

HEDGE FUNDS

THE VOICE OF THE ALTERNATIVE INVESTMENT INDUSTRY **REVIEW**

In association with



Hybrid Structured Credit Funds Securitisation moves into new paradigm

HYBRID CREDIT STRUCTURES

The restarting of private-label securitisation markets, especially in the US is critical to limit the real sector fallout from the credit crisis.



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Predicting the future is a thankless pursuit at the best of times. In a post-financial crisis world, trying to second-guess market movements and innovation is even more difficult.



Making way for a new era in structures

The restarting of private-label securitisation markets, especially in the US, is critical to limiting the real sector fallout from the credit crisis. Coupled with this is the emergence of innovative and investor-friendly hybrid credit funds that are attracting institutional investor interest.

The rise and fall of the securitisation markets is by now a familiar story, if a sad tale for investment managers, banks and investors alike. While some are still arguing that securitisation may not be in the best interests of the financial system, many, including the International Monetary Fund (IMF), believe it is essential that this market starts operating again, albeit at reduced levels. This is just one of the conclusions made by the IMF in its latest global stabilisation report.*

The IMF makes the case that securitisation has been a “key funding source for consumer and mortgage lending in many mature market economies. Before the collapse of the securitisation market, asset-based securities and covered bonds provided 20%–60% of the funding for new residential mortgage loans

originated in the US, western Europe, Japan and Australia.

“As of end-June 2009 in the US, nearly 19% of the outstanding stock of the more than \$18 trillion worth of real estate-related loans and consumer credit was funded by private-label securitisation.”

Securitisation increases the availability of credit and lowers its costs. Research has shown that a 10% increase in securitisation activity implies a decrease of 4–64 basis points on yield spreads, depending on the specific type of loan. The IMF also notes that securitisation increases the availability of credit per capita.

It concludes that alternatives to securitisation, such as increased covered bond issuance, are not an option for non deposit-taking primary lenders “because they do not

have the capital base to retain the loans”.

Securitisation is a process that involves the re-packaging of portfolios of cash flow-producing financial instruments into securities for transfer to third parties. Simply put, it is the slicing and dicing of illiquid assets like mortgages.

The view of the IMF about the need for a securitisation market is at the heart of economic debate. On one side are the supporters of one of John Maynard Keynes's more radical views: that the practice of securitisation is inherently flawed.

Joining with some of the Keynesians are those who are relishing what they see as the retreat of Anglo-Saxon market liberalism.

Even the defenders of the liberal market are finding it hard to resist the seemingly inextricable approach

of regulation that, particularly in Europe, seems aimed at crushing this style of market. The pragmatists believe some moderation is needed after the near financial melt down in 2008.

Continuing conversations

While these debates continue, the uncertainty in the markets is unsettling. With nothing certain there is a danger of paralysis.

But as with every downside, there is a substantial up, even to the financial crisis. Many are seeing opportunities in the fallout and have moved quickly to make substantial profits from the market dislocations and insecurities.

One of the most interesting of these is the emergence of hybrid investment fund vehicles in the structured finance sector.

There are many advantages to a hybrid structured fund as a vehicle to finance the acquisition and holding of investment assets.

There are three main players vying for dominance in the sector: the Cayman Islands, Ireland and Luxembourg. While Cayman retains its dominance in the domicile of funds (article, page 20), Ireland and Luxembourg are keen to take a large slice of the pie and establish themselves as the jurisdictions of choice in Europe.

In the heady days of low interest rates and high leverage before the big crash, global securitisation issuance grew from almost nothing in the early 1990s to a peak of almost \$5 trillion in 2006.

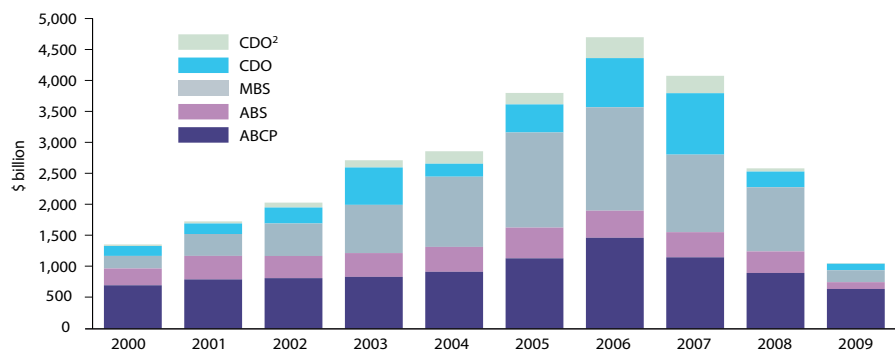
Since then the volumes have dropped dramatically. This is particularly true for collateralised debt obligations (CDOs).

Securitisations in 2007 accounted for over \$2 trillion raised in the US capital markets. By 2008 this source of funding had virtually dried up other than for repo purposes within the US Federal Reserve. Unrelated, but with severe repercussions for markets and investors, the \$50 billion-plus Madoff scandal almost dealt a fatal blow to the fund of hedge fund industry.

Global issuance of CDO and synthetic equivalents in 2007 reached \$269 billion. By the end of 2008 this had dropped to \$71 billion, according to data from Creditflux.

The degree of risk dispersion among the banks fell far short of ideal. In the pre-crisis financial world, banks remained big holders of these risks, either directly or indirectly. For example, at their peak at end-2006, banks made up about

Global private-label securitisation issuance by type



Sources: IMF staff estimates based on data from Dealogic; JP Morgan Chase & Co; Board of Governors of the Federal Reserve System; Moody's; Mizuho Securities; DBRS; Standard & Poor's; European Securitisation Forum; and Inside Mortgage Finance.

Note: ABCP = asset-backed commercial paper; ABS = asset-backed security; CDO = collateralised debt obligation; CDO² = CDOs backed by CDO, ABS, and MBS; MBS = mortgage-backed security. Data for 2009 cover only US and European issuance through end-June. For European ABCP, 2009 data through end-May. ABCP data represent period-end outstandings.

51% of total financial institutions' exposure to the subprime market.

Financial institutions, according to IMF figures, included banks, hedge funds, insurance companies, finance companies, mutual funds and pension funds.

In some cases these organisations retained what they thought were the least risky (senior) tranches based on the performance of highly diversified loan pools. In other cases they bought securitisation products originated by other banks.

Expanding support

Banks also became indirectly exposed to the loans they securitised via their support of the asset-backed commercial paper (ABCP) conduits and structured investment vehicles (SIVs) where the risks associated with the loans had been transferred.

In the SIVs banks held these vehicles at arm's length and with little due diligence in some cases, wrongly assuming risk was widely dispersed.

This was not a formal retention policy but reputational concerns that caused these off-balance sheet exposures to revert to the banks.

The long rise of the equity markets coupled with low interest rates made it seem profitable and safe for these conduits and vehicles to fund their long-term assets in short-term wholesale money markets. But when this funding source dried up, sponsoring banks had to step in with back-up funding, often at high cost, to bridge the maturity mismatch.

Securitisation also led to a lengthening of intermediation chains that increased the complexity and interconnectedness of the financial system. This in turn increased the potential for disruptions to spread swiftly across markets and borders. The longer intermediation chain also gave rise to severe principal/agent problems.

So as risks were passed along the chain, those best placed to maintain prudent loan underwriting and monitoring standards (the banks) were more focused on fee maximisation. The result, following the collapse of Lehman Brothers which held the brass ring holding much of this together, was a total breakdown in credit flows between banks and the near collapse of the entire financial system on a global scale.

That was then and after a near-miss catastrophe that threatened to plunge the global economy into a 1930s-style depression, there has been some recovery.

Market activity

Recent market activity suggests a growing number of investment finance vehicles are being structured not as CDOs issuing rated debt but as hybrid investment funds. This sea change is expected to result in a permanent change to the structure of the investment capital markets.

Investment in capital markets is likely to be affected by a number of permanent and structural changes. Alternative capital models that more accurately represent the investment risk in finance transactions will need to be developed for raising medium- and long-term capital finance.

There has been some modest thawing in borrowers' ability to access capital markets since October 2008 but securitisation markets remain impaired and inter-bank and cross-currency swap markets remain stressed.

Securitized loans have declined by \$1.6 trillion in the US since 2006 and by \$534 billion in Europe (although securitisations retained on banks' own balance sheets for use as central bank collateral have remained high).

Given the previous importance of securitisation in bank funding, impairment of the securitisation process will continue to limit access to credit.

Although Libor spreads have narrowed somewhat, they remain elevated compared to the pre-crisis period and term funding is still available only on a small scale. This is mainly caused by banks clinging to cash and counterparty credit risk concerns throughout the financial system.

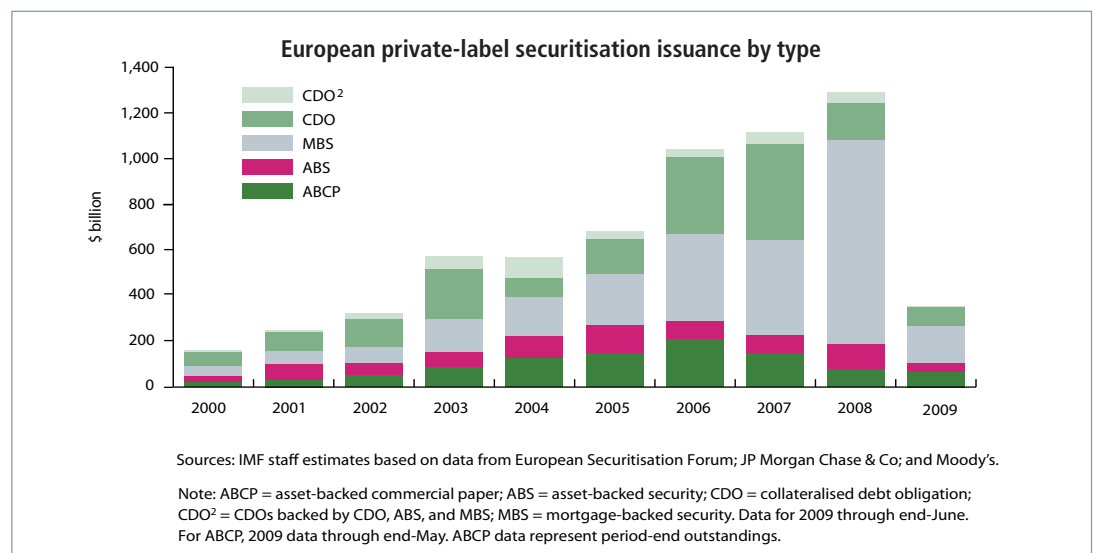
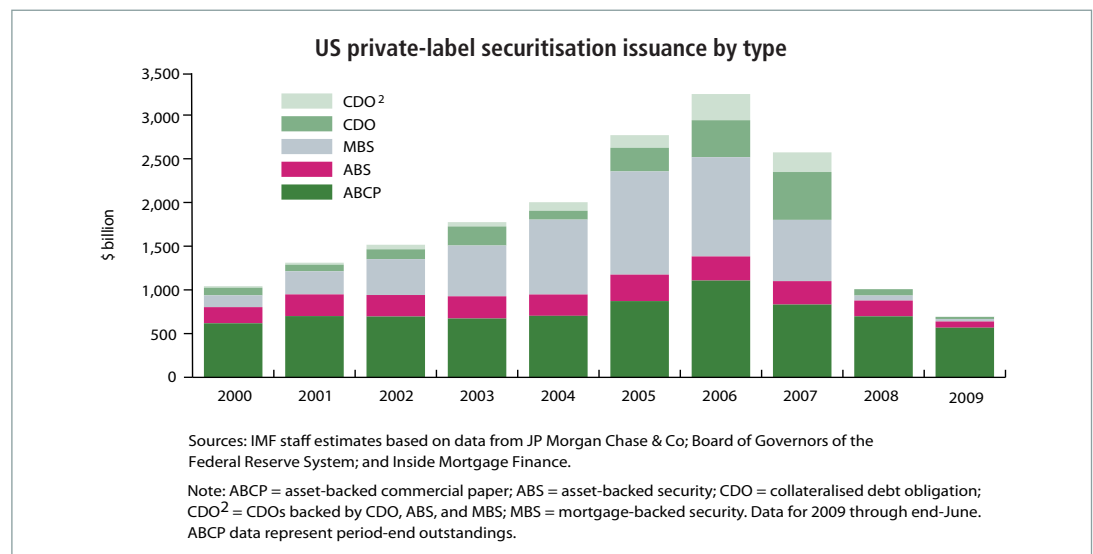
Some banks are reluctant still to enter the interbank markets. Instead they deposit surplus cash with central banks where they receive good

rates and even more assurance that the cash is safe.

Until balance sheet concerns are eliminated, central banks are likely to remain major suppliers of term funding. There are also fears that further writedowns by financial institutions in both the US and Europe could inflict another wave of credit tightening.

Although most central banks, including the European Central Bank, have introduced enhanced liquidity facilities, asset purchase schemes and guarantees for bank debt issuance to prevent fire sales of assets and bank failures, these measures have not been enough (so far) to do more than stabilise a wobbly banking sector. They fall far short of getting the securitisation market back to even modest pre-crisis levels.

The \$8.9 trillion of financing that governments have poured into the sector amounts to less than one third





of the ongoing wholesale financing needs of banks, says the IMF.

Since the facilities were introduced in late 2008, banks have built up guaranteed issuance totalling \$460 billion in 10 countries as of January 2009 with \$130 billion of this in the US.

While overall the state of the financial markets may seem a totally negative development, there is a more positive side to the situation. The recognition that much of the investor risk in a structured finance transaction, such as a CDO, is similar to equity risk, is likely to shift the next generation of finance structure further along the capital spectrum towards that of pure equity.

Options

Transactions that might previously have been structured as collateralised loan obligations (CLOs) are

being set up as loan funds, CDOs are now being established as bond funds and collateralised fund obligations are becoming equity investment funds.

This new generation of fund vehicles holds underlying investment assets, such as leveraged loans or other investment assets similar to those found in the collateral pool of a CDO (and of CDO variants). Hybrid structured funds will also be suitable for accessing private equity assets and the recovery opportunities that are expected to arise when the investment markets begin to normalise.

Over the last 12–18 months a number of qualifying investor funds (QIFs) in Ireland and similar structures elsewhere have been investing in various debt obligations, including CDOs, leverage loans and asset-backed securities.

There are significant differences in the liability side of an issuing vehicle's balance sheet. Issuers are more likely to issue redeemable preference shares subject to lock-up until the end of the investment period, instead of rated medium-term debt notes.

The next generation of finance vehicles will also issue deeply subordinated debt notes that rank *pari passu* with its preference share capital.

Different types of structures

The investment proposition is a convergence of private equity and hedge funds and other alternative funds into hybrids. In these structures investors can be offered equity-type capital securities access to a range of underlying fixed-income and debt obligations.

Long lock-ins and a modified fee

structure are just some of the characteristics. The actual structuring and servicing of these funds, however, presents considerable challenges to both investment managers and service providers.

Contrary to the simpler capital model adopted by a hybrid structured fund, the capital structure of traditional forms of securitisations that utilise tranching of debt securities by seniority and sequencing by maturity dates are far more complex in nature. Tranching in CDOs creates misalignment of interests between senior and subordinated noteholders in managed transactions. This issue is mitigated in hybrid fund structures.

Besides the rush of investors keen to take advantage of the dislocated pricing, lower distribution costs and the more flexible trading environment of funds, the shift away

SECURITISATION AND STRUCTURED CREDIT INVESTMENTS ARE GOOD BUSINESS

Securitisation means a company (both financial and non-financial sponsors) separates (pools) an identified (discrete) group of assets with similar characteristics (including similar terms, structures and credit characteristics) from its balance sheet. In most cases the assets are financial institution-originated, self-liquidating loans (secured and unsecured, fixed or revolving interest rate).

The securitisation places the assets under the legal control of a separate entity usually known as a special purpose vehicle (SPV) or another type of structure (such as in Ireland, using the tax-efficient Section 110 (article, page 20)).

The structure of asset-backed securities (ABS) is intended, among other things, to insulate investors from the corporate credit risk of the sponsor that originated or acquired the financial assets.

The securitisation is essentially selling the assets to investors who rely on the repayment of their principal and interest from the cash flow generated by the underlying pool of assets and the residual (salvage) or market value of the assets.

These investors now essentially finance the assets and the company that securitised the assets off its balance sheet while it receives cash in exchange with which it can invest in new assets.

The company (sometimes known as the sponsor) may retain some

contingent or indirect guarantee or recourse to the assets in the event of non-performance.

The transfer of the assets from the sponsor and the rights and responsibilities of participants (sponsor, trustee and administrator as well as the auditor) is set out in a pooling and servicing agreement which, when translated into a credit fund, is the prospectus.

This will detail what kinds of instruments the fund intends to purchase and will usually have limits on the sectors or types it can buy.

In offering ABS there is generally no business or management to describe. Information about the transaction structure and the characteristics and quality of the asset pool and servicing is what is most important to investors.

There is a good reason for securitising loans. By taking the assets off the balance sheet of financial institutions and providing them with cash, they now have capital to go out and make new loans (which they would not be able to do as quickly if the assets remained on their balance sheet until maturity).

This financing technique takes financial assets that in many cases individually are less liquid that are pooled and converts them into instruments that may be offered and sold in the capital markets.

By securitising assets into structures with various risk profiles and various interest rates and

repayment schedules (tranches), the risk to finance those assets can be spread across a pool of investors and a corresponding larger amount of investment capital can be obtained.

Before the financial crisis, the natural sponsors of asset securitisations were banks, mortgage companies, finance companies and investment banks. The natural buyers for these instruments were institutional investors, including financial institutions, pension funds, insurance companies, mutual funds, hedge funds and money managers.

Generally, ABS is not marketed to retail investors. Now the credit funds are scooping up the most attractive of these remaining securitisations. Corporates who normally would use the securitisation market to raise capital are instead looking to the bond markets where there are attractive rates and spreads. Indeed, the market rates are so attractive many companies are raising over and above what they need at present because the terms are so good.

However, there is a great deal of re-financing that is expected to hit the market over the next five years. It is unlikely companies will be able to get such favourable terms for bond issuance by then and the expectation is that the securitisation markets will have opened for business.

Now that hedge funds and

investment managers in general have discovered the attractions of securitisations, it is also unlikely these types of hybrid credit funds will disappear, although they are likely to change shape. The assets in these funds need to be serviced during the lifetime of the securitisation. The billing, collection and pass-through to investors of scheduled interest and principal payments, prepayments of principal, taxes, insurance and fees depend on the asset class. What makes this particularly tricky for the hedge funds and hybrid structures that now own these securities is that traditional hedge fund administration alone is not enough. To provide a comprehensive service, fund administration, private equity and corporate trust activities must be combined.

Few banks or fund administrators are in a position to provide this kind of service economically and efficiently.

This is a lucrative business.

Some of the functions that need to be performed include making sure the interest and principal payment is correctly allocated and distributed to the investors.

