

# *The Impending Sovereign Debt Crisis, the Return of the Leveraged Loan Market, and Implications for the Cayman Islands*

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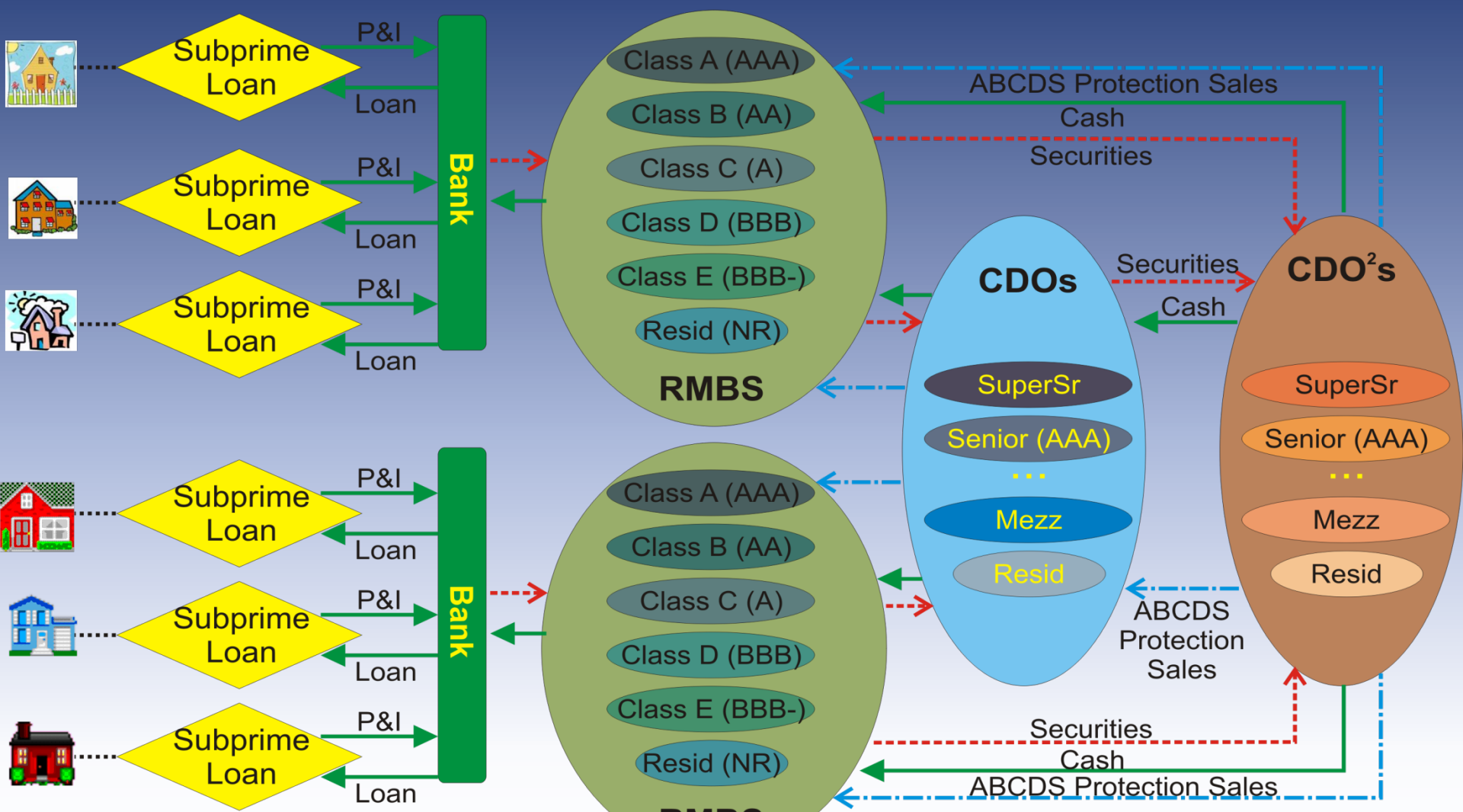
The University of Chicago Booth School of Business

# Agenda

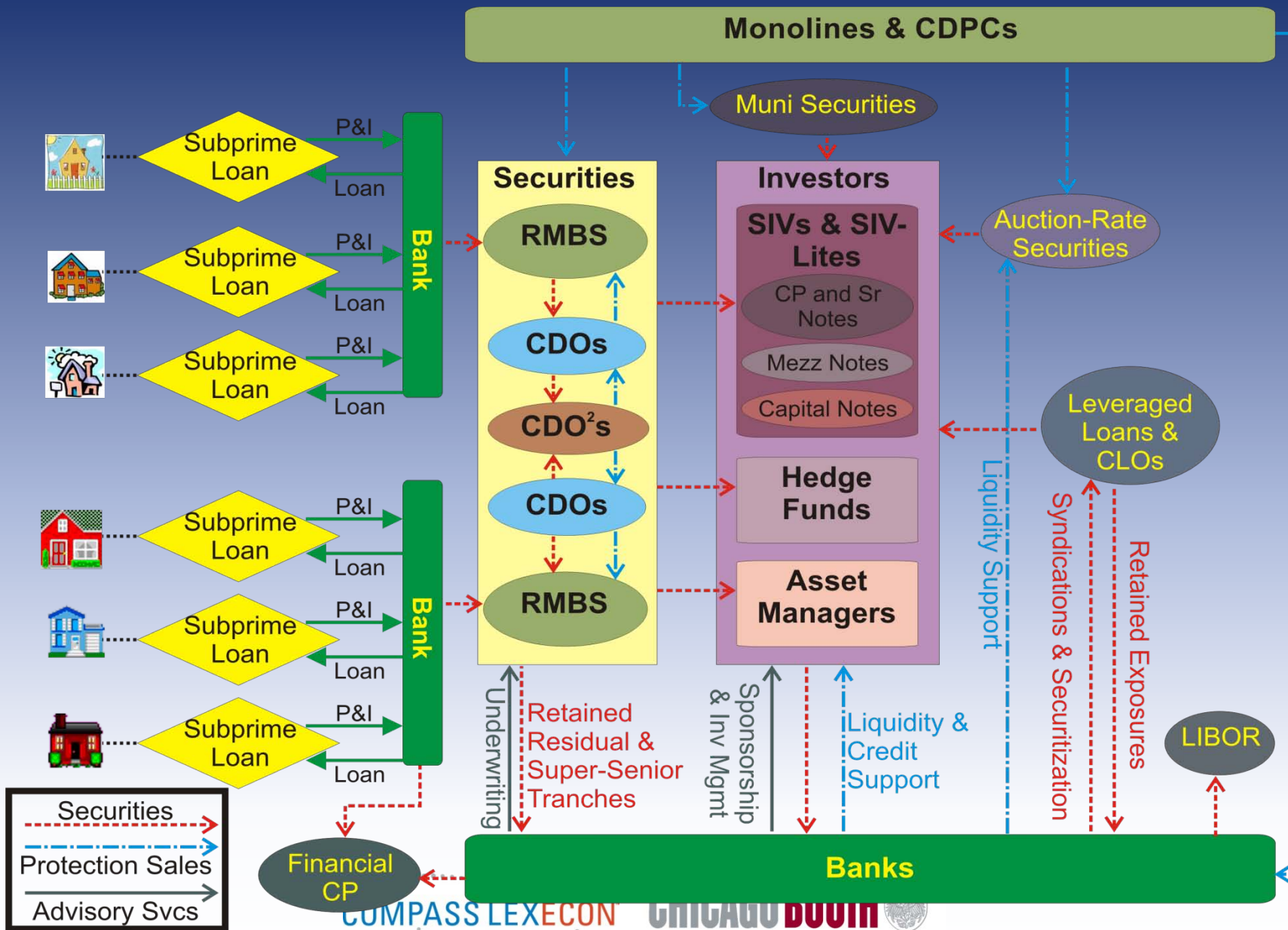
- The State of Structured Credit Markets*
- The Impending Sovereign Debt Crisis
- The Return of Leveraged Loans

