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Could CFO defaults trigger the next round in the credit crisis?

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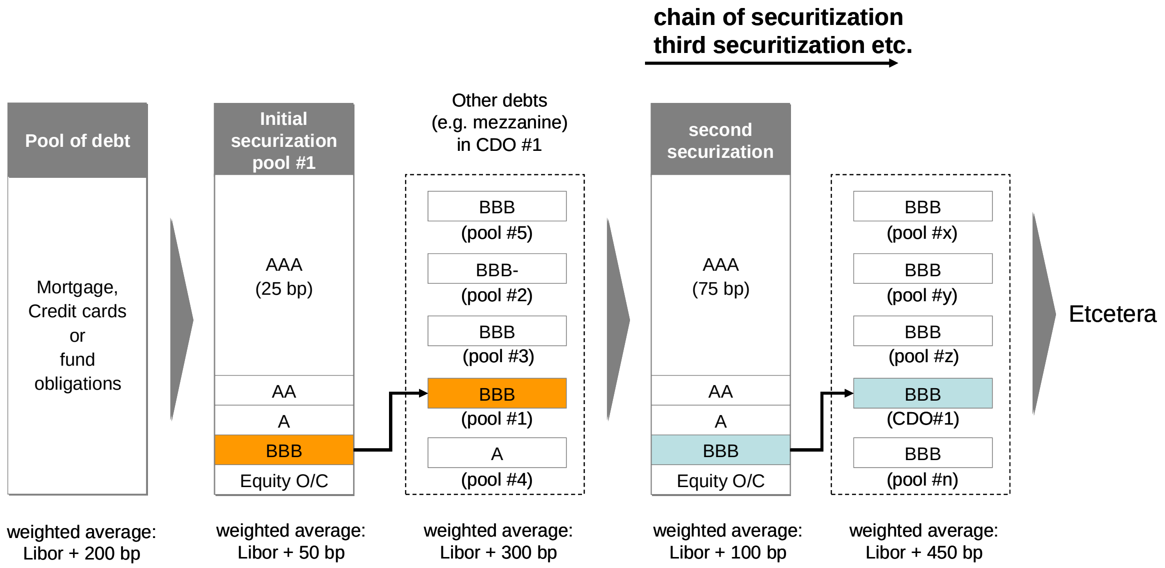
The credit crisis triggered by US sub-prime mortgage defaults is nearly a year old. The private equity industry is considered to be one of the victims. It can no longer rely on cheap debt and is forced to look to other - more operationally driven means of value creation in order to achieve the return they have promised to deliver. Besides being a victim, Wilco Schoonderbeek argues that private equity funds could become an unintended instigator of the next round in the credit crisis.

How is private equity linked to the credit crisis?

Cheap debt vanished when lenders became fearful because they were not sure which vehicles were exposed to US-sub prime. These structured finance vehicles had invested in high quality asset backed securities and funded these investments with short-term debts. The exposures to debt obligations were transferred through securitization. Securitization can involve all kinds of assets. Whether it is residential or commercial mortgages, credit card loans or car loans, the securitization method for collateralized debt obligations (CDO's) as illustrated below, is generally the same.



Simplified Illustration of CDO securitization

Until the second half of 2007 the economical circumstances allowed these finance vehicles to take advantage of the margin between the high quality asset backed securities and the short-term debts. These structures also enable investors to gain exposure to a diversified pool of underlying obligations without having to buy each individual security.

Typical for a structured finance transaction is that the underlying assets have a predictable and steady flow of income into the structure and enough historical data to calculate the probability of default. Looking at the mortgage backed securities, for some time the financial market believed it was possible to make loans to people without the ability to repay, group, slice and regroup them and produce 'risk free' triple A rates securities - the source of cheap debt that fueled the M&A market in general and the buying power of private equity parties in particular.

In the last few years the securitization market has become very complex and has evolved to accommodate new asset classes, such as collateralized fund obligations (CFO). Private equity funds are more challenging to securitize mainly because private equity funds do not have a predictable and steady flow of income on which the structure can rely. The timing of the drawn down out of, and distributions into the structure are unknown. It is subject to capital calls and investment realizations.

What can we learn from the credit crisis?

Due to the expected future defaults and liquidity issues in private equity portfolios investors are increasingly seeking to quantify their exposure to loss. Therefore the concept of risk management for private equity assets is gaining momentum. Risk management techniques such as simulated Value-at-Risk (VaR) could involve generating cash flow and portfolio re-pricing scenarios. Supplemental stress tests can provide more information whether or not there is enough liquidity available if the private equity funds invest without any exit window.

However, models cannot replace reality. If there is one thing we learned from the credit crisis, it's, that even for the well incorporated mortgage backed securities, quantitative data derived from models cannot account for the complexity of the world today. At best models can provide some useful information for decision making. Seemingly robust risk management tools and frameworks can prove inadequate. The credit crisis increased the awareness that return is a byproduct of risk taking. When you invest in something without understanding the risk involved, there is no way you can value the return. Therefore investors should take a holistic approach to risk, integrating operational, credit, market, liquidity and reputation risks and make sure that it is implemented in the day-to-day business.

The 'simple' mortgage backed securities have given rise to a level of losses worse than ever thought possible. The current economic slowdown will answer the question whether securitizing the more complex asset classes such as private equity funds will trigger the next round in the credit crisis.

The views and opinions expressed herein are those of the author. Wilco Schoonderbeek is responsible for the Private Equity and Corporate M&A practice of Protiviti within the Benelux.