

Hybrid Structured Funds

NEW DIRECTIONS IN INVESTMENT FINANCE

Structural Challenges and Market Shift

Global issuance of collateralised debt obligations and synthetic equivalents in 2007 reached US\$269 billion but by the end of 2008 had dropped to US\$71 billion (*source: Creditflux*). Recent market activity suggests that a growing number of investment finance vehicles are being structured not as CDOs issuing rated debt, but as hybrid investment funds. A combination of the various factors summarised below is expected to result in permanent changes to the structure of the investment capital markets.

• Financial Crisis

International capital markets have become impaired as a result of the global financial crisis, with entire market sectors effectively closed for lack of investor interest (e.g. RMBS). Current issuance volumes for repo purposes with the Federal Reserve, European Central Bank and Bank of England are not considered sustainable beyond a short-term support period.

• Lack of Leverage

In response to the financial crisis lending institutions are restricting the supply of credit, requiring tighter loan-to-value covenants and imposing higher borrowing costs. Lenders themselves have been constrained by internal funding limitations with liquidity back-stop and other categories of facility no longer available for structured finance transactions.

• Regulatory Capital

Banks are facing higher regulatory capital charges. Implementation of the revised Basel II proposals is expected to increase tier one regulatory capital requirements from 8% to closer to 10% using the standardised approach to risk weighting. This, in turn, is expected to restrict further the supply of credit and increase the costs of leverage finance for structured transactions.

• Financial Regulation

The reaction to the financial crisis by the on-shore regulatory authorities has been to propose that more onerous and complex regulatory conditions be imposed on arrangers and originators of capital markets transactions. As a result of the collapse of Bear Stearns and Lehmans and the need for emergency government support of a number of leading investment and

commercial banks (e.g. Citigroup, Merrill Lynch, UBS and RBS) the hitherto light-touch regulation of structured finance transactions is expected to end. The European Central Bank has called for sweeping structural changes in the way the financial system is regulated and supervised.

• International Financial Reporting Standards

Technical requirements under IFRS have necessitated the use of mark-to-market valuation methodologies during periods of market illiquidity. This has exacerbated the deterioration in valuations of investment assets and promoted pro-cyclical tendencies. Difficulties concerning de-consolidation analyses and restrictions on the use of off-balance sheet structures are also expected to inhibit any early recovery in transactional volumes.

• Rating Agencies

Loss of confidence in rating agency methodology and investor perception of inherent conflicts of interest between transaction arrangers and rating agencies further threaten recovery in the structured finance market. EU Commission proposals to regulate rating agency operations published last November are likely to lead to a more restrictive approach to credit rating and result in higher disclosure costs.

• Bankruptcy Remoteness

A key requirement for a rating analysis of a structured finance transaction is the bankruptcy remoteness of the issuing company. The US court decision in Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd to assume long-arm jurisdiction over a Cayman special purpose vehicle and impose US insolvency rules on a non-US issuer is likely to prejudice the bankruptcy remoteness analysis of special purpose vehicles.

• Maturity Profiles

Investor concerns over mismatches in asset/liability maturity profiles and the evident funding instability of Structured Investment Vehicles pose additional challenges for securitisation transactions.

• "Skin in the Game"

One of the contributing factors to the US sub-prime mortgage crisis was that lenders derived substantial fees from securitising their loan books but retained no residual risk for the loans that they had originated. Investor preference for greater co-alignment of interests between investors and arrangers and longer term commitment by an arranger to an investment proposition is likely to end the "originate and distribute" model. The proposed EU Capital Requirements Directive would prevent banks from

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investing in securitisation transactions where the relevant originator/arranger retained less than a 5% vertical slice of the overall capital structure.

• Market Participants

The downgrading or disappearance of a number of leading players in the structured finance market (e.g. Bear Stearns, Lehmans, Citibank, AIG, RBS, Merrill Lynch, Morgan Stanley) has already contributed to a material contraction in the scale of global structured finance activities.

• Flight from Complexity

Investor aversion to highly complicated, opaque, "black box" finance structures is expected to lead in the future to a preference for simpler, smaller, transparent and more equity like transactions.

Alternative Capital Models

A combination of the various factors referred to above suggests that the investment capital markets are likely to be affected by a number of permanent and structural changes. In consequence, alternative capital models which more accurately represent the investment risk in finance transactions will need to be developed for raising medium and long term capital finance.

Against this somewhat negative backdrop, a more positive development has been the recognition that much of the investor risk in a structured finance transaction, such as a CDO, is analogous to equity risk. This is likely to shift the next generation of finance structure further along the capital spectrum towards that of pure equity. Transactions that might previously have been structured as collateralised loan obligations are being set up as loan funds; collateralised debt obligations are now being established as bond funds; and collateralised fund obligations are instead becoming equity investment funds.

