

by Neil O'Hara

The Transparency myth

Does the asset-backed market suffer from too little information? Or would the real problem be if too much was out in the open? Market transparency has become the key topic of debate since the subprime mortgage debacle. Could the structured debt market learn from the likes of eBay?

Ever since the bottom fell out of the subprime mortgage-backed securities (MBS) market a chorus of investors and commentators has blamed the woes on a purported lack of transparency in structured credit products.

The complaints rarely specify what additional information the market needs, other than better access to prices, however. Public deals — both MBS and asset-backed securities (ABS) — generally give investors voluminous information in the prospectus about the loans in a pool, thanks in part to Regulation AB which was introduced in 2006. Investors who object to less detailed disclosure in private deals don't have to buy them, either. So what's the beef?

Deborah Cunningham, chief investment officer at Federated Investors, a money management firm in Pittsburgh, has little sympathy for the complaints. "If we didn't feel we were getting adequate disclosure and information about ABS and MBS issues we wouldn't have owned them," she says. "They are more complex than a corporate entity but you can analyze and monitor them." People who cite a lack of transparency either have not done their due diligence, don't look at the monthly information they receive from the issuers or are just angling for newspaper headlines, according to Cunningham.

She says critics of the ratings agencies are off the mark, too. Investors who choose to rely on bond ratings rather than do their own research will always be at a disadvantage. When the market seized up over fears about subprime mortgage exposure, these investors had no idea what was in their structured debt portfolios. In a knee jerk reaction, they stopped buying new bonds until they figured out how much subprime paper they already owned. "If they didn't know what they had they shouldn't have owned it," says Cunningham.

Even the now notorious structured investment vehicles (SIVs) actually offer greater transparency than the banks that created them, she points out. SIVs put out servicing reports on their assets every month, three times as often as banks publish their quarterly financial statements. Neither SIVs nor banks broke out subprime mortgage exposure until earlier this year — but not because they were trying to hide it. Nobody asked for it until the escalating delinquencies surfaced. Cunningham attributes the SIV crisis to a lack of liquidity rather than transparency: the market's assumption that the high grade paper SIVs own was inherently liquid so they did not need to cover their entire funding needs with backup lines of credit turned out to be false.



Too much transparency can have its own unintended consequences

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To some extent the level of transparency available to investors depends on both the issuer and the instrument. Ron D’Vari, managing director, portfolio manager and head of structured finance collateralized debt obligations (CDOs) at New York-based money manager BlackRock, explains that SIVs that issue asset-backed commercial paper (ABCP) typically don’t provide asset-by-asset descriptions of what they hold in their portfolio.

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CIO at Federated Investors*

lios. Instead, they give only a market value at the portfolio level broken down by major categories. “It is somewhat mysteriously derived because they only price certain things at certain times,” he says. Until the recent turmoil, investors were willing to accept limited disclosure because they were only at risk for short periods — 30 days in normal market conditions.

A lot to take in

Investors in public MBS and ABS do get loan level data, so they can run detailed analyses of the expected performance of each pool under different scenarios for interest rates, prepayments, delinquencies and defaults. Investors get full asset disclosure for CDOs, too, but analyzing a CDO that contains ABS or MBS is no mean feat. A typical asset-backed CDO contains 100 different mortgage bonds, each representing a claim on cash flow from thousands of mortgage loans. In theory, investors need to run multiple scenarios on each underlying bond, and even on the loan pools, and then aggregate the results, a data processing chore big enough to tax a supercomputer. “It’s a massive amount of information that has to be digested by the marketplace,” D’Vari says.

The information overload creates a tiered market in which the few investors prepared to build the systems needed to perform a comprehensive analysis gain a competitive advantage. That happens throughout the financial markets, of course, where sophisticated institutional investors always have an edge over retail players with limited resources. D’Vari is unsympathetic to suggestions that CDO managers should level the playing field by making analytical information available to investors. Money managers who take pride in their ability to understand securities — as any manager worth his salt should — have no interest in commoditized analyses that would eliminate their edge. “These people are asking issuers to do their work for them,” D’Vari scoffs. “Data that is consistent with monitoring the borrowers and the origination of that borrowing should be made transparent. We can make our own deductions.”

Even if issuers do provide detailed information down to individual CUSIPs, investors often must go to multiple sources to get everything they need to track a diversified portfolio that contains CDOs, MBS and other structured debt, according to Douglas Magnolia, a managing director at The Bank of New

York Mellon. The data is often presented in different formats, too. “Information is available but it’s not easy to get,” Magnolia says, “And it’s not consistent, which makes it harder to evaluate.”

