



The ties that bind

By Antony Currie

Cover Story — Weathering the Storm

Uncertainty still surrounds the subprime mortgage business. True, much of the immediate bad news is already out in the open. With so few independent firms left we're unlikely to see another rush of lenders close or go bankrupt. And the prices of mortgage bonds and default swaps have mostly stabilized after being in a freefall for several weeks.

But the effects of the crisis are far from over; you cannot simply brush off such a painful end to a four-year bull run. Each of the participants in the financing chain that so benefited each other in the previous few years still faces tough times ahead, whether borrowers, lenders, investment bankers, mortgage bond buyers or CDO players.

Depending on whose research you prefer, anywhere between one million and two million Americans face losing their homes over the next two years. That's when losses are likely to hit mortgage bonds and CDOs, too — though how much is also a crapshoot, and how to deal with it is a topic of much discussion. Analysts cannot even agree how many subprime mortgage bonds lurk within the average structured finance CDO sold in the last couple of years. Estimates range from about two-fifths of the portfolio to as high as 80%.

What's more, the twin threats of litigation and new legisla-

tion hang in the air — for investors as well as those who made the loans. If too onerous, this could stymie any recovery.

But it's not all doom and gloom. The market is adapting to the new realities. Lending standards have sharply improved. Investment banks still want to own a slice of the origination market. And new money in the form of hedge funds and private equity has already jumped in hoping to swoop up assets on the cheap. That's not to downplay the hard choices still ahead. But cooler heads are starting to prevail, and it's looking more like a question of when, not whether, a healthy subprime mortgage industry reemerges.

What's pretty certain is that it will look radically different. And so it should. Any business whose protagonists all played a hand in lurching it first into irrational exuberance and then into turmoil is in need of a major overhaul [See box, p.31]

The good news is, that's already started, as is demonstrated by the broad switch to new lending standards. The vast majority of originators have already pledged to stop offering riskier products to people with poor credit, and instead are returning to basing their lending decisions on the principles of the three C's — character, capacity and collateral. It's not an overnight process, so it's still unclear exactly what the current breakdown



Investors, investment bankers, lenders and borrowers all benefited from the subprime mortgage boom. Now, to varying degrees, they're suffering from the market's slump, or soon will be. There are no quick fixes. But the industry is already adapting.

is: “We are all still working out exactly what the product mix of new loans is,” explains Rahul Parulekar, director, MBS and real estate ABS strategy at Citigroup. “But in general collateral quality is showing signs of improvement over last year.”

That by itself isn’t enough. Buyers are going to be a lot more wary about professions of better loan quality: “This year’s loan product is better,” says Hugh Corcoran, head of mortgage bond trading at UBS. “But it’s a question of believing that you have the right loss models — and that you trust them.”



So even though loan prices have stopped plummeting, and have even recovered somewhat, they’re still not back to normal. “The good stuff is still only trading at par,” says Corcoran. “That has people asking a lot of questions. What will bring the market back? How can businesses sustain themselves until it does come back? And what will it look like— dominated by a couple of major players, just a Wall Street affair, or a mix?”

One type of player seems destined not to play much of a role — the independent specialist. The continued existence of such firms was already under threat last year as the investment banks that had previously showered them with credit lines to get first dibs on their loans started buying businesses outright. Barclays Capital, Deutsche Bank, Merrill Lynch and Morgan Stanley each snapped up lenders, servicers or both.

But the crisis also demonstrated just how fragile their business models were in a downturn that both undermined the price for decent loans as well as forced them to buy back bad loans such as early payment defaults. “The monoline finance firms typically needed to post between two and three points of margin to fund their loan production. And most of their equity cushion was tied up in these warehouse line margins,” says Andy Kimura, co-head of mortgage trading at Credit Suisse. “So consider what an enormous drain on economic capital the last few months were: between 70% and 80% of loans were clearing at around par, which is already only break even at best. The rest were kicked out of deals, and marked down to perhaps 90 cents on the dollar. So any equity that was embedded in these loans disappeared with the mark to market. It didn’t take long for thinly capitalized firms to lose their equity cushion. Their capital structure required them to clear loans at over 102 cents with a low percentage of kick-outs.”