This is a tricky business given that there may be several securitisations within each underlying portfolio and a collection of investors that will want to know the net asset value of the portfolio and be kept regularly informed about the performance of the fund and its underlying assets.

from CDOs has principally been driven by the aversion to leverage and highly levered vehicles. Higher funding costs of CDOs have also increased the burden on originators, leading many to look for alternative sources of financing. Besides a sharp increase in risk premiums amid the credit crisis, funding costs have also been driven up as a result of more stringent capital requirements imposed on regulated financial institutions. Unregulated funds are not subject to the same regulatory capital requirements imposed on banks.

Another reason that is often overlooked relates to branding and marketing. The perception is that CDOs have lost their lustre compared to the day where almost every asset manager and investment bank would popularise the appeal of their product offering with the three-letter acronym. CDOs are now widely avoided whereas funds have more appeal.

“The market opportunity in 2009 alone is worth tens of billions of dollars in asset values,” remarks David Aldrich, managing director and head of alternative investment services Europe, the Middle East and Africa at BNY Mellon.

“Hedge fund managers are looking at the huge quantity of distressed credit assets available and being creative in structuring vehicles to bring these opportunities to investors,” he adds.

Preference share capital, which uses a pricing model based on net asset value (NAV), may provide a better way for investment in recovery situations and secondary investments. This helps speed up the payment of capital gains compared to coupon and capital payments on fixed-income debt.

There are a number of reasons why these hybrid structures are emerging.

First was the rush by investors keen to take advantage of the discounted prices in the loan and CDO market. At one point prices fell as low as 30–40 cents on the dollar, although this has now slowed and prices on many of these loans are now trading at 60 cents on the dollar or higher.

Investors are attracted now to different fund structures, including single strategy, hybrids and credit opportunity funds.

The latter has been the latest and fastest growing segment within the market value CDO sector. By marrying traditional CDO and credit hedge fund techniques, managers

have been able to create funds with lower distribution costs and no requirement for credit ratings.

These funds also have far fewer trading restrictions than CLO structures. The funds are also a good buy for investors looking for exposure to this asset class but with relatively low risk and in funds where little or no leverage is used.

Hedge fund managers increasingly are investing in loan assets and using the non-traditional special purpose vehicle structures, segregated and managed accounts and a variety of other techniques to ensure tax neutrality for the fund with maximum earning potential.

Wedding plans

By marrying the debt and fund techniques, these managers are also closing the gap between hedge funds and private equity structures. Investors are looking at long lock-ins, some for as long as five or seven years.

The development of these funds has, however, highlighted a gap in the ability of service providers to administer, value and generally service these funds. BNY Mellon has emerged as the leader in this crossover between private equity, hedge fund and CLO administration.

“BNY Mellon’s clients brought these opportunities to us looking for equally creative solutions on the fund-servicing element of the structure,” explains Aldrich.

“This client-driven demand for our services has been an excellent way for us to demonstrate flexibility and innovation as a service provider, particularly through the combination of our corporate trust division loan-servicing capability and the fund-servicing piece from alternative investment services,” he adds.

Providing services to these hybrids has been a good business for companies like BNY Mellon. The corporate trust CDO business line generates 70% of its revenue from servicing CLOs and structured loan products and 30% from other types of CDOs and structured products, including hybrid and credit opportunity funds.

These funds are more profitable than the vanilla products, principally because the asset size involved for each fund is larger than the normal launch, particularly now when most hedge fund launches are lucky to raise \$50 million at start-up.

Most of these credit funds have a minimum of \$100 million. The majority target a fund size of \$500

million in year one and are often able to reach \$1 billion relatively quickly.

“The fund size enables us to cover our costs at an earlier stage in the life of the fund and to participate in the upside at the same time as the managers and their investors,” confirms Aldrich.

Being able to service these funds, however, has not been easy. It has meant BNY Mellon pulling together different parts of the operation to create what is in effect a new service

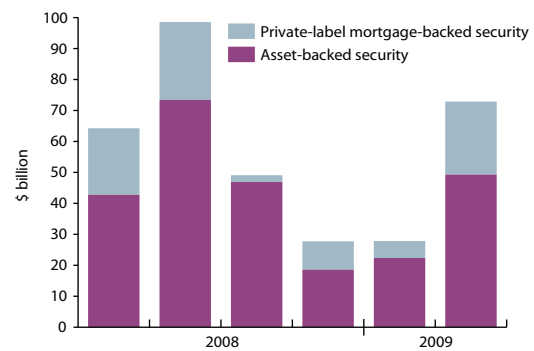
using existing expertise and knowledge.

“The strategy of BNY Mellon is simply to deliver what our clients and their investors require from an alternative investment service provider, regardless of domicile or portfolio composition.

“In the case of structured credit vehicles, this has been the biggest challenge that we have conquered,” acknowledges Aldrich.

“The future for our credit fund services is particularly promising as

US asset-backed security (ABS) and private-label mortgage-backed security (MBS) issuance



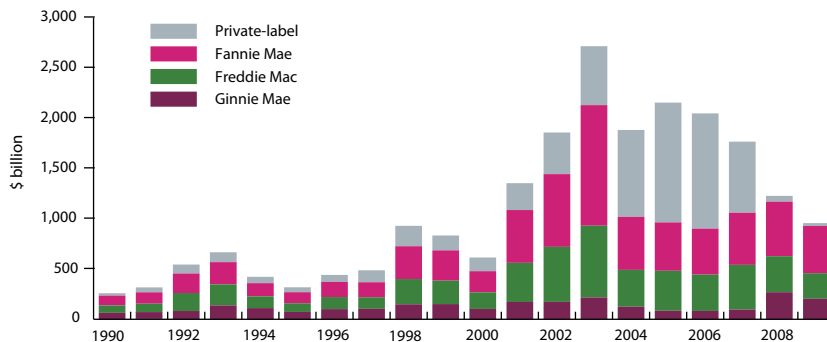
Source: Inside Mortgage Finance.



David Aldrich,
BNY Mellon



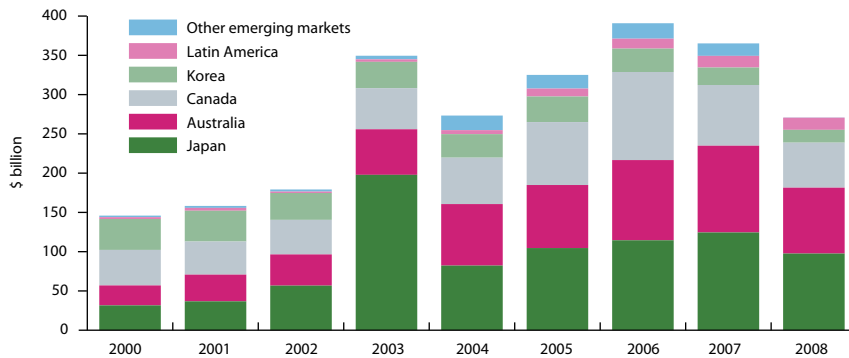
US government-sponsored enterprise versus private-label mortgage-backed security issuance



Source: Inside Mortgage Finance.

Note: Government-sponsored enterprises include Fannie Mae, Freddie Mac, and Ginnie Mae. Data for 2009 through end-June.

Non-US and non-European private-label securitisation issuance



Sources: IMF staff estimates based on data from JP Morgan Chase & Co; Merrill Lynch; Mizuho Securities; DBRS; Standard & Poor's; and Dealogic.

the assets available for investment are enormous and the number of managers entering this strategy and sub-strategies continues to grow. We expect this to help us consolidate our position as one of the top three hedge fund administrators globally over the coming months and years," he concludes.

Institutional investors are also looking to re-balance their portfolio allocations after the crisis. They want to reduce exposure to the volatility on exchanges and stock markets. Investment outflows from residential asset-backed and other classes of asset-backed securities affected by the crisis will also need re-investment of capital in alternative investment opportunities.

Coming back into fashion

Investors in that asset class are slowly coming back into funds of hedge funds but are also re-allocating investment capital to simpler, more transparent structures.

Investors are also worried that the massive capital injections and bailouts by a series of governments (most particularly the US and the UK) could lead to an inflationary period.

Whatever the future holds it is almost certain investors will not want to see complicated, opaque financial structures and will be demanding a lot more transparency in any structure in which they put money.

At the same time many investors are expected to have a preference for new investment proposals structured on a simple and transparent basis with offer documents disclosing clearly all investment risks. The voluminous and highly complex documentation developed for rated securitisation transactions is giving way to the hybrid structured fund that can be relatively simply structured and explained.

The current outlook is exceptionally uncertain. A key concern is that policies may be insufficient to stop the negative feedback between deteriorating financial conditions and weakening economies in the face of limited public support for policy actions.

In some countries, public programmes are offering alternative funding sources access to liquidity and favourable capital treatment, but these have yet to revive securitisation volumes. ■

* *Global Financial Stability Report: Navigating the Financial Challenges Ahead, October 2009, International Monetary Fund*

CALCULATION OF TRANCHE SIZES (STEPS 1 AND 2) WITH ASSUMED 20% EFFORT LEVEL

Defaults	Probability (%) ¹	Dollar losses			
		Total (\$)	Equity (\$)²	Mezzanine (\$)³	Senior (\$)⁴
0	26.31	0	0	0	0
1	37.58	100	100	0	0
2	24.16	200	133.20	66.80	0
3	9.20	300	133.20	133.20	33.60
4	2.30	400	133.20	133.20	133.60
5	0.39	500	133.20	133.20	233.60
6	0.05	600	133.20	133.20	333.60
7	0.00	700	133.20	133.20	433.60
8	0.00	800	133.20	133.20	533.60
9	0.00	900	133.20	133.20	633.60
10	0.00	1,000	133.20	133.20	733.60
Expected loss (\$)		125	85.68	32.06	7.26
Tranche size		1,000	133.20	133.20	733.60
Expected loss/tranche size (%)		12.50	64.3254	24.0668	0.9900
Credit rating			No rating	B- to CCC	A-
Risk weight (%)			1,250	1,250	50

Source: IMF staff estimates. (1) Probability of n defaults = (10!/(n!(10-n)!)*TPD^n*(1-TPD)^(10-n)). (2) Loss(equity) = min{Total Loss, Size(equity)}. (3) Loss(mezzanine) = min{Total Loss-Loss(equity), Size(mezzanine)}. (4) Loss(senior) = Total Loss-Loss(equity)-Loss (mezzanine).

Making sense of the alphabet maze of securitisation

ABS, CDO and CDO² are all part of the language of the heyday of securitisation. This is a guide through some of the terms used then and which are still prevalent in today's market and in hybrid credit fund structures.

The financial crisis saw the rise of some intricate and complex financial structures that few could understand and value.

These structures used bewildering abbreviations that served to mask the underlying difficulties the buyers (mainly banks) had in knowing the exact extent of the risks they were taking.

For example, leveraged super-senior products used leverage to enhance the potential returns on CDO senior tranches that were trading at extraordinarily narrow spreads.

Some of what the International Monetary Fund calls "economic catastrophe risk" was transferred to monoline insurers such as American International Group (AIG), which eventually needed to be bailed out by the US government.

Constant-proportion portfolio insurance products were developed for the CDO, ABS CDO, and CDO² equity tranches for which there were no natural buyers.

Demand for these and other ingredients in structured credit was helped along by the rating agencies' willingness to give these highly complex structures their highest ratings (article, page 12) and the outsourcing of appropriate due diligence by many end-investors.

Most of these products existed only to generate fee income and are unlikely to return.

Nevertheless, understanding these products will help investors putting money into the new hybrid structures better understand some of the jargon still being used. Most of these originated in the US but were bought and sold by banks globally.

Also included are some key phrases and terms that are likely to come up in any conversation dealing with the aftermath of the financial

crisis and the future of the securitisation market itself.

Asset-backed commercial paper

An asset-backed commercial paper (ABCP) programme is composed of a bankruptcy-remote special purpose vehicle (SPV), or conduit, that issues commercial paper (CP) and uses the proceeds of the issuance primarily to obtain interests in various types of assets, either through asset purchase or secured lending transactions.

An ABCP programme includes key parties that perform various services for the conduit; credit enhancement that provides loss protection; and liquidity facilities that assist in the timely repayment of CP.

Until 2007 it was common for ABCP programmes to boost their returns with securitisation (and re-

securitisation) products. These programmes have either collapsed or been phased out.

The repayment of CP issued by a conduit depends primarily on the cash collections received from the conduit's underlying asset portfolio and its ability to issue new CP.

The main risks faced by ABCP investors were asset deterioration in the conduit's underlying portfolio; potential timing mismatches between the cash flows of the underlying asset interests and the repayment obligations of maturing CP; a conduit's inability to issue new CP; and risks associated with the servicing of these assets.

To protect investors from these risks, ABCP programmes and the asset interests financed through them were structured with various protections, such as credit enhance-

ment, liquidity support and CP stop-issuance and wind-down triggers.

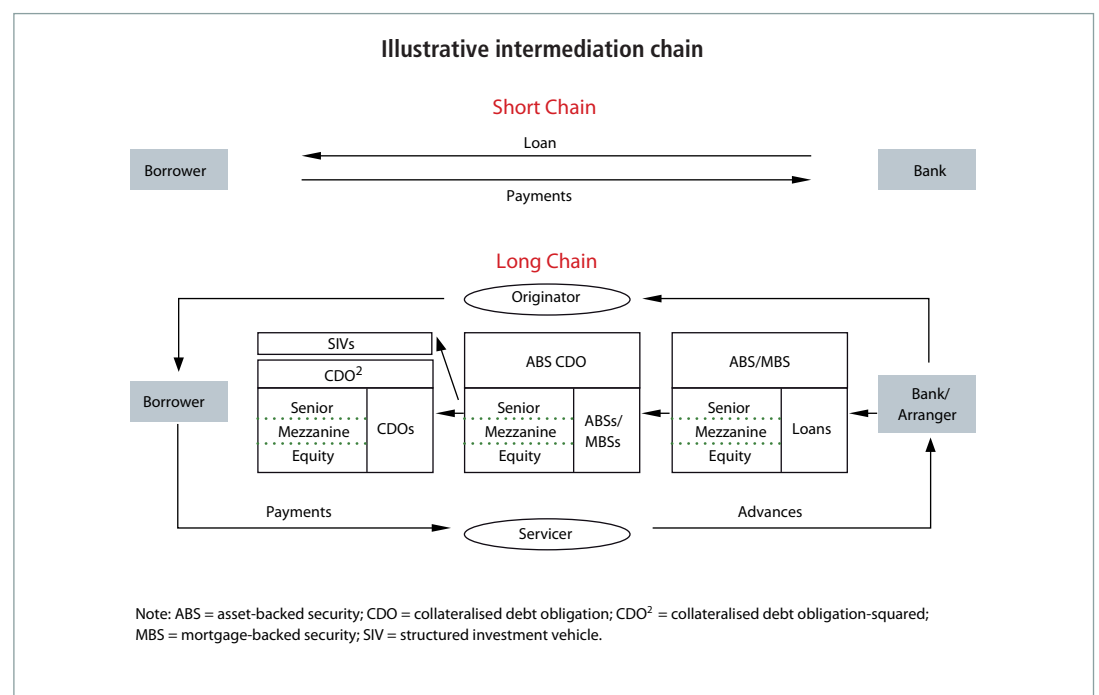
Asset-backed securities

Asset-backed securities (ABS) are bonds or notes collateralised by the cash flows from a specified pool of underlying assets.

These asset pools are made up of receivables from a number of consumer asset types, including credit cards, car loans and home equity loans, as well as other non-consumer asset types such as equipment leases and loans, utilities, aircraft leases and royalties. The financial institutions that originated the loans sell a pool of cash flow-producing assets to a specially created third party called an SPV.

The SPV is designed to insulate investors from the credit risk of the originating financial institution. The SPV then sells the pooled loans to a trust, which issues interest-bearing securities that can achieve a credit rating separate from the inimical institution that originates the loan.

The typically higher credit rating is given because the securities that are used to fund the securitisation rely solely on the cash flow created by the assets, not on the pay-





ment promise of the issuer. The monthly payments from the underlying assets (loans or receivables) typically consist of principal and interest, with principal being scheduled or unscheduled.

The cash flows produced by the underlying assets can be allocated to investors in different ways. Cash flows can be directly passed through to investors after administrative fees are subtracted, creating what is known as a “pass-through” security.

Another way to do this is to allow cash flows to be carved up according to specified rules and market demand, in effect creating structured securities. Within the ABS universe the biggest sector is mortgage-backed securities (MBS), including residential (RMBS) or commercial (CMBS). Other popular ABS structures are backed by car and credit card loans.

Collateralised debt obligations

Collateralised debt obligations (CDO) are credit derivatives backed by a portfolio of assets. If the underlying portfolio is made up of bonds, loans or other securitised receivables, such products are known as cash CDOs. The underlying portfolio may consist of credit derivatives referencing a pool of debt obligations. If that is the case, CDOs are ‘synthetic’.

The credit risk – the potential loss due to credit events – borne by the reference pool is layered into different risk levels. The range in between two adjacent risk levels is called a tranche.

CDOs were largely viewed as a homogeneous asset class although they were not. They were mainly associated to CDOs of ABS, RMBS or other structured finance securities.

CDO-squared (CDO²)

A prototypical synthetic CDO² is backed by a portfolio (outer CDO) consisting of other synthetic CDO tranches (inner CDOs). The outer CDO may refer to up to 1,000 (not necessarily distinct) names, although typically the number of referenced obligors ranges from 250 to 400.

Due to the limited number of liquidity-traded credit default swaps (CDSs), there might be a considerable amount of overlap among the inner CDOs. A default, therefore, might simultaneously affect more than one of the inner CDO tranches and this leads to the necessity of keeping track of the identity of defaulted entities.

Collateralised loan obligation

In contrast to the CDO, a CLO is a securitisation of a portfolio of corporate loans. Another way to look at it is that CDOs are a function of market volatility while CLOs are a function of corporate profitability.

Corporate loans are traditionally viewed as safer instruments than corporate bonds, which include CDOs. This is because of their historically high recovery values. For example, senior secured loans are secured by collateral and sit at the top of the capital structure.

Commercial mortgage-backed securities

Commercial mortgage-backed securities (CMBS) are another type of bond commonly issued in US security markets, backed by mortgages on commercial real estate. CMBS issues are usually structured as multiple tranches rather than typical residential ‘pass throughs’.

A CMBS can provide liquidity to real estate investors and to com-

mercial lenders. Because they are not standardised, there are a lot of details associated with CMBS that make them difficult to value. However, when compared to a residential mortgage-backed security (RMBS), a CMBS provides a lower degree of prepayment risk because commercial mortgages are most often set for a fixed term.

Credit derivatives

The key feature of credit derivatives is that they separate the credit risk from an underlying asset and so allow investors to gain or reduce exposure to credit risk. These instruments allow the active management of credit risk by buying protection to reduce the risk and selling protection to diversify credit risk. Some typical credit derivatives include CDOs and CDO²s.

