New Woes for CDOs

The effect of the subprime crisis on real estate CDOs and the opportunity it presents

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THE COLLAPSE OF THE SUBPRIME residential real estate market in the summer of 2007 and the subsequent credit crisis has led to a widespread deterioration of billions of dollars of assets. One of the areas that have been hard hit is real estate assets underlying certain collateralized debt obligations (CDOs).

A CDO is a structured finance vehicle that issues multiple classes of liabilities to invest in cash assets and/or credit exposures through derivatives. CDOs typically issue several rated debt tranches, with varying credit risk/return profiles, and one or more unrated tranches that occupy the most subordinated position. The senior tranches have the best credit quality and the lowest yields, the mezzanine tranches have slightly lower credit quality but higher yields and the most subordinate or equity tranche generally receives any residual payments and has the highest potential yield.

In managed deals, the CDO manager looks to generate a positive spread between the yield on the assets placed into the CDO and the yield that must be paid on the CDO securities by repackaging loans, securities and other collateral to meet specific investor requirements. Many CDOs have invested exclusively in real estate assets, including mortgage loans, mezzanine loans, commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS), and therefore are referred to as CRE CDOs.

The Subprime Crisis

CDO issuance has dropped dramatically since the beginning of the credit crisis, which began in early August of 2007, and CRE CDO issuance has been virtually non-existent since then. Since that time, investors have increasingly avoided structured finance securities fueled by their perception that the value of their underlying collateral was eroding. Where the CDO collateral included RMBS, these fears in large part originated from panic sparked by the subprime crisis. What's more, the subprime crisis negatively affected CDOs with no RMBS collateral because investors saw the subprime crisis as a failure of the system to effectively manage risk and became more and more leery of the ability of investment banks and rating agencies to effectively manage risk in structured finance transactions.

Tightening credit in real estate lending led to wider spreads on underlying CRE CDO assets, which resulted in wider spreads on the CDO securities that invested in them. In addition, many institutions that had been buyers of CDOs lacked the infrastructure to monitor credit performance and/or estimate expected cash flows of underlying assets. If these institutions lost faith in the ability of CDO originators to properly structure deals or the effectiveness of the rating agencies to accurately reflect the risk inherent to a particular CDO security, they had no choice but to exit the market. Many CDO products are held on a mark-to-market basis, and the paralysis in the credit markets and the collapse of liquidity in these products has led to substantial write-downs.

Since late last year, CDO liquidations have become commonplace as managers of such issues respond to events of default and deterioration of the underlying collateral. As they reassess the creditworthiness of the tranches of some of the CDO deals they evaluate, the rating agencies have been cutting their ratings on several hundred cash-flow, hybrid and synthetic CDO transactions. In addition, ratings on hundreds of tranches of other CDO transactions are currently on watch for possible downgrades.

The majority of the downgraded transactions are CDOs collateralized in large part by mezzanine tranches (investment-grade tranches that are rated below triple A) of RMBS and other structured finance securities. The downgrades have been the result of several factors, including credit deterioration and recent negative rating actions on subprime RMBS, as well as changes the rating agencies have been making to the recovery rate and correlation criteria they use to assess RMBS held within CDO collateral pools.

Current CDO Default Litigation

The disruptions in the CDO market have led to widespread legal battles over cash flow allocations after an event of default (EOD) under a CDO indenture. Litigation has increased significantly in 2008 among issuers, collateral managers, investors and other parties to CDO transactions. Breach of contract and securities law disputes, including allegations of inadequate offering document disclosure, also have become more common.

The CDO market has most notably been witnessing an increase in 'interpleader suit' litigation, typically brought by a trustee seeking clarification on how to direct payment distributions pursuant to a CDO's cash flow waterfalls. In such cases, complications have often arisen concerning how to allocate cash flows in a default situation and how to determine the relative rights of the different tranche investors.

A key component of the tranching structure of CDOs is the use of coverage tests embedded into the covenants of deals. These tests attempt to maintain a minimum level of credit quality and therefore protection for noteholders. Coverage tests can include rate coverage ratios, overcollateralization ratios and par ratios. If these thresholds are not maintained on any payment date, the manager is generally required to liquidate sufficient collateral to ensure that the ratios are satisfied.

The majority of CDOs involved in interpleader actions have gone into an EOD as a result of triggering an overcollateralization test resulting from the declining value of an underlying assets portfolio and not because of a failure to pay interest or principal in a timely matter. Trustees have been filing such interpleader suits to resolve differences of CDO indenture interpretation on cash flow waterfall issues, voting issues and other contentious issues that may be triggered by an EOD under a CDO indenture. The CDO pays all of the cash flow earned from its underlying assets into the court until the judge decides who is entitled to the payments, whether or not to liquidate the underlying portfolio and pending resolution of all other relevant issues that may exist in the interpleader action.