The new generation of fund vehicle is expected to hold underlying investment assets, such as leveraged loans or other investment assets similar to those found in the collateral pool of a CDO (and of CDO variants). Hybrid structured funds will also be suitable for accessing private equity assets and the recovery opportunities which are expected to arise when the investment markets begin to normalise.

There are, however, expected to be significant differences in the liability side of an issuing vehicle's balance sheet. Issuers are more likely to issue redeemable preference shares subject to lock-up until the end of the investment period, instead of rated medium term debt notes. It is possible that the next generation of finance vehicle will also issue deeply subordinated debt notes which rank *pari passu* with its preference share capital. The investment proposition will be convergence or hybrid in the sense that investors may be offered equity type or hybrid capital securities to access a range of underlying fixed income and debt type obligations.

The capital model adopted by a hybrid structured fund is far simpler than that used by the traditional forms of structured finance vehicle. Special purpose debt issuers employed tranching of debt securities by seniority and sequencing by maturity dates resulting in complexity in internal structure and conflicting responses from different investor classes to potential events of default.

Preference share capital, which employs a pricing model based on net asset value, may provide a more appropriate means for investment in recovery situations and secondary investments in that it facilitates recognition of capital gains more easily than would be the case with coupon and capital payments on fixed income debt.

As a result of the financial crisis, institutional investors are expected to re-balance their portfolio allocations so as to reduce exposure to the volatility recently experienced in the public securities exchanges and stock markets. Investment outflows from residential asset backed and other affected classes of asset backed securities will also require re-investment of capital in alternative investment opportunities.

In the context of scale, securitisations in 2007 accounted for over US\$2,000 billion raised in the US capital markets but by 2008 this source of funding had virtually dried up other than for repo purposes with the Federal Reserve. In an unrelated development, the US\$50 billion Madoff scandal may have dealt a near terminal blow to the fund of hedge funds industry and investors in that asset class are also expected to re-allocate investment capital to simpler, more transparent structures.

Investor concerns that the financial crisis may usher in an inflationary era, where adjusted interest rate returns on cash deposits are at real rates of nil or below, are further expected to act as a further spur to investment capital being restructured.

Despite the financial crisis, fund sponsors remain confident that they will be able to complete new transactions because of the substantial amounts of investment capital which remain unallocated. New funds will be able to acquire investment assets at prices at or below intrinsic value and will be in a position to do this initially by financing acquisitions on equity alone, with a view to a partial re-financing when the availability of leverage returns. Arrangers will, however, need to develop alternative investment models which better reflect the nature of the investment risk in a finance transaction.

Hybrid Structured Funds

Emergence of Hybrid Structured Funds

In response to the various factors outlined above, it is anticipated that new forms of investment fund vehicle will find applications in the structured finance sector. The advantages of a hybrid structured fund as a vehicle to finance the acquisition and holding of investment assets include the following:

• Hybrid Issuance

Limited partnerships are frequently used as tax transparent investment vehicles for institutional investors. Limited partner interests typically comprise a relatively small amount of equity, in the form of a capital contribution, which is stapled to a proportionately larger amount of debt, either in the form of a limited partner advance or a binding commitment to make such an advance when a suitable investment opportunity arises.

A hybrid structured fund which takes a corporate form would be able to issue equity securities (such as redeemable preference shares) and debt securities (in the form of subordinated loan note instruments). If appropriately drafted, the fund's constitutional documents would enable subordinated debt notes to be issued which rank *pari passu* with its preference share capital. Coupons on the subordinated notes may be either fixed or variable and cumulative or non-cumulative so as to match the dividend rights on the preference shares.

Subordinated debt notes may be issued on a stapled basis to subscribers of preference shares in designated or variable proportions with preference shares. As an alternative to the above, subordinated debt notes may be issued on a stand-alone basis to investors who, because of their own internal investment restrictions, are restricted to investing in fixed income securities.

Depending upon the fiscal residence of the investors, this flexibility can enable the tax profile of the investment arrangement to be optimised. The versatility permitted under company law in Jersey to make distributions out of capital or of income and the ease in returning equity to investors through a redemption of redeemable shares or a buy back of ordinary shares means that it may be possible in practice to achieve a sponsor's structuring objectives by means only of an issue of redeemable preference shares without issuing any debt at all. Hybrid structured funds set up in Jersey will almost invariably be set up as tax neutral and nil-rated for Jersey income tax.

