International Corporate Rescue

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

Annual Subscriptions:
Subscription prices 2008 (6 issues)
Print or electronic access:
EUR 665.00 / USD 799.00 / GBP 465.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 114 255 9040 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

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EDITORIAL

Structured Investment Vehicles: A Regulatory Quandary?

David Barnes, Partner, Head of Financial Services Audit, Deloitte & Touche LLP, London, UK

SIVs – what are they?

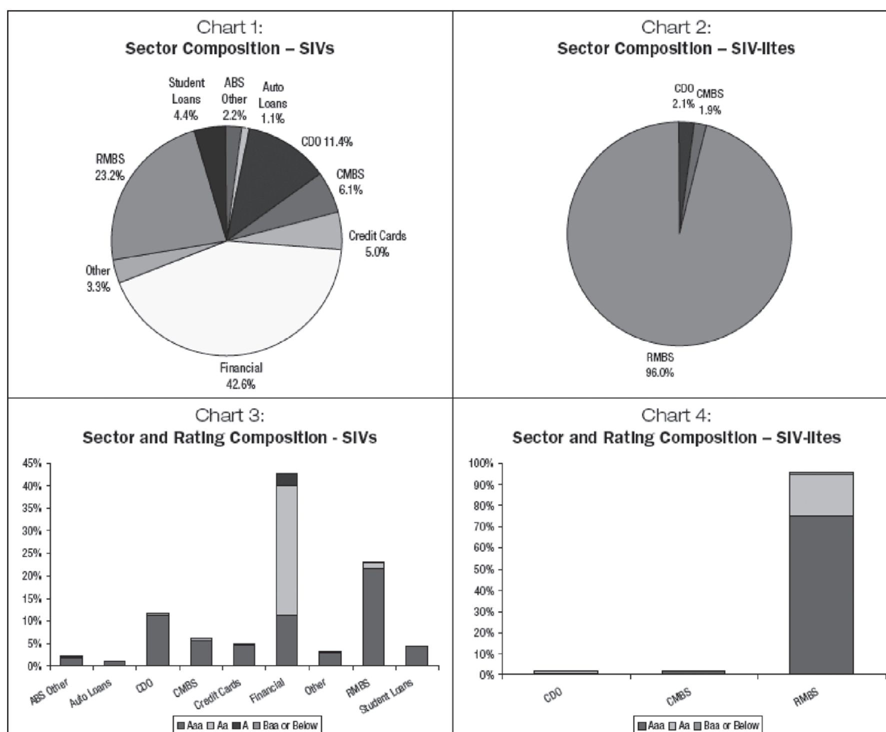
The SIV business model is predicated on taking advantage of the interest rate differential between short and longer term borrowing. By investing in normally highly liquid, and highly rated assets with a weighted average life of circa three years and funding these assets with shorter term liabilities, it was possible to provide healthy returns for the capital or junior note holders. This was on the assumption that the SIV maintained a AAA rating and the note holders continued to roll their financing and that sufficient leverage of these junior obligations was maintained.

A structured investment vehicle has the nature of its operation tightly defined by legal documentation and operating guidelines. These include detailed capital requirements that are captured by a capital model and are required to be agreed up front with the rating agencies.

Vehicles of this type are designed with the intention being able to sell down their assets in the event that liquidity in the short term commercial funding market dried up by holding highly rated asset backed assets that could be readily saleable. The average make up of SIV assets are set out in charts 1–4, below.

Within certain parameters, the manager of the fund is able to switch between different investments in an attempt to maximise returns for the noteholders whilst trying to protect them from potential capital losses by selling any assets that are downgraded or are at risk of downgrade.

These vehicles exhibit a legal structure that is in many ways similar to that of a managed collateralised debt obligation. On the other hand they also have some of the properties of a hedge fund or investment company. These vehicles are not themselves regulated (typically the investment manager or adviser will be) although the constraints and limitations placed on them by the



Source: Moodys and Deloitte analysis

rating agencies impose a certain level of control usually well beyond that of a hedge fund.

Current issues

SIVs are permitted to hold large volumes of asset backed securities including US prime and subprime, ABS and complex CDOs of ABS with high credit ratings mainly AA and AAA.

Falling US house prices, rising interest rates and complex financial engineering have led to much higher than normal loss severity for assets backed by subprime mortgage assets which has in turn led to market value write downs on even the highest rated assets held by these funds. These write downs are as much liquidity as credit driven.

The wider credit crunch that has been created as a result of the crisis has in turn led to an inability of these vehicles to refinance short term liabilities as liquidity in the short term asset-backed commercial paper market has all but dried up.

