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Report From ABS East 2009: Securitization Begins To Move Past The Fear

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Trading Strategies For Illiquid Financial Instruments And Troubled Assets (5:00 p.m.)

MONDAY, OCT. 26, 2009

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Report From ABS East 2009: Securitization Begins To Move Past The Fear

*(**Editor's Note:** This article is not intended to reflect the views of Standard & Poor's Ratings Services. Rather, it summarizes a number of speeches and panel discussions at the 15th annual ABS East conference held in Miami Beach, Florida, Oct. 25-27, 2009--and thus reflects the views of the panelists.)*

Attendees at last week's ABS East 2009 expressed generally positive outlooks for the future of securitization. Many panelists noted the trend of tightening spreads over the past several months and remarked that the government's efforts to revive the market--especially through the Public-Private Investment Program (PPIP) and the Term Asset-Backed Securities Loan Facility (TALF)--have been significant positive factors.

However, despite the generally optimistic backdrop, there was also an undercurrent of concern. Not quite fear, but concern. Several panelists observed that spreads and pricing may be misaligned with fundamentals. One issue is the current inventory of delinquent residential mortgage loans. Market participants are uncertain about the level of losses that will ultimately come from those loans and about the ultimate effectiveness of loan modification programs in mitigating losses. Another issue is the possibility of a second economic dip--a "W"-shaped recession--that could further damage the performance of securitized assets. Although most attendees agreed that a "U"- or "L"-shaped scenario is the most likely (virtually all have ruled out a "V"), they also agree that darker alternatives remain within the realm of possibility.

The following summaries reflect remarks of panelists at selected conference sessions. For the most part, they're based on my notes, and haven't been reviewed or approved by the panelists. While I have tried to capture panelists' remarks accurately, I apologize in advance for any inaccuracies and omissions. In addition, I wish to acknowledge the excellent work of the Information Management Network in organizing and hosting the conference.

Sessions Covered

- Assessing Credit Risk in the MBS Sector (Sunday workshop)
- Valuation and Modeling for Assets (Sunday workshop)
- Trading Strategies For Illiquid Financial Instruments and Troubled Assets (Sunday workshop)
- The Importance of Securitization in Rebuilding U.S. Capital Markets (general session)
- Navigating the Changing Environment of the Consumer Securitization Market
- Asset Managers' Strategy Roundtable: Finding the Hidden Gems and Assessing Reward vs. Risk
- RMBS Traders' and Researchers' Roundtable
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- Keynote Address: Distressed Mortgage Investing and the Role of the PPIP Program
- Lessons from the Financial Crisis: Required Steps for Recovery (general session)
- Unlocking Liquidity in the Secondary ABS Markets: Traders' and Investors' Roundtable
- The Future of Structured Finance Ratings and Methodology
- Restoring Liquidity to the Commercial Real Estate Market: The Role of TALF

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SUNDAY, OCT. 25, 2009

Assessing Credit Risk In The MBS Sector (2:50 p.m.)

What are the best ways to improve the performance of a loan portfolio? Which of the measures regulators encourage are the most effective?

One panelist focuses on the impact of a servicer on the performance of securitized assets. Servicers are "struggling a little bit" because of the high levels of delinquencies. Also, borrowers' behavior is changing in ways that make it hard to use models to draw inferences from their behavior. The panelist recommends a strategy of aligning the investors' interests with servicers' interests by using models that help a servicer focus on the loans that are projected to produce the greatest share of losses. An ancillary strategy is to create dedicated teams that focus on groups of borrowers with common demographic attributes.

What are the best strategies for preventing foreclosures and for handling them when they happen?

A panelist from a credit bureau recommends using behavioral analysis, based on information in borrowers' credit files, as an early warning indicator for borrowers that are likely to get into trouble. A second panelist, also from a credit bureau, encourages using updated credit bureau information together with data from the LoanPerformance database to track rising stress on mortgagees.

Why do loss severities vary among different loan products? What is the best strategy for minimizing losses?

One panelist feels that there are good tools for predicting which loans will become delinquent. A key indicator is whether a loan has previously been delinquent. Another panelist encourages the use of multiple data sources for potential indicators of default risk. For example, the likely success of a loan modification may be different for two borrowers where one is "running up his credit cards" while the other is managing his finances conservatively. Only by aggregating data can a servicer discern the difference between the two.

Another panelist recommends different treatment for loans of different sizes. Loans with balances between the old conforming limit ($417,000) and the new, temporary conforming limit ($729,750) display the best (lowest) severities. Loans above the new conforming limit or below the old conforming limit have higher severities. A different panelist notes that delinquencies are rising most rapidly in the jumbo Alt-A category (Alt-A loans with balances above the conforming loan limits), where the borrowers are frequently ineligible for any government relief programs. The subprime sector has very high--but stabilized--delinquencies. Relief programs have helped borrowers at the lower end of the market, but aren't likely to help minimize losses in the Alt-A sector. The market may start to observe loss severities in excess of 70% for Alt-A loans in California.

Loss severities in the prime jumbo sector have been low so far, but they could rise if home sales decline. One panelist expects loss severities on prime jumbo loans to increase over the winter and to continue rising if unemployment continues to rise.

Another panelist disagrees. He argues that servicers exert a strong influence on loss severities. He observes that seemingly identical defaulted loans may display very different loss severities depending on who services them.

One panelist asserts that information on borrower income is the essential missing piece to the puzzle of loss severity. He implies that if borrower incomes were known, servicers might mitigate loss severities more effectively. The

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panelists from the credit bureaus argue that they're able to model borrower income (from credit file data) pretty reliably.

One of the panelists from a credit bureau argues that too much of the data used in predictive models is distorted. He argues that loan-to-value ratios (LTVs) are frequently off by more than 10%.

An audience member asks where total losses will ultimately end up for the key products and vintages. Where is the asymptote (i.e., the level at which losses stop rising)? A panelist answers that he expects peak delinquencies to occur in 2009 and 2010. Without directly answering the question, the panelist indicates that uncertainty about total losses is diminishing as the loans age.

Another panelist questions the reliability of FICO scores. He asserts that FICO scores have been less reliable in certain regions and that the worst performance was in the West, where default frequencies suggest that FICO scores were off by as much as 80 points. A credit bureau panelist argues that market participants need to use updated FICO scores and to combine FICO scores with other types of data.

Valuation And Modeling For Assets (4:10 p.m.)

The first panelist focuses on residential property valuation. Because of the recent troubles, the market has shifted its emphasis from borrower quality to collateral (home) valuation. Rapidly changing property values are a complicating factor. Using multiple approaches to property valuation is essential to improving the quality of valuations.

During the lifecycle of a mortgage, there are several distinct points of property valuation. Some occur during the origination of a loan. Others may occur if the loan defaults, becomes the subject of modification efforts, becomes the subject of a foreclosure, or becomes REO.

The error distributions of different valuation methods vary. They generally have not been rigorously measured and quantified. Thus, the differences among the error distributions for appraisals, BPOs (broker price opinions), and automated valuations are not well understood. Also, even the method for measuring the distributions is a subject of debate. For example, should REO sales be included in the analysis or not? The key is to embrace the idea of combining models with human analysis of appraisals.

Generally, it seems that automated valuation models (AVMs) have a higher frequency of large errors compared with BPOs and appraisals--though some originators have started to observe what they regard as fraudulent activity in BPOs.

A second panelist also emphasizes that market participants are intently focused on residential property valuations. He notes that loan modifications are a big issue and that information reporting and data analysis are improving in the area of loan modifications. Models are starting to be able to differentiate among modified loans to tell which modifications are likely to fail.

Market participants continue to use a loan's delinquency history much as they did in the past. Now they also use some analysis of home price changes and refinance opportunities. They are expanding the range of data that they use for analyzing residential loan performance. (See note 1.)

