

By Neil O'Hara

Resetting the Bar

From ratings to leverage to liquidity, many of the credit market's fundamental assumptions have been found wanting. Structured finance has felt the pain the most thus far. But chastened players and a new set of market dynamics are already emerging.

The firestorm that roared through the credit markets torched fundamental assumptions about how structured debt instruments trade and what they are worth. Life goes on, however, and money managers have begun to reassess what role structured financial



Leverage is fine, if you can manage the load

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products should play in their portfolios. Like a phoenix, the structured credit markets predictably will rise from the ashes. While the final shape has yet to be determined, it is already clear the post-crisis form will be a different animal.

Of course, the fire isn't out and may not even be under control yet. Despite the dramatic rating downgrades that have occurred so far, Ralph Daloisio, a managing director in the New York-based structured finance group at Natixis, expects another flare-up in subprime mortgage bonds. He points out that in some subprime vehicles a tranche the ratings agencies have already slashed to triple-C — well into junk territory — sits right underneath a tranche still rated double-A. "The top tiers, double- and to some extent triple-A, have started to get hurt," Daloisio says. "But not as much and not as severely as I believe will ultimately be the case." It's a moving target, though, because the agencies have revised the parameters used to determine ratings now that cumulative losses have so far exceeded expectations.

Market prices suggest that investors believe the ratings agencies are still too optimistic, however. Daloisio says Street estimates of cumulative losses outstrip the agencies' assumptions by up to 10 percentage points. That means another round of downgrades could occur unless a systemic change alters the environment. For example, if the various initiatives on Capitol Hill coalesce, a taxpayer bailout of the worst-affected mortgage sectors could persuade the market that the agencies' expectations were correct.

Even without the prospect of rating downgrades, real money buyers — unlevered investment funds — have little incentive to jump into a market dominated by leveraged institutions, many of which face intense pressure to cut back their borrowing. Banks, securities dealers, structured investment vehicles and hedge funds all hold boatloads of structured products for which no market exists at a time when risk managers are screaming at traders to cut back their exposure. Managers of these entities spend their lives juggling potential returns on their assets against the risk of leverage, but the market dislocation has knocked them off balance.

Daloisio notes that Bear Stearns had about four times its net worth invested in mortgage-backed (MBS) and asset-backed (ABS) securities. That wasn't the fatal blow that killed the Bear — concerns about its greater reliance on short-term liquidity played a bigger role. But it was certainly a factor adding to fears the Wall Street firm was overextended. Other dealers have similar leverage. Says Daloisio: "Every firm has to ask whether their MBS/ABS book is the right size relative to their whole portfolio in the current environment, and whether they are using the right amount of leverage." The answers will vary by institution and depend on how much leverage is required to generate returns competitive to those available on other assets. Investment banks

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are already bringing their total leverage ratios down — net leverage hit almost 20 times in the boom years. Lehman Brothers set the new benchmark after it issued \$4 billion of convertible preferred stock in April, taking its net leverage down to around 13.5 times.

Horses, carts and automobiles

In today's market, risk premiums are so high for structured debt that less leveraged and even unleveraged returns may be sufficient, but in calmer times narrower credit spreads will once again drive leverage up.

The conundrum isn't confined to the subprime MBS book. Although defaults will be far lower in Alt-A mortgages and lower still in the prime sector, the capital structure of securitizations already reflects those assumptions. For example, a 1% loss rate in a subprime pool would have investors dancing in the street all the way down the capital structure, while the same rate in a prime MBS pool could be a cause for concern for the triple-A tranche because the historical default rate on which the agencies base their ratings is so much lower. "What really matters is where losses come in relative to the original expectations used to size the capital structure," says Daloisio. It's hard to estimate the ultimate losses on MBS while the housing market is soft, however. History shows that delinquency and default rates soar when home prices shift from marginal appreciation to a decline of 10% or more. Daloisio expects potential buyers of underperforming MBS to stay on the sidelines at least until the rate of home price depreciation slows.

Investors have to reassess the information and technology they need to make sound investment decisions about structured products, too. Even if the available data is reliable, most of it is not updated over the life of the MBS pool. Investors know the borrower's FICO score and loan-to-value ratio at the time a mortgage loan is made but not how the numbers change later on. "How many investors have market price estimates for the assets that serve as collateral in a mortgage pool?" Daloisio asks. "Not

many."

He draws a parallel between today's credit modeling techniques and automobiles at the beginning of the last century. Cars were a huge step forward from the horse and cart, but the early versions broke down frequently and didn't work as expected. By the same token, private-label securitization took root quite recently and the analytical infrastructure is even younger. Structured debt investors need a technology framework equivalent to Lincoln Continental rather than its antecedent, the popular but cranky Ford Model T.