Mortgage-backed securities

A mortgage-backed security (MBS) is a pass-through security that aggregates a pool of mortgage-backed debt obligations. The MBS’s principal amounts are usually government guaranteed. Homeowners’ principal and interest payments pass from the originating bank through a government agency or investment bank, to investors, net of a loan-servicing fee payable to the originator.

Real estate mortgage investment conduit

A real estate mortgage investment conduit (REMIC) is a multi-class, investment grade mortgage-backed security created by Fannie Mae, Ginnie Mae, Freddie Mac and other entities.

The monthly cash flow from the underlying mortgages is allocated to various tranches, resulting in

each tranche having a separate and different maturity, coupon and payment priority compared to the other tranches in the security.

The REMIC is not subject to income tax (except on net income from prohibited transactions, net income from foreclosure property and contributions made after the start-up day).

REMICs also produce a residual of paper gains and losses in value (known as phantom income and phantom loss). Investors in REMICs must pay other qualified entities to purchase the residual and the tax liability it generates (pension plans and non-US individuals are barred from owning a residual).

Residential mortgage-backed securities

Residential mortgage-backed securities (RMBS) are a type of bond commonly issued in US security markets. As a type of mortgage-backed securities, they are supported by mortgages on residential real estate. The cash flows come from residential debt such as mortgages, home-equity loans and sub-prime mortgages.

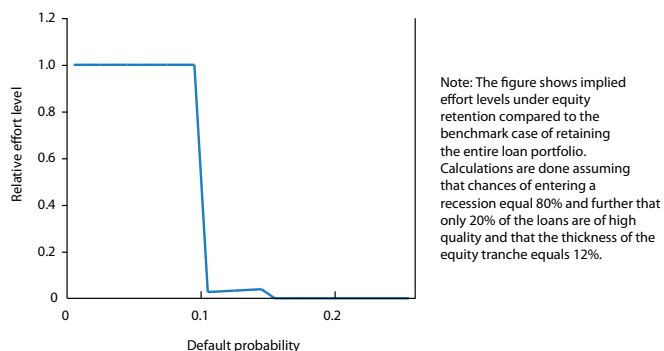
Skin in the game

Skin in the game is a term coined by investor Warren Buffett and refers to a situation where high-ranking insiders use their own money to buy stock in the company they are running. The idea behind creating this situation is to ensure corporations are managed by like-minded individuals who share a stake in the company.

The best vote of confidence is putting one’s own money on the line.

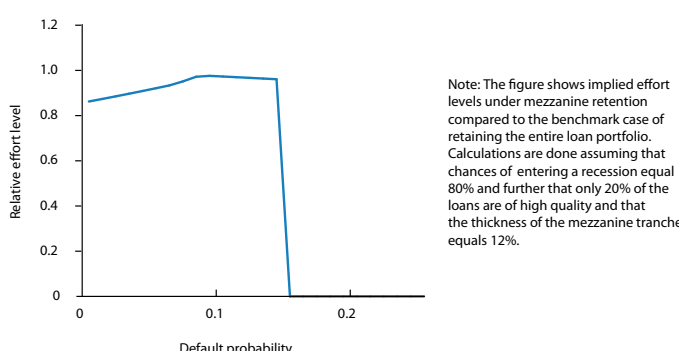
One of the contributing factors to the US subprime mortgage crisis

Optimal effort level of equity retention: low-quality borrowers and high odds of recession



Source: IMF staff estimates.

Optimal effort level of equity retention: low-quality borrowers and high odds of recession



Source: IMF staff estimates.

was that lenders derived substantial fees from securitising their loan books but retained no residual risk for the loans that they had originated. Investor preference for greater co-alignment of interests between investors and arrangers and longer-term commitment by an arranger to an investment proposition is likely to end the “originate and distribute” model.

The proposed EU Capital Requirements Directive would prevent banks from investing in securitisation transactions where the relevant originator/arranger retained less than a 5% vertical slice of the overall capital structure.

Special purpose vehicle

A special purpose vehicle (SPV) is a bankruptcy remote corporation that issues rated securities/commercial paper and uses the proceeds to purchase assets (usually trade and term receivables) from a seller (in a single-seller programme) or multiple sellers (in a multi-seller programme).

The bankruptcy remote aspect is important as it prevents the SPV from being caught up in any problems or failings of the parent organisation and the receivables in the securitisation pool cannot be claimed by creditors of the parent.

Stripped mortgage-backed securities

In stripped mortgage-backed securities (SMBS) the interest and principal payments from a standard Federal National Mortgage Association (FNMA, known as Fannie Mae) MBS are stripped out of the original security to create two new classes of security. One class of security receives the interest only (IO strip)

and one class receives the principal only (PO strip). While they are mutually exclusive they can still be recombined if necessary at a later date. The pricing on either stripped security is usually at a discount from the par value of the underlying MBS.

In a declining interest rate environment when the prepayment of residential mortgages accelerates as home owners refinance to lower rates, the PO strips also experiences accelerated principal prepayment which increases the yield of the PO strip discounted security.

However, in a declining interest rate environment, the IO strip receives less cash due to less outstanding principal balances on which to calculate interest, so the yield actually declines on the IO strip.

Structured investment vehicles

A structured investment vehicle (SIV) is an SPV that buys long-term bonds and other fixed-income securities, funding this by issuing short- or medium-term debt such as CP.

The securities a SIV buys are often mortgage books or some other form of ABS. Typically a SIV will be capitalised with either a mix of equity and subordinated debt or, increasingly, subordinated debt only (these are the hybrid funds that are being created to hoover up highly discounted loans, for example).

SIVs are also called conduits because they create a channel through which the long-term debt they invest in can be funded by short-term debt. They have also been used as a conduit through which banks have bought back mortgage debt they had apparently off-loaded through securitisation; although the banks that buy may not be those that sold, the risk comes back into the

banking system. SIVs can be profitable because they are highly geared and returns on the comparatively small amount of equity can be high.

The business model (borrow short term, lend long term) is similar to that of a bank but by conducting its business through capital markets (rather than taking deposits) and being an offshore entity, it escapes the regulation that banks and finance companies are subject to. They can also often be kept off balance sheet, escaping indirect restraints through regulation of the banks that set them up.

Subordination

Individual securities are often split into tranches of varying degrees of subordination. One tranche will have less credit protection or risk exposure than another. A prevalent type of internal credit enhancement is the senior/subordinated structure.

ABS with senior/subordinated structures are characterised by a senior (A) class of securities and one or more sub-ordinated (B, C, etc) classes that function as protective layers for the A tranche. If a loan in the underlying asset pool defaults, any resulting loss is absorbed first by the subordinated securities.

The upper-level tranches remain unaffected unless losses exceed the entire amount of the subordinated tranches. The senior securities are typically AAA-rated, while the lower-credit quality subordinated classes receive a correspondingly lower rating.

Synthetic CDO

A synthetic CDO is a collateralised debt obligation in which the underlying credit exposures are taken on using a credit default swap (CDS)

rather than by having a vehicle buy physical assets. Synthetic CDOs can either be single-tranche or fully distributed CDOs.

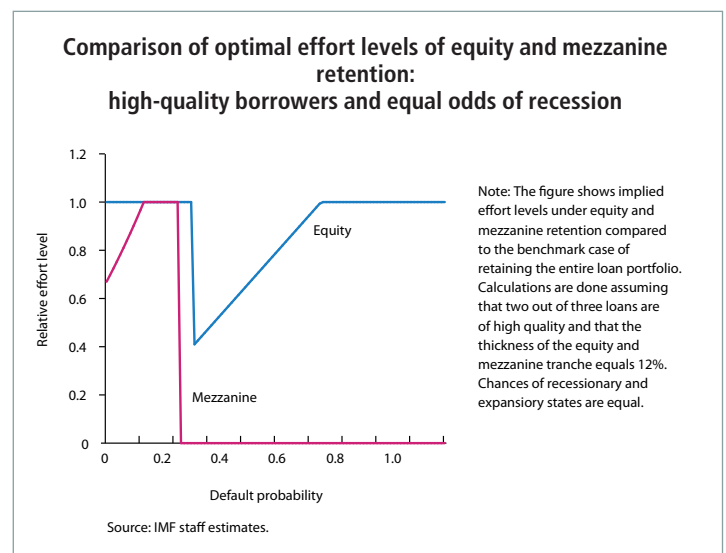
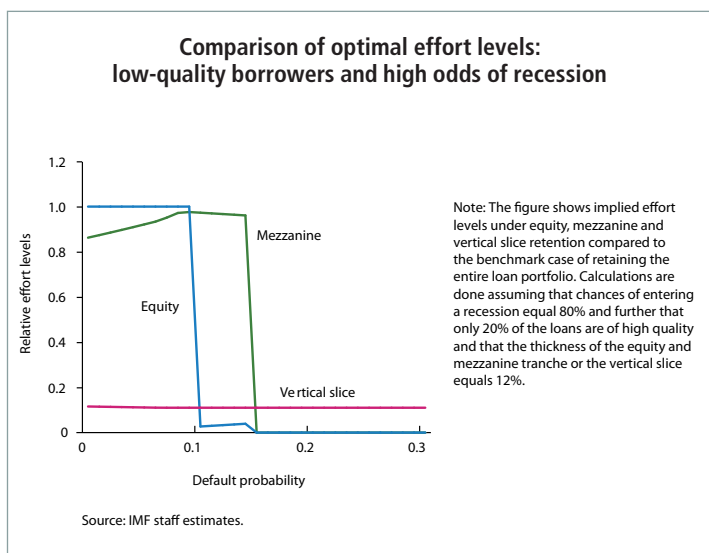
Synthetic CDOs are also commonly divided into balance sheet and arbitrage CDOs, although it is often impossible to distinguish between the two types. They generate income selling insurance against bond defaults in the form of CDSs, typically on a pool of 100 or more companies. Sellers of CDSs receive regular payments from the buyers which are usually banks or hedge funds.

The structure of a synthetic CDO is set up with the bank owning the assets but transferring the risk to a pool of investors through a special purpose vehicle (SPV) set up to act as the intermediary between the bank and investors. The investors contribute capital to the SPV in exchange for principal and interest payment from the underlying securities held by the bank.

In a fully funded synthetic CDO, the originating bank funds the unfunded portion of capital required through an equity tranche. So it is in best interest of the bank to pool the best assets together. The equity tranche is the last to receive funds in the event of a default.

As the holder of assets, the bank purchases a CDS from the SPV. This insures the assets against loss and puts the investors’ assets at risk in the event of a default. ■

■ Sources: *Fixed Income Primer: Asset-Backed Securities*, Dwight Asset Management Company; *Glossary Of Investment Terms*, Friends Provident International; *Financial Times*; *International Monetary Fund*; *Maples and Calder*; *Ogier*; *Investopedia*; *Fitch Ratings*; *Credit & Finance Risk Analysis*.





Rating agencies come under fire after subprime fiasco

Rising delinquencies in the US subprime mortgage sector triggered a flood of downgrades by credit-rating agencies.

As a result, confidence in ratings was shaken and the agencies have come under fire from investors and regulators.

Hundreds of residential mortgage-backed securities (RMBSs) and collateralised debt obligations (CDOs) of asset-backed securities (ABSs) – including some AAA-rated tranches – have been downgraded. The actions severely shook confidence in the reliability of credit ratings and have caused regulators to take a close look at the their role.

However, the credit-rating agencies are not taking this criticism lying down. They are fighting back against draft legislation that could make them all liable for the mistakes of any one of them and make it easier for counterparties to take legal action over reckless or unreasonable rating work.

The agencies are arguing against contentious elements in the draft US Enhanced Accountability and Transparency in Credit Rating Agencies Act published in late September 2009.

Among the most controversial measures outlined in the discussion paper is the imposition of collective liability for credit ratings. This would mandate that each nationally recognised statistical rating organisation (NRSRO) provide to every other rating agency a copy of any information that formed the basis for a credit rating and requires recipients of such information to “review such information and make every effort to verify its accuracy”.

In addition, the draft proposes that in any legal action taken against a rating agency under the Securities Exchange Act, “the same pleading standards with respect to knowledge and recklessness shall apply to the NRSRO as would apply to any issuer or underwriter.”

“If the proposal were to become law, lawyers would use it to argue that NRSROs may be sued for securities fraud whenever they act ‘unrea-

sonably,’” Deven Sharma, president of Standard & Poor’s (S&P) says. “Such a distinction is inappropriate and unfair,” he concludes.

The most divisive element of the discussion draft is a proposal that would allow a plaintiff unable to recover full monetary damages from one NRSRO in a lawsuit to then treat “all NRSROs as jointly liable for the amount of such judgment and the plaintiff may collect any outstanding amount from any other NRSRO.”

Whatever the outcome, the agencies are already facing some cold realities of a post-financial crisis world.

Faulty methods

“Flawed methodologies and data inputs were often used to assign ratings, and the investors who relied on them did not always have access to sufficient information to question and assess them,” says the International Monetary Fund.

Specific criticism has been levelled at the methodologies and inputs used to rate non-prime residential MBS (and CDOs backed by MBS). These were particularly flawed, overestimating the quality of the underlying loans and underestimating the correlation of their performance.

The result was that most of the senior tranches of these products were either downgraded or will be. The flaws were particularly evident in the rating of ABS CDOs. For example, of all the ABS CDO tranches issued in 2005–2007 that were originally rated AAA, only 10% are still rated AAA by S&P, and almost 60% are rated B or less, well below the BBB investment grade threshold.

During credit downturns, structured credit ratings are more prone to severe downgrades than ratings on corporates and sovereigns. So many investors were apparently shocked by the depth and breadth of these downgrades.

This resulted in the extreme spread widening on top-rated securitisation products.

It also meant that not only did the

industry fall into disrepute but also investors who had been relying on these ratings to make investment decisions were caught by the small print.

The rating agencies made it clear that credit ratings were meant to measure only default risk and not market and liquidity risk. This rather important point was apparently lost on many investors.

Meanwhile the securitisation industry is not getting an easy ride with regulators either.

Greater regulation of securitisation and credit default swaps (CDSs) is also needed as current industry initiatives may prove insufficient in fixing the problems in these markets, according to the Madrid-based International Organisation of Securities Commission’s (Iosco) technical committee.

In its September report on unregulated financial markets commissioned by the G20 leaders in November, Iosco says a “measured regulatory response” is necessary to restore confidence in securitised products as well as CDSs.

“Given the magnitude of the crisis and the need to rebuild confidence... it is unlikely that industry initiatives alone will be sufficient to restore transparency, market integrity and market quality,” Iosco adds. Iosco’s main recommendation to regulators for securitisation is a “reconsideration of the incentive structure in the securitisation value chain.”

This is to be achieved by replacing the originate-to-distribute model for securitisations with a system in which originators and/or sponsors of securitisations would be required to retain long-term economic exposure to these products “in order to appropriately align interests in the securitisation value chain”.

The organisation’s proposal ties in with similar suggestions by European and US regulators.

In May the European parliament approved an amendment to the Capital Requirements Directive that will force originators of securitisations to retain at least 5% of transactions when selling to European credit

institutions as of 2011. In June the US Treasury advocated a similar rule for US originators or sponsors, although a formal proposal on such a move has not yet been issued.

However, a blanket approach to retention requirements should not be adopted, Iosco cautions. It says the charge should be “carefully tailored to appropriately align interests in the securitisation value chain.”

As a minimum, a retention charge should bear in mind the economic and regulatory features of the domestic securitisation market, it should be risk-sensitive and it should pay attention to the underlying quality of the collateral backing a securitisation.

More information

Iosco advocates greater disclosure by issuers to investors about the performance of the underlying asset pool, the creditworthiness of parties with direct or indirect liability to the issuer, and the risk assurance practices undertaken by the underwriter, sponsor, and/or originator.

Originators “should have an incentive to ensure that the quality and risks of the underlying asset pool are transparent to investors,” Iosco concludes.

Greater disclosure from originators needs to be matched by improved risk management practices from investors.

“Improved information disclosure and dissemination to investors may not be effective if investors do not undertake, or do not have the capabilities to undertake, appropriate risk assessment and management of the securitised products they acquire,” the report notes.

In the financial crisis many investors in securitised products had effectively “outsourced” their own internal risk management to credit-rating agencies.

Iosco also recommends ongoing training and education for both buy-side and sell-side companies, development of valuation techniques by the buy side, and greater use of independent third parties other than rating agencies to evaluate risks in securitised products. ■



Complexity and variety of products impacts pricing and servicing

Fund managers are facing increased regulatory obligations, a rapid growth of complex assets and structures, as well as greater investor demands for transparency and liquidity. Considering market pricing and risk after the subprime fallout is a major concern for any manager dealing with hard-to-value or over-the-counter products.

Applying rational controls to ensure consistency with marketing pricing and the benefits of independent pricing services as well as the criteria for selecting providers, are important considerations. Over-the-counter (OTC) valuation is increasingly important. As scrutiny from institutional investors, compliance

officers, risk managers and internal boards of directors increases, investment managers are taking a keen interest in how complex instruments are priced.

Hedge funds that invest in derivatives and other hard-to-value products are outsourcing valuation services to fund administrators to

provide an independent price to investors. On the other side investors need to understand the underlying risk of instruments in the portfolios of managers in which they invest. They need some level of transparency in terms of what risk the structured products really represent. Asset managers holding credit

derivatives and interest-rate swaps in their portfolios look to their custodians to value the portfolios.

Now the service has the ability to price asset-swapped convertible option transactions, commodity future options, convertible bonds, credit default swaps, equity index option, foreign exchange options, interest-only bonds, interest rate swaps, mortgage-backed securities, repurchase agreements, restricted bonds and total return swaps.

The bank provides an automated pricing service for complex OTC instruments using independent, derivative-focused pricing vendors providing pricing for a variety of OTC products (article, page 15). It uses high-quality data, ensuring that the calibration of models is consistent, accurate and based on consensus market levels.



The practice of using independent third-party valuation is an important step in the evolution and standardisation of the fund industry. This adds another layer of oversight.

Clients benefit from a highly automated process, with pricing received via electronic data exchange. Prices are calculated from inputs received from major market makers. These inputs undergo a rigorous cleaning process including testing for stale pricing, flat curves and outlying data, before validation. They are provided daily and on request with response time dependent on the security type and availability.

BNY Mellon is one of the leading providers of securities servicing. It has \$20.7 trillion in assets under custody and administration, \$926 billion in assets under management, services \$11.8 trillion in outstanding debt and processes global payments averaging \$1.8 trillion a day.

Michael Devane, vice president, corporate trust, securities servicing, BNY Mellon, manages a team looking after the administration of securitisation vehicles like collateralised debt obligations (CDOs) and collateralised loan obligations (CLOs).

He is also experienced in working with mortgage-backed and asset-backed securities as well as pools of assets such as credit card and student loans.

He says funds investing in such instruments need a service that can cope with the various covenants, underlying transactions and the complex documentation covering this asset class.

Complex service

BNY Mellon services over 12,000 syndicated loan facilities worldwide.

The platform used by the company records all loan attributes, trades and positions and is updated on an ongoing basis with information received from loan agents regarding principal and interest.

