



# New Beginnings

Practical considerations for legal documentation and market practice for post-credit crisis structured debt transactions

**C L I F F O R D**  
**C H A N C E**

## Introduction

Primary public issuance to private investors in the European structured debt market has been extremely rare since the summer of 2007. However, the lack of new transactions since the summer of 2007 has not meant a shut-down in activity for structured debt professionals. New primary public transactions have been replaced by issuances to provide collateral for central bank liquidity schemes, amendments to existing transactions to deal with, among other things, changes to rating criteria and collateral performance and the constant flood of regulations, legislation and industry initiatives to address perceived lacunae and shortcomings in the structured debt market.

The market-leading Structured Debt Group at Clifford Chance has continued to be closely involved in all aspects of the structured debt market throughout this period and is uniquely placed to use its experience to consider and advise on the issues that have arisen out of the credit crisis and which will need to be addressed in the post-credit crisis structured debt market. Now that there are signs that the primary markets for private investors in European structured debt are beginning to thaw, we believe that the time is right to provide our clients and contacts with our collected views in this publication on how aspects of the post-credit crisis structured debt market should be reflected in legal documentation and market practice going forward.

The approach we have taken in each section is to identify key issues and to provide practical guidance – including suggested legal drafting where appropriate – on how to address those issues. We do not expect all market participants to agree with all of our suggestions and we accept that some of our more radical solutions may not gain traction. Nevertheless, it is, in our view, important that proper thought and consideration be given by structured debt professionals to how legal documentation and market practice should be adapted in post-credit crisis primary public issuance of structured debt to reflect the concerns, problems and gaps exposed by the credit crisis. We do not believe simply muddling along with ad-hoc “fixes” on a transaction-by-transaction basis is tenable.

We hope you find this publication useful and thought-provoking. Should you have any questions, comments or observations please get in touch with your usual Structured Debt contacts at Clifford Chance or one of the Structured Debt partners listed on page 95.



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on behalf of the Structured Debt Group  
London, 25<sup>th</sup> November 2009

# Contents

1. Rating agency confirmations – how necessary will they be?	1
2. Difficult decisions in the capital markets - the role of the trustee	5
3. Servicing and cash management roles in RMBS: a poisoned chalice?	13
4. SPV directors and corporate governance	17
5. The UK covered bond market during the financial crisis: maintaining ratings	21
6. SIVs – lessons from the crisis	27
7. CMBS – the last slice of the dice?	33
8. Disposal of assets: greater flexibility all round?	39
9. New rules for a new way forward for commercial mortgage lending	45
10. Synthetic securitisations, CDO <sup>2</sup> and CLNs – distant memories or sleeping beauties?	53
11. OTC derivatives in structured debt transactions	57
12. Investor disclosure	67
13. Lifting the regulatory fog - will the amendments to CRD reveal a new landscape?	71
14. Re-securitisation – holding a costly position	77
15. Bank and building society insolvencies revisited: the impact of the Banking Act	81
16. Government asset schemes and their impact on securitisation	87
17. ECB liquidity transactions - a refresher and an outlook on changes to come	91

1. Rating agency confirmations  
– how necessary will they be?



In this section we explore the differing attitudes of the rating agencies towards the concept of rating agency confirmations (RACs) in the current market, how these impact on both existing and future transactions; the reactions of trustees towards the RAC (or the lack of it), its impact on the trustees' discretion as to material prejudice and ways to address these in existing and future transactions. In our view, requirements to obtain an RAC in existing documentation should not be interpreted by trustees as an imperative prerequisite before exercising its own discretion. In new transactions, replacing an RAC with a determination as to the likely rating effect by other transaction parties responsible for the ongoing management of the transaction could be an appropriate alternative.

Broadly speaking, a rating agency confirmation or affirmation (an "RAC") is a written statement issued by the rating agency that confirms, post-closing, that a proposed action in respect of the relevant transaction will not result in a downgrade or the withdrawal of current ratings of the notes. Traditionally transaction documents may require that certain waivers in respect of, or amendments to, existing transaction documents, changes of counterparties (e.g. servicer, liquidity or swap provider), substitution or addition of assets or changes in certain ratios set out in the transaction documents are contingent upon the receipt of an RAC.

### Rating agency attitudes post-credit crunch

There is currently no market standard, nor published criteria, in relation to when an RAC will be provided upon request, although we note that there was an increasing reluctance to give RACs even before the credit crunch. During the credit crunch, Fitch have taken the most firm view and have issued a report<sup>1</sup> stating that they will no longer provide RACs in connection with structured credit transactions and, in the event that an RAC is requested, Fitch will direct the relevant trustee to the aforementioned report. The rating agencies have argued that they have traditionally taken the role of an independent observer of the

transaction who will rate the credit risk of the issued liabilities based on the transaction documents at the time of closing. Rating agencies are not parties to the documentation and will not have been involved post-closing. Rating agencies, in particular Fitch, have therefore stated that it is inappropriate for them to be asked to sanction, confirm or advise upon any post-closing amendments to the transaction. It seems that Fitch is applying this policy to existing transactions even when there are provisions specifying the circumstances under which an RAC is required.

In contrast, it appears that Moody's, who have not issued any formal guidance, are still minded to give RACs for existing transactions where the documents require RACs to be provided. In new transactions however, we note that Moody's have resisted the inclusion of RAC language in most cases, with the exception of certain principal matters (determined on a case by case basis) where Moody's may still require an RAC to be given.

S&P does not appear to have changed its policy and seems generally receptive to giving an RAC when required under the relevant transaction documents.

Whilst there has been some push back on the provision of RACs by rating agencies, RACs can be distinguished from mere notifications to rating agencies. Fitch, in particular, has stated that it will require

notification of changes to transactions. Fitch may determine whether such changes are material and may issue its opinion in a public statement if such change is deemed material or results in a change of Fitch's rating opinion.

In practice it is simply unrealistic to expect changes to be made to existing transactions without proper consideration of the impact on the then current ratings and this will imply, in most cases, a level of engagement with the rating agencies prior to implementation of such changes regardless of their policies on RACs.

### How has the change in approach affected existing and future transactions?

#### Existing Transactions

There is currently much uncertainty as to what the response from the rating agencies would be upon a request for

"Fitch has stated that it is inappropriate for them to be asked to sanction, confirm or advise upon any post-closing amendments to the transaction"

<sup>1</sup> "Structured Credit Criteria for Reviewing Post-Closing Actions" published by Fitch Ratings 2009

an RAC, which is specified under existing documentation to a transaction. One typical scenario is in the context of amendments to transaction documents or waiver in respect of a breach under the transaction documents. Very often, documents will have provisions to the effect that the trustee may grant consent to a proposed waiver or amendment without noteholders' consent if such matter is not materially prejudicial to the interest of the noteholders or if an RAC is given.

The reference to the latter has created, in our view, a three-fold miscomprehension in the market in the past. First, on the part of the originator, that as long as an RAC is provided, the trustee will give consent as a matter of course; second, on the part of the rating agencies, that they have an "obligation" to provide an RAC and that the matter is contingent on the provision of an RAC; third, on the part of the trustee, that it will not exercise its discretion unless an RAC has been obtained (preferably from all rating agencies that have rated the transaction). During the credit crunch, where this type of language has been tested on a large scale, it has become clear that when an RAC is used in conjunction with trustee discretion, the trustee will always be required to exercise its discretion and should not rely upon the opinion of rating agencies to affirm the course of action to be taken in a particular matter. In our experience, trustees have now clarified, on many occasions, that an RAC is helpful to their analysis, but is not essential in enabling them to reach a view as to material prejudice. In our experience, trustees have also been willing to exercise their discretion where an RAC was not forthcoming from all rating agencies. We believe both of these positions are correct and are an inherent part of the trustee's role. For a more

detailed analysis of trustee discretion, see the section entitled "*Difficult decisions in the capital markets - the role of the trustee.*"

#### **Future Transactions**

It has been our experience that though the rating agencies have moved away from RACs in certain circumstances, to differing extents, Moody's and S&P continue to be willing to issue an RAC in relation to post-closing matters that are fundamental to the rating analysis of the transaction. Drafting counsel should also be aware of the circumstances in which an RAC would be required due to the nature of the relevant matter. It is therefore important that the rating agencies are involved early on in reviewing documentation language for future transactions as the views of the rating agencies differ materially in this area.

Where traditionally an RAC would have been required but, due to the change of internal policy, the relevant rating agencies refuse to include RACs in the transaction documents, we consider the following two alternative approaches should be acceptable to both the rating agencies and transaction parties, with the first approach being the preferred one. These approaches have been included by Clifford Chance in a number of completed transactions:

#### **(a) Replace an RAC with a determination by another transaction party**

In some transactions a party who is close to and involved in the day-to-day management of the transaction, for example a servicer or cash manager, is best placed to provide a confirmation that the relevant amendment will not, in its opinion formed on the basis of due

**"In practice it is simply unrealistic to expect changes to be made to existing transactions without proper consideration of the impact on the then current ratings"**

consideration, result in the downgrade or withdrawal by the rating agencies of the rating. To form such an opinion, it is expected that the relevant transaction party will liaise and consult with the rating agencies or will be able to rely on published rating criteria. This is, in our view, nothing more than an accurate reflection of the actual process taking place. It has been our experience that this language is, in most cases, acceptable to the transaction parties and to the rating agencies.

#### **(b) Definition of "Rating Agency Confirmation"**

In some transactions, the definition of RAC has been amended to include the concept that if the relevant rating agency has been approached in relation to the requirement to obtain an RAC and has not provided an RAC within a specified period of time (nor has it given any negative feedback within such timeframe) the relevant rating agency shall be deemed to have provided such RAC.

Though this wording has been accepted by the rating agencies in certain deals, in our view the concept of a deemed RAC should ideally be avoided due to the fact that it leads to inherent uncertainty for the transaction parties.



## 2. Difficult decisions in the capital markets - the role of the trustee



This section examines the difficulties which arise for issuers who need to communicate quickly or informally with noteholders and for trustees asked to give their consent under existing transactions in the context of modifications, waivers, consents and appointment of replacement third party service providers. The downturn in the market and the increased need to revisit existing documentation in the context of, in particular, rating downgrades and restructurings has brought these issues to the top of the agenda for originators, issuers, trustees and investors alike across the market.

- How to assist a trustee to use its discretionary powers to agree to modifications or waivers or give its consent under the documents given the difficulties with it getting instructions from noteholders.
- Improving the existing mechanics for communicating with noteholders and/or getting their input outside of formal noteholder meetings.
- Ensuring the trustee can amend manifest errors or make technical/minor amendments without noteholder consent even if the amendments are in respect of a Basic Terms Modification/Reserved Matter.
- Dealing with ratings downgrades in respect of third party service providers.

### What we are seeing in the market?

The need to anticipate (and document accordingly) the likely areas in a transaction where the originator/issuer/lead manager will require ongoing amendments/consents to increase the likelihood of the trustee being able to exercise its discretion in the absence of noteholder consent. If noteholder input is inevitable, the need to achieve simpler and more accessible channels of communication.

This section sets out a number of specific issues that have arisen in our recent experience with trustees on structured finance transactions and which, until the “credit crunch”, had rarely been at the forefront of interested parties’ minds. These issues have critically exposed constraints on parties’ ability to react in good time and measure to some of the problems caused by the recent turmoil in the financial markets and have had an adverse effect, or caused considerable frustration for all concerned. They need to be resolved or mitigated as a matter of priority.

The approach we set out below is not a panacea and will vary between different types of structures, product types, regulatory and jurisdictional issues, transaction as well as the role assigned to the trustee and the commercial expectations of the parties. However, if trustees will be required to take a more active role in future transactions whilst communications with noteholders remain difficult, then the documentary provisions will need to give the trustee more assistance and guidance than previously provided to enable them to do so.

### Recent rating downgrades

A familiar problem faced by trustees in the market in recent months arose in the context of a number of entities performing the role of swap counterparty, liquidity facility provider and/or account bank suffering rating downgrades taking their rating below the requisite level required by the terms

of existing transactions (but not, however, below the level required by more recent revised rating agency criteria published after the closing date of existing transactions).

These downgrades triggered provisions in existing transactions which would impose onerous obligations on the relevant entities to post collateral or, in the case of liquidity facility providers, to make a stand-by liquidity drawing available to the issuer and, in many cases, require the relevant issuer to find a replacement entity with the requisite rating to perform the relevant role (which is often a difficult task in the current markets). These provisions were triggered notwithstanding the fact that the relevant entity continued to meet the requisite ratings required by more recent published rating agency criteria for transactions of the type in question and this led to issuers and/or counterparties seeking trustee consent to amend or waive the required rating definitions in existing transactions on the basis of the revised published rating agency criteria and rating agency confirmations of the ratings of the notes.

Trustees have, however, been faced with inflexible language used in the required ratings definitions in existing transactions and in many transactions, the relevant trustee has been unwilling to exercise its discretion under the No Material Prejudice Limb (see “*Trustee discretion – modifications, waivers and consents*” below) and instead took the decision to call noteholder meetings in order to

approve the amendment and/or waiver. Due to the relatively innocuous nature of such proposals and inability to enfranchise noteholders, the trustees have in many cases struggled to obtain quorum at the relevant noteholder meetings and the process for agreeing such waivers or amendments has been cumbersome. To avoid these problems in future transactions, our recommendation is that flexibility should be built into all required rating definitions with suggested drafting along the following lines:

“The Issuer Account Bank shall at all times be a financial institution having a short-term senior unsecured debt rating of at least “A-1” by S&P (or, where no short term unsecured debt rating by S&P is available and a long term rating of the account bank is available, at least “A” by S&P) and at least “F1” by Fitch (or “A” (long-term) by Fitch if the relevant entity does not have a short-term rating) and at least “P-1” by Moody’s (or, where no short term unsecured debt rating by Moody’s is available and a long term rating of the account bank is available, at least “A2” by Moody’s) or such other ratings that are consistent with the then published criteria of the relevant Rating Agency as being the minimum ratings that are required to support the then rating of the Most Senior Class of Notes (the “Issuer Account Bank Required Rating”). In the event that the Issuer Account Bank no longer satisfies the Issuer Account Bank Required Rating, it shall notify the Issuer, the Cash Administrator and the Note Trustee as soon as practicable and the Issuer, with the consent of the Note Trustee, shall use reasonable endeavours to procure that a replacement Account Bank, satisfying the Issuer Account Bank Required Rating is appointed in accordance with the provisions of the Account Bank Agreement within 30 calendar days.”

### Trustee discretion – modifications, waivers and consents

The modification and waiver provisions in securitisation transactions traditionally give the trustee a discretion to agree to modifications and/or waivers without the need for noteholder consent under two limbs, namely (1) amendments/waivers which would have no material prejudice (the “No Material Prejudice Limb”); and (2) formal, minor or technical amendments or amendments required to correct a manifest error (the “Manifest Error Limb”). These provisions are designed to circumvent the lengthy process and costs involved in calling noteholder meetings in situations where the modification or waiver in question should, by virtue of the nature of the modification or waiver in question, be non-controversial (or, in the case of a manifest error, be required to correct a clear mistake).

In addition, it is common for securitisation transactions to require a trustee to give its consent to a variety of changes during the lifetime of a deal ranging from, for example, approving the appointment of a new service provider to agreeing material commercial changes in respect of the underlying asset pool (a “Consent Provision”). However, as the complexity of securitisation transactions has grown, it has become increasingly difficult for a trustee to determine whether or not it should give its consent, particularly as little or no real documentary guidance has been provided for the trustee in these more complex circumstances.

### No Material Prejudice Limb

In the current climate, issuers/originators have been and are likely to continue to face challenges when seeking to utilise these provisions or restructure existing transactions

based upon the No Material Prejudice Limb/Consent Provision in light of the lack of guidance/parameters traditionally given to trustees to enable them to make such a determination.

In a number of highly structured transactions - in particular, whole business securitisations - clear, disclosed guidelines have been hard-wired into the documentation in connection with the No Material Prejudice Limb/Consent Provisions to assist the trustee in making its decision as to whether a matter will or will not cause material prejudice to the Most Senior Class of noteholders (or, as will be the case in whole business securitisations, the wider universe of creditors (including the noteholders)) or to set out the basis on which it should give its consent.

Such guidelines might take the form of certain key statements enshrined in the documentation as to what will and will not constitute material prejudice (i.e. “the amendment or waiver will not adversely impact the obligor’s ability to make payments due in respect of the [Notes]/[debt]”) or, with the Consent Provision, set out clearly how the Trustee will decide whether to give its consent eg “without the consent of the trustee (the Trustee relying on the advice of [specify relevant expert])” or “the Trustee shall give its consent if provided with a certificate signed by XYZ confirming ABC”.

Another example is that, if the transaction documentation grants permission to the Issuer (or a servicer on its behalf) to amend the economic terms of an underlying loan subject to trustee consent, the trustee’s consent to such amendment could be pre-wired into the documents providing that as a result of such amendment, certain parameters set by reference to a pre-closing agreed financial model (one

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which has been agreed by the originator and the lead manager) are not breached. The relevant parameters should be coupled with a certification obligation in favour of the trustee from either the originator or other third party service provider having relevant knowledge in relation to the underlying financial model and the trustee should be enabled to grant its consent solely by relying on that certificate.

The aim of these examples is to enable the trustee to give its consent after it has been provided with the relevant certification/provision of expert advice/other without noteholder approval. Whilst it may not, without the benefit of foresight, be possible to tailor this concept to the No Material Prejudice Limb/Consent Provisions on a general basis, if the transaction parties are aware at the outset of aspects of a transaction where they know they want the flexibility to change them during the lifetime of the deal, the use of such a mechanic could bring greater certainty and efficiency to trustee decision making going forward.

Provided that these indicators of material prejudice/consent are disclosed to investors in the prospectus, we believe that the trustees, originators and investors can all benefit from clear parameters upon which to build a trustee's decision making process as to whether an amendment/waiver causes material prejudice or whether its consent should be given (noting that in conjunction with these guidelines the trustee is also likely to seek a rating agency confirmation to support its decision – although readers should note our discussion on the future of rating agency confirmations in *“Rating agency confirmations - how necessary will they be?”*).

This model has not previously been adopted for more vanilla paradigm true sale securitisations and we would suggest, in light of the challenges being faced by trustees on many of these transactions, that serious consideration should be given to a similar model being followed for all transactions going forward to increase clarity for trustees and to also raise the likelihood of issuers/originators being able to utilise the No Material Prejudice Limb/Consent Provisions to full effect in appropriate circumstances whilst still protecting investors' interests.

Notwithstanding the above, in all cases we would (in our view rightly) expect to see Basic Terms Modifications/Reserved Matters carved out of the No Material Prejudice Limb thereby entrenching the most fundamental provisions for the benefit of all classes of noteholders (see the example drafting and our discussion on the same below in relation to the Manifest Error Limb).

#### **Manifest Error Limb**

We are aware of a number of transactions in the market where the

manifest error discretion given to the trustee has carved out any amendments which constitute “Basic Terms Modifications” or “Reserved Matters”. The Basic Terms Modification/Reserved Matter concepts were established to protect noteholders against changes to provisions fundamental to the noteholders, such as the interest rate payable on the notes or the due date for payment of interest or principal. They are an important part of the bargain between the investors and the issuer. However, in order to facilitate efficient and pragmatic decision making, in circumstances where an amendment to a provision is necessary to correct a manifest error or is of a formal, minor or technical nature, the trustee should not be constrained by the Basic Terms Modification or Reserved Matter restriction and should, in these circumstances, have the ability to agree to such amendment without noteholder consent even if the proposed amendment is one that would otherwise fall within the Basic Terms Modification/Reserved Matter definition.

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“we believe that the trustee can benefit from clear parameters upon which to build its decision making process as to whether an amendment/waiver causes material prejudice”

If there is a manifest error in a provision, for example, the interest rate/maturity date, it is important that the Trustee has the ability to correct this.

If the Manifest Error Limb is made subject to the Basic Terms Modification or Reserved Matter restriction, this will result in time, cost and inconvenience (or at worst, an impasse) for a non-controversial amendment or (in the case of manifest error) a necessary amendment to the documents to reflect the original commercial intentions of the parties. Subject to the trustee being given satisfactory evidence that the amendments fall within the Manifest Error Limb, the use of its discretion in these circumstances should not be considered detrimental to noteholders (and, in the case of manifest error) beneficial. It is therefore important to ensure that in new transactions, the modification and waiver condition (and the corresponding clause in the underlying trust deed) is drafted in the way proposed, with the Basic Terms Modification/Reserved Matter concept applying only to the No Material Prejudice Limb of the discretion and not to the Manifest Error Limb. An example of such a clause is set out below.

#### Sample drafting

The Trustee may, at any time and from time to time, without the consent or

sanction of the Noteholders or any other Secured Creditors, concur with the Issuer and any other relevant parties in making:

- (a) any modification to these Conditions, the Trust Documents (other than in respect of a Reserved Matter or any provision of the Trust Documents referred to in the definition of a Reserved Matter)<sup>2</sup>, the Notes or the other Transaction Documents in relation to which its consent is required which, in the opinion of the Trustee, will not be materially prejudicial to the interests of the holders of the Most Senior Class of Notes then outstanding; or
- (b) any modification to these Conditions, the Trust Documents or the other Transaction Documents, in relation to which its consent is required, if, in the opinion of the Trustee, such modification is of a formal, minor or technical nature, or is made to correct a manifest error.

#### Most Senior Class

There will inevitably be situations where a trustee is asked to consent to modifications or waivers in circumstances where it feels unable to exercise its discretion on behalf of noteholders under either the Manifest Error Limb or the No Material Prejudice Limb and will instead seek the direction of noteholders in respect of the relevant modification or waiver. In such circumstances, we have found that documentation is often unclear (or indeed silent) as to which class of noteholders the trustee should turn to for direction where the particular amendment or waiver affects or may cause material prejudice to more than one class of noteholders. This has resulted in trustees taking the cautious

approach of calling meetings of each class of noteholders before agreeing to consent to the relevant matter, which leads to delays and often to statement between different classes of noteholders.

We are of the view that for the purposes of modifications, waivers and consents where the trustee has not chosen to exercise its discretion under the Manifest Error Limb or the No Material Prejudice Limb (excluding Basic Terms Modifications/Reserved Matters), the transaction documentation should give clear and consistent authority to the trustee to seek directions from the noteholders in respect of the Most Senior Class of notes only (without regard to the effect of such direction on the junior ranking classes of notes). This approach will serve to make a typical structure more dynamic and will enable trustees to be more responsive to requests for amendments, waivers and consents. Whilst we accept that there may be a debate on this point in some existing transactions where junior noteholders are seeking to exert pressure on trustees in respect of restructurings and are looking for a seat at the table, particularly where their views differ from those of the Most Senior Class of notes, for transactions going forward, we are of the view that this is the cleanest approach to take and aligns

“if there is a manifest error in a provision, for example, the interest rate/maturity date, it is important that the trustee has the ability to correct this”

<sup>2</sup>Note: as discussed, the Reserved Matter carve-out is not included in limb (b).

with the risk that junior noteholders take when buying notes ranking further down the capital structure (bearing in mind that all noteholders will continue to benefit from the Basic Terms Modification/Reserved Matter mechanics). From a documentation perspective it will be important to ensure that this risk is clearly disclosed to investors and that all aspects of the documentation (from the terms and conditions of the notes to the underlying trust deed) align with this position.

### Sub-Classes of Notes

Where a trustee is seeking direction from a particular class of noteholders (whether as a result of a Basis Terms Modification/Reserved Matter or where the relevant class is the Most Senior Class of noteholders) and that class comprises several “Sub-Classes”, documentation should give clear authority to the trustee to call a combined meeting of all Sub-Classes unless it considers that would be materially prejudicial to the interests of the holders of one or more Sub-Classes within a class (rather than the more usual “conflict” language). This is to decrease the occurrence of multiple meetings of sub-classes of noteholders who rank equally in all material respects in the waterfall (and whose commercial interests should therefore be aligned). Failure to hold combined meetings of sub-classes in these circumstances can unnecessarily exacerbate the chances of not passing an extraordinary resolution.

### Channels of communication with noteholders

If a trustee is unable to exercise its discretion as described above, the formal

decision making process in capital market transactions is generally cumbersome and inflexible, requiring the trustee to obtain consent from a class or classes of noteholders using the noteholder meeting provisions in the trust deed. These provisions require a physical meeting of noteholders and are more suited to binary decision making where noteholders can vote for or against a defined proposal. Likewise, current communication methods for issuers/service providers to contact their investors are neither swift nor designed for continuous and/or informal dialogue with them, be it in a restructuring situation or otherwise. Issuers and trustees alike are also materially constrained in their ability to communicate freely with investors due to, for example, stock exchange rules, the market abuse directive and their obligation to communicate any material information to all investors at the same time (rather than to just those whose identity is known to the issuer/trustee).

All these issues have caused problems in existing transactions throughout the credit crisis (particularly with restructuring proposals naturally evolving during any consent process and/or when investors were desperate to receive information about their potentially (or actually) defaulting securities).

Frequent delays in investors receiving notices/other communications from issuers/trustees was a specific concern highlighted by investor representatives at this year’s ESF/IMN ABS conference in London. Delay arise in particular given that such notices generally have to be sent through the clearing systems and so pass through a chain of sub-custodians, often using non-standard communication format. The

“current communication methods for issuers/service providers to contact their investors are neither swift nor designed for continuous and/or informal dialogue with them”

consequence of this is two-fold: (i) information contained in notices to investors may change and may reach the final recipient in summary form – hardly ideal if the matter requires timely consideration and response regarding potentially complex, commercially important issues; and (ii) due to delays in transmission, investors are unable to attend the relevant noteholder meetings causing unwelcome delays and costs for all.

Many investors would welcome more flexibility in the way that information is communicated to them. Most investors prefer to receive notices via Bloomberg or Reuters (for example). Provided the information is published in accordance with the rules of the relevant stock exchange and clearing systems and making such information public does not breach any applicable market abuse legislation, it makes sense to expressly include references to these alternative communication methods going forward in standard notice provisions of the terms and conditions.

At the very least, within the current noteholder meeting regime, in order to mitigate the problems arising from such a binary decision making process, mechanics need to be developed (with

## “Many investors would welcome more flexibility in the way that information is communicated to them”

appropriate controls to protect investors’ interests) to allow resolutions put to noteholders at meetings to be amended at the meeting itself or upon the vote of a noteholder representative committee in order to avoid the need to call a further noteholder meeting (and wait for the required notice periods to expire) to deal with a revised resolution. Another idea could be to give issuers or trustees the ability to cancel meetings once they’ve been called (again, with appropriate controls) rather than to require the Issuer to go through the cost and time of holding, for example, original and adjourned inquorate meetings when it’s clear that the resolution will not be passed.

However, we also support the development of new mechanics to facilitate decision making outside of the existing communication methods and noteholder meeting regime. Such new mechanics could take the form of “creditor representatives”, being an investor or group of investors acting on behalf of the noteholders as a group, and the establishment of steering committees akin to those used in the bank lending market. Another option is the appointment of a “commercial expert”, being a third party service provider acting to collate the views of the noteholders and advise the trustee accordingly. Clauses can be included in the noteholder meeting provisions of the trust deed to contemplate noteholders voting on the appointment of such representatives or experts. Where formal

mechanics for representative/creditor committee/expert decision-making are put in place, in our view, the trustee should be removed from the decision making process altogether (other than in respect of Basic Terms Modifications/Reserved Matters) (and in turn, this would also serve to remove the requirement of any such representative/creditor committee acting on behalf of the noteholders to indemnify the trustee in these circumstances).