# Background: Securitisation

Subprime Lending      Securitization      Resecuritization      Re-Resecuritization

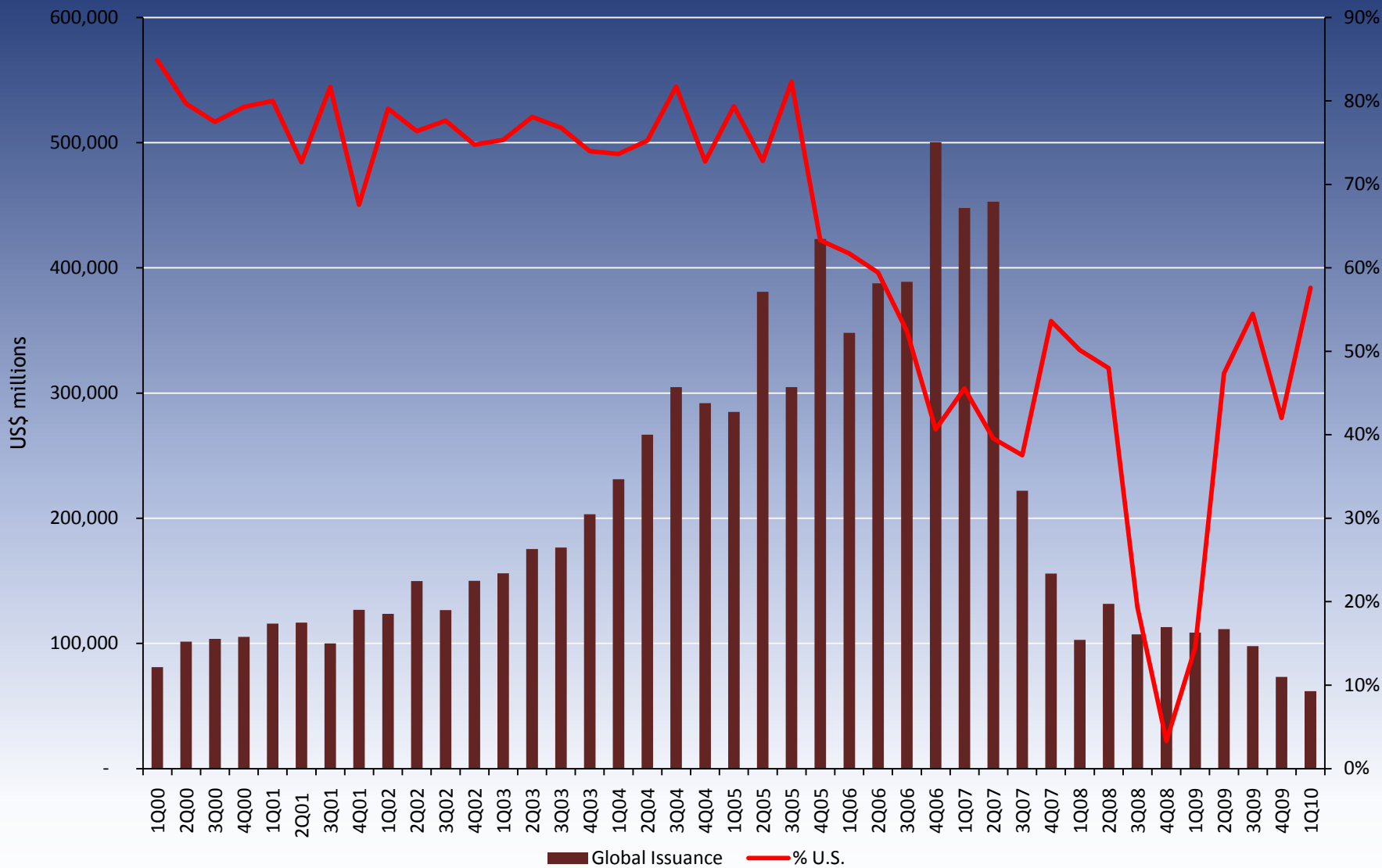


# The 2007 Chain Reaction



# Asset-Backed Securities Issuance Plummet

## Global ABS Issuance, 2000Q1-2010Q1

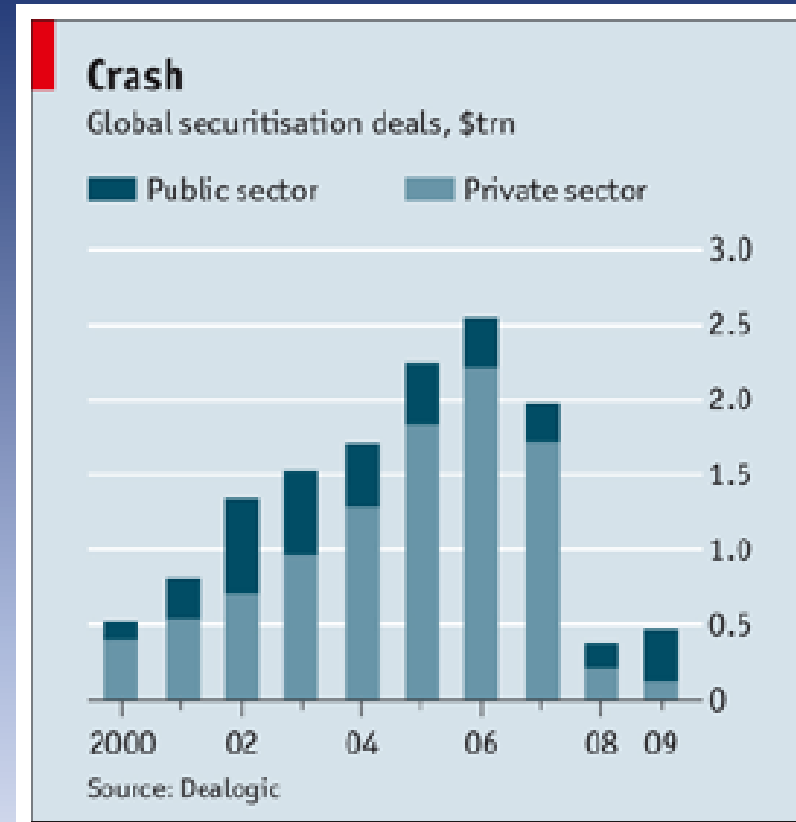


SOURCE: Thompson Reuters



# The Public Sector and ABS Issuance

- A lot of new issuance has been the result of TALF and similar programs around the world
- TALF is phasing out, and only some private issuance is returning

