

Whose Credit Crunch is it *Anyway?*

The securitization industry has never found itself in such an uncomfortable position. Sure, there have been a few blips during its 20 years or more as a major arm of the capital markets. But in previous credit crises it usually remained the calm port in the storm, the one haven issuers and investors could rely on. Not this time.

Wall Street has taken tens of billions of dollars in write-downs on bonds and collateralized debt obligations backed by subprime mortgages. Two top chief executives — Merrill Lynch's Stan O'Neal and Chuck Prince of Citigroup — have been forced out as a result. Dozens of lenders have gone out of business. There was a run on a mortgage bank, Northern Rock, in the UK. Federal Reserve chairman Ben Bernanke has had to open the spigot on a number of occasions to try to calm markets and inject liquidity, as have his opposite numbers at other central banks. The Fed has also been active in its role as bank regulator,

tion of subprime mortgages — was simply the first fissure to appear in the five-year-long bull market in credit.

In case that sounds like a matter of bias trying to overcome adversity, let me put that comment in some perspective. No doubt displaying the kind of cynicism one might expect from my profession, I, along with many of my fellow journalists, have been pondering the potential excesses of the bull market for bonds pretty much since it began. Banks' rediscovered appetite for proprietary trading sparked my first such article back in 2002. A year later, the first stories predicting a broader credit crash appeared, and have done so regularly since, with fewer and fewer people taking any notice until early last year.

No one wants bad news

In hindsight, that in itself was a warning sign. No one wanted to hear bad news. And everyone wanted to talk property. I lost



as have the FDIC, the OCC and the SEC. Even the Federal government has gotten involved. President Bush and Treasury Secretary Paulson have both been active, either by putting forward recommendations to help struggling homeowners or by trying to do what they can to stabilize jittery capital markets.

But not only has securitization been caught in the turmoil, it's regarded by some as one of the chief culprits behind whipping it up. This kind of knee-jerk analysis, while it contains a kernel of truth, misses the broader point. That's not to absolve the industry or its participants of responsibility — one does not have two or more years of shoddy mortgage loan underwriting without willing, and unwitting, players in all corners of the market, whether issuers, underwriters, ratings agencies, investors or even, dare one say it, borrowers.

But securitization — or, to be more specific, the securitiza-

tion of the number of people, from senior bankers to my local bartender, telling me until very recently that there were these great new mortgage products that allowed you to buy a house without putting much, if any, money down. I'd be mad not to jump in, they told me. It was akin to those apocryphal conversations almost a decade ago people hark back to, that they could tell the stock market was about to crash because their barber was trying to give them investment advice. By the way, whether by luck or simple poverty, I didn't buy.

And what was the line from professional investors? To generalize: trust us, we know how to manage risk, how to recognize problems; and no, you won't see us dumping everything in a flight to Treasuries like last time. We've heard this before, both in the run-up to the Russian crisis in 1998 and before the Enron-induced corporate credit crisis after 2001.

It's securitization's first time at the center of such a crisis. But it didn't happen in a vacuum. As *American Securitization's* editor, Antony Currie, explains, the subprime and CDO rout was simply the first crack in a five-year-long bull market in credit.

What causes such beliefs to resurface time and again? In part, it's simple short-term business logic: investors, whether in stocks, bonds or asset-backed securities, have money to put to work and benchmarks to beat.

But this time there was also a sense that new developments really had meant that risk was widely disseminated and that markets could cope so much better with crises, because recent experience seemed to point that way. The return of prop trading in 2002 caused a scare at JPMorgan and one or two other banks, but was easily handled. The whipsawing 10-year Treasury yield in the summer of 2003 didn't, contrary to many expectations, cause a raft of banks and hedge funds to lose their shirts as negative convexity wreaked havoc with their holdings of prime mortgage bonds. When General Motors and Ford Motor, two of the biggest issuers of both corporate and secured bonds, were downgraded to junk in spring 2005, all that hap-

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credit crisis. Take the now widely held view that mortgage lending got out of whack because originators passed on all the risk to bond investors. But 100 or more bankrupt, shuttered or otherwise defunct subprime lenders tell a different story. It wasn't lack of new business that killed off many of them so quickly — though over time it would have done. It was their lack of appreciation of the very real risk of investors throwing back at them at par both fraudulent loans and mortgages suffering from early payment defaults. Ignoring risk is not the same as there being no risk.

Another misplaced assumption held that secured debt is by rights much safer than unsecured. That actually holds true in just about every asset-backed security aside from collateralized debt obligations and subprime mortgage bonds. Consider research undertaken recently by Deutsche Bank's securitization analysts Karen Weaver and Anthony Thompson: less than 2%

The credit crisis has stirred President Bush, Fed chairman Bernanke and Treasury Secretary Paulson to action (opposite page, left to right). And it has cost Merrill's Stan O'Neal (right) and Citigroup's Chuck Prince (far right) their jobs.



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After 2005, markets managed to convince themselves that the Fed's constant rate increases were effected at a slow enough pace to allow speculators to unwind their most exposed trades in good time with rarely more than minimal damage. Few were spooked by hedge fund blow-ups, either: Amaranth's demise in 2006 was met with no more than a shrug, while even the collapse of Bear Stearns two mortgage-heavy hedge funds looked wholly manageable for a while.