Inevitably, mechanics of this nature will bring their own challenges, for example: (a) where the costs of third party “commercial experts” will be met in the waterfall of payments – the “commercial expert” will expect these to rank super-senior but rating agencies may have concerns over potentially open-ended costs being met in priority to payments on the notes; (b) whether such expenses (and liabilities of any investor representative) can be recovered through the super-senior provision at the top of the waterfall; (c) whether the market will see creditability in such mechanisms at the outset – it will inevitably take time for participants to gain confidence in any such communication channels; (d) whether there is merit in noteholders having the ability to switch on/switch off such mechanics in certain scenarios. Whilst this is a developing area, our view is that noteholder meeting provisions in the trust deed should allow for such appointments, such appointment parties should be remunerated for their fees through the issuer waterfall at the same level as the trustee’s fees and expenses (however any indemnity required by the representatives would be provided by the noteholders themselves and would not be met by

the Issuer through the waterfall) and that noteholders can vote to discontinue such decision making arrangements at any point, reverting to the traditional noteholder meeting mechanics.

## Appointment of replacement third party service providers – trustee discretion to select a replacement

Most termination provisions in cash management and servicing agreements give the trustee discretion to agree with the issuer to appoint a replacement third party service provider following the termination of an existing appointment. The challenge for the issuer and the trustee is in coming to an agreement on a suitable replacement in the absence of any explicit guidelines written into the termination provisions.

Our view is that this issue can be differentiated by reference to two scenarios:

- **if the originator of a transaction is solvent and not in default:** the replacement third party service

Such new mechanics could take the form of “creditor representatives”, being an investor or group of investors acting on behalf of the noteholders as a group, and the establishment of steering committees akin to those used in the bank lending market

provider provisions should expressly contemplate the originator/servicer performing the primary role in terms of identifying a suitable replacement entity with the issuer being the entity formally appointing such replacement and the trustee consent to such appointment being pre-wired provided that the replacement entity satisfies the relevant rating criteria and any other specified criteria (e.g., in an RMBS transaction, any replacement administrator must have “experience servicing residential mortgage loans in the United Kingdom”); and

- **if the originator/servicer is insolvent or otherwise in default:** the replacement third party service provider provisions should require the issuer and the trustee to agree a

replacement entity. To facilitate trustee consent, this scenario is ideally suited to the proposals discussed above in relation to noteholder representatives/commercial experts.

### Conclusion

What we hope this section highlights, is the range of problems being encountered in relation to trustee decision making on existing transactions and the types of solutions which in our view need to be considered going forward. These solutions range from simple drafting fixes which should hopefully iron out uncertainty and reduce the likelihood of impasse between classes of noteholders if incorporated into future transactions to more complex proposals which will require thought from originators, issuers, trustees and investors alike across the market. Needless to say, these solutions will not necessarily serve to remove the problems being faced by parties on existing transactions and it remains to be seen whether further lessons will be learnt from the current restructurings taking their course over the coming months.

3. Servicing and cash management roles in RMBS: a poisoned chalice?



The failures during the credit crunch of several originators of residential mortgages have brought into sharp relief the practical difficulties that may be faced by servicers and cash managers in the day-to-day operation of RMBS deals. These issues have been particularly acute where the originator or seller does not have an ongoing involvement as servicer or cash manager. Further, the failures or downgrades of other transaction parties (such as swap providers, liquidity facility providers or account banks) have brought about new challenges in administering mortgage pools and determining cash flows.

### Mortgage Administration

We expect there to be more focus on the servicing and cash management arrangements being documented through arms-length, fully inclusive agreements, rather than “broad-brush” SPV documents where some aspects of day-to-day operation may be left to be figured out after the transaction has closed. A number of specific aspects are considered below:

#### Fees, Costs and Expenses

The amount of fees payable to servicers is typically expressed as a percentage of the aggregate amount outstanding in relation to the underlying portfolio of mortgage loans. This arrangement may be less than ideal for servicers (particularly third party servicers who are not the originator/seller) in circumstances where the performance of the portfolio has deteriorated, or an originator/seller has suffered an event (such as insolvency or administration) amounting to a perfection event. In such circumstances, the servicer may be required to do substantially more work than originally anticipated, particularly if it is necessary to perfect the issuer’s legal title to the loans (by notifying borrowers) and related mortgages (by executing the relevant transfer documents and lodging those with HM Land Registry). Unlike in CMBS transactions, where an increased level of fees payable to “special servicers” reflects the increased level of work required where borrowers are in default, the typical RMBS transaction documents do not provide for such an increased level of fees.

It would be advisable to specifically consider the different scenarios, and include provisions that specifically address each of these scenarios; an example might be providing for a higher level of fees where larger than expected numbers of borrowers are in default (for example, during a recession).

Whilst a servicer will typically be able to recover the resulting increase in its “out-of-pocket” costs and expenses from the issuer, it is often not contemplated that the servicer be remunerated for the extra time it has spent in doing the work. In addition, the term “out-of-pocket” costs and expenses itself may not be broad enough to encapsulate expenses of a servicer which may be incurred in extraordinary circumstances.

Whilst we do not expect a radical change, such as the introduction of a CMBS-style special servicer role in future RMBS transactions, we expect that servicers may consider the increased amount and complexity of the work that may be required at different stages in the life of a deal; particularly given that it will have to be performed at a time when the transaction cash flows may be under pressure due to the performance of the portfolio, or when the portfolio may be in jeopardy due to an originator’s failure. This may be reflected in more sophisticated contractual provisions relating to fee arrangements and the recovery of costs and expenses.

This was perhaps less of an issue when the RMBS market was largely

performing, but now there is much more for the servicer to do and, potentially, without additional compensation.

Previous practice is perhaps a result of the parties underestimating the role before agreeing fees, or assuming that the mortgages will continue to perform in line with historic averages. Going forward, it will be of far greater importance where the roles of originator/servicer are split at the outset, although it would be wise to contemplate a potential split of roles during the life of the transaction (for example due to the sale of parts of an originator’s business).

Potential solutions or features which are likely to be included in future agreements are provisions which provide for the review of servicer fees in certain circumstances (though this may be resisted by the issuer who may prefer fees to be renegotiated subject to agreement with the issuer or subject to a pre-determined cap) and more comprehensive provisions detailing which expenses can be reimbursed.

#### Borrower Administration Fees

A number of transactions contain provisions carving out certain fees

“the servicer may be required to do substantially more work than originally anticipated”

payable by borrowers for particular services performed by the servicer (for example, at the request of the borrower providing a lender's reference or a redemption statement) from the general pool of receipts, and paying this to the servicer outside the general revenue waterfalls. However, over time and as the aggregate balance of the portfolio diminishes and redemptions, transfers of mortgages, and other changes in borrowers' circumstances become more frequent, such fees may become an increasingly important part of the economics of a deal for servicers. In addition, where the maximum amounts of such fees are specified in the servicing agreement and there is no specific mechanism for increasing the amounts, the amount of the fee chargeable for a particular service may, over time, become inappropriately small. In this context it may also be worth considering whether or not the underlying loans (i.e. the agreements with borrowers) provide for an increase in the amounts or types of fees that might be charged. We anticipate that, at the time of entering into a transaction that contains this structural feature, servicers may want to do some due diligence on the terms and conditions of the underlying loan agreements (or require assurances from originators/sellers in this regard).

## Cash Management

In a typical RMBS transaction, the cash managers have little, if any, discretion to make determinations about how to apply cash in a deal. This would generally have been the commercial intention where the cash managers would not want to be responsible for making "judgment calls" in relation to amounts payable to noteholders and other parties.

However, this has caused some difficulty in practice where an unexpected situation arises which is not provided for in the documents or, for example, where assumptions are made in relation to the calculation of amounts and these assumptions subsequently transpire to be false. In such circumstances, cash managers have at times been left without clear instructions in these unanticipated situations; either where there seems no clear direction on how a certain amount should be calculated or where there are clear instructions, but following these to the letter would lead to an economically "odd" result which is unlikely to be what was originally intended by the transaction parties.

Problems include potential liability for the cash manager where it has an absolute obligation to calculate an amount to be paid but to do so is impossible without the cash manager having to interpret or deviate from, the documents or calculations and payments are required to be made where results appear contrary to what the parties commercially agreed. This might even result in cash becoming "stuck" inside the deal.

In many of these situations the cash manager has no ability to make its own decisions, nor is there provision for recourse to another transaction party or to the decisions which would be made by a prudent cash manager acting in accordance with market standards. In practice, seeking to obtain direction from the issuer and/or trustee in such situations has been unproductive.

Potential solutions might, for example, include:

- (i) adding more detail and trying to anticipate these unexpected circumstances, resulting inevitably in significantly longer and more

We expect that, where transactions provide for such a fee payable to the servicers, it is likely that servicers would want to incorporate such a mechanism in the servicing agreement. This may, for example, be drafted as follows:

- (1) by incorporating a provision in the Mortgage Administration Agreement that provides that:

"A current list of servicing activities in respect of which Borrower Administration Fees will be payable, and the current level of fees associated with each such activity (which activities and/or fees are subject to being changed from time to time in accordance with the terms of the Loans by the Mortgage Administrator acting as a Prudent Mortgage Administrator) is set out in the Schedule to the Mortgage Administration Agreement."

- (2) by including a defined term stating that:

**"Borrower Administration Fees"** means all amounts relating to fees payable by Borrowers in respect of specific servicing activities undertaken by the Mortgage Administrator in respect of Loans following their origination in respect of which the relevant Borrower is, under the terms of the Loan, obliged to pay a fee.

Whilst such, or similar, clauses have been included in certain deals, we expect to see more emphasis on ensuring this flexibility going forward.

comprehensive documents. However, since it is not possible to anticipate all eventualities, this may amount to “moving the goal posts” without changing the game. We do, however, think more time will be taken to deal with, at least, the situations which have arisen most commonly in the credit crunch.

- (ii) providing for the cash manager to use its discretion, act in accordance with market practices or to have opportunity to consult with or seek direction from other parties, e.g. trustees, where the documents are inconclusive or appear to lead to economically bizarre results (and expressly obliging such third parties to give such a direction within a specified time). However, we anticipate that giving such discretion to the cash manager may be unpopular with arrangers and cash managers alike.
- (iii) limiting the liability of cash managers in relation to such decisions and requiring the issuer itself to make decisions where the documents are unclear (but issuers may not want this responsibility; we

discuss the possibility of an increased and more active role for issuers and their directors elsewhere in this publication – see “*SPV directors and corporate governance*” on pages 17-20).

### Conclusion

It is our experience that, over time, practices in relation to administering mortgage loans may change, which can lead to some differences between what the transaction documents anticipate and how the assets are administered in practice. In addition, as events that were previously considered to have a very remote likelihood of occurring have in fact occurred over the past couple of years, many parties have suffered losses or have in practice been unable to perform their functions as expected without, for example, going to noteholders for directions.

We anticipate that transaction parties may in future spend more time considering exactly how each part of the process will operate in practice, to ensure that all documents actually reflect working practices and processes, and on the other hand, making some provision for changes to working practices. This will likely result in longer, more comprehensive (and more robustly negotiated!) servicing and cash management agreements.

## 4. SPV directors and corporate governance



The sudden collapse of Lehman Brothers in September 2008 and the unprecedented economic conditions since have thrown up a range of dilemmas for parties to securitisations. The transaction documents typically did not envisage the possibility of a counterparty becoming insolvent overnight - for example, rating downgrade triggers and related covenants envisaged a more gradual replacement mechanism.

The purpose of this section is to provide a summary of the governance issues facing SPV directors and trustees in light of the current economic circumstances and to suggest a number of practical solutions to these issues going forward.

In this section we consider the decisions, which are ultimately commercial, that underpin the role and responsibility of finding and appointing replacements and ask who is best placed to take these decisions; the duties of SPV directors; and the need for professional advice and improved documentation to help the decision-making process.

### **To whom should the role of finding a replacement counterparty be allocated?**

Generally, the trustee (in its capacity as security trustee holding security over the Issuer SPV's rights under the transaction documents) has no duty under the transaction documents to exercise any of its rights or powers prior to an event of default of the Issuer SPV and/or the security becoming enforceable (and this, of necessity, will not occur simply because a transaction counterparty has defaulted). However, as any amendment or modification to the transaction documents (including the appointment of a successor agent by the Issuer SPV) will inevitably require trustee consent, trustee involvement in replacing a transaction counterparty is a pre-requisite. To the extent the trustee can exercise its discretion to consent to any amendments or modifications, this is typically where the change is not (in its determination) materially prejudicial to the noteholders. The commercial ramifications of exercising the Issuer SPV's rights of termination under

a contract and the decision to appoint a replacement (at market rates which may differ from the deal struck with the original counterparty), make the material prejudice test difficult to determine, especially where a conflict between classes of noteholders could be construed.

Therefore, rather than exercise its discretion, the trustee will in all likelihood approach the noteholders for consent and, possibly, the rating agencies for rating affirmations. In order to obtain consent from the noteholders, noteholders' meetings must be convened which can be time consuming, with requirements for material notice periods and adjournments for want of quorum. The structure will come to a grinding halt while the different classes seek common ground. Where the transaction documents expressly provide for the trustee to follow the views of one class of noteholder, this is less of an issue – see *“Difficult decisions in the capital markets - the role of the trustee”* above.

Additionally the trustee will lack the required expertise to make an informed decision as to the suitability of a replacement agent and whether the commercial terms of the replacement agent are acceptable. While the transaction documents purport to grant the trustee much room for discretion, in practice the trustee will be hesitant to use discretion in circumstances which were never contemplated when the

transaction was concluded.

Further, even where noteholders exercise any rights of direction to the trustee, the trustee will not necessarily have a right of direction to the Issuer SPV (as opposed to a right of approval) in conjunction with replacement counterparties.

As between the Issuer SPV and the trustee, it is therefore inevitable that the directors of the SPV are likely to retain discretions in dealing with circumstances affecting the Issuer SPV which had not been contemplated at the time the transaction was documented. In determining the exercise of such discretions, they should have regard to their fiduciary duties as directors.

**“No amounts of planning can avoid circumstances occurring in the future which were never contemplated in the documents. By giving SPV directors more protection and availability of support, more flexibility is afforded to the Issuer to act decisively and quickly”**

## The duties of an SPV director

The directors of an SPV owe fiduciary duties to the SPV and the shareholders like other directors of a company (although SPVs are typically structured as orphan vehicles with the shares held on charitable trust).

These duties include the duty pursuant to the Companies Act 2006 “to act in a way that would be most likely to promote the success of the company for the benefit of its members as a whole” or more simply to act in the best interests of the company.

This fiduciary duty to the SPV means that every commercial decision the directors make must be aligned with this overriding duty. They cannot hoist this fiduciary burden on another party, and must ensure that all decisions made in relation to the SPV are in the SPV’s best interests.

Ideally, while the directors should want to protect the investments of all stakeholders (be it the shareholders or the creditors including the senior noteholders or the junior noteholders, for example), they owe an overriding duty to act in the best interests of the SPV (although priority consideration must be given to the interests of creditors when facing insolvency). In determining the best interests of the SPV, there ought to be no reason why the directors cannot exercise such judgment, albeit on behalf of a special purpose vehicle with a limited profit-making ability.

Although little attention is typically paid to the management expertise of the directors of the SPV in a securitisation, as investors would focus on the quality and management of the servicer which manages the underlying assets rather than management of the Issuer SPV (which is intended to be for the most part a passive company), directors of the SPV are typically professionals specialising in the provision of directorship services.

## The need for professional advice and improved documentation

Where directors of the SPV are exercising discretions in circumstances which were never envisaged at the outset of the securitisation however, it is unlikely that there will necessarily be a self-evident conclusion on what is in the best interests of the company. SPV directors may also lack the required expertise or even access to the relevant information to make an informed decision on replacing an agent. Despite their overriding duty towards the SPV, the directors will feel reticent in exercising discretions if they feel that their decisions will expose them to potential liability in respect of the secured creditors, for a judgment investors were not relying on the SPV directors to make.

Express contractual provisions are required to ensure the directors are able to seek professional advice to help them in their decision making process. When

the documentation does not already provide a clear process (e.g. a creditor committee process - see *“Difficult decisions in the capital markets - the role of the trustee.”*) The transaction documentation should be updated to protect the SPV directors who act on independent professional advice from liability to secured creditors who might be prejudiced as a result of the SPV directors’ actions. Also, the priorities of payment provisions ought to expressly contemplate the possibility of funds being to be made available to the directors to pay for such professional advice.

With these changes there should hopefully be a better framework for SPV directors to exercise discretions which the SPV has been left with and although this may not negate the need for trustee involvement, such changes should provide more comfort for SPV directors taking a more proactive role in breaking the decision deadlock which may otherwise result. In other words we believe it would be desirable for transaction documentation to make it clear that residual decision making power resides with the SPV directors and that the SPV directors have the tools, and legal protection, to exercise it proactively.

**“Directors will be reticent in exercising discretions if they feel that their decisions will expose them to potential liability”**



5. The UK covered bond market during the financial crisis: maintaining ratings



Like other issuers of structured debt securities, UK issuers of covered bonds have faced difficult market conditions since the autumn of 2007. While Government schemes have supported the market by providing an essential source of funding, the failures of some banks and building societies, lack of market liquidity and the publication of new criteria by rating agencies, have resulted in new challenges for structuring covered bond programmes. Market conditions have driven the rating agencies to scrutinise structures and challenge the delinkage between an issuer's corporate rating and the rating of its covered bonds.

Solutions include the introduction of pass-through covered bonds, and various adjustments to mechanisms aimed at maintaining asset pools (for example refinements to the Amortisation Test) or ensuring that cash flows are not interrupted even if an issuer should fail (for example requiring the appointment of back-up servicers).

Since the public market for UK covered bonds effectively closed towards the end of 2007, banks and building societies have issued covered bonds for the purpose of accessing liquidity through the government schemes which have emerged and accept highly rated covered bonds and asset backed securities. The issuers have included both banks and building societies that have continued to issue covered bonds out of their existing covered bond programmes, and banks and building societies which have established new covered bond programmes.

The Government support for covered bond issuance has contributed to continued activity in the covered bond market throughout the financial crisis. However, given recent signs of revival in the public market for covered bonds, with Barclays Bank PLC and Abbey National successfully issuing covered bonds into the public market in October 2009, it appears that investor confidence in this area is returning and there is likely to be an increase in the volume of covered bond issuance placed with third party investors going forward.

### Structuring challenges and responses

The credit crisis, and in particular the difficulties faced by several UK banks and

building societies since the autumn of 2007, prompted the credit rating agencies to re-evaluate the link between the ratings of covered bond programmes and the relevant issuer's corporate ratings.

Traditionally UK covered bonds have had "bullet" repayments similar to German *pfandbriefen* and other European covered bonds; this meant that there was a mismatch between the maturity of the bonds and the maturity of the underlying assets (such as residential mortgage loans which amortise over a period of a number of years).

The effects of the maturity mismatch prior to issuer insolvency were alleviated by the fact that, while the issuer remained solvent, investors would rely on the issuer's ability to service its debt (rather than the actual performance of the cover pool). However, following an issuer event of default (such as insolvency or other unremedied failure to pay by the issuer), the mismatch in cash flows becomes more hazardous, as investors will then rely only on the cover pool to service the principal and interest elements of their debt. Should an issuer fail shortly before a series of covered bonds matures, it would be necessary for the manager of the cover pool quickly to sell or re-finance the assets in order to make payments on the maturing covered bonds. Such a sale or

refinancing may be difficult in a market where there is a lack of liquidity for the underlying assets; if the cover pool manager cannot raise sufficient funds, the maturing covered bonds would consequently not be repaid in full on the maturity date.

### Overview of rating agency approaches to maturity mismatches

As a result, rating agencies have adopted the view that the rating of UK covered bond programmes cannot be de-linked from the corporate rating of the issuer. Issuers (and investment banks advising on the structuring of covered bond programmes) have therefore proposed a number of solutions to deal with this structural challenge.

The rating agencies are also assuming that in the current market it will take longer to sell or refinance a portfolio of mortgage loans, and that the proceeds of a sale or refinancing would be below the nominal value of the portfolio. An overview of the approach of each rating agency is set out below.

#### Fitch Ratings Limited

Fitch assesses the likelihood that failure of an issuer may affect the receipt of timely payments under the covered bonds

through assigning a “discontinuity factor”, or D-Factor, to the covered bonds. D-Factor scores range from 0% to 100%, with a lower score signifying a lower link between the issuer’s corporate rating and the covered bond rating.

An increase in the weighting Fitch gives to the “liquidity gaps” component of the D-Factor score has increased the importance of the structural mechanisms issuers might use to manage the liquidity gap.

#### **Moody’s Investors Service, Inc.**

Moody’s refers to its assessment of the likelihood of timely payment being made to covered bond investors following default of the issuer as the “Timely Payment Indicator”, or TPI. There are six levels of TPI, ranging from “Very Improbable” to “Very High”; the higher the TPI, the better the chance of timely payment following issuer default.

#### **Standard and Poor’s Financial Services LLC**

S&P is expected shortly to amend its criteria, with the effect that it will group covered bond programmes into one of three distinct liquidity risk categories (Categories 1 - “match-funded”, 2 - “minimal liquidity risk”, or 3 - “heightened liquidity risk”). Covered bond programmes that have greater maturity mismatches would rely more heavily on asset sales or other refinancing techniques. S&P regards this as an increased risk and is expected to reflect this, for each category, in the extent to which its rating of the programme can exceed the issuer’s corporate rating for each category.

### **Structuring solutions to maturity mis-matches**

There are a number of possible structuring solutions that can reduce the effects of maturity mismatches and the resulting linking between issuer ratings and covered

bond programme ratings by the rating agencies. The following are some of the more common structural features used in covered bond programmes, which have been given credit – to a greater or lesser extent – by rating agencies.

#### **Pass-through covered bonds**

The fact that covered bonds issued by UK issuers have traditionally had bullet maturities, whilst the cover pool assets amortised over a period, is the main reason for the liquidity mismatch, and rating agencies’ linking of covered bond programme ratings to the issuer’s corporate ratings, as described above. A number of programmes have recently been amended to include a pass-through feature – specifically to address these concerns.

Where covered bonds are specified to be pass-through or “long-dated” covered bonds, following certain events (usually delivery of notice to pay on the LLP, linked to failure by the issuer to pay the final redemption amount by the specified final maturity date) the covered bonds will be redeemed on an amortising basis. On each interest payment date, after making more senior payments under the guarantee priority of payments, the LLP will use available funds to partially redeem the covered bonds. In this way principal redemption of the bonds operates in a way more akin to residential mortgage backed securities than traditional, bullet covered bonds.

The pass-through maturity date will fall after maturity of all assets in the cover pool, so that it should not at any time be *necessary* to sell selected loans to make redemption payments. There may, however be specific instructions to the cover pool manager about selling assets when an appropriate price may be achieved.

When introducing a pass-through feature, it may be necessary to amend the payment waterfalls, certain elements of calculations

### **“There are a number of possible structuring solutions that can reduce the effects of maturity mismatches”**

(e.g. of the Amortisation Test) or to switch off certain tests or triggers. For example:

- the “Guarantee Priority of Payments” is usually amended to make specific provision for the payment of principal on pass-through covered bonds (after payments in respect of bullet covered bonds);
- the calculation of the amount of negative carry for purposes of the Asset Coverage Test and the Amortisation Test should be amended to take into account the fact that there should not be any negative carry beyond the next interest payment date (as any principal receipts would be used to reduce the principal amount outstanding on the pass-through covered bonds rather than trapped within the structure);
- in a number of programmes the Amortisation Test is completely “switched off” where the only outstanding covered bonds are pass-through covered bonds.

As the pass-through feature potentially affects cash flows to investors, it is also important to ensure that the mechanism is adequately disclosed in the prospectus (including appropriate risk factors). An example of a specific risk factor would be:

“In the six months prior to, as applicable, the Final Maturity Date (in the case of a Series of Hard Bullet Covered Bonds) or the Extended Due for Payment Date (in the case of a Series of Extendable Maturity Covered Bonds which are not Pass-

Through Covered Bonds), the LLP is obliged to sell the Selected Mortgage Loans for the best price reasonably available notwithstanding that such price may be less than the Adjusted Required Redemption Amount. If any Series of Pass-Through Covered Bonds is outstanding, the LLP will not at any time be permitted to offer to sell the Selected Mortgage Loans for a price which is less than the Adjusted Required Redemption Amount for the outstanding Series of Pass-Through Covered Bonds. This may delay the payment of principal to investors.”

On some transactions a concern has been raised that, if bullet covered bonds and pass-through covered bonds were to be outstanding at the same time, the pass-through covered bonds might effectively be time-subordinated to the bullet covered bonds. We do not consider such concern to be justified because, for example, the issuance of bonds or notes with a diverse range of maturities is a common feature of bank debt, and by their very nature, many structured programmes (for example, RMBS or CMBS master trust structures, or credit card master trust structures) where investors are willing to consider, and take a view on, the resulting risks of subsequent issuances being shorter-dated and hence repaid in time priority notwithstanding a deteriorating but not defaulting securitised portfolio. However, should the perceived concern need to be covered off in documentation it might be addressed by stipulating that at any time there can only be either pass-through covered bonds or bullet covered bonds outstanding, but not both. Although the appetite of investors for more complex structures should be considered, there may be other solutions. It may also, for example, be possible to create a structure that allows both pass-through and bullet covered bonds to be outstanding at the same time, although none have yet been implemented owing to a lack of necessity where bonds are used

for the discount window facility with the Bank of England. Our view is that, as the market for public placement thaws, the need for a covered bond programme to issue both pass-through and bullet covered bonds will likely become unavoidable. To achieve a solution further analytical and structural refinements will be necessary.

A question that has arisen recently is when the pass-through feature should be activated. In the case of pass-through covered bonds issued in more than one series where the pass-through feature is triggered on a different date for each series, there is a risk that if more than one series of covered bonds are outstanding then the earlier maturing series of covered bonds will start receiving repayments of principal on a pass-through basis in advance of later maturing series of covered bonds. This means that if the residential property market deteriorates significantly, the later maturing series of covered bonds might be disadvantaged. This risk was not initially considered significant: first because most issuers had only one series of covered bonds issued for the purposes of liquidity schemes, and secondly because most covered bond mortgage pools were adequately over collateralised.

Some issuers of pass-through covered bonds are now choosing to address this risk by adopting a test similar to the Amortisation Test, upon the breach of which all outstanding series of covered bonds would immediately start repaying principal on a pass-through, pro rata and pari passu basis. A similar test might also be used to test whether different series of pass-through covered bonds should accelerate simultaneously or in a phased manner on their original final maturity dates. The purpose of these tests is to ensure that later maturing series of covered bonds are not unduly prejudiced. We believe such tests may become a

common feature of the market for UK covered bonds going forward.

Investor appetite for pass-through covered bonds in their current form remains limited; however, indications are that such covered bonds will for the time being continue to be accepted into the various central bank liquidity programmes. This underlines our view above that covered bond programmes will need to be able to issue both pass-through and bullet covered bonds.

#### **Extendable maturity periods**

Covered bonds may also be issued as “soft bullet” covered bonds – that is, they have a specified final maturity date and an extension period, with final repayment due only by such extended maturity date. Extension of the covered bonds will usually only follow if the issuer fails to pay the final redemption amount on the original final maturity date, and if the LLP does not then have sufficient funds to make such payment under the covered bond guarantee.

The purpose of extension is to ensure that the cover pool manager will have enough time to raise funds by, for example, selling selected loans. The extension period should in theory also mean that assets can be sold at better prices than might have been the case in a “fire sale” scenario.