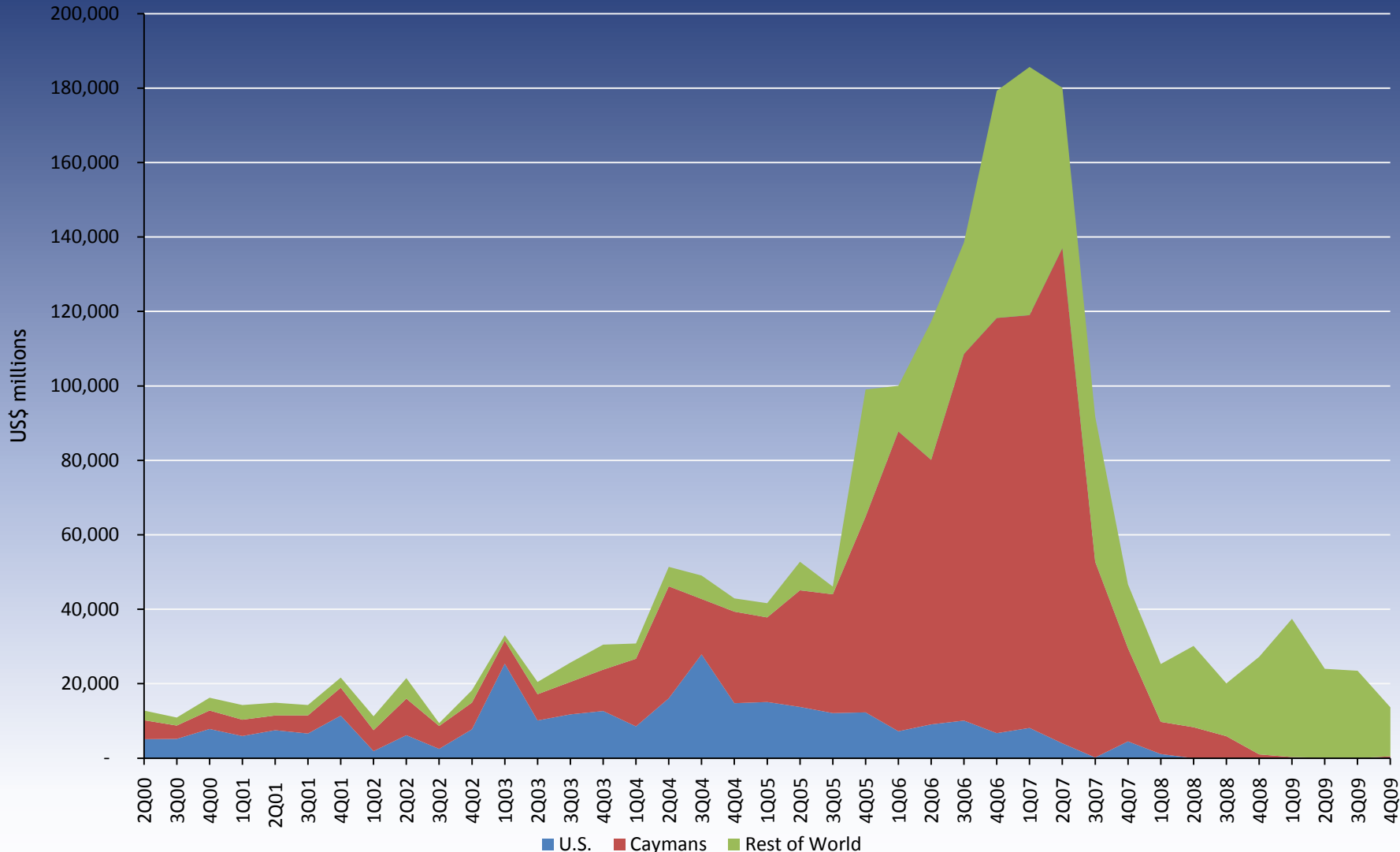


SOURCE: *The Economist* (March 25, 2010).

- What will happen to ABS liquidity when TALF loans begin to come due?