Take Accredited Home Lenders as an example. Before the troubles hit in February the firm had more cash on hand than many of its peers, about \$400 million. It had burned through most of that by mid-March. What pulled it back from the brink? A lifeline from one of the new players in the business — a hedge fund. San Francisco-based Farallon Capital stumped up a \$200 million loan. Why? Well, it was handed warrants to buy 13% of the company at \$10 a share, below where the stock was, and is,

trading. That’s some good upside. Farallon is also protected on the downside. The loan is not only secured, it also carries a 13% coupon — double the return on the average junk bond.

Of course, Farallon is not alone. Other hedge funds have been active as well. Citadel took a 4.5% stake in Accredited a few days later, just two weeks after beating Credit Suisse in an auction for ResMae. Others, including Carrington Capital, Ellington Capital and Newcastle, a unit of Fortress, have been big buyers of loan portfolios sold at a loss by the likes of Fremont and New Century. Carrington also bought New Century’s servicing business.

That hedge funds, especially those like the latter three that specialize in mortgages, are buying distressed loans, servicing platforms, and even taking small but significant equity stakes is no surprise. It fits in well with what they do already.

But it’s private equity that is taking on the mantle of the leading independent lenders. In the last 12 months two big LBO shops have suddenly become major players. Fortress bought Centex Mortgage and Champion Mortgage last year, merging them to form Nationstar.

Meanwhile, Cerberus now owns a majority stake in Res-Cap, even managing to hold off closing the deal until previous owner General Motors stumped up to cover the deterioration in book value as the mortgage market soured. By the end of the year it should add Option One. It has agreed to pay current owner H&R Block book value at closing less \$300 million. That could work out to be less than \$400 million, according to UBS analyst Kelly Flynn. If, as many expect, Cerberus merges the two units it will not only reap a bundle in synergies, it will also own what would be, on last year’s numbers, the largest subprime lender in the country.

Of course, they’re not the only ones to have swallowed troubled assets whole. In April Barclays Capital managed to cut by two thirds to \$76 million the price it was paying for Equi-First, Regions Financial’s subprime business. Citadel picked up ResMae, and Credit Suisse snared Lime Financial.

The upshot is that virtually all the major subprime lenders are now in the hands of much better capitalized institutions, be they investment banks, private equity funds or large banks like HSBC and Wells Fargo. This shift ought to be positive. For starters, these firms are much better equipped to deal with a prolonged downturn. Says Michael Marriott, co-head of mortgage trading at Credit Suisse: “What the embedded costs of the business are is of crucial importance now. No one knows how long it’ll take for the market to recover. So the lower the fixed costs now, the better.”

There is also the assumption that larger players are more careful owners. “It’s preferable that the industry is in better capitalized hands,” says Kimura. “It should foster more financial discipline — the feedback from the performance of the loans in capital markets deals should run through the system more quickly, and be heeded more.” Of course, there’s no guarantee. After all, being big didn’t stop HSBC from tripping up.

There is at least the comfort that, if there were another crunch in the market, these new owners would be much better

placed to weather the storm. After all, large commercial banks and Wall Street firms are more than willing, and able, to sell regular corporate loans at a loss just to get them off their books and free up capital — though admittedly in the hope of winning other more lucrative business.

Better standards, more attention to credit quality, owners that are bigger, better capitalized and, in theory more disciplined, should all shore up the market. “So loan pricing should improve,” says Kimura. Of course, there’s always the snag of competition, and that’s playing a role even now, he explains: “To get 102.5 cents on the dollar and be profitable you need to charge borrowers interest rates over 9% in the current market, almost a percentage point more than last year. But there are still players out there making cheaper loans, which continues to strain the industry.”

How the lending market is changing is just part of the story. For the rest, we have to turn to the capital markets. Here, three questions dominate: will the government enact legislation that makes Wall Street and investors liable for poor lending? Where are the losses? And will CDO managers regain their voracious appetite for subprime mortgage bonds? The answer to all three is a simple one: no one knows.

Let’s consider the losses. There have been no blow-ups, no money managers leaving their posts under a cloud. And every single U.S. investment bank posted first-quarter results that showed barely a scratch from the market upheaval. That’s probably one of the reasons why it’s so attractive to blame Wall Street for subprime’s woes. With little blood on show, outsiders can be forgiven for thinking that securitization has taken its cut and escaped scot-free.

