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The purpose of this article is to outline the parties involved in a debt capital markets *structured finance* transaction, looking at a transaction from the outset until maturity date. We assume the reader is familiar with the concept of a structured finance transaction; certainly in the general media we observe an increased amount of reports produced by the financial press, as well as a significant number of books covering this topic from various angles. We consider here the main participants in the market, and look at a transaction from each party's point of view.

<u>Originator: Asset Management Houses and Commercial Banks</u>

For many transactions, the primary party that initiates the deal is an asset management house or fund manager. The asset manager wishes to extract arbitrage opportunities that arise due to differences in yields between assets and liabilities, while maintaining exposure to these assets. The key to securitisation is the creation of a new legal entity that is separate from the originator, the Special Purpose Vehicle (SPV), to which assets that are being securitised are transferred. The same process is used by commercial banks, the other main originator of deals, who wish to obtain regulatory capital relief and additional funding by transferring assets (such as corporate loans) to the SPV.

In addition to the asset manager initiating the transactions, they can also be involved through three other routes. Firstly, an experienced manager can be asked to support static transactions so that if there is a credit event or a possible credit event of the underlying portfolio, they are requested to suggest an alternative route of action with regards to the current condition of the portfolio in order to continue to meet the targeted returns and obligations of the transaction to the note holders. The second way in which asset managers are involved in such transactions is through a managed transaction, where their experience is paramount to the performance of the deal over the life of the transaction. This route may be sought by a manager who already has a portfolio of assets and is looking for the capital relief as mentioned earlier; it acts in conjunction with an investment bank that acts as the structurer or an underwriter for the sale of the notes (and usually performs both functions). The third route in which managers become involved in such transactions is through being identified as experienced and expert practitioners - other asset management houses and investment banks look for such a manger to become involved on deals that use other managers' assets. This has been observed recently in the CDO market as the vintage / returns / experience of managers become more measurable.

With the second and third routes of involvement, the manager has a long-term commitment to these transactions as their performance measurement is dependent on how well each transaction performs. This commitment is shown by an investment in the subordinated notes, also known as the equity piece or the first loss tranche. Their role in the managed transactions is to provide constant monitoring of underlying portfolio and their trading is restricted by credit improved, impaired securities and also through discretionary trading, typically limited to 20% of the aggregate principal balance of the portfolio per annum for a pre-determined period.

Investment Bank

The role of the investment bank is to structure transactions and model an assumed portfolio to project returns subject to market conditions. This sounds fairly straightforward, although through personnel experience, one can confirm this is not the case. The model produced needs to take into account rating agency conditions and other comfort factors, which we discuss later. The investment bank also produces, via its external counsel, the legal documentation that describes the deal. This is a key responsibility, to ensure that the objectives of the structure are detailed in full in these documents.

In addition to this role the investment bank will look to take the position as an underwriter for the transaction. This function is relatively straightforward. The investment bank will look to sell the notes on to investors, and in the event that the deal is closing or pricing and full issuance amount of the deal has not been completely sold off, the investment bank will purchase the remaining notes with the scope to sell these in the (near) future. For this function, the investment bank will charge a fee to the SPV which is typically used to cover the cost of funding.

Following the close of a deal, the investment bank continues to have an involvement with the deal. These roles can be with respect to restructuring of the portfolio and the legal documentation to allow for this to occur. In some deals, we observe tap issues of tranches and notes which require assistance from the structuring desk. They also help by producing a secondary market in those asset classes. The investment bank also assists with post-closing by providing analysis on the deal based upon up-to-date portfolios and can provide current valuations on the notes held by investors. Note that these values are not always the price at which a trader would be willing to buy or sell these notes at, it is in effect a net present valuation for future cash flows on the current underlying portfolio. Being able to provide all of these functions gives strength and support to asset managers / investors / rating agencies through the life of the deal and are normally provided by all investment banks. However the quality of a structurer can be seen from the quality and vintage of deals already in the market (bearing in mind that performance of the deal is up to the asset manager). In addition to this knowledge, the investment bank is chosen for its ability to innovate. An example of innovation in the market, more specifically in the Collateralised Debt Obligation (CDO) market, is where JPMorgan Chase structured a synthetic CDO which allowed Rabobank as the asset manager to use its knowledge and experience of the credit derivates market to manage a portfolio of credit default swaps to gain exposure to the market and provide a more tailored credit risk portfolio.

