PRINCIPIA PARTNERS

What next for conduits?

If the expense involved in setting up an ABCP programme increases, banks will have to find ways to address the costs. Leonora Walters reviews some of the options.

Recent proposals in the second draft of the Bank for International Settlements (BIS) Basle Capital Accord could increase the costs of setting up asset-backed commercial paper (ABCP) programmes for Banks. The proposals suggest that the risk weightings on liquidity facilities for ABCP programmes should be increased. Liquidity facilities of less than one year would have their risk weightings increased from 0% to 20%.

ABCP programmes are normally 100% liquidity-backed, so they will become more expensive for banks to set up if the proposals are implemented.

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SIVs

Could one possible alternative to setting up an ABCP conduit be to set up a structured investment vehicle (SIV)? Software company Principia Partners, which produces an investment management system for SIVs and other asset-backed securities, suggests that SIVs would have the following advantages if the Basle proposals were implemented.

- SIVs qualify for the clean break requirements the Basle accord requires between a bank and securitised assets, so that the asset can be removed from the bank's balance sheet, and be exempted from the risk-based capital requirements of the bank.
- They have efficient liquidity facilities, ranging from 5% to 10% of issuance.
- SIVs fund flexibly, issuing commercial paper (CPs) or medium-term notes (MTNs).
- SIV credit enhancement is efficient. It is monitored and maintained regularly, sometimes daily.

SIVs are being further developed. Initially, they had only been able to invest in investment grade assets, but Citibank's 5 Finance Corp SIV can now invest in non-investment grade assets. This could be an alternative to putting lower-rated assets into ABCP conduits.

Another development might see SIVs entering into credit default swaps, though Dominic Swan at Moody's suggests that this development is more likely to happen in large volumes in 2002 rather than 2001. Swan thinks that Basle may cause an increase in people trying to set up limited purpose investment companies (LIPICs), Moody's preferred name for SIVs. This is because LIPICs rely on assets rather than third party liquidity. "LIPICs take a long time to close - around a year or two," says Swan. "However there will probably be a rise in the number of programmes this year."

Interest in SIVs is certainly growing, though it is not certain whether this is a direct result of the Basle Accord. Standard & Poor's (S&P) report that issuance volumes for SIVs increased from US$61bn in 1999, to US$80bn in 2000, a rise of 31%. S&P predict that 2001 will also be another high performance year, with at least seven new SIVs launched.

Furthermore, at a recent Strategic Research Institute conference in Arizona, delegates were reported to have expressed great interest in SIVs. Many firms said they were setting up SIVs, or were interested in doing this in 2001. Principia also reports that enquiries from parties setting up SIVs have increased. "We are seeing many enquires from SIV managers," says Brian Donally, partner at Principia. "Recently we have had around 20 enquires, and the majority of these were from Europe. I would term the increased interest as explosive growth."

He says selling the assets through the use of an existing multi-seller SIV (a SIV rental), or converting ABCP programmes to a SIV are also possible options.

Irvine at Bank One, which has ABCP programmes, advises: "Anyone considering launching a securities arbitrage conduit may alternatively want to consider making an investment in the rated capital notes of a SIV. The underlying collateral is typically rated AAA to A, similar to the conduits, with the added benefits of not having the concerns and costs of either establishing the conduit or building the infrastructure to support such an effort. Investors should of course consider not only the structure of the various SIVs, but also the commitment and strength of the sponsoring institution."

He continues: "We see the SIV as a natural progression of what the bank is already doing in securitisation. Anyone considering a SIV needs a real business reason for doing so. You can not get a SIV up and running quickly as it takes at least 15 to 24 months."

SIV Drawbacks

As well as taking longer to establish than ABCP, SIVs are more complex to set up. Deborah Seife at Fitch in New York says: "There are certain complexities involved in launching, including the issuance of capital notes, which can be difficult to sell."

Donally explains the complexities of running a SIV: "A major hurdle in creating SIVs is the system side. Running a SIV is like running a virtual bank - the mangers have to take into account assets, funding and hedges to manage interest rate, foreign exchange and credit risk."

He continues: "A SIV is highly dependent on a solid credit rating to fund itself by issuing CP or MTNs. It is carefully watched over by a rating agency, and has complex reporting requirements, dictated by the rating agency's strict criteria, which necessitate more sophisticated systems. Traditionally, the ABCP structure does not have the same onerous reporting requirements as a SIV, because the sponsor acts as a liquidity back-stop."