The perils of bottom fishing

Investors' caution may be reinforced by the experience of a few brave souls who went bottom fishing too early and got caught out. Most were left licking their wounds, but others, including \$2 billion London-based hedge fund Peloton Partners, ended up irreparably damaged. "Many thought Peloton made good credit decisions on what they were buying, but they applied too much leverage and got closed out," Daloisio says. Peloton's not the only one. Sowood Capital hit the skids last summer, losing half its assets before being rescued by Citadel.

Even funds that invested in prime mortgages and debt issued by Fannie Mae and Freddie Mac have run into difficulties — most notably Carlyle Capital, although borrowed money was the tipping factor there: the fund had leverage of more than 30 times its equity. Bear Stearns' overall gross leverage was around the same — although as with most of its peers dropped to the mid- to upper teens on a net basis. "This leverage emerged as a 'solution' to the steady tightening of credit spreads in recent years and assumed that liquidity was a free good — an assumption that turned out erroneous," wrote JPMorgan analysts Jan Loeys and Margaret Cannella in a recent analysis on the crisis.

A palpable fear of leverage pervades the market as a result of the ructions of the past year. It's a classic dilemma: conservative players worry about the backwash if more aggressive leveraged

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competitors receive margin calls and have to sell. "We don't wear a seat belt in a car because of our own driving," Daloisio says. "It's the other guy who is the problem." Prices may need to fall to levels at which returns are attractive on an unleveraged basis before the real money buyers will step in.

In today's market, it's almost impossible to get leverage against mortgage related assets anyway. James Finkel, chief executive officer of Dynamic Credit Partners, a \$5.5 billion New York-based investment firm that manages both collateralized debt obligations (CDOs) and hedge funds, points out that without leverage most alternative asset managers cannot deliver the mid-

teen percentage returns their investors have come to expect. He sees attractive opportunities among the senior tranches (double- and triple-A-rated) of structured debt vehicles that are unlikely to default, but while the unleveraged returns are at best barely in double digits a manager who charges standard hedge fund fees (2 percent of assets plus 20 percent of the increase in net assets) cannot justify the investment. "At the prices at which we or our investors would like to own them, the banks would rather keep the assets," Finkel says. "It's a standoff."

Questioning the ratings agencies

CDO managers like Finkel learned the hard way how vulnerable the structures are to rapid and severe rating downgrades. While sophisticated players may have understood the risk, nobody anticipated ratings changes that in extreme cases cut triple-A tranches to below investment grade at a single stroke. Finkel says the industry needs to devise vehicles in which payouts are not so dependent on the ratings agencies' opinions. "It's a flawed investment concept as a structural matter," he says.

Finkel expects the established ratings agencies to refine their methodology for assessing structured credit risk and sees new entrants getting into the business as well, a development he welcomes. He also believes that future structured vehicles may have fewer tranches: "Structured financings are not going to be dependent on conventional ratings. They will be simpler structures where you are not trying to squeeze the last drop of water out of a stone."

Chastened investors also discovered that when correlations break down a hedge can turn into a stick with dirt on both ends. As the market unraveled last spring, people who bought what they thought were cheap individual subprime MBS tranches and tried to hedge through short positions in the ABX indices found to their horror that prices on the long side continued to decline while the indices rallied on short covering. "It created a whipsaw effect," says Finkel, "That is what brought the Bear Stearns hedge funds down. We have learned some tough lessons about trying to hedge illiquid assets with technically driven index products." In fact, it goes both ways: Morgan Stanley's subprime-related losses last year derived from using triple-A ABS CDOs as the economic hedge to pay for their short positions in the index.

Opportunities for the informed

Widespread carnage has left many hedge funds and other traditional leveraged market participants gun shy, either unwilling or unable to cash in on what appear to be juicy returns on structured debt. The field is open to real money players like pension funds and insurance companies, but these instruments are so complex it takes time to build the information technology infrastructure and hire skilled people who know how to analyze them. Mutual funds probably won't be significant players, though. Poor liquidity makes structured debt unsuitable for vehicles that have to report daily net asset values and accommodate daily purchase and redemption requests.

Finkel expects to see more transactions like the recent rescue of Thornburg Mortgage, in which hedge fund Matlin-Patterson Global Advisors, a distressed debt specialist, put up \$500 million in exchange for a 40% stake. Thornburg subsequently raised \$1.35 billion in new capital, including bonds that bear an 18% coupon and carry warrants to buy Thornburg equity at \$0.01 per share, a potential home run for investors if the stricken prime mortgage lender turns around. "The best opportunities will be acquiring companies that are sitting on distressed portfolios rather than in straight asset purchases," says Finkel.

