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The End Game in Insolvency for Hedge Funds: Special Case or No Favoured Treatment? – Part Three

Jorge M. Guira, Associate Professor of Law, Warwick University, Warwick, UK

As the international financial crisis regarding sub prime financial instruments seems increasingly unresolved, Part Three (Volume 5, Issue 2) focuses on the current crisis and its resolution. This builds upon Part One's (Volume 4, Issue 6) focus on the core dimensions of preventing and containing such financial crisis within the the context of an international regulatory framework with significant holes as to dealing with hedge fund regulatory and insolvency issues. Part Two (Volume 5, Issue 1) addressed the above credit crisis within a historical framework and discussed available remedies.

> 'I am firmly convinced that hedge funds provide considerable benefits to financial markets and our economies, but they also can present potential challenges and risks … It is in the US interest to promote a thriving, competitive global hedge fund industry that facilitates price discovery and promotes liquidity in financial markets, while maintaining investor protection and promoting financial stability. Market discipline, focusing on the risk management of regulated counterparties, is the most effective way to address potential systemic risk concerns.'[126]

VIII. The dimensions of the debate about insolvency risk and their implications for hedge funds in the current international financial and regulatory architecture

A. Background

The August Quant crisis has arisen primarily due to the default concerns relating to sub-prime mortgages that have been issued by conduits for originators and purchased by investors. Many of these investors have been hedge funds. In Parts One and Two, the focus of our journey was on how hedge fund restructuring and insolvency would be prevented, contained, and resolved. Some reference was made in the latter sections of Part Two to current insolvency cases such as In re Sphinx and Bear Stearns High-Grade Structured Credit Strategies Master Fund Ltd., 07-12383, and Bear Stearns High- Grade Structured Credit Strategies Enhanced Leverage Master Fund Ltd., 07-12384, U.S. Bankruptcy Court, Southern District of New York (Manhattan).

Consideration of which type of insolvency regime was optimal was the focus of Part One given the distinctions between corporate and banking insolvency regimes. Part Two focused on how consideration of mitigating insolvency risk could be undertaken by certain legal reforms, especially given the fact that hedge funds are Highly Leveraged Institutions (HLIs) that are too complex to fail. Part Three now turns to questions of how the August Quant crisis may best be resolved in light of the above background and some specific issues articulated in greater detail below.

B. The crisis revisited: focus on the informational dimension

The extent of losses from the sub prime market collapse is not clear for the reasons set out below. Specifically, losses are sometimes difficult to determine, and many investors have failed to report such losses, notwithstanding the requirement for firms subject to Sarbanes Oxley that material changes are reported without delay under Section 409.

The uncertainty, related to a real lack of information in some cases, and sometimes a hiding of losses (given human nature and the history of operational risk) has had 'knock-on' effects on funding which banks provide for through private equity transactions, especially bridge loans.

Increasingly, private equity firms, in the context of massive global liquidity were able to use their bargaining power to achieve preferential terms in recent years,

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126 10 February 2007, Statement by US Treasury Secretary Henry M. Paulson following the Meeting of the G7 Finance Ministers and Central Bank Governors Essen, Germany, found at <www.ustreas.gov/press/releases/hp255.htm>.

including 'covenant-lite' loans with which financial monitoring of loans by the lenders was either nor limited or not required.

Banks, faced with not knowing the extent of their obligations to their own funds, and the heightened probability of default generally given the collapse of the CDO market, have pulled back, until the extent of the damage is assessed. This is indeed a rational response, and it is important to understand the collateral impact that the CDO implosion has had. Having said this, there is a counterbalancing factor in the strength of manufacturing orders and general economic growth from Asia that will provide a basis for increased liquidity and avoidance of global recession.