“We reconcile expected cash receipt against the actual cash received and resolve any discrepancies in a disciplined manner with third parties.

“Our scale allows us to develop relationships with third parties to resolve discrepancies in a timely manner. We deal with the entire loan portfolio needs,” says Devane.

He continues: “Our pricing coverage is excellent. Our primary source is typically Markit but we also utilise additional sources as outlined within the pricing matrix in the fund documentation.”

Compliance reporting

Devane’s team uses these prices to value the portfolio of assets. In addition the team undertakes a level of compliance reporting, monitoring the portfolio to ensure the manager is investing according to the terms of the fund, watching the percentage invested into certain asset types.

Devane says the combination of in-house and vendor applications gives the bank’s system more depth and a “distinct advantage in modeling assets, securities transactions and much more complex compliance reporting around the calculations.”

Within a portfolio there may be loans that can be at par value but with a number of caveats. If the assets underlying the loan also have other terms, these need to be taken into consideration. In short, the administration of a loan portfolio is complex and needs experienced people to deal with it.

UNDERSTANDING LOAN TERMS A-Z

Alan Asset swap

Describes the package of swap plus investment where an interest rate swap or currency swap is used to change the interest rate exposure and/or currency risk exposure of an investment. Usually a combination of an interest rate swap plus fixed-rate bond. The obligations under the swap are usually independent from those of the asset.

Availability period

Period of time between the signing of a loan agreement and the expiry of the lender’s commitment to lend, during which the borrower is permitted to draw down advances, or if applicable, issue bills or letters of credit, provided the conditions precedent have been satisfied and the repeated conditions precedent continue to be satisfied.

Balloon

Final repayment of a facility where the repayment schedule is heavily weighted to the final amortisation payment.

Break funding

Break funding seeks to ensure that neither party to a secondary loan trade is disadvantaged as a result of movements in the underlying funding rate where the settlement date is not a loan rollover date. It is the LMA standard default position on all trades. The calculation is based on the difference between the Libor rate from settlement date to the next loan rollover date, and the relevant funding rate for the loan during the current interest period. Often referred to as ‘break costs’.

Bullet

The bank(s) appointed to run the books during the execution phase of syndication with responsibility for issuing invitations, disseminating information to interested banks and informing both the borrower and the management group of underwriters of daily progress. High-profile role and generally considered the most desirable syndication task.

Commitment fee

An annual percentage fee payable to a bank facility. Typically paid quarterly in arrears.

First lien

Usually a loan with a senior claim on security being a first charge on a borrower’s/obligor’s assets.

Leveraged loan

A loan that has higher levels of debt leverage when compared to an investment grade credit. Institutions may define a leveraged loan differently, although it is reasonably common to be determined against a bank loan rating (e.g. Ba1, BB+ or lower from one or more of the major rating agencies), or for non-rated borrowers, a margin of around 125–150 basis points a year or more.

Mezzanine finance

The capital structure layer of funding between common equity and secured borrowing, usually subordinated, it sometimes may carry an equity warrant. Mezzanine finance may also involve an element of interest being accrued and capitalised on a PIK (payment in kind) basis.

Pari passu

A *pari passu* covenant is incorporated into debt instrument documentation to ensure that the borrower’s indebtedness under the relevant facility/instrument would at least rank equally with all other unsecured indebtedness of that borrower.

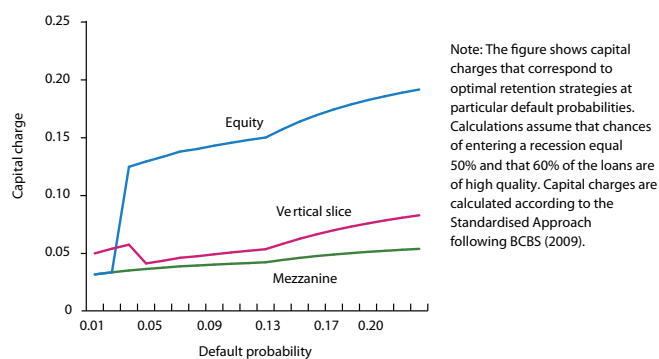
PIK

Payment in kind typically does not provide for any cash flows from borrower to lender between the drawdown date and the maturity or refinancing date. PIK interest accrues and capitalises periodically over the life of the debt instrument, thus increasing the underlying principal (i.e. compound interest).

Ring fence

In lending terminology, when a specific company is made structurally bankrupt remote from the rest of the parent group. This may be applied for regulatory reasons (such as for UK electricity distribution companies) or to protect certain assets from claims by other creditors. A European second lien is a loan with a secured charge or attachment on a borrower’s assets ranking behind the first lien loan but ahead of any mezzanine debt.

Corresponding capital charges for equity, mezzanine and vertical slice retention: high-quality borrowers and equal odds of recession



Note: The figure shows capital charges that correspond to optimal retention strategies at particular default probabilities. Calculations assume that chances of entering a recession equal 50% and that 60% of the loans are of high quality. Capital charges are calculated according to the Standardised Approach following BCBS (2009).

Source: IMF staff estimates.

**Anne King,
BNY Mellon**



To deal with the administration of these products, Devane has a staff of 65 in Dublin that covers European administration.

There is also an operation in London handling administration and a similar operation in the US.

Trustee services

Anne King, head of trustees, and Manuel de Rosales, trustee manager at BNY Mellon Trust Company (Ireland) Limited, work closely with Devane and others in the bank to administer these products. "Irish trustee are constantly required to deal with new products," says Rosales.

He notes that some aspects of certain products need to be harmonised so that all players approach valuation and other issues in a similar and consistent manner.

King believes Ireland is becoming the preferred location for these products. "We have the skills and expertise and are well placed to take the lead in this area," says King. They

both explain that each portfolio is different when it comes to pricing.

"Obviously it is easier if there is an independent third party pricing the instruments. Then there is normally no conflict of interest.

The Irish regulations permit the appointment by the board of a 'competent person' for the independent valuation of OTC derivatives and unlisted securities," notes de Rosales.

Pricing is one of the trickiest challenges. The 'competent person' provides prices for these types of assets. These prices are used for the calculation of the NAV. Sometimes there could be a conflict of interest if, for example, the competent person is the investment manager of the scheme, who would also benefit from a higher pricing *vis-à-vis* performance fees.

The trustee is required to approve the appointment of the 'competent person' and where there is a potential conflict of interest, would normally review the procedure that addresses this conflict of interest. ■

PRIVATE EQUITY FUND ADMINISTRATION EXPERTISE OFFERED

Alan Flanagan, managing director and global head of BNY Mellon private equity fund services product, believes the worlds of private equity and hedge funds are growing closer. This convergence, he says, is epitomised by the hybrid investment forms that are being used to tap into the structured credit market.

On the surface, private equity and hedge fund structures have little in common. Private equity funds are generally close-ended with a typical life time of around seven years, during which the goal is to acquire a private company, improve value and operational efficiencies by restructuring and/or refinancing and exit through a private sale or initial public offering. Hedge funds are open-ended with investors having the option to enter and exit at predetermined intervals.

The two distinct business models have different characteristics. But, says Flanagan, they are converging. The meeting of the funds is in the hybrid investment form. This mixing of hedge fund and private equity is not without challenges, including accounting complexities, in terms of management and performance fees, as well as drafting of fund documents and the administration of the funds.

With the credit hybrid, Flanagan is seeing hedge-fund investing wrapped in a private-equity structured vehicle. The lock-ups for

these usually run for three to four years although a seven-year lock-up is not unheard of. Some penalise early departure from the fund. Similar to private equity funds, these vehicles are structured with a finite life; when they reach a certain point in time they must return all their profits and principal to the investors.

Some private equity funds will not take performance fees until investments are realised (deal by deal) and then they are subject to clawback based on the overall performance of the fund. The hybrids are not quite going that far but they are structuring fees in a similar fashion to private equity. They are paid performance fees after full return of capital, then reaching a preferred return, generally 8%–10% before they then enter into the more typical hedge fund split of 80% for investors and 20% for the investment manager.

Flanagan believes this continuing convergence will be accelerated by the creation of hybrid vehicles that continue to share aspects of both hedge funds and private equity.

"The capital structures are quite different," says Flanagan. "The longer investment horizon of the private equity funds drives the incentive fees. They do not pay out deal by deal and only have cash flow once they reach the end of the investment. Only then do investors get all their money back, with the

general partner not receiving any money until there is a full return of capital and performance return over capital to investors," he explains.

He thinks the poor returns by hedge funds in 2008 could influence the way fee structures in general develop. With the introduction of the hybrid funds, he believes the need to adopt a more private equity-style fee structure will become the norm.

The fund administration for these funds is also a challenge. Flanagan says Europe is ahead on the independent administration of private equity funds. "It is more common here," he says, although he believes having some of the large investors saying they will only invest in funds with third-party administration will also influence the manager's decisions to outsource.

Flanagan also believes BNY Mellon's own position is a plus point. "BNY Mellon is not an investment bank. We are a custodian bank. Our credit exposure was relatively small when compared to some of our competitors so we faced the crisis and came out of it very well," notes Flanagan. In addition to the services BNY Mellon provides for hedge fund administration, it also offers administration services for private equity funds. Reports are delivered through a web-based system where the general partner can see real-time capital account balances and current portfolio performance. The services

apply to all types of private-equity deals including buy-outs, venture capital, mezzanine financing, real estate and hybrid hedge fund deals.

The service begins before the fund is set up, with time spent helping to develop and structure the fund before launch. This includes structuring the fund from an accounting perspective as well as discussions and workflow models around waterfall distribution carried-interest calculation methodology.

Other services includes the provision of escrow and the safekeeping of assets, help in deal-flow transactions, as well as processing, reporting and communicating all fund capital calls and distributions.

The corporate trust business services over \$12 trillion in outstanding debt from 56 locations around the world, covering all major debt categories. As the largest custodian of syndicated loans with more than a 30% share of the market, BNY Mellon has the capacity to service over 1,200 syndicated loan portfolios. This includes collateralised loan obligations, credit opportunity funds and other structured loan products as well as private equity.

Finally as a top-rated custodian, the bank can execute transactions, ensure safekeeping of securities and maintain a complete register of investments.



Markit wants standardisation

Financial information services company Markit offers the most comprehensive loan data in the marketplace through its loans service, acquired in January 2004. Markit's loans pricing service offers accessible and comprehensive global secondary market-to-market pricing on over 6,700 loan tranches.

The company supports over 40 global sell-side institutions active in loan sales and trading, promoting market liquidity and pricing transparency. The service allows clients to track the value of proprietary loan portfolios through its easy-to-use, secure website or via direct feeds to client internal systems. Markit also integrates loan terms and conditions, pricing history and analytics, mapping tools and loan market news.

It is the leading provider of independent loan market data and loan portfolio management software, its loans products are currently used by over 400 financial institutions to manage over \$1 trillion in assets.

Acquiring a mature service operator with a number of years of experience means Markit was able to position itself as an independent provider of aggregated dealer quotes. The expansion of the service was also in response to the need for an independent source to aggregate dealer quotes, explains Sally Moore, managing director of Markit. In 2000 the US Securities and Exchange Commission (SEC) mandated pricing for bank loans. These loans had to be marked to market – recording the price or value of a security to reflect its current market value rather than its book value.

With around 400 accounts, Markit is responsible for providing independent valuations on over 6,700 loan tranches made up of first and second lien and mezzanine finance for both par and distressed.

A first lien is usually a loan with a senior claim on security being a first charge on a borrower's or obligor's assets, while the second lien is a loan with a secured charge or attachment on a borrower's assets ranking behind the first lien loan but ahead of any mezzanine debt. Mezzanine

finance is the capital structure layer of funding between common equity and secured borrowing, usually subordinated. It may sometimes carry an equity warrant. Mezzanine finance may also involve an element of interest being accrued and capitalised on a payment-in-kind (PIK) basis. PIK typically does not provide for any cash flows from borrower to lender between the drawdown date and the maturity or refinancing date. Interest accrues and capitalises periodically over the life of the debt instrument, increasing the underlying principal.

"The process that we use at Markit reflects a collated price that brings together feeds that come in as quotes from dealers spanning 65 trading desks globally," says Moore. Markit has invested heavily into technology as well as human resources. It employs around 300 people globally in its loan focused businesses.

Looking to Wall Street

Markit uses Wall Street Office (WSO) to interface directly with its loans pricing service. This allows for the automation of importing prices at the asset or positions level for all WSO-supported asset types from Markit loans pricing.

Markit acquired FCS Corporation, a provider of syndicated loan market portfolio and risk management software and services, including the WSO family of products from JP Morgan in September 2008. This acquisition enabled Markit to develop ways to improve operational efficiency and transparency in the loan markets. Markit has recently announced its intent to acquire ClearPar loan settlement system from FIS to bring further efficiencies to the loan market.

WSO is a suite of products for the administration, accounting and reporting of bank loans, bonds and other investments. This comprehensive system is designed to facilitate the management of portfolios and structured deals more efficiently and effectively, with functionality tailored to the asset types found in structured deals, as well as compliance reporting specific to each

structure. The software is currently used to manage over \$300 billion in assets and provides access to real-time data.

However, the human element in the pricing service is essential, notes Moore. There are ranks of analysts studying the manual pricing information feeds. There are literally thousands of loan prices that are processed daily with composite information available at 4pm London and 4pm Eastern Standard Time every trading day. Markit helps unify the buy- and sell-side discovery. But there is one crucial element missing.

There is no standard identification for each loan trade. Moore is convinced that standardisation of loans is needed in order to help the loan market advance. She points out that at present there are inherent inefficiencies in the market.

"Markit is well placed through its transmission of prices, its level of expertise and ability to collaborate with third parties to help aid the electronic trading and settlement of these loans," says Moore.

At present Markit is working to help introduce a global standard identifier for bank loans. "We are putting a lot of work into this. Markit is working with Standard & Poor's (S&P) Cusip to adopt Cusips as a global standard for bank loans," Moore adds.

Cusip Global Services (CGS) powers efficient capital markets by providing unique identifiers for millions of securities and their issuers worldwide. The acronym Cusip refers to the Committee on Uniform Security Identification Procedures and the nine-character alphanumeric security identifiers that they distribute for all North American securities for the purposes of facilitating clearing and settlement of trades.

The Cusip distribution system is owned by the American Bankers Association and is operated by S&P. The Cusip Service Bureau acts as the National Numbering Association for North America and the Cusip serves as the National Securities Identification Number for products issued from both the US and Canada.

Moore believes there will be "increasing pressure for the market to address operational efficiencies in the loan market ahead of regulatory measures." She points out that there is a lack of transparency in the market because deals are structured as private transactions and so are not easy to standardise. She believes Markit ensures the quality of information it receives from the sell side.

According to Moore, once prices are received they go through a series of processes to 'clean' the data. North American and European dedicated analysts utilize approximately 3,000 real-time quote information from multiple sources in addition to end of day sheets from traders.

Markit validates the data and uses best practices to ensure the prices are 'clean' and accurate.

"We operate a robust price challenge process," she explains. Clients can come back to Markit during the day to challenge a price if they have executed a transaction at a different amount. Markit will then challenge the dealer to make sure the price is an accurate reflection of the market.

Steady prospects

Looking into the future for this market, Moore believes the volatility of the last two years on both the buy and sell side has calmed. Until July 2007 the trend was stable, pricing these loans at par or above. "After July 2007 there was severe dislocation in the market. Many of the prices fell significantly lower than they have been previously priced," Moore says.

There is still scope for price movements, believes Moore, but this depends on broader economic trends as well as the supply and demand around this asset class.

She, like others in the industry, is hesitant to forecast how the loan market will develop.

"I think the primary view is that investment will come back. Issuers are using high-yield bonds as alternatives to loans," notes Moore. However, she adds that there are significant levels of re-financing coming up and she does not think these will be able to be financed purely through high-yield bond issuance.

Commenting on Markit's work with pricing committees and the boards of directors of funds that trade loan assets, she explains the company meets with auditors and others. Periodically clients come in to discuss the pricing methodology used by Markit as well as its operational functions. Like other service providers, Markit is also being asked to respond to formal due diligence questionnaires.

For the future Moore believes Markit will continue to grow through client acquisitions. "We've seen new funds coming in, albeit not at the same rate, but still we are seeing new clients. People are focused on independent pricing and on what we offer in bringing transparency to the market," she concludes. ■



Flexible administration caters for hybrid products

As the hedge fund industry has continued to change and evolve, fund administration has also had to change.

Help and advice on finding the right structures and vehicles for strategies is one of the most important aspects of fund administration. It is also a service BNY Mellon offers its clients for free, according to Caoimhghin O'Donnell, head of alternative investment services operations, BNY Mellon Fund Services (Ireland) Limited.

Because the fund administration service in Dublin has seen a wide variety of strategies, vehicles and different ways to meet the demands of investors as well as the fund manager's own ideas for the fund, he and his team are able to offer the advice and help many fund managers starting up or moving into new areas need.

One example is the co-mingling of the debt and equity worlds with the emergence of hybrid products. Over the past months he has seen a lot of credit funds coming to the bank for servicing.

O'Donnell found a lot of traditional hedge fund clients were looking at credit funds and searching for a way of structuring an unregulated vehicle (the loan obligations) inside a regulated structure, like an Irish qualifying investor fund (QIF).

He believes the ability of his bank to service all aspects of such funds gave it an edge in attracting this business. That coupled with the experience of having serviced a wide variety of funds and the ability to pull together three separate but related functions – hedge fund and private equity administration with corporate trust services – made BNY Mellon's offering attractive.

One of the reasons BNY Mellon is well placed to provide fund administration services to the emerging hybrid vehicles is its acquisitions in 2006 of JP Morgan Corporate Trust, a collateral administration business with a broad range of administration capabilities and expertise in servicing structured credit invest-

ments, including collateralised debt obligations (CDOs), collateralised loan obligations (CLOs), hybrid debt and fund structures.

Edmund Kwan, former head of product management for structured products at JP Morgan corporate trust, is one of the senior managers who came over to BNY Mellon with the acquisition. According to Kwan, who is now global product manager for structured credit products at BNY Mellon corporate trust, "joining BNY Mellon brought about a renewed commitment to our business model and an even higher level of investment in people and technology. These investments have kept us at the leading edge of innovation and many clients frequently look to us for guidance."

Together with its existing hedge fund and private equity fund administration, the addition of the collateral administration gave the bank the ability to service the different aspects of a fund dealing in securitised loan structures within a traditional hedge fund structure with private equity-style aspects involving longer investment horizons.

At present BNY Mellon provides hedge fund administration services to around 150 clients, over 900 funds with total assets under administration of more than \$200 billion. The corporate trust business services over \$12 trillion in outstanding debt from 56 locations around the world covering all major debt categories. Furthermore, corporate trust is the largest third party administrator of syndicated bank loans, servicing over 12,500 loan facilities or 60% of outstanding facilities in the US and European syndicated loan markets. It services over 1,200 syndicated loan portfolios globally, including CLOs, credit opportunity funds and other structured loan products.