A number of UK covered bond programmes already have the ability to issue “soft bullet” extendable covered bonds. We see this as a likely feature of UK covered bond programmes going forward.

#### **Deferral of due date at the issuer's option**

Some programmes allow for deferral of the covered bonds for a specified time. This differs from the more common extension provisions in that the latter only become relevant following service of a notice to pay on the LLP and failure by the issuer to

make payments when due. This mechanism potentially gives the issuer extra time to refinance the cover pool.

It has the advantage over typical extension provisions in that, as deferral does not require an issuer event of default, it would not trigger cross-default provisions in other financing transactions that the issuer may then have outstanding (such as EMTN programmes).

During the deferral period the issuer might start making partial redemption payments in broadly the same way as under a pass-through covered bond, whilst the LLP might simultaneously attempt to raise funds by way of a sale of selected assets. If, at the end of the deferral period, the issuer remains unable to make the scheduled redemption payment, and the LLP has been unable to raise sufficient funds, the covered bonds may be extended for a further specified period (where they will be treated the same way as “normal” extendable covered bonds).

### **Pre-maturity Test**

The purpose of the pre-maturity test (which usually only applies if rating triggers are breached) is to test, some time before a scheduled principal repayment on a “hard bullet” covered bond becomes due, whether the LLP has sufficient cash or other liquid assets to make such repayments should the issuer fail to make such principal repayment when due.

If the test is not met, the LLP must raise the necessary cash, either from a capital contribution by the issuer or by selling assets. The timing of the pre-maturity test is aimed at allowing the cover pool manager enough time to raise funds without having to sell assets in a “fire sale” scenario.

Whilst the relevance of the pre-maturity

test may be diminished in programmes where recent issuance comprises predominantly pass-through or extendable covered bonds, a similar test (or an adapted form thereof) may also be useful in covered bond “treasury operations” (which we deal with in more detail below). We further believe that, as long as investor appetite for bullet covered bonds remains, the pre-maturity test will remain a feature of UK covered bond programmes.

### **Other Areas of Concern**

There have been some other areas of concern that have been considered in relation to UK covered bond programmes. A number of these are set out below:

#### **Alternative management of the cover pool**

As the issuer often fulfils multiple roles in a covered bond programme – including that of manager of the cover pool on behalf of the LLP and cash manager – an issuer event of default may also mean that the LLP will have to appoint an alternative manager, as the LLP itself will not be able to carry out this function. This may result in a default on the covered bonds should an issuer event of default occur shortly before a payment is due.

To address this risk, rating agencies have started to require the programme transaction documents to expressly provide for either the appointment of a back-up manager at the inception of the programme (but with the appointment only being “activated” if certain rating triggers are breached), or alternatively to provide that a back-up or standby manager will be appointed following the occurrence of a rating trigger event. We believe this trend will continue.

In appointing alternative managers, it will also be necessary to consider issues

such as confidentiality and data protection, the protection of proprietary systems and information, as well as the practicalities of transferring servicing functions to a third party.

#### **Dedicated reserve funds**

Some programmes require dedicated reserve funds (in addition to the usual reserve funds) to allow for payment of, for example, interest on the covered bonds for one interest period. This improves short-term liquidity and reduces the risk that interest may not be paid in a timely fashion. However, this would not address concerns related to the payment of principal amounts due.

The requirement to fund such reserves may be triggered by a rating downgrade of, for example, the cash manager or a swap counterparty.

We expect that, for the foreseeable future at least, this type of reserve fund will continue to be a feature of covered bond programmes.

#### **Covered bond treasury management**

The changes in the rating agencies’ approaches to rating covered bond programmes mentioned above have to a large extent been driven by the rating agencies’ views on mismatches between the maturity of cover pools and covered bonds issued by the banks. We have already mentioned above that this has introduced structural complexity into the traditional UK model of a covered bond and has raised the issue of how to combine issuance of hard-bullet bonds and bonds with repayment profiles more closely tied to the performance of the cover pool.

In our view, this issue can be addressed, at least in part, through active management of issuance through the covered bond

programme and, potentially, issuance tests as to the proportions of different types of covered bonds. Consequently, we believe that, in addition to the structural changes we have highlighted, the time may be ripe for issuers to consider a dedicated “treasury” function in respect of a covered bond programme. This might, for example, be achieved by the issuer and/or the LLP appointing a liquidity manager, who would be tasked with actively monitoring the funding mix of the covered bond programme – i.e. monitoring the maturity profiles of the cover pool and covered bonds in issue and to be issued on a stand-alone basis, rather than merely as part of the issuer’s overall funding strategy. The liquidity manager would play an active role in managing any liquidity mismatches – for example, by recommending, and arranging for, the issue of further series of covered bonds with particular features and

the addition of further assets to the cover pool – to ensure that expected cash flows of the covered bond programme are

sufficient to meet its payment obligations by reference to the mix of covered bonds outstanding.

### Conclusion

Whilst indications are that the covered bond markets will remain an important source of funding for UK banks and building societies, recent changes, particularly in the approach taken by rating agencies to rating covered bonds, have created some challenges for issuers and their advisors. In current market conditions, which remain largely driven by central bank schemes, it is often necessary to maintain a AAA rating on the bonds, and therefore to minimise the link between the ratings of a covered bond programme and the corporate ratings of the issuer. These considerations, among other things, indicate in our view a focus on asset cashflow and hence closer convergence between the covered bond markets and the market for RMBS. As investor appetite for UK covered bonds continues to sharpen, as mentioned, we would nevertheless expect to see a move back to more traditional hard and soft bullet maturities, as market investors are not generally supportive of the uncertain maturity profile created by the pass-through mechanism. In our view, this will lead to more structured innovation and treasury management in order to permit issuance of both hard and soft-bullet maturities.

## 6. SIVs – lessons from the crisis



Structured investment vehicles have largely disappeared from the market, but leave as a legacy valuable lessons for structured finance and a growing body of important caselaw.

Structured investment vehicles (SIVs) have been one of principal casualties of the financial crisis and their demise has been well publicised. From a peak in 2007, with some 30 vehicles and \$400 billion under management, today almost all SIVs have either been taken on balance sheet by their sponsor banks or have entered into receivership or been restructured.

In this section, we look at the lessons to be learned for structured finance from SIV design flaws, the implications of case law that the SIV sector continues to generate, and some restructuring techniques that may have a role for other asset-backed issuers. To set the discussion in context, we briefly recap on the structure of SIVs.

SIVs are limited purpose investment companies which buy highly rated medium and long-term debt (primarily asset-backed securities) and fund themselves by issuing cheaper, highly rated commercial paper and medium-term notes and 'equity-like' capital notes, subordinated to the senior debt. The SIVs' short-term funding therefore needs to be continually refinanced.

The chronic lack of liquidity in the financial markets meant that SIVs were unable to issue or re-issue commercial paper, forcing them to draw on available bank liquidity and in many cases to liquidate assets.

### Is there any future for SIVs?

Given the level of negative publicity which SIVs have attracted, it is widely assumed that this type of vehicle has disappeared, never to return. Certainly, it is unlikely that any product called a 'SIV' will ever be marketed in future. But

the basic concept behind SIVs – arbitraging the spread between long-dated assets and cheaper, mostly short-term liabilities – is as old as banking and fundamental to it. And as investor confidence and risk appetite return, we are likely to see demand for products which arbitrage the spread between longer and short-term debt. The history of finance shows that financial innovations rarely disappear completely, but more often mutate into other products with similar features. If there is to be any future for vehicles with SIV-like features, it is clear that many of the design flaws of SIVs will need to change, including the following.

### Liquidity Support

Unlike a traditional asset-backed commercial paper conduit, SIVs did not have committed liquidity facilities covering the face amount of short-term liabilities. Instead SIVs sought to address the need for liquidity through a net cumulative outflow (NCO) test which monitored the maximum projected cash outflows over defined time periods and required liquidity to be held in an amount equal to multiples of the applicable NCO. Liquidity coverage could take the form of bank liquidity lines, asset purchase or repo facilities or assets classed as 'liquid assets'. It is clear that SIVs' liquidity structure did not work in a sustained liquidity crisis and that a different liquidity structure will be needed if similar vehicles are to be assigned high ratings in future. Future vehicles will need to have liquidity structures designed to survive a liquidity crisis of 2007 proportions.

One obvious alternative would be to require bank liquidity or asset purchase

#### This section examines:

- Whether there is any future for SIVs or similar vehicles
- What the impact is of the latest case law on the drafting of security documents and waterfall provisions
- What can be learned from SIV restructuring techniques

#### How will issues be addressed in documentation?

- Achieving effective time subordination of *pari passu* liabilities may require explicit exclusion of the principle of *pari passu* distribution on insolvency
- 'Non-standard' waterfall or other provisions should be supported by other documentary evidence of the parties' intentions, such as risk factors
- Contractual security enforcement provisions should include creditor opt-out from mandatory liquidation provisions

facilities to cover the face amount of outstanding short term-debt. However the diminishing pool of banks with suitable short-term ratings is much more reluctant to provide these type of liquidity facilities, given their increased regulatory capital cost and perceived increased riskiness as a result of the SIV crisis. The cost might in any event be prohibitive. Another alternative would be to require a higher proportion of liabilities to consist of medium rather than short-term debt.

Other possibilities include: (i) closer management of asset-liability maturities

through the use of extendible CP and call and put options on the CP so to achieve a degree of maturity matching, coupled with SIV-like NCO tests (ii) establishing the vehicle as a regulated financial institution – a special purpose bank – with access to interbank funding and central bank liquidity and (ii) use of synthetic structures to reduce the need for continuous funding.

During the SIVs' death throes, many SIVs resorted to using repos of portfolio assets to provide liquidity when commercial paper could not be issued or rolled over. However, since repo counterparties own the repo collateral, the effect of this form of liquidity is, in effect, to confer on repo counterparties a 'super priority' and it is probable that rating agencies will in future impose stricter limitations on the use of repos as liquidity.

### Unwind Triggers

SIV documentation typically included stop-loss triggers designed to protect senior creditors. The two main triggers were the NCO tests (described above) and the capital adequacy test. The capital adequacy test assumed that the SIV was unable to rollover its funding and was required to liquidate assets at their market value. If the tests were breached, the SIV moved from its normal operating mode to 'restricted operations' and eventually into enforcement or wind-down.

The capital adequacy test, which was intended to mitigate losses, in fact made matters worse and probably increased losses by forcing SIVs into deleveraging or enforcement, resulting in many cases in the liquidation of assets in a highly depressed market. It is notable that, despite significant falls in the mark-to-market value of their

assets, there was no drastic deterioration in the actual credit risk of SIV portfolios – only a small proportion of their portfolios were downgraded.

One of the restructuring measures adopted by surviving SIVs or successor entities was to remove or modify 'hard-wired' market value tests that would otherwise trigger a liquidation of the underlying portfolio.

Although it may be difficult to convince investors to abandon completely unwind triggers based on portfolio valuation, it seems that more flexibility is needed in how these triggers operate. The challenge is to distinguish between market value declines which are warnings of credit problems of a particular vehicle and those which reflect wider systemic dislocations. Possibilities include ensuring certain hard-to value structured finance assets from the triggers, or amending the mechanics of triggers so that they are not automatic.

### Transparency

For competitive reasons, most SIVs did not include asset-specific disclosure in their investor reporting. Monthly investor reports would typically provide high-level portfolio information only. One of the root causes of the SIV crisis was that investors were fearful of the extent of SIVs' exposure to US sub-prime mortgages. Although most SIVs in fact had little exposure to US sub-prime (as opposed to some 'SIV Lites', which did), and many rushed to issue press releases confirming this, in the fevered atmosphere of summer 2007, investors were not in the mood to differentiate between 'aggressively' and 'conservatively' managed SIVs. In retrospect, more granular reporting may have avoided this panic. If similar

vehicles return, it is clear that reporting will be more detailed and will have to provide asset-specific disclosure. Under the new Article 122b of the Capital Requirements Directive (CRD) "highly complex resecuritisations" will in any case be a straight deduction from capital unless the investing bank demonstrates to the competent authority that it has complied with the due diligence and ongoing monitoring requirements contained in the amended CRD.

### Market Value Structures

The collapse of the SIV market calls into question whether it will be possible in future to assign a AAA rating to market value structures for certain asset classes such as ABS, given their potential vulnerability to price volatility. We would expect market value structures to disappear for the foreseeable future.

### SIV Litigation

The SIV crisis has been a fertile source of litigation and has produced some important case law.

Most of the litigation has turned on the interpretation of enforcement provisions and waterfall priorities. In some SIVs, the occurrence of an enforcement event was intended to trigger acceleration of the SIV's senior liabilities; in other cases enforcement was intended to produce a controlled wind-down, but no acceleration. This has been a critical issue, because the acceleration of the SIV's liabilities (or not) determined whether senior creditors continued to be paid sequentially in order of maturity (the 'pay as you go' model) or *pari passu* with other senior liabilities, regardless of maturity.

The most recent and authoritative

decision is *Sigma Finance Corporation (in administrative receivership)* [2009] UKSC2, the first judgment to be delivered by the new Supreme Court. The case turned on the interpretation of a security trust deed and how it was to be enforced on the occurrence of an enforcement event. An enforcement event did not trigger acceleration of Sigma's liabilities, but required the security trustee to form pools of assets which were maturity-matched to liabilities. The various classes of senior creditors were to be confined to recovery out of a particular pool during a realisation period. In relation to the short-term pool, the security trust deed provided that "the Security Trustee shall so far as possible discharge on the due dates therefor any Short Term Liabilities falling due for repayment during such period, using cash or other realisable or maturing assets of [Sigma]".

The Supreme Court considered that its task was to interpret the security trust deed as a 'reasonable man' would approach its meaning and understanding. This required the Court to interpret the security trust deed as a whole "in light of the commercial intention that may be inferred from the face of the instrument and from the nature of the debtor's business". By a four to one majority, the Supreme Court favoured a *pari passu* distribution and concluded that it was never intended to leave to chance (in terms of the timing of maturity) the priority of payments. In a dissenting judgment, Lord Walker endorsed the views of the majority of the Court of Appeal that the Court should not rewrite the contract on behalf of skilled and sophisticated investors.

The Sigma decision illustrates the recent tendency for appellate courts to favour a purposive interpretation of the parties' supposed commercial

intentions over objective interpretation of contractual terms.

Although the decision is specific to the context of the Sigma security trust deed, it has potentially wide-ranging implications for the drafting of security and intercreditor documents. The narrow point is that to displace what Lord Walker calls the "strong instinctive feeling" of judges and insolvency practitioners for *pari passu* distribution on insolvency, it will be advisable in cases where time subordination of *pari passu* liabilities is actually intended whether or not the issuer is insolvent to include in the drafting an explicit exclusion of the principle of *pari passu* distribution.

More generally, the implications for those drafting security agreements is as follows. The Court will look at the agreement as a whole in order to construe the meaning of certain clauses which lead to results which are perceived to be outside commercial norms. Accordingly, if parties have negotiated provisions which are not market-standard, then special care needs to be taken to ensure that they are not only clear and unambiguous, but also that they are not expressly or impliedly contradicted by other provisions in the document. In appropriate cases, we would suggest that a risk factor in disclosure documents may be an effective method of providing contextual evidence of parties' intentions.

### Cashflow Insolvency - In the Matter of Cheyne Finance PLC (in receivership)

The receivers of the Cheyne Finance SIV sought clarification from the Court as to how proceeds of underlying assets should be distributed to creditors

in the period between appointment of the receivers and the occurrence of an "Insolvency Event". The Court instructed the receivers to apply the monies on a 'pay as you go' basis, meaning that monies were to be paid to senior creditors in order of maturity of the relevant liabilities.

However, the receivers quickly determined that meeting senior debts as they fell due would require the immediate sale of Cheyne's assets, a step which would prevent the company from paying future debts of later-maturing creditors. The receivers then applied to the Court to determine whether the company was, or was about to become, "unable to pay its debts as they fall due as contemplated in Section 123(1) of the [Insolvency] Act [1986]".

The Court held that the receivers could determine that there had been an "Insolvency Event" with respect to Cheyne as soon as it appeared on the balance of probabilities, or that it was more likely than not, that Cheyne could no longer expect to pay all of its senior liabilities in full as and when they fell due.

The result in the *Cheyne* case depended upon the fact that the issuer had a fixed cashflow profile and determinable returns and that there was virtually no prospect of a refinancing.

Accordingly, although the result may be different in the case of a trading company with variable and indeterminate cashflow streams and liabilities, the case has important implications for SPVs and their directors. If language equivalent to that in Section 123(1)(e) of the Insolvency Act 1986 is used in definitions of events of default or enforcement events, directors will need to monitor carefully

the effect of portfolio losses or defaults to assess whether the issuer is cashflow insolvent. They should also exercise caution in signing solvency certificates without consideration of projected cashflows and liabilities.

Parties will also need to consider carefully whether they wish to include this form of cashflow insolvency test in events of default, enforcement events or other unwind triggers. The ability to take into account future debts when determining whether a default has occurred may be used by creditors to argue that a default has occurred much earlier than would be possible prior to the *Cheyne* decision, and as a lever in workout or restructuring negotiations.

### Limited Recourse provisions

As a footnote, the *Cheyne* case casts some light on the effect of limited recourse provisions limiting the creditors' recourse to the value of specified assets of the issuer. The documentation of the Cheyne SIV contained limited recourse provisions. The necessary consequence of the Court's determination that the SIV was cashflow insolvent was that the limited recourse provisions, as drafted, did not limit the SIV's debts by reference to available assets but only restricted the

creditors' ability to make a claim in excess of the value of the SIV's assets. Accordingly, in drafting limited recourse provisions, consideration needs to be given to whether these provisions are intended to apply both pre- and post-enforcement and whether they are intended to affect contractual provisions triggered by inability to pay debts.

### Lessons from SIV Restructurings

The restructuring of the Cheyne Finance SIV (renamed SIV Portfolio PLC) was a template for several other restructurings of distressed SIVs. The restructuring was effected by Goldman Sachs, on behalf of the receivers, auctioning part of the SIV's assets. The remainder of the assets were transferred to a new SPV. Senior creditors in SIV Portfolio PLC had the option to receive cash based on the auction prices, an investment in the new SPV, or direct ownership of a 'vertical slice' of the underlying portfolio. This allowed creditors to avoid the effect of forced asset liquidation in an illiquid market.

The technique of 'vertical slicing' may prove to be an important restructuring option in the future. This involves creditors being allocated a proportionate share of each asset in the portfolio, calculated according to their

proportionate share of the issuer's liabilities. This technique allows creditors to manage the assets on their own balance sheet and issuers to reduce their liabilities. Since participating creditors retain exposure to each asset in the portfolio, vertical slicing also helps to mitigate litigation risk, since it eliminates the argument that certain creditors have cherry-picked better performing assets. One practical problem with vertical slicing is the inability to slice certain assets because of minimum denomination or transfer restrictions. This problem can be addressed by establishing custody arrangement pursuant to which non-transferable 'stub' assets are held for the benefit of participating creditors.

Although the restructurings effected by receivers appointed under SIV security documents have demonstrated the effectiveness and flexibility of receivership as a contractual insolvency procedure, it has also highlighted deficiencies in contractual liquidation procedures, in particular the inability in many cases of any formal mechanism for creditors to direct or vote on the timing of liquidation of assets. In future, documentation should include provision for creditors to opt out of mandatory liquidation procedures prescribed by security documents.



7. CMBS – the last slice of the dice?



Noteholders, lenders, trustees and other market participants are now having cause to revisit the complex and highly-leveraged CMBS transactions completed prior to the credit crisis and the commercial property market decline. In this section we consider trends and developments in the CMBS market prior to the credit crisis and issues that have become and are likely to become relevant to market participants as many CMBS transactions approach their expected final maturity. Additionally, we set out our thoughts on the implications for the future development of the CMBS market.

### Market overview

Rising commercial property values fostered by easy access to credit in the debt markets and strong demand from investors from the mid-2000s until August 2007 drove the rapid expansion of the commercial mortgaged-backed securities (CMBS) market in the UK and Continental Europe. Banks were able to originate loans confident that the risk could be quickly sold down through packaging up the loans and selling them into the bank and capital markets. Banks were therefore able to earn good fees without incurring onerous capital requirements and borrowers/sponsors were able to obtain increasing leverage in the medium term at a low all-in capital cost. Increasingly complex capital structures providing for multi-layering of debt (so called “slicing and dicing”) enabled investors to access paper that matched the risk and yield they were looking for, including mezzanine and junior tranches held within or outside the CMBS transaction. Over time the spectrum of real estate assets broadened from traditional investment properties to more specialised assets such as leisure parks and private hospitals.

The liquidity crisis and rapid decline in commercial property values has resulted in many CMBS transactions being subject to rating downgrades<sup>1</sup>, breaches of loan-to-value and other covenants and, in some cases, tenant or borrower defaults.

Historically low interest rates (even taking into account the impact of interest rate swaps struck in a higher interest rate environment) have meant that to date, despite the large market value decline, interest cover ratios have generally remained strong and borrowers have been able to support interest payments on the loans that support the notes.

Most CMBS transactions were structured with little or no amortisation, exposing investors to significant refinancing risk. The legal final maturity of the CMBS Notes is therefore typically structured to be (depending on the number, size and type of real assets and jurisdiction) at least two to three years after the expected legal maturity, being the final repayment date under the related loan(s). Although the size of the CMBS market relative to the aggregate amount of secured real estate lending over the boom period is small, the proximity of the transactions means that many of the transactions will come up for refinancing within the next 24 to 36 months. It is now widely expected that borrowers will be unable to refinance the loans supporting the current crop of CMBS transactions leaving investors with the prospect of a loss or at the very least extension risk on their investments.

However, despite a rising number of defaults in CMBS transactions and the expectation that there may be much worse to follow, there has not been the

flood of distressed loans, notes or asset sales that might otherwise be expected in a downturn. This is not for want of demand on the buy-side, rather the lack of liquidity results from the absence of forced sellers. There are a number of possible reasons for the lack of secondary market activity:

- The reluctance of “hold to maturity” investors to crystallise a loss on their investment.
- The expectation (or hope) that the worst is over and that values will improve sufficiently over time and ahead of expected legal maturity.
- The comparatively small number of defaulted transactions, meaning that demands on management time are not unduly burdensome.
- The subjectivity of property appraisals and uncertainty as to where value really breaks in a particular transaction.
- In the case of junior investors, perceived “hold-up value” in any future restructuring.

### Observations

Whilst the legal structures for CMBS transactions (both single asset and multi-loan conduits) follow a well trodden path, the same cannot be said for some of the key commercial/intercreditor terms. The terms are often a product of the

preferences and/or motivations of the arranging bank at the time the transaction was entered into, the nature of the property asset and the jurisdiction in which it is located. As such, a one-size fits all analysis of the existing CMBS transactions is not possible, but we have attempted to summarise the main issues that have arisen upon recent CMBS restructurings, are likely to arise in the future and that we consider relevant to market participants.

Real estate work-outs in the past have tended to be bank-led through a steering committee of the lead banks on the transaction. Banks' interests have on their face been aligned as an investor class given they hold a senior secured pari passu investment. In addition, decision making has been relatively straightforward in line with majority or instructing bank approvals customarily found (and easily understood) in loan documentation. The only complexity has been the demise of the "London approach" and the emergence of secondary trading of loans and the entry into the market of distressed investors who share different aspirations and whose "break-even" points are different to original lenders of record. However, these senior lenders have now been replaced by a passive special purpose vehicle (incapable of managing its loan investment) whose senior debt has been tranching into various classes of tradeable securities creating classes of investors with different terms and often conflicting interests. Thus, each CMBS transaction will have appointed servicers and special servicers to manage the issuer's investment in its loan(s) typically, for so long as the notes are not in default, without recourse to the noteholders. The servicer and special servicer may similarly be servicing the loan for any junior or so called "B

lenders" who have participated in the same "whole loan" as the issuer but sit below the rated CMBS securities in the capital structure under an intercreditor arrangement. In each case, the servicer and special servicer have a relatively broad discretion to service and work out the loan subject to a servicing standard. This follows precedent in the US CMBS market but largely remains uncharted territory in the UK/European CMBS market. The experience to date suggests that the special servicing model is not necessarily working out as contemplated on the face of the legal documentation. Here are a few of the reasons why we believe this to be the case:

- In some instances, servicers have other interests in the capital structure (whether as an "in the money" hedge counterparty or "out of the money" B lender) leading to concerns regarding conflicts of interest (real or otherwise).
- The absence of a sponsor/borrower. Non-recourse structures have allowed sponsors/borrowers who took out their dividend on origination of the loan and who have no incentive to inject new equity into the deal to walk away from their investment. Without an engaged borrower, servicers and special servicers have no counterparty to work with. This circumstance is not explicitly contemplated or addressed in the existing CMBS documentation.
- Transaction documents may specify that a particular action may not be taken without a rating affirmation or rating agency confirmation, which may either not be forthcoming from the rating agencies or no longer of relevance in light of existing downgrades.
- Noteholder activity and an expectation of enfranchisement even in spite of the absence of a note event of default. This has led to Special Servicers consulting informally and formally with noteholders in the exercise of the servicing standard in the hope of obtaining a consensus in spite of the competing interests across investor classes.
- The complexities and ambiguities of the servicing standard (and related intercreditor arrangements) leaving servicers and special servicers nervous of the risk of legal challenge from a disaffected investor class and potential resultant liability. This is often compounded by other ambiguities in the legal documentation (not always by design). Additionally what is the proper exercise of the servicing standard will also depend on the size of the asset and any future re-letting risk.
- Uncertainty as to who is the "controlling class" and whether or not a "Control Valuation Event" has occurred. The controlling class of investor is typically the most junior class of investor provided that a Control Valuation Event has not occurred. The controlling class typically has the right to replace the incumbent special servicer and to appoint an operating adviser to look after their interests. The class potentially fluctuates depending on the most recent valuation and thus it may not be clear at any given point in time as to whether a particular class of creditor is subject to a control valuation event. Further, given its subjectivity, any valuation used to determine the occurrence of a control valuation event may be challenged by junior creditors (who may request or seek a further valuation).

- The need for a detailed jurisdictional insolvency/enforcement analysis triggered not just by the location of the real estate but also the jurisdiction of the real estate owner and any general partner (in the case of limited partnership structures).
- Enforcement strategies may be impaired by the “super-senior” mark to market value of any fixed/floating interest rate swaps entered into between the borrower and the swap counterparty and which would be crystallised on any acceleration of the loan or insolvency of the borrower. Projected investor recoveries are being reduced by potential sizeable termination claims of interest rate swap counterparties in light of current very low rates of interest and which would be paid ahead of investor principal.

What is clear is that noteholders have tended to gain an entry point in the transaction earlier than originally contemplated. However, to a large extent and with the exception of the controlling class provisions, the note terms and conditions are traditional ABS note terms and do not provide a proper basis for communicating with or instructing the special servicer. In particular, there is no documented means for more informal methods of communication or the establishment of creditor committees (that may be more appropriate within the context of CMBS restructuring where the special servicer is likely to be seeking instruction on a number of specific matters on an ongoing basis). Rather the existing arrangements for communications with noteholders typically require any decision of noteholders to be made at a physical meeting convened on at least 21 clear days’ notice, which is slow and impractical. Further, the most senior class will typically have control rights over all

matters other than entrenched matters which relate specifically to the notes (as opposed to the underlying loans) which may not be what junior investors actually expect to be the case.

In any event, it may be difficult to reach a consensus between noteholders/creditors whose preference in relation to a particular issue may, for example, be determined by their respective rankings (senior creditors will typically be motivated to see the return of capital in the short term which can be reinvested at current market rates whereas junior creditors will typically seek maximisation of recoveries over a longer term).