So, what were some of the key informational benchmarks that we can look to that provide clues to how this apparent 'information lacunae' developed? The case of the Bear Stearns funds (currently in bankruptcy) which is discussed above perhaps provides the best way to encapsulate the dilemmas of the crisis as they have affected financial institutions and hedge funds who have been plunged into insolvency. Here is a chronology with some commentary.[127]

Bear Stearns key dates

February 2007: Many sub prime investment conduits announce that they have suffered losses of up to 50%

15 May 2007: Bear Stearns reports losses of only 6.5% – it is doing relatively well- maybe it had only purchased the most highly rated tranche(s) of sub prime debt.

June 2007: Bear Stearns announces 19% losses – when the credit market paradoxically is rebounding, and US Federal Reserve's Chairman Bernanke suggests the worst is over.

Bear Stearns bails out a fund with USD 1.6 billion to meet a margin call.

18 July 2007: Bear Stearns says it cannot figure out the true extent of losses but indicates that one fund has lost over 90% of its capital and the other fund has lost virtually everything.

Two weeks later: Bear Stearns funds file for bankruptcy

After the above events, various other funds started to disclose that they had serious or potentially serious financial liquidity or credit problems. Accordingly, central banks globally provided or facilitated massive liquidity injections as discussed in Part One. The unravelling of market confidence and the beginning of the end (or at least the possibility of a restructured second life) for some other hedge funds had now begun.

C. Key dimensions of financial instruments

Many of the investments at the centre of the crisis use above referenced collateralised debt instruments (CDOs). It is important to understand how CDOs work and what their core characteristics are in order to understand the current financial crisis.

Other investments that have come under financial distress are called special investment vehicles (SIV) or 'special investment vehicles lite' (SIV-lite) due to their characteristics of having short term liabilities provide the yield spread along with any credit enhancement and liquidity support *vis-à-vis* medium to long-term assets (mortgage receivables).[128]

The next section discusses the typical CDO transaction which hedge funds employ (such as Bear Stearns), and also discusses the type of structures by contrast, which SIVs use (such as Cheyne Capital). However, the transaction structures below are general and may not correspond therefore to the specific features of any particular fund.[129]

D. Examples: CDO, SIV, SIV-lite, and ABCP structures and termination events

The fundamental concept behind any financial product is simple. Borrow at a lower rate than your obligations and take the difference in profits. This concept is taken one step further with structured financial products in which case short term liabilities are issued that will provide investors with a lower yield than longer term financial asset obligations such as mortgages.

Again, pocket the difference between the cost of borrowing for you (the investment vehicle) and the yield on the products you are administering in your receivables pool. So, for example you buy a pool of packaged mortgages which a bank sponsor has sold to a special purpose entity to keep it off the balance sheet, and reduce capital adequacy requirements. The banks, bank syndicate, or other highly rated counterparties provide limited recourse via liquidity facilities. This should solve

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127 This is adapted form the excellent discussion by Prof. F Partnoy found at <ftalphaville.ft.com/blog/2007/08/10/6480/frank-partnoy-bear-stearns-cdos-and-the-roots-of-current-market-volatility/>.

128 This is, for example, a usual strategy for a bank with respect to its funding. For example, to minimise interest rate risk it will borrow short term to fund its medium to long-term obligations.

129 See also J McWhinney, 17 November 2005, Massive Hedge Fund Failures, <www.investopedia.com/articles/mutualfund/05/HedgeFund Failure.asp>.

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the problem of a mis-match in cash flows as between the flows from the liabilities that fund the assets.

In a typical CDO structure, an originator has bundled securitised assets, such as mortgages. These are sold to a special purpose entity with certain collateral-credit enhancement, as well as liquidity provision in the event of funding shortfalls. The hedge fund then uses its capital to buy CDOs. The cost of the borrowing is less than the yield on the CDOs. This is the spread or profit differential. To the extent that leverage through more borrowing is provided there is greater opportunity for profit as to the trade. Credit default swaps constitute the 'protection insurance' as purchased in the over the counter markets.