A third panelist, from a pricing service, supports the second panelist's view, stating that the availability of data is critical. However, he notes that market participants may suffer from data overload, and that, beyond a certain

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point, having additional data does not affect the pricing of securities.

A fourth panelist observes that the availability of data from different servicers varies. He notes that investors have to be able to adapt to the differing degrees of data availability and data quality from servicers. (See note 2.)

One panelist describes how the RMBS market environment has changed over the past two years. Bonds used to trade at fairly predictable spreads relative to an index. Then, the spreads became very wide and the durations extended dramatically. Today, many of the bonds trade at dollar prices (distressed levels). The improved availability of data is only a small factor in the overall, fundamental picture.

One panelist states that the idea of "mark to model" has become obsolete. The models produced valuations that were so different from actual trading levels that most market participants have lost confidence in pricing models. Another panelist disagrees, stating that for illiquid instruments, many market participants need to rely on models for applying market-value accounting or for determining the net asset value of managed portfolios.

One panelist feels that liquidity has been restored to the RMBS market. Bid-ask spreads have become "reasonable," allowing investors to trade in and out of positions. Another panelist adds that liquidity can vary depending on the availability of information for different bonds. Bonds with better information display better liquidity. However, because much of the population of outstanding bonds is exposed to the risk of credit loss, it is unlikely that bonds will trade "generically" at spreads to an index.

The CDO-of-ABS sector is a tough one because it depends on the ability to value all the underlying assets. One panelist observes that the exercise of valuing a single ABS CDO tranche may not be worth the effort because it could consume all the potential profit from a trade.

One panelist reemphasizes the "data overload" factor, stating that additional data may not help as a practical matter in trading bonds. A second panelist counters that the marginal data can make a difference in marginal situations. He seems to envision relative-value strategies that would involve frequently trading in and out of specific securities based on the latest data. In contrast, the first panelist seems to envision using data primarily to develop macro-level strategies involving slower portfolio turnover and greater emphasis on sector allocation than on individual security selection.

Trading Strategies For Illiquid Financial Instruments And Troubled Assets (5:00 p.m.)

One panelist, from a buy-side institution, states that his firm started focusing on distressed RMBS in 2006. He asserts that the main factors behind pricing for distressed RMBS are: (1) the liquidity premium, (2) horizon returns rather than yield-to-maturity, (3) risk-adjusted returns in competing asset classes, such as corporate bonds, and (4) funding costs and internal rate of return (IRR) targets of other market participants.

A total return strategy has the advantage of using active marks (valuations) on positions. It motivates active management of the portfolio, and it is well suited for liquid securities. A disadvantage is that marks on illiquid securities may be unreliable. Another is that it focuses on short-term returns and is not well suited to illiquid assets (e.g., because it contemplates active trading).

The advantages of an absolute return strategy include a focus on fundamentals in underwriting, limited reliance on

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marks, and the added value of asset-specific servicing.

This year has revealed a shift from fear to greed as the key motivator for market participants. Early in the year, valuations were opaque, prices were falling, intermediary balance sheets were not available to provide financing, and illiquidity was persistent. Later in the year, after the start of the U.S. Treasury's PPIP, forced selling abated and some market participants started arguing that PPIP-eligible securities had acquired "scarcity value" (i.e., value from being in short supply).

There are open questions concerning opportunities in distressed RMBS in the near future. What will be the source of tradable bonds? Will sellers have an incentive to sell? Will financing be accessible? Will the RMBS market weaken to a point where it comprises only a large number of small untradeable positions, as did the manufactured housing ABS sector after 2001? Which investors will be interested in buying RMBS? Can the market accurately forecast the relevant macroeconomic drivers? Will RMBS use simpler structures? Will the structures become so simple that the securities no longer command a yield premium for complexity?

The panelist expects distressed RMBS to continue to offer opportunities. He notes the possible creation of a standardized index based on prime-quality RMBS. He suggests that the 2006-2007 prime vintages may be the most likely to offer opportunities for such an index.

A second panelist focuses on potential opportunities in CDOs. He notes that about 340 recent-vintage ABS CDOs (of a total of 560) have experienced events of default (EODs) and that 128 have been liquidated. About $275 billion of CLOs are outstanding, much of which Moody's has downgraded. The panelist estimates that there is $10 trillion to $12 trillion of distressed assets and that supply far exceeds demand. (See note 3.) He favors the single-A-rated tranches of CLOs, which have credit support in the range of 13% to 15% and trade at dollar prices ranging from 50% to 60%.

The second panelist also asserts that initial jobless claims are a leading indicator of defaults. The default rates for bonds and corporate loans are likely to peak in the first quarter of next year, and he predicts that the peak rates will be about 15% for bonds and around 10% for loans. He expects default rates to decline sharply after the peak and believes that recoveries will be very hard to predict because of covenant-light loans and other risky features in many loans. He notes that the trading prices for triple-C loans have improved from the area of 40% several months ago to the 70% area today.

Another panelist asserts that the improving liquidity of raw loans should make the comeback of the CLO sector less likely because many investors would rather own the actual loans than a tranche from a CLO backed by the loans. However, the first panelist replies that it might be cheaper to buy an outstanding CLO than the underlying loans; the non-CUSIP collateral (loans) often commands higher trading prices than the bonds. Therefore, even if new-issue CLOs are slow to return, trading opportunities in outstanding paper are important.

Another panelist focuses on the practicalities of strategies for trading distressed RMBS. Some investors have been focusing on total-return strategies that emphasize trading securities that have better liquidity. The challenge is that an investor pursuing such a strategy must compete against both securities dealers and with other investors that have access to leverage through either the PPIP or the TALF. The panelist prefers an absolute value strategy, which should focus on assets that aren't eligible for PPIP/TALF. Funds that have lock-ups for three or four years may be in a position to benefit from focusing on less-liquid investment opportunities. He asserts that second-lien deals with bond insurance have performed very well, with valuation differences stemming primarily from differing views about the

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value of bond insurance. He notes that the trading values dropped to the area of 20% and then recovered to the 50s, and that the uninsured value of the bonds was probably in the mid- to high-teens.

Another panelist, from a dealer, asserts that liquidity is back. That means that yields are lower than they were several months ago. Last week there were $6 billion of BWICs (i.e., "bid lists" or solicitations of bids on specific securities by holders interested in selling) in the residential space, and all of it traded. That suggests that the market has substantially recovered. It's now much tougher to find bargains. It took a long time for the market to reach consensus on appropriate stress scenarios for valuing and trading the securities. However, the past two years have helped drive a consensus about the projections and forecasts for many of the bonds. CLO prices have returned to where they were before the financial crisis, and triple-A-rated tranches trade at yields of 5%. Prices have improved for senior securities in the residential sectors.

The panelist recommends looking at the mezzanine tranches from RMBS deals backed by prime and Alt-A loans. He recommends 2005-vintage RMBS backed by option adjustable-rate mortgages (ARMs). Small investors should worry about competing with (1) dealers firms, (2) money managers approved under the PPIP program, and (3) TALF-eligible investors. A small investor ($50 million sector allocation) should focus on odd lots (i.e., small trades), which may offer pricing advantages of up to six points. It may be possible to achieve yields of 20%. For the midsize investor, the strategy should be to focus on off-the-run, seasoned, second-pay tranches from high-grade CDOs. Opportunities may come from working with a midsize dealer who will work with the investor, not against him. For the large investor, the best opportunities may be "behind" the cash market for securities in warehouse financing for residential mortgage loans or student loans.

MONDAY, OCT. 26, 2009

The Importance Of Securitization In Rebuilding The U.S. Capital Markets (10:00 a.m.)

Issuance of nonagency securitizations (i.e., securitizations not issued or guaranteed by a government-sponsored entity) has been very slow in 2009 compared with the peak levels of 2005-2007. There is virtually no nonagency RMBS issuance, and the most active area of this segment has been nonmortgage ABS. Outside the U.S., there has not really been a revival because central banks have financed most of the issuance. Also, in the U.S., government programs such as TALF have financed much of the issuance.