### Conclusions/thoughts for the future

It is unlikely that the highly leveraged, complex and tiered structures that characterised the peak of the CMBS market will be repeated in the short to medium term. In particular, the multi-loan conduit transactions are less likely to return. However, even with lower geared transactions with less complexity and tiering, there are lessons that can be learned from today’s (and very likely tomorrow’s) CMBS experience.

Transparency and clarity is key. Loans are more likely to be tranching upfront rather than bifurcated as between the lenders “behind the scenes”. In terms of who controls decision making and enforcement, we might see a return to conventional lending and security principles, namely that the most senior class controls in all circumstances except where it would cut across entrenched rights of the junior classes. Subordination is of course the risk that the junior investors are being compensated for. Cure and purchase rights might survive albeit on more

limited terms. Servicing Agreements are likely to be more specific in terms of the duties and standards of special servicers. We would expect more clarity to be given to the servicing standard (especially where there are competing and conflicting interests). For instance, a special servicer might be expressly allowed to disregard the interests of any investor who ceases to have any meaningful economic interest in the underlying assets. Conceivably this could be extended to enabling principal of junior classes to be written off to facilitate a restructuring and to eliminate hold-up value where investors have no skin left in the game.

As for loan arrangers, we doubt very much that there would be appetite amongst the investor community for arrangers to take a “skim” on the margin through a AAA rated Class X Note. Rather, we will see a return to traditional deferred purchase price arrangements at the bottom of the waterfall allowing arrangers to take out excess spread only to the extent that the bonds are fully performing.

As we note elsewhere in this publication, we would expect the drafting of the note terms and conditions to catch-up with the realities of modern day technologies and the experience of current and the imminent CMBS restructurings. Thus one might expect provision to be made for a more informal means of noteholders communicating with the note trustee, servicers and other creditors, including the ability to appoint noteholder representatives and establish noteholder steering committees, with the waterfalls providing the representatives with a super-senior claim to recover amounts paid to the note trustee pursuant to any indemnity required to be given to the note trustee at the time of

the representatives' appointment. Additionally, the basis for providing an indemnity might be open to challenge if an instruction mechanism can be found

which obviates the need for the intermediate step of instructing the trustee to instruct the note issuer/servicer. It is reasonable also to

expect originators/issuers to maintain secure investor websites for the purpose of disseminating information.

### An example of successful restructuring - REC 6 Alburn

A recent success story in the market is the successful restructuring of a multi-property UK sterling CMBS which was in breach due to LTV covenant defaults. The success of the restructuring was largely due to the involvement of the borrower, Alburn Properties and the sponsor, NM Rothschild, who engaged with noteholder steering committees at an early stage and were committed to find a solution. The borrower was willing to commit significant time and resources to the transaction in the belief that the value of the properties will recover to an extent that there will be realisable equity in the structure when the loan matures in 2013. The key terms of the restructuring were as follows:

1. Disapply the loan to value ratio covenants and amend the interest cover ratio covenants.
2. Deliver the loan by requiring the borrower to dispose of at least £50,000,000 of properties on a best efforts basis before maturity of the loans and to use the proceeds of such disposals to prepay the notes on a sequential basis.
3. Provide for all surplus cash flow accumulating in the rental income account following payment of certain prior ranking amounts to be swept into a new account and to use amounts standing to the credit of such account to amortise the senior loan: (i) on each interest payment date on which swap breakage costs are less than or equal to zero; (ii) on the final repayment date; and (iii) on any interest payment date on which senior noteholders have directed the issuer by an extraordinary resolution to require the borrower to prepay the senior loan up to the amount standing to the credit of such account.
4. Require all amortisation payments due to the junior lender to be paid to the issuer (in its capacity as senior lender) and to be applied to prepay the notes on a sequential basis.



8. Disposal of assets: greater flexibility all round?



We expect to see increasing flexibility in the market allowing for more frequent disposal and acquisition of businesses which include securitised assets (“securitised businesses”), as well as greater ability to dispose of assets from transactions and to add assets originated by another entity to existing securitisation programmes.

Prior to the outset of the financial crisis, portfolio sales were fairly common, particularly as market players were trying to rid themselves of unwanted assets and shore up some liquidity in the process. As the credit crunch began to bite, however, these asset sales slowed to a trickle and in many instances stopped altogether as there was limited or no appetite for further burdening balance sheets that were already being stretched to capacity. However, as we come to the time when a significant number of transactions being used for the central bank liquidity schemes will require refinancing (and as the central banks are making concerted efforts to wean banks off these schemes), there will undoubtedly be a number of originators asking themselves what to do with their existing portfolios, as well as a few players out there willing and able to purchase them. Against a backdrop of greater stability (and to some degree, increased liquidity), we focus on how this will impact the securitisation market in three ways: first, in terms of the ease of disposal and acquisition of assets; secondly, in terms of how easily assets acquired (rather than originated) by a bank can be incorporated into their existing securitisation programmes; and thirdly, we consider asset disposals from another angle, namely, disposal of a business that includes existing securitisations.

### Accessing the assets and liquidating existing structures

Prior to the recent market turmoil, it was relatively rare for originators to have the ability to collapse existing securitisation structures in order to have access to the underlying assets, which they could then dispose of. The reasons behind this were varied, but included concerns for the

integrity of the true sale analysis together with the fact that the exercise of such an option by an originator would have been unpalatable to investors. However, this is not such an issue for retained deals, where the originator holding all the notes has overall control. It should therefore generally be a relatively straightforward process for originators that hold the notes in retained

transactions to collapse their existing structures, thereby easily accessing the securitised asset.

The situation is more complicated in transactions where some or all of the notes are publicly-held as transactions cannot easily be unwound without the consent of the third party investors who

#### Principal issues

- The ability of originators to collapse retained deals and access the underlying assets.
- Incorporating new assets into existing programmes such as master trust structures and covered bond programmes.
- Acquisition and disposal of securitised businesses.
- Changing of counterparties following any acquisition or disposal.

#### What are we seeing in the market?

- Push for “investors” in retained deals to access the assets.
- Greater freedom to free up and transfer assets from retained deals leading to availability of assets which are able to be transferred into other deals.
- Generally, counterparty roles clearly established as being fully separate, allowing an individual role to be replaced relatively easily.
- For more difficult structures such as originator trust or CMBS a move towards separate, stand-alone servicing provisions meaning replacing a servicer is made easier.

#### How will the documentation be affected?

- Documents may become more flexible for easier access to removing the assets in line with retained deals in order to facilitate any sale process.
- Eligibility criteria, servicing procedures and representations and warranties to be examined to permit new assets to be added to existing programmes (possibility of confirmation of no adverse rating impact rather than noteholder consent).
- Mandatory disclosure updates following any material acquisition or disposal and also following the addition of any new assets to existing programmes if eligibility criteria widened.
- Detailed provisions regarding the appointment of replacement counterparties to facilitate securitisation disposal or acquisition.

hold the notes. It is therefore very likely that unless originators start dealing directly with investors (through, for example, liability management exercises), assets that are currently tied up in publicly-held securitised transactions will remain included in the collateral pool of those transactions for the foreseeable future. The other interesting area to consider is the ability to tap into the assets currently being used for retained deals and how the practice for unwinding transactions will be shaped going forward.

Lately, there has been a push by the current “investors” themselves (at this stage, mainly the central banks but in some circumstances other third party investors) to have the ability to access the assets in “default” situations. Recent covered bond transactions in particular have been incorporating the ability of the bondholders to force the guarantor to liquidate the portfolio and sell the assets, rather than activating the guarantee payments (see “*The UK covered bond market during the financial crisis : maintaining ratings*”). While this is an interesting counterpoint to rating agency concerns in respect of “fire sales” and “market value” stresses, it could be taken as an indication that there is a trend towards a greater ability to tap into the assets directly in certain circumstances and that this push is coming both from the bottom (investors) as well as the top (originator/issuer) of the structure. If this is true, we would expect the documents to be more flexible to allow access to these assets in specified, typically “default”-type, circumstances, although careful consideration would need to be given to the drafting to ensure there are limited circumstances for investors to obtain the assets, that there is no cherry-picking of the best assets and that existing ratings remain unaffected.

### **Incorporating new assets in existing structures**

As the securitisation market starts to allow for greater flexibility to free up and transfer the underlying assets, originators may find themselves wanting to incorporate new asset portfolios in existing securitisation programmes, such as master trust or covered bond structures.

Assets originated by different entities may therefore form part of the same collateral pool. The obvious advantage of this approach is mainly cost effectiveness (in that it would cost much less to tap into an existing structure rather than to set up a new one and the lower ongoing costs of running one programme, as opposed to two) as well as being less time-consuming and resource-intensive.

There are, however, a number of challenges with this approach. In addition to the practical considerations (such as system compatibility), separate originators are extremely unlikely to have identical originating and servicing policies, so from a documentary perspective, the eligibility criteria, servicing procedures and, most importantly, the representations and warranties will all have to be revisited in light of the new assets. In certain programmes and transactions, the waiver of any representation or warranty is permitted, provided that rating agency consent or confirmation is obtained. How this consent or confirmation can be addressed in the future is discussed in “*Rating agency confirmations: how necessary will they be?*” above. Such flexibility would avoid the need for noteholder consent to be obtained in order to add in new assets which fail to meet any of the specified criteria.

A further thought is that although we would expect representation and warranty packages on existing ‘AAA/Aaa’ securitisations to be fairly

consistent among themselves and the eligibility criteria and servicing procedures to be fairly widely drafted, it will not always be the case that they permit the inclusion of the proposed new assets. An originator will therefore have to think about whether any updates to its disclosure and whether any amendments to the transaction documents will be required. In light of current trends towards increased disclosure and greater transparency, it is likely that originators will have to provide disclosure about any new underlying assets which are added to the current securitised portfolio or which may be relevant to the rating analysis going forward. Furthermore, if any amendments are required to be made to the underlying documentation, trustee consent will need to be sought and the ratings will need to be unaffected. We believe that this will remain addressed through the consideration as to the role of the trustee in giving its consent (see further “*Difficult decisions in the capital markets - the role of the trustee*”).

### **Disposals of businesses that include existing securitisations**

In addition to the disposal of assets that may previously have been used by originators in securitisation structures, there will also be disposals of entire businesses that include securitisations. Recent examples include RBS acquiring ABN AMRO, Lloyds TSB acquiring HBOS, Barclays acquiring Standard Life and the Nationwide acquiring a number of smaller building societies.

The acquisition of a business that includes existing securitisation programmes will involve the consideration of issues such as the definition of “originator” and, a review of the transaction documents to ensure that

## “As the securitisation market starts to allow for greater flexibility to free up and transfer the underlying assets, originators may find themselves wanting to incorporate new assets in existing securitisation programmes, such as master trust or covered bond structures”

certain rights of the “old” originator are readily transferrable to the “new” originator. To take the right to receive deferred consideration as an example, this might be more easily achieved if the right to the deferred consideration is effected by the issue of a residual certificate in transferrable form. In addition to these rights, however, the “new” originator may also have a number of ongoing obligations, not just in relation to repurchasing the assets, but also in terms of certain servicing functions in the capacity of servicer and/or cash manager.

The following type of wording can be included in a transaction to facilitate transfer of the business from one originator to a successor entity at some point in the future:

“If the [relevant transfer conditions] are satisfied, the parties hereto agree that (a) all parties will use their best efforts to take all steps required to novate on a timely basis the rights and obligations of the [originator] under this agreement to the [succeeding entity] and (b) the trustee shall enter into such documents as the [succeeding entity] may reasonably require to effect such novation. Following such novation, it is agreed and acknowledged that references in this agreement to the [originator] in any capacity shall be read and construed as references to the [succeeding entity] in the relevant capacity. The [succeeding entity] shall represent and warrant to the Issuer and the trustee on the date of such novation in the form set out in [insert reference to representations and warranties of the succeeding entity].”

The “transfer conditions” will, broadly speaking, consist of certain conditions precedent to ensure that the agreements are properly novated, legal opinions are obtained and confirmation that the ratings of the notes will not be adversely affected by the transfer.

The most relevant counterparty change in the context of the acquisition of a business that includes securitisations is likely to be the servicer and this will be the most significant change for both rating agencies and investors. In most structures, this is relatively easy conceptually as the roles of originator, servicer and cash manager are treated and documented separately and distinctly from each other even if carried out by the same entity.

The process of replacing a servicer or a cash manager may itself be time-consuming if the provisions in the documentation for appointing a replacement are inadequate or unclear. For example, for any transactions incorporating common terms replacing a servicer would almost certainly involve all parties to the transaction re-executing the relevant documents. However easy the appointment may be from a procedural perspective, rating agencies and investors are likely to have concerns about the ability of any replacement servicer to carry out the servicing functions to the same standard as the previous servicer. In addition, the existing servicer may have delegated certain functions to third parties and may therefore be a party to existing delegation agreements, which may create problems when the servicer is changed. We believe more time will need to be spent prior to execution of documents in considering and documenting the eligibility requirements for replacement servicers, including impact on ratings and the mechanics for changing a servicer. In many areas, we

believe it will be prudent to “hard-wire” these matters into the underlying documentation (see *“Difficult decisions in the capital markets - the role of the trustee”* above for some further considerations in this regard).

As noted above, most securitisation structures distinguish the originator and the servicer role in cases where the role is performed by the same entity at the outset. However, in originator trust structures, for example, this distinction is often less clear, as usually the administration of the loans is carried out by the originator and is rarely contained in a separate agreement (as the originator is the continuing “owner” of the assets, albeit as trustee). Clearly, the addition of different assets and the possible accession of a replacement servicer would present more complications under these structures. We have started to see a move in the market towards having separate and more detailed servicing provisions even in originator trust structures. This is especially the case in CMBS transactions where the servicing function is crucial to the transaction, particularly in stressed scenarios where the underlying commercial real estate may require proactive management. This will facilitate a new servicing entity being appointed to carry out the servicing functions. For further considerations on this matter, please see *“CMBS - the last slice of the dice?”* above.

A further challenge in the current market is that finding suitable replacement counterparties at suitable cost and within a suitable time period may not be easy (any incoming servicer is likely to want to negotiate a new fee package, for example). To such an extent, in fact, that rating agencies and/or trustees have started to require the appointment of stand-by servicers and stand-by cash managers at the outset of a number of

transactions or at the very least, detailed provisions about the roles and appointment of any replacement entities. This may include the following type of provision allowing different aspects of the servicing and cash management roles to be separated out, thereby allowing the trustee to appoint

more than one entity if finding a suitable replacement to carry out the entire role proves difficult:

“The Trustee shall concur with the Issuer in (a) appointing more than one successor servicer to act simultaneously and allocating between such successor servicers the rights, duties and obligations of the Servicer set out in this agreement; and (b) making such amendments to the Transaction Documents as may be necessary in order to facilitate

the appointment of more than one successor servicer and the allocation of the rights, duties and obligations of the Servicer to such successor servicers.”

We believe this trend will continue and will result in more complete servicing contracts and greater documentary focus on the role of servicers and their replacements in stressed scenarios.

## Conclusion

We are seeing a degree of liquidity returning to the bank market and a growing focus by financial institutions on meeting competition considerations, liquidity requirements and capital adequacy concerns. Added to this are increasingly frequent disposals of easily-accessible assets from existing securitisations alongside disposals of businesses which include securitised assets. In view of all of this, the frequency of the acquisition of assets into existing transactions and the sale and purchase of existing securitised business is only set to increase. We have seen both how transaction documentation can assist such activity but also how it can hinder it. With disposals and acquisitions on the increase, flexibility will be key and transaction documentation will need to adapt accordingly, not least by including more pre-planned steps and procedures.



9. New rules for a new way forward  
for commercial mortgage lending



The commercial mortgage market remains subdued and many banks have large amounts of credit impaired or, increasingly, defaulting commercial property backed debt on their books. This is, therefore, a good time to look to the future in terms of what is required to re-start the market and whether any changes are required to reduce the risk of a repeat of the credit crunch or something similar. This is important if investors are to be attracted back to the property market and would, indirectly, help the banks clean up their balance sheets.

Before looking at what is required for the future it is worth looking at some high level issues which might have contributed to the credit crunch. These issues include the way properties are valued, the tax system, the availability of easy finance, lack of transparency and the front ended remuneration structure for bankers.

## Valuation

Lenders do not trust all of their borrowers to pay the right price so they ask for a valuer (or appraiser) to appraise the value of a property before advancing a loan to fund a purchase or refinancing, whether for commercial or residential property. A valuation speaks as of the date on which it is given and is determined in considerable part by reference to comparable evidence in the market and the availability of finance for the purchase of the property concerned. As a general rule, a buyer will pay more for a property if he can raise debt finance to buy it than if he had only to use equity. The more finance that is available, the more buyers there are in the market, the higher the value of the property, or at least that is the likelihood. One can see the potential for the creation of an inflationary bubble, particularly if one adds in the ability of borrowers to refinance unrealised equity with debt (a practice which was common place leading up to the credit crunch) and the impact of a series of purchasers over paying for assets resulting in overly optimistic comparable evidence on the valuation of other properties. One now sees the position in reverse: property values are down in considerable part because there is very little debt available in the market. The more values fall, the less

new debt finance is available and so on. There needs to be a review of the way properties are valued.

## The tax system

Investors can off-set their interest costs against their income and so reduce their tax charges. In short, the more debt that a borrower can raise at the time of purchase, the less tax he should pay through the life of the loan. The name of the game for the investor is to ensure that his investment “washes its face” (or pays for itself) but leaving him with as much equity as possible with which to do the next deal and hope for yet more capital gain. This is not to suggest that the borrower’s ability to deduct interest costs from rental income for tax purposes should be abolished which would not be popular nor necessarily desirable but, perhaps, there should be a review to establish whether or not the balance is currently right. For example, for property transactions there could be a rule that tax is only deductible on borrowings up to 75% of day one loan to value. There might be a potential trade-off in the form of a reduction in the amount of stamp duty land tax (SDLT) payable in return for any tightening of the deductibility rules. As things stand the 4% SDLT charge inhibits transactions so loss of tax revenue caused

by a reduction might not be as much as the Government might fear. Although tax changes are usually not popular, inflationary bubbles are not ultimately in the interests of most investors.

## Availability of easy finance

We all know that the availability of finance increased through the early and mid 2000s up until the onset of the credit crunch in mid 2007. The commercial property finance market had its part to play in the creation of the credit crunch. Traditionally, an investor buying a good commercial property was able to raise 65% or 70% of a property’s value by way of senior bank debt. The investor would have financed the balance out of equity or, possibly, some equity and some mezzanine (or junior) debt finance. In the 1990s mezzanine finance went from being exotic to somewhere near normal. In the 2000s traditional mezzanine finance was increasingly replaced by “stretched senior” debt so that senior loans sometimes accounted for more than 90% of the purchase price or value of a property. In extreme cases, a mezzanine financier would provide further debt and part of the equity to the borrower. This happened in parallel with the development of the securitisation market where banks were able to sell on their loans to third party

investors and re-lend the proceeds. Banks were not always able to securitise all of their mortgage debt so a market developed for “B notes”. B notes were created out of the piece of debt which a bank could not securitise. It would be sold (or retained by the originating bank) junior to the securitised part of the mortgage debt but carrying a higher rate of interest, often involving complicated inter creditor arrangements and, sometimes, further securitisation style structures. The increase in availability of (cheap) finance fuelled increased values.

### The role of bankers, investors and regulators

The system encouraged bankers to do as many deals as they could. Those bankers did not want to lose money. On the contrary, a loss would potentially deter investors in mortgage products and, at best, interrupt the bankers’ ability to write new business and earn money. However, the system which developed arguably encouraged bankers to take risks which they did not appreciate fully. The bankers were remunerated through origination fees, through the arbitrage afforded to them through securitisation and the sale of B notes. They did their due diligence and sought their valuations but, overall, they made one fundamental mistake. They forgot or did not fully appreciate that the whole market could go down at once. They were not the only ones as most investors and Governments made the same mistake.

### The need for change

We know where we are now. We do not need to rehearse the story of bank bail-outs and restricted levels of credit but it is worth looking at what could be done to help prevent this type of economic disruption happening again. Although

lenders and borrowers are now chastened and unlikely soon to make the same mistakes again, memories fade, good times return and sooner or later the same old temptations will befall another generation of bankers and investors. It is worth looking at some possible new rules for lenders. These would help bring confidence back, not just to lenders themselves but also for their investors, particularly the people who buy their shares and bonds. At the same time the new rules would operate to build in good practice for the future. It is worth noting that not everything in the world of commercial property finance pre-2008 was bad so there is still, potentially, a place for securitisation, covered bonds and other debt products. They just need to be bolstered by some new rules in order to help remove some unnecessary risk.

### Covered bonds or securitisation?

The UK already has a covered bond market but it is mainly utilised for residential mortgage finance and not used as a means of raising finance for the commercial property sector in the UK. There are a number of reasons for this including restrictions on including commercial mortgages in UCITS compliant schemes and the nature of a covered bond means the related assets and liabilities remain on the bank’s balance sheet. This means that the bank must continue to hold capital against the assets. In contrast, a securitisation should normally constitute a sale of the assets for regulatory purposes with the assets and liabilities moving off the bank’s regulatory balance sheet so that the bank’s ability to lend is not constrained by the size of its balance sheet. Whilst there are arguments that keeping all assets and liabilities on a bank’s balance sheet helps to keep the

bank “honest” with incentives aligned to investors, the consequential constraints on the banks’ ability to lend may mean that there is insufficient capital available in the market place to fund the mortgage market.

### A new set of rules

A new set of rules, conservatively drafted, would encourage investors to provide liquidity to the commercial property market safe in the knowledge that their money must be used only in accordance with strict criteria, thus restoring market confidence. The rules would also introduce a much greater degree of transparency so that borrowers, originating lenders, investors and regulators would all be able to see who owes what to whom and on what terms. With strict criteria and greater transparency it would also be possible for mortgage origination to be linked to the issue of bonds, thereby creating a new debt based asset class for both professional and retail investors offering an alternative to bank deposits and Government bonds. Attracting new finance to the property sector should, in time, help banks clean their balance sheets of so-called toxic debt by re-starting a property market into which they can sell distressed assets. As well as providing market infrastructure for new investors, tight rules would encourage good practice and therefore help dampen the possibility of the market over-heating in the future, although the wider regulatory framework is also important in this regard. Any new regime should not outlaw traditional bank lending or funding outside the regime, but should act as an additional form of finance available to the wider market. In other words, the new rules should provide a framework for a quality kite mark rather than a restriction on how mortgage business is carried out.

## “Any new regime should not outlaw traditional bank lending or funding outside the regime, but should act as an additional form of finance available to the wider market”

How would such a new lending regime work? A new set of criteria could be applied across the market for securitisation, covered bond and debenture stock issues, perhaps even for mortgage loans intended only for syndication. New criteria could prescribe:

- (a) valuers to be instructed in a standard way to reduce risk of borrower or lender influence;
- (b) minimum financial covenant tests;
- (c) (possibly) amortisation requirements at least for higher loan to value deals;
- (d) categories of property suitable as security;
- (e) minimum levels of due diligence which must be undertaken prior to origination;
- (f) transparency as to inter creditor arrangements;
- (g) origination fees capped or payable in stages to discourage too much front-ended remuneration and risk taking;
- (h) restrictions on the ability of borrowers to refinance equity and so realise profit prior to a sale; and
- (i) the ways in which mortgage loans must be managed and what will happen on default.

The key is that criteria would be simple and objective but allow enough flexibility to allow deals actually to be concluded.

## Financial covenants

Valuation is not an exact science but valuations would be carried out on a consistent and conservative basis, perhaps always assuming that a borrower must invest a minimum amount of equity on purchase (say 30%) and that a loan of more than 50% loan to value will be amortised to 50% or less or by a certain percentage amount. Ongoing loan to value tests are unpopular for borrowers but a solid valuation at the outset is essential in order to help ensure that the loan is of the right sort of proportion at the time of origination. In a rising market valuers tend to be primarily instructed by borrowers whereas in a falling market valuers tend to be instructed by lenders. This is, perhaps, an over simplification but there is a potential moral hazard in that the former could conceivably help drive up values and the latter could conceivably drive down values thus arguably bringing into question the full worth at any time of valuations. The key is good all round due diligence at the time of origination, of which valuation should be a part but not the be all and end all.

It is worth looking at financial covenant tests in a little more detail. The easiest test for all parties is a day one loan to value test at the time of the origination of the loan. The more conservative the initial loan to value test, the less one should need financial covenants in the loan documentation, a continuing loan to value covenant in particular. If the maximum loan to value were 60% then, assuming a robust valuation process, there should not be a need for ongoing loan to value covenants. Above 60% life starts to become more complicated. Ongoing loan to value tests are not popular with borrowers as they are driven by matters outside the borrower's control. If the initial valuation is carried out on a prudent basis, other origination criteria are met

and the loan is properly managed, then one can argue that an ongoing loan to value test should not be required. One can also argue that with differences of opinions as to value at any time, the merit of an ongoing test is questionable if there is an interest cover test and/or a debt service cover test.

Ongoing interest cover and debt service tests tend to be more acceptable to borrowers than ongoing loan to value tests but their exact terms can vary a lot from deal to deal. Depending on the vagaries of a particular property or portfolio, it should be possible to settle upon a suitable test which would work across the market as part of a new set of rules. In any event, it is always open to the borrower to cure a financial covenant breach by reducing the amount of the loan and putting up more collateral, finding a new tenant or otherwise procuring an increase in rent.

## To amortise or not?

Linked to financial covenants is the subject of amortisation. Old fashioned lending terms demand that a borrower reduces a loan over a period of time. In recent years, interest only mortgages (or mortgages with very limited amortisation requirements) have been popular with borrowers as large borrowings mop up potential tax liabilities and leave more money for other deals, with the associated potential for capital gains. As a general rule, the higher the initial loan to value, the greater the pressure there should be on the borrower to reduce the loan over time. An amortisation requirement could be included as part of the new rules but would not be popular with borrowers. The new rules would need to protect lenders but also be sufficiently workable for borrowers. That said, amortisation does focus the mind.

## Special purpose vehicles – a good thing?

Another aspect of financing in recent years worthy of review is the trend for special purpose entity (or vehicle) (SPE/SPV) financing. This is where a sponsor of a deal forms an entity solely to acquire an asset or a group of assets. This has been attractive to lenders and borrowers alike. Secured lenders like this arrangement because it should give them exclusive access to the underlying assets of the borrower, should there be a default, without the need to compete with other creditors. Investors like it because it allows them to ring fence each investment. The difficulty with SPE financing is that it could perhaps cause both investors and lenders alike to see the property as the borrower rather than as the security for the borrower's obligations. It also denies the lender access to other assets of the borrower should the loan default. SPE financing is not bad in itself and is probably here to stay but, arguably, it encourages irresponsibility and perhaps there should be tighter requirements for SPE financing than for where a sponsor is prepared to put its assets generally on the line. Any rule along these lines would probably be too arbitrary but the subject is at least worthy of debate.

## Compliance with new rules

A new set of rules would be useless without a system for certifying compliance. Self-certification by those involved at the time of origination could be an option, but it would need to be subject to independent audit or verification by an independent person. The auditor (or other independent person) would examine not just the work of the originator but also the work of the originator's advisers to ensure that forms and procedures had been followed in the

prescribed way. Those opting into the rules would be able to use a kite mark (or brand) which sends a message to investors in the market that the mortgage loans which they are buying directly or the secure bonds have been originated have done so in the prescribed manner.