SIVs do not require 100% liquidity support as do CDOs, and instead typically use about 7% of outstanding commercial paper. They are mark to market whereas CDOs may not be. They are more heavily reviewed by the funding agencies. An SIV is typically leveraged up to 12 times. 'SIV-lites' are so called because they have a fixed maturity as to the pool of assets, and may therefore be perceived to be riskier. The tranches are rated from AAA to BBB, to an unrated first loss piece of equity. Asset-Backed Commercial Paper (ABCP) programmes borrow in the short term commercial paper market and benefit from the spread as to the mortgage-backed securities, typically.

However, what if, as the events of summer 2007 have shown, the investors stop buying the short term paper? Further, what if as a reaction, hedge funds sell as many assets and collateral in the pool that they can thereby reducing the existing liquidity available? And finally what if the short term rates go up sharply even becoming punitive, near the levels for emergency central bank discount window funding or above? At this point, further borrowing or rolling over is producing a negative yield on the assets – a winding down is only subject to a termination event arising

For each security, there is a contract provision that sets forth a termination event that will provide the trigger for the restructuring of the underlying obligation. When this event occurs, the fund must be wound down. The conduit must be solvent vis-à-vis its net worth. Non-defaulted assets of the principal should equal or exceed those of ABCP outstanding. Third, there should be no loss. Fourth, liquidity to restore the fund should be available. Finally, it may also be required that credit enhancement is available. So, if the above tests cannot be met for a certain number of days, the fund must be wound down.

What will have happened in the case of ABCP or SIV programme (or hybrid) conduit is that the investors are no longer buying the commercial paper in the market that funds the asset backed securities, such as sub-prime loans. As a consequence, the lack of liquidity means that rolling of the assets cannot take place.

To prevent this, the fund may seek to find sources that will provide further liquidity. Once, such an event is triggered and no suitable investor has stepped in, creditors will be paid (but only to the extent that is possible). As above, liquidity will initially be provided by the commercial bank sponsor as the liquidity back up support. The bank may go to the central bank, if needed, as additional support. However, it must ordinarily keep its liquidity within certain parameters.

Therefore a hedge fund that is holding an SIV, or, 'SIV lite' vehicle, that is being wound up may pay something on their claim. However, after the top rated securities holders are paid out, there may be nothing left. The fact is that this seems extremely likely due to the underlying dynamics of sub prime debt default rates rising and insufficient credit enhancement, unless new funding is provided to recapitalise the fund. This is what Barclays has done with its liquidity injection of Cairn to prevent a termination event from taking place.

This does not represent a loss over time to the extent that the capital provided extends the life of the SIV, and even if it is later unwound, this occurs much later on. In this regard, it is similar to the banker's restructuring device of extending the maturity on a loan, and sometimes providing or indirectly facilitating fresh capital, as well. In this way, the fund lives to see another day, and hopefully it is sufficiently well capitalised to defer, or avoid, further termination events, as is the case with any business decision to restructure.[130]

E. Representative concerns prior to and in restructuring

Accordingly, ensuring that funds are made available as referenced in the Barclays (UK) restructuring of SIV Cairns is crucial. But there are limits on the capacity of banks to assist brokerages that may be in place. For example, in the US, banks cannot lend to affiliates (brokerages), although the US Federal Reserve in an August 20 letter provided an exemption to Citigroup and Bank of America in order to extend liquidity to their mortgage related, including mortgage-backed securities (MBS) businesses.[131]

Another obvious concern is the extent to which the above set of liquidity crises affects the capacity of funds to maintain solvency. Moreover, one of the concerns is that traders often will use similar financial strategies, and that therefore there is a substantial amount of

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130 Cairn Capital's Letter to Investors announcing the restructuring is attached in Appendix I.

131 P Eavis, 'Fed Bends Rules to Help Two Big Banks', *Fortune*, 24 August 2007 found at <money.cnn.com/2007/08/24/magazines/fortune/eavis_citigroup.fortune/index.htm?cnn=yes>.

