capital markets and funding
FORENSICS

Dissecting a CDO

In the midst of the credit crunch are the debt markets. In the midst of the debt markets lies structured finance, and in the midst of the alphabet soup of structured finance products lurk toxic assets. Within this morass are investors facing losses. How did it come to this? And, faced with a loss, what avenues of redress are available?

There have been downturns before. The big change this time around is that the very nature of debt has changed. For over a decade banks have not simply made loans to corporates but have broken up large loans into smaller packages, converted them into bonds and then sold them to investors in a securitisation process that has offered investors a new type of investment. However, these bonds have themselves been broken up and reprocessed as part of collateralised debt obligations (CDOs) or collateralised loan obligations (CLOs). CDOs and CLOs are open to investors, who have recently seen ratings downgrades, followed by defaults and the risk of losses.

Consider the view of Lord Turner in his first speech as chairman of the FSA: "If by some terrible accident the world lost the knowledge required to manufacture one of our major drugs or vaccines, human welfare would be seriously harmed. If the instructions for creating a CDO squared have now been mislaid, we will, I think, get along quite well without." However, we cannot de-invent the CDO, as investors are becoming all too readily aware. And investors are not simply other banks, hedge funds and private equity funds; they are also corporates and corporate pension schemes, so this is an issue of concern not just to bankers but to treasurers too.

WHAT IS A CDO?

- A CDO is a bankruptcy remote special purpose vehicle which re-securitises debt securities or synthetic interests in debt securities and issues notes with sequential rights.
- CDO securities have risk/return profiles based primarily on structural features of the CDO and the default risks (and recovery rates) of the underlying collateral.
- A CDO investor buys a participation interest in the cashflows from the CDO collateral portfolio.
- Cash CDO collateral typically includes debt securities – asset-backed securities, bonds, loans – which generate cashflows (principal and interest).
- Synthetic CDOs are typically based on credit default swaps written on reference credits.
- Notes are tranched and rated; senior notes have primary rights to payment over junior notes and equity. Senior notes are protected by over-collateralisation, subordination and early amortisation triggers.
- CDO tranches can be credit-enhanced by financial guarantees or credit default swaps transferring risk to third parties.

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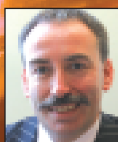
Executive summary

- **All is not lost for the treasurer faced with an investment in a defaulted CDO. Today, there is expertise, technology and data links that can determine what has gone wrong.**

When a CDO goes into default, which will lead to a restructuring, write-down or sale, investors will be split across the capital structure, and will inevitably have differing agendas, making it difficult to reach an investor consensus, which may well compromise negotiations. A so-called optimal solution will be optimal to some note holders, but not to others. But wherever an investor is in the structure, the big question is whether there are opportunities for compensation – or litigation to obtain compensation – for any losses suffered? The answer is a resounding yes!

One obvious remedy is to pursue the mis-selling route, claiming



STEPHEN NORTON PUTS THE CASE FOR STRUCTURED FINANCE FORENSICS.

that the risks were never properly explained. To date, though, the English courts have shown little sympathy for this approach, judging that the investors were sophisticated enough to have known what they were doing. But, sophisticated or not, the investor relies on others to manage the assets in accordance with the structures of the transaction. If they did so, then fine, but, if they did not, that offers a more realistic opportunity for redress.

KEY ROLES AND RESPONSIBILITIES

Cash CDO

- *Collateral manager*: responsible for managing a portfolio of debt obligations that are credit-impaired or credit-improved, and can also engage in discretionary trading of up to (typically) 20% of the portfolio per annum within the limits of the restrictive covenants as set out in the deal documentation. Certain tests must be satisfied so that the liabilities maintain their credit rating.
- *Collateral administrator*: responsible for modelling the deal according to the documentation. Distributes regular reports with a breakdown of the assets, liabilities and covenant tests. Checks collateral substitutions for compliance, and administers cash on both the asset and liability side in accordance with the priorities of payment.
- *Trustee*: holds the security over the collateral and covenants of the issuer on behalf of the note holders. Duties are governed by the trust deed. Generally a passive role unless discretion is required, security needs to be enforced or directed to act on the instructions of the note holders.

Synthetic CDO

- *Collateral manager*: deals can be static, lightly managed or fully managed. A lightly managed deal can be traded by a manager, dealer or the investor. Only a small degree of defensive trading to prevent the portfolio from deteriorating is permitted and trading gains and losses are normally kept outside the transaction. Fully managed deals will allow maximum trading flexibility with trading gains and losses fully borne by the CDO.
- *Collateral administrator*: as for cash CDO.
- *Trustee*: as for cash CDO.
- *Verification agent*: verification events typically occur if the cumulative losses arising from credit events equal or exceed a certain percentage of the threshold amount (say 80%). If such an event occurs, the verification agent will review all credit events to confirm their validity and subsequent claims for losses.

So what does this mean in practice? There are a number of obvious pitfalls.

First, at the very beginning when the deal closed, did the underlying collateral conform to the criteria set out in the prospectus and other marketing material, and to the legal covenants?

Second, during the life of the transaction, investors are sent reports detailing performance. Were these reports received on time or were they occasionally – or even regularly – late? Late reports would indicate a failure to reconcile the portfolio and cashflows on a daily basis. Further, have there been inconsistencies with the coverage test results, and have any profile test results been close to deal triggers?

Third, was sufficient accurate data in place to enable a correct effective date report to be produced?

Fourth, trade substitutions: if reports have been received late – which in itself indicates a failure to reconcile – how can the proposed substitutions have been fully tested? Further, if the changes were tested, were the tests performed accurately and in precise accordance with the often extremely complex documentation. The key point is that mistakes in the monthly investor reports may also have affected investor analysis, secondary market valuations or trading decisions.

FORENSIC ANALYSIS So, having established that there is a problem – or a potential problem – what can be done? This is where structured finance forensics service such as that provided by Law Debenture Asset Backed Solutions (LDABS, a specialist in CDO administration) come into play.

First, such a service will analyse the underlying deal documentation and the investor reports, focusing on areas such as the complexity of the testing requirements, portfolio substitutions, and the closeness of reported test results to triggers. Once this has been completed, and potential problems identified and highlighted, a decision can then be made to develop this into a full forensic analysis, which will involve taking the deal back to the beginning, and reworking it to identify what mistakes were made, when they were made, and who made them.

In essence portfolio positions can be reversed through the life of the deal, retrospective covenant tests can be run and test results or hypothetical trade requests that were inaccurately reported can be highlighted, which could act as a springboard to litigation or financial compensation.

So for the treasurer faced with an investment in a defaulted CDO, whether as a direct corporate investor or via a corporate pension fund, all is not lost. While there may be no desire to reinvent the CDO, the expertise to determine forensically what has gone wrong, to apportion blame, and establish a route for compensation, is now to hand.

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