Finally, the investment banks are also counterparties to asset level swaps and interest rate hedges on the overlying portfolio.

Trustee

The role of a Trustee in simple terms is to monitor the functions of the parties involved in a structured finance transaction to ensure the interests of the note holders are looked after. Normally the Trustee does this by monitoring covenants set out in the documentation surrounding the deal. This monitoring role is typically ‘outsourced’ to an experienced party such as a portfolio administrator.

There are a number of other roles the Trustee plays within a transaction although these are also outsourced to other experienced departments within a Trust business. These functions include, Custodian, Paying Agent, Account Bank and Calculation Agent. Due to this outsourcing, parties involved in Structured Finance transactions rarely see these functions being performed individually and therefore view that the Trustee is responsible for such tasks, albeit, legally binding on each individual / group, it is the Trustees role to ensure that these roles are being performed correctly.

In general, the three main roles played (or outsourced) by a Trustee are those of Custodian, Account Bank, and Portfolio (or Collateral) Administrator. The role of custodian in a structured transaction is the same as in any other financial firm; they hold the assets in the name of the deal and focus on trading / settlement issues and monitoring income from dividends / coupons and corporate actions. The role of the Portfolio Administrator is to monitor covenants on the deal and ensure that the asset manager adheres to trading guidelines as set out in the documentation. In addition to their work set out above, on payment dates, it is their function to prepare the priorities of payments (waterfalls) to determine the amounts payable to the note holders and other related parties such as rating agencies, investment managers, auditors, etc.

The portfolio administrator works with the account bank, typically a role performed by the same person(s). It is their function to monitor inflows from the credit pool and that these credits reach the correct accounts and funds are applied appropriately.

The paying agents’ role is to essentially take the figures given by the portfolio administrator on each payment date and take the funds to pay the appropriate clearing system the amount in aggregate for the note holders who then pay the note holders (or their custodian) in their system based on the holdings position recorded in their system at the rates notified by the paying agent. Note the paying agent does not pay funds directly to note holders except on physical holdings, which are very rare in today’s market. In addition to this, they do not know who holds each note. Their knowledge is of *w* amount of notes being held by the clearing systems, that is *x* by Clearstream, *y* by DTC and *z* amount by Euroclear. This information is provided to the paying agent by the common depository who holds the Global Notes of the issuance.

The role of the calculation agent is to determine the amounts payable to each class of notes and to notify relevant parties such as the clearing systems, Asset Managers and the Trustee.

Audit Firm

The scope of an audit firm appointed is two-fold. The initial role is for them to undertake due diligence of the structuring model in conjunction with the investment bank prior to deal closing.

The second role is post close of the transaction where at each payment date they undertake due diligence of the portfolio and the covenants surrounding the deal and to ensure the portfolio administrator has calculated the results based upon the documentation. In addition to this, they also recalculate the 'waterfall' to ensure they are in line with the portfolio administrator.

More recently, in a view to keep costs lower, the role of an audit firm post close is only engaged when there is a requirement to pay down on the notes due to a ratings downgrade.

Rating Agency

There are three main rating agencies in the market, Moody's, Fitch, and Standard & Poor's. Although there are others, these three are the most commonly involved in Structured Finance transactions.

The role of a rating agency in these transactions is to rate the debt notes. Equity notes are not rated on the basis that this note typically receives a residual payment of the flows through a waterfall. On occasions, combination notes are rated, although this is dependant on the combo note includes equity or not. In such cases, the combination of the rated notes should provide sufficient cash flows to meet timely payments regardless of income from the equity piece. The appointed rating agencies works with the investment bank to ensure its criteria is met so the notes issued receive an initial rating in line with the credit quality of the underlying portfolio relative to each tranche of notes Rating agencies do not assist in pricing. A simple view on how this is achieved is by using a target portfolio for the transaction and then applying the appointed rating agencies default methodology, for example, Standard & Poor's uses a Monte Carlo simulation approach and Moody's uses a Binomial Expansion Theory (BET) to test the future cash flows and defaults over the life of the deal. On balance, the investment banks model should achieve this relatively easily due to prior experience in having notes assigned.

