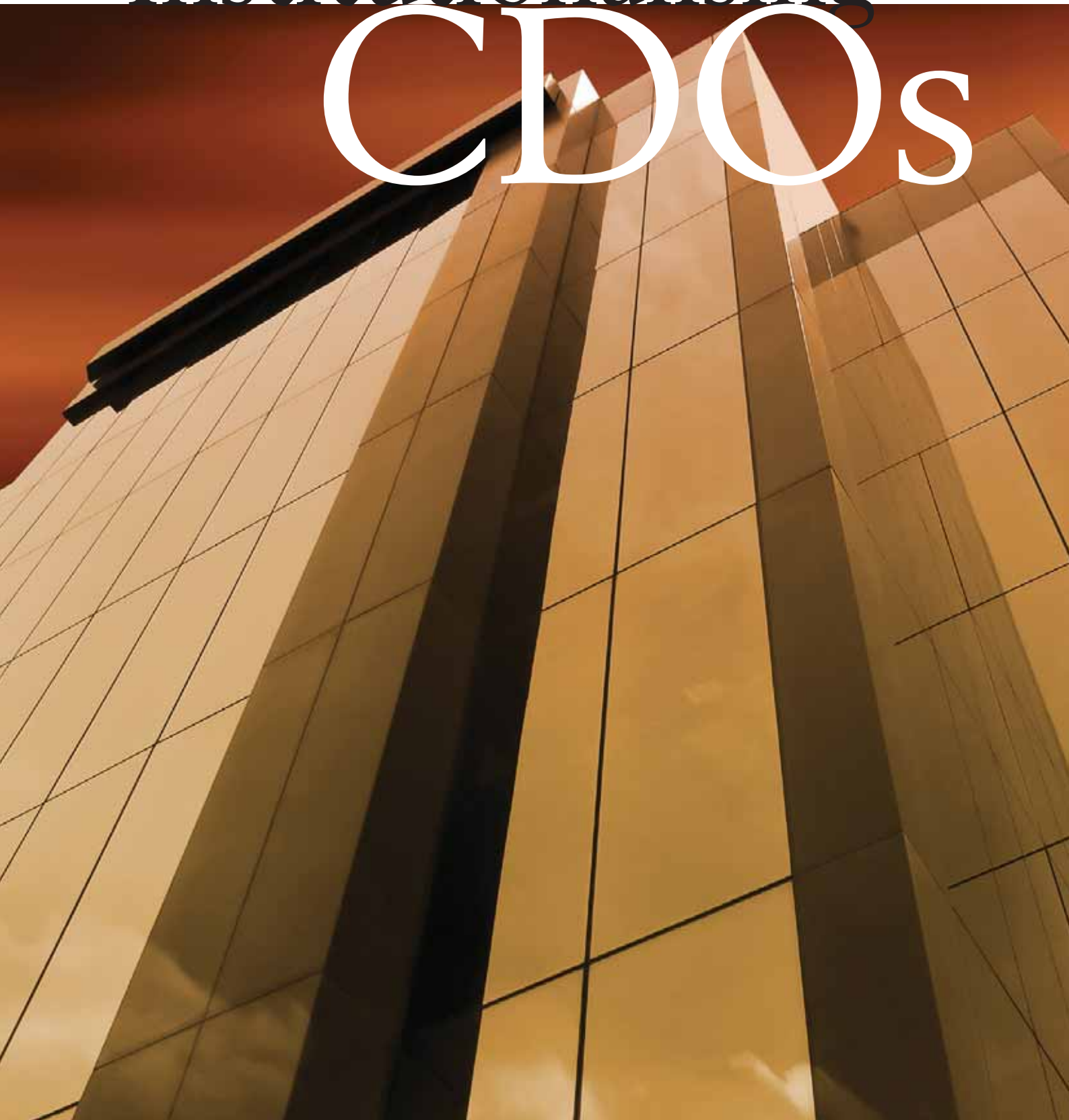


CDOs

# Institutionalising CDOs



While concerns prevail about the role of collateralised debt obligations in the Australian market, they continue to make an appearance in ever-increasing numbers – and in ever-changing permutations.

story by fiona haddock

According to rating agency Standard & Poor's (S&P), the collateralised debt obligation (CDO) market has almost reached A\$5 billion this year to date compared with about A\$2.5 billion (US\$4.2 billion) in 2005. Although the volume this year has been helped by two large balance sheet collateralised loan obligations (see p36 for further discussion of CLOs) – which are necessarily larger because the notes for the entire structure are issued as opposed to just a single tranche – the figure is still noteworthy.

But where do Australia's institutional investors fit in this picture? Australia is known for its heavy retail and middle-market presence in the CDO space; institutional investors are considered the exception. What's more, many fund managers have openly expressed their disapproval of the product.