## Amount of loan

One of the most difficult areas is the level of debt which can be raised against any particular property whilst keeping risks low. A property which is well located, well let and well managed is likely to be a safer bet than a property which is badly located, vacant and owned by an investor with a poor track record. There are a number of safety nets which can be built in, including a conservative valuation process, a possible restriction on refinancing except by reference to the original purchase price of the property (and not by a re-valuation) but, ultimately, new rules would need to set out how much debt in loan to value terms could support the branded bonds. The conservative nature of the rules might cause a lender to make a loan to a borrower outside the scope of the rules where the security looks very good. Whilst this conservative approach will not always allow sufficient flexibility for good borrowers and thus potentially remove prime property from the branded asset pool, on balance, the need for investor confidence is arguably greater. Greater confidence should translate to lower pricing and therefore is a bigger reason for lenders and borrowers to opt into the regime, including for very good properties.

## Inter creditor considerations

It should be quite possible to introduce a new set of branded low risk bonds secured by mortgages over commercial property for the first 50% to 60% of a

purchase price. This would be the end of the issue if a borrower were to finance the balance out of its own funds. In the real world, however, there is likely to be a demand for higher loan to value commercial mortgage debt. Even in times when markets have been relatively conservative, for good quality commercial property, borrowers would expect to be able to raise senior debt finance up to approximately 65% or 70% of value. There are, therefore, questions as to where the loan to value line should be drawn and whether or not the kite mark should go further and restrict the type of debt which ranks junior to the senior mortgage debt. On balance, for the best quality of the branded bonds, it would be preferable to restrict the amount of junior debt but this is unlikely to be entirely practicable. In any event, the rights of junior debt holders should be subordinated to the senior mortgage debt. Further, control of the enforcement and loan management processes should invariably rest with the more senior level of debt, which has tended not to be the case for securitised debt. This will likely mean that, in percentage terms, investors in commercial property will need to put up more equity than was the case prior to the on-set of the credit crunch. Most will consider this a positive step towards the long-term stability of the commercial property market, even if short-term possibilities are less exciting than previously might have been the case.

## The danger of refinancings

In an inflationary environment the temptation for lenders to agree to refinance borrower equity without a new sale or purchase can be great. Refinancing of equity (and subordinated debt) should be prohibited in any new kite mark system. This would improve

the quality of day one loan to value/ loan to purchase price analysis as reference to value would be by reference to a real market value transaction. High transfer tax costs mitigate against real property level transactions and encourage refinancings. This is another potential argument for a change to the tax system in so far as it applies to property.

## Flexibility

In order to meet the market demand for loan to value of up to 70% without compromising the principle of a clear, conservative framework, the mortgage loans could allow investors to buy in at different levels or to take on different levels of risk. For example, there could be a low risk "green" level of mortgage debt at under 55% of loan to value, a riskier "blue" level of 55% to 65% and a more risky "orange" level of 65% to 70%. Bond issues could be structured with mortgages only at one level, for example, a "green" level of debt under 55% loan to value. Alternatively, bond issues could include more than one level of mortgage debt to create more investment possibilities, such as an issue which includes mortgage debt of up to 65% loan to value, which would consist of "green" and "blue" debt. This would be in addition to any credit rating applied to the bonds. Unlike the A/B structures developed for the pre-credit crunch securitisation market, there should, in any event, be transparency as to the levels of interest and the amounts payable to the investors at each level so that all lenders and bond holders can see the total liabilities of the borrower secured against shared security and who, exactly, controls what.

## Who owns what debt interest?

A potential problem in allowing lenders to originate differing levels of debt is that it can become tempting for them to keep

the junior, more risky pieces of debt, thereby storing up potential problems on their balance sheets. This was an issue in the pre-credit crunch mortgage securitisation market. There has been recent discussion amongst regulators that lenders should retain a proportion of the risk in order to keep them honest and align incentives with investors (see *"Lifting the regulatory fog - will the amendments to CRD reveal a new landscape?"* on page 71 below) but this was already as a matter of fact often the case for many securitised transactions where first loss was retained and did not prevent disastrous results all round. Lenders who opt into a kite marked regime should, ideally, not be required (and perhaps not even able) to retain the riskiest parts of the loans on their balance sheets. Prudent lending and compliance with a set of clear rules should be the protection afforded to the market. Conservative lending criteria might have another less obvious benefit but lenders might be encouraged (or required under regulatory proposals) to retain a small piece of the loan on a side-by-side "pari passu" basis with the much larger part of the loan to be sold. It might be possible to operate the rules in a way that allows mortgage loans to be fungible in terms of providing security for branded bonds. In other words, originating lenders could establish a specific pool or specific pools of mortgages to support bond issues but be able to remove mortgage loans and replace them with new ones as security for the bonds and, for large pools, spread risk for investors. Well spread risk should ultimately feed through to lower pricing for borrowers.

## The role of rating agencies

Whether or not the bonds are rated by one or more rating agencies would be up to the issuer or the person arranging the issue. A

rating should not be a pre-requisite of the new rules. Compliance with the rules would be intended as the protection afforded to investors (although the arranger or issuer might apply for a rating in order to assist distribution and liquidity in the light of the fact that some investors are restricted from investing in products which do not have a rating). If a rating becomes a pre-requisite to a transaction it is at least arguable that there is a risk that the credit committee of the arranger or issuer might be influenced by what the rating agency wants when deciding whether or not to advance a loan rather than forming its own view of a transaction. The need for compliance with a set of clear-cut rules as to the determinant and protection for investors takes away the uncertainty as to what rating a particular transaction might or might not achieve.

## Government support (or not)?

A Government guarantee should not be necessary to support a branded bond scheme. Although, in the absence of a guarantee, initial take-up of a new scheme might be slow, it would be preferable for the market for kite marked lending to develop on its own. In any event, a guarantee would not come without a cost to the lender both in pure monetary and regulatory capital terms, which would be passed onto borrowers negating some of the benefits of off-balance sheet lending, at least for securitised products. There may, however, be a role for a Government guarantee for mortgage loans to fund UK Government or social projects.

## Government or banking industry led?

How would such a new regime be introduced? One option would be

industry self-regulation, but with confidence in the banking industry at a low ebb, legislation or regulation may be preferable. Legislation or regulation would give added comfort to domestic and international investors. It could also have the advantage of providing an appropriate regulatory framework for the audit process and for deciding which financial institutions should, within a kite mark framework, be licensed to originate mortgage loans and issue (or arrange the issue of) branded low risk bonds. The new rules should not be restricted to mortgage lending in the UK but should enable mortgage lenders to originate or arrange mortgage debt secured on property throughout the EU so long as the specified criteria are satisfied.

However, if the commercial mortgage industry were able to demonstrate a sufficient level of appetite for introducing and policing their own rules, Government intervention might be unnecessary.

### **Introduction of new rules**

A new set of rules for mortgage lending is not the only solution to current problems in the wider markets but will establish a benchmark for best practice across the property and mortgage industries, provide a transparent minimum level of comfort for investors and encourage new lending, enabling banks to begin cleaning up their balance sheets. The commercial mortgage industry (or, if not them, the Government) should turn its attention to enabling rules

**“A new set of rules for mortgage lending will establish a benchmark for best practice across the property and mortgage industries, provide a transparent minimum level of comfort for investors and encourage new lending”**

or, if necessary, legislation or regulation. We encourage those engaged in the mortgage and property industries to debate the topics raised in this section.



10. Synthetic securitisations, CDO<sup>2</sup>  
and CLNs – distant memories  
or sleeping beauties?



In this brief overview, we look at what will need to be achieved for synthetic securitisations to re-emerge as a popular securitisation technique. In addition, we note the difficulties faced by managers of synthetic CDOs and the impact that the “Big Bang” and “Small Bang” developments will have in the credit-linked note area.

Synthetic securitisation structures were a regular feature of the landscape until the financial crisis began. They provided and can continue to provide a very efficient tool for banks seeking to transfer risk without having to go to the cost of actually transferring assets and disrupting commercial relationships. Side by side with synthetic securitisation structures was a prosperous structured credit market producing all kinds of complex (and sometimes opaque) structured finance products, such as CDO<sup>2</sup> and CDOs of ABS.

Probably because they sound particularly complicated, and because many journalists and politicians have only a limited understanding of how they work, credit default swaps, and therefore synthetic securitisations based around credit default swaps, have been one of the favourite whipping boys throughout the financial crisis, regularly being accorded a large slice of the blame for everything that is wrong with the world of structured finance. This situation was not helped by the fact that Lehman Brothers was one of the major arrangers and sponsors of synthetic securitisations and credit linked notes. With the recent tentative recovery in the markets, can we expect to see synthetic securitisations and structured credit products return from the dark days of old? There have been some signs of recovery, with appetite returning in particular for first loss tranches by yield hungry hedge funds and some investor interest in mezzanine tranches.

## Restoring Confidence

Credit default swaps, both funded (in the form of synthetic securitisation) and unfunded (in the form of portfolio credit default swaps) remain a powerful and flexible tool for banks in managing their balance sheet and regulatory capital requirements. Credit linked notes can also continue to

provide an attractive investment for investors. In fact, in some ways, synthetic securitisations expose investors to less risk, and in particular less unwind risk, than traditional asset-backed securitisation.

Nevertheless, in our view, synthetic securitisations are not likely to return to a meaningful extent unless:

- (i) the trust which investors placed in rating agencies can be repaired;
- (ii) investor demand returns for risk at the different levels of the capital structure at spreads which make economic sense to originators;
- (iii) there is greater clarity for originators as to what constitutes “significant risk transfer”; and
- (iv) the impact of the regulatory initiatives covering central counterparty clearing, collateralisation of OTC exposures and amendments to the Capital Requirements Directive (“CRD”) are fully assimilated.

Providing greater transparency on reference assets is not always as easy as it may sound due to the need to comply with data protection laws and duties of confidentiality. Restoring confidence in rating agency methodology will also not be easy. In addition, the more complex and esoteric structures create reputational and regulatory concerns for financial institutions that can cause participants to shy away from their use.

To help restore confidence, in depth investor education and involvement in structuring new transactions from the outset, particularly in more complicated structures, is likely to be required. However, it is likely that many investors will not have the time or resources to develop the expertise required to assess properly the risks and rewards of investing in synthetic structures and may, once again, need to rely to a material

extent on the ratings given to synthetic deals. This may cause some regulatory issues which could limit their ability to invest (see *“Lifting the regulatory fog - will the amendments to CRD reveal a new landscape?”*).

For originators, a key benefit of synthetic securitisation (whether funded or unfunded) is avoiding the need to achieve a true sale of the assets, and therefore ensuring a much more flexible replenishment mechanism to manage the portfolio over the life of the transaction. For originators operating under the internal ratings based approach under Basel II, synthetic securitisation also offers a more straightforward way of transferring only a proportion of the risk in respect of individual reference obligations, and allows for more dynamic management of FX exposure in connection with reference obligations denominated in different currencies than does traditional securitisation. These features mean that credit default swaps and synthetic securitisation remains a powerful and flexible tool for originators to manage their balance sheet and regulatory capital requirements.

However, if the spreads for synthetic securitisations are significantly wider than the spreads for cash securitisations, originators are not likely to have an incentive to use synthetic technology unless there are other compelling business reasons to do so, such as the difficulty of complying with transfer restrictions or a commercial desire not to upset bank/customer relationships which might result from seeking consent to a transfer.

## Regulatory Oversight

In market conditions where outright asset sales have been difficult to structure in an economic manner, market participants

have sought to structure credit protection arrangements in other ways. Some of these arrangements may have been more cosmetic than real and may not have transferred significant risk away from the originator of the assets to a third party. Going forward, regulators can be expected to be more vigilant to the substance of transactions or series of transactions to ensure that the letter and spirit of their rules are complied with. In July 2009, the UK Financial Services Authority made it clear that it expected the letter and spirit of its rules to be complied with and requested providers and purchasers of regulatory capital structures to discuss with their supervisory contacts proposed transactions prior to executing them. Regulatory initiatives amending the CRD are likely to require increased and ongoing exposure and it remains unclear how the proposals to increase collateralisation requirements for non-central counterparty cleared trades will affect the market. Overall, in our view, this will mean a greater focus on regulatory compliance and documentation being prepared with the possibility of regulatory review in mind.

### **Managed CDOs**

Managed CDOs have had a tough time over the last two years, with multiple tranches of synthetic transactions having been downgraded. In addition, synthetic CDO managers have struggled to comply with portfolio criteria for many reasons, including widening spreads,

reduced market liquidity, less origination of the underlying assets and fewer dealers. As a result, many synthetic CDOs that were intended to have the benefit of CDO management have in practice become static. The result of this has been the restructuring of many transactions (which has not always been straightforward) to adjust subordination levels and portfolio parameters. Of all the areas that have used synthetic technology, managed synthetic CDOs seem the deepest in their slumber.

### **Credit-linked Note Issuance**

The “Big Bang” and “Small Bang” developments in the credit derivatives world introduced a 60 day back-stop date for credit events, an ISDA determinations committee to make binding decisions regarding credit events and related matters as well as an industry standard auction settlement mechanism (unless the parties decide otherwise). The market standardisation created by “Big Bang” and “Small Bang” may give an impetus to the issuance of credit-linked notes, particularly off of repackaging and debt issuance programmes which allow for a very cost effective method of issuing credit-linked notes. While some credit-linked notes continue to be issued using dealer quotation methodology for determining loss payouts, investors will move to demand more frequently that credit-linked notes generally follow auction settlement pricing determinations as industry standard pricing so far has

resulted in lower loss amount determinations and, therefore, higher payouts to noteholders. Whilst the notes themselves may not always require auction terms to be embedded in their conditions, the increased use of the auction process will inevitably flow through to dealer quotes and then into cash payments under the notes.

### **The Future**

The destination and size of the first-loss piece of an issuance will be of increasing importance to investors, and will interact with the new “skin in the game” requirement for arrangers to retain an exposure to some or part of the securitised assets (see *“Lifting the regulatory fog - will the amendments to CRD reveal a new landscape?”*). Investor and regulator demands for transparency, simplicity and a greater depth of explanation of the details of synthetic products are likely to lead in due course to the emergence of simpler synthetic securitisation and structured product transactions. While it seems like a long time since we had an active synthetic securitisation and structured products market, the use of synthetic technology is a very efficient tool for transferring risk (as can be seen by its extensive use in a number of government backed asset support schemes) and, subject to confidence being restored in how risks can be modeled and rated, we should see synthetic technology make a gradual return from its current slumber within the next twelve months or so.



# 11. OTC derivatives in structured debt transactions



The global financial crisis has resulted in a re-examination of the practical operation of OTC derivatives in the context of structured finance transactions, particularly in the context of the remedial actions to be taken following the downgrade of swap counterparties.

#### Main issues:

- The swaps supporting many structured finance transactions are usually tailored to the underlying assets and require in-depth knowledge of the asset pool and the structural features of the overall transaction, all of which makes these swaps difficult to price. This results in a lack of the liquidity essential for the effective calculation of collateral requirements or procuring replacement swap counterparties where required.
- Recent litigation arising from the collapse of Lehman Brothers has thrown the efficacy of commonly encountered provisions in structured finance transactions into doubt. This is particularly so for swap counterparties incorporated in the US, and therefore subject to the US Bankruptcy Code.

#### What we are seeing in the market?

- Swaps are becoming more difficult to put in place, and pricing is less favourable than was the case prior to the onset of the global financial crisis.
- Replacement of swap counterparties once downgrade trigger levels have been reached has been problematic and impractical, largely due to problems with obtaining credible mark-to-market swap valuations.
- Recent bankruptcy driven litigation causing concern for rating agencies as to enforceability of common contractual provisions.
- Pending regulatory initiatives by the G20, the US Congress and the European Commission to strengthen the financial system will impact on the collateralisation and clearing of OTC swaps, although it is currently unclear how the proposals will affect derivative transactions used in structured finance transactions.

#### How will issues be addressed in documentation?

- To the extent that it is possible, there will need to be greater focus on swaps being drafted so that cashflows can be calculated independently of knowledge of the underlying assets and transaction structure.
- There will be refinements to collateral calculation mechanics to minimise risk to noteholders of an extended delay in obtaining a replacement swap counterparty.
- A move away from US swap counterparties in structured debt transactions towards English incorporated entities, possibly backed by US parental guarantees.

## Background

Most structured finance transactions incorporate OTC derivatives as a tool for managing or metamorphosing cashflows or hedging exposures within the structure.

However, developments in financial markets since the onset of the global financial crisis have forced both rating agencies and the parties to these derivative transactions to reconsider how these transactions operate in a stressed financial climate.

In some cases, this has been as a result of commercial considerations, and, in particular, the reality that the features of such transactions which were intended to minimise the exposure of noteholders to the credit risk of swap counterparties have not operated as intended. In other cases, the reexamination has resulted from legal developments, particularly those arising from the collapse and insolvency of Lehman Brothers in September 2008. By examining the principal issues and difficulties which have emerged during the past year, it is intended to offer some guidance and suggestions for how these difficulties can be minimised in future transactions.

## The role of OTC derivatives in Structured Debt Transactions

The primary role of OTC derivatives in structured finance transactions is to manage the cashflows associated with the transaction. Swaps are essential for converting the cashflows generated by the underlying assets or reference obligations into the cashflows which the issuer requires to meet its obligations to noteholders and other creditors. In particular, currency and interest rate swaps are necessary, where the underlying assets are either denominated in a different currency from the currency of the notes, or generate income on a different basis from the interest which is payable on the notes.

However, whilst at a basic level these swaps are based around exchanging currency or interest rate cashflows, they are often very different from “plain vanilla” OTC interest rate or currency swaps. Rather, the cashflows generated by the swaps will be, of necessity closely tied to the cashflows generated by the underlying assets, investment accounts and collateral

within the deal. As a result, the terms of these swap transactions will depend significantly on the nature of those underlying cashflows and sources, and are specifically negotiated by the arrangers of the transaction, along with the rest of the transaction documentation. Frequently, the arranger or one of its affiliates is the counterparty to the swap with the issuer.

Where the notes issued in a structured debt transaction are to have a AAA rating, the rating agencies require the swap counterparties to the issuing vehicle to have at least an A or AA rating and to comply with certain criteria prescribed by the rating agencies. In particular, if the swap counterparty is downgraded, it is required to take specified remedial action to ensure that the downgrade does not expose noteholders to the risk of a swap counterparty default.

### Rating agency criteria for OTC derivatives

Historically, the three major rating agencies (S&P, Moody's and Fitch) required both OTC derivatives which supported structured debt transactions and the counterparties that provided them to comply with comparable criteria. Broadly speaking, these requirements can be divided into "termination provisions" and "downgrade provisions".

The termination provisions themselves have two key features. First, the circumstances in which a swap counterparty is permitted to terminate a swap transaction is limited to events which, in practice, would be likely to result in the structured finance transaction being unwound or the disapplication of which would be so commercially unattractive to a potential counterparty as to make it difficult to find a willing party (e.g., a payment default or insolvency of the

issuer). The other termination events are those that are not taken into account in the rating process (e.g., change of tax law or illegality). The global financial crisis has, by and large, not resulted in any concerns with these provisions. The second group of termination provisions relate to the level at which the swap counterparty receives payments in the post enforcement priority of payments applicable to the transaction. Rating agency criteria distinguish between whether or not the swap counterparty is in default on its obligations under the swap. If it is not, then generally it will receive sums due to it (if any) in priority to the noteholders; if it is in default, then it is entitled to any payments that may be due to it after the noteholders have been paid out. This "flip" feature of rated structured debt transactions has recently been the subject of significant litigation which is discussed below.

The second category of rating agency criteria, the rating downgrade provisions have undergone significant reworking and modification in recent years, particularly since the onset of the global financial crisis. However, the fundamental principles remain unchanged. Essentially, if a swap counterparty is at or is downgraded below a specified rating level, it is required post collateral to support its obligations under the swap. Alternatively, or additionally it may also elect to obtain a guarantee of its obligations under the swap from a third party, or transfer its obligations under the swap to a third party where, in either of the latter two cases, the third party has the required ratings. If the swap counterparty is subsequently further downgraded below a second rating level, posting collateral is no longer a sufficient remedy, and the swap counterparty is required to find a guarantor or replacement swap counterparty.

The aim of these downgrade provisions is to ensure that the issuer is not faced with an insolvent swap counterparty by ensuring

that, prior to the occurrence of that insolvency, the swap counterparty will have taken appropriate action to ensure that the issuer (and therefore the noteholders) are not adversely affected by that insolvency. This approach is, however, predicated on the assumption that the ratings of swap counterparties do not migrate from investment grade status to insolvency within the period of time prescribed for the swap counterparty to take the requisite remedial action. Historically it was assumed that a swap counterparty experiencing financial difficulties would undergo an orderly transition of its rating evidenced by a series rating downgrades over time, thereby providing sufficient time for the remedial action required by the rating agency criteria for swap counterparty downgrades to be carried out and avoiding the disruptive consequences for structured debt financings of a non performing swap counterparty. However, the recent experience of Bear Stearns, AIG and Lehman Brothers as well as the rapid decline in the asset base of US and European banks has challenged these traditional assumptions and timelines.

The response to these experiences has been for the rating agencies to raise the trigger points at which swap counterparties are obliged to take remedial action and to reduce the timelines in which they have to act. The options available to the swap counterparties have also been narrowed particularly at the lower rating levels where self-collateralisation by the swap counterparty is not an option, leaving third party guarantee and novation as the only course open to the entity. In part, this is to avoid the risk of collateral being clawed back upon the occurrence of the swap counterparty's insolvency. It also seeks to reflect the view that rating migration may occur more rapidly than the parameters used in older analytical models had assumed.

## The problems with swap counterparty downgrade provisions

The two key remedial actions to be taken following the downgrade of the swap counterparty are to require the swap counterparty to post collateral or to find a replacement swap counterparty.<sup>1</sup> However, because of the way in which OTC derivatives work, both these courses of action are implicitly predicated on the existence of a liquid market for swap transactions having the same economic effect as the swap transactions in question. Where the swap counterparty is to post collateral, the amount of collateral to be posted is calculated by reference to the mark-to-market value of the transaction (usually with a volatility buffer add-on). Similarly, where a swap counterparty is to be found, that replacement swap counterparty will either charge or be required to pay an up-front fee for entering into the replacement transaction. This fee will also be based on the mark-to-market value of the transaction. Where there is little effective liquidity for equivalent transactions, determining that mark-to-market is difficult to determine.

The difficulty arises because, in practice, there is not a deep and liquid market for the type of tailored OTC derivatives which are used in structured finance transactions. As discussed above, while these transactions are often interest rate or currency swaps, in practice the terms of these swaps are closely tailored to the underlying assets. To price these transactions, with all their idiosyncrasies, and therefore to calculate their mark-to-

market value at a given point in time, requires detailed knowledge of the underlying assets and the other features of the structured finance transaction. (For example the termination provisions discussed above mean that the ISDA master for these types of swaps differ markedly from those found in the high volume “flow” markets.). This deal specific information cannot be gleaned from a simple review of the swap documentation alone, but requires extensive review of the overall transaction documentation, accompanied by discussions with the other transaction parties. In addition examination of the underlying asset pool, any credit enhancement that may be embedded in the structure and any collateral that may be held by the security trustee for the benefit of creditors (including the swap counterparty) will also be required. The result of all this is that it is difficult to obtain a realistic mark-to-market value for these swap transactions, making it difficult to calculate the correct amount of collateral to be posted or a commercially realistic transfer value.

Furthermore, even if the correct mark-to-market value can be determined, it is difficult to find a replacement swap counterparty to take the transaction on at that price, because, by definition, the mark-to-market value represents the price at which the transaction would not result in either party being in or out-of-the-money, and any built-in profit in the transaction (e.g., arising as a result of a market or credit spread payable by the issuer) would therefore be retained by the outgoing swap counterparty. In practice, given the significant work which must be undertaken to price these swap

“One consequence of the collapse of Lehman Brothers has been a growing body of insolvency-driven litigation, much of it relating to OTC derivatives of the kind prevalent in structured finance transactions”

transactions appropriately, a replacement swap counterparty will only be prepared to take on such a transaction where it will receive a significant uplift from, or benefit from a worthwhile mark down of, the mark to market value. Accordingly it follows that any such benefit accruing to the transferee swap counterparty will entail a corresponding loss of value for the outgoing swap counterparty, which it will naturally be reluctant to bear. (The only other outcome would be for the issuer to bear the loss which would be unpalatable to the noteholders and therefore also the rating agencies.)<sup>2</sup> The consequence for the swap counterparty of not agreeing to the transfer (namely, termination of the swap at its true mark-to-market value) may well be preferable to the loss of value associated with transferring to a replacement swap counterparty at an unattractive price.

These difficulties are exacerbated by the fact that the swap downgrade criteria deal with each transaction in isolation of the broader market. In reality, however, a relatively small number of swap counterparties are responsible for providing

<sup>1</sup> The third option, to find a guarantor of the swap counterparty's obligations, is rarely a viable remedy in practice, as it is very difficult for swap counterparties to find such an arms length guarantor where the swap counterparty has already been downgraded. Also the issues of accurate valuation of the swap obligations discussed below, apply equally to the pricing of such a guarantee. Consequently, where guarantors are used, it is usually limited to circumstances where the swap counterparty is a subsidiary of the guarantor, and the guarantee is provided at the commencement of the swap transaction,

<sup>2</sup> As noted above, in many cases, the original swap counterparty will be a member of the originator or arranger's corporate group, and therefore the costs associated with entering into the swaps are either factored into the original swap pricing, or recovered through the fees earned by the arranger as part of the issuance.

the bulk of the OTC derivatives supporting structured debt financings, all of which are based on the same rating criteria. Therefore, the downgrade of a swap counterparty not only presents a problem for the note issuers which have to deal with a swap counterparty in a stressed situation. It also has significant impact for that downgraded swap counterparty (which suddenly finds itself needing to post substantial amounts of collateral and/or find replacement swap counterparties) An illustration of this was the situation which developed with AIG after September 2008, when it ceased to have the required ratings to act as swap counterparty for most of the structured financings in which it was involved. Despite the rating criteria applying to those financings requiring AIG to be replaced as swap counterparty in short order (no more than 60 days from the date of the downgrade), such replacement in fact took many months, and, at the time of writing, is still continuing for some transactions. This inability to comply with the downgrade provisions in anything approaching the prescribed timeframe serves to illustrate not only the lack of the liquid market for these sorts of swaps but also the frailty of the assumptions underlying the criteria.

It is not possible to eliminate these concerns and difficulties entirely. However, below we offer some suggestions for ways in which they can be minimised for future transactions.

### **Current uncertainties: subordination of defaulting counterparties and suspension of payments**

One consequence of the collapse of Lehman Brothers has been a growing

body of insolvency-driven litigation, much of it relating to OTC derivatives of the kind prevalent in structured finance transactions. Two cases which have particular implications for structured finance are the decision of the Court of Appeal in *Perpetual Trustee Company Limited v BNY Corporate Trustee Services* [2009] EWCA Civ 1160 ("*Perpetual*") and the decision of the US Bankruptcy Court on a motion by Lehman Brothers Special Financing Inc. or "LBSF" to compel performance by Metavante Corporation under certain derivative contracts with LBSF<sup>3</sup> ("*Metavante*").