So why is securitization important? What are the benefits of securitization? Can we live without securitization? Where are we now?

A recent IMF report said that 19% of all primary debt is financed by securitization. In the past, one of the benefits of securitization was that it had been cheaper than issuance of straight debt. Also, securitization can be a vehicle for transferring risk. In addition, securitization allows for creating customized investment products to appeal to different investors. Securitization can also provide better asset-liability management.

One panelist asserts that a benefit of securitization is that it allows financial institutions to "manage" their regulatory capital requirements. However, there can be too much of a good thing, as illustrated by the structured investment vehicles (SIVs), which were off-balance sheet vehicles that ended up returning to institutions' balance sheets.

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Another panelist focuses on the credit quality of underlying assets. He states that the market is in the process of finding the "middle ground" of good asset quality combined with access to securitization funding for originations so that originators are not limited to portfolio lending.

A third panelist focuses on the diversity of funding sources. He also emphasizes the importance of risk management and the need for institutions to define their risk appetites.

A key development over the past year has been that regulators and policymakers have realized that, although some areas of securitization have performed poorly, most of it has worked properly and should be retained as part of the U.S. financial landscape.

Another panelist feels that next year will be a pivotal one for securitization. He feels that a resurgence of securitization could provide an outlet for both significant refinancing activity over the next several years and for financing the overhanging inventory of unsold homes. Another panelist believes that the prime jumbo mortgage market is likely to recover before the subprime sector.

One panelist remarks on the issue of leveraged investing through the use of "synthetic" securities (i.e., credit default swaps, or CDS).

Another panelist feels that TALF is one of the most successful government programs. It has strongly helped revive issuance of triple-A-rated nonmortgage ABS, but it has done nothing to help the market absorb lower-rated tranches (which issuers have had to retain).

One panelist asserts that TALF has been key in the tightening of CMBS spreads. Whenever bond values exceed collateral values, securitization activity occurs. However, patience is necessary because different sectors are recovering separately. The recovery in the corporate market occurred earlier and was stronger than in CMBS, and it captured activity that otherwise would have become CMBS deals. The bigger problem, however, concerns lenders' balance sheets, because the slowdown of CMBS activity means that they can't shed risk through securitization. Delinquencies are already at 1993 levels. If the Fed raises interest rates, it could create additional pressure because interest rates on refinancings of construction loans and maturing balloon loans would also go up.

Another panelist views the CMBS area as similar to the RMBS area because both have had poor credit performance. The markets need to figure out the "real transaction of the future" and the right subordination levels to counterbalance credit risk.

A third panelist asserts that nonagency RMBS issuance activity has been suppressed by very low mortgage rates for conforming loans. He expects to see a resurgence of nonagency RMBS issuance when conforming loan limits return to their regular levels next year. (See note 4.)

Another panelist notes that there is more pain to come in the CMBS area and that new deals will be structured with more credit enhancement than what was typical in older deals. A different panelist observes that the CMBS investors that have remained active are the ones that dig into the details of transactions.

One panelist argues that CDOs are essentially similar to other securitizations because they structure cash flows. He says the problem for CDOs was that some of the underlying assets did not work well. He asserts that unsecuritized mortgage loans in bank portfolios performed just as poorly as securitized mortgage loans. A second panelist says that the market will have zero appetite for CDOs of ABS in the short run. He remarks that corporate CDOs may be

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different. A third panelist notes that the market is taking a baby step of securitizing some unrated residential mortgage pools with very high credit enhancement levels. He adds that corporate CDOs have reasonable prospects to come back. One of the other speakers feels that the TALF program may produce the necessary spread tightening to get nonagency mortgage securitization restarted. Another panelist observes that weak transparency is impeding a recovery in CDO issuance. Nonetheless, he feels that there are opportunities in secondary trading of existing CDOs.

One panelist argues that the key to allowing a government exit from the securitization market (i.e., termination of stimulus programs like PPIP and TALF) is improvement in the credit quality of underlying assets.

Another panelist focuses on the complexity built into securitizations and the role of servicers and trustees. Many market participants did not contemplate the intricate details that have become important (e.g., servicing arrangements in RMBS and events of default in CDOs). A second panelist agrees that the market will learn a lot and is still being tested in areas such as loan modifications and conflicts between different classes of bondholders within a given deal.

One panelist feels that it is possible for very conservatively underwritten deals to get done. He remarks that a sufficiently conservative basis would be to use property values equal to the values from 2000.

Another panelist feels that 2007 commercial real estate valuations had "nothing behind them" and that some property values can fall to 1990s levels.

Navigating The Changing Environment Of The Consumer Securitization Market (12:00 p.m.)

One speaker asserts that TALF has been very successful for the consumer ABS space. Liquidity is strong for TALF deals and spreads have tightened significantly, though not to pre-market-disruption levels. Also, a greater proportion of "off-the-run" deals, such as rental car and timeshare deals, have come to the market as TALF-eligible transactions. Accordingly, she expects that even after the TALF program ends, the market will continue to function and spreads will avoid a dramatic widening.

Another panelist observes that TALF has not addressed the issue of subordinate tranches (which are not eligible for financing under TALF). Some non-TALF deals from major issuers have achieved even tighter pricing than many TALF deals. However, it remains unclear how readily the market will absorb mezzanine and subordinate tranches after the TALF expires.

A third panelist notes that many traditional investors have returned to the securitization market, but they are being very selective and have somewhat less appetite than before. She asserts that deals backed by nonmortgage consumer assets are very strong and should avoid problems.

Another panelist asserts that TALF investors were willing to accept tight spreads because they can use generous leverage through the TALF program. However, after TALF expires, those same investors may become attracted to mezzanine and subordinate tranches in order to achieve the same returns on investment (ROIs). He questions whether the PPIP market may draw interest away from mezzanine and subordinate investment offerings.

One panelist asserts that the Credit Card Accountability Responsibility and Disclosure Act of 2009 (Pub. L. No. 111-24) has had some unintended consequences. Some lenders have cut back on consumers' credit lines or cancelled

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their card accounts. Most credit card companies have suffered losses this year. Not allowing credit card companies to base their pricing on risk will result in curtailing credit to less-creditworthy borrowers. He argues that credit card issuers should be allowed to use risk-based pricing because they have to be allowed to make profits. Otherwise, there will be fewer credit cards, and consumer credit will be constrained. Another panelist argues that current credit card regulation is "schizophrenic" because it simultaneously pushes for both increasing credit (to provide stimulus) and tightening credit standards.

Another panelist notes the rising uncertainty about fundamental assumptions, such as the enforceability of contract rights. The bankruptcies of the auto companies raised troubling questions about the rights of secured lenders. The push for loan modifications on distressed residential mortgage loans highlights similar issues. Thus, the policy decisions to help consumers and employees may have unintended consequences. If lenders and investors perceive greater risk about the certainty of their contractual rights, they likely will require incremental yield to compensate for that risk in the future. The panelist notes that if the yields on ABS increase, the price of credit to consumers and companies must also rise.

One panelist notes a recent publication in which Moody's announced that only card issuers that have corporate ratings of 'Aa3' or higher will be able to achieve ratings of 'Aaa' on their credit card transactions. This is a result of the recent accounting changes under FAS 166 and FAS 167 and the resulting uncertainty of safe-harbor status for the securitizations under FDIC conservatorship/receivership procedures (see "Is True Sale In Jeopardy In Certain U.S. Bank-Originated Securitizations?" published Aug. 10, 2009). Another panelist asserts that the FDIC is aware of the problem it has created and is going to demand concessions from issuers in exchange for fixing it. She argues that Congress is going down the wrong path in pushing for loan level data for all asset classes, because not all asset classes are like residential mortgage loans.