But that’s the thing with securitization. Because it’s designed to withstand a degree of loss, pain flows through very slowly. That means developments in the next 12 months will be critical for determining when, and in what form, the subprime

mortgage finance market gets back on both feet.

There are already some encouraging signs. Spreads on mortgage bonds are still wider than at the peak of the boom, considerably so for much of last year’s vintage. But they have come back in for those backed by this year’s improved crop of loans: triple-B paper has been launching as tight as 250 basis points over Libor.

CDO managers seem to be coming back somewhat as well, though at much reduced levels. That’s especially true for CDO managers taking exposure through the mortgage credit derivatives market: “The CDO bid is back, but it’s much smaller, by as much as 75%,” says Greg Lippman, head of ABS and CDO trading for Deutsche Bank in New York.

But it is far too early to determine whether this is the beginning of the turnaround. Much of the CDO activity may be little more than bottom fishing for existing deals. That, as well as any appetite for new mortgage bonds from the broader markets could falter again if losses on earlier investments start hitting, or if Congress does indeed take punitive action [see box, below].

The big test, at least on the former, might not be that far away. The ratings agencies have already started downgrading subprime RMBS. “The next thing we’ll see are CDO downgrades, probably before the end of the year,” says Anthony Thompson, head of ABS and CDO research at Deutsche Bank. “It’ll probably be a similar story to high-yield bond CDOs in the late 1990s: experienced managers with proven track records will rise above the pack. Many of the rest will just go away.”

In other words, losses are just as likely to force a shake-out of CDO managers as they did among lenders. “The next 12-18 months will see consolidation and retrenchment,” says Thompson. “Neither subprime mortgages nor the mortgage default swap product CDO managers have increasingly relied on will go away. But they will likely be refined.”

That’ll cause some conflicted emotions on Wall Street. On

The case against legislation

Even Warren Buffet’s taking pot shots at securitization. At the annual shareholders meeting of his investment firm, Berkshire Hathaway, the Oracle of Omaha had this to say: “Once you package those things and sell them through major investment banks, discipline leaves the system...Securitization has made the problem worse.”

He’s not alone. Washington’s politicians are hunting for subprime mortgage scalps. And some, including Barney Frank who heads the House Financial Services Committee, are talking of extending liability for poor lending to MBS and CDO investors. It’s a good way to score points with voters. But any such legislation runs the risk of undermining the mortgage market altogether.

That’s not to absolve investors of their role in the crisis. Their hunt for yield fueled at times blind demand for subprime product even as the signs of

a housing slowdown grew. They weren’t alone. Subprime mortgage finance became a lucrative business: New Century’s net profit jumped more than eight-fold between 2001 and 2005. Keeping that train rolling was enticing. Some borrowers got greedy as well, for example overstating income to secure a loan.

But Congress has arrived late to the game. Lending standards have tightened, new business has dropped sharply, and the capital markets have already repriced risk, leaving deals with the worst loan pools looking like toxic waste.

Lawmakers may still have a role. But it shouldn’t be to target the secondary market. In fact, laws already exist to punish institutions that buy fraudulent loans from originators [see article, p.44]. Nor should investors be the focus of Washington’s wrath. They are too removed from the lending process. And in any event poor investing decisions will be

punished by losses as defaults increase.

Worse, putting investors on the hook for dud loans could scare many of them off. For starters, assigning liability to investors would not be easy. That would make it tricky for them to assess the risks they’d be taking. Meanwhile, those who stayed in the market would probably demand a fatter premium. The end result would be much bigger profits for the remaining investors, but more expensive mortgages for borrowers and no guarantee that fraudulent or improperly sold loans would be a thing of the past.

Reinforcing the industry’s newfound appreciation of stricter lending and property valuation standards, while not as headline-grabbing as going after Wall Street, would be a better use of Congress’ time. It would remove most incentives lenders had to accommodate the voracious appetite of investors, borrowers — and themselves.

the one hand, fewer CDO deals means less fees. On the flip side, investment bank trading desks will be somewhat more protected. Over the last couple of years CDO managers very much gained the upper hand over them, often regardless of an asset manager's skill or experience. They would park cash bonds in investment banks' warehouses for weeks while ramping up deals, or submit multiple bid lists for default swaps that they had spent days or weeks evaluating and now wanted their middle men to execute within hours.