#### **(a) Subordination of insolvent swap counterparties – the *Perpetual* case**

The *Perpetual* case concerned a common feature of many structured finance transactions, whereby the swap counterparty ranks in priority to noteholders upon enforcement of the security over the collateral unless the swap counterparty itself is in default (which includes where the swap counterparty is insolvent), in which case the swap counterparty ranks below the noteholders in the priority of payments.<sup>4</sup> This was referred to by the court as the "flip" provision. The rationale for the flip provision is readily apparent. Given that it is market practice for swap transactions to terminate at their then current mark-to-market value, regardless of which party is in default, the flip provision is an important protection for noteholders. It ensures that it cannot be advantageous for an in-the-money swap counterparty to default on its obligations under a transaction, thereby forcing the issuer to terminate the swap and unwind the structure and ensuring a profitable payout for the swap counterparty and a potential loss for the noteholders. Arguably, it also reflects the proposition that

a defaulting counterparty should in some way bear the burden of its delinquency or at least the noteholders should not suffer for it. By moving the swap counterparty down the priority of payments when it is in default, the noteholders are better protected and more likely to receive a greater proportion of the termination payments.

However, the issue which arose in *Perpetual* was whether the flip provision contravened the "anti-deprivation" principle. This principle is best summarised as the rule that "there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors."<sup>5</sup> This rule has a long judicial heritage dating back to the 19th century, although the precise scope and application of the rule has been the subject of considerable and increasing uncertainty in recent years, particularly where, as in the case of the flip provision, the asset in question is an intangible asset such as a contractual right. The issue is to what extent do contractual provisions, which change the nature of an intangible right upon the insolvency of a party, themselves constitute an integral part of the asset (in which case there is no dealing with the asset to which the anti-deprivation principle can apply) or amount to a dealing with the asset (and which will therefore be subject to the anti-deprivation principle)? In the landmark House of Lords decision in *British Eagle International Air Lines Ltd v Compagnie Nationale Air France* [1975] 1 WLR 758 ("*British Eagle*"), the majority of their Lordships held that clearing house arrangements which provided for the multi-party netting of debts and credits owed between an insolvent airline and a group of

<sup>3</sup> See Transcript issued by Judge Peck of the US Bankruptcy Court on 15 September 2009 pages 3–4 and 99–113.

<sup>4</sup> Although the relevant swaps in the *Perpetual* case were credit default swaps, the issues arising in the case apply equally to any other type of OTC derivatives in a structured finance transaction.

<sup>5</sup> *Ex p Jay; In re Harrison* (1880) 14 Ch D 19, 26.

other airlines constituted a disposal of the insolvent airline's assets and, therefore, following the onset of insolvency proceedings in respect of that airline, was a dealing with those assets in contravention of the anti-deprivation principle.

In *Perpetual*, the swap counterparty (the insolvent LBSF) argued that the flip provision involved a breach of the anti-deprivation principle because it had the effect of reducing the value of the assets of LBSF (i.e., its right to have its claims against the issuer satisfied out of the proceeds of collateral held by the security trustee in priority to the claims of the noteholders) as a result of the insolvency of the swap counterparty. This argument, if successful, would have had significant implications for the many structured finance transactions containing flip provisions of this kind.

Fortunately for the structured finance market, the Court of Appeal affirmed the validity of the flip provision. It held that the effect of the flip provision was not to divest LBSF of any asset currently vested to it, but merely to change the order of priorities.<sup>6</sup> The asset held by LBSF was the right to enjoy the proceeds of the enforcement of the security. The extent of this right was set out in the terms of the documentation, of which the flip provision was an essential component. Unlike *British Eagle*, where the multi-party netting arrangements were held to be a dealing with the assets of the insolvent airline, in *Perpetual*, the flip provision was an essential feature of the asset vested in LBSF, not a provision which varied an otherwise existing asset on the insolvency of LBSF.

In reaching this conclusion, the court recognised the necessity of ensuring that

the law in this area is clear and consistent. Whilst the court recognised that this has not always been the case, it stated that “the need for consistency and clarity is all the greater now that commercial contracts are becoming increasingly complex both in their underlying nature and in their detailed provisions, as is well demonstrated by the contracts in the instant cases”.<sup>7</sup> The court also recognised the desirability of giving effect to the contractual terms to which parties have agreed, particularly in the context of complex financial instruments where “the parties are likely to have been commercially sophisticated and expertly advised”. In fact, the court went further, acknowledging that even in those cases where the anti-deprivation principle may be relevant, it will often be possible to avoid its application by careful drafting.<sup>8</sup> The court referred to the “anti-avoidance” provisions in sections 238 and 239 of the Insolvency Act, and stated that, in light of the detailed statutory regime laid down by Parliament, it would only rarely, if ever, be appropriate for the courts to invent their own anti-avoidance policies and frustrate the terms of commercial contracts freely entered into by sophisticated parties. These comments from the court are helpful, giving renewed support to the principle of freedom of contract and indicating reluctance for the court to interfere in arrangements agreed to by sophisticated parties unless such interference is absolutely necessary.

However, notwithstanding the foregoing, the reasoning of the Court of Appeal is not entirely satisfactory. One of the reasons referred to by the Master of the Rolls for the court finding that the flip provision did not contravene the anti-deprivation principle was that the collateral over which the issuer had granted security in favour of

the swap counterparty and the noteholders had been almost entirely acquired by the issuer using the proceeds of the subscription money advanced by the noteholders.<sup>9</sup> In fact, this appeared to be the key point for the Master of the Rolls, who also suggested that had this not been the case, there may have been room to argue that the flip provision would have contravened the anti-deprivation principle.<sup>10</sup> However, it is difficult to understand why the fact that the collateral was purchased with the noteholders' subscription moneys should be a relevant consideration. A noteholder does not retain any proprietary interest in its subscription money following its payment to the issuer. All the noteholder has is a debt claim against the issuer for repayment of the redemption proceeds in accordance with the terms of the notes. Additionally, a noteholder does not have any interest in the assets belonging to the issuer, except via the security interest which it holds (through the security trustee) over the collateral. Given that the legal status of the claims of both the swap counterparty and the noteholders is ultimately identical (i.e., debt claims secured against the collateral held by the issuer), this preference for the interests of the noteholders over that of the pari passu interests of the swap counterparty is unsettling and appears contrary to the general principles of English insolvency law.

It is possible that the decision of the Court of Appeal may be appealed to the Supreme Court. If this is the case, it is to be hoped that the Supreme Court upholds the decision of the Court of Appeal, but without the apparent reliance on the fact that the collateral had been purchased with the proceeds of the

<sup>6</sup> Paragraph 62.

<sup>7</sup> Paragraph 58.

<sup>8</sup> Paragraph 92.

<sup>9</sup> Paragraph 61.

<sup>10</sup> Paragraph 67.

## “The court also recognised the desirability of giving effect to the contractual terms to which parties have agreed, particularly in the context of complex financial instruments”

noteholders’ subscription moneys. While this requirement may be unlikely to cause a concern in the context of structured finance transactions where the collateral has been bought out of the subscription proceeds, the uncertainty of the legal basis for this requirement does leave an opening through which to attack the validity of arrangements such as the flip provision.

There is also a further potential complication with *Perpetual*. A parallel proceeding is under way in the US Bankruptcy Courts where LBSF is arguing that the flip provision offends the anti-deprivation provision in Chapter 11 of the US Bankruptcy Code and, on that basis, cannot be binding on LBSF, notwithstanding that the relevant documents are governed by English law. The argument is not surprising given that in most jurisdictions, the provisions of insolvency legislation are of mandatory application, for to allow otherwise would enable parties to contract around inconvenient legislative provisions. The Court of Appeal did not address the implications of Chapter 11 in its decision in *Perpetual*, but it was briefly considered at first instance in the English High Court in response to a request from LBSF for a stay in the English proceedings pending the outcome of the decision in the US Bankruptcy Court. In that case, the Chancellor decided that, on the facts, there were no grounds for him to grant a stay at the present time and therefore parked the

issue to one side.<sup>11</sup> It is expected that the US hearing will occur in late November 2009 and, if that hearing concludes that the flip provisions do contravene the anti-deprivation provisions of the US Bankruptcy Code, this will give rise to considerable uncertainty as to how such provisions would apply in structured finance transactions involving US incorporated swap counterparties, notwithstanding that the provisions are valid under English law. As noted below, should this situation come to pass, one solution would be for US based swap counterparties to enter into swaps in connection with structured finance transactions through English subsidiaries, backed, where necessary, by a parent company guarantee from the US entity.

Prior to the Court of Appeal handing down its decision, Fitch had reacted to the uncertainty generated by this litigation by announcing that it would require an unqualified legal opinion on the enforceability of flip provisions in structured finance transactions. For the time being, the Court of Appeal decision at least means that it should be possible to give such an opinion as a matter of English law. However, Fitch has indicated that it requires such opinions to cover the laws of all relevant jurisdictions, which may not be possible, particularly in light of the ongoing litigation in the US related to *Perpetual*. In any case, this requirement is a significant departure from the previously established position that transaction opinions address only the consequences of insolvency of the issuer, and not of other parties to the transaction. In fact, one of the primary reasons for the inclusion of downgrade provisions in structured finance derivatives is to avoid the situation where the issuer is facing an insolvent swap counterparty. If those rating downgrade provisions apply, there should be no need

for legal opinions to address the enforceability of flip provisions following the insolvency of the swap counterparty.

### (b) Suspending payments to insolvent swap counterparties – the *Metavante* case

Under the ISDA Master Agreement, which applies to almost all OTC derivatives used in structured finance transactions, the obligation of a party to make payments in respect of a swap transaction is conditional on there being no event of default continuing in respect of the other party. As an event of default includes the insolvency of a party, if a swap counterparty does become insolvent, and that insolvency cannot be cured (which will almost always be the case, particularly where a winding up petition has been presented and has not been dismissed within 30 days), then the issuer can rely on that insolvency to stop making payments on the swap without having to terminate the swap. This applies, even when the swap counterparty is in-the-money.

This is an application of the construct which is often referred to as a “flawed asset”. Because the issuer’s obligation to perform is contingent on the swap counterparty not being in default, the asset (i.e. the right of the swap counterparty to receive the payment flows under the swap) is “flawed” by that contingency. When it is not possible for the swap counterparty to cure the default (i.e. the insolvency), there is no way for the liquidator of the insolvent swap counterparty to cure the flaw and “unlock” the value which would otherwise be available to the in-the-money swap counterparty. The ability of the issuer (or any non-defaulting party) to rely on a “flawed asset” provision has been upheld under English law. It is an important protection for an issuer where it is apparent that the counterparty is well on the road to

<sup>11</sup> *Perpetual Trustee Co. Ltd v BNY Corporate Trustee Services Ltd* [2009] EWHC 1912 (Ch), Paragraph 63.

bankruptcy and the issuer is faced with making a payment before the formal onset of insolvency proceedings or where an insolvent swap counterparty which has failed to procure a replacement swap counterparty to take its place prior to the onset of the insolvency. This provides the issuer with breathing space while it looks for a replacement swap counterparty willing to enter into a new swap to allow the structured finance transaction to continue.

However, the ability of the issuer to rely on such flawed asset provisions against a swap counterparty incorporated in the US was dealt a blow in the *Metavante* case. Although that case did not involve a structured financing arrangement, it nevertheless involved a party which was out-of-the-money relying on the insolvency of LBSF to avoid making payments under the flawed asset provision in a swap transaction with LBSF. Under the US Bankruptcy Code, a party to an executory contract is not entitled to rely on a flawed asset triggered by the bankruptcy of its counterparty to delay or avoid performance of its obligations under that executory contract.

Swaps are a form of executory contract. However, they are generally granted favourable treatment relative to other executory contracts for the purposes of the US Bankruptcy Code because the Code provides “safe harbour” provisions to excuse performance of swaps which provide for close-out netting arrangements in the event of the insolvency of one of the parties. However, in *Metavante*, the US Bankruptcy Court held that the purpose of these safe harbour provisions was to provide for an orderly close-out of such transactions and, accordingly, only apply where the non-insolvent party promptly exercised its right to terminate the swap in question. If the non-insolvent party did not do so, it was taken to have waived its right to terminate, and was not entitled to rely

on any flawed asset provisions to excuse performance of its future obligations under the swap. What the judge was particularly concerned about was a non-insolvent party which was out-of-the-money relying on the flawed asset provisions to “ride the market” until such time as it found itself in-the-money, and terminate at that time.

The judge’s reasoning is not entirely satisfactory as it appears to conflate two separate issues (namely, the right to terminate and the right to rely on a flawed asset provision) into a single issue. Put another way, it is the failure to exercise the right to terminate promptly which resulted in the swap losing the protection of the safe harbour provisions, and therefore the inability of the non-insolvent party to rely on the flawed asset provisions. In practice, it may prove difficult to ascertain how promptly a non-insolvent party must act to terminate, and for how long it is entitled to rely on the flawed asset provisions to avoid making payments prior to exercising its right to terminate. In some cases, the non-insolvent party may not immediately be aware of the insolvency of the swap counterparty, or even if it is aware, the sheer number of transactions which need to be dealt with in such circumstances may mean that there will be a significant period of time between the onset of the insolvency and the termination of the swap. This was certainly the case with the Lehman insolvency, and is very likely to be the case in many structured finance transactions where the issuer is not permitted to exercise any termination rights without the consent of the trustee. The experience with the Lehman insolvency has been that trustees are often reluctant to grant that consent without the approval of the noteholders, which can also take a considerable time to obtain.

Further, where the issuer is out-of-the-money, if it is forced to terminate the swaps “promptly” following the insolvency

of the swap counterparty, this may require the issuer to unwind the entire structured finance transaction if it is unable to find a replacement swap counterparty to enter into a new swap within that time frame. This is an unsatisfactory outcome for investors where the underlying assets may still be performing as expected. Additionally, if the result of the *Perpetual* case to be heard in the US courts is that flip provisions are not enforceable in the event of a US incorporated counterparty’s bankruptcy, then it may be that noteholders receive little or nothing by way of payment, if the out of the money payment to the swap counterparty absorbs all the assets of the issuer.

As with the concerns arising from the US litigation running parallel with the *Perpetual* case, one solution to these difficulties is for structured finance transactions to avoid using swap counterparties incorporated in the US, and/or for US swap counterparties to utilise subsidiaries incorporated in England, possibly backed by a guarantee from the US parent company if necessary. This would avoid the need to rely on the flawed asset provisions against a US incorporated entity.

## New beginnings: where next?

Since the onset of the global financial crisis, it has become more difficult to put swaps in place for structured finance transactions, and pricing for those swaps has been less favourable for investors. Nevertheless, swaps remain a valuable (and in many cases, essential) tool for managing the cashflows and exposures within a structure. While we are aware of transactions being (re)structured to avoid the need for swaps, in our view, swaps are likely to remain a feature of many transactions.

Despite their shortcomings, rating downgrade provisions do perform a

valuable role in structured finance swaps, although it is to be expected that they will continue to evolve as the rating agencies seek to reach the most workable solution. However, within the constraints of the existing criteria, and in light of the difficulties which have arisen with these provisions, it is necessary for arrangers, when structuring transactions, to give greater consideration to what would actually happen if the swap counterparty is downgraded and either collateral needs to be posted or a replacement swap counterparty needs to be found. Some suggestions in this regard include the following:

- To the extent possible, swap transactions should adopt market-standard terms. For example, if a pool of mortgages supporting an RMBS transaction pay interest based on a market-standard “screen” rate, then rather than the issuer’s payment obligation under the swap referring to “the amount of interest payable on the mortgages”, it would be better to define this amount by reference to that screen rate and a notional amount (subject to an expected amortisation schedule). This would avoid potential replacement swap counterparties needing to trawl through the transaction documents in order to be able to understand the cashflows, and therefore price the transaction. Of course, the ability to rely on market-standard terms will depend on the nature of the underlying assets. But to the extent possible, originators and arrangers should bear these factors in mind when selecting the underlying assets for a particular transaction.
- Consideration should also be given to whether “composite” transactions can be broken down into separate transactions. For example, it may be possible to divide an interest rate

swap into a basis swap, which may be more difficult to price, and a plain vanilla interest rate swap which would be easier to price.

- To the extent that more time is required to find a replacement swap counterparty, consideration should also be given to adjusting to the amount of collateral required to be provided by the swap counterparty. One way of addressing this concern is by the use of independent amounts, or including in the calculation of the swap exposure amounts which represent the expected payments required to be made by the swap counterparty on the next few payment dates.<sup>12</sup> This has the benefit of ensuring that the swap counterparty will be able to continue making its scheduled payments over the next few payment dates, regardless of movements in the mark-to-market exposure of the swap, while the parties attempt to find a replacement swap counterparty. While this is not a substitute for posting collateral in connection with the mark-to-market value of the swap, it may provide additional comfort for the rating agencies and justify allowing a longer period of time to obtain such a replacement.

Attention also needs to be given to how these swap transactions would be unwound if the swap does terminate early. This is particularly relevant in “balance guaranteed” swaps, where the quantum of the payment obligations is dependent on the size of the portfolio of underlying assets at a given point in time. At origination, the swap is priced on the basis of the expected amortisation of those assets over the life of the deal. However, how that amortisation should be modelled on early termination, when the portfolio is to be or has been sold needs to be made

clear if the market quotation mechanism under the ISDA Master Agreement is to provide a meaningful valuation. Much of this can be addressed in the drafting of the swaps at origination, and thereby avoid confusion and uncertainty if a transfer is subsequently required.

It is also possible that the current discussions about introducing “living wills” to manage the orderly winding-up of financial institutions in the UK (and similar proposals which may be made in other jurisdictions) may at least partially address some of the difficulties associated with finding replacement swap counterparties (for example, through pre-agreement of replacement swap counterparties, so that the transfer can occur immediately upon the relevant downgrade occurring).

Finally, as discussed, the uncertainties raised by both the *Perpetual* and *Metavante* cases can be minimised by avoiding using US entities as swap counterparties. Of course, this does not mean US banking groups cannot perform this role. Rather, where possible, issuers should seek to transact with subsidiaries of such groups which are incorporated in England where, to date at least, the contractual provisions at the heart of both cases have been upheld. Most of the US banking groups already have locally-incorporated subsidiaries which can be used for this purpose, and where such subsidiaries do not have the required ratings themselves, they can be supported by a guarantee from the US parent company without causing the uncertainties which arise from having a US entity as the swap counterparty directly.

This approach would avoid any of the uncertainties which may arise if the US proceedings running parallel to the *Perpetual* case find that the flip provisions

<sup>12</sup> This is, in fact, consistent with the approach taken by Moody’s in relation to some types of swaps.

contravene the anti-deprivation provisions of the US Bankruptcy Code. This is because the anti-deprivation will only bite where the insolvent swap counterparty is “in-the-money”, but a guarantor can never be “in-the-money” in this way, as the issuer will never owe any amounts to the guarantor. Thus, where the swap counterparty is out of the money, the issuer would have a claim against both the swap counterparty and the guarantor, but where the swap counterparty is in-the-money, the swap counterparty’s right to share in the proceeds of the collateral would be subordinated to those of the noteholders. Unless the Court of Appeal decision in *Perpetual* is subsequently overturned by the Supreme Court, this arrangement would be valid as a matter of English law.

Similarly, in the situation arising in *Metavante*, the issuer would not need to rely on any flawed asset provisions against a US incorporated entity, and would therefore not need to be subject to the limitations on the safe harbour provisions in the US Bankruptcy Code arising from that case.

### The impact of Centralised Counterparty Clearing and enhanced regulatory collateralisation requirements

Although most of the regulatory initiatives relating to OTC derivatives are emanating from the US and Europe, the involvement of the G20 as a co-ordinating body for the regulatory response to the global financial crisis means that the decisions in Washington and Brussels will impact on other nations too. Broadly, the proposals in play are:

- Use of central counterparty (“CCP”) clearing for OTC derivative contracts.
- Increased use of and incentivisation for exchange trading for derivatives .

- Collateralisation of OTC derivative contracts which are not cleared by a CCP.
- Increased regulatory capital charges for derivatives that are not subject to CCP or exchange trading.
- More transparency through pre and post trade reporting and the use of trade repositories to capture data for OTC transactions, with the possibility of regulator-imposed position limits.

Several legislative proposals have been introduced in the US to promote these initiatives and the EU has a proposal of similar effect. Whilst there are differences in the detail between the various bills currently circulating in Washington and between the US proposals and those of the European Commission, the overall thrust is similar.

The proposals envisage that standardised derivative contracts should be cleared through CCPs and that non-standardised OTC contracts should be subject to collateralisation requirements that are more penal than the corresponding margining requirements of a CCP. There are various approaches to determining whether a contract is “standardised” some involve designation by a regulator, this involves it being accepted by a CCP. Whichever method is to apply, there must be a latent concern that the structured nature of the swaps under consideration could result in them falling outside the standardised category. If so then, apart from the concern that this will leave them in a smaller less liquid market than before, thus exacerbating the pricing and replacement cost issues discussed above, they will also be vulnerable to the collateralisation requirement imposed by the regulators. Consequently, it is likely that they will be subject to collateralisation requirements of both of the regulators and the rating agencies. It is important to note that

collateralisation under the rating agency criteria only occurs in certain circumstances, whereas it is likely that the regulatory collateralisation rules will be standing requirements. Also, it is by no means certain that the collateralisation amounts required by the regulators will be less onerous than those of the rating agencies.

The proposed increased regulatory capital charges which are to apply, after the effect of collateralisation and netting are taken into account, are currently applicable to only banks and investment firms. Even so, the fact is that most swap counterparties to structured finance transactions fall into one of these categories. Therefore, there is a concern that the capital charges will add to the increased costs of institutions entering into such swaps, forcing some participants out of the market and reducing the liquidity still further.

Institutions will also have to address the increased transparency and trade reporting requirements, adding more costs, although these are likely to be small beer compared with the impact of collateralisation. It remains to be seen whether the ability of regulators to impose position limits on individual banks’ derivative exposures will challenge the market still further.

### Conclusion

The global financial crisis, and litigation which has arisen as a result of the insolvency of Lehman Brothers, has resulted in a need to re-examine the place of swaps in structured finance transactions. Whilst this presents a number of challenges, we remain of the view that swaps will continue to play an important role in structured finance, and that the lessons learnt from the past 18 months will result in more robust derivative structures in the future.

## 12. Investor disclosure



In the aftermath of the credit crunch, a concern has emerged as to a perceived lack of disclosure by issuers of asset-backed debt securities (both at the time of issuance and during the life of the securitisation) as a contributor to both market failure (in particular, in terms of secondary market liquidity) and reticence on the part of investors to re-invest in such instruments.

Simplicity, transparency and standardisation are the well publicised cornerstones of efforts by regulators and securitisation market participants to restore confidence in the asset-backed securities market, as a precursor to the return of public issuance. However, there is a lot more to simplicity, transparency and standardisation in the context of asset-backed securities than would seem apparent from such self-explanatory objectives.

Whilst investors will need to be able to satisfy themselves that they are able to and have adequately evaluated the manifest and embedded risks relating to such bonds, securitisation is also a process and not simply a product. It allows originators to enhance liquidity to their balance sheet and transfer risk and a tool which assists the availability of credit to a host of borrowers ranging from consumers to utility companies. Whilst restoring investor confidence remains key, the availability of financial innovation and flexibility to meet the end user's financial objectives cannot be forgotten.

The market has evolved from the securitisation of relatively homogeneous mortgage loans (at a time where the range of mortgage products to the average consumer was relatively limited in nature) to a tool to finance football stadiums. We now present our thoughts on the boundaries of the objectives of simplicity, transparency and standardisation and the manner of its likely implementation as public issuance re-emerges.

## Simplicity

Complexities of asset-backed securities, depending on the nature of the structure of the instrument and the structure of the collateral, can be categorised as either relating to the bonds (ranging from the forecasted cashflows, yields and extension risk) or the underlying transaction structure. In some transactions, there may be a simple looking bond backed by a complex structure whilst on others there may be more complex instruments with simpler underlying collateral.

The complexities of analysing credit risks are of course not unique to the asset-backed securities market. The recent public issuances in the UK by Tesco's,

Lloyds and Nationwide demonstrate the appetite for pricing credit risk but none of these securitisations have allocated the potential for extension risk which was previously allocated to investors in the pre-credit crunch environment.

If securitisation is to retain its importance to allow banks to match fund their assets and where funding is to be re-invigorated from the investors in the 5 to 7 year floating rate market for funding long-term financial assets, unless there is a simple allocation of extension (and prepayment) risk to the investors as was market practice, financial innovation could retain a part to play. UK RMBS master trust structures have however drawn particular criticism for perceived complexity and embedded risks.

Will innovation be possible and tolerated in structuring instruments such that certain tranches retain a relatively certain cashflow profile (without embedded risks), subject to credit considerations or will the market be limited in the foreseeable future to short-term revolving assets, credit-linked securities with longer tenors and soft bullet bonds with an investor put option?

In the short to medium term, we believe that the dynamics will be driven by: (i) the regulatory capital treatment of the financial assets under Capital Requirements Directive for the originator (and intention to minimise any capital arbitrage between off-balance-sheet and on-balance-sheet positions); (ii) the depth of and the pace at which investor appetite will appear for "A"/"A2" and "BBB"/"Baa2" rated tranches; and (iii) the resilience of the covered bond market.

## Transparency

Themes to be considered in the context of improving transparency are: (i) granularity of investor reporting (loan level data); (ii) efforts to ensure asymmetrical information knowledge between buyers and sellers of asset-backed securities (including data portals); and (iii) origination criteria, standardisation of asset warranties and the necessity for pool audits to re-enforce repurchase procedures.

Credit institutions investing in asset-backed securities will, pursuant to Article 122a of the Capital Requirements Directive, have to be able to demonstrate procedures to monitor performance information on the exposures underlying

their securitisation positions (with a corresponding obligation on sponsors and originator credit institutions to ensure that prospective investors have readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cashflows and collateral supporting a securitisation exposure as well as such information that is necessary to conduct comprehensive and well-informed stress tests on the cashflows and collateral values supporting the underlying exposures). Investors will have to be able to test rating agencies' assumptions and arrive at their own views on probability of loss in differing economic scenarios.

Further, it has been suggested that given the speed at which the market for sub-prime RMBS deteriorated and the ensuing lack of secondary market liquidity, having access to better granularity of information regarding the performance of underlying loans and borrowers and frequent reporting ought to be a priority for the market going forwards. Without adequate loan level information, investors (buyers and sellers) will be unable to assess the value of the securities, which sensitivity will be exacerbated in times of economic distress.

Although loan level reporting may be restricted by data protection laws and banking secrecy laws, having conducted a pan European legal analysis, we do not foresee insurmountable hurdles in this respect. However, in our view it will not be mandatory for investors to have access to loan-by-loan level data (as opposed to loan level data) to comply with their due diligence requirements under Article 122a. Stress tests are typically conducted on an aggregated basis rather than on an individual asset level. To be effective, regular investor reports will have to provide more

granularity than has previously been the case, and indeed, investors will likely require increased detail in performance reports for purposes of complying with their monitoring obligations during the course of their investment. Investor reports going forward should, at a minimum, contain narrow categorisations for stratification of data with such categories properly defined in the context of the securitisation so that investors can better ascertain the true performance of the underlying pool. Given the movement by rating agencies to provide more transparency on rating migration by reference to varying thresholds of default and loss assumptions, tailoring the categorisation of data in investor reports such that investors are able to test current transaction data against the original rating approach and assumptions, ought to be a sensible balance between the need for investors to test performance against tensions in providing loan-by-loan level reporting.