Another panelist addresses the issue of linkage between the ratings on ABS issuers and the ratings on the ABS that they issue. He notes that there has been linkage in the area of rental car securitizations (see "Revised Global Methodology For Rating Rental Fleet ABS" published June 29, 2009). He notes that the failure of a rental car company can lead to sudden increases in the credit volatility of its ABS. He notes that there are new standards for backup servicing in new transactions to address the risk that the originator goes out of business and no longer services the assets. Another panelist feels that the rating linkages are diminished when strong backup servicing arrangements are used. (See note 5.)

One panelist asserts that not all deals should be able to achieve triple-A ratings for their senior tranches. Another panelist notes that investors are likely to be receptive to non-triple-A senior securities.

Another panelist asserts that the low historical default frequencies of single-A-rated credit card tranches suggest that they should have higher ratings. Other panelists object, raising the issue of loss severity if the securities default. One panelist notes that ratings may also reflect the credit stability of an issue (see "Standard & Poor's To Explicitly Recognize Credit Stability As An Important Rating Factor" published Oct. 15, 2008).

One panelist asserts that spreads of 400 basis points on triple-A-rated credit card ABS were unreasonably wide. He argues that such spreads are inherently inconsistent with the notion of the high credit quality associated with triple-A-rated securities.

Another panelist returns to the issue of home prices and the economy. He observes that the problems are not nearly over, and that the overhang of unsold homes will remain a drag on the recovery for some time. Consumers are

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spending less. Payment rates on credit cards have leveled off and have been steady for the past four or five months. A different panelist highlights that there are important variations in credit card performance across states. Unemployment is highly correlated with consumer performance and, therefore, the weak outlook for the labor market points to a weak outlook for the performance of consumer receivables. This suggests that servicing efforts need to retain their intensity to best manage losses. Another panelist agrees that unemployment rates and alternate sources of liquidity for consumers are key drivers of consumer receivables performance. However, housing also has a big impact, and consumers in the states that have had the worst housing markets are the ones who have produced the worst performance on their nonmortgage obligations.

One panelist argues that consumer lending standards are tight. This is partly because it's harder for credit card lenders to charge sufficiently high interest rates to offset the risk of lower-quality borrowers. High-quality borrowers are also experiencing cutbacks in their credit lines because their accounts may not be profitable for the credit card issuers (because they often don't carry a balance). Another panelist argues that consumer lending standards are appropriately tight. However, the regulatory pendulum may have swung too far, which may disrupt securitization and inappropriately curtail the availability of consumer credit.

Some important regulators favor FAS 166 and 167 because they're a backdoor way to allow a lot of capital to enter the banking system.

Asset Managers' Strategy Roundtable: Finding The Hidden Gems And Assessing Reward Vs. Risk (2:15 p.m.)

The Public-Private Investment Program (PPIP)

In the PPIP, the U.S. Treasury matches private investments in legacy securities and then provides additional financing. (See note 6.)

PPIP has various rules and allows interest rate hedging but not credit hedging. The appeal of the program is that it provides boosted leverage for periods of up to 10 years with greater flexibility than other forms of financing. PPIP funds offer reasonably safe returns in the mid- to high-teens. The challenge for investors at this stage is to find available assets that will perform well. The universe of potential assets is around $1.5 trillion, and the aggregate capacity of the program is only about $40 billion. Accordingly, PPIP can have an important effect on the margin, but it cannot absorb all the potentially available supply. One panelist feels that because PPIP funds focus on senior tranches trading at distressed levels, there is a very strong likelihood of good returns for investors.

Potential sellers of PPIP-eligible assets have several possible motivations to sell. One is to harvest gains on positions that were previously marked down to low values (i.e., the investor previously booked mark-to-market losses on the positions). Another is to clean out distressed securities from portfolios to improve the appearance of company portfolios for shareholders or management by allowing them to say, for example, that they have eliminated all their exposure to Alt-A or subprime loans. In that vein, some recent sellers had a level of losses that they were willing to accept, and when trading levels rose to those levels they became eager to liquidate positions. Also, the longer the market remains distressed, the harder it is for companies get their auditors to accept inflated valuations. This creates additional selling pressure for companies that may have been slow to mark down distressed positions.

PPIP funds are allowed to make distributions of up to 8% annually from interest on the investments. This has created a preference for high-coupon, fixed-rate securities in PPIP funds. Nonetheless, PPIP funds also invest in

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floating-rate securities. Indeed, it is wrong to generalize that PPIP funds focus only on certain asset classes or types of instruments.

Investors in PPIP funds (and PPIP fund managers) should focus on duration. They should favor short-duration assets to dampen price volatility from changes in interest rates.

Researchers find it easy to write about PPIP funds because the rules are fully transparent.

PPIP fund managers must have procedures for handling potential conflicts of interest involving allocations among their PPIP portfolios and their other managed portfolios.

Competitive advantages

A panelist from one asset management firm notes that his organization has built a 20-person mortgage trading operation that includes many former traders from securities firms. Because of the firm's direct investment in diverse businesses, it gains superior insight that informs its strategy in trading RMBS.

A panelist from another firm focuses on the need to analyze individual securities to be able to distinguish securities that have a realistic chance of producing negative returns from those that are relatively safe. A panelist from a third firm focuses on the value of his firm's experience spanning many different areas. He notes that although securities values have increased markedly over the past few months, this is arguably reasonable because "new" money has returned to the securitization market.

On the other hand, another panelist highlights that fundamental performance continues to deteriorate in the residential mortgage sector, notwithstanding that RMBS prices have risen. He argues that the PPIP does not produce enough incremental demand to justify the increase in prices, and that prices have become too high in some sectors. He predicts that the technicals (i.e., price levels) are not here to stay and wonders who would be the natural investor for bonds that offer expected yields of only 7% to 8% and that present material risk of loss. He expects that there will be some pain when the fundamentals of the housing market start to flow through (i.e., when losses from home foreclosures ultimately become losses on securities that currently command tight spreads).

Another panelist asserts that the securitization market has had the benefit of light supply compared with that of the corporate sector during the year. Another panelist agrees, noting that yields in other sectors have been very low, thus encouraging increased allocations to securitization investment.

One of the key lessons of recent years is that liquidity is highly variable in the structured finance market. When an investor really wants liquidity, it may not be there. One panelist emphasizes that relative value strategies must allow the manager to take both long and short investment positions. Other panelists agree that hedging strategies are important, as is liquidity management.

What will the securitization market look like in five or 10 years?

One panelist observes that some of the complexity and the structures that were prevalent at the top of the market were ill-conceived. He expects future structures to be simpler, with fewer, but thicker, mezzanine and subordinate tranches. He predicts that rating agencies will have some form of increased accountability and that issuers will have to have "skin in the game" (i.e., retain risk in the assets that they originate). A second panelist feels that in five or six years, the CMBS market may return to the practices it embraced in 2003-2005, but that it is unlikely to return to the practices of 2006-2007.

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Picks and pans included:

- One panelist is hesitant about CMBS because of fundamentals. He's anxious about commercial defaults. In contrast, the residential cycle is further along, and the concern is now about loan modifications and loss severities following foreclosure. He favors RMBS over CMBS.
- A second panelist favors non-TALF-eligible super-senior CMBS tranches (with 30% credit enhancement). They offer yields of 8% to 9% and a potential upside if the market stabilizes.
- A third analyst notes that REO inventories are shrinking while foreclosures are increasing. He believes that there is a distortion that creates a falsely positive view of the residential sector. He also notes that servicers suffer from having too much work and that loan modifications create uncertainty. He has a negative view of principal securities but believes that interest-only securities may offer good investment opportunities. He thinks that there likely will be good buying opportunities later in the year.
- The fourth panelist favors selected seasoned deals because they had stronger loan underwriting. They have suffered devaluations in excess of their fundamental deterioration. However, market sentiment feeds on itself and can become a self-fulfilling prophesy.
- In response to a question from the audience, one panelist remarks that nonmortgage consumer ABS temporarily experienced a dramatic spread widening to 600 basis points for triple-A tranches. The spreads later tightened to below 100 basis points. He remarks that credit enhancement levels are driven primarily by the rating agencies rather than by investors.

