LEGAL ISSUES FOR STRUCTURED FINANCE INVESTORS

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What credit ratings in structured finance transactions do not disclose - some tips for institutional investors

The deficiencies of credit ratings in structured finance transactions have come under scrutiny. In particular, rating agencies are accused of not having paid sufficient attention to the ratings of assets exposed to the US sub-prime market. If the ratings process and the value of ratings are coming under examination, then perhaps it is now also time to look at what important aspects of structured finance transactions the ratings agencies *do not* analyse.

What do credit ratings purport to do?

Standard & Poor's says, in its Rating Methodology For Global Structured Finance Securities: "We base our ratings framework on the likelihood of default rather than expected loss or loss given default. In other words, our ratings at the rated instrument level don't incorporate any analysis or opinion on post-default recovery prospects." Moody's Investors Service says: "Moody's ratings are based on the concept of expected loss and address the ultimate cash receipt of principal and interest.... Expected loss is calculated by weighing losses associated with all possible binomial scenarios with the probability of those scenarios occurring."

So what are the deficiencies of a credit rating in a structured finance transaction?

There has perhaps grown up a tacit assumption by investors that because a structured finance security has been given a credit rating then the rating agents have implicitly "negotiated" or performed a legal due diligence exercise on the transaction documents on the investor's behalf. This is clearly a mistake. The fact that credit ratings of structured finance securities do not address these issues is itself no implied criticism of the rating agents.

So what are the issues that investors should investigate for themselves? Here are some:

Self-damaging "forced sale" provisions

As has become apparent from the turmoil in the structured finance markets during the summer of 2007, there are a number of commonplace transaction structures with features that may promote a disorderly market in the liquidation of portfolio collateral. Most "managed" structured finance transactions will require regular testing of the quality of the portfolio. One standard test assesses, on a regular basis, the average rating of the assets within the portfolio. Failure to pass this, or any other, test is likely to result in forced changes to the composition of the portfolio in an attempt to bring the portfolio back into compliance. This will invariably mean the sale of certain assets. Recent market turmoil has demonstrated that the reconstitution of the portfolio of a CDO (cash or synthetic), a SIV (Structured investment Vehicle) or a SIV-lite may well lead to a fire sale of assets at a time of extreme market price volatility. Even at the time of writing, there are a number of instances of structured finance transactions where the transaction parties agree that the portfolio is generally healthy and that its current market valuation does not reflect its true value if held to term. Investors in transactions that include such triggers should look carefully at whether those triggers will serve only their intended purpose – i.e. to mitigate poor performance specific to the transaction portfolio or portfolio manager or whether those triggers might necessarily also be affected by general market disruption and volatility.

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Regular reporting to investors

Many CDOs require that investors are given regular updates on the performance of the portfolio underlying the CDO (so-called "Trustee Reports"). That portfolio may consist of actual securities or a synthetic portfolio made up of a number of discrete, single name credit default swaps and/or a single credit default swap referencing a portfolio of assets. And those assets may be loans, bonds or indeed other ABS. However, the provision of regular reports to investors setting out the performance of the portfolio, any changes to its composition and the values at which positions have been traded is not a precondition of a credit rating. Rating Agents do not generally impose, and indeed are not in a position to dictate, any requirements on the transaction arranger to make provision for monthly reporting to investors. Consequently, many transactions do not provide for regular reports.

In these cases, how can institutional investors fulfil their fiduciary obligations to monitor their investments properly without access to regular information on the performance of the portfolio and the portfolio manager? Accordingly, investors should ensure that the documentation of any proposed structured finance investment includes a provision for regular reports. These reports should enable investors, for example in a synthetic CDO, to see details of the occurrence of any credit events, Final Price determinations, and the effect on tranche subordination, among other things.

Problems relating to liquidity and finding a means of disposing of a structured finance investment

Questions of liquidity, and obtaining a fair valuation of an investment can be a particularly difficult problem in complex structured finance transactions. It is not always possible to gauge accurately how widely the Notes are distributed (unless the transaction arranger is very open about this or unless the transaction is very clearly a private placement). Therefore it is not possible to know from time to time how easy it will be to find a buyer for any investor that would wish to sell. However, in a structured transaction it is always theoretically possible to liquidate the component parts of a structure in proportion to the seller's holding of the entire deal.

This would involve (i) unwinding a proportion of each related hedge/ derivative contract (which of course will lead to swap breakage costs payable either to, or by, the counterparty); (ii) selling a portion of the underlying assets; (iii) making any required compensation payment to an investment manager (e.g. for loss of future fee income) and so on. It may be that the transaction documentation will deal in precise terms with the way in which these calculations are to be made but in many transactions this has not been the case.

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Investors should examine the transaction documentation to ensure that (1) there is a clear requirement upon the Issuer to buy back any Notes (absent extraordinary market conditions); (2) the valuation methodology of each of the above steps is set out in detail; and (3) the timetable by which this procedure should be carried out is stipulated.

These are just some of the important features of structured finance transactions that are not covered by a typical securities credit rating. The December edition of this newsletter will examine a number of further considerations important to the understanding of key provisions of structured finance transactions.

If you would like to contribute to this discussion please send your comments to: issues@daviddoble.com.
Our next edition will carry a survey of the responses.

Read on...

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ABOUT DAVID DOBLE SOLICITORS

Legal advisory to institutional investors...

David Doble Solicitors was established in London in 2005 to provide legal advice to institutions, within Europe and beyond, investing in complex structured financial instruments.

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