• Maturity Profile

A hybrid structured fund will be able to issue both debt and equity securities which are expressed to have maturity and redemption profiles exceeding the tenor of the underlying investment assets, thereby eliminating re-financing risk.

• Regulatory Capital

Hybrid structured funds can be set up to invest in leveraged and mezzanine loans, as well as infrastructure, real estate and distressed corporate debt. However,

unlike regulated financial institutions, hybrid structured funds are not subject to the funding costs of complying with the regulatory capital requirements imposed on banks by Basel II.

• International Financial Reporting Standards

A hybrid structured fund may take the form of a limited partnership, limited liability company or unit trust and has the flexibility to adopt accounting policies which are appropriate to its investment proposition. Accordingly, it may be possible for a hybrid structured fund to dispense with the requirement to carry out mark-to-market valuations of its investment assets. It is recognised, of course, that investors may have a preference that a fund adopts and complies with IFRS.

• Consolidation

Concerns about substantive consolidation with an arranger or originator, which may arise with a conventional structured finance transaction, should not occur in the case of a hybrid structured fund as typically it will be funded substantially by equity capital.

• Non-Recourse

Investors in equity securities issued by hybrid structured funds would be entitled automatically to participate in any residual surplus assets of the fund remaining after all prior claims have been met. There should be no requirement, as in the case of certain categories of junior notes of CDOs, for the issuer's payment obligations to be structured at an excess level, subject to a non-recourse or a payment-in-kind basis.

• Co-Alignment of Interest

In an investment fund transaction the sponsoring or arranging group is frequently expected to maintain a strategic investment in the fund in order to promote a co-alignment of interest between investors and managers. In European arranged private equity transactions the management group will typically be incentivised by means of a performance fee or carried interest participation based upon portfolio performance over the life of the fund, as opposed to being on a "per deal" basis (which tends to be US market practice), re-enforcing the co-alignment aspects.

• Capital Gains

Unlike special purpose vehicles which tend to issue medium term notes having a fixed coupon and/or commercial paper issued at a discount, the capital structure of an investment fund and the net asset valuation method typically employed are better suited to recognition of investors' interest in any capital gains in a fund's portfolio. It is anticipated that, as the global economy recovers from the financial crisis, there will be investment opportunities in recovery structures which typically produce a significant portion of investor returns in the form of capital appreciation.

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• Distributions and Returns

A hybrid structured fund which is subject to Jersey company law would be able to finance payment of distributions from a wide variety of sources and not merely out of distributable profits. Distributions may now be made directly out of most capital accounts without the need to obtain any court sanction for a reduction in capital. Alternatively, capital may be returned to investors either on a redemption or buy-back of shares. The rules on distributions which apply to limited partnerships and unit trusts are flexible and permissive.

• Flexibility

A hybrid structured fund which is established either as a limited partnership or as a company in Jersey will be subject to various rules which, although based on English law, are significantly more flexible than those which would apply in the UK. In addition, a structured fund can take the form of an incorporated cell company which enables statutorily recognised ring-fencing to be put in place between different asset pools.

• Market Participants

The barriers to entry for securitisation and complex forms of structured finance transactions were set at levels where only investment banks or regulated financial institutions could develop any recognisable market share. In the case of a hybrid structured fund which is set up as an Eligible Investor Fund (please see Regulatory Requirements below), there are no requirements for the arranger to have an established track record or to be an institution of stature having a minimum capitalisation. One of the side-effects of the global financial crisis has been a migration of experienced investment professionals from the international investment banks to start-up investment boutiques. Investment professionals who have the technical knowledge required to structure investment transactions as well as access to an investor base may find the hybrid structured fund to be an optimal issuing vehicle for debut arrangers.

• White Box

In the aftermath of the financial crisis, many investors are expected to have a preference for new investment proposals to be structured on a simple and transparent basis with offer documents disclosing clearly all investment risks and operating costs. In comparison to the voluminous and highly complex documentation developed for rated securitisation transactions, the constitutive documents for a hybrid structured fund can be relatively straightforward and concise.

• Regulatory Requirements

A regulatory classification which has recently become available in Jersey may be ideally suited for use as a hybrid structured fund. An Eligible Investor Fund can be set up on a fully flexible and fast-track procedure within a matter of days and is highly cost effective. The new unregulated funds regime in Jersey employs a flexible definition of "eligible investor" which covers institutional investors investing or making investment commitments of

not less than US\$1 million (or equivalent), professional investors, carried interest participants as well as any further category of investor which the fund manager is able to certify as suitable for the relevant investment product. The offer document is subject to limited content requirements and there are no investment restrictions, concentration exposures or leverage limitations imposed by regulation. It is also possible to convert an Eligible Investor Fund into a Listed Fund or, alternatively, to establish a hybrid structured fund as an Exchange Traded Fund which would also provide access to investors who have a preference for investing in listed securities. (Client briefings on Eligible Investor Funds, Listed Funds and Exchange Traded Funds are available on request).