RMBS Traders' And Researchers' Roundtable (3:15 p.m.)

Existing home sales surged in September, but that's just one of the many conflicting signals about the condition of the housing market. Housing affordability is near all-time highs, and home prices recently strengthened. However, foreclosures are also high, and a large proportion of mortgage loans are underwater, which may produce a dangerous negative feedback loop with foreclosures.

So, where are we in the housing cycle and what's the outlook?

One panelist recounts an analysis from 2008, which suggested that home prices would have hit bottom in mid-2009. That has not happened. However, most of the ultimate peak-to-trough decline already has occurred, and any further drop should be limited. The key drivers are employment and income. The affordability index is not the heart of the story, because home prices are quite strong in some areas where affordability is low. The story varies in different areas depending on local economic conditions. The panelist expects flat home prices for five or six years and notes that the overhang of foreclosures will take years to complete. There are about seven million foreclosures coming, which will spread over a period of up to seven years. The inventory of REOs and foreclosures is changing the dynamics of the housing market because it transforms the market into a "price clearing" market rather than one where sellers take homes off the market when they can't get their target prices. He challenges the notion that there are many strategic defaulters. Rather, borrowers default because of poor initial underwriting.

A second panelist focuses on delinquencies. He notes that a very large share of loans that become delinquent by 60 days or more ultimately end up in foreclosure. Analysis today has become more difficult because one has to consider "reperforming" (modified) loans as a separate category from performing loans or defaulted loans. The panelist is skeptical about the prospects for modified loans to avoid redefaulting. However, the reperforming loans slow down the cash flows of the deals. This can create opportunities in deep-discount, last-cash-flow securities, which may

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experience a boost in yield from weighted average life (WAL) extension.

One panelist observes that loan modifications arguably are just delaying foreclosures that ultimately will have to occur. Even worse, all the efforts toward loan modifications may be gumming up the works for processing foreclosures. On the other hand, loan modification programs that focus on DTI (debt-to-income) ratios actually can work to prevent foreclosures. Also, government stimulus programs are helping the housing sector. It is important that government programs provide monetary incentives to servicers for successful foreclosures. So, all this means that the market is nearing the peak rate of foreclosures and that it should be able to avoid fire-sale situations and a vicious cycle of falling prices and increasing foreclosures.

Another panelist observes that the backup of loan liquidations will continue through next year, as many loans remain in the modification process rather than moving to foreclosure.

A third panelist argues that loan modifications are bad for investors because the ultimate severity of loss on foreclosure is worse when a loan is modified. The borrower on a modified loan may stop maintaining his house and view the situation as an option. That is why only 50% of modifications are successful. That rate of failure suggests that borrowers may not even want to stay in the homes.

A fourth panelist expects a CMBS crisis to come in the middle or toward the end of next year. He feels that the PPIP is affecting technicals (by amplifying demand) and will continue to do so next year. He feels that re-REMICS (resecuritized real estate mortgage investment conduits) are an opportunity for holders of mezzanine tranches. He does not see opportunities in the whole-loan area.

Another panelist feels that current prices aren't sustainable in the subprime sector and in the whole residential sector. She feels that bonds are being priced based on unrealistically rosy projections. She feels that fundamentals are out of line with pricing. Pricing of subprime securities implies that there will be a "V"-shaped recovery at the end of the year. She expects the stock market to decline and that there will be a big sell-off across many parts of the market. She asserts that single-digit yields are not enough to compensate for bonds with binary outcomes (e.g., subordinate or mezzanine tranches that may suffer 100% principal loss if they default).

A different panelist has a brighter (but still generally dark) outlook. He focuses on the underwater borrowers. He notes that not all of them will default. He argues that some borrowers produce rolling delinquencies (i.e., they're in a perpetual state of delinquency because of past uncured delinquencies, but they continue to make steady monthly payments), but they will not necessary default. He feels that there is strong potential for partial recovery of principal on certain mezzanine or subordinate bonds. He says that the shape of the economic recovery will be a long "U," not a "V." However, there is such a thing as survivorship; many borrowers will not default. His bottom line is that there is potential upside in some bonds. The range of fair values can be from 20% to 80%. And some bonds are highly sensitive to the level of losses (i.e., "thin" tranches).

A panelist from a pricing service notes that the market rallied recently for several varieties of mortgage products and that the PPIP has had a noticeable impact of supporting pricing. The recent rally means that fund managers may find it difficult to get the double-digit yields that they initially intended to achieve. However, Alt-A hybrids and option ARMs offer opportunities for yields in the range of 10% to 15%. The PPIP should help reinforce positive sentiment in the market and should help establish benchmarks for valuation of toxic assets.

One analyst reiterates his earlier remarks about favoring double-A mezzanine tranches. A second panelist notes that

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she favors some older double-A mezzanine tranches from deals where the senior tranches are nearly paid down.

CDO Market Post-Mortem And Outlook (4:45 p.m.)

One panelist observes that the bond insurers arguably never had sufficient capital to have become involved in ABS CDOs. Taking ABS CDO risk seemed like a smart strategy at the time, but things turned out differently. A second panelist feels that the reason things did not work is because key participants had conflicting interests. Originators had incentives only to originate the highest volumes. Investors were interested in the true quality of the deals. Although CDOs are somewhat similar to banks (because they're pools of debt obligations against which other debt obligations are issued), they did not have the same incentives and constraints as banks.

Another panelist differentiates the experience of various CDO sectors. He argues that what went wrong in ABS CDOs was correlation. The true correlations among the underlying assets was very high in ABS CDOs. In contrast, he argues, there is much less risk of underestimating correlations in corporate CDOs. Also, because CDO managers earn much lower fees than hedge fund managers, CDO managers' primary motivation is to continually do new deals, so that they can increase their assets under management. He argues that many market participants have overreacted to the experience of the ABS CDO sector, applying unreasonably high correlation assumptions to corporate CDOs.

A third panelist recounts the pitch that dealers used to use in selling ABS CDOs--that multiple layers of subordination provide protection. However, the deals also had multiple layers of leverage. The panelist mentions "rating shopping," which is when issuers and underwriters use the rating agencies with the easiest criteria. He argues that rating agencies need to be totally transparent about their criteria and clear about the economic scenarios corresponding to each level on their rating scales. He argues that rating agency performance should be measured for accuracy, perhaps by an official body composed of investors. He further argues that rating criteria should be neither too lax nor too strict; if it's too lax, it produces weak deals, and if it's too strict, all deals will be shopped away from the rating agency.

Another panelist remarks that rating agencies should be required to refund their fees if a deal's actual performance varies substantially from the performance that the initial ratings implied. He focuses on rating transitions as the main variable to monitor.

A lawyer panelist observes that investing in ABS CDOs is different from investing directly in RMBS because there is an additional structural layer and a dimension of active management.

One panelist raises the issue of Tropic CDO V Ltd., in which Texas Pacific Group (TPG) is attempting to purchase certain collateral at below-market prices by making outside-the-deal payments to the CDO's equity holders. He emphasizes the need to scrutinize the legal documents for a CDO transaction. Another panelist reinforces the point, noting that there was little standardization in CDO documents and that each dealer had its own forms. The forms varied materially on issues such as events of default, voting rights, and control rights. Also, in the rush to get new deals closed and because of the practice of cloning documents from one deal to the next, many errors got replicated after they first occurred. He also notes that there is a dangerous lack of transparency in the CDO market, where even basic deal documents and trustee reports are not readily available to market participants. Another panelist urges caution in using CDO trustee reports because they may contain errors. He also remarks that some of the cash flow models of CDOs also may contain errors and may be inconsistent with the indentures for the deals.