The rating agency also performs rating analysis of the collateral held in the deal which ultimately affects the overlying transaction holding such debt securities. Sometimes such information is not publicly available and therefore the asset manager will need to request a 'shadow rating' which is a private rating specifically for the CDO transaction, at a cost, or if another rating agency publicly rates the security held, the asset manager can infer a rating although documentation causes inferred rated assets to be notched downwards, typically one notch for investment grade assets and 2 for high yield, although each transaction can possibly vary. An asset manager requires these ratings is based upon certain covenants the rating agency may impose on the transaction, such as a minimum weighted average rating factor. It should be noted that there are more covenants set out on a CDO than on any other type of structured finance transaction. In addition, the more rating agencies on a deal, the more covenants there are to meet, although the investment bank will work with the concerned parties to ensure that the number of these tests are kept within a reasonable limit, as too many tests may make the deal impractical to manage.

The covenants are essentially high level markers for the rating agencies to maintain surveillance after each reporting period. In addition to these high level markers, the rating agencies also monitor the underlying pool of securities to confirm initial ratings or the place the deals on credit watch, positive or negative or even to re-rate specific tranches of the transaction. The rating agency uses their initial model to provide the initial ratings but with new underlying collateral information to perform this surveillance which allows them to compare the current portfolio versus the previous or initial portfolio. This surveillance can have material impact on the structure. If the appointed agency chooses to downgrade tranches of notes, this triggers a prepayment of the notes in accordance with the priorities of payments at the next payment date up to the point where the rating is restored or principal and interest cash has been exhausted. Ideally if the covenants are met and the underlying portfolio of assets are sound then this is unlikely to occur although as rating agencies increase their surveillance methodology and certain deals have exposure to unfavourable debt, we are seeing more transactions being placed on watch which is not always beneficial to the investor, but is a key sign of transactional support being placed on these deals for the long term as an asset type.

As mentioned earlier, rating agencies continually innovate within the market and they are a primary source of information for explaining how these structures work. Research material is freely available of each of their websites and is frequently updated when there are developments within the structured finance market.

<u>Mono / Multi Line Insurers</u>

Certain deals, due to investor requirements or deal type, require an insurer for specific tranches of notes in these transactions; normally the most senior notes rated AAA. In return for a premium (paid in line with the payment dates of the deal), the insurer will make sure that the protected class of notes will receive their scheduled interest payment due in the event that there are insufficient funds to pay interest and ultimately repay any capital loses on that note if this occurs although the probability of this happening on a AAA rated note is very low. In the event that the insurer has to pay interest on these notes, these funds will be repaid at the following payment date if there are sufficient monies. In terms of this premium being paid out of the flow of funds, this would ultimately mean fewer residual funds reaching the equity note holders which dissuade investment into this tranche. This is simply dealt by the insured tranche of notes receiving a lower fixed coupon or spread to account for the increased cost to the transaction. There are a number of investor who prefer to receive a marginally lower coupon in the knowledge that their investment is protected (or insured) from loss.

Investors

The key party to all structured finance transactions is the investor. They are the party who invests in accordance to the credit risk profile of the deal and carry exposure to possible loses, and with respect to investors in equity, they also look to have a potential upside in their higher risk tranche.

The type of firms who invest in these transaction are typically asset management houses, pension firms, insurance firms, other structured finance transactions and investment banks. Each investor has their own credit risk to return profile to meet, and especially on CDOs, the risk is closely modelled to cover each of their requirements although complexities arise when different risk profiles needing to be met by their investment. In addition to these risk profiles, there may also be regulatory reasons why these investors cannot invest in certain types of debt and therefore a CDO removes such direct exposure and enables them to achieve their required investment aim. Such transactions also allow for investors to gain exposure to a more diverse portfolio of assets which in theory reduces risk to specific industries or single named obligors when their investment is relatively small.

Investors are also driving the product types forward to the extent that we have seen single tranche CDOs which allow for credit risk portfolios to be used to tailor the product offered. In addition to this risk profile being tailored to an investor, we are seeing investors choose a designated asset manager to run the deal, albeit at the agreement of the asset management firm.

Issuer

The role of the issuer to create the Special Purpose Vehicle and to prepare the financial accounts of the structure for regulatory reporting purposes. In theory, the Issuer is responsible for the management of the portfolios, although this function is outsourced to the asset manager. The company is a legally registered investment firm off-shore and the issuer has independent directors and has to produce financial statements to the regulatory authorities regarding the performance of trading portfolio, i.e. monitoring financial gains and loses and income over the life of the transaction. The mangers of the SPV also ensure that all fees and expenses are paid within a reasonable timeframe.