Originators are typically responsible for ensuring and certifying their compliance with origination criteria and warranties in respect of the asset pool at the time of sale. Given the perceived abuses around self-certification, some have queried whether investors will require some type of third party auditing (either at the outset of a securitisation or on a periodic basis). In our view, for large scale RMBS and other consumer credit transactions, wholesale audits of the asset pool by an arranger or adviser of the issuer is likely to be a step too far from a cost/benefit perspective as compared to a sensible loan sampling exercise which may typically be conducted. We will however expect express disclosure in the prospectus on the scope and depth of due diligence conducted on the asset pool – rather than a caveat emptor that there has been no verification of the asset warranties by the trustee or the issuer. In addition, attention

“Greater transparency does not necessarily equate to a need for a greater volume of data, but it does mean access to better data. Aggregated data can be more effective and encourage as much, if not more, transparency in the securitisation transaction. The better stratification of data so that rating assumptions can be tested and validated effectively may, in the end, be more useful than providing investors (some of whom may not have the resources to process such information) with overwhelming pool tapes of thousands of loans”

should be paid to the language used in transaction documentation regarding repurchase of assets by the originator upon breach of warranty. In general, parties should avoid the use of materiality thresholds or language that allows the originator any latitude to subjectively determine its own compliance with particular representations and warranties.

### Standardisation

Industry bodies and regulators are considering developing a standardised reporting template for originators to

provide loan level data to investors. Focus has been on RMBS transactions to date, but the intention is to create similar templates for CMBS and SMEs. The development of these templates stems from a belief that the standardisation of the disclosure package across transactions will assist investors in making comparisons between different transactions and among different originators. These templates will provide standardised raw data for investors to generate their own models and complete stress tests on the cash flows and collateral values of the underlying assets. Should this approach be implemented, the incorporation and adaptation of a standardised template may involve a significant lead time period for originators for the necessary overhaul of their IT systems. There has also been discussion of setting up centralised data portals for securitisations where investors, rating agencies and other market participants can (on subscription) access loan level data of all securitised assets for all originators. These completed loan templates would be inputted into this data portal, tagged accordingly, and dynamic fields therein updated on a regular basis. Rating agency reports and monthly investor reports would be accessible through the data portal. Investors would also be able to use the data portal to access summarised data through search engines within the portal.

Standardising reporting templates also by implication requires standardising definitions in relation to a particular financial product. In our view, while the movement to standardise the presentation of all data may provide some clarity, standardised definitions may in effect have the opposite effect. Accuracy may suffer in the move to standardise presentation. To be effective, standardised definitions will have to account for jurisdictional differences in a legally fragmented European market and, more importantly, the product types (and financial innovation) of each originator. Originators will continue to develop products which will not neatly fit within prescriptive standardised definitions. We would therefore question whether the standardisation of reporting templates will in fact meet the objective of providing better comparative data.

There are also initiatives to create categorisation of certain asset-backed securities which can be independently labelled as high quality from an investor perspective. For example, the prime collateral securities ("PCS") initiative's stated objective is to "*meet the requirements of investors seeking well-defined, high quality standards*". The proposals firmly state that the scheme is not intended to be a replacement for credit analysis or even investor due diligence. Rather, it is intended to be a tool for market participants to ensure that their securities comply with a

notional "gold standard" and an important step towards restoring market confidence and establishing a more liquid market.

One of the asset classes that perhaps lends itself best to the PCS initiative is residential mortgage backed securities. It is easy to see how a homogenous pool of prime residential mortgages, using a simple paradigm securitisation structure and containing detailed disclosure about the underlying assets can be easily assessed against certain pre-determined criteria.

However, even with residential mortgage securities, mortgage products are constantly evolving to meet the needs of the banks' customer bases. Mortgages linked to current accounts (off-sets, secured overdrafts, mortgage reserves) are becoming increasingly popular and these more complicated products present a new set of challenges for securitisation structures that are required to change and evolve in order to meet these challenges. It is also worth noting that the asset classes which perhaps lend themselves best to this initiative are, coincidentally, also the ones that have been showing the first independent signs of recovery with the recent public UK RMBS issuances. Whilst there may be investor apathy to analyse extension/cashflow risks, we would question the need for quality kitemarks from a credit perspective in a market with an institutional investor base.

13. Lifting the regulatory fog  
– will the amendments to CRD  
reveal a new landscape?



The prospect of a requirement for securitisation originators to retain a portion of securitised exposures (which has become known as the “skin in the game” requirement) is old news. It has been much discussed amongst market participants and Directive 2009/111/EC has finally been published, setting out the new Article 122a of the Capital Requirements Directive. Now that Article 122a is part of EU law, and the process of Member State implementation will start next year, this article looks at the practical and structural implications of the new retention requirements and the areas where further guidance from national regulators is needed.

Article 122a states that “A credit institution, other than when acting as an originator, a sponsor or original lender, shall be exposed to the credit risk of a securitisation position in its trading book or non-trading book only if the originator, sponsor or original lender has explicitly disclosed to the credit institution that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5%.”

There are four specific ways of retaining a “net economic interest”:

- (a) retention of no less than 5% of the nominal value of each of the tranches sold or transferred to the investors (in other words, a “vertical slice” of the securitisation);
- (b) in the case of securitisations of revolving exposures, retention of the originator’s interest of no less than 5% of the nominal value of the securitised exposures (in other words, a *pari passu* share of the pool);
- (c) retention of randomly selected exposures, equivalent to no less than 5% of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination; or
- (d) retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total no less than 5% of the nominal value of the securitised exposures.

### Why are Originators and Sponsors being required to retain a portion of risk?

The stated aim of the EU Parliament in enacting the new Directive was to align the interests of originator and investor. The retention requirements come as part of a package of measures currently at various stages of implementation in the EU. These include new investor due diligence

requirements (as to which see “*Investor disclosure*”) and regulatory capital penalties for re-securitisation, as to which see “*Re-securitisations-holding a costly position*,”. As a whole, these measures are aimed at eliminating two of the more risky features of the pre-crisis securitisation market, namely the “originate to distribute” model and the growth in re-securitisation activity. In requiring originators to retain a significant interest in their transactions, the hope is

that in securitising assets, originators will in future be driven more by economic factors than by regulatory capital arbitrage.

The Committee of European Banking Supervisors (CEBS) recently issued its response to the Call for Advice from the European Commission as to whether to increase the retention requirement from 5%. The CEBS expressly stated that an increase in the retention would not automatically align the interests of originator and investor, as originators may incorporate pricing compensations to offset the risk. Whether this will be the effect of the retention even at the 5% level remains to be seen. The CEBS also expressed some support for a requirement which takes into account the originator’s overall incentive, rather than a fixed figure.

For originators, the CEBS advice is welcome. The EU is scheduled to address possible increases in the 5% requirement by the end of the year, and it required receipt of the CEBS response before doing so. We will be watching for further developments.

### How will the retention requirements impact current structures and asset classes?

#### Who is affected?

Article 122a impacts any ‘credit institution’ exposed to a ‘securitisation position’. This

language catches more than the noteholders. The definition of securitisation position is “an exposure to a securitisation”, so the requirement also applies to counterparties such as swap or liquidity providers. Originators are not given express obligations by Article 122a, but they are indirectly required to hold the retained exposures in so far as they wish to sell notes to credit institutions.

#### **What are the obligations of the relevant credit institution?**

The retention requirement is satisfied if the “*originator, sponsor or original lender has explicitly disclosed to the credit institution that it will retain, on an ongoing basis, a material net economic interest*”.

There is no express primary requirement on the originator, sponsor or original lender to in fact retain a material net economic interest on an ongoing basis. The onus is on the credit institution not to invest unless such explicit disclosure has been given. However, prior to enforcement of the security granted by the issuer over the transaction documents, there is usually no contractual nexus between the investor and the originator, sponsor or original lender under which this disclosure obligation would be documented.

To address this issue, we would anticipate that the originator will need to give a covenant to the Issuer in the asset sale agreement, and to the managers in the subscription agreement, along the following lines:

*“The originator undertakes:*

*(i) to hold a material net economic interest pursuant to paragraph ((a) to (d) as applicable) of Article 122a(1) of Directive 2006/48/EC until maturity of the Notes and;*

*(ii) to provide all information required to be made available to Noteholders under Article 122a (1) to (7) to the Issuer and the Trustee on request, subject always*

*to any requirement of law regarding the provision of such information, provided that there will be no breach of this covenant if the originator fails to do so due to events, actions or circumstances beyond the originator’s control.”*

As the originator and investor(s) may not be subject to supervision by the same national regulator, some discussion may arise as to the standard with which the originator covenants to comply, especially where there is an SEC registration or 144A offer contemplated. In the U.S., a retention requirement of 10% may be imposed if current draft legislation is introduced (although an amendment to the draft has been proposed which would reduce the retention requirement to 5% and allow the retained portion of CMBS transactions to be held by a third party investor). Throughout Europe however, we would envisage that national regulators will impose largely standardised requirements for compliance, so a covenant to comply either with Article 122a or the national implementing rules should not cause undue difficulty.

In the ordinary course, the trustee will receive the benefit of such a covenant as the issuer will assign its rights under the transaction documents to the trustee by way of security pursuant to the deed of charge or security deed. However, it may also be possible to rely on the operation of the Contracts (Rights of Third Parties) Act 1999 to confer the benefit of the covenant on non-signatories such as the noteholders or other transaction parties.

The Prospectus will also need to make disclosure of the covenant. It may also be prudent for the originator to certify its holding to the issuer at closing, and the closing certificate to be disclosed.

#### **How and when is the 5% measured?**

Article 122a further requires that “net

economic interest” is to be measured at origination and shall be maintained on an ongoing basis. How net economic interest can be measured “at origination” is unclear – where a portfolio is subject to a ramp-up period, does this mean the interest should be measured at the portfolio cut-off date, or perhaps at the date of note issuance? We may have to wait and see how the FSA interprets this requirement, or individual financial institutions may seek their own guidance from the FSA.

The drafting of the new directive states that “ongoing basis means that retained positions, interest or exposures are not hedged or sold”. As the measure of net

#### **Key points for arrangers and underwriters**

- The application of the retention requirement is investor driven rather than originator driven, however originators are affected if securitised notes are being sold to credit institutions which fall within the CRD
- Article 122a is scheduled to be applicable to new securitisations issued on or after 1 January 2011 and after 31 December 2014 to existing securitisations where new underlying exposures are added or substituted after that date
- The retention requirements apply to credit institutions holding a securitisation position, this includes liquidity facility providers and swap counterparties
- The retention requirements are accompanied by detailed due diligence obligations for investors and punitive capital charges apply for failure to meet these obligations

economic interest at origination is 5% of the nominal amount (of the exposures in each of options b to d of Article 122a and of each of the tranches in option a)), this possibly means that the originator must, for the life of the deal, continue to hold the assets or the notes which amounted to 5% of the nominal value at the outset, but is not required actively to manage the value of its holding as a proportion of the exposure outstanding on an ongoing basis. What is not clear is whether, in the case of an originator retaining assets which happen to pay down first so that the originator is no longer at risk, there would be any breach of the retention requirement, or any correcting action required to be taken. Again, this is an area where further clarification may be forthcoming from national regulators, or may be sought by individual financial institutions.

### What are the sanctions for non-compliance?

If an originator fails to satisfy the 5% requirement there are no express sanctions on the investor or the originator within Article 122a. There are however punitive capital requirements imposed on an investor who fails by reason of negligence or omission to comply with the due diligence requirements set out in Article 122a (4) and (5). These require investor credit institutions to be able to demonstrate a comprehensive understanding of, and to have formal policies and procedures for analysing and recording;

- information disclosed by originators as to the interest they are maintaining;
- the risk characteristics of the securitisation positions and their underlying exposures;
- the prior performance of the originator or sponsor in securitising that asset class;

- statements by the originators as to their due diligence on the pool and any collateral;
- methodologies by which the collateral is valued, and the policies of the originator to ensure the independence of the valuer; and
- the structural features of the securitisation which could impact the performance of the securitisation position it holds.

They must also monitor performance of their securitisation positions as a whole, including the diversification, default rates and loan to value ratios of their entire portfolios.

There are also punitive capital charges imposed on an originator credit institution which fails to disclose to investors the level of its commitment to retaining the required exposures as required by Article 122a (7). Originators are also required to provide prospective investors with all materially relevant data on the credit quality and performance of the underlying exposures, as well as such information as is necessary for the investor to perform stress tests on the cash flows (see *“Investor disclosure”* section on page 67 above for more details). Breach of this latter requirement also attracts a punitive capital charge for the originator.

The fact that there is no sanction for a strict breach of the 5% requirement may support a view that the requirement is not a strict one to be managed actively by originators, but rather a requirement to take 5% of the relevant exposures at the outset, and to continue to hold those exposures through the life of the deal, providing investors with all materially relevant data on the performance of the pool. However, national regulators are required by Article 122a(9) to disclose, by the end of 2010,

the criteria and methodologies they have adopted to review compliance with Article 122a, and no doubt this will further clarify what is expected of originators. We anticipate, considerable interaction between industry participants and national regulators, particularly the FSA in the United Kingdom, throughout 2010, to develop and refine such criteria and methodology.

### How do the retention requirements impact other regulatory capital rules?

In order to exclude securitised positions from the calculation of risk weighted exposures under the Capital Requirements Directive, regulated originators must transfer significant credit risk to third parties. As noted by the CEBS, a significant increase in the retention requirement could endanger the ability of firms to achieve regulatory capital relief via significant risk transfer. In any event, the more of a first loss tranche an originator retains, the higher the capital charge to the transaction.

In July of this year, Directive 2009/83/EC set out some clarification aiming to align the application of the existing rules on significant risk transfer across EU member states. This directive included provisions which set out how significant risk transfer may be achieved when an originator holds a first loss piece or mezzanine piece of a transaction. Alternatively, significant credit risk will have been transferred if the competent authority is satisfied that the originator credit institution has procedures in place which ensure a commensurate level of risk is transferred which justifies the reduction in its capital requirement achieved by the transaction. The latter approach has been the previous practice of the FSA. It is not clear currently how the

regulators envisage the 5% retention requirement and these rules on significant risk transfer to interact, although we understand that the FSA is seeking input from market participants as to how they currently satisfy themselves that significant risk has been transferred. We would hope that the retention requirement would not adversely impact the FSA's analysis of whether there has been significant risk transfer in a particular case, but further guidance to the market is needed.

### **How will these requirements be addressed in Prospectus Disclosure?**

It is evident to us that the prospectus for any securitisation issuance will be a focal point for disclosure required for regulatory compliance by investors. In our view, it will be desirable to collate required regulatory information in one place in the prospectus, both for ease of confirmation of compliance by investors but also for ease of prudential review by regulators. As this information will be of significant importance to many investors we believe it will be

placed in a prominent position in the prospectus. Our recommendations, therefore, will be to include a separate page following the "Summary Information" (or similar) section of a typical prospectus. We would propose that it be called "Additional Information for Investors" and set out, as a minimum, the following;

- compliance with EU Credit Rating Agencies Regulation requirements for prospectuses e.g. "All credit ratings applied for in relation to the Notes will be issued or endorsed by credit rating agencies established in the European Community and registered under Regulation (EC) No 1060/2009";
- article 122a compliance covenant (see above);
- obligation on originator to provide ongoing information;
- how investors can access ongoing information; and
- compliance or otherwise with applicable Industry Codes of Practice e.g. the European Securitisation Forum's RMBS Issuer Principles.

### **Conclusion**

It is clear that the effect of Article 122a cannot be ignored by any industry participant. Originators will effectively be required to comply, whether they are regulated institutions or not, if they want to be able to sell their securitised notes to credit institutions. We expect that the retention and due diligence requirements will lead to much more interaction between market participants and their regulators at national level. The range of new disclosure rules and guidelines from regulators and market bodies means we are likely also to see the extent of pool disclosure becoming an area of greater focus, both prior to investment and on an ongoing basis. During 2010, the FSA and other regulators will be required to produce their implementing rules, and hopefully these will address some of the uncertainties outlined above.



14. Re-securitisation  
– holding a costly position



The recent proposal for a directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies (“CRD3”) includes provisions which would require banks taking positions in transactions described as “re-securitisations” to hold aside more regulatory capital than under the current rules. The directive describes a re-securitisation as a securitisation which has at least one underlying exposure that is a securitisation in its own right. The explanatory memorandum to the proposed directive explains the risk of high correlated losses and unexpected impairment losses on such positions as being the driving cause for the increased amount of capital that needs to be held in respect of them.

Although the broad consensus is that the new rule is intended to discourage the market creating, or investing in, securities such as CDOs of ABS and CDOs, the broad definition of re-securitisation, combined with the elusive definition of securitisation itself in Basel II and Directives 2006/48/EC and 2006/49/EC (“CRD1”), could also be construed to capture more benign securitisation financing models such as those employing two-tier structures and asset backed commercial paper conduits.

### Two tiered structures and ABCP conduits

Two-tier structures present issues under CRD3 to avoid the securitisation being viewed as a re-securitisation of the first tier. We consider there are likely to be two approaches:

- (i) first, if the current proposal is implemented as drafted we would imagine that when two tiered structures are put in place work would be done to ensure that credit enhancement and tranching only takes place at the point in the structure where the securities are issued. Any intermediate entities (be they French FCTs, Italian law 130 companies or borrowing SPVs in

whole business securitisations amongst others) would need to ensure that all the benefit and risk of their exposure is passed directly to the main issuing company so as to avoid any risk of those intermediate entities being considered as falling within the definition of a securitisation; and

- (ii) second, the term “re” itself in “re-securitisation” indicates a concept of time so could be construed as only applying to securitisation of already existing securitisations. If that was the case, most two-tiered structures would likely fall outside the ambit of this rule which we believe would reflect the clear intention of the wording and is consistent with the spirit and substance of the concern being addressed by the rule. Nevertheless, it is hoped that regulators would clarify their interpretation of this rule if the proposed wording passes into law without amendment.

If an ABCP conduit has even one underlying transaction that could fit the definition of securitisation itself then that could easily lead to the conclusion that any investment in the conduit (whether as commercial paper noteholder, liquidity provider or credit enhancement provider) would constitute a re-securitisation

exposure. Such a result would be unfortunate as it would increase the costs involved in maintaining ABCP conduits which provide a valuable source of working capital and other finance to many businesses which may not be able to access such ready liquidity elsewhere.

That said, on a positive note, the third compromise proposed by the European Council on the draft CRD3 dated 12 October 2009 (the “Third Compromise Proposal”) included a recital suggesting that where there is a single class of commercial paper being issued by an ABCP conduit and the commercial paper is fully supported by the ABCP conduit’s sponsor, then the commercial paper should not generally be considered a re-securitisation exposure. Similarly, where liquidity is transaction specific, the recitals to the Third Compromise Proposal suggest it should not constitute a re-securitisation exposure if first loss protection is provided by the underlying originator.

### Highly complex re-securitisations

The EU Commission has expressed a view that re-securitisations that are highly complex should be entirely deducted from capital. This view arises from the enhanced due diligence

investigations that now need to be undertaken by investors (under Article 122a, paragraphs 4 and 5) which the commission believes cannot actually be met in the case of highly complex re-securitisations. Only in cases where credit institutions can demonstrate to their regulators that they fully understand the risks involved in the re-securitisation and have performed the requisite due diligence will they be allowed to risk-weight their exposure. The recitals to the proposed CRD3 suggest that re-securitisations of leveraged buy-outs and project finance debt are of a “highly complex” nature so would fall within this regime. This would

be a significant disincentive for institutions attempting to finance these types of assets through securitisation.

Significantly, the Third Compromise Proposal suggests deleting the proposed rule about highly complex re-securitisations entirely. Given the

complexity that would surround attempting to define exactly what a highly complex re-securitisation is and the fact that re-securitisations are already penalised through a very significant risk weight, this approach would be welcomed by the market.

### Conclusion

There will be a need for institutions to consider historic and new transactions carefully and make structural adjustments in some cases. Additionally, given the wide definition of securitisation there may be a need to consider some other financial products in light of CRD3 although that is outside the ambit of this section.

It would be helpful to get further clarity from the European Parliament and Council in drafting and from regulators on implementation.



15. Bank and building society  
insolvencies revisited: the  
impact of the Banking Act



The credit crunch was a salient reminder that bank and building society originators are not immune from insolvency. Structured finance transactions are, of course, designed to withstand the insolvency of the originator and so this fact alone did not cause alarm, but the rapid introduction of new wide-ranging powers for financial regulators to deal with failing banks and building societies (such as the Banking Act 2009) did cause some initial concerns despite their laudable intentions. Now that the dust has settled, while a few uncertainties remain, market participants have generally got to grips with the impact of the Banking Act and, at least in this context, it's back to business as usual.

Despite its laudable intentions, the introduction of the Banking Act 2009 did cause some initial concerns but, now that the dust has settled, most of the issues have been worked through and it's back to business as normal. In summary:

- the wide powers afforded to the authorities raised various worries mainly concerning the separation of assets and liabilities and the re-writing of contracts;
- now that market participants have had the opportunity to reflect (and seen the powers exercised in a relatively benign fashion on one occasion) people have become increasingly comfortable;
- there is likely to be minimal impact on documents (except that our legal opinions have become slightly longer).

### Special Resolution Regime

The Banking Act 2009 (the "Banking Act") introduced a special resolution regime for UK banks and building societies encountering financial difficulties. The special resolution regime provides three stabilisation options to address the situation where a UK bank or building society has encountered, or is likely to encounter financial difficulties, namely: (i) sale of all or part of its business to a private purchaser; (ii) transfer of all or part of its business to a company that is wholly-owned by the

Bank of England (known as a "bridge bank"); or (iii) transfer into temporary public ownership.

The stabilisation options can only be used where the Financial Services Authority, in consultation with the Bank of England and HM Treasury, is satisfied that the bank or building society is failing, or is likely to fail, certain threshold requirements and that it is unlikely to be able to satisfy the threshold conditions in the absence of the exercise of the powers.

### The devil is in the detail

The objectives of the Banking Act are to protect the financial system, and those who invest, from instability and loss of individual rights. At a "big picture" level, it provides a level of certainty that previously did not exist: you only have to compare the clinical way in which the Banking Act was applied to Dunfermline Building Society ("Dunfermline") to the problems that ensued when Northern Rock plc encountered difficulties a little more than a year before, to see the benefits of the Banking Act in action.

We believe the Banking Act is a "good thing" for financial institutions. The resort to the general law of insolvency (implicitly preferred by some) has shown itself to be cumbersome and slow and, at worst, not fit for purpose. Having said that, if you

analyse the provisions of the Banking Act in detail, then it is possible to identify provisions that, when taken in isolation, could be cause for concern. We provide a summary of our current views on some of these points below followed by a discussion of how we think the Banking Act would most likely be applied to a securitisation or covered bond transaction. We conclude with some recommendations for addressing issues arising from the Banking Act in future deals.

### Expropriation of covered bonds

The share transfer powers give the Bank of England and HM Treasury the power to transfer securities issued by a bank. The definition of "securities" in this context is very wide and includes debt securities. Since covered bonds are debt securities that are issued by the bank itself (rather than by a special purpose vehicle) they fall within this definition and there is the possibility that bank covered bonds could be subject to a share transfer under the Banking Act. Although the Banking Act provides a mechanism for compensation to be paid in the event that assets are expropriated, this may not be adequate or timely.

This is effectively government risk and, accordingly, market participants seem comfortable with it. It has not had

## “We believe the Banking Act is a “good thing” for financial institutions”

any impact on the structuring of new deals and is simply an additional risk that is brought to the attention of potential investors.

### Splitting assets and liabilities

Under the Banking Act, it is possible that only some of the property, rights and liabilities of a bank or building society will be transferred to one person (and the remainder will be transferred to someone else or left behind in the insolvent “bad” bank). This flexibility was included to give the authorities the option of separating the performing (or “good”) assets from the non-performing (or “bad”) assets. This raises the possibility that rights and correspondent liabilities may be separated, which potentially causes concern for many different types of transaction.

In recognition of these concerns, HM Treasury has imposed restrictions on such “partial transfers” in The Banking Act (Restriction of Partial Property Transfers) Order 2009 (the “Safeguards Order”).

The Safeguards Order only applies to “partial property transfers” as defined in the Banking Act. Curiously, this definition does not link the partial transfer to a particular transferee. Accordingly, a property transfer instrument that transfers, for example, some of the property, rights, and liabilities of a bank to one party and the rest to another party would not be a “partial property transfer” despite the possibility that there may be a resultant separation of rights and liabilities.

For the reasons summarised below, we

do not think that this drafting anomaly should cause particular concern in the context of structured finance transactions although, because of its effect on netting and set-off arrangements, it may cause greater concern to parties entering into derivative transactions. One comfort may be that it is less likely that a property transfer instrument will provide for the transfer of all the property, rights and liabilities of a failing bank to more than one party (because there are likely to be some liabilities that the authorities want to leave behind in the “bad bank”).

The Safeguards Order does contain a specific protection for structured finance transactions: a partial property transfer may not provide for the transfer of some, but not all, of the property, rights and liabilities of a bank which are, or form part of, a “capital market arrangement” to which the relevant banking institution is party. This protection suffers from the same loophole as the definition of “partial property transfer” discussed above: there is no restriction on the transfer of part of a capital market arrangement to one party and the rest to another party but, again, for the reasons discussed below, we do not think that this is a cause for concern.

In this context, the term “capital market arrangement” takes its definition from the Insolvency Act 1986 (the “Insolvency Act”) but its use differs from that in the Insolvency Act in two main ways: (i) in the Safeguards Order, it is not necessarily qualified by reference to a “capital market investment” as it is in the Insolvency Act; and (ii) in the Safeguards Order, it is used to delineate the boundary of certain property, rights and liabilities whereas in the Insolvency Act, it is only applied in a binary fashion.

A “capital market investment” is, essentially, a bond that is rated, listed or traded (or designed so to be) or one

that is issued to certain classes of investors. Without this qualification, the definition of “capital market arrangement” would extend to other types of transaction such as secured or guaranteed lending transactions.

That aside, once you know what “capital market arrangement” means, it is likely to be easy to conclude that some property, rights and liabilities of the banking institution form part of one. Equally, it is likely to be easy to conclude that other property, rights and liabilities fall outside the capital market arrangement. There is, however, bound to be a “grey area” of uncertainty at the periphery.

The capital market arrangement safeguard in the Safeguards Order was clearly modelled on the safeguard that was introduced for set-off and netting arrangements, which are quite different from structured finance transactions. Securitisation and covered bond transactions do not depend on the identity of the contractual counterparty and there is, therefore, no need to keep the relevant parts of a transaction together.

Contracts that securitisation issuers and covered bond asset-holding companies enter into generally fall into one of two categories. Contracts with financial support counterparties (such as swap counterparties, account banks and liquidity providers, etc) are usually protected with rating downgrade provisions. Contracts with service providers (such as servicers or cash managers) are unlikely to be protected by rating downgrade triggers (because they do not need to be) but are protected by “inability to perform” and “insolvency” termination events. It would probably be inappropriate, in any event, to try and end this latter category of contracts abruptly since a transitional period is likely to be necessary in many cases.

Assuming that rating downgrade triggers remain effective in the light of the Banking Act (and we believe that the better view is that they do – see below under “*Turning off events of default*”), we see no reason why the various roles in a securitisation or covered bond need to be held together. For this reason, we are generally relaxed about the operation of the Safeguards Order in the context of securitisation and covered bond transactions.

### Amending the terms of contracts

The Banking Act contains various “continuity obligations” including, among others, those placed on (in the case of a property transfer) the residual bank and its group companies and (in the case of a share transfer) the former group companies of the transferred bank to provide such services and facilities as are required to enable the transferred business or entity to operate effectively.

It is worth noting that there is no similar reverse continuity obligation and so the transferee is not necessarily under an obligation to provide services back to the residual bank (this would be particularly relevant if, for example, all of the servicing assets and infrastructure were sold to a third party but certain loans were left behind in the “bad” bank). The authorities may try to put in place a transitional servicing arrangement with the purchaser of the servicing assets but this is not certain.