Andrew Baume, director in Deutsche Bank's relative value group, responds that institutional investors have been around from the beginning: "Retail investors have always been more visible, but institutional investors are an important part of the market." He points out that all but one of the Deutsche Bank deals have included institutional tranches.

However, ANZ Investment Bank (ANZ)'s head of structured product sales, Nick Fyffe, comes from another angle. He describes a sea-change this year: "Twelve months ago, not only were 90 per cent of institutional investors not investing but they were actively against CDO products." He says this is no longer the case: "Fifty per cent are vaguely enthusiastic and 50 per cent are potential participants."

### The flow of cash

But this doesn't entirely correlate with comments by investors. Some say they aren't interested – at the moment, or at all. Several others confirm they do invest in CDOs, but make it clear there is not much to be had in the local corporate synthetic market.

Aberdeen Asset Management (Aberdeen)'s portfolio manager fixed income, Ky Van Tang, says her group has only invested in a minimal number of CDOs. She points to an increase in the gearing, much thinner subordination levels and a continued lack of transparency in pricing and says very few structures would appeal at the moment. She adds: "We're happy with what we've got, but there are only so many names to invest in before it becomes repetitive."

Meanwhile, Steve Howell, chief investment officer for funds management at Basis Capital – one of the largest CDO participants in Australia – is not convinced by what’s on offer locally. He points out that Australian Stock Exchange-listed CDOs are largely static and unmanaged CDOs comprised predominantly of unsecured credit risk.

Apart from not being keen on static CDOs, Basis Capital prefers cash flow CDOs, where real assets are match funded with real liabilities – all within a special purpose vehicle. “The structure is more robust and there is 100 per cent transparency,” Howell says.

Perpetual Investments (Perpetual) holds a similar view. The fund manager set up its structured fund on 1 October this year. At this stage, it is only open to wholesale clients. While the fund is active on the secondary market, Perpetual’s senior portfolio manager, Darren Langer, dismisses local currency deals. “We tend to avoid domestic CDOs. They’re done with retail investors in mind, plus there’s often an additional layer of fees over what an institutional deal would charge to cover distribution costs,” he comments.

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**Ky Van Tang, Aberdeen AM**

He also points to the fact they’re 100 per cent corporate synthetic. Perpetual, he says, is more interested in asset-backed and loan cash flow CDOs, the preserve of Europe and the US.

Langer believes other fund managers are of a similar frame of mind. “Most are avoiding the domestic CDOs because they’re not terribly well diversified and they have access to better quality deals from offshore banks that are often tailored to suit their portfolios.”

### **Slim pickings**

The overriding problem for the Australian market is its size. It doesn’t have the requisite number or diversity of names to structure such deals. Europe, on the other hand, draws half its volume from cash flow CDOs, says S&P. While this reflects the fact cash flow CDOs release all the notes, similar to CLOs, it is telling when compared with Australia where they don’t figure at all. Perhaps it’s not surprising then that wholesale issuance constitutes most of the CDO market in Europe.

Deutsche Bank’s Baume acknowledges the appeal of overseas deals. Referring to cash flow CDOs backed by leveraged loans, he says: “I like the sub investment-grade referenced credits. There’s lots of subordination, which is great.”

He says a lot of institutional investors are moving more into this market. One reason he gives is that they can see the US and Europe creating good structures. But he also points out that while they have already



invested in the investment-grade entities underlying synthetic CDOs, “they don’t have access to the leveraged loans market”. “That’s where the vast majority of institutional investor interest is,” he comments.

It’s not a light decision, however. Bob Sahota, head of debt investments at Challenger Financial Services (Challenger), says his group took a top down view and chose to go the purely leveraged loans route. It then proceeded to short list managers in Europe and the US – a necessary task given their proliferation over the past year to two years, says Sahota. Ultimately, Challenger decided to put its money in credit opportunities funds – what Bill Barden, director, structured products, at SG Corporate and Investment Banking (SG), describes as a mixture between a hedge fund and traditional fund manager with a bottom-up credit research approach.

“Off-the-shelf CDOs didn’t fit,” Sahota explains. “Here there are fewer rules and they’re more flexible than standard CDOs.” Credit opportunities funds have more discretion in their investment approach with less emphasis on rating agency methodology and rules. “They’re generally not as leveraged as a regular CDO,” Sahota adds.

## Beyond vanilla

The CDO market, with all its combinations and permutations, is driven by the search for yield. This means that as regular CDOs begin to look less profitable, other more complex instruments are being introduced into the market. As SG's Barden points out, CDOs are considered vanilla instruments these days. Constant proportional debt obligations (CPDOs) are where it's all at.