With this growth and development the bank has recognised the benefits of offering clients loan

administration, fund administration and investor services combined into one package.

According to O'Donnell many of the hybrid funds were interested in the use of what is known as section 110s. This refers to a part of the Irish tax code which offers an optimum taxation treatment if a special purpose vehicle (SPV) is regarded as a 'qualifying company' under section 110 of the Taxes Consolidation Act 1997.

"They were looking for a way of combining different structures in a tax-efficient way and we were able to help advise them because we had the experience and expertise drawn from different parts of the company," says O'Donnell.

With these new structures fund managers did not have need of a prime broker for leverage as effectively the leverage was built into the price discount. Many of the funds were taking advantage of the ability to buy loans at up to 60 cents or less on the dollar. They were then taking these loans and putting them into hybrid structures that had elements of a private equity structure. O'Donnell says the funds were looking at performance fees that were closer to private equity funds but still within a hedge fund structure. Servicing of the loans themselves needed expertise available from the corporate trust area of the business.

"We have been in business a very long time and have serviced complex clients. It gave a lot of comfort to promoters and to investors that we could leverage off the expertise of our colleagues in corporate trust. We were capable of servicing a full

portfolio of loans while offering the hedge fund and private equity administration needed for the fund," says O'Donnell.

"By working together, corporate trust and the alternative investment services area began to better understand each other's business and realised the potential from sharing information. This is what was needed to service an entity that was both regulated and unregulated," he notes. Corporate trust was able to deal with the dedicated loan instruments within the section 110s, while the alternative investment services could deal with the fund administration part of the structure.

"We needed to make sure we presented one face to clients, not two. We needed to streamline internal operations and make it possible for the client to deal with one entity, BNY Mellon," O'Donnell says.

Another challenge the hybrid credit fund structures presented was in the area of systems where the bank invested heavily to enable different systems in the respective departments to communicate with each other and produce a best of breed solution.

O'Donnell says BNY Mellon has been "very proactive" putting together structures and working with clients to find the right operational model. "We work very closely with clients. There has been rapid change over the last 12 months. Fund structures have changed. Our clients have seen value in our experience of dealing with different structures. We have been able to offer advice on structure issues and different ways of administering funds," concludes O'Donnell. ■



Corporate debt offers investment opportunity



Discounted corporate debt has presented good investment opportunities for fund managers and investors. How the market for structured products, including securitised loans, will develop in the future is, however, an open question.

Over the last 18 months many fund managers have been able to take advantage of the significant discounts offered on collateralised loan and debt obligations (CLOs/CDOs), a result of the previous boom in global issuance of CDOs and synthetic equivalents. Investment vehicles structured as hybrid investment funds have been able to take advantage of market factors that have combined to offer investment opportunities through these arrangements.

While these particular investment possibilities may have run their

course, a permanent change to the structure of investment capital markets coupled with continued market volatility is likely to continue to throw up new opportunities in the future.

The new generation of fund vehicles that have emerged hold underlying assets such as leveraged loans and other investment assets similar to those traditionally found in the collateral pool of a CDO (and of CDO variants). Hybrid structured funds have emerged as a way to access opportunities that have arisen as investment markets begin

to normalise. Funds have been able to acquire investment assets at prices at or below intrinsic value.

The advantages of a hybrid structured fund as a vehicle to finance the acquisition and holding of investment assets has been attractive to investors keen to take advantage of what many see as a short-term opportunity in this market.

The hybrid structured funds can be used to access a variety of asset types, from fixed-income investments to alternative asset classes. In the recovery period investment opportunities will be concentrated in asset classes such as distressed debt, stressed financial credits, mezzanine and leveraged loans and others.

Leveraged loans as an asset class have appealed to investors, says Michael Devane, vice president, corporate trust, securities servicing, BNY Financial Services. These structures have appealed to investors who saw the opportunities offered in the loan market as an attractive proposition to access through a variety of fund structures. The popularity of leverage loans was strongest in the first nine months of 2009, driven mainly by

an imbalance between supply and demand in the syndicated commercial loan market. This imbalance has now eased which may lead to a less enthusiastic appetite for this asset class in 2010.

Ireland has been well placed to take advantage of this offering, says Brendan O'Regan, vice president, alternative investment services product manager, BNY Mellon Fund Services (Ireland) Limited. He says the ability of Ireland to offer a fund structure that takes advantage of the country's numerous double-taxation agreements as well as the high level of knowledge on hedge fund structures, trustee services and other services related to funds has led to a proliferation of hybrid credit fund structures over the last 18 months.

Welcome competition

Ireland's reputation as a jurisdiction with sound but flexible regulation has also attracted managers, says O'Regan.

While Luxembourg may be catching up on Ireland's initial lead in this area, he believes there is room in the market as there are opportuni-

ties yet to be exploited by the fund structures.

O'Regan sees an uncertain landscape for funds in the future. However the current climate where leverage is restricted has played well for the credit funds. For O'Regan the opportunities remain; he believes further writedowns, particularly in the banking sector, are likely to fuel future demand for these funds. He believes BNY Mellon was well placed to take advantage of the emergence of these hybrid structures. Its ability to marry hedge fund and equity administration functions with the bank's significant corporate trustee and custody services has given it a first-mover advantage over others. Its experience, too, in helping fund managers structure appropriate vehicles for the investments has led the bank to create what is in effect a new service offering that O'Regan believes will continue to have applications in the future.

As these hybrid structures develop, O'Regan believes BNY Mellon will continue to improve its service offering. "Transparency, disclosure, information and reporting have become important areas for funds following the financial crisis," he says. He believes the ability of BNY Mellon to use its existing technology together with a combination of services not easily available elsewhere, will continue to make it a leader in servicing these new structures in the future.

Derek Delaney, head of client services and new business, alternative investment services, BNY Mellon Fund Services (Ireland) Limited, agrees that the bank and Ireland should continue to benefit from the emergence of different credit fund vehicles.

Mortgage-backed and corporate asset-backed securities as well as bonds, sovereign debts and other corporate securitisations will continue to create opportunities for investors and fund managers in future, he believes.

Delaney points to the innovation by fund managers seeking to capitalise on the opportunities offered in the debt markets. He has seen fund managers offering innovative fee structures based on varying lock-in periods where management fees are discounted if investors opt for longer lock-in periods. This benefits not only the investment manager but also the investors, as it allows the portfolio sufficient time to realise the underlying assets, most of which are distressed debts. The bet is that by the time these come to maturity,

the value will have risen considerably compared with the discounted prices at which they were obtained.

"Now some managers who are not historically debt managers are starting to look at these assets. They have no expertise specifically in buying debt but they are able to give investment capital to a number of specialised investment managers to exploit the opportunities," notes Delaney. He says a number of investors are seeking exposure to these funds, including funds of hedge funds.

In the US the Public Private Investment Program (PIIP) introduced by Treasury Secretary Tim Geithner, is aimed at combining public and private money to buy commercial and residential mortgage-backed securities (MBS) from banks in an effort to get these illiquid assets off their balance sheets and at the same time increase their lending capacity. With the US government committing \$75-\$100 billion to PIIP, there are significant opportunities for investors, too.

This has also created an opportunity for BNY Mellon. It is servicing seven of the nine PIIPs set up so far. This experience will further add to the bank's existing expertise in administering and supporting hybrid investment funds dealing in illiquid instruments available in the credit market.

A new business team created by BNY Mellon is able to help managers talk through various structures that can be used for this type of fund. Delaney believes the service BNY Mellon can offer these funds benefits on both sides. "We offer experience. I'm a qualified accountant and most of my team are, too. We are able to

support all the operations needed to administer these new hybrid fund structures, including valuation, custodian and trustee functions," says Delaney.

Another member of BNY Mellon Fund Services (Ireland) Limited, Conor MacGuinness, alternative investment client services, agrees the bank's ability to act as a trustee, protecting shareholders, coupled with its other services in administering the funds, has made it a good choice for fund managers seeking to open these funds.

"Mortgages, corporate debts, mortgage-backed securities – they are all different. We can receive various trade files for different sub-portfolios on a daily basis and consolidate this up to a master fund value. That requires our expertise and infrastructure," says MacGuinness.

IT attraction

He believes the technology and skills the bank offers in providing systems to process and monitor these complex portfolios have been attractive to originators of hybrid fund structures. Through systems such as Wall Street Office, the bank is able to offer transparency to investors and fund managers, giving them the ability to see and monitor individual loans in the fund with great detail. MacGuinness also thinks the banks' ability to handle the cash flow and intricate periodic payment profiles for the underlying assets held by these funds has given confidence to fund managers and their investors that these structures will be administered efficiently and cost-effectively.

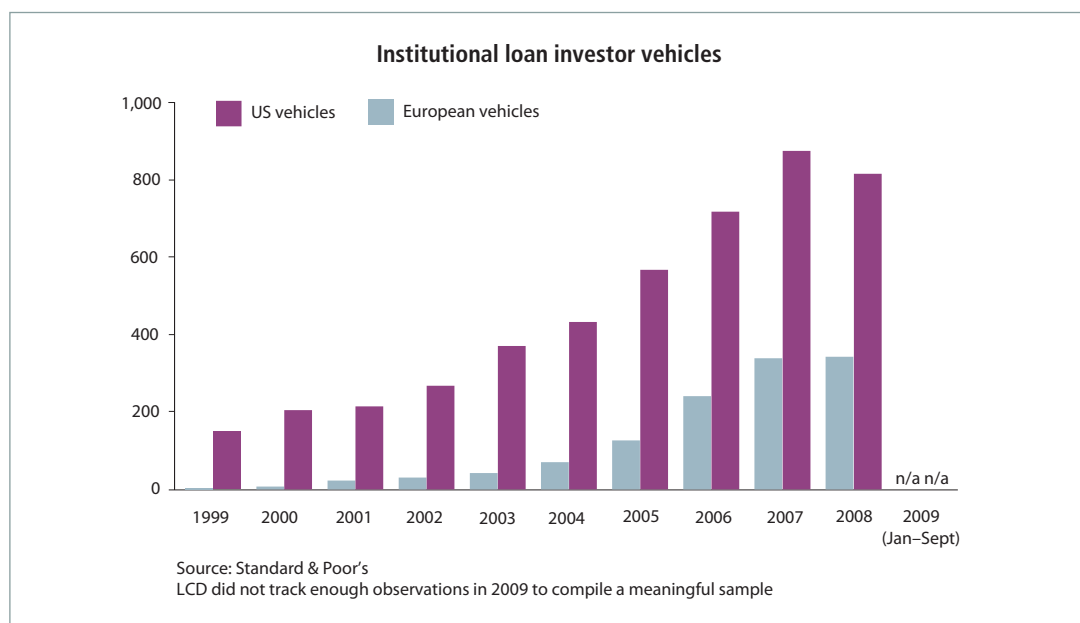
"Within the regulated Irish

qualified investor fund [QIF] market pricing is needed," explains MacGuinness. He says the corporate trustees are expected to find pricing vendors to provide independent valuations. "Markit is one of the leaders in institutional loan pricing," says MacGuinness, confirming BNY Mellon's partnership with the company (article, page 16).

For these funds, the pricing of each pool of assets usually grouped within a section 110 special purpose vehicle under the umbrella of the Irish QIF, is a complicated and time-consuming activity which the bank is well placed to perform. "The funds are used to the alternative investment services we offer. These coupled with the trustee functions allows us to service these funds in a joined-up service. We work closely together internally to provide a seamless service to clients," confirms MacGuinness.

"We have seen these funds grow quickly. The opportunity is focused on 'cheap' debt. As the general economy picks up, however, inflation worries will surface. As the interest rates start to rise, it is likely we will see more distressed debt coming onto the market as well as banks continuing to write down debt," predicts MacGuinness.

He believes these emerging fund structures will continue to attract investment interest not only from the high net worth investors but also from institutional investors. Both are keen to diversify portfolios into what is seen as a good investment opportunity but one where special fund management skills and expertise are needed. ■



Hybrid fund structures embrace innovation

Hybrid structured funds can be used to access a variety of underlying assets, from fixed-income investments to alternative asset classes. Three jurisdictions have emerged as leaders in offering credible, tax-efficient vehicles in which to place these assets.



Dualta Counihan
Matheson Ormsby
Prentice

Recent market and regulatory events in the world's financial markets have created challenging conditions for the global hedge fund industry. One way it and others in the alternative funds area have reacted is seizing opportunities brought about by the market dislocations. Collateralised loan obligations (CLOs) were such a chance to get high returns. At one stage many of these assets were selling at as low as 30 or 40 cents to the dollar.

To take advantage of this opportunity, hedge funds and others in the alternative industry looked around to find structures that would allow them to buy, hold and eventually sell or bring to maturity these and other structured credits.

Before the financial crisis Ireland had become one of the locations of choice for the establishment of special purpose vehicles (SPVs) for an impressive variety of transactions including asset-backed securitisations (ABSs), repackaging, collateralised debt obligations (CDOs), CLOs, warehousing, structured investment vehicles (SIVs) and other structured finance transactions, according to Matheson Ormsby Prentice (MOP) law firm in Dublin.

As the global market became more sophisticated, Ireland as a jurisdiction responded in terms of its legal and tax framework in order to continue to position itself as the location of choice for issuers of debt securities.

Ireland has come a long way since the securitisation industry first made an impact in the country in the early

1990s. Recently Ireland has been at the forefront of global structured financing. In a recent league table published by Thomson MOP was rated as a top 10 advisor to issuers in European CDO transactions.

Ireland's growing position at the centre of the structured finance market in Europe is in part attributed to its status as an onshore and regulated jurisdiction, something that is particularly attractive for arrangers and investors post-financial crisis.

As the market takes its first steps back to traditional deals like CLOs and ABSs, the legal firm is confident in an Irish context that the section 110 companies used in structuring these vehicles will retain their popularity.

MOP believes the prospects of an increasing volume of transactions coming from emerging markets and the general move towards onshore investment present a great opportunity for those involved in the Irish structured finance industry to build on the substantial existing track record.

The main reason for Ireland's success has been the attractive taxation regime for Irish SPVs, commonly known as section 110 companies. This refers to a provision under Irish tax law that forms the basis of the structured financing industry in Ireland.

Tax benefits, a thoughtful legal and regulatory framework and a solid infrastructure of professional advisors and service providers have

all contributed to the success of the Irish structured financing industry.

Establishing an SPV in Ireland means the basic framework of Irish company law applies to the SPV and its directors. This framework provides a balance of sufficiently detailed regulation and enforcement to satisfy arrangers and investors but without being unduly and unnecessarily burdensome.

As in any hedge fund (or alternative structure) it is critical to minimise any potential taxation leakage that might affect the return for investors. The optimum taxation treatment can be achieved if an SPV is regarded as a 'qualifying company' under section 110 of the Taxes Consolidation Act 1997. Some of the preferential tax treatments available include payments of fees to collateral managers – something that is important in the context of managed CDOs – being exempt from Irish VAT.

An Irish issuer that is a qualifying company can calculate its taxable profits as if it were a trading company. So while the income of a qualifying company is taxable, deductions are available for revenue expenditure, including swap payments and interest payments on notes, of the issuer. This ensures if a transaction is structured properly, Irish issuers can achieve tax-neutrality.

Interest payments on sweep notes that are common in CDO transactions are not classified as distributions. If they were, interest payments would not be deductible. These structures are also exempt from stamp duty and transfer of notes issued by a qualifying company.

There are two principal domestic exemptions from Irish interest withholding tax. One is the quoted eurobond exemption; the second is an exemption for interest payments

“The section 110 tax designation is useful as it allows the fund to pass money to its subsidiary, the section 110 company, back and forth”

**Dualta Counihan,
Matheson Ormsby
Prentice**

“The section 110 tax designation is useful as it allows the fund to pass money to its subsidiary, the section 110 company, back and forth. The section 110 subsidiary takes a loan or note from the parent,” explains Counihan. Partner Tara Doyle at MOP confirms the tax treatment offered by the section 110 categorisation was “on the table” when Ireland’s corporation tax regime was examined by the EU and so has been sanctioned by the Brussels authority.

Unlike some tax structures in Europe and elsewhere that have come under criticism or attracted unfavourable attention, Doyle and Counihan are confident of the tax arrangements Ireland is able to give these funds.

By using this structure the returns on the underlying assets can be made to investors in the QIF without the need to pay local with-

holding tax because of the double taxation treaties which the SPV can often access (in circumstances where the QIF may not be able to access the relevant treaty due to its effective tax exempt status under Irish law).

This structure also gives investors the benefit of a regulated fund structure through the QIF that is regulated by the Irish Financial Services Regulatory Authority (Financial Regulator).

Investors in the QIF benefit from the tax-exempt status while the SPV, although not totally tax-exempt, only pays tax on the profit it retains. Over the last two years Dualta Counihan, partner at law firm Matheson Ormsby Prentice in Dublin, has seen more fund structures use section 110 companies. The use of a section 110 company under a QIF will often depend on the intended investment strategy of the QIF, with

certain asset classes providing more substantial withholding tax savings, such as European bank loans, than others.

However, the use of section 110 companies under QIFs has become quite common and has been used for all types of investment strategies and funds. Recently there has been a lot of interest in using section 110 companies for CLO/CDO hybrid structured credit funds, putting the individual or portfolios of CLOs/CDOs in a series of section 110 companies sitting under the overall structure of an umbrella QIF. This use of a regulated Irish fund vehicle (the QIF), with or without a section 110 company underneath, he believes is driven partially by investors who prefer a safe, onshore jurisdiction within the EU but with favourable tax treatment. MOP itself is well known as a law firm

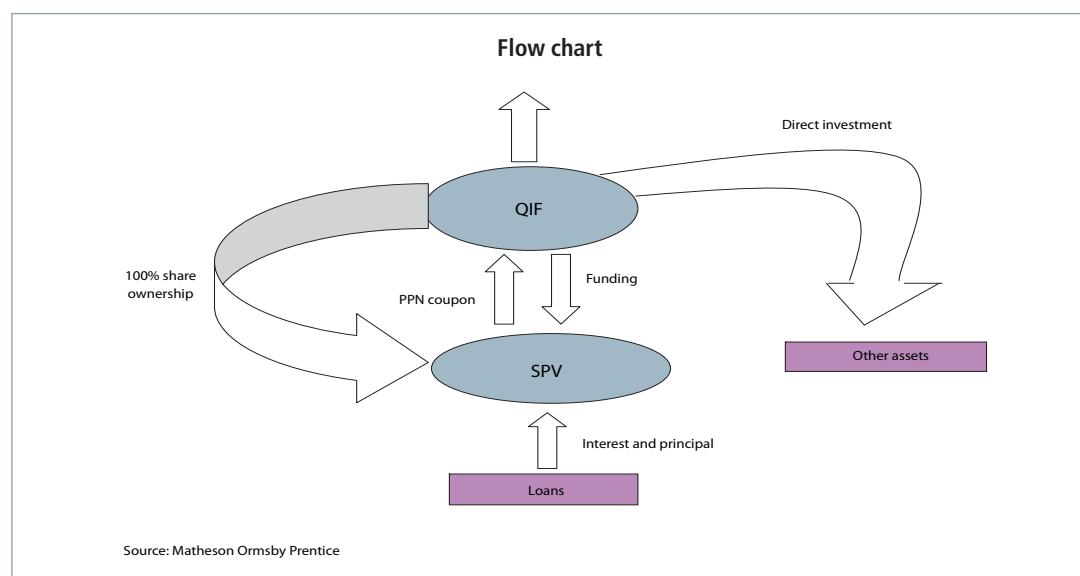
to a person resident in the EU or a double-taxation treaty jurisdiction. Ireland has an extensive and ever-expanding double-taxation treaty network, with the most recent treaty signed with Bahrain and treaties with Saudi Arabia, Egypt, Kuwait and the United Arab Emirates in the pipeline.