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One panelist explains that his firm started investing in distressed CDOs around a year ago. He believes that he found attractive opportunities, and the market's rally over the past few months has affirmed his view. He favors conditions where various market participants have differing outlooks because that is necessary for having both buyers and sellers and for promoting liquidity. He's concerned about refinancings of many corporate loans without covenants. He feels that the new loans may have extended the lives of companies for a year or two, but that the risk of ultimate default for such companies remains very high. His overall outlook is rather negative.

Another panelist asserts that the market was excessively bearish in March, though he was bullish based on his assessment of the option value of the securities. He argues that too many market participants have unreasonably bullish outlooks today. He expects some single-A securities to terminally pay in kind (PIK, i.e., distribute no further cash). He argues that there is some unreasonable investing behavior because investors may have too much cash and are forced to put their money to work. A second panelist notes that some triple-C loans that were trading at prices around 5% of par subsequently rallied to prices around 90%. The first panelist focuses on the binary (i.e., all or nothing) payout profile on many securities and the issue of net asset value (NAV) coverage.

Outlook

One panelist feels that the CLO market has active secondary trading. The rising prices of the underlying loans have had a strongly positive impact on trading levels for CLO tranches. In the ABS CDO area, there are opportunities because some short sellers need to cover. Some funds are interested in secondary trades of ABS CDOs, and other players are focusing on opportunities where CDO tranches trade at discounts to their underlying NAVs. The reputation of CDOs is terrible right now, but the technology is still being used in other areas, such as re-REMICs. The panelist asserts that re-REMICs are simply ABS CDO technology. (See note 7.) He notes the reasonably good performance of CLOs and thinks it will be a long time before new managed ABS CDOs come to market.

Several panelists share the view that CLO activity is likely to come back, but with less leverage than before. Most feel that ABS CDOs are unlikely to come back. One panelist expects investors to have greater focus on legal documentation than before.

TUESDAY, OCT. 27, 2009

Keynote Address: Distressed Mortgage Investing And The Role Of The PPIP Program (9:00 a.m.)

Marathon Asset Management is one of the nine managers the U.S. Treasury has selected to manage portfolios of distressed legacy securitization assets under the PPIP.

A consistent pattern among banks is that their consumer loan books show weakness. Of the 8,200 banks in the country, up to 1,000 may get into trouble before the system recovers. None of the big banks is likely to be closed, but many smaller banks may disappear. The 40 largest banks account for roughly 95% of assets and deposits, and the largest 10% account for more than 80%.

It will take time for the banking system to heal. The process for banks may mainly be to earn their way out of losses over time. The banking system is much stronger than it was a year ago, when it was on the brink of collapse.

Simplicity is preferable in regulation. Overly complex regulation has been one of the factors that exacerbated

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problems in the banking sector. The question is whether Congress has the fortitude to reform the disjointed system of banking regulation in the U.S., including the existence of too many separate regulatory bodies.

The government spent, lent, and guaranteed about $16 trillion to rescue the banking system. The programs were very effective, but letting Lehman Brothers collapse was not. Institutions should be allowed to fail, but regulators need to control the way that they fail. TALF and TARP have been successful. The Fed has been effective in purchasing as much as $1 trillion of agency MBS, and there's a good chance that the banks will repay the TARP money to the government. The commercial paper (CP) support program was able to mitigate the disruption of the CP markets. Now, however, the market and the government have to deal with the process of gradually getting the government out of the financial system and disentangling it from the markets.

The PPIP is the first time that the U.S. Treasury has hired private contractors to manage assets. More than 100 qualified money managers applied to be PPIP managers. The program focuses on securities that originally carried ratings of triple-A. The Treasury provides up to $1.1 billion to each of the nine managers, matching private investment dollar-for-dollar. Then, the Treasury provides additional debt financing for 1-to-1 leverage for each manager. The investment horizon for most of the funds is eight years.

The Fed is focused on stimulating the issuance of new securities through the TALF. The Treasury is focused on stimulating the market for legacy securities through PPIP. The FDIC also is working with banks to provide cheap financing for sales of legacy assets.

The fundamentals for residential real estate have bottomed, though there's potential for a further dip. Residential real estate is in a trough, which may persist for some time. Prices have corrected to 2002 levels, and mortgage rates also are low. This makes homes more affordable than they have been in 18 years. We're in a transition period of working through an overhang of homes. Home prices may suffer a further decline of a few percentage points, and the commercial real estate sector is still deteriorating. Capitalization rates for commercial real estate are up by as much as 300 basis points. While delinquency and default rates should stabilize soon in the residential sector, they're likely to rise in the commercial mortgage and real estate areas.

Just as the structured finance area holds some distressed-debt opportunities, so does the corporate sector. Some opportunities relate to companies in bankruptcy or in work-outs. The bankruptcy of General Motors was an example. The holding company of Washington Mutual also offered investment opportunities around the time the bank failed.

Internationally, the big story is China. For 2010, China will grow at roughly 8%. Chinese bank loans are growing at a rate of 35%, and auto sales are growing at a rate of 40%. In contrast, the rate of growth in the U.S. will be in the range of 3% to 4% in 2010. A continuing problem in the U.S. is that both consumers and many companies are over-leveraged. The unemployment rate likely will pierce 10%, and the economic recovery may be a "jobless recovery." Then the U.S. economy will settle into slow and anemic growth that will continue for a number of years.

Lessons From The Financial Crisis: Required Steps For Recovery (9:30 a.m.)

You can't figure out what to do about a crisis until you reach some agreement on what went wrong. The keynote speaker remarked earlier that restoring liquidity is a necessary condition for the recovery of the ABS sector. This panel considers a broader range of conditions that would be sufficient.

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Before the crisis, the ABS market was vibrant, with $2.7 trillion of ABS issuance and $755 billion of private-label MBS issuance in 2006. (See note 8.) For 2008, the issuance volumes were only a small fraction of their prior levels.

Assets

One panelist feels that the problem boils down to greed. Originators started originating loans that didn't make sense. Some lenders are returning to the lending standards that they used in the 1980s. The TALF program is pushing technicals (prices) to levels that aren't justified by the true fundamentals. The distressed legacy securities are the product of an environment in which many U.S. consumers lived beyond their means. Today, many consumers are deciding to spend less and to save more. This may further challenge home values and fundamentals. Also, the prospect of higher unemployment may put additional pressure on fundamentals.

Another panelist highlights that the Fed made conditions worse by maintaining low rates for too long. Also, the securitization industry aggravated matters by creating products for repackaging other products (e.g., SIVs and CDOs buying ABS and MBS).

A third panelist highlights the change in the American cultural attitudes toward debt. From the 1930s through the 1970s, the general sentiment was one of prudence toward incurring debt, even for purchasing homes. Corporate America also had conservative attitudes about debt. However, over recent decades leverage increased and debt represented a greater share of corporate balance sheets. By 2003 or 2004, attitudes had changed entirely. Consumers were willing to accept very high debt loads, and corporations were relying heavily on asset-backed commercial paper programs for a large share of their funding. Hundred-year-old money management firms started to enter the CDO business as ABS CDO managers. All the ABS CDOs that they created ended up defaulting. "Leverage blew up the whole world."

Originate to securitize

One panelist feels that the "originate to securitize" business model and the use of mortgage brokers were important contributing factors to the crisis. The essential element was that performance did not deteriorate until long after underwriting standards had deteriorated. He argues that the key to avoiding dangerous mistakes in securitization investing is to understand the true character of the underlying assets.

A second panelist agrees. He believes that many investors didn't understand the true character of the assets underlying the securities that they bought. Also, they didn't fully understand the deal documents, the role of the servicer, or the role of the trustee.

A third panelist feels that requiring originators to retain limited "skin in the game" is only a partial solution. The retained interest may not represent enough risk, or the originator may sell it after a short required holding period. The deciding factor for an originator may simply be how long he must retain "skin in the game" and what his exit strategy will be after the required holding period expires.

