Market Pipeline

Friday, February 1, 2008

Securitizing Mortgages: When Smoke Finally Clears

(American Banker) Market watchers say it will take at least a year to 18 months for the asset-backed securities market to reopen to disfavored collateral like nonagency mortgages.

In order for that to happen, it will take more than simply the passage of time. Market participants say several changes in how the business operates will have to occur. Among them: overcollateralization and residual value insurance, to satisfy wary investors; the elimination of structures like collateralized debt obligations; and a new, more narrowly defined role for ratings agencies.

Even with those, subprime mortgages likely will take years to stage a rebound, experts say. And the nonagency residential mortgage securitization business that does return will have a distinctly vanilla flavor.

"It's likely that you'll see a simpler menu of choices, a move toward simplicity," said George Miller, the executive director of the American Securitization Forum, a trade group.

Greg Cioffi, a partner at the New York law firm Seward & Kissel LLP, said securitization deals will no longer include the kind of small, complex tranches that bewildered many investors. "The learning curve in understanding the transaction will be too high," he said.

Darrell Duffie, a finance professor at Stanford University's Graduate School of Business, predicted that mortgage-backed securities will no longer garner triple-A ratings if the underlying pools contain a mixture of products from alternative-A to subprime mortgages. Instead, issuers will create "nice fat juicy homogenous asset classes," with fewer tranches, "in order to restart the market."

Also, "there is going to be a lot more scrutiny of off-balance-sheet methods of financing and credit risk transfer," he said. Financial institutions will make many structured credit products more legally and financially "remote," because bankers do not want to hold illiquid mortgage

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securities on their balance sheets, as the structured investment vehicle debacle has forced them to do.

"The idea that you would put an embedded put option in these products so they come back to you exactly when you don't want them — well, that was kind of dumb," Prof. Duffie said. SIVs and collateralized debt obligations will not return, because "the latest episode has poisoned the well."

Ron Borod, a partner and the chairman of structured finance at the Boston office of the New York law firm Brown Rudnick Berlack Israels LLP, said there will have to be a way to make disclosure documents "more readable."

The securitization market became a victim of its own growth, he said, and too many participants rubber-stamped disclosure documents.

"People got so good at running very complex Excel spreadsheets and generating pages of disclosure documents that, in a sense, the computer models outstripped the humans," said Mr. Borod, who teaches a course on securitization at Boston University's School of Law. "If you tried to read them, it would take a day's work for an intelligent reader to get through just the disclosure documents" in a typical securitization deal.

But he acknowledged that securitization issuers already comply with the "plain English rule" adopted by the Securities and Exchange Commission in 1998.

Mr. Miller said investors will have to spell out what they mean by "greater" disclosure and transparency.
"There's an awful lot of information available in securitization transactions," he said. "Has the disclosure to investors been adequate to define and articulate the risks? That's a qualitative and judgmental exercise."

Indeed, even if the bonds become simpler, the work of evaluating them may become more involved, because investors are apt to rely less on the ratings agencies. They will conduct greater due diligence and demand access to the same or even more information than what the agencies had collected, observers said.

"The days of trading on ratings are over," said Len Blum, a partner and managing director at Westwood Capital LLC, a New York investment bank. "Market participants will pay increasing attention to the underlying assets and pools."

Moody's Investors Service Inc., Standard & Poor's Corp., and Fitch Inc., have been roundly criticized for being slow to downgrade bonds backed by subprime and alternative-A mortgages as defaults started rising.

"You need better overcollateralization design so that triple-A ratings are really triple-A," Prof. Duffie said. "That's the starting point, and that requires proper understanding of the sources of risk, particularly the correlation of the default risk of the underlying borrowers."

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Peter Cockhill, a partner who specializes in structured finance at the law firm Ogier, in the Cayman Islands, said that one obvious result of the liquidity crisis is that originators and banks "can't just pass off risk because the ratings agencies have rated such securities" anymore. As a result, the agencies will no longer have the final say on risks, which likely will fall heavily to bond purchasers or will come about through regulation, he said.

However, Mr. Cockhill said that the ratings agencies "are the only game in town," and that in time they are likely to change their criteria and surveillance processes.

"Certainly investors are questioning why the ratings agencies didn't get it right the first time, but the world needs them and, if anything, it needs more of them," he said.

It may also need something to replace the monoline bond insurers, whose guarantees allowed some securitizations to garner top ratings. Today, several of these insurers have either lost their own triple-A marks or are in danger of losing them. Mr. Borod said that residual value insurance, which covers losses in the market value of assets up to a preset amount, is being used in securitizations of nonmortgage assets, and so could be used in mortgage deals as well.

In the short term, issuance will remain moribund.
"It's going to be a slower market, and it will take a while for volume to come back, if it ever comes back to where it was," Mr. Blum said.

One reason for the wait is that banks are still marking-to-market CDOs and other mortgage-related products.
Mr. Cockhill said investors are still struggling with "an opacity problem": They do not know what the mortgages in their portfolios are worth. "We're still six months away from a final picture emerging" of losses, much less the market starting up again, he said.

Michael Youngblood, the managing director of fixed-income research at Friedman, Billings, Ramsey Group Inc.'s FBR Investment Management Inc., said it will be late 2008 "at the earliest" before any major upswing in nonagency mortgage securitization. It will not happen "until the major ratings agencies reestablish criteria that are credible to institutional investors," he said. But "very little that they have done in the last year inspires confidence, either in the rigor of their criteria or their surveillance processes."

Standard & Poor's Corp. and Moody's Investors Service Inc. have only partially altered their criteria, Mr. Youngblood said, through "stealth revisions" included in updates of their methodologies for rating CDOs (which are bonds backed by other bonds).

Neither S&P, Moody's nor Fitch Inc. returned calls for this story.
Robert Pratte, a partner in the Minneapolis office of the law firm DLA Piper, said the product mix and yield requirements will change but that banks will still use securitization to get risk off their balance sheets. "Five

years from now, people may have forgotten there was a subprime crisis and there will be some rebound," he said. "But in the short term, it's going to take awhile for everyone to recover from this."

Posted by Cormick Grimshaw at 9:52 AM

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