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News

Scratching the surface

Refinancing call for structured credit-related ARS

Recent broker settlements in the auction rate securities (ARS) market only scratch the surface of the problems being experienced in the sector, accounting for around US$40bn of an estimated US$330bn of outstanding paper. With structured ARS experiencing average mark-to-market losses of between 50% and 80%, it seems inevitable that such securities will also be refinanced or restructured in due course.

The settlements to-date have primarily been offered to retail and not-for-profit holders of high quality municipal bond and student loan ARS. As the majority of outstanding ARS paper is held by institutional investors, Houlihan Smith & Co senior analyst Brian Weber suggests that in order for the market to begin to thaw, settlements also need to be structured for these investors.

But, with high quality ARS continuing to be called, the outstanding paper is backed by more problematic assets, including structured ARS issued by CDOs, CLNs, CDPCs and contingent capital vehicles. Nonetheless, UniCredit md and head of credit strategy & structured credit research Jochen Felsenheimer agrees that settlement of the outstanding amount is the logical way ahead for the market, as regulatory pressure rises and brokers become increasingly aware of the reputational issues at stake.

However, it is likely to be a long-term process involving settlement/restructuring on a case-by-case basis, accompanied by regulatory calls on a case-by-case basis, and a continuing decline in ARS outstanding. "The settlement mechanism for structured ARS will depend on the underlying, as well as the investor," notes Felsenheimer. "Restructuring is an alternative, but the performance of such securities isn't yet clear. For instance, around US$50bn-US$100bn of CDOs are thought to have been restructured since the crisis hit - in reality only a small part of the market - and I wouldn't be surprised if it's a similar story for the ARS sector."

Weber confirms that there is demand for brokers to settle the more complex structured ARS. "Conceptually brokers could offer holders of structured ARS similar liquidity and/or buy-back mechanisms at around 50 to 80 cents on the dollar, but this is unlikely to occur any time soon. While there is an economic floor for muni and student loan ARS because of the ability to refinance at comparable rates, there are credit concerns surrounding the more structured ARS which means that brokers can't help issuers refinance at comparable prices."

Brokers could also argue that - unlike muni or student loan ARS - they don't have to underwrite the securities or back the auctions for structured ARS, and that the risks to institutional investors were outlined in the offering documentation. However, it appears that in reality there was little understanding of the risks associated with structured ARS.

It is difficult to get a handle on potential losses in the structured ARS market because there is no standardisation in terms of credit quality or call mechanism, so an investor could experience an average MTM loss of anywhere between 50% to 80% for such instruments. But Felsenheimer says it isn't surprising that the problems in the structured ARS sector are seemingly being ignored for now.

Using UBS' settlement as an example, it has agreed to buy back US$20bn ARS at a loss of US$750m (plus a US$150m charge) - translating into an MTM loss of 3.75%. This provides a rather optimistic value for the ARS at 96.25.

"Although these positions may see further MTM losses in the future, it could be argued that - given the large amount of securities linked to the housing and structured finance market on its books - structured ARS are not the bank's most pressing problem at the moment. The market price for CDO ARS [which account for around 8% of the sector, or US$20bn], for example, is below 50c on the dollar and so these instruments have already been discounted to a large extent. This is a minor issue when compared with the other losses that brokers are facing," he argues.

Weber believes that the ARS market for CDOs and CDPCs is over. "The only way for these vehicles to issue ARS going forward would be by offering higher maximum rates. The typical ARS spread of 100bp over Libor doesn't allow much room for spreads to widen, so a spread of, say, 1000bp over would help investors feel more secure. However, while such a spread would mean a lower probability of the auction failing, it would mean increased uncertainty for the issuers," he concludes.

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