Investors will reach different conclusions, of course, but their analysis is only as reliable as the data that goes into it. In the residential MBS market, especially subprime, the raw data is often flawed. For example, owner-occupier mortgages have fewer delinquencies and defaults than mortgages on rental properties so lenders offer them at a lower interest rate. As a result, borrowers have an incentive to stretch the truth when they apply for a loan. A borrower who buys a condominium and rents it out a month later may still qualify for an owner-occupier loan, and lenders have their work cut out to prove the borrower bought it as a rental property. Meanwhile, MBS investors have no way of knowing how many questionable deals like that have tainted the loan pool credit quality.

In a market abuzz with rumor and innuendo stories have circulated about servicers manipulating delinquency triggers, too. If bad loans reach a threshold amount, the servicer is supposed to suspend payments to the residual interests, but seller-servicers — who often own the residuals — may prefer to buy back bad loans to keep delinquencies in check. Jason D’Angelo, a vice president of AIG Global Investment Group, points out that investors wouldn’t necessarily find out even if it happened. “Servicer repurchases are not always disclosed on a remittance report,” he says, “It’s a good example of lack of transparency.”

Mark Adelson, a securitization consultant at Adelson & Jacob, a New York based firm that specializes in structured finance, says even when issuers do provide loan level data investors can’t rely on its accuracy. It is typically posted on a website but not filed with the SEC, so if the data is incorrect investors have no recourse. “If the issuer makes a material misstatement or omission in a prospectus, somebody can go to jail. I’m comfortable relying on that information,” Adelson says. “I’m skeptical where he has no downside.” He still likes to see loan level data because it’s probably more right than wrong and it can raise red flags like concentrations of risky attributes in a cluster of loans, a sign the deal is more likely to run into trouble.

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Although the data could be made subject to prospectus liability at the outset, that provides little protection later on; after 30% of the loans are paid off investors need current data on the 70% that are left.

A small step to fraud

It’s a small step from borrower misrepresentation to outright

fraud, too. One seller-servicer discovered a borrower who had taken out several mortgages, all scheduled to close within two weeks and all declared as owner occupier loans. Some owner-occupiers never spent a night on the premises before renting them out. Other borrowers who took out no-document loans inflated their income.

A recent Fitch Ratings study cited occupancy misrepresentation, inadequate attention to suspicious items on credit reports, incorrect calculation of debt-to-income ratios, failure to review stated income loans for reasonability and substantial numbers of first time buyers with questionable credit or income as the principal underwriting deficiencies. Fitch plans to enhance its scrutiny of subprime and Alt-A originators and issuers in the future. The agency estimated that “lax underwriting and fraud may account for as much as one-quarter of the underperformance of the 2006 vintage of subprime RMBS transactions.”

The mortgage originators either did not check the information — after all, it’s not so easy to verify before the closing that a borrower intends to occupy the house — or didn’t care. An originator who sells the loan at closing to a Wall Street firm or an integrated mortgage lender for repackaging into a securitized debt offering receives its entire compensation up front. Although in theory the buyer has the right to put a loan back to the originator if it falls delinquent soon after the closing, in the recent

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crisis it became a worthless option in most cases because originators were wholly unprepared: few had retained or built up the capital to stand behind the guarantee. “The person making the economic decision doesn’t bear the risk,” says Andrew Chow, a fixed income portfolio manager at San Francisco-based money manager SCM Advisors. “The originator is acting as an agent and the actual MBS investor who is going to be at risk hasn’t even been identified yet.”

Chow says originators ought to have some skin in the game, perhaps receiving only part of their compensation at closing with the rest spread out over the life of the loan. In prac-

tice, high delinquency rates among subprime mortgage loans originated by third parties have already caused most integrated lenders to drop these programs. Future originations will come through the lenders’ own sales forces, whose ranks can be held accountable for credit performance long after lenders repackage and sell the loans.

James Callahan, executive director of Pentalpha Capital Group, a Greenwich, Connecticut-based consulting firm that specializes in structured finance, blames the market disruption almost entirely on fraud. Pentalpha’s surveillance division monitors servicer performance for pool trustees. It collects 195

data fields about each loan every month, far more than Regulation AB requires in a prospectus or the most transparent servicers make available to investors or the ratings agencies. That wealth of information gives the firm unusual insight into pool performance based on factors like borrower payment patterns. Until market participants get a handle on how pervasive fraud is in each particular deal Callahan says bid-offer spreads represent nothing more than a guess as to what cumulative losses



Could its model offer a solution for illiquid ABS markets?

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in the pool will be. “We have a one-time fraud problem,” he says. “We have to get all those bad loans out of the system. That will probably take another 18 months.”