ABN AMRO launched the first CPDO into the Australian market at the end of August. Known as SURF, it followed on from its inaugural launch in US dollars and euros in mid-August.

Merrill Lynch also brought a multi-currency CPDO deal to the market in late September. Named Rated Enhanced Dynamic Index (REDI) notes, issued through the bank's CLEAR vehicle, the deal offered \$100 million in Australian dollars.

A CPDO is a non-principal protected, synthetic, fixed income credit which has a triple-A rating on both the principal and coupon. It fuses technology from traditional CDOs and collateralised proportional portfolio insurance (CPPI) – an instrument which derives from the insurance industry and enables you to principally protect your investment, at a cost.

In a CPPI deal, you are subject to a leveraged asset portfolio where the leverage amount can vary over time, explains S&P's director, structured finance ratings, Stephen McCabe. The leverage, he says, is generally a function of the "reserve" – defined as the difference between the current net asset value (NAV) of the portfolio and the bond floor.

In a CPDO, there is no principle protection, but it is also a dynamic leverage trade – albeit with differences. In ABN AMRO's CPDO, the portfolio is dynamically adjusted in order to actively target the payment of the stated coupon (190 basis points over bank bill swap rate (BBSW)) and the repayment of the principal at maturity. Hence, the target portfolio is compared with the current portfolio size and if they differ by more than 25 per cent, ABN AMRO will adjust the leverage accordingly.

"We have a known outcome that we're working towards," says Bevan Silvester, derivative solution group, ABN AMRO. "Basically, when the NAV of the notes rises above the value of a triple-A bond paying bills plus 190 we actually unwind all the credit default swaps. All the scheduled coupons and principal will be paid until maturity."

Based on the Dow Jones European iTraxx and the US CDX indices, the CPDO is automatically rolled out of the old indices and into the new ones every six months as the new indices are released.

"What you have is this nice self-cleaning mechanism," Silvester says. "So while you're still at risk of the Enron and Worldcom-type scenarios, you're not going to sit there as with a static CDO



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**Bill Barden, SG**

and hold a name while it goes through that falling angel stage and defaults. Once it drops below triple B minus, it is cleared out of the portfolio with the index rolls."

By rolling into the new indices you also keep the liquidity in the structure, says Silvester. "The most liquid indices are always those that are on-the-run."

Silvester notes another key point for this deal is its transparency. "There's no correlation input used to price a CPDO, unlike CDOs where it is a key factor in determining pricing. With this structure, because it's all public information – and everyone can see where iTraxx and CDX are trading – there are no surprises in the valuation."

About A\$50 million of the SURF notes were sold into the Australian market. Silvester says the deal has attracted a significant number of fund managers: "We're certainly seeing a lot of interest in this structure and a lot of the interest has come from non-traditional buyers of structured credit."

One of the reasons for this is the rated principal and coupon, unlike CPPIs where just the principal is rated. "That's stopped many people purchasing CPPI deals," Silvester says, "because many mandates and banks balance sheets want to have a fully rated coupon and principal."

According to Perpetual's Langer, the rated principal and coupon means you can invest in a true triple-A rating. But the downside of the CPDO, he says, is the mark-to-market risk – the NAV can change significantly because of the leverage in the structure. "It's very price sensitive, especially in the first few years. You wouldn't want to put your whole investment in it."

S&P's McCabe points out that as well as CPDOs being subject to mark-to-market risk, and hence spread risk, there's also credit risk and an interest rate risk element.

In terms of rating the deals, McCabe says: "We're not comfortable in assigning a rateable level to the base correlation for the tranches of the indices which affects the mark to market. Base correlation is not an issue when looking at the whole index so we are comfortable rating structures that reference the whole index."

He adds: "Even though the CDX and iTraxx only allow investment grade names into the indices and are reset



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**Phil Preston, Colonial First State**

every six months we don't ignore defaults. We look at them as well as the spread and interest rate risk."

Baume at Deutsche Bank reckons time will tell whether it's a good trade, but says: "If investors are comfortable the credit spreads aren't volatile for a while, CPDOs may be perfect."

However, McCabe offers a warning: "These are more complex products than plain vanilla CDOs. If an investor is not comfortable with the risks inherent in a plain vanilla CDO, they should not be comfortable with mark-to-market and interest rate risk found in CPDO structures."

He also points out that it's not a tried and tested product: "They are a very new product and thus obviously have no track record." But he acknowledges: "A return of 200 basis points over BBSW is appealing."

### Correlation conundrums

Correlation has been a contentious issue for the CDO market since last May when Ford and General Motors' debt was downgraded to junk bonds, resulting in considerable volatility in the credit-default swap market.