# Collateralized Debt Obligations

Global CDO Issuance, 2000Q2-2009Q4



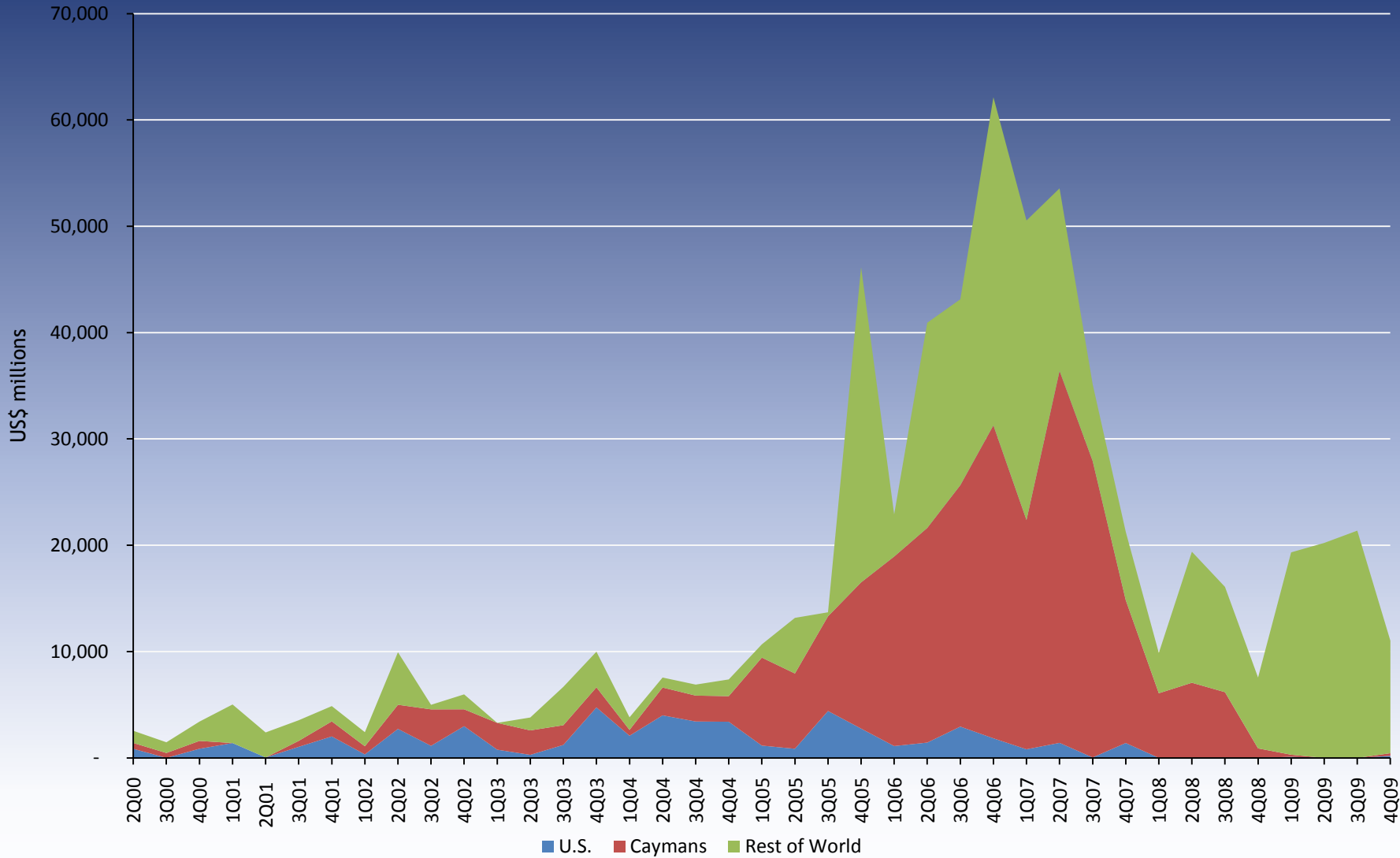
SOURCE: Thomson Reuters





# Collateralized Loan Obligations

Global CLO Issuance, 2000Q2-2009Q4



■ U.S. ■ Caymans ■ Rest of World

SOURCE: Thompson Reuters



# CDO/CLO Issuance Remains Stalled

- Demand Factors
  - The repricing of risk on structured products persists
  - Investors are still demanding yields for CDO/CLO securities in excess of rates on most underlying sources of collateral
- Supply Factors
  - Uncertain status of the GSEs
  - New regulations
  - Accounting policy changes

# Some Structured Products Are Bouncing Back...But Slowly and on an Ad Hoc Basis

- European Corporate CDOs
- Auto-Loan-Backed ABSs
- Structured project financings (mostly European public-private partnership loans)
- Natural catastrophe insurance-linked securities are slowly regaining their footing (but that largely Bermuda-centered market is relatively small)

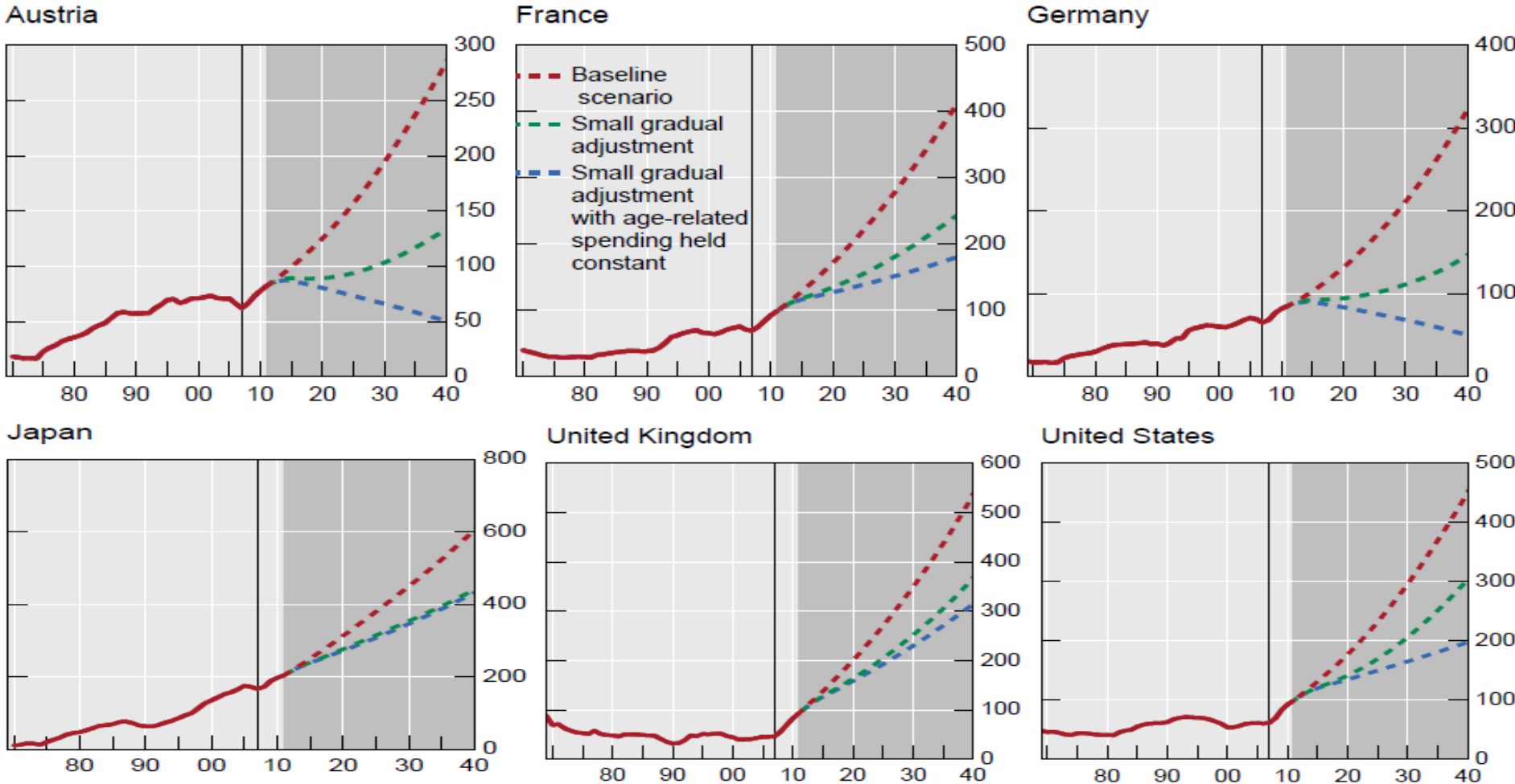
# Two Particularly Noteworthy Areas to Watch for Opportunities *and* Warnings

1. Structured Products Based on Sovereign Debt
2. CLOs of Leveraged/High-Yield Loans

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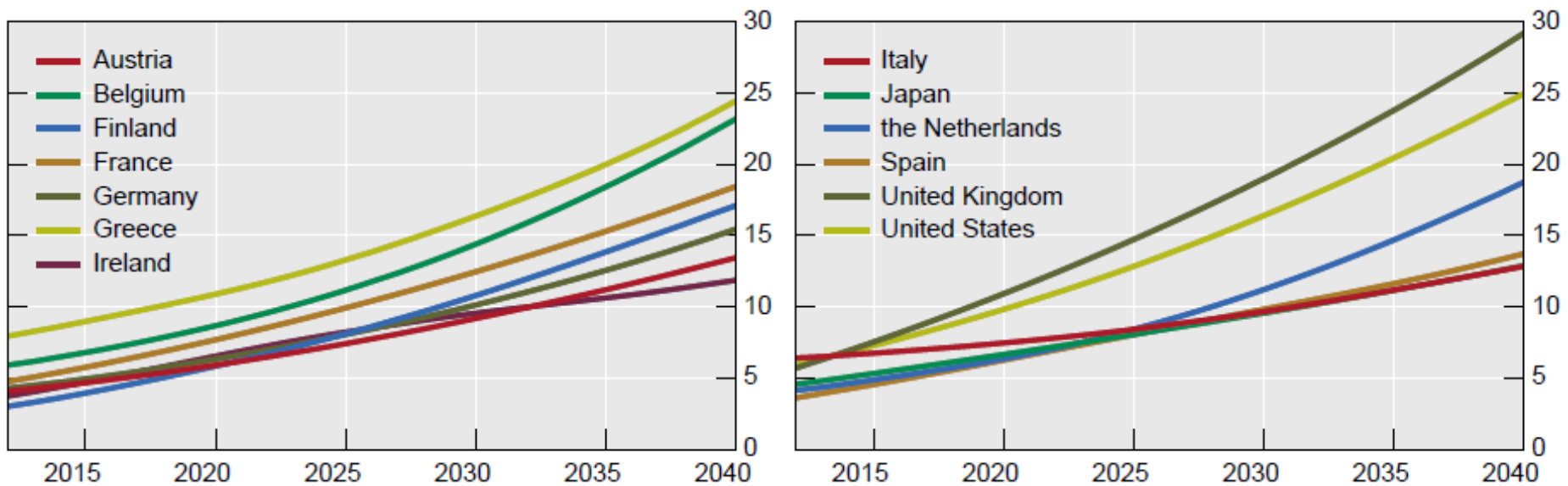
# Public Debt/GDP Projections



NOTE: The 1996 Stability & Growth Pact sets a ceiling of 60% on debt/GDP ratios.