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correlation risk as traders engage in similar trading behaviour. In this regard, the days of AW Jones, when hedge funds were truly defensive in their orientation has fundamentally changed as swaps and options have become a key feature of hedge funds. Further, a fee-seeking fund manager focuses on reaching levels that will qualify them for performance fees.

Another major issue is the question of fund valuations generally, and of valuations as to structured credit products more specifically. Indeed, a major issue raised repeatedly in this paper is the extent to which the use of mark to market mechanisms have delayed the reporting of losses for financial institutions, and the extent to which non-financial institutions (counterparties) may still have not reported losses even 6 months after the event.

However, astute investors have been aware of the possible downsides of certain sub prime products since February 2007. How certain CDO sales were subsequently undertaken will come under further legal scrutiny, especially as securities fraud lawyers and insolvency lawyers compete as to what funds properly belong to the post-restructuring estate.

It will be interesting to see how many fraud suits arise, and how they are constructed. At least one quote attributed to an optimistic fund manager has aroused recent and unfortunate press attention:

To wit:

> 'In an environment plagued by sub prime related volatility, SIVs represent a fairly safe haven of stable risk adjusted return facilitated by structural protections designed to withstand and effectively respond to market vagaries.'[132]

However, in fairness, the fund manager is correct: SIVs did offer the above features to investors. Specifically, it typically has a closer ongoing reporting relationship with credit rating agencies. One of the reasons that an SIV may have collapsed prior to other structured financial products is because information as to credit quality, diversification, asset and liability maturity, risk limits, capital adequacy, leverage and liquidity may be updated more frequently. Other non SIV funds may have problems that are as yet unreported.

F. Summarising the core questions to consider

The 'bogeymen' identified above have been labelled as key in resolving the crisis. This concern is in addition to the broader concerns of information asymmetry as discussed in greater detail in Parts One and Two. So, what are some of the key questions that may be relevant to restructuring and insolvency? And what solutions may assist in resolving the current crisis? A set of key questions is presented to address this in the next section, and some possible answers are provided in the section that follows that one.

IX. Understanding some of the core restructuring and insolvency dimensions of the August Quant crisis

A. General issues for consideration and specific questions to address

The below is not intended to provide a complete list of all the issues but rather to suggest an approach, and discuss some key issues of relevance to the financial community, in the broader background of Part One and Two, as well as the specific issues of relevance to restructuring, insolvency, hedge fund, financial institution professionals.

First, the current dilemma needs clarity as to the exposures arising from CDOs and the impact this will have on the markets.

Information gathering, and monitoring is an ongoing process, and, to use an English expression, it is still 'early days'. The information dimension is crucial because it highlights the difficulties in determining where the valuation floor is placed. The question of how to remedy the above is likely to grow and the following section addresses how the unfolding crisis may be addressed as to various stages of resolution, and reflection as to possible financial law reform.

B. Specific questions with brief commentary

1. Is the current UNCITRAL Model Law based system of cross border insolvency sufficient to address the concerns of speedy and efficient resolution?

Kaufman and Bliss in their Chicago Federal Reserve paper clearly describe the costs and benefits of the banking insolvency versus corporate insolvency approach. The corporate approach is typically considered to be less speedy. The issue of efficiency and to what extent insolvency legislation should serve other ends is another question. The Cross border insolvency regime has been adopted in the UK, and the US, as well as the EC, but has different modifications that have been set and articulated which is beyond the scope of this article.

A further study is needed to specifically and squarely address the above issues as to HLIs, and in part to assess

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132 From Kumar Tangri, principal, Eiger Capital, found at <ftalphaville.ft.com/blog/2007/09/04/7033/sivs-junk-and-rock-n-roll-global-abcp-summit-07/>.

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the impact of the UNCITRAL law in its application to hedge funds, and whether there possibly are modified insolvency regimes which may better promote the interest of financial stability. As Professor Richard Herring presciently notes in his study on insolvency, time is of the essence when insolvency looms for financial conglomerates, such as HLIs because of the knock on effect of default.