Since then, correlation has declined, which has been bad news for those investors that bought into the more senior pieces of CDOs. "As correlation has declined, it has pushed the value of CDOs from the mezzanine and senior tranches into the equity pieces," Silvester says. "Generally, Australian fund managers haven't bought equity tranches of CDOs and that's where the value of CDOs is at the moment."

However, Phil Preston, senior manager credit, Colonial First State Global Asset Management (CFS GAM), says that the mezzanine pieces are often being mispriced. "Within the structure, the super senior and equity parts are more likely to be adequately compensated than the mezzanine part."

He is not convinced by the assessment of risk. "The ratings models are still a bit naive regarding credit risk – especially correlation risk. This risk is extremely difficult to model unless you use the most sophisticated credit technology. We think some mezzanine tranche ratings aren't accurately reflecting their risk," he comments.

Others in the market highlight the changes to S&P's rating model. This has created tighter attachment and detachment points between tranches at different rating levels compared with those a few years ago. This means CDOs are much more exposed to rating migration than they used to be, says Perpetual's Langer. Newer synthetic CDOs have less of a buffer to protect them against adverse moves in the underlying portfolio. This increases the likelihood of having downgrades in the CDO rating, forcing investors to sell if the rating falls below mandated minimum ratings.

S&P's McCabe says it is very much a function of when the downgrades happen. "Due to the decrease in default probability of an obligor over time, if there

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is no rating movement in the underlying reference entities, a CDO will build a cushion between support provided (the attachment point) and support required (the scenario loss rate). Thus downgrades later on in a transaction attract much less volatility in the CDO rating.”

Aberdeen’s Tang believes issuers have been opportunistic as far as the tighter attachment and detachment points are concerned. Baume, meanwhile, says it reflects market forces. In an extremely tight credit environment, investors are calling for more yield – low attachment points being the inevitable result. “It’s market driven,” Baume says. “The rating agencies are not letting people have a free kick.”

### Just managing

SG’s Barden says in retrospect, he would have gone for more subordination in the bank’s EDEN deal.

He adds that he has been put off static CDOs. “I’d rather have a manager in there if the deal is over five years.” He points out that in seven years, you could

be facing two credit cycles. “Things can change for a company.”

If the CDO has a triple-A rating, Barden says, “you probably don’t need the best manager in the world”. However, he adds: “Lower down you need someone to really work at it.”

Howell at Basis Capital agrees. “Static CDOs aren’t the way to go. If there are unexpected defaults there – boom! With managed CDOs, at least there is the managers’ reputation on the line, to help protect all concerned,” he comments.

But CFS GAM’s Preston queries managed CDOs. He says the deals’ managers can face conflict of interest. “Super senior, mezzanine and equity investors are all after different things. Super senior wants diversification with low correlation; equity wants concentration with high correlation – the more diversified the pool, the greater risk for equity. Mezzanine is caught in the cross-fire, but more diversification in the pool is generally not good for them.” ■

# Alternative

It’s difficult to get a reasonable yield on plain vanilla synthetic collateralised debt obligations (CDOs) these days. It’s not surprising then that arrangers continue to devise new-look structures: cross-subordinated CDOs squared: long/short portfolios; hybrids; step up/step down structures; and leveraged super senior have all made their way into the market.

One recent development in the CDO market has been the referencing of alternative assets such as commodities. These deals are known as collateralised commodity obligations, or CCOs. The assets in these transactions are a number of European-style commodity options that behave in a similar way to credit default swaps, explains Stephen McCabe, director, structured finance ratings, Standard & Poor’s (S&P). “A default of the asset is equivalent to the option being exercised, which will happen if at the maturity date the price is lower than a trigger level.”

For European options, it is only the price of the underlying asset on the maturity date that is important, says McCabe.

“For example, if a commodity option has a trigger level of 30 per cent then the asset is in default if the price at the five-year maturity date is less than

30 per cent of the strike price. If the price falls to below 30 per cent before the maturity date, but is above this value on the maturity date, this is not considered to be a default event. Thus the default event is a function of the trigger level and the price at the maturity date.”

In September, Macquarie New Zealand (Macquarie) joined the market. It issued NZ\$121 million (A\$106 million) in commodity bonds, through Generator Bonds Ltd in its capacity as trustee of the Commodity Bonds Trust, a Macquarie vehicle. Listed on the New Zealand Exchange debt market (NZDX), the notes have a five-year maturity and offer a fixed rate of 8.25 per cent paid quarterly. They attracted a double A- rating from S&P.

Macquarie explains: “The product is designed to generate fixed income from a portfolio of commodity positions selected from the precious metal, base metal and energy sectors.”

Another alternative asset to have registered some interest is equity default swaps. However, McCabe says that while there have been a lot of enquiries about them, this has not resulted in a large number of transactions.

# Assets