Bursting the bubble

One panelist emphasizes that markets are all about supply and demand. Borrowers with modest incomes should not be able to purchase very expensive homes. However, bubbles are a fact of life. New Yorkers who bought apartments at the peak levels of the 1980s had to wait until 2000 for apartment prices to recover to their 1980s highs. The fundamentals of the real estate market remain very weak. The stimulus programs are keeping security valuations artificially inflated, but the securitization market is not going away. Once the fundamentals get settled (probably around the middle of next year) borrowers will still need mortgage loans to buy homes and institutional investors

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will still need high-quality (highly rated) investments in which to invest.

Another panelist feels that the bubble was exacerbated by overly loose credit. However, the problem was not really with consumers, it was with corporations. Banks and other financial firms had excessive leverage--AIG took $1 trillion of corporate credit risk, and Citibank took $150 billion of risk through off-balance-sheet vehicles. Key lessons: Use less leverage and accept lower earnings.

Transparency, reporting, and availability of information

Trustees are providing more information, including making deal documentation more readily available. Also, many new service companies are emerging to provide enhanced flows of data and information on deals. However, the GSEs still do not supply loan level information for the loans that back agency MBS. Structures became too complex, creating a smoke screen that impaired transparency. The days of investors simply relying on ratings is over.

Accounting considerations

The elimination of "gain-on-sale" accounting was a positive policy measure, but it wasn't enough. Accounting policies encouraged high leverage through the use of off-balance-sheet strategies.

The role of the rating agencies

One panelist feels that rating agencies were part of the "collective delusion" that afflicted the whole securitization industry. Strong continuing performance of securitized assets belied the deterioration of underwriting standards. Rating agencies should start placing greater emphasis on operational reviews to determine whether originators follow their underwriting standards. Too many rating analysts focus on statistical modeling rather than on the real assets backing deals. The huge amounts of downgrades of structured finance securities contributed to the market dislocation because structured finance ratings had been so stable for so long. Another panelist asserts that faulty correlation assumptions were a key driver. He adds that there was a fundamental mistake in assuming that not all markets can go down at the same time. A third panelist returns to the issue of information availability.

Lessons learned

One panelist feels that the key lessons are de-leveraging and simplicity. Also, investors should focus on cash flows more than documents. Understanding the collateral is more important than modeling. In the subprime sector, it's less important to focus on the quality of every single loan in a deal because there is a lot of structure and comparatively high levels of credit support to cover weak loan performance. In contrast, in the prime sector, where credit enhancement levels are much thinner, the performance of every loan counts.

A second panelist feels that securitization will recover. He's eager to see the first new nonagency mortgage deal. When it happens, it likely will involve fully documented loans with low LTVs.

Unlocking Liquidity In The Secondary ABS Markets: Traders' And Investors' Roundtable (11:00 a.m.)

(See note 9.)

Some panelists feel that trading levels appropriately reflect fundamentals and the renewed availability of financing for leverage. One panelist asserts that the market suffers from excessive complexity, which impairs transparency. Another panelist complains that investors want equity-like returns with no risk. He contends that if something appears to deliver that result, it probably contains hidden risks or problems. Investors need to be more realistic and

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decide whether they want high returns or low risk. A third panelist remarks that investors suffered severe losses last year and, therefore, their demand for high returns is reasonable. Even so, returns of 25% are not reasonable and should not be attainable without taking very high risk. Investors reasonably want to get fair returns on an unlevered basis. The panelist expects a pull-back in valuations to a level in between today's prices and the low price levels of March. A fourth panelist asserts that attractive structured finance investment opportunities still exist, but the real issue is what assets are available to feed the pipeline for new deals. He argues that the problem is that raw assets are locked-up in institution portfolios and aren't being released as they might have been through the PPIP. Many institutions still have the raw assets marked at high levels and aren't inclined to sell at prices that force them to book losses. He also notes that there is a serious continuing problem of Alt-A residential mortgage loans (and others) that are in default but that aren't viable candidates for loan modifications.

Another panelist remarks that although lots of money is on the sidelines, investors' appetite is muted because they "took it on the chin" over the past year. Even so, many investors seem to have suffered short-term amnesia about the losses that they suffered. (See note 10.)

A different panelist remarks that government stimulus is helping. She contends that the government stimulus will persist for the "long haul." Other panelists disagree. One feels that the government will withdraw its stimulus in the near term. Another feels that the government hasn't done everything that it could have to provide stimulus. He contends that the government merely "played it safe." He argues that it will take strong urging from the securitization industry to get the government to take some policy risk in providing more aggressive stimulus.

One panelist contends that lack of transparency can help an investor who is seeking the highest yields. However, better transparency helps the market as a whole. This is evident from the history and evolution of the stock market. Most market participants will be better off with improved transparency.

Another panelist observes that there is significant uncertainty about the macroeconomic outlook, which makes it difficult to formulate a strategy for taking risk. Hedge funds need to resume taking real risk if they want to achieve double-digit returns. When securities prices were very low earlier in the year, there were many attractive opportunities to take on incremental risk. In contrast, now may be the time to divest risk.

The PPIP can help avoid distressed sales of assets by banks, and this can provide time to allow banks to earn their way out of problems. Therefore, even though the PPIP is limited in size, it can have a strong effect because it influences the marginal trades. It's arguably an example of "technicals becoming fundamentals." Another panelist disagrees. He notes that the announcement of the PPIP program brought about a material tightening of spreads and it became a self-fulfilling prophesy. However, he believes that the program itself is too small to actually make a difference.

One panelist expects securitization to be revived by deals involving prime mortgage loans and nonmortgage assets. Another panelist feels that securitization must reemerge because it has become a critical financing vehicle for the American economy.

The Future Of Structured Finance Ratings and Methodology (1:45 p.m.)

One panelist focuses on the recent changes at Standard & Poor's, including organizational, analytical, and transparency-related. The key organizational change is the creation of a separate, independent group that develops

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and tests criteria. A second newly created group monitors the application of criteria and adherence to analytical policies and procedures. In the area of analysis, a key change was the publication of a report titled "Understanding Standard & Poor's Rating Definitions" (published June 3, 2009). A key theme of that report is enhancing the comparability of ratings across market sectors. Stress scenarios are a new tool that Standard & Poor's uses for enhancing comparability. The stress scenario for the 'AAA' rating level is the Great Depression, and the recent criteria changes in the RMBS and CDO areas are specifically calibrated to the historical experience of the Great Depression. In the area of transparency, Standard & Poor's has renewed its emphasis on providing a thorough explanation of both the ratings and the criteria. This appears in the published rationales for ratings, in criteria reports themselves, and in published "what if" scenarios.

Another panelist (an investor) observes that the steps described by the first panelist are good first steps for rating agencies to restore credibility. Other steps include the introduction of volatility ratings and the dissemination of loan level information. However, more needs to be done. He asserts that the rating agencies need to better explain how their models work and should consider selling their models. (See note 11.) There are other third-party models available, and it would help the market to achieve better transparency if the rating agencies were more transparent about models. Also, rating agencies need to be more transparent about why some securities suffer downgrades and others do not. And rating agencies should require independent, third-party reviews of the collateral underlying securitization deals.

The first panelist explains that Standard & Poor's makes several of its most important models available to the market. Also, the rating agency has established an independent, internal group to validate models.

Another panelist (a regulator) says that the main lesson from recent experience is that there has been overreliance on ratings. He feels that rating agencies have done an excellent job in the "single-issuer" (municipal and corporate) space. However, the problems have been concentrated in the asset-backed space, where the rating agencies don't necessarily have a "natural advantage." Recently the National Association of Insurance Commissioners (NAIC) announced that it is seeking bids for a model to produce conditional expected losses on securitizations. He believes that non-rating-agency entities may be able to produce such models that are as good as or better than the rating agencies'.