In addition to the tradition SPV structures, more recently dual fund/SPV structures have become popular. An existing or new Irish-regulated fund, usually a qualifying investor fund (QIF) subscribes for a nominal amount of share capital in the SPV.

The QIF is one of Ireland’s most successful fund structures. Because of their flexibility and time-to-market (with a 24-hour authorisation procedure) QIFs are the vehicles most frequently used for alternative investment funds including hedge funds, funds of hedge funds, venture capital/private equity funds and real estate funds, as well as for holding investments directly or via section 110 companies.

The QIF provides funding to the SPV through a profit participating loan or by subscribing for a profit participating note in the SPV. The SPV then uses this money to buy the distressed loans or other assets in jurisdictions where Ireland has a double-taxation treaty. The QIF may also invest in other assets in addition to those held through the SPV.

The coupon paid by the SPV to the QIF is made up of almost all of the return received by the SPV through its underlying investments. The SPV retains only a small profit, usually around €1,000 a year.



IRISH-QUALIFIED INVESTOR FUNDS GIVE MANAGERS FLEXIBLE AND ADAPTIVE STRUCTURE

The Financial Regulator automatically does not apply all of the general non-Ucits fund investment and borrowing restrictions in the case of non-Ucits funds that are qualified investor funds (QIFs). The Financial Regulator does not impose any investment concentration or leverage restrictions of any nature on QIFs, save that in the case of investment companies, they must observe the general principle of risk spreading.

This risk-spreading requirement derives from the Companies Act 1990 and so does not apply to unit trusts, common contractual funds (CCFs) or investment limited partnerships (ILPs). If a fund intends to engage in significant over-the-counter (OTC) derivatives trades, the Financial Regulator will expect the fund to limit its exposure to each OTC counterparty to 40% of net assets unless the fund intends to appoint a prime broker, in which case it may have unlimited exposure to such prime broker.

The absence of Financial Regulator-imposed investment restrictions has resulted in QIFs becoming attractive

vehicles for the establishment of highly leveraged funds, funds using investment policies that involve high concentrations of investments in individual issuers, private equity or venture capital funds, property funds and emerging market funds.

Following extensive consultations with industry representatives, the Financial Regulator approved a significant overhaul of the authorisation procedures for QIFs by introducing a one-day fast-track authorisation procedure.

This means a QIF can be authorised by the Financial Regulator within 24 hours of a single filing of documents.

Authorisation can be granted on the day following the date of filing of appropriate QIF documentation, once the Financial Regulator receives a completed application by 3pm on the filing date, all relevant parties to the QIF (such as the promoter, directors and service providers) have been approved in advance of the application and the fund certifies that it complies with certain agreed parameters.



specialised in securitisation and within Ireland is usually ranked at the top of any league table for this type of product.

Section 110 subsidiaries can also be used to segregate assets and liabilities into a separate legal entity, as they are private limited companies.

However, umbrella QIFs can also be established with segregated liability between sub-funds under Irish law, so a section 110 subsidiary may not be required unless there is a particular concern that assets are held in a jurisdiction that might not recognise the statutory segregation of assets and liabilities of a QIF under Irish law.

Both say it is impossible to give an accurate figure for the size of the market for these kinds of structures. Any figures tend to be anecdotal. However, they confirm that in just the last few months MOP has helped launch several of these kind of funds and that many more are in the planning stages. In the case of bank loan funds, these tend to be larger than the current hedge fund start-ups, as in order to invest in the bank loan market, a fund generally needs

to launch with \$100 million and will usually grow in size from there.

The QIF regime itself is also proving very popular with both investments and fund promoters at present. The flight to quality and regulation and away from unregulated tax havens has seen the number of new QIFs increase rapidly in the last two years.

While it is still too early to say what impact the final terms of the alternative investment fund managers directive will have on the structure of the industry, it is clear that this is already a factor which is causing some managers to move product from Cayman to Ireland.

Ireland intends to capitalise on this growing interest and it is expected that legislation that will allow the re-domiciliation of existing funds into Ireland will be enacted within the next few months.

Luxembourg's view

In Luxembourg a slightly different structure is used, according to Johan Terblanche, an attorney and senior associate at law firm Loyens & Loeff Luxembourg.

LUXEMBOURG FUND STRUCTURES AND TAX ADVANTAGES

In Luxembourg investors are now offered fund structures for alternative investments that can profit from flexibility, a favourable tax regime and less stringent regulatory supervision due to the nature of the qualified investor base to which these funds are targeted: the specialised investment fund (SIF).

Luxembourg introduced the SIF under a law enacted in February 2007. This completed the range of investment products available for private equity and the fund industry. It allows for a wide range of investment possibilities including transferable securities, real estate, private equity, hedge funds, funds of funds and commodities.

A SIF is reserved for "well-informed investors" defined as institutional investors, professional investors and other well-informed investors including high net worth individuals (who must meet threshold criteria).

As an undertaking for collective investment, a SIF can take the legal form of a common fund (FCP) or any Luxembourg corporate vehicle which may be formed with either variable capital (Sicav) or fixed capital (Sicaf).

The registered office of the fund or

management company (as the case may be), the central administration and the depositary all have to be located in Luxembourg. A SIF has to publish an offering document specifying the investment strategy and the inherent risks.

Within six months after the end of the financial year, the annual accounts reviewed by Luxembourg authorised auditors have to be published.

The taxes paid by a SIF are limited to a subscription tax of 0.01% of the net assets. The SIF is not subject to corporate income tax, wealth tax or capital gains tax for non-resident investors.

Luxembourg has implemented the EU directive on the taxation of savings income in the form of interest payment, known as the savings directive.

Non-resident investors can either opt for the exchange of information relating to income they have received in Luxembourg in the form of interest payments or accept the application of a withholding tax of 15% that will increase progressively up to 35% by July 1, 2011.

Investment funds are supervised by the *Commission de Surveillance du Secteur Financier* (CSSF).



Tara Doyle
Matheson Ormsby
Prentice

He specialises in investment funds with a special focus on hedge and alternative funds.

Terblanche admits the Luxembourg environment can be a "tough one to navigate" especially if the person is not familiar with the structures. He thinks the specialised investment fund (SIF) is the ideal vehicle for hybrid funds and confirms that over the last six to eight months there have been a number of these types of investment vehicles launched.

He believes the SIF regime is chosen because of its flexibility particularly for distressed and debt restructuring instruments, as well as for its tax exempt status. There are a number of different choices of fund vehicle within the SIF. Most hedge funds choose a corporate SIF.

Another way to structure these funds is for the SIF to invest through what is known as the securitisation vehicle (SV) governed by the law of March 22, 2004 on securitisation. Securitisation is defined as the transaction by which a securitisation undertaking acquires or assumes, directly or indirectly through another undertaking, risks relating to claims, other assets, or obligations assumed by third parties or inherent to all or part of the activities of third parties, and issues securities (*valeurs mobilières*), the

value or yield of which depends on such risks.

There are three types of SV: securitisation undertakings which carry out the securitisation in full (so they acquire the securitised risks and issue the securities); undertakings that participate in the securitisation transaction by assuming all or part of the securitised risks (the acquisition vehicles); and undertakings that participate in the securitisation transaction by issuing securities to ensure the financing (the issuing vehicles).

An SV can be structured as a company or as a fund. An SV company may be set up as a public limited liability company (*société anonyme*) (SA), a corporate partnership limited by shares (*société en commandite par actions*), a private limited liability company (*société à responsabilité limitée*) (Sàrl) or a co-operative company organised as a public limited liability company.

An SV may also be formed as a co-ownership of assets (without legal personality), a securitisation fund, to be managed by a Luxembourg-based management company.

The securitisation fund may also be set up under a fiduciary arrangement. In this form the assets are held by a fiduciary for the account of the investors.

As is the case for SIFS, an SV

may be compartmentalised so that each compartment represents a distinct part of the assets and liabilities of the SV. The compartmentalisation allows for the segregation of the assets and liabilities between various compartments so assets are ring-fenced on a compartment-by-compartment basis in the case of insolvency of the SV. Between investors each compartment is treated as a separate entity, unless otherwise provided for in the constitutional documents of the SV.

Recently the securitisation transactions in Luxembourg involved diverse assets, such as commercial loans, mortgage loans, car lease receivables, consumer credits, non-performing loans, distressed debt, deferred purchase receivables, commodities, operating businesses and other instruments.

The regulator has loosened some of its previous positions relating to SVs. It accepts the possibility to securitise loans not yet fully drawn down, or revolving loans. Such loans must contain a predetermined framework and the SV cannot have any discretion regarding the choice of borrowers or the terms of the loans, the SV must passively manage its assets. The role of the SV is strictly limited to the administration of financial flows linked to the securitisation transaction itself and to the management of the securitised risks. An SV cannot engage in any

“A significant proportion of new funds for us – and we believe the same is true for other practices – has been hybrid credit structures”

**Johan Terblanche,
Loyens & Loeff
Luxembourg**

activity likely to qualify the SV as an entrepreneur.

One of the main reasons in selecting a Luxembourg SV is its tax-efficiency and neutrality. A corporate-type SV is subject to Luxembourg corporate income tax and municipal business tax.

It will be regarded by the Luxembourg tax authorities as Luxembourg tax-resident, and should also be covered by the parent-subsidiary directive.

The SV is exempt from the annual

LEVERAGING CORPORATE ASSETS IN THE CAYMAN ISLANDS

The Cayman Islands has been dealing with capital markets and structured finance transactions for a global client base of institutional clients for several years. The typical structured finance transaction involves a debt issue made by a Cayman Islands corporation, trust or partnership known as a special purpose vehicle (SPV), which then acquires the underlying assets from the promoting financial institution.

This allows the financial characteristics of those underlying assets to be converted into readily transferable marketable debt instruments issued by the SPV. The instruments can be notes or bonds and may be rated and listed. Acceptance of such issues was established when debt issues by Cayman Islands SPVs first obtained AAA ratings from the rating agencies. The English courts have also reviewed the Cayman debt-issuing vehicle and concluded the structure withstands scrutiny.

Financing arrangements undertaken by SPVs include

everything from a simple capital markets euro paper issue, re-packagings, aircraft and ship financing, to more complex securitised transactions involving acquisition by the SPV of real property mortgages, credit card or other receivables, finance leases or interests in mutual funds. Any financial or other asset that provides an income stream may be acquired by an SPV.

Cayman Islands law has facilitated the treatment of the SPV as a bankruptcy-remote entity specifically by the use of the charitable purpose trust, well recognised in the financial markets in London, New York and Tokyo, or the purpose trust which is formed under the Special Trusts (Alternate Regime) Law, 1997 (STAR). This introduced the Cayman Islands' version of non-charitable purpose trust legislation and is commonly known as the STAR law.

This legislation has subsequently been integrated into the trust law, revised in 2007.

MAKING SENSE OF LUXEMBOURG ACRONYMS

SIF (specialised investment fund) is a product for qualifying investors. The SIF provides a number of features, including a broad definition of 'eligible investors' to include institutional professional and 'sophisticated' private investors.

Sicav (*société d'investissement à capital variable*) can be translated as an investment company with variable capital. It is a collective investment scheme, usually open-ended, common in Western Europe, especially Luxembourg, Switzerland, Italy, Spain, Belgium and France. The investor is in principle entitled to request the redemption of units and payment of the redemption amount in cash. Sicavs are increasingly marketed cross-border in the EU through the Ucits (undertakings for collective investments in transferable securities) directive.

Sicaf (*société d'investissement à capital fixe*) is an investment company with fixed capital and is used primarily in closed-ended structures.

SV is a securitisation vehicle governed by the law of March 22, 2004 on securitisation.

UCI (undertakings for collective investment) includes all non-Ucits collective investment schemes in Luxembourg. The SIF law replaced the 1991 Law on UCIs in 2007. Despite the legal change, a number of UCIs are still in existence.

Ucits is a set of EU directives that allows collective investment schemes to operate freely throughout member states on the basis of a single authorisation from one EU member. Although originally aimed mainly at the retail investor, many hedge funds use a Ucits wrapper for institutional products.

net wealth tax of 0.5%. Obligations (engagements) *vis-à-vis* its investors and other creditors ((future) dividends, interest and others) are considered to be deductible 'interest payments' for income tax purposes. If properly structured the taxable income of an SV can be minimal.

The distributions are not subject to withholding tax. A non-resident investor owning or having owned a participation of over 10% in the share capital of an SV may be subject to Luxembourg income tax if shares are transferred within six months following their acquisition, unless treaty protection is available for such an investor.

A common fund-type SV is transparent for tax purposes, so it will not be subject to corporate income tax, trade tax or net wealth tax. Distribution of profits is not subject to Luxembourg withholding tax.

Terblanche says that tax efficiency is a crucial aspect to be taken into account in structuring funds of this type. He points to Luxembourg's extensive tax treaty network, and although not crucial to specific funds, it is "very often one of the main drivers. Tax neutrality in itself is not enough. Access to tax treaties is usually of paramount importance and Luxembourg's vast network of tax treaties comes in handy," he says.

He also believes investors are erring on the side of regulation and want to see funds set up in regulated jurisdictions inside the EU. "Luxembourg is very well known in the Ucits area," Terblanche notes. "The SIF is the most popular of the alternative products."

He points out that the Luxembourg regulator is well acquainted with the complicated CLO structures and the strategies used to trade in these instruments. He says the use of SVs with segregated compartments able to offer differing terms for various different CLOs is a model that has been successfully used with an umbrella SIF on top. So far his practice has been concentrating mainly on European-based managers who are setting up these kinds of funds, although there have been a few clients from North America.

Cayman approach

At Maples and Calder, Paul Govier, the partner responsible for the investment funds group in London and a joint managing partner of the London office, says Cayman has seen a proliferation of structured credit funds, including distressed. This has included traders coming out of the large CLO/CDO trading desks of investment banks looking to set up on their own either because



FAVOURABLE TAX FOR SECTION 110

Ireland has a favourable tax regime for section 110 companies. A section 110 company is an Ireland-resident company that has no specific local management requirements and holds or manages financial assets.

A section 110 company provides an onshore platform in an environment of increased international focus on tax havens and principles of the Organisation for Economic Development (OECD), especially transparency. In practice a section 110 company can be almost tax-neutral from an Irish perspective. All profit-participating interest payments should be tax-deductible, as should swap payments, management fees, service fees, and other funding costs.

There is no withholding tax on interest payments made by a section 110 company to persons resident in an EU/treaty country or on interest payments on 'quoted eurobonds' made to persons resident anywhere. A wide treaty network should limit or eliminate withholding tax on inbound flows into Ireland such as interest, dividends and royalty payments.

Substance requirements for Irish tax-residency purposes are minimal. A section 110 company can hold a wide range of financial

assets – for example, shares, loans, futures, options, swaps, and similar instruments (and partnership interests in these).

A section 110 company has a number of applications as an investment platform. It can be used as an onshore vehicle for offshore investors. For example, an offshore fund would set up a section 110 company and provide the investment in the company through a profit-participating loan. This is an attractive vehicle because of its low effective tax rate, onshore/EU and eurozone status and access to Ireland's treaty network with minimal substance requirements. It can also be combined with other vehicles such as a qualifying investor fund (QIF) and/or used as an investment platform into countries with favourable treaty provisions.

A section 110 company can be formed as a public or private company. However, a QIF can be formed as a public company, unit trust or a partnership, but not as a private company. So there is flexibility to set up the entity as an eligible entity under the US check-the-box rules and an election can be made to treat the entity as fiscally transparent from a US tax perspective.

of restructuring in the organisation or a desire to work on their own.

"Cayman has seen a large number of these funds launched out of the US and Europe. There have been a number of high-profile, big launches over the last 12 months, many with strategies aimed at distressed credit structures," confirms Govier.

He is sceptical of the term 'hybrid', as it tends to blur the true nature of the product and its liquidity.

He also is keen to quash the urban myth that funds are drifting away from Cayman to Luxembourg and Ireland. He believes there is a lot of "noise" around this but, as yet, little real substance. Indeed, the latest numbers from the Cayman Islands Monetary Authority show fund numbers hovering above 9,800. "Given where we are, that's still a huge number. Not as large as at the peak (slightly over 10,000 funds) but it dwarfs Luxembourg and Ireland," states Govier. He believes the attraction of Cayman will not wane, despite attacks on offshore jurisdictions. His reason is the absolute simplicity with which Cayman operates, as well as its depth of experience and knowledge. "In the US it is still always Cayman, almost without exception," he confirms.

There are no problems holding

real securities, there is no need to try to find loopholes because there is simply zero tax. "That is why Cayman can accommodate these products," says Govier.

In Cayman he says there are basically three forms of vehicle used for these funds: a company, a limited partnership and a unit trust. "We tend to find the choice of vehicle is not strategy driven," he says. Structures are generally geared towards the preference of the country where the investors are based. For the US, it tends to be limited partnerships; the Far East, unit trusts; and in Europe, it tends to be corporates.

"Cayman's market is built on simplicity. The investor buys what he wants, provided he has been told what he is buying," he notes.

He thinks many other jurisdictions try to cram square pegs into round holes. "We can launch a Cayman product very simply. We let the manager match the liquidity to the assets, and oblige him to tell potential investors how he has done that."

He says the current move into credit products can be accommodated through a segregated portfolio company (SPC), a single legal entity with separate ring-fenced portfolios created, with board approval, to hold each vintage. "One segregated portfolio for each vintage," he notes. The same effect can be achieved using separate companies under the main fund, ring-fencing each portfolio within a separate company (SPV) to ensure safety.

"If you want a bulletproof structure," says Govier, "you need an umbrella fund or SPC on top holding assets through the a series of separate SPVs. Because not all jurisdictions have the concept of an SPC, we prefer to use SPVs because the courts of most jurisdictions understand the concept of a separate company better than a segregated portfolio."

In conclusion his advice is keep it simple. Over-complicating things he believes only leads to trouble and confusion.

What other jurisdictions can achieve through rather complicated structures and regulation, particularly concerning the tax-neutrality of the fund and its underlying holdings, can be achieved in Cayman with the same structures that have been in place almost from the start.

Because Cayman itself levies zero tax, there is no need for a convoluted and overly confusing tax structure that is often the case in other jurisdictions, believes Govier. ■

CATEGORIES OF FUNDS REGULATED UNDER CAYMAN ISLANDS LAW

There are three categories of funds regulated under the law in the Cayman Islands.