The desire of central bankers to stave off systemic risk (the greater evil) may diminish market discipline, leading to moral hazard. More importantly, the LTCM crisis demonstrates that attempts to liquidate illiquid positions may exacerbate losses. Close-out netting is an imperfect solution, and the cost and benefit implications of the US bankruptcy law reforms on markets should be the subject of further reflection.

2. Or is a modified system, whereby non bank-banks are treated as financial intermediaries preferable?

Although some experienced financial law commentators have essentially suggested this or at least have articulated concerns that would lead to a re-consideration of how financial regulators should treat these issues directly, it is too early to pre-judge whether this is a good idea. However, it certainly should be considered at least as to enhanced disclosure, and risk based systems.

However, a key problem is that sometimes institutions may not know their total exposure, notwithstanding their advanced IT systems; collateral and mark to market securities as to prime brokers for hedge fund clients. Moreover, this is an imperfect solution. In the final analysis, the fact that hedge funds have a significant role to play in the credit markets due to their use of OTC derivatives, for example, suggests a re-examination is required. We are long past the days of Bagehot and the post 1907 Panic days when banks are the primary credit players in the global township.

3. Is it enough for the central banks to engage in the approaches that they have so far undertaken, including the extension of the discount window and the taking of collateral – or is this much too limited?

Obviously, a co-ordinated response is helpful, and President Bush has offered to limit the damage by providing a guarantee on past 90 day loans for example through Federal Housing Agencies. This will provide the basis for avoiding downgrading further of many CDOs in the pool, or provide a possible basis to justify a capital injection from investors, as distress is precluded from the guarantees. Whether this is in time and how widespread an impact this will have, are questions we simply do not know the answer to.

Professor Buiter's suggestion of the US Federal Reserve as market maker of last resort is of great interest. The central banks will clearly monitor the situation in an attempt to maintain orderly markets while avoiding the overshooting of liquidity leading to inflation. Further measures such as AMCs (a consolidated reconstruction of mortgage lenders similar to the previous Resolution Trust Corporation) for troubled financial institution affiliates should be considered, as a further but only last resort contingency.

The author has perceived this to be a possible solution should this become a real credit solvency crisis rather than an illiquidity crisis since the early days of August, but it is too soon at the end of August to know whether an AMC is genuinely required.[133]

4. And how about the ECB and its mechanisms to assist problems such as BNP Paribas funds?

It would seem the facilities for this are somewhat limited at this stage, and this has caused some concern. The reason: BNP has said it does not know how to value its positions and therefore withdrawal is not allowed. The ECB can purchase such collateral, when values can fairly be established, and can help out by applying discretion and relaxing its requirement that the securities are euro denominated as it does affect a European financial institution. It is unlikely that this would be controversial. The interesting question here is the extent to which the ECB may consider becoming a market maker and purchase securities as collateral if the crisis spreads.[134]

5. Further, what criteria should be used for intervention – should it be a US style least cost based solution taxpayers as the basis for any banking insolvency style application of resolution procedures to hedge funds?

A set of specific bailouts of hedge funds by the government should be avoided, except to the extent a credible argument can be made that the functioning of the markets is thereby implicated.

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133 See especially N Roubini, 27 August 2007, 'Fiscal versus Monetary Solutions to the Sub prime Crisis', found at <www.rgemonitor.com/blog/roubini>.

134 See W Buiter and A Sibert, found at <maverecon.blogspot.com/2007/08/central-bank-as-market-maker-of-last.html>.

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6. Whether the US and UK cross border insolvency regimes, both based upon the UNCITRAL model law have nonetheless set up the basis for regulatory arbitrage in this respect must be considered?

This is unlikely to be considered a significant issue as to the resolution of this issue. The real question is whether the site of the main proceedings will be the offshore place of formation, or where most of the creditors lie (e.g., Cayman Islands versus the US, for example). However, it is important that this is monitored because if there is a major imbalance it could substantially affect capital flows. The same is true as to other jurisdictions that use similar mechanisms.

