

Subprime Crisis:

The ripple effect continues

How is the subprime crisis affecting corporate restructuring and the capital market?
Louise Verrill and Patrick Elliot analyse developments



Introduction

As we all know, the subprime crisis has caused substantial damage in global capital markets. Widespread debt downgrades have created losses in the value and liquidity of securitised debt backed by subprime residential mortgages. Much of this debt was held by major US banks, resulting in multi-billion dollar write-downs in the second half of 2007. The recent write-downs announced by prominent European banks highlight the global nature of this problem. As an example, Swiss financial giant UBS AG revealed subprime-related write-downs of \$18.4bn in April 2008.

These losses have also caused pain outside of the securitisation markets, for example the normally serene US municipal bond market has been invaded by the subprime virus. Recently, the inability of municipal issuers to attract bidders to their auction-rate securities has triggered penalty rates of over 20% for these otherwise credit-worthy issuers.

In the UK the current priority is to stave off a recession. To this end, the UK

government has made available some £50 billion worth of government-backed securities in exchange for mortgage debts and has signalled the availability of a further £50 billion. This seems to have helped to settle the markets, although they remain wary as to whether the extent of losses is fully known.

In Europe, as in the US, many are anticipating a response from government regulators. The International Monetary Fund has discarded its growth forecast for 2008, warning that the credit crisis may force governments to resort to radical measures. In the face of recent stock market turmoil, the scandal at Société Générale and the crisis at Northern Rock, there is a call for order to be restored in the capital markets. Several European leaders present at a recent 'credit crunch' meeting in London echoed this call and stressed the need for increased cooperation among national regulators, which would provide for greater transparency in financial markets and led to earlier warnings of global systemic risks.

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which guarantee the repayment of bonds, are a crucial source of liquidity in the bond markets. They are struggling to remain viable market participants. They once limited their business to guaranteeing municipal bonds, but began insuring mortgage and other asset-backed securities (effectively “renting” their AAA ratings to these securities), which offered higher margins. Now, as the rating agencies have downgraded some of the monolines and are contemplating additional downgrades, the finance industry is bracing for a ripple effect. Securities wrapped by the monolines

would have to be downgraded, forcing a wave of sell-offs by regulated investors.

This type of climate may suit opportunistic investors, as shown by Warren Buffett's recent offer to purchase the municipal bond guarantees of three major monolines – although not surprisingly Buffett made no offer for the monolines' toxic debt security guarantees. In a similar vein, Financial Guaranty Insurance Company (FGIC) announced a plan to create a "good bank / bad bank" structure, whereby it would transfer its municipal exposure into the "good" subsidiary and its structured debt exposure into the "bad" subsidiary. This triggered immediate opposition from banks that would suffer further write-downs on their exposure to structured credits backed by FGIC.

Paper crisis

The underlying problems driving bank write-downs and rating downgrades are also plaguing the structured investment vehicle (SIV) industry. Experts believe that we are still in the middle of a commercial paper crisis, much of which can be attributed to SIVs and related conduits. These entities issue short-term, low-yielding debt in the form of commercial paper and invest the proceeds in longer term, higher yielding assets, often in the form of securitised or bank debt. They need to continually roll over their commercial paper for liquidity, but the liquidity crunch has brought their commercial paper issuance to a virtual halt, leaving them unable to refinance their outstanding debt.

Rhineland Funding Capital Corp., a conduit of German bank IKB Deutsche Industriebank AG, was an early victim of the commercial paper crisis. Rhineland had almost \$27.3bn of outstanding commercial paper in the markets in July of 2007. When investors refused to roll over some of these notes, Rhineland called on IKB to provide a line of credit, which a conduit-sponsoring bank is often required to do (although the same obligation does not exist with respect to SIVs). However, IKB lacked the cash to meet this request and was unable to liquidate enough assets to provide the funding, thus threatening to trigger the bank's collapse. In an effort to stop growing panic in the commercial paper sector, the state-owned German bank, KfW Bankengruppe, offered an \$11.9bn credit facility. Unfortunately, this action may have had the reverse effect, as investors began shunning SIV commercial paper.

Plummeting value

The ongoing turmoil in the capital markets has forced some SIVs into receivership. Rhinebridge Plc, another IKB-sponsored entity, was placed into receivership in October of 2007 and is still negotiating a plan. Cheyne Finance Plc, a \$6.6bn SIV, was put into receivership in September of 2007 after a substantial decline in the value of its assets triggered an enforcement event. The High Court considered whether, pursuant to Cheyne's insolvency event clause, Cheyne was able to pay its debts as they fell due, even though it had sufficient cash to continue paying its creditors. It determined that Cheyne would likely lack sufficient cash in the future due to the deteriorating value of its assets, and on this basis found Cheyne insolvent.

In February of this year Whistlejacket, an SIV sponsored by London-based Standard Chartered Bank, entered receivership. Standard Chartered had initially pledged to support its SIV with some \$7.15bn in funding. However, a plummet in the value of Whistlejacket's assets constituted an enforcement event, triggering automatic receivership and causing Standard Chartered to withdraw its support. The High Court decided that creditors whose debts fell due on the date of the receivership should be paid in full, but others whose debts fell due within 30 days should not be. This decision was appealed before the Court of Appeal on 12 May 2008, and its decision is being eagerly awaited.

Following the decisions in Cheyne, a number of other SIVs and conduits could be determined insolvent, irrespective of their balance sheet solvency. We may see more SIV receiverships, which offer the advantage of flexibility and speed, decisiveness and the experience of stakeholder management. However, many view SIV restructuring as a preferable alternative to insolvency. In the Cheyne receivership, an agreement was reached to sell Cheyne to bidders (including Goldman Sachs) who plan to recapitalise and restructure the troubled SIV.

Restructuring

Private restructuring led by the sponsoring bank is also a direction in which the SIV industry is heading. In December of 2007, Citigroup – the world's largest sponsor of SIVs – followed the lead of HSBC, SocGen and Rabobank by taking its SIVs' assets back on balance sheet. HSBC is restructuring its \$26bn SIV, Cullinan Finance Ltd, replacing it with two new HSBC-backed conduits that

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will issue new notes to replace the Cullinan notes. This plan, approved by Cullinan investors, was no doubt crafted with a careful eye towards the tension that exists between SIV investors and the sponsoring bank's shareholders, who likely resent the adverse effect that the assumption of a SIV's troubled assets has on the bank's balance sheet.

Although markets have settled following injections of liquidity by the ECB, the Bank of England and the Fed, the securitisation market will need time to recapitalise the monolines, restore confidence in the rating agencies' methodologies, and correct the excesses and misalignments of interests that have undermined trust in the market. Value investors like Goldman Sachs are beginning to purchase securitised debt and commercial paper. This should provide interim relief to issuers and help the markets to settle. Additionally, opportunistic investors could consider lending to troubled SIVs and conduits, demanding high rates in exchange for their risk. This liquidity could provide the issuers with a longer runway for negotiating their permanent recapitalisation. This window of opportunity for value investors, however, may be brief, as it could be displaced by government and regulatory intervention.



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