Licensed mutual funds submit to the Cayman Islands Monetary Authority (CIMA) a completed registration form (MF3); the current offering memorandum; the certificate of incorporation or evidence of registration or establishment of a partnership or unit trust; a personal questionnaire; and references and police clearance certificates for all directors of the fund or if it is a unit trust or limited partnership, the trustee or general partner. CIMA reviews the documents and considers the promoter's acceptability to receive a licence for the fund.

CIMA cannot grant the licence until the fund passes the statutory test,

satisfying the authority that each promoter is of sound reputation; the administration of the mutual fund will be undertaken by persons who have sufficient expertise to administer the mutual fund and are of sound reputation; and the business of the mutual fund and the offer of equity interests will be carried out in a proper way. If the fund is acceptable and on the payment of an application fee the licence will be issued.

Another category of fund is the **administered mutual fund**.

The regulatory responsibility for the administered mutual fund that has more than 15 investors and is not a licensed or registered mutual fund is placed largely in the hands of the licensed administrator

who must apply the statutory test detailed in the legislation.

The administrator is responsible for and must pay the initial and annual government fees. The fund's offering memorandum and completed registration form (MF2) must be submitted to CIMA, as well as any subsequent material changes.

Also required is form MF2A, whereby the mutual fund designates its principal office in Cayman to be at the office of the licensed mutual fund administrator.

The mutual fund administrator is required by law to report to CIMA if there is reason to believe that the fund, or the promoter of any fund for which they provide the principal office, has problems as specified under "powers of the

monetary authority".

The concept of private sector regulation is therefore taken beyond the initial registration stage with respect to the administered mutual fund.

Registered mutual funds are suitable for funds with a minimum subscription of \$100,000. They are also for funds listed on a stock exchange (including over-the-counter markets) specified by CIMA. Under this category the fund is simply registered with CIMA by the submission of a completed registration form (MF1), which would include specific details from the fund's current offering memorandum, along with the initial and annual registration fee. At the end of September CIMA had 9,218 funds registered, 487 administered and 133 licensed.



Illuminating the credit markets

When Eric Harrison joined Luminous Capital in July 2008 as head of portfolio construction and alternative investments, his first order of business was to create a strategy to exploit what he viewed as the most important investment theme of the next several years: distressed credit.

Harrison sees the credit markets being driven by forced sellers seeking to unload toxic assets at discount prices.

The process is unlikely to be orderly. He believes there will be a series of sudden capitulations whereby banks and fund managers become forced sellers of distressed assets like mortgages, corporate debt and commercial real estate.

Harrison describes the scenario as “an extraordinary investment opportunity not easily articulated within traditional fund strategy parlance.

It is hard to predict who the forced sellers will be, when they will sell or what assets they will

sell,” he explains. In 2008 Luminous established a multi-manager vehicle to invest opportunistically in distressed credit. The idea was to create a structure that was flexible enough to invest in a broad range of assets if they became available at a significant discount to their intrinsic value or replacement cost.

Harrison highlights the importance of being able to move quickly in order to capture the highest returns. “A huge amount of capital has been raised to invest in distressed credit and the windows to purchase the most attractive assets may be fleeting,” he says. “The early movers will see the best returns,” he adds.

Luminous made its first distressed credit investments in the residential mortgage-backed securities (RMBS) sector. After Lehman collapsed in September 2008, these assets were trading at “ridiculously distressed prices,” says Harrison.

Distressed credits offer a fertile hunting ground for managers looking to take advantage of the fallout from the credit crunch. Kris Devasabai talks to one manager who is exploiting the situation.

“At those valuations investors could still recover principal even if default rates hit 90% and loss severities were as high as 60%. Those assumptions were far too extreme. We decided that purchasing RMBS that reside at the top of capital structure was a very good risk-adjusted strategy,” he says.

Luminous took advantage of this by allocating capital to companies like TCW, Pimco and Fortress, which had well-established

distressed investing capabilities. A core requirement for Harrison was that the managers hired by Luminous should have “mortgage underwriting capabilities and the ability to do their own credit work, since you could no longer rely on the credit rating agencies.”

Having taken positions on residential mortgages, Luminous shifted its focus to the corporate debt market. Harrison reasoned that banks, hedge funds and institutions

“We needed the structure to be up and running quickly because the opportunity was immediate. BNY Mellon was the only company that could meet our timeline”

**Eric Harrison,
Luminous Capital**



offering actively managed collateralised loan obligations (CLOs) would become forced sellers of corporate debt as a result of the margin calls being made on them.

Luminous delayed making allocations to this trade until the distress started to manifest. By the end of 2008 senior secured bank debt was trading at 65 cents on the dollar. Harrison saw the opportunity for “a trade of a lifetime”.

“We had never seen senior secured bank debt trade at 65 cents on the dollar. The market was coming under huge technical pressure that was not supported by the fundamentals.

There was an opportunity to acquire strong companies with two to three times total debt to EBITDA through the bank debt trading at 65 cents on the dollar, which was just remarkable,” he says.

Picking the best

Luminous created a dedicated separate account to invest in a dozen or so of the most promising distressed names. Matt Barrett, head of distressed debt and special situations investing at Barclays Capital, was hired to run the portfolio. The mandate was to invest only in senior secured bank debt at the top of the capital structure with no leverage used within the account.

“The idea was to buy and hold these assets until liquidity returns to the credit markets. When these assets trade to within 7% yield to maturity, there is a forced unwind of the positions leading to a natural liquidation of the fund,” says Harrison. He expects the account to

generate annual returns of 15%–20%.

Through the first quarter of 2009, Luminous was also allocating capital to managers investing in distressed corporate debt through its multi-manager vehicles. This included managers investing in distressed debt for control as well as those seeking to exploit arbitrage opportunities arising from dislocations in the market.

At present the multi-manager vehicle is invested 50/50 in managers investing in residential mortgages and corporate debt, says Harrison.

Going into the trade Harrison felt the downside risk was limited even in the event of a protracted economic recovery similar to Japan following the stock market collapse in 1990.

“At that time we felt there were two probable scenarios. On the one hand we could have a very slow painful process like in Japan, in which case it could take several years for the credit markets to recover.

“The other possibility was that balance sheets would be fixed quickly and we would grow through the problem by having the government lending to the banks at low rates,” comments Harrison.

His best estimate was that it would take two to three years for the credit markets to recover. “In fact it has happened much faster than anyone could have guessed,” he says.

“We had assumed that servicing bank loans was a commodity service. In fact there were only a handful of companies that had this capability.

We needed the structure to be up and running quickly because the opportunity was immediate. BNY Mellon was the only company that could meet our timeline,” says Harrison. BNY Mellon also acts as the settlement and loan-servicing agent for the separate account managed by Barrett.

Future opportunities

Harrison believes opportunities in distressed credit will continue to emerge as the market goes through its recovery cycle. He describes residential mortgages and corporate debt as “the first legs to fall”.

“Once you deal with the problem of the toxic assets that were more or less being driven by technical pressure, you have the longer-term problem of the commercial real estate loans that sit on bank balance sheets. That will be the next leg to fall,” says Harrison.

Many of the commercial real estate loans on bank balance sheets are currently marked to par. The regulators have been relatively light-handed in their treatment of these assets.

“The only banks that have been forced to deal with these issues are those that have extraordinary problems,” says Harrison. He thinks it could be two to four years before these loans are written down to reflect their true values.

Harrison believes competitors or the Federal Deposit Insurance Corporation (FDIC) will acquire

failing banks. Luminous will focus on purchasing distressed assets on the public markets as opposed to purchasing illiquid assets on bank balance sheets, he adds.

“If you are investing in illiquid assets you have to be prepared to do that over several years in a locked-up structure, due to inherent illiquidity in the investments” says Harrison.

However, Luminous is planning to gain exposure to commercial real estate by investing with managers that enter into sale-leaseback transactions with non-investment grade companies.

Harrison believes a raft of companies will be forced to sell core real estate assets under sale-leaseback arrangements in order to repay debt entered into under a bullet structure, whereby all the principal must be repaid on a single date. A huge number of these loans will mature over the next five years.

“Many of these companies are over-levered. They cannot restructure this debt,” says Harrison.

He thinks sale-leasebacks make for attractive investments because they provide contractual cash flows and can be structured with rent escalators based on the consumer price index to provide an inflation hedge.

He believes returns could be in the mid to high teens. “It could be a replacement for long-bond or high-yield exposure with better downside protection,” says Harrison. ■

FACTS ABOUT LUMINOUS CAPITAL

- Based in Los Angeles and Menlo Park, California, Luminous Capital is a Securities Exchange Commission (SEC) registered investment adviser that provides investment advice, asset allocation strategies and portfolio construction recommendations to wealthy individuals, family offices and institutional clients.
- The company was established in May 2008 by a team that previously worked together in the private client divisions of Goldman Sachs and Merrill Lynch. The investment philosophy at Luminous Capital is geared towards preserving wealth.
- The company has earned a reputation for staying one step ahead of the falling dominoes of the current financial crisis.
- In 2007 the investment team advised clients to reduce their exposure sharply to equities after they became concerned about the problems brewing in the mortgage sector. That move shielded clients from the brunt of the stock market crash in 2008..
- The company is now focused on exploiting distressed opportunities in the credit markets
- Luminous Capital oversees around \$2.6 billion in client assets.

AXA IM gears up for European loan market



When a market opportunity presents itself, Nathalie Savey, head of European leveraged finance at AXA IM, is keen to take advantage of it. After a flurry of product launches, the department laid fallow for a couple of years. Now Savey sees value.

“Why haven’t we launched anything since the end of 2006? The market was too hot. Assets were too expensive and highly leveraged. For us it was important to limit our growth at that point,” explains Savey.

That meant it was prudent to consolidate and wait for the right time to launch products geared for the new market conditions and changed investor appetite.

The current market setting provides the opportunities for a new round of investments in European loans, believes Savey. She says that the European loan market has long been the investment realm of CLOs and banks, but that there is no reason as to why traditional institutional investors cannot get wider access to this asset class.

The breadth and depth of the market itself, coupled with a substantial level of liquidity, means it is both wide enough to invest substantial amounts and to build diversified portfolios enabling active management.

Although the asset class is still not that widely known or under-

After taking a cautious and measured approach to the development of the European loan market, AXA Investment Managers Paris is set for a new beginning on the European loan market.



“We are very keen on explaining to investors how a loan portfolio is performing, its risk and its type of exposures”

**Nathalie Savey,
AXA Investment Managers**

stood in Europe compared with the US, the European market accounts for 250 billion of assets and 250 issuers scattered across a number of industries.

Whereas she recognises that the market has already partly rallied from the lows reached over the first half of 2009, she points out that there still remains potential for capital appreciation. But most of the current value of loans lies elsewhere, believes Savey.

“At current valuation, the principal source of returns for loans resides in their capacity to generate recurrent and enhanced cash-flow returns considering their below-par purchase price.”

At current returns of 6.5% over Euribor, the market can suffer a quite substantial amount of losses before investors lose any money. However, given current loan prices, she says it is important to protect performance against any loss driven by credit deterioration. That is why AXA IM’s investment approach to European loans remains cautious and selective.

“Given that loans allow tapping various levels of subordination, we prefer to currently focus on senior secured loans, the highest in the debt structure,” says Savey.

Such a cautious approach is also replicated at the sectoral and geographical allocation levels. Savey’s team targets mostly non-cyclical sectors such as telecommunications, cable and healthcare, and prefer to steer clear of highly cyclical areas such as automotive, consumer and building materials.

They have a limited exposure to industries exposed to raw material costs such as food and chemicals. In general they also look at minimising exposure to economies featuring weaknesses, especially when investing in industries like retail, consumer products.

On top of an adequate strategic asset allocation, Savey believes that the performance of a loan portfolio can only be generated through active management based on both fundamentals and market technicals.

“Loan investments warrant a deep credit analysis given that most issuers are, by definition, heavily leveraged,” explains Savey.

At the current time, after an important market rally, she believes that it is especially important to avoid overpriced assets, whose return profile may prove highly binary. Loan market technicals play an important role on performance as well. The market can be subject

to strong technical pressures due, amongst others, to the nature of the players on this market and temporary supply and demand imbalances.

This may present a number of opportunities and risks and definitely requires strong trading skills and deep understanding of the liquidity drivers.

“Loans are subject to a heavier trading process than traditional credit. The liquidity, albeit sufficient, is lower, and the settlement time is longer. That’s why you need to pay heed to optimising liquidity and adequately executing trade ideas,” says Savey.

Structure issues

As to an adequate fund structure for investing in loans, Savey and her loan team, who have traditionally targeted European investors, believe a structure such as an Irish-qualified investor fund would give investors the comfort of an onshore, regulated vehicle for the unregulated loan market products.

Savey also believes being within an EU member state is also important, particularly given the uncertainty over how proposed regulation of the industry will develop.

As regards fund administration and asset custody, AXA IM’s Leveraged Finance Team has long worked with BNY Mellon.

Savey says that BNY has the expertise and knowledge needed to handle the complexity of an investment vehicle such as a fund invested in European loans. The need for an administrator with expertise in loans as well as hedge funds makes BNY Mellon a natural choice, she says.

For Savey and her team, communication with investors has also long been a primary concern. Savey believes the transfer of information to investors is “critical” and says she has always sought to make sure that investors understand their investment, regardless of the investment vehicle in which AXA IM has been managing their assets.

“We are very keen on explaining to investors how a loan portfolio is performing, its risk and its type of exposures,” she says.

This she believes has been made all the more important in the wake of the crisis. Investors, she believes, need to understand what they are investing in and be aware of the risk the portfolio carries. Having that information should give them the ability to make intelligent decisions on their own loan exposure. ■

Innovation leads Swiss Cap to senior secured bank loans

Investor demand for assets that offer highest protection and exploitation of the recent market dislocation form the basis for the latest product offering from Swiss Capital Group. The Zurich based alternative investment manager has found an innovative way to tap the secondary markets for senior secured bank loans.

Hans-Joerg Baumann, CEO and senior partner along with Urs von Büren, portfolio manager of the Swiss Capital Pro Loan program, believe senior secured bank loans offer investors an unique opportunity in these currently unprecedented market conditions.

“The initial idea to launch this product dates back to November 2008 when markets were literally melting down and capital markets acted as if every company was on

the verge of bankruptcy. In these turbulent market conditions senior secured bank loans were priced well below historic recovery rates, at levels which were unprecedented and extremely unlikely to be sustainable.

“These observations, and more than 10 years of experience in distressed credit, convinced us to structure a long-only, secondary loan product as a club deal for a number of our key clients,” Baumann explains.

GETTING TO KNOW SENIOR STRUCTURE BANK LOANS

Corporate loans historically have the highest recovery rates. Thanks to collateral/reserves and covenants, recovery rates are higher in comparison to other segments such as investment grade loans. Recovery rates play an important role in the optimisation of the internal rate of return in the Swiss Capital portfolio. In case of default, intelligent actions may maintain value significantly. This can be demonstrated by the different recovery statistics: traded recovery, the value immediately after the announcement of a default; and ultimate recovery, value after restructuring measures have been initiated.

Because of the deleveraging process particularly by banks, CLOs and hedge funds, senior secured first lien loans, issued by banks to sub-investment grade companies, have found their way to the

secondary markets with discounts that are fundamentally not justified. Since in the past senior secured bank loans have mainly been held by banks themselves or specialised fund managers, they have exceptional security standards, not only with regard to financial security but also to legal covenants for the deployment of capital.

Different asset classes anticipate various macroeconomic scenarios through their present price levels. Credits reflect a more conservative scenario than bonds or equities.

So there are significant disparities in the potential pricing risks in the future. Based on these market distortions, interesting risk-adjusted investment possibilities arise, in particular for first lien senior secured bank loans, issued by banks to non-investment grade corporations.

“Bonds in general are perceived as less risky than bank loans by investors,” Baumann says. “However, that perception is incorrect. Historically, the more secured assets are senior secured bank loans and they offer a much better recovery rate. This is why we focus on this asset class,” Baumann adds.

Senior secured loans are secured by collateral, which represent a first lien on a company’s assets in case of a default. Hence, these loans have the highest quality in the capital structure of a company and always need to be repaid first. “They have the highest protection and during 2009 provided equity-like returns,” confirms Baumann. During the market recovery in 2009, this asset class returned more than 40%.

For 2010 and the following one or two years, von Büren expects returns in the high single-digit area, which are in equity territory and represent an exceptionally great risk-adjusted return, particularly if one considers the current low interest rate environment.

The Swiss Capital PRO Loans product inception was in June 2009. The asset value currently stands at \$185 million and the fund is invested in approximately 120 corporate loans of which over 90% are ranked as senior secured first lien.

As with every Swiss Capital product, the fund is based on a multimanager concept which provides regional dispersion and diversification with regards to investment styles.

Each of the four managers has a strong commitment to fundamental credit analysis and has signed a specific set of investment guidelines which define the regional and currency exposure, the position and sector limits, the rating-grid and the investment styles which are either fundamental value or event realisation and trading.

“One of Swiss Capital Group’s core competences is to identify and choose the best managers in the universe and we believe that the current group is well positioned to generate stable returns with hardly any overlap,” von Büren adds. The overlap between the four managers

with regards to borrowers is less than 10%.

Unlike most comparable products the Swiss Capital PRO Loan pays a floating rate coupon and has a defined maturity profile of three years with a prolongation period of up to two years in case market conditions demand it.

The fund is closed for new investors (from December 2009). “This structure provides a short and clearly defined maturity, all our investors were very focused on having this feature”, says Baumann.

The reinvestment period lasts until December 2011. Starting January 2012 any cash out of repayments, amortisations, disposal of loans, and others will be paid back to investors.

The vast majority of the capital is expected to be returned to investors before the three-year maturity. Any remaining positions will be disposed of during a two-year prolongation period.

Given the performance fees are based on realised IRR, the managers are incentivised to optimise the cash management and return capital efficiently. This guarantees an alignment of interest of all parties involved including investors, managers and Swiss Capital Group.

The closed-end structure provides a clear exit and allows creating a potential follow-up product based on then prevailing market conditions. There is a danger that payouts to investors within this period may not be reinvested by clients. Swiss Capital Group however is convinced that satisfied clients are likely to reinvest their funds with a successful manager.

Von Büren expects to generate returns of Libor plus 600 to 800 basis points (bp) a year which he believes is an attractive rate for a conservatively constructed portfolio.

There is an inherent inflation protection through the floating rate character of these credits. In the past such portfolios had a return of approximately Libor plus 290bp, which was squeezed towards 200 basis points during the heights of the credit boom.



Baumann explains that apart from seeking the highest protection from a lender's point of view, investors are also focused on transparency and mitigating exposures towards individual money managers. Swiss Capital Group addressed this issue in two steps.

First, a managed account concept circumvents the usual risks of commingled products. Second, the investment vehicle is the lender of record and directly owns the loans, not the manager.

This concept would easily allow the transfer of a whole portfolio of loans to another manager if an existing manager were faced problems or resigned from the mandate.