The subprime storm isn't over. But silver linings are starting to appear.

Credit Suisse's Marriott agrees. "There was a disproportionate amount of risk assumed by the dealer community. That led to some pain, so our side of the Street will probably demand CDO managers who are both more experienced and better capitalized."

Investors in CDOs will probably entertain similar thoughts. Of course there are many who perhaps should not have been buying CDOs to start with who might now be scared off. Consider a couple of jaw-dropping stories in the press during the crisis. An article in the Wall Street Journal in the first half of March got hold of the scuttlebutt at a Citigroup European credit conference in Monaco, where some European credit investors who had bought CDOs were complaining that they were not aware their holdings held exposure to U.S. subprime mortgages. Fast forward a few days to a Bloomberg story, in which a Texas pension fund manager admitted he bought CDO equity hoping to reap some outsized returns yet without actually knowing what the underlying collateral was.

Losing these less savvy investors is no doubt a good thing for the market. If enough of this blind demand for such paper is purged from the system, it could have precisely the effect politicians like House Financial Services head Barney Frank want to see at the other end of the financing chain: interest rates that are high enough to discourage individuals from searching for cheap financing when they really aren't, financially, in a position to buy a house.

But there's also a danger that investors of all hues will have to divert their attention from new deals to clean up their existing portfolios if and when downgrades start hitting CDOs. It could even get to the point where the different classes of investor battle for control of CDO cash flows. Consider this scenario: in a recent report, Moody's pointed out that because of the way many deals are structured, investors in senior debt tranches might actually be better off if their slices are downgraded. That's because once downgraded by a certain number of notches various fail-safes are triggered that shut off payments

to equity investors and re-route the cash to protect those higher up the structure. Senior debt holders could then be pushing the ratings agencies for multiple downgrades, while equity owners lobby for fewer.

Such issues might only be a temporary distraction. But if there are enough downgrades to cause pain across the capital structure, even the most sophisticated investors could decide to abandon the subprime CDO product. It's happened before — just mention manufactured housing and high-yield bond CDOs to anyone who's been in the market for more than three or four years. "If there are large-scale downgrades it will cause problems. For example, it'll make it more difficult to source equity," says Thompson. "That's a sophisticated, but somewhat limited, pool of money. And if those investors get too hurt they'll be reluctant to buy the same product simply on a promise that it's a better version of what came before. Many will move on to something new."

That wouldn't kill off subprime lending. But it would quickly reverberate back along the finance chain. Without the demand from investors in CDO equity, there'd be much less demand for the riskier tranches of subprime-backed mortgage bonds. If it gets harder to sell those portions of deals over the long term, then issuers would have to pay higher interest coupons on their bonds. For an industry that is already struggling to make loans at break-even rates, there's only one option: pass on the extra costs to the borrower.

That's a doom and gloom scenario. But the better-prepared CDO managers still have a few tricks up their sleeves. First, many learned from their experience with high-yield and manufactured housing CDOs and added a double-B bucket to their deals that they left empty. This means that they can hold on to downgraded assets if they feel they're still a good longer-term investment, rather than being forced to sell them at a loss.

Then there are triggerless CDOs. These started making an appearance in the middle of last year, accounting for 21 of the 90 mezzanine structured finance CDOs sold in 2006, according to Credit Suisse CDO analyst David Yan. Those who bought the senior debt might not be so happy now, but the lack of triggers to divert cash flow up the structure gives equity holders a lot more protection in a downturn. There are even a handful of CDO managers who apparently raised money a year or two ago but didn't actually put it to work. Now, according to bankers, they're picking up assets on the cheap.

Longer term, taking a position in the subprime U.S. housing market will still offer opportunities. It will after all remain a significant part of the economy. Deutsche's Thompson explains how it might work after the shake-out: "The market could simply divide into two camps: investors seeking subprime exposure without the idiosyncratic manager risk will move towards index and leveraged index products; others will continue to sponsor a limited universe of superior managers who indeed have outperformed and continue to justify being paid a fee to do so. But given the risks of the asset class, there's going to be a lot less room for the mediocre middle." Coupled with a more responsible lending market, that could mean a more robust subprime mortgage finance market. But getting there will be a bumpy ride. ▼