

Crystal Ball Gazing: CDO New Issuance and Restructuring



BY SIMON RAFTOPOLOUS AND NICHOLAS DAVIES

From 2005 until the first phase of the credit crisis hit the capital markets in August 2007, the volume of issuance of structured finance instruments generally, and CDOs in particular, rose dramatically: from US\$158 billion in 2004 to US\$521 billion in 2006, according to data published by the Securities Industry and Financial Markets Association (SIFMA). Global CDO issuance dropped off dramatically as the credit crisis hit, falling to US\$43 billion for the final quarter of 2007 and to just US\$758 million by the second quarter of 2009.

The good news is that a revival of sorts seems to be taking place in the CDO new issuance space, especially in the European markets. The issuance of asset-backed securities (ABSs), as well as some residential mortgage-backed securities (RMBSs), is also now on the rebound both in the US and beyond, and other more esoteric asset classes will likely follow. It would seem then that the issuance hiatus is likely to be temporary and, further market turbulence notwithstanding, CDOs will continue to remain an important part of the product-mix in both the global and US financial markets.

The majority of CDOs have a lifespan of 7 or 8 years and so, although the effects of the credit crisis and the composition and perceived value of the underlying assets on a mark-to-market basis have caused CDO defaults, a lot of the complex instruments issued at the peak of CDO issuance are still in play today.

However, there is a looming debt maturity balloon which is going to need to be restructured. In many cases the value of the pool of underlying assets will be insufficient to meet obligations to investors. Often the only solution for asset managers seeking to avoid default (and potentially knock-on cross-defaults) is to negotiate with the trustee and with investors to restructure the CDO. On-point restructuring and legal advice will be a crucial component of any such liability management exercise, given the myriad of parties involved and conflicting interests.

The Cayman Islands has long been established as the leading offshore jurisdiction for the incorporation of special-purpose vehicles (SPVs), used as issuing vehicles for CDOs and other capital markets products. During the CDO boom years of 2005, 2006 and 2007, the proportion of CDOs issued through Cayman SPVs was estimated to have peaked at 80% of global issuance. The Cayman Islands popularity as a jurisdiction has been, and continues to be, due in large part to its well developed and stable legal and financial regimes, coupled with its flexible regulatory approach and tax-neutral status. Cayman will continue to offer benefits to arrangers and underwriters looking to structure CDOs in as stable a jurisdiction, and in a manner that is as investor-friendly and tax-efficient as possible – over and above those benefits which onshore, and many other offshore, jurisdictions can offer. This, together with the ongoing financial instability in Europe and the increasing reemergence of appetite for

new structured products from the US and elsewhere, suggests that Cayman SPV-issued CDOs will make a comeback sooner rather than later. These new instruments are likely to look substantially different than the complex CDOs issued during the boom years – in terms of structure, risk appetite and the nature and diversification of underlying assets.

Appleby

Appleby has been involved in a number of global restructurings in both the corporate and capital markets space and has teams on the ground in all of the key offshore jurisdictions, as well as in London, Hong Kong and Zurich. Within the Cayman Islands office, Appleby has a dedicated team of capital markets

specialists, at both Partner and Associate level, each with significant offshore and onshore experience in advising underwriters/arrangers, asset managers and trustees on all aspects of structured finance transactions.

Should you have any questions or requests for further information, please contact:

Simon Raftopolous

Partner

sraftopoulos@applebyglobal.com

+1 345 814 2748

Nicholas Davies

Associate

ndavies@applebyglobal.com

+1 345 814 2742

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