SOURCE: S.G. Cecchetti, M.S. Mohanty, & F. Zampolli, "The Future of Public Debt" (BIS, Feb 2, 2010).

# Interest/GDP Projections

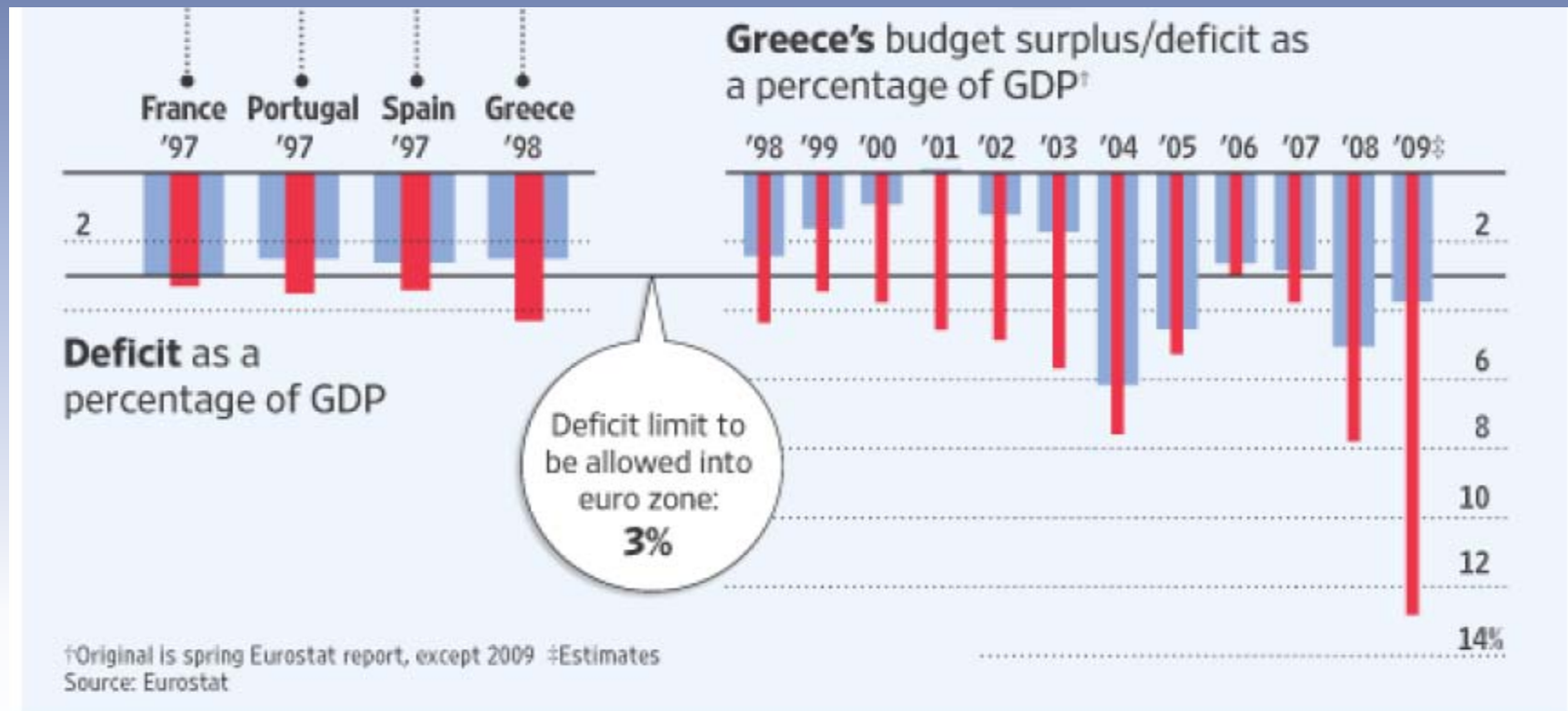


SOURCE: S.G. Cecchetti, M.S. Mohanty, & F. Zampolli, "The Future of Public Debt" (BIS, Feb 2, 2010).

- Yield curves are looking very steep
- Flood of new public debt issuance
- Inflationary expectations (loose money combined with huge spending)

