Structured Finance Litigation: CRSM v. Barclays

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1 Introduction

Mr. Justice Hamblen of the Commercial Court in London recently handed down a judgment in which he dismissed all claims that had been brought against Barclays.[2] The claim related to a series of structured finance notes (CDO^2) with a combined par value of EUR 230 million which were structured by Barclays and sold to Cassa di Risparmio della Repubblica di San Marino SpA ("CRSM") in 2004 and 2005 and to a subsequent restructuring of the transactions. CRSM initially brought a claim for misrepresentation but shortly before trial amended their pleading to fraud.

The decision in this case has implications for both the banks that create and structure CDOs and the investors who purchase them. This article gives a brief summary of the transactions underlying the case, the key findings by the judge, and some of the implications of the judgment.

2 Background

The Transactions

In December 2003 Cassa di Risparmio della Repubblica di San Marino SpA ("CRSM") was seeking funding for its consumer finance subsidiaries, known as the Delta Companies, and approached Barclays. Barclays determined that securitisation, CRSM's preferred funding method, was not feasible and instead proposed that the loan be supported by credit linked notes (CLN) bought by CRSM.

The total amount lent by Barclays to the Delta Companies was €700m, spread over several tranches and over a period of 8 months, and supported by five CLN transactions with aggregate principal of €450m. One of the CLNs did not contain a CDO^2 component and was not part of

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[2] *Cassa di Risparmio della Repubblica di San Marino SpA v. Barclays Bank Ltd* [2011] EWHC 484 (Comm).

the claim. The four disputed CLNs were comprised of €176m credit default swaps ("CDS") on the Delta Companies, and €230m in CDO^2.

The CDO^2 were all single-tranche synthetic transactions, where CRSM purchased a bespoke mezzanine tranche and Barclays effectively held the equity and senior tranches. Each CDO^2 consisted of six inner CDOs and AAA-rate ABS such that the overall rating of each Note was AAA.

Subsequent Events

In March 2005, CRSM expressed concern about the presence of certain names in the reference portfolios. There was an ongoing crisis in the US automotive industry at the time and a general concern about the creditworthiness of entities in the industry. Following discussions between the parties, Barclays proposed a restructuring of the four CDO^2, with two components: i) replacing some of the reference entities and ii) adding "cross-subordination" to the CDO^2 structures.[3]

The restructuring was implemented on 14 June 2005. This included revisions to the documentation and changes to the CDS to reflect cross-subordination and the changes in attachment and detachment points.

In late 2005 the quality of the CDO^2 began to deteriorate as defaults in the underlying reference entities began to occur. In April 2006 Barclays agreed to repurchase the first of the Notes (par value €100m) at a dirty price of 98.63%. The second Note (par value €60m) was repurchased in November 2006 at a dirty price of 95.84%. The final Notes (par value €70m) saw their principal eroded by a string of defaults, and in February 2010 Barclays formally notified CRSM that the principal had been reduced to zero.

CRSM filed their claim in the High Court in August 2008.

[3] The addition of cross-subordination to the structures meant that the attachment and detachment points had to be changed. The net result was an increase in subordination at the inner CDO level, and a slight decrease in subordination at the outer CDO level.

3 The Case

Points of Contention

CRSM claimed that the CDO^2 at the heart of the CLNs were riskier than was implied by their AAA rating, and that Barclays was aware of this. CRSM contended that a rating of AAA implies a very low probability of default (PD) (less than 1% over a 5 year period), whereas Barclays' internal pricing model implied a PD of about 30%.

While not in the original claim, they eventually contended that this increase in risk had been achieved by what they called "credit ratings arbitrage", namely the selection of reference entities with high spreads for their ratings. According to CRSM this both obscured the actual risk of the Notes and created an instrument whose actual default risk was much higher than was implied by its rating. According to CRSM, this "arbitrage" allowed Barclays to book large profits from the transactions, which CRSM claimed more closely corresponded with the "true" risk levels to which they were exposed by the Notes.

Similarly, CRSM claimed that the effect of the restructuring was the opposite of what was represented by Barclays: namely that it increased CRSM's risk, thereby reducing the value of the Notes even further, and gave Barclays the opportunity to extract further profits.

Barclays responded that CRSM's so-called "arbitrage" was based on a meaningless comparison: a AAA credit rating is an opinion from a ratings agency about the expected performance of a security over its entire life; it is therefore a long-term view. On the other hand, internal modelling such as Barclays carried out is not concerned with estimating how risky a transaction is but rather with valuing it based on market spreads, to mark it to market, to calculate the appropriate hedge and to calculate notional expected profit at the time of the transaction; it is inherently a short-term view.