The SIV has also to demonstrate compliance with the rating agency's terms for capital adequacy. These include: liquidity adequacy; interest rate sensitivity; currency sensitivity limits to exposure of concentrations in asset type; geography; and industry.

If the SIV does not comply, there is typically a five-day cure period during which the SIV must either comply or liquidate.

Too much work?

The complexities of SIVs may deter some entities. Vas Kosseris, senior director at Fitch suggests that new SIVs are more likely to be set up by sponsors of existing SIVs. Irvine at Bank One predicts that as capital becomes less attractive because of Basle, the SIV industry will grow, and that there might be an increased demand for capital notes. But he adds: "I do not think we are going to see the huge growth in SIVs that some are anticipating because they involve a tremendous amount of work. Rather, as the liquidity price gets more expensive there may be developments in the conduit market. For example, we are already seeing conduits that require less than a 100% liquidity."

Last year Citibank restructured its Eureka programme to reduce the amount of liquidity needed to maintain a Prime-1 rating. The liquidity support required will be reduced from 100% to around 60%. Kosseris says: "We may see a trend where liquidity facilities for ABCP programmes become reduced from 100% to some amount of partial support."

Innovate or die

Several options are being explored to mitigate the effects of increased risk weighting on ABCP liquidity facilities. ABCP programmes may restructure, or turn to derivatives.

Perry Inglis at S&P says: "So far, the segregated re-pack programmes, arbitrage conduits, and SIVs have been structured and run entirely separately from each other. Over time, I expect that the differences will blur. For example, the SIVs are run very differently from arbitrage conduits in that they have lower levels of liquidity, but much higher levels of surveillance, monitoring and reporting.

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He continues: "The arbitrage conduits are already looking at using swaps or repos as alternative ways of repaying commercial paper if the market closes. If they place repo agreements in the conduits, perhaps the next step is for these vehicles to take market risk or reduce liquidity levels utilising some level of SIV technology. I expect to see this technology transfer in the next couple of years." Swaps would mean that the swap provider would be responsible for all credit and liquidity events.

A recent Moody's report suggests that most new conduits are contemplating the ability to issue MTNs, which typically do not have liquidity facilities. Jean Dornhofer at Moody's explains: "In response to the potential need for increased capital requirements, issuers will look at extendable commercial notes (ENCs) or other alternatives, such as MTNs."

Dornhofer continues: "Issuers may also look at market value structures which require little or no liquidity, or at structures which will have alternative forms, such as sellers providing liquidity, like the Commerzbank conduit."

Kaiserplatz, the Commerzbank conduit, is the first European conduit where the interest component is not covered by Prime-1 rated banks but by unrated sellers through a cash deposit. Moody's reports that some market participants are exploring the possibility of having liquidity support provided by Prime-1 rated corporates.

Dornhofer concludes: "Issuers might also look at synthetic structures. As in other market sectors synthetics have grown, the main advantages being efficiency and ease of execution." Synthetics are advantageous in that they allow risk transference, but also get capital relief.

Another option would be for banks to put their assets into other banks' conduits. "Bank One has US$40bn worth of assets under management, and we have a number of institutions that rent conduit space from us," says Irvine. "The overall cost of setting up a conduit deters people, so they look to existing conduit managers. If they use someone else's conduit it will be less expensive to set up," says Irvine. "I am not saying that all the market will go that way, but some smaller banks might want to. If you do not have resources to structure your own conduit, renting space from an established conduit provider may make sense."

ABCP still strong

Despite concerns over the Basle proposals, the ABCP market still appears very healthy. A recent Moody's report says that the European ABCP market increased by about 40% in 2000. In 1999, US$61.8bn was issued, compared to issuance worth US$86.7bn in 2000.

Kosseris at Fitch says that many banks in the United States have started setting aside economic capital. "Any additional costs will presumably be passed to sellers. But we think that sellers will probably stay with these programmes even if costs do go up, given the other benefits that they offer, including diversification of funding sources and anonymity."

Dornhofer says: "The outlook for many existing sponsors is that they will have to restructure to reduce their liquidity facilities." Nevertheless, Moody's predicts measured growth. "There is much untapped potential in the market."

Irvine also thinks there will be some more growth in the ABCP market. "I think the market will still grow, but my personal view is that it is more likely that there will be closer to 100 conduits rather than 1000 over the next four to five years. One of the main attractions of a conduit is to gain regulatory capital relief, which Basle will impact. But this is a very efficient market and it is not going to go away."