The next section will provide some recommendations as to possible enhancement of the mechanisms of resolution.

X. Summary of suggested inter-related reforms to improve market functioning and better deal with restructuring and insolvency issues

A. Partnoy's complaint

An FT article, preceding a question and answer section with Professor Frank Partnoy summarises well two concerns that go to the heart of the recent market travails.[135]

To wit:

> '"The recent collapse of two hedge funds at Bear Stearns (NYSE:BSC) Asset Management raises two questions few people can answer," writes Frank Partnoy, law professor at the University of San Diego. "How did they lose so much money so quickly? And where else are similar problems buried?"
>
> "It is virtually impossible for investors to understand how much exposure an institution really has to the sub prime markets," argues Partnoy. Now that investors seem to understand this, the markets are swinging wildly. "Volatility is highest when people realise they cannot figure out what investments are worth," he writes.'

A certain degree of disorder in economics is the normal state of affairs, and is the root of financial innovation. To stamp it out with over-regulation would in the end be worse than the cure. But to fail to realise that the extent of hedge fund involvement in global financial affairs demands some review seems naïve.

The extent to which further refinements are needed as to the provision of information, enhanced risk based policies on the part of financial institutions and hedge funds alike, and processes to improve corporate governance and re-assess regulatory arbitrage opportunities based upon laws of disclosure and of insolvency are matters that require co-ordinated and careful attention, on a domestic and international level.

Further areas of specific concern as to insolvency law are discussed next.

B. Specific issues to be addressed

The market for derivative products is not going to go away. Further, it is unlikely that investors will not suffer gains as well as losses in this market. They have options.[136] They can exit the market and not participate. They can be loyal-that is to say they can participate knowing financial institutions disclosures are somewhat opaque, and may be biased to present a rosier picture of risk that reduces their cost of capital. Or they can voice their concerns and seek modifications that will: (1) enhance the market's capacity to function, (2) encourage financial stability, and (3) provide enhanced or optimal insolvency rules for resolution of these specific type of crises.

This study has raised as many questions as it has answered because the dimensions of this problem are complex and require considerable review which is far beyond this modest attempt at clarifying some of the major parameters of the issues presented and their relationship to restructuring and insolvency law.

Accordingly, the author suggests that the issues raised above as to the application of the UNCITRAL Model Cross Border Insolvency Law as expressed through hedge fund insolvencies, and whether a modified banking insolvency scheme may not be more appropriate is something which may be considered. Even if modifications that are made are minor, this area should be reconsidered to the extent that financial stability rather than investor bail out is promoted. Further, issues as to derivatives law, netting, and their application should be evaluated in light of recent market events. These focal points of concern would promote a more coherent and orderly resolution process of distressed hedge funds, and of their counterparties in the financial markets.

C. Considering the scenarios presented

The primary issue at present is to re-establish market confidence so that the restructuring of the securities held by hedge funds, and financial institutions can be re-sold. Greater liquidity in the money markets is also

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135 'The Fall out from Bear Stearns', FT, 15 August 2007, found at <us.ft.com/ftgateway/superpage.ft?news_id=fto081520071034109150&referrer_id=yahoofinance>; see also F Partnoy, *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets* (H Holt, 2003).

136 A O Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, MA: Harvard, 1970).

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needed as investors shy away from the above structured financial products. Absent a liquid market, the potential counterparties wait until they have a better sense of the floor price on these securities. A second problem is banks are waiting to assess what their exposure is before engaging in any major credit decisions and are trying to renegotiate those in which high leverage may be implicated, and business conditions may not support such transactions quite as comfortably, or not at all. (For example, the provision of bridge loans or other financing to private equity funds that may be later funded through other vehicles, such as high yield debt, or so called 'covenant lite' loans where terms for repayment are flexible have been tightened).