Under normal circumstances such vehicles would sell liquid assets to meet maturing liabilities. But due to the degradation in underlying asset prices, it has not been possible for them to sell at high enough prices to meet liabilities as they fall due, or without suffering such losses in the process so as eat through the capital or junior notes of the vehicle.

The result is that unless the SIV can secure new funding either from a sponsoring bank, existing investors or through some kind of refinancing, they are likely to eventually reach a position where they breach one or more of the triggers that are tightly defined within the legal documentation. When this happens they are placed in a permanent wind down state known as 'enforcement' and may eventually become insolvent either from a cashflow or balance sheet perspective.

Most SIV managers are currently watching the market closely and considering their options as are the rating agencies who are now keen to act quickly to downgrade any SIV they consider to be close to danger. The higher costs of funding following the credit crunch, the flight from asset backed risk that continues in the market today and the tainted reputation of the these vehicles means that it is highly likely that even if the manager is able to navigate the market in such a way as to avoid capital losses for its note holders their vehicle may not have a viable long term future in today's market conditions.

This situation highlights the structural issues with these vehicles and the problems associated with concentrated investment in assets of a certain type. Had this structural feature been challenged prior to 2007 it would have been hard to foresee the set of circumstances that have led to the drying up of liquidity and crashing in price of particular assets at precisely the same time. Whilst the financial community looks for someone to blame, the regulators, central banks and similar organisations around the world must decide whether this is a storm that could not have been predicted and managed or the result of inadequate regulation either by the regulator or the market.

Knock on effects in the market

As large numbers of SIVs have sold some or a significant portion of their assets in an attempt to unwind at a reasonable pace and avoid or limit capital losses the resulting impact on price and the perception of a 'need to sell' when any SIV puts bid lists out to market has further depressed the market and created further illiquidity.

Results for the major investment banks in Q3, speculation about further losses in Q4, and information from the wider investment community suggest that the losses have been spread wide and deep. Investors who do not normally expect significant risk of capital loss, such as money market and retail banks, have had their investments impacted. Such senior investors may well be forced to sell downgraded SIV liabilities due to their own investment or rating agency criteria. At least one of the rating agencies have stated that they are considering downgrading the rating of money market funds themselves that continue to hold downgraded SIV liabilities.

Arguments for regulation

As with hedge funds, many SIVs are incorporated 'Offshore' and it is questionable what can reasonably be done. Indeed, one could argue that institutional investors should have been aware of the risks of vehicles that in essence fund long term assets with short term liabilities and seek to profit from interest rate differentials. Retail investors are less well placed to perform research and due diligence and therefore the types of vehicle that can be marketed to retail investors is regulated. However, this has not completely insulated retail investors, as we have seen some money market funds are already suffering.

When considering retail investment vehicles across the EU, under the UCITS rules, fixed income securities, such as those issued by SIVs, are permitted investments. It is thus possible for UCITS funds to have hedge fund characteristics whether invested in debt or other securities. However, there are tight regulations relating to the sale of investment products across the EU and the UK is particularly focused in this area through the FSA's Treating Customers Fairly (TCF) requirements. But, none of this was sufficient to prevent any retail investors invested in the impacted money market funds being affected.

This begs the question of the adequacy of regulation and practices around credit markets more generally. Ba-

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sel II has made capital requirements of banks and other institutions within its scope, more sensitive to risk. This is important since under Basel I many national regulators, including the FSA, did not impose any capital requirement on liquidity facilities provided to conduits. Had a capital requirement been imposed, it is possible the growth in SIVs and the ultimate fall to earth would not have been so spectacular. Basel II does impose a capital requirement on most such liquidity facilities. Although, whilst there are requirements for stress testing and adverse scenarios and Pillar 2 of the capital requirements specifically considers liquidity risk, common international standards for liquidity is lacking and the Basel Committee is currently addressing this.

The Bank of England in its financial stability reviews had identified as a risk that trading of credit in financial markets particularly in benign economic conditions may mean that those arranging the loans may be less inclined to assess credit quality at origination if they feel confident that they will ultimately bear little of the ultimate risks.

The problems of SIVs and short term liabilities combined with long term assets may have received sufficient media attention to dent confidence to make this a less likely source of market failure or investor suffering in the future. But in the meantime, the knock on effects of the current turmoil are still playing out.

Could different or better regulation have prevented the crisis over the last 6 months? Perhaps – but the last thing that is required is a knee jerk over reaction. The root cause of the problems would seem to point to inadequate consideration of liquidity particularly where the quality of the underlying debt, although highly rated, is known to be questionable. However, this should not be the assumed conclusion and equally regulation is not necessarily the answer. There must be a proper consideration of the causes before deciding whether changing regulations would be appropriate.

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International Corporate Rescue

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