals that prevent the surrender of CLO notes for cancellation without due consideration. These provisions help avoid situations observed in pre-crisis deals in which managers purchased mezzanine and junior CLO tranches at substantial discounts in order to avoid violations of rating agency triggers that threatened to cut-off the managers' compensation and/or reinvestment opportunities.

Recent CLOs have included explicit provisions dealing with so-called "amend and extend" transactions involving the underlying loans collateralising those CLOs. Prior to the inclusion of such provisions, CLO managers were plagued with controversy and apparently inconsistent practices as to whether amend and extend transactions were subject to applicable CLO reinvestment criteria (eg weighted-average life restrictions on underlying loan collateral).

Restrictions now limit "non-core" investments by CLO managers and require a substantial majority of CLO portfolios to be invested in senior secured, broadly-syndicated, leveraged loans. Tighter restrictions now apply to other collateral (eg relatively higher-risk covenant-lite and second-lien loans), as well as exposures to non-US borrowers.

Although changes like the above have clarified

several important legal and documentation aspects of CLOs, not all of the changes in the market have been risk-reducing. For example, post-crisis CLOs have also included greater flexibility for redemption or refinancing of specific tranches and have generally reduced the dependence of the structures on rating agency confirmations for certain amendments and other deal changes. Nevertheless, these risk-increasing changes in the complexion of CLOs have generally been transparent to investors.

Information about the collateral and risks underlying ABS, moreover, is more easily accessible by investors now than before the credit crisis. Yet, many ABS are still not fully transparent to investors, and there is probably room for more improvement in this regard.

In addition, a significant underlying reason for the renewed interest in certain ABS (and the lack of interest in others) is the relative performance of the underlying asset classes themselves. In recent years, auto loans, credit card receivables and leveraged commercial loans have experienced relatively low default rates and corresponding positive performance, whereas non-agency mortgages have experienced relatively poor performance with relatively high default rates. So, we cannot entirely discount the notion that investors have returned to certain ABS markets in search of risk-adjusted yields purely on the basis of the recent performance of the underlying collateral.

The regulatory wildcard

Even if the recent renewed interest in structured products is the result of rational and informed investors seeking to achieve diversification and/or yield enhancement from economically legitimate securities, the prospects are not necessarily rosy for the revitalisation of the US structured finance market. In particular, the unfinished work required to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 looms dauntingly. Although two years have elapsed since the passage of Dodd-Frank, the required rulemakings are less than 50 per cent complete¹², and many of the required rules that have yet to be promul-

gated or finalised may significantly impact structured products. Some examples are discussed below.

The Volcker Rule: The Volcker Rule aims to eliminate proprietary trading by banks on the grounds that federally insured deposits should not be used to support banks' position-taking in risky transactions and to limit the ability of banks to invest in entities that engage in such proprietary trading. Although the proposed rule requires that "the ability of a [bank] to sell or securitise loans" should not be affected, the Volcker Rule (as currently written) could in fact significantly attenuate such securitisation activity.

Specifically, the Volcker Rule heavily restricts banks from engaging in "covered transactions" with "covered funds". The intent of the Volcker Rule was to limit the ability of banks to take risks through their sponsorship of and dealings with private equity and hedge funds, but, as proposed, "covered funds" may include many SPE issuers of structured products¹³. As such, the Volcker Rule could meaningfully limit the ability of banks to invest in and interact with securitisation SPEs as sponsors, credit or liquidity support providers, derivatives counterparties, and warehousing agents, without which SPEs could find it difficult or impossible to issue securities with the types and amounts of risk support demanded by investors.

Risk retention requirements: Numerous regulators expressed concern in the wake of the credit crisis that loan and asset originators lacked sufficient "skin in the game", thereby creating incentives for them to select only the worst credits for securitisation¹⁴. As a result, US banking regulators and their European counterparts have proposed that originators must retain at least five percent of the risk exposure in any securitisation¹⁵.

This rule poses several potential problems for future ABS issuance. Perhaps most notably, risk retentions by originators often vary considerably based on the type of underlying collateral and include exposures that are not part of the securitisation itself and, hence, are ignored by the proposed rules. For example, credit card ABS often involve lower risk retentions of actual

ABS tranches by originators because they already retain relatively high first-loss exposures through loan-loss reserves. Similarly, some mortgage originators have relatively high retentions of risk through their retained mortgage servicing rights. None of these sources of originators' skin in the game are addressed in the present proposed rules. As such, the new regulations could force originators to retain so much risk in the securitisation structure that their total risk exposures to the underlying collateral (inclusive of the retentions not included in the rule) become high enough to render the entire securitisation uneconomic. The proposed rules also extend to so-called open market CLOs, in which a third-party collateral manager buys underlying collateral in secondary transactions. In this case, the "moral hazard" meant to be addressed through risk retention is hard to identify. In addition, one particularly controversial element of the proposed rule is the concept of "premium capture reserve requirement", which seeks to avoid a sponsor "financing" its required risk retention with the sale of "premium" securities (ie with a principal amount that exceeds the par amount of the collateral). While intellectually flawed (think excess spread), this concept is proposed to be required for the life of the transaction and is in addition to otherwise required risk retention. As a practical matter, this requirement would render CLOs and, assuming their return, non-agency MBS uneconomic.

In addition, there are significant differences between the proposed regulations in the United States and the corresponding requirements in Europe. Concerns regarding the extra-territorial application of each, moreover, are pervasive amongst market participants.