Additionally, Barclays pointed out that structuring CSOs inherently involves putting together reference portfolios with high credit spreads relative to the coupon paid on the CSO^2. The object of the exercise is to repackage portfolios of high-yielding, lower-rated credits into a lower-yielding, higher-rated structure. Barclays accepted that it had sought to make a profit on the transactions and restructuring by selecting high spread names; this is the basis of the business.

However, it did not consider those profits to mean that there was a high or equivalent real world PD.

What emerged as one of the central areas of dispute between the parties was whether an implied PD derived from either Barclays' modelling or CDS premia provided a reliable measure of "real world" probability of default. CRSM claimed that it was a highly reliable measure, and that the results of these calculations showed that Barclays was aware that the Notes had considerably more risk than was implied by the AAA rating.

Barclays' response was that this approach was fundamentally flawed. They pointed out that it has long been known in the academic literature that credit spreads reflect more than default risk. The exact reasons for the difference between implied probabilities and historical or "real world" probabilities have come to be known as the "credit spread puzzle". For example, Hull *et al.* state:[4]

> *Why are the two estimates of the probability of default so different? The answer is that bond traders do not base their prices for bonds only on the actuarial probability of default. They build in an extra return to compensate for the risks they are bearing.*

Given the credit spread puzzle, Barclays argued it was not surprising the implied PDs from their modelling should differ from the historical default rates for AAA-rated securities; nor was it a reason to doubt the validity of the rating agencies' assessment that the CDO2 qualified for a AAA-rating.

The Decision

Mr. Justice Hamblen made numerous findings, but among the most important for the readers of this publication are the following:

1. *The use of ratings in representations to clients.* The judge held that a statement by an arranging bank about a AAA rating was not a general or abstract statement about risk or PD, but only a statement about the rating agency's opinion. He said that the fact that a Note had been rated AAA:

[4] Hull, J., Predescu, M., White, A., "Bond Prices, Default Probabilities and Risk Premiums," *Journal of Credit Risk*, Vol 1, No. 2 (Spring 2005), pp. 53-60. See also Longstaff, F. A., Mithal, S. and Neis, E. "Corporate Yield Spreads: Default Risk or Liquidity? New Evidence from the Credit Default Swap Market", *The Journal of Finance*, Vol LX No. 5 (October 2005), pp.2213 – 2253.

"was not a statement about market opinions concerning default probabilities or risk. It was certainly not a statement about a structuring or selling bank's estimate of modelled (spread-implied) default probabilities or risk."[5]

2. *Are implied PDs reliable estimates?* The judge found that historical default data, gathered over long periods covering all phases of the business cycle, are a reliable source for estimating expected future default rates.

   "... an implied probability of default derived from EL figures taken from the output of a pricing model such as that used by Barclays does not provide a reliable measure of the real world probability of default"[6]

3. *Using Barclays' modelling to derive PDs.* Judge Hamblen rejected CRSM's claim that the model used to compute Barclays' expected P&L could also be used to estimate the PDs expected over the life of the Notes:

   "... it was the valuation figure that banks such as Barclays were interested in for hedging, MTM and P&L purposes. It was not viewing or using the model as an estimation of long term default risk."[7]

4. *"Non-reliance" clauses.* The judge found that a contractual term in the sales contracts (similar in substance to an ISDA "Non-reliance clause) would in any event have precluded the claim, with no finding of fraud. By the term, CRSM warranted that it understood and accepted the terms, conditions and risk of purchasing the notes.

   "It is contractually estopped from asserting that it was induced to enter into the contract by a misunderstanding of the nature of the risks entering the transaction and purchasing the Notes."[8]

4 Implications

This case was considered a test case for other potential cases involving the sale of structured finance investments. The outcome of this case does not mean that other cases involving CDOs or CDO^2 cannot be brought, but that they will have to meet the criteria laid out by Justice Hamblen in his carefully reasoned judgment if their case is to succeed in the English High

[5] CRSM v. Barclays, ¶264.

[6] CRSM v. Barclays, ¶296.

[7] *Ibid.*, ¶302.

[8] *Ibid.*, ¶525.

Court. Alternatively, potential plaintiffs could seek to bring their case in other jurisdictions that are perceived as being less "bank friendly" than London. Several such jurisdictional disputes are ongoing at this time.