# Greece

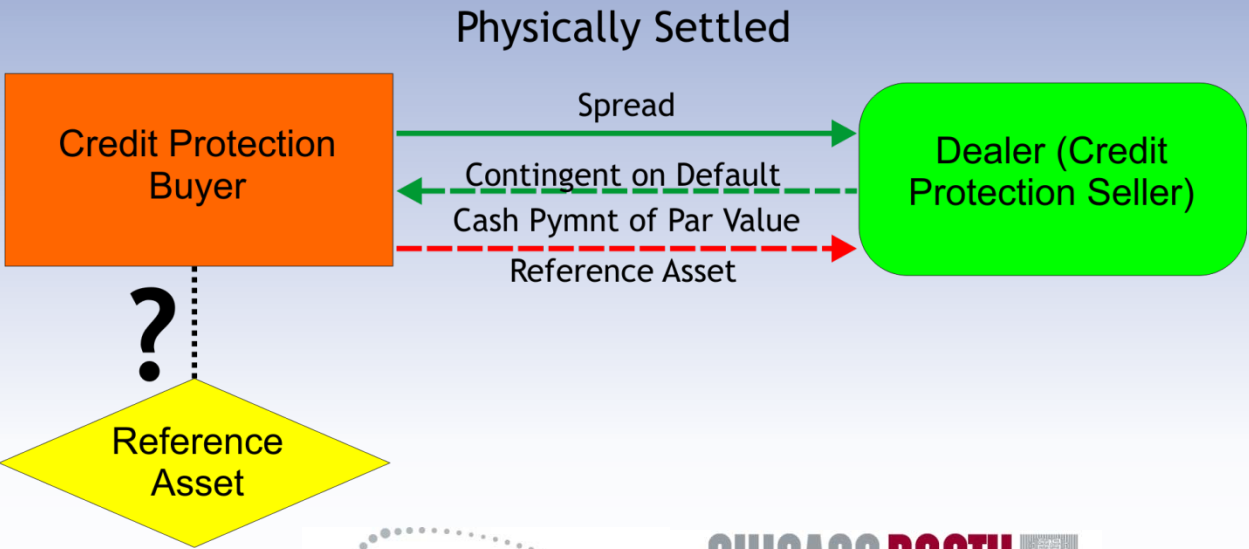
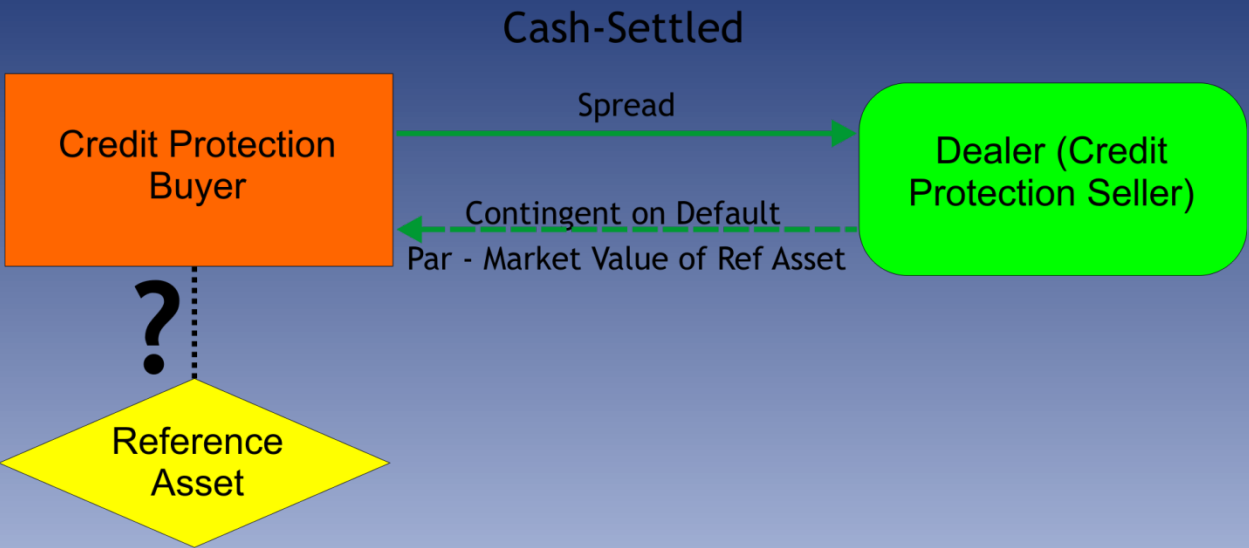
- Classic example of vast over-spending
- Deficit estimates have been revised upwards every year since 1997
- Late 2009 budget deficit revision triggered a panic



# Sovereign Debt Disclosure Issues

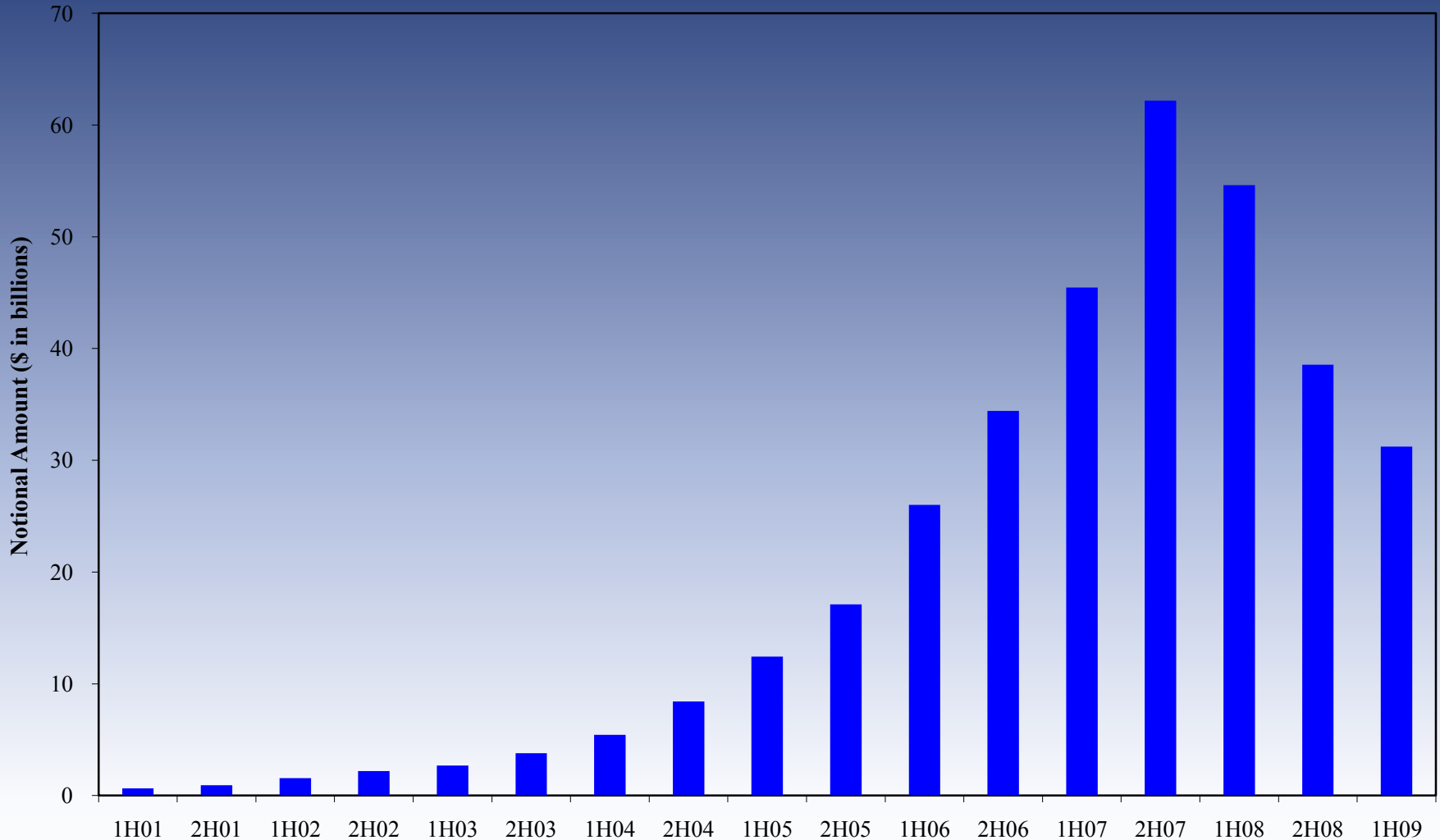
- EU sovereign uses of off-market swaps
  - Italy since 1996
  - Greek swap in 2001 (details are still fuzzy)
  - Latvian Riga Bridge swap in 2005
- Accounting policies blurred the real photo
  - Eurostat provided accounting guidance that virtually encouraged such swaps
  - Not until March 2008 did Eurostat accounting for sovereign debt force full disclosure by Greece
  - Latvia restated 2005 & 06 debt, and the Riga Bridge debt now is about 1% of Latvian GDP

# Credit Default Swaps (CDSs)



# CDS Issuance Plummeted After the Credit Crisis

Notional Amount of Credit Default Swaps Outstanding, 2001 - 2009H1



SOURCE: ISDA

# Are CDSs Canaries or Cats?

- Canaries in the Coal Mines
  - Provide indications of problems
  - Enable firms to manage risks
  - Facilitate credit investment
  - Messengers of bad news, not the source of it
- Cats among Pigeons
  - Facilitating so-called Bear Raiding
  - Promoting so-called de-stabilizing speculation