That’s not all, though. Getting hold of the relevant data on subprime mortgages can be tough. In fact, often “we don’t have enough data to know who’ll default, or whose loan to modify,” Callaghan said at the American Securitization Forum’s (ASF) *Way Forward* seminar in December. Sometimes, the information just isn’t there. Other times, the challenge is unearthing it. At the seminar he described a conversation he had with a client about an individual’s loan on its books. They had asked Pentalpha to come up with a valuation. The data at Callaghan’s disposal initially showed the borrower was 90 days delinquent, had a loan-to-value of 115%, had \$900 of disposable income a month, and couldn’t be contacted. Pentalpha said it was worth 53.5 cents on the dollar.

“The client said we were crazy, as they had a much higher valuation,” continued Callaghan. No, this wasn’t wishful thinking. But the client hadn’t mentioned that the borrower had paid 22 of the last 24 months, that his employer had gone bankrupt and couldn’t pay him, that the servicer had in fact spoken to him and that he really wanted to make his payments. On that basis, the loan was probably worth more like 80 cents on the dollar. “We need to be able to get more information from the servicers,” said Callahan. “Simple stuff can be very important, like what

day of the month a borrower pays on. Whether or not a servicer has talked to the borrower ought to be an easy question to answer: yes or no. But often that information is stored in software that might not link up with other parts of a servicer's databases." Standardizing storage of, and access to, this kind of basic information — difficult though it can be — should be a priority.

To improve future data integrity, Moody's and others have proposed that an independent third party — an accountant or trustee acting on behalf of investors, not dealers — should review a sample of loan files in MBS deals to check them for accuracy. It's similar to the loan reviews commercial banks have used for years to monitor their lending books, according to Ralph Daloisio, a managing director in the New York-based structured finance group at Natixis. "Where has that standard been in the subprime residential MBS market?" he asks. "Whatever mortgage loan review has been going on has been largely biased or superficial rather than objective and critical." Independent verification would soon separate the wheat from the chaff among originators and create a powerful incentive for all participants to ensure their origination data was accurate.

An alternative proposal would allow creditworthy sponsors of MBS to forgo a third party review in favor of representations and warranties about data integrity. To make this work, Daloisio says the market needs a mechanism that obliges seller servicers to identify defective loans and repurchase them from the pool — one robust enough to be enforced, unlike the hollow remedies for breach of contract granted in the past.

ASF itself, in conjunction with the European Securitisation Forum, is exploring whether an industry-wide data portal might improve overall transparency. It would act as the gateway to those sections of issuer websites where they would post all their offering documents and initial and updated pool information. Investors and other participants would have free and unrestricted access to this information.

The portal could even be expanded to link to cash flow modeling services provided by commercial providers, on a pay-per-view or subscription basis. There are no plans, though, for the portal to be a trading platform.

Even assuming that the market has reliable data, additional information about loans in a pool won't improve price discovery if a security never trades. Daloisio draws a distinction between a dealer's quote, which indicates only where a security might trade; a price, which reflects an actual transaction; and a security's value, which is what a market participant believes it is worth. "Quotes and values may be very disconnected from price," he says.

The opposite of equities

Daloisio points out that structured debt comprises tens of thousands of securities, each of which is owned by relatively few investors; as a result many seldom trade, if ever. The market is almost the antithesis of equities traded on an exchange. The New York Stock Exchange lists about 2,800 securities, each held by hundreds or thousands of investors. The vast ma-

jority trade every day and the most active tick multiple times per second. Price discovery based on the last sale is reliable and instantaneous.

The agency MBS market trades like water, too. Daily volume in 2006 averaged \$253 billion, according to the Federal Reserve Bank of New York, with bid-ask spreads as low as one basis point. The corporate bond market can't match liquidity on the NYSE or in agency MBS, but most bonds still trade regularly. SCM's Chow says a \$500 million corporate bond may have 200 holders and while it may not trade every day, it may trade at least once a week. The last sale price may be stale in a volatile market but a steady flow — albeit intermittent



Is this all you see when looking at mortgages? You're not alone

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— ensures that investors have a good idea what their bonds are worth, especially now that broker-dealers have to report all bond trades on NASD's Trade Compliance and Reporting Engine (TRACE) within 15 minutes.

In contrast, Chow says a typical \$1.5 billion private label residential MBS transaction is divided into perhaps 40 different tranches, some of them owned by just one or two investors. "The likelihood that those tranches will trade on any given day, or in any given week, is very close to zero," he says. No amount of disclosure about the underlying asset pool is ever going to change that, either.

Chow argues that a price reporting requirement would be counterproductive, too. "If only two people own a bond and whoever buys it is going to have the price disclosed to everybody else the incentive to buy is significantly reduced," he says. Structured debt trades don't have to be reported on TRACE at the moment and Chow reckons a requirement that could impair already inadequate liquidity is hardly a step in the right direction.