The “continuity obligations” go further than this, though, and give the relevant authorities the power to create or modify contracts or other arrangements between (in the case of a property transfer) the purchaser, the residual bank and its group companies and (in the case of a share transfer) the transferred bank and its former group companies.

These provisions can only be exercised to the extent necessary to ensure the provision of such services and facilities as are required to enable the transferred bank or business, as the case may be, to operate effectively.

These provisions are of greater relevance to covered bond transactions rather than securitisation transactions since the asset-holding LLP in a covered bond transaction is likely to be a group company of the bank and, therefore, within the scope of the continuity powers. In this context, it is not clear whether contracts that are not between the LLP and the bank might be affected by virtue of being part of an “arrangement” between the LLP and the bank.

In the context of partial property transfers (subject to our observations about the scope of the Safeguards Order in “*Splitting assets and liabilities*” above), the Safeguards Order does provide quite a degree of comfort because it restricts the application of the powers associated with the continuity obligations that would terminate or modify property, rights or liabilities which are or form part of a capital market arrangement to which the relevant bank is a party.

While this is helpful, it is worth noting that the wording of the Safeguards Order does not match that of the Banking Act (which also extends to imposing rights and obligations).

### Turning off events of default

The authorities were obviously concerned that counterparties would attempt to circumvent the provisions of the Banking Act by including new events of default and other provisions that would be triggered by actions taken under, or in relation to, the Banking Act. The inclusion of such “poison pill” provisions is, generally, frowned upon by regulators

since it fetters their ability to deal with a failing bank.

In response, the Banking Act contains the power for the authority to “turn off” default event provisions in documents. These powers are drafted very widely and capture not only events of default but also other rights (such as the right to receive a sum of money or to change an interest rate) that counterparties might want to be triggered by actions taken under the Banking Act.

In the context of structured finance transactions, there was some concern that these provisions may prevent the operation of rating downgrade triggers in contractual documents. While it is not completely beyond doubt, we think that by far the better view is that rating downgrade provisions should still work as intended. The reason for this is that the restrictions in the Banking Act say that the relevant instrument made under the Banking Act is to be disregarded for the purposes of determining whether the default event provision has been triggered. In our view, even if you disregard the making of the relevant instrument, the relevant entity has still had its rating downgraded and, therefore, the provision should be enforceable.

It is, however, worth noting that the power to disapply contractual default event provisions is optional. Although it was exercised in the case of the Dunfermline transfers, it may not always be exercised on future transfers. Counterparties should, therefore, consider whether it is appropriate to include events of default and other provisions that relate to the taking of action under the Banking Act in new contracts, recognising that it is possible that they will not be effective if the authorities choose to exercise their disapplication powers.

### Suggested event of default

There is exercised in respect of it, or any member of the group, by any governmental, regulatory, supervisory or similar body or official, a stabilisation power under the Banking Act 2009, or under similar legislation or regulation, a power (capable of affecting the rights of its creditors generally) to transfer a significant part of its property, rights or liabilities, or a power to transfer a significant part of any shares or other securities issued by it.

### A matter of trust

One of the knottiest provisions of the Banking Act was a provision that, when a property transfer instrument makes provision in respect of property held on trust, it may also make provision about the terms on which the property is to be held after the instrument takes effect (which may remove or alter the terms of the trust).

Trusts are a key feature of structured finance transactions and the uncertainties that this provision introduced regarding the rights of third parties was unfortunate. While there were different views initially, many people found comfort in the fact that the objectives of the Banking Act include protecting and enhancing the stability of the financial systems of the UK and avoiding interfering with property rights in contravention of a person's human rights – neither of which would be achieved if this provision could be used to re-write trust deeds and reallocate settled property.

The authorities gave more definitive comfort on this point when they made The Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order 2009. This limited the power to remove or alter the terms of a trust to the

extent necessary or expedient to transfer the title of the banking institution in the property held on trust to the transferee. While this is not completely satisfactory (since it only applies to partial transfers), it is a welcome indication of the authorities' benign intent and, in any event, whole property transfers are thought unlikely to occur.

### Likely impact on a new deal

Recent experience suggests that bank bailouts tend to happen on a Sunday. Although the authorities may have had some prior warning, and, therefore, the time to put in place some preparations, given the complexity of the issues that are raised by the Banking Act in relation to structured finance transactions, there is a concern that they may not have enough time to give sufficient consideration to the intricacies of a particular deal. There are likely to be two aspects to this analysis: does the transaction have sufficient value to merit transferring it and is it possible to transfer it (bearing in mind the restrictions in the Safeguards Order).

The complexities of structured finance transactions taken together with the wide protections afforded to them by the Safeguards Order (including the fact that the precise scope of some of the provisions of the Safeguards Order is not entirely clear) may mean that the only practicable short-term solution available to the authorities is to keep the failing bank's rights and obligations under them in the "bad" bank.

This does not, of course, preclude the possibility of a subsequent transfer at a later date but it may not be what market participants expect.

It is clear that the authorities are keen to protect the interests of retail depositors (for example, the Safeguards Order contains a carve-out from the "capital

market arrangement" protection for deposits) but the concerns of noteholders in structured finance transactions may not be their top priority. This does not suggest that the authorities are likely to harm the interests of such noteholders (which, after all, would not be conducive to the first objective of the Banking Act, which is to protect and enhance the stability of the financial systems of the UK) but adds further weight to the suggestion that noteholders may find their structured finance transactions left behind in the "bad" bank.

Since structured finance transactions are designed to withstand the insolvency of the originator, this should not be a cause for concern (provided rating downgrade triggers can still be relied upon – see *"Turning off events of default"* above). Any revolving transactions are, though, likely to move into an amortisation phase (because of an insolvency trigger or because the originator no longer has sufficient "virgin" assets to sell into the structure).

One particular point worth considering is the likely impact on any servicing arrangements. As discussed under *"Amending the terms of contracts"* above, the servicing (or any similar) obligation may remain in the "bad" bank but the assets and infrastructure required to carry out that function may have been transferred to someone else. In the circumstances, it would be helpful if the authorities were to put in place a transitional servicing arrangement but this is only likely to be the case if they can see some value in continuing to undertake the role. Unless there is a back-up servicer in place, it is difficult to see how the servicing role could be transferred to a third party overnight (since there are usually systems issues to be overcome).

It may be worth considering adding a covenant to servicing-type arrangements that, in the event that the servicer is unable

## “The only short-term solution available to the authorities may be to keep the failing bank’s rights and obligations under structured finance transactions in the “bad” bank”

to fulfil its obligations under the agreement, it will use its reasonable endeavours to put in place a sub-servicing agreement. Of course, if the “bad” bank is placed into bank administration, the enforceability of this covenant would then not be certain.

### Changes for new deals

The implications of the Banking Act need to be considered at the outset of any new deal. It is worth bearing in mind that, even if the main counterparty is not a bank or

building society, the provisions of the Banking Act may still apply if there is a bank or building society in the corporate structure (for example, some UK supermarket chains have bank subsidiaries and may, therefore, be subject to the Banking Act).

We may also see the introduction of new representations in subscription and dealer agreements to the effect that a bank or building society is not the subject of any action taken under the Banking Act and, to their knowledge, no such action is contemplated. The first part of this representation is necessary because there is no central register of actions taken under the Banking Act (although any significant action is likely to be reported widely in the press).

References to types of insolvency proceedings in documents are also likely to need updating to include specific reference to the bank insolvency and bank administration regimes that have been introduced by the Banking Act.

In terms of legal opinions, most law firms’ initial reaction was to include a broad reservation, which was not always acceptable to the rating agencies. As things have moved on, we have been able to reduce the reservation’s stringency and give reasoned opinions in relation to the application of the Banking Act to particular aspects of transactions. This has, by and large, been acceptable to the rating agencies.

### Conclusions

Generally, while there are uncertainties in the detail, the overall effect of the Banking Act has been to introduce a degree of certainty to the financial markets: in future, we know that a failing bank is likely to be dealt with swiftly and clinically by the authorities. This should, in general terms, be a cause for celebration not concern.

## 16. Government asset schemes and their impact on securitisation



Various government schemes in place have inevitably dictated, to a varying degree, the structure and documentation for liquidity trades structured during the credit crunch. In this section we will explore the various governmental schemes and discuss how they have impacted the securitisation documentation, in particular, in respect of asset transfer and buy-back, simplification of note tranching and absence of excess spread stripping, lack of currency hedging and more stringent ongoing reporting requirements.

### Government schemes in place since credit crunch

Various government schemes have been put in place - or in relation to the ECB monetary operations, been utilised - to provide liquidity to financial institutions since the onset of the credit crunch. These include, notably, the Bank of England Special Liquidity Scheme (SLS) and the Discount Window Facility (DWF), the ECB money market operations (ECB MMO), the US Term Loan ABS Facility (TALF) and the UK Government RMBS Guarantee Scheme. We will not discuss the UK Government Asset Protection Scheme (GAPS) in this note. GAPS, although using mechanics very similar to an unfunded credit default swap, is now likely to be unique to RBS and is unlikely to have a significant impact on the securitisation market as a whole.

The Special Liquidity Scheme (SLS) was announced by the Bank of England in April 2008 with the aim of enabling banks to access liquidity by swapping illiquid ABS for UK Treasury Bills. It closed on 3 January 2009. Most of the collateral actually received by the Bank of England was from RMBS or residential mortgage covered bonds. An announcement by the Bank of England on 3 February 2009 stated that the total nominal value of securities held by the Bank as collateral in the Scheme amounted to approximately £287 billion. The Bank's valuation of those securities as at 30 January 2009 was approximately £242 billion, an effective discount to par of about 16%. In

January this year, the Bank of England also announced the extension of its discount window facility (DWF) which covers a much wider range of collateral eligible for such operation with an extended maturity of up to 364 days. The DWF has been increasingly used by banks as part of their balance sheet management and planning.

The ECB MMO, which allows counterparties to enter into repurchase transactions with the ECB or a national central bank, was already in place before the financial crisis. To be eligible, assets must be a debt instrument, with a zero, fixed or floating coupon and the asset transfer must be a 'true sale' governed by the law of an EU member state. Certain relaxations to the eligibility criteria were made in the last year or so in the light of the financial crisis, for example, extending the scheme to securities in non-euro denominations, whilst certain other aspects of the eligibility criteria have been tightened, for example, the restrictions on the provision of currency hedging and the prohibition of tranches of other ABS being eligible assets backing the ABS. In July 2009, the total value of collateral held by the ECB was €12.2 trillion (as announced in a key note speech on 13 July 2009 by the President of the ECB). For further discussion on this topic see the section entitled "*ECB liquidity transactions – a refresher and an outlook on changes to come*".

TALF was announced in November 2008. Its stated aim is to increase credit

availability to households and small businesses by supporting the issuance of ABS collateralised by a variety of loans. The facility allows the Federal Bank of New York to lend up to \$200 billion to any US person or business entity holding certain AAA-rated ABS, with a term of up to 3 years (or 5 years in certain cases) on a non-recourse basis to the borrower, secured on the eligible ABS. As at 21 October 2009, a total amount of \$2,124,921,093 TALF loans have been requested. The facility is due to cease making loans collateralised by newly issued CMBS on 30 June 2010, and loans collateralised by all other types of TALF-eligible newly issued and legacy ABS on 31 March 2010.

The RMBS Guarantee Scheme was announced on 19 January 2009 and due to expire by the end of 2010 following its extension. The stated aim of the scheme was to improve banks' access to wholesale funding markets, help support lending, and promote robust and sustainable markets over the longer-term. The Government provided two types of guarantee attached to eligible AAA rated asset-backed securities, including mortgages and corporate and consumer debt: the ABS Credit Guarantee which covered the obligations of an issuer to make payments of interest and principal when due, and the ABS Liquidity Guarantee which guaranteed the issuer's obligations under a call or put. So far the RMBS Guarantee Scheme has not been utilised by any originators.

## The use of securitisation technique and documentation

A notable common theme of the government schemes is the utilisation of securitisation techniques both in terms of structuring and documentation. By way of example, transactions structured for the ECB MMO and the SLS are effectively single investor securitisations. The RMBS guarantee is essentially a traditional stand-alone or master trust RMBS with the additional benefit of the government guarantee or funding support on the exercise of a call.

From our experience for most of the ECB and SLS liquidity trades closed in the past two years, existing securitisation structures and documentation are widely used with adaptations, where necessary, to fit the relevant transaction into the eligibility requirements of the relevant scheme. Although no transaction using a RMBS guarantee has closed so far, it is conceivable that the paradigm structure and market standard securitisation documents will be used again adding the guarantee language as the additional building block.

## How have the government schemes shaped the paradigm securitisation structure and documentation post credit crunch?

The adaptations that originating/structuring banks have to make to fit the relevant transaction into the government schemes broadly fall within the following categories: (a) asset transfer; (b) tranching of note and excess spread strip; (c) restrictions on the provisions of support by the originator; and (d) ongoing reporting requirements.

### (a) Asset transfer

It is a long established criterion of the ECB operations that only a “true sale” of the underlying assets may be eligible for ECB money market purposes. It is also clear that the ECB is the ultimate arbiter of what constitutes a true sale and not legal analysis. Synthetic transfers through credit-linked notes or credit derivatives have been expressly prohibited. The criteria are not specific on whether less common types of asset/risk transfer would be eligible, e.g. originator trust structure or secured loan structure, regardless of their legal analysis. For example, we have executed some transactions using English law or Irish law governed originator trust structures which were accepted (correctly in our view) by central banks as eligible securities on the basis that an originator trust structure is “*enforceable against any third party ... and beyond the reach of the originator and its creditors, including in the event of the originator’s insolvency*”. Central banks in continental European jurisdictions where there is no trust concept may have difficulties in recognising this type of transfer notwithstanding the legal analysis of the technique vis-a-vis the “true sale” criterion. As to this and other aspects of the “true sale” analysis, see further the section entitled “*ECB liquidity transactions – a refresher and an outlook on changes to come*”.

### (b) Tranching of note and excess spread strip

A notable structural feature of the liquidity trades is the simplicity of note tranching and lack of capitalised instruments as a means to stripping excess spread from the deal (e.g. residual certificates). More often than

not, notes issued in the liquidity trades will only have an AAA tranche to be repo-ed with central banks (sometimes with horizontal slices to reflect the assets splits for the purpose of satisfying the SLS legacy assets requirements) and an unrated junior tranche to be held by the originator. We have been involved in many transactions where only a single AAA tranche was issued and the credit enhancement was achieved by the establishment of reserves funded by the originator. The need to achieve an efficient structure - which was one of the primary drivers and innovations of deals pre-credit crunch - has been replaced by the need to maintain the AAA rating of the notes to obtain funding/secure liquidity.

### (c) Restriction on the provision of currency hedge and liquidity support

The ECB announced in September 2008 that securities are no longer eligible for the currency swap provider to the issuer or the guarantee of such securities or to the bank that provides liquidity support of more than 20% of the nominal value of the ABS.

Given the pricing of a third party currency hedging in the current market, the former has resulted in some deals being structured without a currency hedge in place. This has necessarily resulted in structuring and documentation changes which allow the currency mismatches to be dealt with by additional collateralisation and more cumbersome calculations to be conducted by cash managers.

As an alternative, many UK originators have issued Sterling securities - which are eligible for the ECB MMO until December 2010 - subject to an additional haircut to encourage investors. On some of these Sterling

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transactions, some central banks have requested that Sterling interest payable in respect of the securities to be repo-ed with the relevant central bank should not be paid until a period agreed with the relevant central bank has elapsed, in order to avoid the relevant central bank receiving Sterling denominated notes and returning such amount to the originator as manufactured interest under the relevant repurchase transaction. Again we have introduced structuring to meet this request by creating long first coupon notes coupled with mechanics that allow an amount that is equivalent to the quarterly interest amount that would otherwise have been made to be retained by the relevant issuer without breaching, for tax purposes, the payment conditions for UK securitisation companies.

(d) Ongoing reporting requirement

In the liquidity trades, the ECB and the Bank of England have tried to impose more stringent reporting requirements on the servicer. The ECB, in particular, is presently considering loan level information disclosure on a loan-by-loan basis. These reporting requirements, if implemented, are likely to have long-term impact on

securitisation transactions in the future. For a more detailed analysis of ongoing investor reporting, see further the section entitled “*Investor disclosure*”.

Contrary to the adaptations made to fit the relevant transaction in the eligibility criteria, a reverse side of the coin is that transactions structured for the central bank schemes are mainly for the purposes of liquidity and balance sheet management. As a result, it is desirable for the originator to be able to “claw-back” the assets at any time from a structuring perspective when the originator intends to exit the relevant schemes. This has resulted in many bespoke seller buy-back options built in the liquidity trades which are either structured by way of options to buy back assets by the originator (e.g. an option for the originator to buy all the assets in the portfolio at par at any time or following the occurrence of certain triggers) or options to call the notes which are exercisable by the originator or a combination of both options. These options, though maximising the flexibility afforded to originators to exit the relevant transaction, have given rise to some true sale opinion issues to be considered by transaction counsel.

In addition, a notable consequence of the “retained” feature under central bank schemes is that the originator will not be able to obtain capital relief in respect of the assets put under these schemes on the basis that it has not transferred sufficient amounts of risk in respect of the relevant assets. These deals are therefore almost exclusively for liquidity purposes rather than obtaining capital relief. As a result, the issues that are often hotly debated on transactions structured with a view to obtaining capital relief in addition to funding (e.g. originator implicit support in the context of asset buy-back) are often moot in these liquidity trades.

In transactions funded by the central banks, post-transaction amendments (in

particular, in relation to transactions repo-ed with the Bank of England) could be an involved process. This is primarily because notes issued for the Bank of England trades tend to have a longer funding period (contrary to the ECB trades where notes are typically repo-ed with central banks on a one or three month rolling basis). Given the Bank of England is essentially the only noteholder of notes repo-ed with the Bank of England, obtaining their consent has become necessary where the trustee is unable to make determination on the basis of non material prejudice. We have structured and standardised documentation to facilitate this process.

### Will these influences continue when the public market comes back?

Following the note issuance out of the Permanent programme by Lloyds and the Silverstone programme by Nationwide, it is hoped that the public RMBS market will come back in the short term. Consensus is that the market, when it is back, will not be back to the level and sophistication of the pre-credit crunch level. We would also expect there to be a bifurcated market where central bank liquidity trades (as discussed above) will continue to be structured and executed while at the same time (and possibly in the same issuance) transactions will be executed with notes intended to be sold to public investors. It is therefore unlikely that the structure and documentation put together solely for the liquidity trades will continue in their current form when the public market gradually reappears. However, we believe some of the factors mentioned above will become “standard” in the market, particularly as our expectation is that many transactions (especially RMBS) will not seek regulatory capital relief.

17. ECB liquidity transactions  
– A refresher and an outlook  
on changes to come



This section looks at the rules governing collateral eligibility for the ECB's liquidity scheme, which has been a lifeline to the market over the last few years. We discuss the ECB's recent rule changes and offer our observations as to where future rule changes may be made.

The 20 November announcement that the ECB will require two ratings instead of one for ABS effective from 1 March 2010 and comments that the ECB would like to wean the market off its lifeline are likely to lead to a significant reduction in the number of deals being structured for ECB liquidity purposes.

As the ECB's rules change from time to time, it is important, where possible, to ensure that there is enough flexibility in deal documentation to allow for continued eligibility after a rule change.

### The ECB's scheme

The ECB has provided critical liquidity to the market over the last two years. A cornerstone of its liquidity operations has been its rules regarding the types of assets it will accept as collateral for liquidity purposes.

### Eligible assets – a refresher

The ECB accepts two types of assets as collateral for its liquidity schemes – marketable assets and non-marketable assets.

Marketable assets generally include:

- corporate debt with an issuer or guarantor rated "A" or above;
- ABS rated "AAA"; and
- regulated covered bonds rated "A" or above.

Non-marketable assets are essentially credit claims (e.g., loans) and non-marketable retail mortgage-backed debt instruments.

### What's not eligible?

A number of factors may render particular securities ineligible. The main ones being:

- an issuer established outside the EEA and any of the other non-EEA G10

countries (which renders securities issued by Cayman Islands or Jersey SPVs ineligible);

- the securities not having a rating from one or more recognised rating agencies (or, for ABS securities issued on or after 1 March 2010, ratings from two or more recognised rating agencies - see *Grandfathering* below);
- the currency not being euro, sterling, US dollars or yen;
- the securities not being the most senior tranche;
- for ABS issued after March 2009, the underlying assets comprising asset backed securities; and
- for ABS, the acquisition by the issuer of the underlying collateral for the ABS not being a "true sale" governed by the laws of an EU member state.

### Close links – further tightening?

Counterparties wishing to use the liquidity schemes cannot have "close links" with the issuers of the securities they want to use as collateral. The

primary prohibition is on submitting collateral which a counterparty has issued or guaranteed itself. There are also other rules prohibiting other types of "close links", such as the rule that if a counterparty submitting collateral provides any foreign exchange hedging to the collateral, such collateral will not be eligible. To date, counterparties providing interest rate hedging, or liquidity support of up to 20% of the relevant transaction, have not fallen foul of the "close links" rule. In addition, a counterparty servicing assets has not been regarded as having a "close link" with the securities being submitted for collateral purposes. While there has been no official announcement in relation to any tightening of these rules, there is speculation that the close links rules will be tightened, in particular in relation to interest rate hedging and liquidity support in general.

To guard against a transaction ceasing to be eligible for ECB liquidity purposes, consideration should be given to the inclusion in the transaction documentation of provisions allowing for a change of interest rate counterparty or liquidity provider should that become necessary to comply with any new "close links" rules.

## True sale

For ABS to be eligible, the transfer of the underlying assets to the issuer must be a “true sale”. This requirement is well known and national central banks routinely request legal opinions to confirm the true sale analysis. However, there have been some extensions of the true sale requirement in particular deals which have been challenging for market participants to satisfy.

### Traceability of “true sale” to origination and underlying assets:

Historically, for true sale purposes, the national central banks have never looked further back than the sale of the assets from the originator to the issuer of the securities. However, in recent transactions, this approach has been changing. For CDOs of ABS issued before March 2009, requests have been made for comfort that not only was the sale to the issuer of the underlying ABS a true sale but also that the underlying ABS themselves were true sale transactions (a very difficult requirement to satisfy unless the counterparty requesting eligibility had arranged the underlying ABS transactions and could provide the true sale legal opinions delivered in relation to them). There is nothing in the rules which suggested that such an interpretation might be made and an extended application of the rule without warning was not a welcome surprise. In addition, we are aware of CLO transactions where true sale comfort has been required, not only in relation to the sale by the originator of a portfolio of loans to the issuer of the securities, but also in relation to the originator’s own acquisition of individual loans from the market. Again, it came as a surprise to the market participants in those deals when the national central bank extended the true sale requirement beyond the sale of the underlying collateral by the originator to the issuer of the securities.

**Originator Trusts:** The legal status of originator trusts in English law equates to that of a “true sale” and structures using English law trusts have been accepted by national central banks on many occasions. That said, there has been one instance recently which we are aware of where an Austrian originator trust structure was rejected as being ineligible by the relevant national central bank. Although we do not anticipate any issues with tried and tested originator trust models (Austrian law is different to English law) there is a possibility that national central banks may analyse the legal aspects of trusts and how readily they equate to a “true sale” in more depth going forward.

## National central bank arbitrage

The central bank of the country where the securities being submitted are listed gets the job of determining whether or not the relevant securities will be eligible for collateral purposes.

Market participants have sometimes noticed different approaches appearing to be taken by the various national central banks over the interpretation of eligibility criteria and turn-around times for applications. As a result, counterparties have sometimes tried to arbitrage these differences in order to achieve a particularly fast turn-around or the acceptance of a particular type of asset. The differences in approach were broadly seen as being due to the way the national central banks were very separate institutions and did not (or did not appear to) have a particularly joined-up approach.

Recently, national central banks have been communicating a lot more and as a consequence of this their interpretation of the eligibility criteria has become more uniform. Accordingly, it would appear that

the opportunities market participants may have had for central bank arbitrage have largely disappeared.

In terms of organisation, the national central banks have started to allocate certain tasks to one of their number to allow for greater consistency in application across member states. For instance, the French national central bank centrally decides on the theoretical value of securities whose value cannot be determined in the market and where a theoretical valuation needs to be made.

## Asset valuations

The absence of any real market for many ABS securities means that theoretical values have to be assigned to such securities in order for the ECB to be able to calculate how much it can lend against those securities. In some instances, the values attributed by the ECB to ABS securities submitted for collateral purposes have been significantly less than par. Counterparties faced with low valuations have sometimes been successful in obtaining a higher valuation, particularly where the originator of the receivables has agreed to provide enhanced disclosure on the underlying assets.

To assist with valuation of ABS submitted as collateral, there was speculation that the ECB would publish new requirements stipulating minimum ongoing disclosure standards that would need to be adhered to. On 24 November 2009, a member of the executive board and governing council of the ECB published an article stating that the ECB was studying, together with investors, originators and rating agencies, the introduction of loan-by-loan information requirements for ABS. The purpose of such disclosure requirements would be to improve the quality of the surveillance processes

conducted by investors and rating agencies and to help restore confidence in the ABS market. The introduction of such disclosure requirements would also allow for easier valuation of securities relying on a theoretical valuation.

## Grandfathering

The grandfathering of changes to the ECB's eligibility criteria is not guaranteed. In instances where grandfathering is not permitted, transactions which satisfied the criteria at the time they were put into the scheme may no longer do so and would need to be withdrawn if they do not comply with the new or changed rules.

If changes are not grandfathered, sufficient prior notice may be given so that market participants are not taken by surprise. For example, additional haircuts to ABS transactions and changes to the close links rules came into force on 1 February 2009 with no grandfathering, although prior notice had been given to the market that these changes would be made.

An example of when changes were partially grandfathered was in March 2009 when ABS of ABS and CDOs of ABS became ineligible. However, the ECB grandfathered the use of these types of assets until 1 March 2010 provided they

were issued prior to 1 March 2009. As of 1 March 2010, all ABS of ABS, or CDOs of ABS, will cease to be eligible for collateral purposes.

On 20 November 2009 the ECB announced that ABS issued on or after 1 March 2010 must have ratings from two or more rating agencies that meet the minimum rating requirement in order to be eligible. ABS currently in the ECB's liquidity scheme that do not meet this requirement are being partially grandfathered until 1 March 2011 as of which date all ABS in the scheme, irrespective of when they were issued, will need to meet this requirement.

## Secured structures using non-ABS criteria

As there are different eligibility criteria for ABS, corporate bonds and covered bonds, there may be scope for structuring assets into one category if they do not fit into another. For instance, ABS securities require an "AAA" rating to be eligible, but this is not of course always possible. For such transactions, one entity (with an "A" rating itself or issuing with the benefit of a guarantee from an entity with an "A" rating) could issue bonds guaranteed by an SPV. The guarantee from the SPV could be secured on the underlying

assets, similar to what happens in many covered bond transactions (but without the issuer actually being required (or able) to satisfy the requirement to issue a regulated covered bond). With this type of structure, assets not capable of backing an "AAA" rated ABS can be used to support or enhance an obligation issued by an entity (or guaranteed by an entity) with an "A" rating, without the structure falling within the ABS rules and, therefore, without the need to get an "AAA" rating and provide a true sale opinion.

## The future

The ECB's open market operations were never intended to be a permanent form of financing for credit institutions. With the financial recovery that is under way, we expect a continuing tightening of the rules on what will constitute eligible collateral going forward.

Credit institutions which currently rely heavily on the ECB for their funding requirements will need to take care to ensure that they can structure assets that will be compliant with future rule changes or be in a position to restructure existing deals to make them compliant.

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