# CDSs and Greece - Canaries

- France, Germany, Greece, Luxembourg, and some in the U.S. have supported bans on CDS speculation
- Evidence does not support that the Greek crisis was caused by CDS
  - Compare US\$9bn in CDS with €300bn in Greek bonds
  - Most buyers of CDS on Greek debt are European banks holding the debt
  - Problems with Bear Raiding theories in general (*i.e.*, easier to allege than prove)

# Sovereign CDS Restrictions Could Have Wide-Ranging Impacts

- Quelling speculation with CDSs also will inhibit the return of synthetic CDOs
- Adverse risk management impact
  - *E.g.*, Major Spanish dealers forecast a huge increase in CDS sovereign hedging in 2010, without which many opportunities for bands/corporates to manage risk will be lost
  - Hurts borrowers/issuers
- Lost investment opportunities

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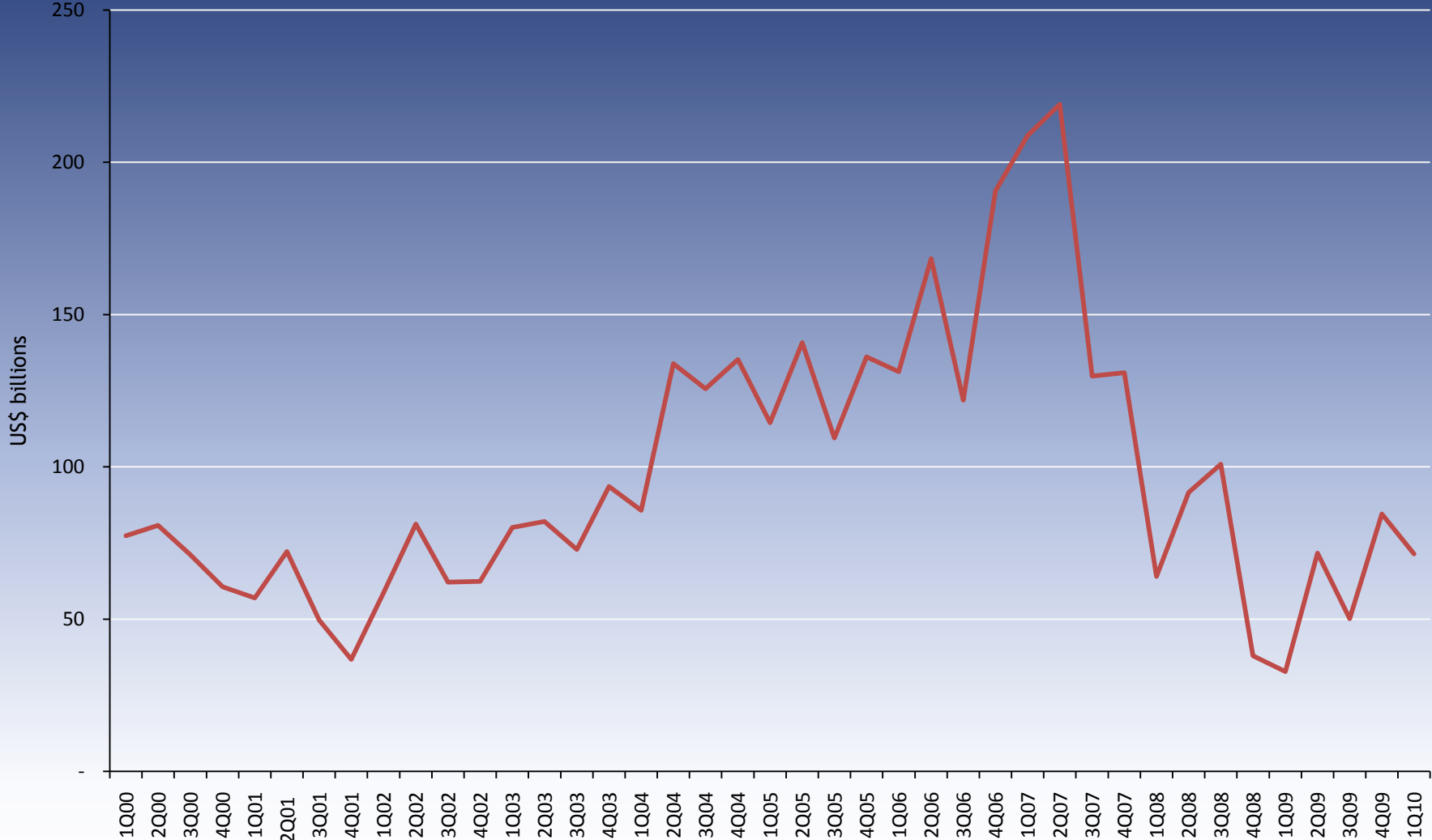
- ☑ The State of Structured Credit Markets
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- ☑ *The Return of Leveraged Loans*

# Leveraged Loans

- Speculative-grade loans to finance leveraged refis, LBOs, M&As, etc.
- Prior to the crisis, as much as 70% of institutional leveraged loan issuance was purchased by CLO managers
- Because of demands by investors for higher yields, many of these loans were relatively borrower-friendly
  - Cov Lite
  - Second lien
  - PIK Toggle
- Appetite helped fuel an LBO boom in 2006 and 2007H1