Accordingly, the first step is to see what the level of exposure is and to see if a market develops as to the sale of the securities. To an extent, if this is not the case then the question arises what it will take for parties who have cash to enter the market? One focus of financial regulators therefore is to provide a basis where such impetus is established. It is possible that some government intervention (such as Professor Buiter's suggestion that the central banks become market maker of last resort) will have to be used.

Certainly, to the extent that the data (in complex conditions of uncertainty) supports the view that a sufficient risk exists of orderly market activity not being re-established and possibly, systemic risk, then further government measures should be considered.

These remedies may include development of a US style 'Resolution Trust Corporation' style, as this author has suggested must be considered as a contingency plan since his earliest consideration of the emerging financial crisis. To an extent, the government as guarantor of illiquid assets that back the above securities will help (as President Bush has offered (for certain mortgages 90 days past due)).

Indeed, it may be possible that doing nothing more than the above and lowering interest rates is sufficient. However, gathering information on parties who may have such a degree of exposure that they truly may be 'too complex to fail' is absolutely crucial. Getting this information through formal legal and informal networks for those who may have the greatest exposure is crucial.

This will help determine to what extent any additional intervention such as the above further government intervention is needed. However, it could also be possible that the severity level of the crisis increases, and that a full set of drastic measures is needed. Absent further information at this point about the scale of the crisis, it is possible to discuss possible options that should be under consideration, but not to assess the most appropriate measures.

D. Sum

It is sincerely hoped that the discussions in Part One, Two, and Three provide the basis for further discussion on the core issues of how to play the 'end game' when insolvency is threatening hedge funds, as well as what must be considered as to the efficacy of such financial distress resolution mechanisms.

Appendix I

Dear Investors,

There was a good deal of weekend press coverage of the restructuring of Cairn High Grade Funding I ('CHGF') which was completed last Thursday. CHGF is one of the seven ABS CDO transactions managed by Cairn Financial Products Limited ('Cairn'), and Cairn's ABS business is part of its wider credit asset management business.

This was the first successful restructuring of a SIV-Lite transaction and provides a significantly better result than a forced wind down. The refinancing was required following the shutdown of the asset backed CP market upon which CHGF relied for the majority of its funding.

As Cairn saw liquidity in the ABCP market deteriorate at the start of the summer, we began to work on the potential refinancing and continued to drive the process throughout. Cairn identified the credit protection provider that allowed Barclays to provide liquidity on a hedged basis. The refinancing was completed on a commercial, arms' length basis.

The refinancing was only made possible because of the high quality of the underlying portfolio which Cairn had invested in and managed over the eighteen months since CHGF launched. Against the backdrop of an extremely turbulent market and deteriorating fundamentals for the sector, the portfolio maintained its 100% AAA/Aaa profile and continued to meet all its market value tests. This, we understand, is different to other SIV-Lite transactions and, whilst we hope that this restructuring provides a template for other restructurings, they may be more challenging to the extent the portfolios are not of similar high quality.

Cairn and Barclays worked with the Rating Agencies on this restructuring and agreed the rating actions before their announcement. In summary the rating actions on CHGF's liabilities are:

- the commercial paper (which will be repaid as it falls due over the next few months) was affirmed A-1+ and P1
- the restructured Tier 1 notes were assigned a AAA principal only rating

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- the restructured Tier 2 notes were assigned a AA principal only rating
- the restructured capital notes are not rated.

We were happy to complete this restructuring in a short timescale and would like to thank the parties involved in the restructuring, the Rating Agencies and, most importantly, the CHGF investors for their efforts, diligence and timely responses in this very testing market environment.

While we are not happy that CHGF investors' returns were negatively impacted, we are confident that the restructuring gives the best solution and certain that it would not have been achieved without our determination; our capabilities in structuring, portfolio management, and legal; our relationships in the banking community; and the trust and confidence of our investors.

There are no cross holdings of CHGF notes by any other fund or portfolio managed by Cairn.

We attach the press release issued on Friday.

We would be happy to answer any questions you may have.

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International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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- Identify and assess potential problems and avoid costly mistakes.

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