This second feature is unique and Swiss Capital Group is not aware of

other similar products offering this kind of protection to investors.

The fund is set up as an Irish qualified investor fund (QIF) in the legal form of an Irish public limited company.

The QIF has been tailored to meet specific reporting needs for Swiss and German investors. Swiss Capital Group, the investment advisor, has appointed BNY Mellon as the custodian. This ensures seamless trade execution and monitoring of each single investment.

"We chose BNY Mellon after thorough analysis of several possible service providers," notes Baumann. "We concluded they offered a full range of services. They understood senior secured bank loans, the content and the handling of

these loans. Their infrastructure and value points as well as the overall commitment of individual senior managers down to the operations level were impressive. So we launched this product with BNY Mellon," he adds.

Swiss Capital Group retains a veto right on all positions and combines the monthly manager reports to a monthly report on a master fund level including tailor made reports for key investors, with information down to each single asset, if required.

The secondary loan markets have rallied in the second half of 2009 along with the overall correction of the capital markets. In addition the supply/demand imbalance created a strong technical bid. After the primary loan markets showed some signs of life during the fourth quarter 2009, further improvement in new issue activity is expected for 2010.

Swiss Capital Group believes the systematic risks caused by the Lehmann bankruptcy have all but disappeared and the down side risk of its conservatively structured portfolio is limited. "We feel comfortable with our portfolios from a risk point of view. The overall average duration

is less than four years and the vast majority of positions are expected to be repaid at par and before contractual maturity. Subject to the avoidance of unexpected defaults and bankruptcies, the returns of 600-800 basis points over Libor are very predictable," von Büren explains.

Swiss Capital Group has launched the product in a highly specialised market. The multimanager concept with a veto right on each transaction and the transfer of the ownership rights of the loans to the Investment with investors being the shareholders are features not seen in this combination before.

"Clearly, this concept can be replicated and we are in discussion with investors for a follow-up product which may focus on both the primary and the secondary loan markets," Baumann points out.

"Additionally, Swiss Capital Group is working on a distressed real estate product with very similar features such as multimanager-concept, annual coupon, diverse investment strategies, etcetera. Like the senior secured loan markets at the beginning of 2009, distressed real estate offers a once in a life-time opportunity over the next 12-24 months," he says. ■

SENIOR SECURED BANK LOANS

	High-yield bonds	Senior secured bank loans	Investment grade bonds
Collateral	none	secured – first lien	none
Lien	subordinate	senior	senior
Covenants	partial	complete	partial
Maturity	7–10 years	5–8 years	1–30 years
Coupon	fixed rate	variable rate	fixed rate

Source: Swiss Capital PRO Loan.

SWISS CAPITAL PRO LOAN

Full name of product:	Swiss Capital PRO Loan
Investment advisor:	Swiss Capital Alternative Investments, Zurich
CEO and Senior Partner	Hans-Jörg Baumann
Portfolio manager:	Urs von Büren
Contact information:	Talacker 41, Postfach 2865, CH-8022 Zurich (+41 44 226 5252; baumann@swisscap.com; vonbueren@swisscap.com)
Platform:	managed account with full position control and veto right of the advisor in regard of risk concentration on the portfolio level
Inception date:	June 10, 2009
Program assets under management:	\$190 million
Target clients:	limited circle of Swiss and German institutional investors (club deal)
Minimum Investment	\$10 millions
Target return:	annualised Libor plus 600-800bp
Strategy:	multi-manager portfolio (four to six loan managers, minimum 65% fundamental value style, remaining event realisation and trading)
Investment style:	long only
Leverage:	none
Currency:	US dollar; currency hedge possible
Taxation:	in Switzerland as a collective investor scheme; in Germany as a foreign investment with 95% tax exemption
Regulatory treatment:	non-listed equity, private placement (qualified, for example, in Germany for fixed insurance reserve and is not subject to the German Investment Company Act (InvG)
Custodian and administrator:	BNY Mellon
Domicile:	Ireland
Management fee:	0.5% a year
Performance fee:	details on request
Liquidity:	buy and hold with an investment horizon of three years. Aim is to liquidate the portfolio continuously within the first three years. The capital could be paid back earlier but the program can also be extended by a maximum of two years
Payments:	aim for coupon of Libor plus 150bp paid semi-annually; periodic capital redemption.



Asset manager with a big appetite

Alcentra, a global asset management company, focuses on sub-investment grade debt fund management. Assets under management have grown continuously since 2000 with the European arm now managing around €9 billion.

Alcentra is an interesting asset management company. It has distinguished itself by focusing on sub-investment grade debt fund management, something that you might not think would be attractive in a post-financial crisis world.

Nonetheless, Alcentra sees good opportunities there and, it appears, so do their investors.

With over \$18 billion under management through a number of European and US funds (see box, page 32), the company boasts an experienced management team of over 50 in London and New York, including 15 investment professionals in Europe and 15 in the US.

Between them the team has extensive experience of leveraged loans, high-yield bonds and distressed situations.

Capitalised by Alcentra's management and BNY Mellon, Alcentra NY (New York) and Alcentra Limited (London) are subsidiaries of BNY Alcentra Group Holdings of which BNY Mellon retains a 91% ownership interest. Alcentra refers to Alcentra NY and Alcentra Limited combined.

Management and employee share ownership encourages a long-term commitment by staff and has helped the company build not just a solid track record but expertise and experience across a range of asset classes within sub-investment grade debt.

With BNY Mellon, one of the largest asset managers coming out of the financial crisis in a strong position, Alcentra looks set to continue in a strong position incor-

porating what it sees as the three reasons it has been so successful: the ability to source deals; expertise in credit analysis; and active portfolio management.

Two-stage process

The investment process Alcentra uses follows what it calls "a rigorous investment analysis and selection process" for every transaction.

The procedure follows two stages. First, an industry analyst researches the potential credits and creates an initial review. This is followed by a preliminary discussion by a committee which decides whether to go ahead or to throw out the idea. If the idea gets the green light, a longer due diligence is undertaken.

This longer due diligence often includes meetings with manage-

ment, financial modelling, reviews of commercial and accounting due diligence, and finally a review of the legal documentation. The analysis is then presented to the investment committee and, if approval is granted, may be purchased by the portfolio managers

Julian Colville, head of business development, confirms Alcentra's credit expertise is at the centre of its offering. He believes that over the last 10 years the perceived attractions of the asset class have grown. Up until 2008 demand had continuously grown.

There were record levels of issuance in 2006–07 with US senior loan volume hitting a high in 2007 before falling below 2003 levels in 2008.

So far 2009 has seen very low levels of issuance. Institutional



“The volume of primary deals has been low. However, these newer deals have generally had better covenants, higher margins, and lower leverage making for a better proposition for us as lenders”

Julian Colville, Alcentra



share in the volume of activity dipped in 2008 because of the difficulty of raising new collateralised loan obligations (CLO) funds and the value available in the secondary markets.

At the same time European senior loan volumes mirrored the US market, with record levels of issuance in 2006 and 2007 followed by a steep drop in 2008 and levels below 1999 in 2009.

Intentional investors in European loans however, have taken an increasing share of primary business principally through CLOs and hedge funds.

Nevertheless, institutional share dipped in 2008 for the same reasons as in the US market.

Through the sell off and subsequent rebound in the market Alcentra has kept its access due to its long-standing and significant presence in the leveraged loan markets.

Relationships in the market have been built up over the years giving Alcentra good access to secondary sources of assets.

At the same time Alcentra also participates in numerous transactions sponsored by a diverse pool of private equity companies.

The credit team boasts analysts that are sector focused with specific industry knowledge. The average experience of investment professionals in the team is over 11 years.

Dedicated portfolio management infrastructure allows Alcentra to manage its multi-portfolio platform.

Alcentra invests in senior secured debt that is at the top of the capital structure which is secured on cash flow and assets.

It also invests in mezzanine debt, lower down the capital structure but with higher coupons, stressed and distressed debt, and structured credit.

Alcentra watched in 2007 and 2008 as the market weakened following the initial sub prime sell

off in 2007 then accelerated downward during 2008. Banks, hedge funds using total return swaps, and market value CLOs were all sellers during this period.

In many ways this presented a great opportunity, remembers Colville, as it was possible to buy loans at steep discounts to intrinsic value as a result of this increasingly panicked selling.

This year has been characterised by lower issuance volume and a strong recovery in prices in the secondary market.

Alcentra has benefited from this environment with both its Global Special Situations Fund and its recently launched Structured Credit Opportunities Fund (launched on September 1, 2009) performing well.

“We have a long way to go to get back to where we were in terms of issuance. The volume of primary deals has been low. However, these newer deals have generally had better covenants, higher margins, and lower leverage making for a better proposition for us as lenders,” notes Colville

Colville expects Alcentra to benefit from undervalued assets for a few more months, although he expects stability to come to the market in the first quarter of 2010 with a gradual improvement throughout the year. “But it will remain a challenging economic environment,” he adds.

Alcentra’s focus is on sub-investment grade loans in mainly Europe and North America.

Alcentra, according to Colville, likes to concentrate on companies that can produce a strong cash flow that is steady and predictable.

Typically, the company looks for market-leading businesses, good management teams and stable, predictable cash flows.

“But we’re always looking for the downside,” he confides. This, he believes, is a consequence of their

experience in sub-investment grade and a “debt mindset”

“We want to avoid mistakes,” says Colville. As credit managers dealing with loans that are rated BB+ and downwards, he believes it is important to be confident on the capital pay-back for every position the company takes.

Looking to the future Colville thinks the market will evolve. Looking a bit further out, he believes there will be significant refinancing needs starting in 2012 and peaking around 2014.

Many companies will get refinanced during that period but demand for capital may be great enough that even relatively healthy companies struggle.

“This will put us in a strong position for all our funds as we can pick and choose where to invest. We believe that our portfolio is in good shape overall and we expect to see plenty of opportunity going forward” concludes Colville. ■

ALCENTRA’S FUNDS

Alcentra manages 42 funds focused on the European and US sub-investment grade debt capital markets. These funds include Collateralised Loan Obligations (CLOs), total return funds, mezzanine funds and managed accounts.

Thirty one CLO vehicles are currently under management in Europe and the US. In Europe there are 16 CLOs with total assets under management (AUM) of around 7.6 billion, while in the US there are 15 CLOs with a total AUM of roughly \$4.9 billion. The company also offer managed accounts.

European and US total return funds include the Alcentra European Loan Fund, the Alcentra Global Special Situations Fund, the Alcentra Structured Credit Opportunity Fund and the US Bank Loan Fund. Alcentra also manages four Mezzanine Funds; two in Europe and two in the US.



Predicting the future is a thankless pursuit at the best of times. In a post-financial crisis world, trying to second-guess market movements and innovation is even more difficult.

“The outlook for the structured finance market and structured credit products will be shaped by many factors, not least shifts in the regulatory landscape and changes in accounting rules. The coming of age of syndicated loans in terms of its transformation from a physical instrument to an electronically transferable security will have a profound impact on the market as this will drive market liquidity and growth in the asset class,” says Edmund Kwan, global product manager for structured credit products in BNY Mellon corporate trust.

“The prevailing credit crisis has affected investor sentiment the world over,” Kwan continues. “However, given the importance of securitisation as a financing tool for all types of loans (access to loans, in my opinion, is the lifeblood of economic growth), I fully expect securitisation volumes to return to levels not significantly shy of 2007 levels.”

Kwan notes that the types and variation of structured credit products that “find the most appeal will be heavily influenced by changes in investment and funding strategies,

as well as changes in investor attitudes.”

Arlene Allen, vice president, corporate trust, BNY Mellon expects to continue to see money flowing into hedge funds.

Managers are currently looking at potential new opportunities and how they can leverage off their existing structure to bring these new transactions to market. “We are seeing some innovative ideas from managers,” she says.

The prospects of an increasing volume of transactions coming from emerging markets and the general move towards onshore investments does present some opportunities for the Irish structured finance industry.

The future market and products will be shaped by many factors, including shifts in the regulatory landscape, consolidation of the financial regulatory institutions, industry adoption of centralised clearing and reconciliation platforms and changes in investor attitude towards different investment products.

There is likely to be demand for more stringent vetting of assets,

while it is uncertain if structured credit products will take the form of CDOs or something else in the long term. Despite the current market turmoil, the Irish structured finance industry is well positioned to build on its track record.

Section 110 companies are likely to retain their popularity, creating a bridge between the debt and equity markets, although how assets will be securitised in the future is an open question. How the various government stabilisation programmes will play out is uncertain.

While the banks continue to be reluctant to lend, the market for securitisation will continue to be a challenging one.

“Some corporates are issuing bonds in excess of what they require due to the low interest rates,” says Allen. For now there is an appetite for investing in corporate bonds due to the transparency which they can offer to investors.

Looking up

Allen is sure securitisation will return. “Maybe not to the levels of 2006–07, maybe only 50% of that. But it has to happen. Securitisation is a tool which banking institutions use to generate profits, there is no way it will not come back. It just remains to be seen when and in what form? How much leverage will we see in new transactions?,” she asks.

Tim Murphy, chief operating officer, alternative investment services, Europe at BNY Mellon Fund Services (Ireland) Limited is more upbeat. He believes opportunities

will come from the emerging markets, particularly the economies of Brazil, Russia, India and China.

“Basically all these markets have great potential, particularly China, India and Brazil,” says Murphy. He sees a “breadth of service” for the bank as “new and interesting structured markets” emerge.

For Murphy the clients will drive the bank’s services. “First the market has to have a client take us there. We’re open to ideas, but the capital has to be there before we are,” he says. He is also confident that when the opportunities arise, the bank will be well placed to take advantage of them.

“There are not a lot of competitors that can match the combination of services we offer,” declares Murphy.

He believes BNY Mellon’s experience over the past year in pulling together internal departments to provide what is in effect a new service built around servicing hybrid structured credit funds is a model that can be used in the future.

He also believes the size of the bank’s internal operations in these areas gives it a competitive advantage over other banks that might be in a position to offer similar services. “It takes a lot of work to pull this together,” notes Murphy. “We are able to bridge the divides. We are focused on the alternative sector. We can handle hedge funds and anything from highly structured alternative funds to private equity, funds of funds – anything around hybrids. We are seeing more and more imaginative and innovative structures.



Tim Murphy,
BNY Mellon

What we as a bank are good at is engaging with our clients to offer a service matched to these new structures," Murphy says.

Where will the market go next, however, is as unclear to Murphy as to others, although he has some ideas. "We're likely to see a lot of illiquid assets become more liquid. These are likely to be packaged together in these structures. Maybe they will not be the same loan types.

"A number of illiquid assets will find homes in pooled structures. The opportunity is to find a model that is flexible enough," says Murphy. He believes BNY Mellon has that flexibility as well as the experts needed to service any new structures that may emerge.

Competitive advantage

With a majority of the structured products market serviced in the bank's corporate trust division, Murphy says BNY Mellon is the dominant player. "We have to be able to do anything. We can deliver solutions. If there is a underlying portfolio, we have the expertise to put a wrapper around it and service it," states Murphy.

He believes the financial crisis has played somewhat to the strengths of BNY Mellon. The bank has emerged in a strong position with a solid balance sheet. At the same time, while other banks were "fire-fighting"

BNY Mellon used the time to focus on its strengths. "We never stopped innovating," says Murphy. This, he believes, will help the bank seize opportunities as they arise in the post-financial crisis world.

He says investors like pension funds have not stopped putting their money into investments. These investments, however, will be different in future. Already new asset classes are popping up, including carbon credits and other innovations where illiquid assets are being turned into pools of instruments with the potential for future profit. Murphy is confident of the bank's ability to grasp opportunities as they appear.

The bringing together of hedge and private equity fund administration with corporate trust to form a service able to cope with a mixture of assets as well as investment fund structures has placed BNY Mellon at the forefront of innovation, believes Murphy.

He does not think his is the only bank able to offer such services but does believe he has a first-mover advantage as well as a scale of operations his closest rivals will find hard to match. So while the future for securitisation and structured products may remain uncertain, Murphy is sure BNY Mellon will be able to cope with anything the market throws at it in future. ■

GOOD PROSPECTS FOR HEDGE FUND INVESTMENT TO 2013

Hedge funds are forecast to make a strong comeback, particularly as investors in all regions look for higher returns to make up for losses in 2008 and 2009.

Hedge fund assets are expected to reach almost \$2.6 trillion by the end of 2013, according to a report* by Casey Quirk and BNY Mellon. North American institutions will be the greatest source of institutional net flows into hedge funds between 2009 and 2013.

The return of high net worth investors (HNWIs) to hedge funds will rely on capital market conditions and hedge fund returns during the next several years.

Europe is forecast to be the second largest source of hedge fund assets after North America, with over \$720 billion in total hedge fund assets by year end 2013.

European investors will be the second-largest source of inflows after 2010, accounting for more than a quarter of total hedge fund flows between 2010 and 2013.

Institutional and individual European investors continue to access hedge funds primarily through funds of hedge funds (FoHFs). By 2013, more than half of all European hedge fund assets will be invested through FoHFs.

The largest direct investors will be found on the continent, not in the UK, and will come from select large European pensions and large family offices.

European investors highlighted alignment, transparency and investment performance as the primary challenges for the hedge fund and FoHF industry. European investors' concerns were broadly consistent with those of North American investors.

By 2013 Asian investors will account for approximately 15% of global hedge fund assets, or \$382 billion, compared with \$344 billion in 2007, estimates the report.

Japanese banks, a key institutional segment that historically were prominent investors, are predicted to

play a smaller role due to regulatory constraints.

Overall, Asian investors will maintain a roughly even split in hedge fund assets between direct and FoHF investments. However, Asian institutional investors will invest a larger proportion of their hedge fund assets directly.

Asian investors believe investment performance is as important as alignment, transparency and regulation as the primary challenges for the hedge fund and FoHF industry. The majority of Asian interviewees place a greater emphasis on investment performance compared to interviewees from other regions.

North American institutions are predicted to account for over 60% of net flows for the five years between 2009 and 2013. Public pensions are expected to make up over half of North American institutional flows for the period.

The return of North American HNWI hedge funds is highly

sensitive to future capital market conditions and hedge fund returns overall.

The difference in 2013 hedge fund assets between bull and bear scenarios forecast by the report for North American HNWIs is significant at over \$380 billion.

The share of North American hedge fund assets invested through FoHFs is also forecast to increase for institutional and HNWIs. In 2008 approximately 41% of total North American hedge fund assets were invested through FoHFs. The report estimates this share will increase to 47% by 2013.

North American investors say alignment, transparency and investment performance are the primary challenges for the hedge fund and FoHF industry.

This identification of challenges is the same for European investors surveyed for the report.

* *The Hedge Fund of Tomorrow: Building an Enduring Firm*, April 2009, BNY Mellon and Casey Quirk.



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Get your copy of BNY Mellon and Casey Quirk Thought Leadership white paper,

The Hedge Fund of Tomorrow: Building an Enduring Firm. Go to bnymellon.com/hedgefundpaper or call us:

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