In other words, market participants rested on their laurels after five good years. Assumptions and even a degree of complacency set in. One of our guest commentators, Lazard Asset Management's Ronald Temple, outlines this aspect in his article on page 11. That has also affected the reaction to the ensuing

of all ABS deals issued before 1995 were downgraded, and no triple-A-rated ABS deals were ever downgraded before 1999 due to poor pool performance.

Throw in first CDOs and then subprime mortgage bonds, though, and problems start. CDOs accounted for three quarters of downgrades on ABS sold between 1997 and 2001. A tenth of all ABS deals issued in 2006 and 2007 have been downgraded. But virtually all of them are CDOs and subprime MBS — between them they account for 99% of all ABS downgrades on paper sold since 2005. And all recent downgrades from triple-A were on CDOs.

Say what you like about ratings agencies — and lambasting them for the subprime mess is fair game — but these numbers don't show they dropped the ball on everything. The message for investors, though, is clear: simply slapping the tag "securi-

tization” on a product and giving it a top-notch rating doesn’t make it safe.

But no one should for a moment think that securitization was unique in delusions about risk. It was rife across the markets, largely because so much cash was sloshing around seeking a home. One can point to any number of indicators: the rapid rise in hedge funds and other alternative investment strategies; the growing popularity of payment-in-kind notes and toggle notes for high-yield bonds and leveraged loans; the ever-decreasing margins prime brokers demanded from their lucrative hedge-fund clients; and the ever-tightening spreads on virtually all types of credit.

The reward market participants were being paid became, in general, far too low for the risk many didn’t realize they were taking. In a credit bull market that almost always causes the same reaction: as spreads tighten, take even more risk to boost returns.

In securitization, that meant subprime mortgages. In fact, it really meant subprime mortgage-backed CDOs that bought the triple-B mortgage-bond tranches. And this is where the real fear that created the credit crisis resides. Rising defaults by the actual borrowers play a large role, of course, and are hardly irrelevant to financial markets. But these are to an extent quantifiable, even if assumptions change. And they could change for the worse: the fear that the subprime housing bust could trickle up through the economy has been enough for Morgan Stanley’s economists to predict a mild U.S. recession, and for others to think there is a greatly increased likelihood of it happening.

Where it goes, nobody knows

But ABS CDOs have compounded the fear. How? Quite simply, because no one knows just how big the exposure is. Let’s go over some rough calculations. Some \$600 billion of subprime mortgage bonds were issued in 2006. Say 5% of the capital structure, or \$30 billion, is triple-B or below and all of it goes into mezzanine ABS CDOs. Say another 5% is the portion of single-A and double-A snapped up by high-grade ABS CDOs. Throw in issuance in 2005 and 2007 and you hit perhaps \$160 billion. Let me just stress again that these are very rough calculations.

That’s nice and quantifiable. Yet just going over the numbers from a handful of banks that have owned up to their CDO pain — Bank of America, Citigroup, Merrill Lynch, Morgan Stanley, UBS — yields exposure of more than \$100 billion between them to just the super-senior tranches.

Of course, these five banks didn’t buy virtually every CDO for the last three years. It’s the existence of mortgage bond derivatives that skews the calculations. How much, though, is anyone’s guess. Literally. After months of asking bankers, analysts, CDO managers and investors, I am no nearer to a ballpark

figure for total ABS CDO issuance that enough people feel comfortable with than I was at the start. Some think derivative CDO issuance equates to perhaps just one-fifth of cash issuance. Others that it’s about equal, while some reckon it’s double or more. And here’s one CDO manager’s assumptions from late 2006: if a \$10 million triple-B subprime mortgage bond was regarded as a good credit, it was coveted. At the height of the boom it could have generated as much as \$300 million in notional exposure tied up in CDOs — 30 times the face value of the underlying.

That will not have happened for every bond by any means, but it gives an indication of just how wildly popular ABS CDOs were with investors.

Tot up these assumptions, and one could be looking at additional

CDO exposure beyond cash issuance of between perhaps \$30 billion and \$500 billion. That’s hardly helpful, and this lack of clarity of how much exposure there is to U.S. subprime mortgages has locked the markets in crisis mode. It has left investors worried that anything from conduits to structured investment vehicles to good old asset-backed commercial paper has been jammed full with the stuff. Investment funds as disparate and far apart as Germany, Florida, Australia and Norway have been hit. For a time, investors wouldn’t even buy European mortgages structured into covered bonds, even though much of the risk actually stays on a bank’s balance sheet.

Banks have even balked at lending to one another as their fear of the extent of their peers’ exposure to risky investments from CDOs to lending to hedge funds has stayed their hand. As a consequence, the spread between three-month T-bills and three-month Libor, a handy measure of risk in the financial system, hit an intra-day high of 240 basis points last August. After recovering, it shot back up again towards the end of the year. It had not been at that level since the stock market crash in October 1987.

But CDOs didn’t force their way on to investors’ books. Nor did other riskier products offering juicy yields in the bull market. Buyers opted to load up on them to try to beat their benchmarks all the while convincing themselves they understood the risks, just as their predecessors did with technology stocks, high-yield bonds or Latin American sovereign debt. The structure was just the vehicle of choice. The stock market still exists, as do high-yield and emerging-market bonds. True, the assumptions underlying subprime mortgage bonds and ABS CDOs might need ripping up, and the credit crisis is a painful and expensive way of learning that one has misjudged financial risk. But securitization as an asset class remains as viable and valuable a part of the capital-raising process as ever. ▼

Antony Currie is editor of American Securitization. He is also a commentator for breakingviews.com.

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