# Leveraged Loan Issuance

## Leveraged Loan Syndications, 2000Q1-2010Q1

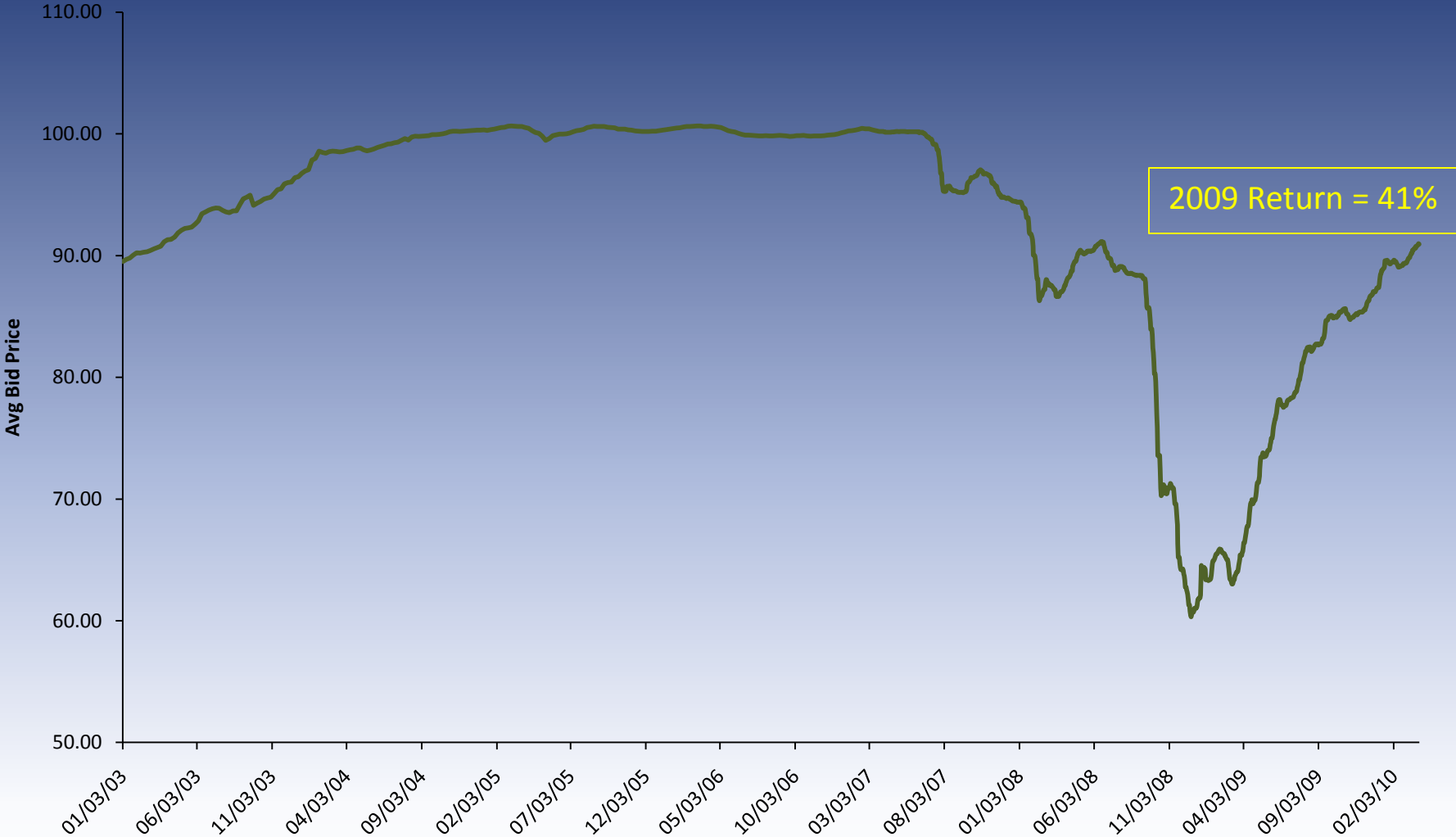


SOURCE: Reuters Loan Pricing Corp.

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# Leveraged Loan Performance

## S&P/LSTA Leveraged Loan Index, 2003-2010



SOURCE: Reuters Loan Pricing Corp.



# Leveraged Loan CLOs Re-emerge

- Citi COA Tempus CLO (March 2010)
  - \$500mn (half new, half re-pack)
  - First non-repack CLO S&P rated since 3/2009
- JPM, Deutsche, & BofA also reported have new CLOs about to enter the pipeline
- And...

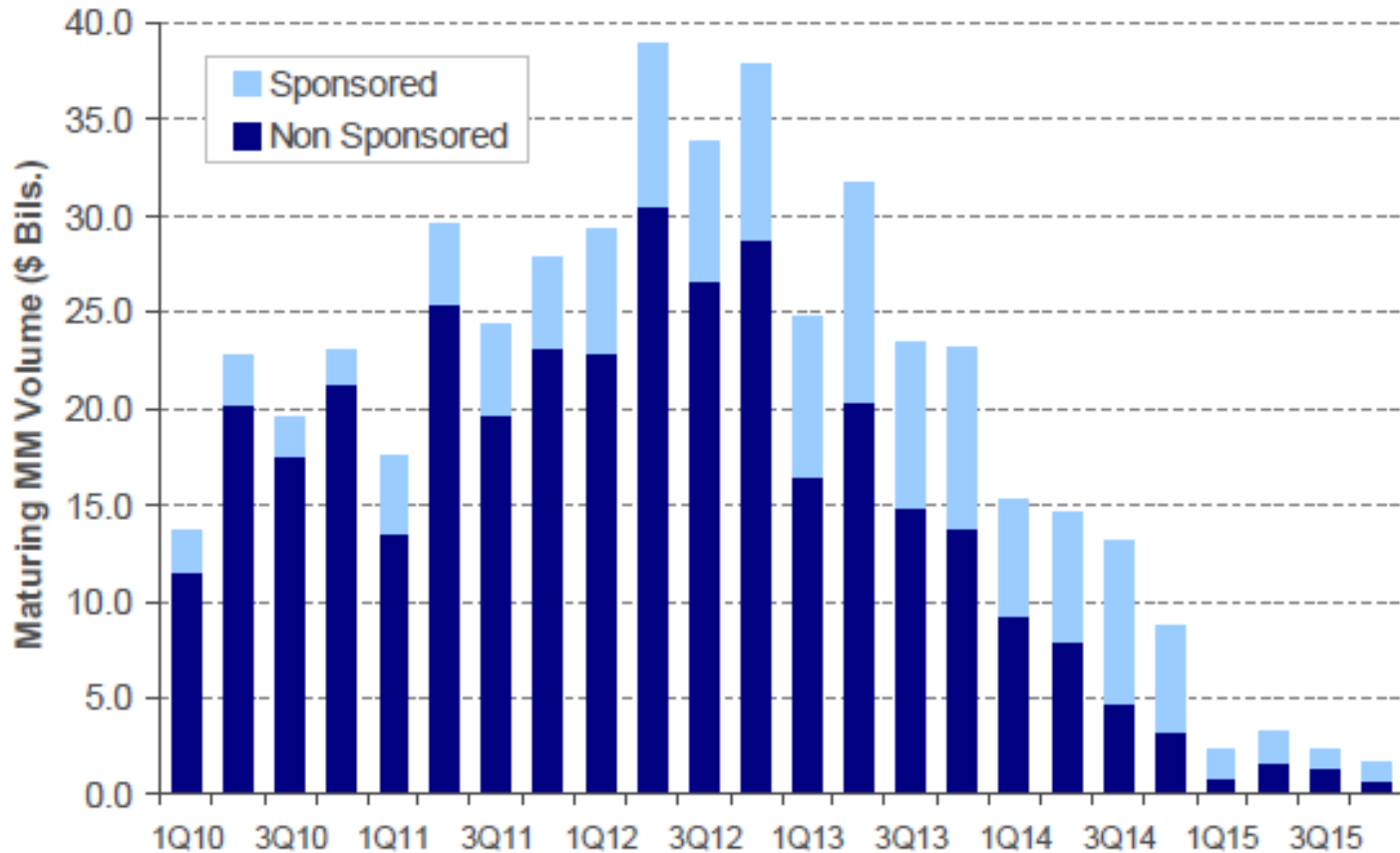


# Leveraged Loan-Based CLOs

- Opportunities
  - Investment appeal
  - Default rates sensitive to macro conditions
  - Historically high recovery rates
  - Lower leverage, better covenants (sometimes), and structural enhancements
- Warnings
  - New AAA structures are pricing at L+190 (compared to L+725 in 4/2009)
  - L+190 is near where things were in mid-2007

# And Beware the Refinancing Cliff

\$470 billion in MM loans maturing through 4Q14



# Conclusions for Caymans

- Do not let the critical link in the SF transaction chain that is the CI break
  - Keep current on trends in collateral and product design
  - Preserve the pipeline role for issuance, distribution, and placement
- Recognize that structured products like CDOs help redistribute the risks of assets like leveraged loans and impaired sovereign debt
- Accommodate investor demands for
  - Simplicity
  - Transparency
  - Stability
- Watch for regulatory arbitrage opportunities
- Resist the temptation to over-regulate

# Questions?