Another panelist notes that a likely source of problems was overreliance on models. He believes that rating agencies need to rely less on models and more on their analysts' judgment in making ratings. He asserts that there is little evidence that the way in which rating agencies are compensated (payments from issuers) has ever actually caused rating agencies to publish distorted ratings. Nevertheless, the appearance of a conflict of interest needs to be eliminated in order to restore confidence. He proposes an alternate compensation scheme in which both issuers and investors would pay for ratings. The system would work in the same way as the Municipal Securities Rulemaking Board's, by imposing a small charge for every deal. He suggests a charge in the range of five to 10 basis points on each deal and on each secondary trade. Rating agencies would be paid on a "cost plus" basis. The system would have a governing board that would assign deals to rating agencies. Rating agencies that produced superior performance eventually would receive more assignments. He believes that without reform of compensation, the appearance of conflicts will not be addressed and confidence will not be restored.

Another panelist suggests rating agencies could be paid fees through the cash flow waterfalls of the deals that they rate, similar to how deals pay trustee fees. Payments over time would depend on deal performance. The previous panelist counters that a system modeled on trustee fees might not be adaptable to areas other than structured

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finance.

A different panelist suggests that the NAIC might be able to serve as the entity to assign rating agencies to provide credit ratings to deals. That approach would essentially retain the "issuer-pay" business model but would add a regulatory body to serve as an intermediary. The NAIC has approved RealPoint as a rating agency for determining insurance company capital charges.

Competition among rating agencies raises interesting problems. One is the problem of "rating shopping," where issuers select the rating agency with the standards that are the most lax (i.e., in order to achieve the lowest credit enhancement levels). Another panelist adds that there should be more disclosure about rating shopping. Investors want to know what ratings would have been assigned by the rating agencies that were not selected to actually issue a rating. He adds that ratings may become more reliable if there are more rating agencies competing. Another panelist reemphasizes that he wants the most reliable ratings for determining capital requirements for insurance companies. He notes that quantitative modeling arguably is the easiest piece of the puzzle and that other factors may create tougher challenges.

One panelist feels that rating agencies are necessary for the proper functioning of the capital markets. A second panelist feels that rating agencies can be helpful in restarting the market but he's not certain that regulators need rating agencies, although he notes that investors may need ratings. A third panelist says that many investors do use ratings, and rating agencies provide a "common ground" that helps to enhance liquidity. A fourth panelist feels that the rating agencies have made very appropriate changes, and that if the market did not have rating agencies it would have to invent something like them.

Restoring Liquidity To The Commercial Real Estate Market: The Role Of TALF (2:35 p.m.)

What is TALF CMBS and how is it supposed to work?

TALF CMBS is a loan program by the Federal Reserve Bank of New York to make nonrecourse financing available to eligible investors in CMBS. TALF was originally designed for consumer ABS but was subsequently broadened to include both legacy CMBS and newly issued CMBS. TALF CMBS for new issues will expire June 30, 2010. The other TALF programs are scheduled to expire March 31, 2010. An eligible borrower under TALF must be a U.S. company, but it can be controlled from offshore. Eligible collateral includes most dollar-denominated CMBS and nonmortgage ABS issued after Jan. 1, 2009 (for new issues). For ABS other than CMBS, eligible collateral must have the triple-A ratings from two of Standard & Poor's, Moody's, and Fitch, and no lower rating from the third. For CMBS, there are five eligible rating agencies.

CMBS TALF loans provide for haircuts of 15% for CMBS with weighted-average lives (WALs) of five years or less. The haircut increases by one percentage point for each additional year of WAL in excess of five years. Qualifying collateral must have a WAL of 10 years or less. The interest rate on the TALF loans is the swap rate plus 100 basis points, with fees of 10 basis points for nonmortgage collateral and 20 basis points for CMBS collateral. Loans are available for terms of either three years or five years.

TALF attempts to restart the market from the investor side. By providing 85% leverage, investors using TALF can achieve attractive double-digit returns on invested capital. One panelist notes that the TALF program offers what is essentially a once-in-a-lifetime opportunity to achieve attractive returns on a nonrecourse, leveraged basis. However,

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the program has some big limitations that have constrained its impact. The program benefits eligible investors but provides no help to the underlying real estate borrowers.

The CMBS TALF calls for collateral to be well diversified (by borrower, geography, etc.), but most actual deals do not meet the standard. They have to be addressed on a case-by-case basis.

What is the buzz on CMBS TALF, and what deal flow is in the pipeline?
Only a handful of new deals have come along. They contained very conservative loans, but did not have strong diversification. Single-borrower transactions are likely to occur in November or December. Multi-borrower deals are likely to come in the first quarter of 2010.

One panelist asserts that CMBS TALF is not actually reviving the overall CMBS market, just a few key borrowers. (See note 12.) The program is unlikely to reach many people.

Many new commercial real estate loans will not be eligible for TALF because the underlying properties are in declining markets.

Some investors can't avail themselves of investment opportunities using CMBS TALF because they don't have the 15% equity the program requires. Also, because current capitalization rates for commercial loans are much higher than in recent years, many refinancing borrowers are caught in a situation where they cannot get a large enough loan to retire their outstanding debt.

Compared to ABS TALF, the advance rates in CMBS TALF are very low. Many borrowers borrowed with LTVs in the 70s and 80s (percent) and with cap rates in the range of 5% to 6%. That will leave a significant share of them in positions where it is impossible to refinance. The effective advance rate at the triple-A level is around 40% for a single-property/single-borrower deal. This comes from a capacity of debt analysis. The advance rate can be somewhat higher for a diversified pool based on the notion of diversification.

One panelist feels that the solution to the tight standards of the CMBS TALF program would be for the government to take more risk and accept tranches with ratings below triple-A. He asserts that the government's risk posture in CMBS TALF is much more conservative than its position on providing support to banks under the TARP.

One panelist notes that the TALF program for legacy CMBS has tightened spreads considerably, which could be a significant help to new deals.

Notes

(1) An unanswered question is whether the additional data actually make predictions and forecasts more reliable.

(2) He does not address the issue that data may not be filed with the SEC and, therefore, may not have the benefit of extra quality control that companies frequently apply to filed information.

(3) The numbers seem high. The total amount of residential mortgages in the U.S. was around $10.9 trillion as of second-quarter 2009.

(4) The regular conforming loan limit for 2008 was $417,000. Section 201 of the Economic Stimulus Act of 2008 (Pub. L. No. 110 185) raised the limit to $729,750 for loans originated in certain high-cost areas between July 1, 2007, and Dec. 31, 2008. Section 1203 of the American Recovery and Reinvestment Act of 2009 (Pub. L. No.

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111-5) sets the conforming loan limit for 2009 as the higher of the 2008 limits and those originally specified for 2009 in section 1124 of the Housing and Economic Recovery Act of 2008 (Pub. L. No. 110 289).

(5) The panelists seem believe that linkage comes entirely from servicing considerations, but this is not always the case.

(6) The Treasury has selected nine money managers to manage funds under the program. Each manager receives matching equity investments from the Treasury for each dollar of private capital that it raises to invest in eligible securities, up to $1.1 billion of matching funds per manager. In addition, the Treasury provides debt financing up to 1-to-1 leverage. Thus, if a PPIP manager raises private capital of $1.1 billion, the U.S. Treasury provides matching equity of $1.1 billion, producing total invested equity of $2.2 billion. In addition, the Treasury provides debt financing of up to $2.2 billion, producing a potential fund size of $4.4 billion. Therefore, the nine PPIP investment portfolios will potentially amount to $40 billion all together.

(7) The panelist seems to ignore the fact that re-REMICs are generally static resecuritization structures, whereas most CDOs provide for active trading of the asset portfolio.

(8) The $2.7 trillion figure seems way too high unless it includes GSE MBS issuance and non-U.S. issuance. The $755 billion figure for private-label MBS issuance is reasonable.

(9) Arrived 20 minutes after the start of this session.

(10) The second statement seems to contradict the first.

(11) The panelist may not be aware that the major rating agencies generally do make their most important models available to the market.

(12) This seems inconsistent with earlier remarks.

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