Fixed-income investors of whatever hue may be more tempted by non-mortgage ABS. Spreads have blown out even though the underlying collateral is not directly affected by the mortgage credit crisis. Thomas Glandel, executive vice president at Boston Portfolio Advisors, a Fort Lauderdale-based consulting firm dedicated to the financial services industry, says some of his clients — especially insurance companies — have started buying credit card and auto loan ABS. "The short duration minimizes interest rate risk," he says. "Clients feel those spreads are the widest, given the level of risk."

And of course the dynamics of the credit card and auto loan businesses were very different to those of subprime mortgage lending. While leveraged funds like SIVs were buyers — hence some of the spread widening as these entities sell assets to raise cash and deleverage — they weren't as susceptible to a drop in lending standards. After all, unlike houses, cars rarely rise in value, and it's easier to increase interest rates on credit card balances. Moreover, non-mortgage ABS issuers usually retain a



Structuring models need to be more like this 1941 Lincoln Continental... Getty

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portion of the deal, and in credit card securitizations there's an incentive for them to keep investors happy: if the deal goes sour, the issuer risks losing the main source for funding the business. That all adds comfort to buyers of the paper.

Glandel's clients are still leery of MBS, however. Until the financial system has shed its excess leverage, investors fear that if they buy what looks like a cheap asset at 60 cents on the dollar a forced seller could dump a portfolio at any moment and push the price down to 50 cents overnight. That psychology has turned what began as a liquidity shortage last August into a full-scale credit crunch. "People have money to lend or invest but they are now saying they don't know enough to pull the trigger," Glandel says. For borrowers who insist on having money, the price has gone through the roof. One of Glandel's bank clients just sold a deal rated triple-



...and less like this much-used but rickety Ford Model T

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A at 250 basis points over Treasuries; a year ago, a package of identical assets would have gone for 50 bp.

Privacy protects

Investors not subject to constant public scrutiny are better placed to withstand temporary adverse marks so Glandel expects hedge funds will be among the first to dip their toes back in the water. He expects the optimum strategy will be to focus on assets selling at discounts to their fundamental values rather than relative value trades among bonds for which the underlying collateral is of questionable quality. "You may be the best looking pig in the pigpen, but you're still a pig," Glandel says. "Investors want to be absolutely accurate in their assessment of the collateral and relatively correct in the price point at which they buy it."

Hedge funds may also be able to tap pension funds and other mainstream institutional investors who recognize the opportunity but lack the expertise to manage direct investments in structured products, according to Douglas Long, executive vice president responsible for business strategy at Principia Partners, a New York-based firm that develops software for the structured finance industry. He points out that before the credit crisis about half the highly rated paper was held by SIVs and conduits, which are either liquidating or have been absorbed on to the balance sheets of sponsors that are under pressure to sell. Cheap assets are there for the taking and distressed debt funds provide a vehicle through which pension funds and other mainstream investors can participate without getting their fin-

gers dirty. "You have to have the systems, staff and knowledge to manage these products if you buy them directly," Long says. "The new players don't have that experience."

Some mainstream institutions are learning fast, however. Long says investors who owned capital notes in SIVs have negotiated vertical-slice transactions in which they exchange their capital notes for an equivalent share of the entire leveraged SIV portfolio. The investor crystallizes any loss on the capital notes

and takes on to its balance sheet at a discount high-quality assets that should pay out at par when they mature. Economic necessity drives the deals. "They are reluctant investors," Long says. "If they held on to the capital notes they would end up with nothing." Investors have to ramp up their expertise to manage the assets they receive, which sows the seeds for future participation in the market even after

the current inferno has died down.

In an odd twist, Long says potential investors in distressed structured debt instruments complain they find it hard to buy what they want despite the enormous overhang of high-quality assets on the market. Although bid lists circulate, sellers are often more interested in a mark for valuation purposes than letting assets go. Trades tend to be small, but distressed investors need a ticket big enough to justify the due diligence and monitoring they have to perform. Conversely, "sellers are not putting everything out there because they don't want to take the loss," says Long.

When the standoff is resolved it could rekindle a final cathartic burn-out that will set the stage for a sharp recovery in prices, at least for the upper echelons of the capital structure. For the lower tiers and more exotic products, including CDOs of ABS and products supported by monoline insurance guarantees, it's a different story. These assets could remain untouchable even after the ashes are stone cold. Perhaps that's why the more adventurous distressed specialists still seem largely to be waiting on the sidelines. ▼

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