Abstract (Summary)
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Full Text (920 words)
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London -- The investments were "synthetic" but the pain may be real.

Investors are already paying the price for buying billions of dollars of complex securities, known as synthetic collateralized debt obligations, tied to the fate of U.S. homeowners. Now, they may be in for some unpleasant surprises from the much larger market for similar investments linked to the credit-worthiness of companies.

All but nonexistent a decade ago, synthetic CDOs grew popular in recent years, especially in Europe, as a way for insurance firms, banks and hedge funds to invest in a diversified portfolio of companies without actually buying their bonds. While the investments have stabilized since suffering with the broader credit markets earlier this year, some analysts are warning of more trouble ahead.

The problem: Most corporate synthetic CDOs are linked to the debt of U.S. companies, some of which are looking a lot shakier amid an economic slowdown. To make matters worse, some credit-rating experts burned by the subprime-mortgage crisis are taking a closer look at the way they rated synthetic CDOs. That could trigger downgrades in the $6 trillion market, forcing some investors to sell their securities or at least post significant losses.

"We will start seeing investors getting increasingly nervous" as downgrades pick up, says Michael Hampden-Turner, credit strategist at Citigroup in London. "There is more . . . pain for synthetic CDO investors."

As opposed to regular CDOs, which contain actual bonds, synthetic CDOs provide investors with income by selling insurance against debt defaults, typically on a pool of 100 or more companies with relatively high "investment-grade" credit ratings.

To attract different types of investors, they issue securities with different levels of risk and return: Holders of the riskiest pieces reap the highest return but suffer the first of any losses. That makes it possible for other, more-senior pieces to win top-notch grades from ratings companies.

Banks and insurance companies, such as American International Group and French insurance giant Axa, snapped up highly rated pieces, which typically offered a better return than similarly rated corporate bonds. Hedge funds often bought the riskier pieces, attracted by even higher returns.

Now, though, the CDOs aren't looking as good as they once did. That is in part because the banks that created them, in order to achieve more attractive returns, often filled them with companies that had among the lowest of investment-grade ratings, meaning they were among the riskiest of high-quality borrowers.

As the financial crisis takes its toll on the broader economy, some of those companies are seeing their credit ratings downgraded to "junk" - moves that have a negative impact on the ratings and value of CDOs that contain them. In May, ratings firm Standard & Poor's downgraded to junk status Countrywide Financial Corp., one of the
more widely referenced companies in synthetic CDOs. Another investment-grade company popular in CDOs was Sprint Nextel Corp., which S&P downgraded to junk last month.

CDOs' problems could also be magnified in coming months by a new policy at Fimalac SA's Fitch Ratings, the third-largest bond-rating service after Moody's Corp.'s Moody's Investors Service and McGraw-Hill Cos.' S&P. Fitch plans to apply a much more severe methodology when it reviews the ratings on hundreds of synthetic CDOs over the next few months.

Nearly half of the $50 billion of top-rated synthetic CDO paper Fitch rates could face a warning and possibly a downgrade, while about $8 billion of lower-rated deals could fall to "junk" status, according to a report by J.P. Morgan Chase analysts Jonny Goulden and Yasemin Saltuk.

Analysts aren't expecting a similar wave of downgrades by Moody's and S&P just yet, but they aren't ruling out the possibility. S&P spokesman Mark Tierney said his firm has focused mainly on adjusting the way it rates mortgage CDOs, though key assumptions on all CDOs are "under review." A Moody's spokesman said the firm may tweak its methods for synthetic CDOs rated out of Europe, but that this shouldn't result in downgrades.

Because many banks and insurance companies face strict limits on the ratings of the investments they can hold, downgrades could trigger selling, pushing prices down and exacerbating losses.

"There are some investors that could become forced sellers," says Jeffrey Kushner, managing director at New York-based BlueMountain Capital Management, an asset manager that focuses on credit investments.

To be sure, whatever troubles synthetic CDOs face in the months ahead probably won't be as bad as those seen with CDOs linked to mortgage debt, analysts and investors say. Most companies' finances remain relatively healthy. Also, corporate CDOs are simpler beasts with a longer track record, having survived a downturn early this decade.

To some extent, the current prices of synthetic CDOs already account for significant difficulties to come. One index that tracks the cost of default insurance, the Markit CDX index, suggests investors are expecting about one in 13 investment-grade companies to default over the next five years, according to Ashish Shah, global head of credit strategy at Lehman Brothers in New York. That is more than has been seen over a five-year period since the 1980s, he says.

Still, analysts see ample reason for concern. For one, many economists are expecting the current downturn in the U.S. to be worse than the relatively mild recessions of the past couple decades. Beyond that, says Brian Yelvington, a strategist at independent research firm CreditSights in New York, the original credit ratings on many deals were far too rosy. So even if defaults don't break records, many CDOs could still face downgrades.
How Does a Synthetic CDO Work? 📝

Synthetic CDOs provide investors with income by selling insurance against defaults, typically on a pool of 100 or more companies.

The synthetic CDO sells insurance against corporate debt defaults.

Corporate defaults become losses.

Banks, insurance companies

Hedge funds

Investors

Buyers of Insurance

Pay insurance premiums

AAA rated

AA

BBB

unrated