Prohibition on conflicts of interest: A proposed SEC rule (pursuant to a requirement in Dodd-Frank) would prohibit conflicts of interest in securitisations, where such conflicts are deemed to occur if a participant (eg sponsor, underwriter, equity purchaser) benefits from a short position in any tranches (or facilitates a third party doing so) and investors in those

other tranches would consider the short position of the participant to be "material information". Pro-active disclosures of any such conflicts by participants, moreover, does not eliminate the so-called conflict of interest – ie the participant is prohibited from engaging in conflicted transactions even if it is fully disclosed to other investors. In its present form, the proposed rule is rife with ambiguity and raises significant questions – eg: How will materiality be measured ex ante? How does the rule impact warehousing and ramp-up facilities? How would cross-deal aggregate hedges be taken into account? Will the rule be applied to affiliates of the participant and, if so, how? Depending on how these and other vagaries of this rule are resolved, the resulting impact on structured product issuance could be quite significant and adverse. The contemplated rule also seems to discourage or prohibit relative-value capital structure arbitrage strategies within and across structured transactions. Such prohibitions could engender less efficient pricing and more deviations of securities prices from their fundamental values.

The above issues are just some examples of regulatory uncertainties hanging over future structured product issuance, but they are by no means the only such uncertainties. For example, additional (and weighty) questions remain about the impact of new regulatory developments regarding rating agency reforms (eg the so-called "Franken Amendment"), regulations pursuant to Title VII of Dodd-Frank in the over-

the-counter derivatives market (which could negatively impact "synthetic" derivatives-based securitisations), the implementation of Basel III and other required minimum capital and liquidity standards for banks, various disclosure requirements for securitisations (eg proposed SEC Reg AB II), regulations on money market funds that inhibit their investments in ABS and ILS, and the panoply of proposed changes to the market for Agency RMBS and the government-sponsored enterprises that issue them.

Conclusion

Only time will tell, of course, what the future holds for US structured finance markets. The data currently indicates renewed investor interest in many of these products, and, in our view, the post-crisis changes in the design and documentation of these products together with heightened investor awareness and better access to information suggests that such interest is not merely irrational yield-chasing.

Yet, the regulatory wildcard poses a significant potential threat to the future of US structured finance. Many of the potential dangers arising from pending or proposed regulations, moreover, seem to be unintended consequences of rules that were not specifically aimed at structured finance (eg the Volcker Rule). Unless considerable efforts are made by regulators to address those unintended consequences (and perhaps some intended ones), the prospects for the return of a vibrant and well-functioning structured finance market may be much dimmer than recent market developments otherwise indicate.

The views expressed herein are the authors' alone and do not necessarily represent the views of any organisations with which they are affiliated (or their clients). Mr. Culp further acknowledges (in compliance with the University of Chicago Booth School of Business academic disclosure policy) that he is periodically retained to provide consulting services on the issues discussed in this article.

END NOTES

¹ The Cayman Islands are a popular domicile for ABS SPE issuers with US sponsors thanks to its open and English common law-based legal framework, tax-neutrality, abundance of high-quality financial and legal advisors, flexible and robust regulatory system and relatively low fees.
² See, eg G.B. Gorton, Slapped by the Invisible Hand: The Panic of 2007 (Oxford University Press, 2010).
³ See Gorton, op. cit., and C.L. Culp and J.P. Forrester, The Shape of CDOs to Come, Cayman Financial Review No.18 (2010Q1).
⁴ Actively managed CLOs typically have a life cycle consisting of three periods: a ramp-up period in which the initial collateral is acquired; a reinvestment period in which principal received on maturing collateral investments is used to purchase new collateral; and an amortisation period in which no new investments are made and principal received on collateral is used to finance principal payments on the outstanding CLO securities.

⁵ See, eg C.L. Culp, Structured Finance and Insurance (John Wiley & Sons, 2006).
⁶ In 2012, there was also a significant increase in structured insurance transactions that are alternatives to ILS – eg collateralised reinsurance, sidecars and country-weighted industry loss warranties.
⁷ One reason that sponsors sought structured insurance and brought a lot of new ILS issues to market in 2012 was to replace lost capital following the large payouts arising from the 2011 Tohoku earthquake and tsunami, New Zealand earthquake and Thai flooding.
⁸ See, eg Standard & Poor's, Insurance-Linked Securities Market Adapts to Changing Conditions, Commentary Report (July 17, 2009).
⁹ By way of disclosure, Mr. Forrester's law firm represented parties involved in these transactions.
¹⁰ See, eg A. Schwartz, "Origins of the Financial Market Crisis of 2008," Cato Journal Vol. 29, No.1 (Winter 2009), J.B. Taylor, Economic Policy and the

Financial Crisis: An Empirical Analysis of What Went Wrong, Critical Review Vol.21, Nos.2-3 (2009), and A. Greenspan, "The Crisis," Brookings Papers on Economic Activity Conference Draft (Spring 2010).
¹¹ See Culp and Forrester, op. cit.
¹² Davis Polk, Dodd-Frank Progress Report (18 July 2012) (http://www.davispolk.com/files/uploads/FIG/071812_DoddFrankProgressReport.pdf).
¹³ The proposed rule defines "covered funds" by referring to certain exemptions under the US Investment Company Act that, while used for funds that engage in proprietary trading, are also used by structured finance SPEs.
¹⁴ The empirical evidence is ambiguous and certainly does not provide overwhelming support for this concern.
¹⁵ The five per cent retention could be satisfied by either retaining five per cent of each tranche, five per cent of total assets in the first-loss tranche, or an equal combination of the foregoing.

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