

By Antony Currie

# Can *banks* take up the securitization slack?

The credit crisis has widened spreads for asset-backed securities so much that the market might be too expensive for issuers for a while. Arguably that should give commercial banks the upper hand over investment banks when clients come looking for funding. But banks face their own balance sheet constraints, which could limit their ability or desire to reintermediate, especially if an economic downturn is on the cards. That, ultimately, would be good news for securitization.



**S**urely this is the kind of environment commercial banks have been waiting for. Returns from the good old-fashioned business of lending have been whittled away over the past two decades as disintermediation took hold — or to put into English, as investment banks devised more ways to raise money for corporations in the capital markets. The effect has been stark: median net interest spreads and margins of the largest three dozen U.S. commercial banks have declined by 25% or more over the last 15 years. But the current credit crisis could change that.

Some were pushing this line early last Fall, when senior bank executives like Citigroup's chief financial officer Gary Crittenden were throwing around a new buzzword: reintermediation. This was their chance, they were essentially saying, to lend more, and with luck reap better returns doing so. Their counterparts at investment banks like Goldman Sachs and Morgan Stanley were understandably more dismissive of this being a new trend. Who's right?

On the face of it, the commercial banks would seem to be. After all, there's no doubting that the crisis has taken its toll. The cost of borrowing both secured and unsecured capital-markets debt has risen, in some case by a significant amount. By December, spreads on five-year triple-A asset-backed credit-card deals had jumped from just above flat to swaps in July to 60 basis points. Two-year auto-loan securitizations, which traded inside swaps at times in the first half of last year, were at 65bp over, and commercial mortgage-backed bonds gapped out as wide as 130bp, from some 15bp in March. That makes bank loans look more attractive. Rates on these have gone up, too, but not by as much.

While some asset-backed bondholders regard these prices as opportunities, others have become more wary of the assets on sale. And in securitization land, at least, a large slug of buyers has disappeared. "The structured investment vehicles and other forms of conduits were buying 50% of highly rated structured finance assets in the market," says Dr Doug Long, EVP of business strategy for Principia Partners. "That's now gone away."

What's more, banks have more ways to finance their operations: retail deposits are a much cheaper source of funding, and by

and large banks don't mark their core assets to market. That affords them an advantage over investment banks whose modus operandi is either not to originate loans at all, or to originate only if they can then redistribute them, often in a securitization, rather than holding them on balance sheet. And if things get really messy, banks can tap the Fed for emergency cash; investment banks cannot.

As a sign of just how much markets have changed, Lehman Brothers, the doyen of the originate-to-distribute model, made a rather startling comment when reviewing its fourth-quarter 2007 results in December: that in a few cases it had sold senior tranches of asset-backed securities, but held on to the lower parts of the capital structure because it just could not sell them. Lehman can probably do that here and there, but that defeats the purpose, and the economics, of lending to securitize.

It looks more and more like commercial banks are top dog. In fact, they ought to be able to profit in more ways than just lending. The collapse of the SIV bid has been one of the major drivers of widening spreads of highly rated assets as these vehicles were forced to sell them en masse, making the top of the capital structure of securitizations very cheap. One European-based trader says that the likes of British building societies were quick to take advantage of this. Triple-A mortgage bonds were a favorite. Factor in the 20% risk weighting these UK institutions had to set aside, says the trader, and spreads were at one point wide enough to offer a whopping 30% return on capital with no need to mark to market.

### Strong constitution needed

Considering that most asset-backed paper is trading at wider levels, that's not the only potentially great trade. But don't expect a slew of banks to jump in and help bring spreads down to less stratospheric levels. Strong stomachs are required with the markets still jittery, and that will likely reduce bank risk managers' tolerance for taking too much exposure — especially if they feel just taking a small position can bring outsized rewards.

Banks also need to be well capitalized to consider making these trades. And that's where their role as buyer of stressed assets, and as reintermediating lender, gets tougher. We have already witnessed a number of financial institutions raise new equity capital in the last couple of months of the year, whether banks like Citigroup and UBS, insurers like MBIA, mortgage buyers Fannie Mae and Freddie Mac, and investment banks like Morgan Stanley.

There is likely more on the way. In Europe, investment bankers say they see raising bank capital as one of the best money-spinners for their equity underwriting units this year. In the U.S., few banks can boast fortress-like balance sheets. At the end of September, the average tier-one capital ratio for U.S. banks was 79 basis points below its long-term average, according to Deutsche Bank. Money center bank ratios were only in line because Bank of America and JPMorgan were substantially above their long-term averages.

That's not to say the U.S. banking system is teetering on the edge. No institution's capital base is near the 6% tier one

level at which regulators start to get concerned. But most prefer to keep a buffer above that, and some are skirting it. Even after a \$7.5 billion from Abu Dhabi Investment Authority, for example, Citi is still below its stated goal of 7.5%.

Mortgage-related write-downs have already caused problems at various institutions, but what if the economy worsens? After a five-year bull market in credit, default rates on bonds and consumer loans can't get much lower, but they can rise. There is already evidence of that: delinquencies on auto and credit card loans are increasing, as are non-performing loans in general.

Yet reserves to loans at U.S. banks, at 1.2%, are at the lowest level since 1983. And the ratio of tangible capital and reserves to assets is the lowest in 22 years. This "reduces financial flexibility for share buybacks, dividends, cash acquisitions and balance-sheet growth," according to Mike Mayo, banks and brokerage analyst for Deutsche Bank in New York, who ran the numbers.

### Some bright spots

That's not, on the face of it, encouraging for those companies that might need a friendly bank to fill in any funding gaps created by the crisis. There are bright spots. Bank of America, JPMorgan, US Bank and Wells Fargo all have healthy-looking balance sheets, leaving their lending arms well placed to take advantage of capital-markets pain.

And the credit crunch has not dimmed investor appetite for asset-backed credit card debt: by mid-December issuance of floating-rate paper last year jumped 62% compared with 2006. Of course, most of that comes from large banks that need ABS to fund their credit-card business. And they have a big incentive to avoid problems in the securitized portfolio, as they could trigger early amortization events, which would leave them with two unpalatable choices: get shut out of the business, or fund it all on balance sheet. So banks are more willing to pay up on spread than other issuers — and of course can easily pass on costs to the cardholders — and that in turn gives investors more comfort.

But let's just go back to that part about banks not wanting even their own credit-card assets on their balance sheets. That is the crux of the reintermediation debate. Banks do indeed have more options for funding themselves, and can be more flexible than pure investment banks because they don't always have to mark assets to market. But they have been just as affected by the two-decade-long trend of disintermediation as their clients.

Their balance sheets may afford them a bit of added heft in a crisis, but they do not have the wherewithal to pick up the financing baton dropped by the capital markets in recent months. To do so would require a significant amount of new capital. Just bringing the ratio of reserves to loans back to historical averages could mean a 20% drop in earnings for U.S. banks, according to Deutsche's Mayo. That's probably too expensive for shareholders. But it's good news for another part of the market: if banks are unable to fill the void, Wall Street's securitization desks may be busier again soon. ▼