Applications of Hybrid Structured Funds

Hybrid structured funds can be used to access a variety of underlying assets, from fixed income investments to alternative asset classes. They employ a capital structure which implicitly recognises that the nature of an investor's exposure to the underlying investments is conceptually that of equity risk. In the period of recovery which is expected to follow the financial crisis, it is anticipated that investment opportunities will be concentrated in recovery opportunities and in the following asset classes:

- Distressed Debt
- Stressed Financial Credits
- Mezzanine and Leveraged Loans
- Infrastructure Loans
- Secondaries
- Real Estate
- Real Estate Loans
- Private Equity

(A client briefing on Uses of Hybrid Structured Funds is available on request).

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Selection Factors

In order to avoid the build up of internal headcount and to enable arrangers to free up time to focus on their core competencies, hybrid structured funds are increasingly outsourcing fund administration to specialist providers in the same location as the fund's domicile. Having a real and substantive connection between a fund's registered office and its Centre of Main Interest not only reinforces corporate governance aspects for regulators and investors but may also serve to validate offshore management control and tax status. New fund arrangers should take the following factors into consideration in selecting fund service providers:

- Knowledge and Expertise
- Track Record and Experience
- Quality and Continuity of Professional Staff
- Infrastructure and IT
- Pricing
- Risk Management and Corporate Governance

Hybrid Structured Fund Support Services

A simpler internal structure means that hybrid structured funds can be less expensive and quicker to establish than traditional structured finance vehicles. The next generation of investment fund arrangers will place a premium on the control of start-up and on-going operational expenses. The provision of integrated administrative and legal services can deliver material efficiencies to a structured fund's overall cost/expense ratio. Arrangers are also likely to be sensitive to conflicts of interests which may arise, where a lending counterparty also seeks to be mandated, for example, to provide trustee services to an issuing vehicle.

Ogier has developed a cross-jurisdictional package of integrated administration and legal services which include the following:

- Fund Formation
- Capital Calls and Drawdowns
- Bridge and Credit Facility Administration
- Investment Acquisition
- Portfolio Maintenance
- Valuation Reporting and Net Asset Value Calculations
- Operational Expenses, Advisory Fees and Carried Interest Calculation and Processing
- Cash Management and FX

- Investment Accounting and Financial Statements Preparation
- Set up and Administration of Investment Holding Subsidiaries
- Distributions
- Investor Reporting
- Directorship and Legal Advisory Services
- Registrar and Transfer Agent Services
- Tax Filings and Statement Returns
- Stock Exchange Listing Services

Why use Jersey

Jersey has a leading reputation among the international finance centres and has the legal and administrative expertise to facilitate set up and performance of complex finance transactions. Its proximity to London makes the Island an ideal centre for European arranged structured fund transactions.

Our Approach and Credentials

Ogier is a leading global provider of integrated administration and legal services. We have developed a global investment funds practice comprising over 80 investment fund lawyers and 100 fund administration professionals in four key jurisdictions specialising in offshore fund services. Ogier has under administration over 5000 investment structures having aggregate funds under management exceeding US\$200 billion. The Firm has developed a truly integrated offering in relation to hybrid structured funds and is able to provide a long term partnering solution to meet the full range of a fund sponsor's formation and ongoing operational requirements. In the last three years we have acted in relation to over 1,500 investment funds and have particular experience with private equity and mezzanine loan funds.

Industry Recognition

Ogier's Global Investment Funds Practice continues to receive significant industry recognition.

Listed below are some of the awards our team has won recently.

'Offshore Law Firm of the Year 2008' *British Legal Awards*

'Offshore Law Firm of the Year 2008' (Europe) *Hedge Fund Journal*

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About Ogier

Ogier is an award winning world leader in the provision of offshore legal and fiduciary services. Our integrated legal and fiduciary approach has proved a winning combination which enables us to secure awards for the quality of our services and our people.

The Group employs over 850 people and provides advice on all aspects of BVI, Cayman, Guernsey and Jersey law and fiduciary services through our international spread of offices that cover all time zones and key financial markets. Our network includes Bahrain, BVI, Cayman, Guernsey, Hong Kong, Ireland, Jersey, London, Shanghai and Tokyo.

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Ogier includes separate partnerships which advise on BVI, Cayman, Guernsey and Jersey law. For a full list of partners please visit our website.