In most cases, if an EOD has been triggered in a CDO, the controlling class will argue that the CDO's underlying assets should be liquidated and that the CDO should be terminated. Often, this results in a change to the CDO's priority of payments waterfall that causes the most senior classes to be paid off with the proceeds of the liquidation on an accelerated basis, with remaining amounts paying down the other classes of securities and certain other parties involved in the transaction.

Since the underlying assets may have deteriorated to a point that would not leave enough liquidation proceeds to cover all classes of notes, especially the most subordinated tranches, the more junior classes will often object to the acceleration and liquidation scenario. To protect their interests, the junior classes will often assert that no EOD has occurred. Hoping to receive future distributions on their securities over the remaining term of the CDO, the subordinated classes will typically parse the indenture to find possible arguments to contest liquidation of the issuer's underlying assets portfolio.

Opportunities in Stressed CDOs

As is often the case in real estate, there can be opportunity in market disruption. Many CRE CDOs are looking to shed assets either to meet coverage and overcollateralization ratios or because an EOD has occurred and the CDO is being liquidated. Under the terms of some CDO indentures, an asset of 'collateral interest' can be considered a 'defaulted interest' as a result of such factors as a rating decline (in the case of a security) or a decline in the value of the underlying collateral (in the case of a loan) even though the particular asset may not be actually in default. Collateral managers are required to liquidate such defaulted interests.

A savvy investor with capital and the ability to underwrite and accurately value underlying CDO assets may be in a position to acquire such assets at attractive prices. In addition, an investor with the ability to assess the entirety of a CDO pool may be able to acquire mezzanine or subordinate CDO securities at significant discounts and may even be able to gain control of the liquidation process. However, because of the growing potential for CDO litigation, a potential CDO asset or security investor must possess both the ability to value the underlying assets and to analyze the workings of the CDO.

Factors to Consider When Analyzing CDO Indentures

CDO indentures are never identical from deal to deal, and each one must be scrutinized thoroughly when evaluating the rights of the parties to a CDO. Factors to consider when reviewing CDO indentures include:

- the priority of payments waterfall, which dictates the order of how each class of noteholders and other parties will be paid from the income generated by the underlying assets of the CDO;
- the specific events that constitute an EOD under the indenture, how easily these could be triggered and what the possible cure periods may be (coverage test failures, payment defaults, etc.);
- the relative decision and approval rights of different classes of noteholders while the transaction is progressing normally and how they change after an EOD is declared;
- potential auction provisions, clean-up call provisions and optional redemption provisions, particularly who can call them (the issuer, a certain class or classes of notes via the trustee, etc.), under what circumstances (the triggers and potential liquidation scenario mechanisms), whether any consents are required and how any such provisions affect noteholders' rights across different classes of notes;
- required principal payments to certain classes of investors; and

- the various other rights that different classes of noteholders may have, including voting rights (how is the controlling class determined at the onset of the transaction and what different types of events, including EODs, or other circumstances could alter such rights over the life of the transaction).

The way voting rights are drafted is crucial; the decision to liquidate is not always at the discretion of the senior classes of investors. CDO indentures vary in how they allocate voting rights and, in some cases, the CDO may need a simple majority or a two-thirds majority of the other classes to support any acceleration and liquidation. A potential investor also should be aware of regulatory pressures that might affect a particular CDO originator or collateral manager, and other factors might force liquidation despite poor market conditions for the sale of assets contained in a CDO's portfolio.

CDO Activity Looking Forward

Where does the CDO market go from here? CDO market growth factors will depend in part upon collateral managers focusing investments on highly rated types of collateral, creating simpler CDO structures and balancing risk perception by monitoring the performance of underlying collateral. In addition, it will depend on market participants helping to stabilize the housing market, thereby enticing investors to return to the market, and rating agencies developing reliable criteria and sustaining credibility for valuing and rating CDOs. Transparency will be critical to regaining investor confidence, including presenting data on underlying collateral performance in ways that enable market participants to easily understand what is going on despite the complexity of any CDO they evaluate.

Already, the market for a specific segment of CDOs, collateralized loan obligations (CLOs), is showing significant new issuance activity. As of February 2008, CLO transactions have started to pick up, with several large planned issuances currently in structuring phases. Some new CLO transactions are tapping a recent source of liquidity through the Federal Reserve Bank's new primary dealer credit facility. The Fed has created the new facility so that primary dealers can borrow at the Fed's discount window using several forms of collateral including mortgage-backed loans. The form of the loan is a repurchase agreement, or repo, where the primary dealer sells a security to the Fed and agrees to buy it back at a later date (generally the next day) at a higher price that includes interest. CLOs using the facility put up loans as collateral to draw down on the Fed facility.

When the currently volatile markets for numerous types of asset classes (including mortgage assets and related securities) eventually settle, it is reasonable to project that a resurgence in the issuance of CDOs also will occur to take advantages of these opportunities.

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