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Have Pre-Crisis Levels of Risk Returned in US Structured Products?

Christopher L. Culp and J. Paul Forrester dispel several widely held beliefs about heightened risk in structured products but suggest that regulatory measures and regulatory uncertainty may threaten the very future of the US structured finance market.

From 2011 through 2014, new issuance of US structured products backed by subprime auto loans or leveraged corporate loans grew by 55 percent and 716 percent, respectively. During this same period of time, various regulators and market commentators warned that the credit risks inherent in the collateral underlying related to US structured products has returned to—and, in some cases, exceeds—pre-crisis levels. Some observers contend, moreover, that the recent heightened demand for structured products is fueling a "credit bubble" akin to the subprime mortgage lending and house price "bubbles" that ended in the credit crisis that erupted in 2007.

"While evidence points to higher risks in collateral, analysis doesn't indicate a commensurate increase in risks to investors."

Culp and Forrester's paper analyzes recent activity in these markets and activity and risks in the loan markets underlying auto asset-backed securities (ABS) and collateralized loan obligations (CLOs). While the empirical evidence presented points to higher risks in auto and leveraged loan collateral, the authors' analysis does not indicate a commensurate increase in risks to investors in the structured products based on those loans. For a comparison, market activity and risk indicia in US insurance-linked securities (ILS) are reviewed, which—unlike auto ABS and CLOs—serve a pure risk transfer purpose and do not result in any significant extension of credit by investors to sponsors. The paper also considers the likely impacts of the Volcker Rule and the Credit Risk Retention Rule on US structured product markets, concluding that these regulations are likely to stifle market activity and discourage legitimate risk transfer.

"Robust investor interest in structured products is not merely irrational yield-chasing."

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The full paper can be found at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2580049.

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Current data indicates robust investor interest in many structured products, and Culp and Forrester believe that post-crisis changes in the design and documentation of these products together with heightened investor awareness and better access to information suggest that such interest is not merely irrational yield-chasing. The authors also hold that, in the post-crisis world of structured products, the recent surge in new issuance of auto ABS, CLOs, or ILS is not a *prima facie* reason to be worried about these markets.

In particular, regarding subprime auto ABS, the empirical evidence does not substantiate the widespread concerns that these products will be a repeat of subprime RMBS. Despite an expansion in subprime auto lending and various indications of higher risks for subprime auto lenders, auto ABS investors seem to be largely—albeit not entirely—insulated from those heightened risks.

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Similarly, the leveraged loan collateral underlying CLOs has indeed experienced a discernible increase in risk in the last few years, especially with regard to the proportion of borrower-friendly loans syndicated. Nevertheless, the authors do not see any obvious indications that these heightened risks translate into higher potential losses for investors in CLO liabilities.

The ILS market provides clear evidence that investor demand for structured products does not automatically imply fuel for the expansion of a credit bubble because ILS do not involve any extension of credit by investors to sponsors. The evidence indicates, moreover, that investors in ILS have become more diversified, better attuned to the risks underlying ILS, and more conscientious about ILS product design in recent post-crisis years.

By contrast, significant ongoing regulatory uncertainties pose real threats to the future of the US structured finance market. Unless considerable efforts are made by regulators to address the significant costs imposed on structured products (without any obvious benefits) by certain new and proposed regulations, Culp and Forrester continue to fear for the prospects of these markets.

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