Other market participants disagree, however. BlackRock's D'Vari points out that a trade reporting obligation transformed liquidity in municipal bonds and could do the same for at least some structured debt. He acknowledges that dealers and investors will resist because timely price disclosure deprives them of opportunities to accumulate positions in securities they perceive as undervalued. D'Vari isn't looking for dealers to disclose

their identity, though, just a screen where investors could find the amount and price at which the last few trades took place.

For inactively traded securities, the price may be stale but investors would at least know the volume and date of the last trade. “It’s better than nothing,” D’Vari says, “The market has to make a decision whether that last mark was valid.” He compares it to residential real estate, another illiquid asset class. If an owner sells one house on a block below market it tends to drag down prices on the whole street — but not if it’s a seller in financial distress unless the other owners are in similar straits.

SCM’s Chow says an auction mechanism in structured debt instruments could supersede current market practice, in which potential sellers put out bid lists to brokers who then solicit bids from their clients. “It’s an incredible waste of time because 80% of the bonds never trade,” Chow says. “The only reason the list was sent out was to try to figure out where the bonds should be priced.” Potential buyers have to analyze the bonds to come up with a bid, but if no trade takes place they end up as nothing but a pricing service—for which they don’t get paid.

Chow points to eBay as a model the structured debt market could emulate. The internet auctioneer has a huge array of merchandise on offer but only a few potential buyers for each item, yet the market still clears and price discovery occurs. A rating system for sellers on eBay identifies participants just looking for a price, who are soon evicted from the market because buyers refuse to deal with them. “The marketplace can self-police if you have something formal like that rather than the current system,” Chow says.

A fragmented market holds little appeal for stock exchanges or electronic trading platforms like TradeWeb, which thrive on high volume. Illiquid securities trade by appointment, rather like fine art or antiques, according to Adelson, the securitization consultant. “What is the price of a Louis XIV chair?” he asks. “There is a market for them but they don’t sell that often. With illiquid securities it’s exactly the same.”

An eBay-style model could help. And there are already somewhat similar systems in other markets. Liquidnet brings together buyers and sellers of equities without necessarily needing to use a broker as an intermediary. And trading solutions providers like TradingScreen are investigating similar strategies in a wide range of asset classes — chief executive Philippe Buhannic reckons it’s a trading model well suited to otherwise illiquid asset-backed markets.

Frustrated managers

Adelson says professional fixed income portfolio managers are frustrated because they not only don’t know the last price for structured debt instruments but also can’t figure out what the price ought to be in the current environment. Nobody knows what the ultimate delinquency rate on subprime mortgages will be, of course, but the models used to estimate bond values depend on too many unknown variables: how borrowers will react to interest rate resets, where interest rates are headed, how much home prices will drop, and how tight credit will get. “The

uncertainty is thwarting our best efforts to do good analysis,” Adelson says.

Market participants don’t always understand how the rules that govern cash flows within structured debt instruments really work, either. Adelson says some investors were surprised to find that excess spread cash flow can go to the residual interest at the bottom of the capital structure even after delinquencies on the underlying loans breach an embedded trigger. “It’s a logical consequence of the rules, but it’s not blazingly obvious from those rules,” says Adelson. Buyers of lower rated investment grade tranches, triple-B or single-A, discovered to their horror that money that could have protected them from loss is leaching away to the unrated residuals below.

Both arrangers and investors missed a fundamental flaw in the ABS CDO structure, too. CDOs rest on the bedrock notion that by reallocating cash flows from a diversified pool of sub-investment grade loans into hierarchical tranches a majority of the capital structure can attract an investment grade rating. But where is the diversification if a CDO contains only triple-B subprime MBS backed by loans from 25 originators who offer the same products marketed in the same way to the same potential borrowers through the same brokers who use the same FICO scores and sell the loans to the same securitization houses? “They ignored what was in front of their eyes,” says Adelson. “When you spell it out, to think there would be diversification is preposterous.”

Transparency is no defense against market participants who refuse to take off their blinders. It doesn’t trump investor sentiment, either. Even if investors had access to accurate loan level data on every transaction, the computer power to analyze it and a reliable source for the trading history of each security, the market could, and probably would, still have frozen up this summer. Transparency, after all, has not prevented stock market crashes, even though up-to-date share prices are easy to find and standardized analytical tools like ebitda models and price-earnings ratios abound.

The great strength of securitization technology — the ability to parcel out risk to those most willing to accept it — turned into a weakness overnight because it obscured which counterparties had what exposure to deteriorating subprime mortgage credit. As appealing as it would be if there were a magic switch we could flick to reveal the exact face amount and current valuations of all these securities and their derivatives, the market needs to work with, and improve, the tools that are already available. That won’t be enough to avoid meltdowns in the future, as crises in more transparent and liquid markets continually prove. But if done properly, it should be a step towards restoring investor confidence more quickly when it shatters in times of crisis. ▼

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