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Structured products: approach with care

What a difference a few months make in the financial markets. Just one year ago trade journals trumpeted that structured products were "music to the ears" of structured finance professionals. Maureen Nevin Duffy examines what has happened since.

The market for Collateral Debt Obligations (CDOs) grew by 80% between 2004 and 2006 and the chiefs of Wall Street were declaring healthy profits from the sector. Yet today, the same monarchs are losing their thrones, and some their heads, over the same instruments.

Despite the trillions of dollars invested in mortgage-related structured products over a few short years, the subject is now taboo. Communications specialists at the country's major banks confide, "I doubt I can get you anyone to speak on this..." Institutions decline to comment. "We don't discuss our investment strategy." Some just don't return calls.

"Obviously, asset managers are wary of structured products in the wake of recent problems," says Leslie Rahl, president of Capital Market Risk Advisors, in New York. Rahl has made a name for herself and her firm testing risk models for flaws. "We are focusing on helping our clients stress test the assumptions that underlie the structured products." A pet peeve of Rahl's has been that investors rarely analyze vehicles when they're yielding high returns. The real estate and credit markets meltdown provides yet another example.

So it's difficult to perform a post-mortem on the sudden collapse of the now shunned structured products market. "Effectively, the market (for structured products) is dead," pronounces Brad Bailey, a senior research analyst with the Aite Group, a consultancy based in Boston. "There is no appetite for risk," says Bailey, since regulatory standards tightened up right along with the deals themselves and investor demand. "It's all part of a wide-spread credit mess!" He says the market is jammed stuck for the moment, unable to move either forwards or backwards.

"The CDO side was absolutely frothy," says Bailey. "Prudent people said, 'This is crazy...look at these spreads'." He recalls the famous line from Citi Group CEO Chuck Prince, whose fate has been mentioned with the recently 'retired' Merrill Lynch CEO and Chair, Stanley O'Neal. Prince had vowed to keep dancing the credit derivative waltz until the music stops. "Housing peaked in 2005," notes Bailey. Apparently, for some the band played on.

Not everyone who suffered from the credit crisis was holding derivatives. In early September, Russell Read, the chief investment officer for the California Public Employees Retirement System (CalPERS), told his board, "CalPERS hasn't been hit hard by credit developments, although there's been some flattening of the investment performance overall in the past few months from indirect hits on asset classes." Funds which sold off equities to liquidate assets and cover short positions when the credit market plummeted, sent the US equities market into a tailspin as well.

Read said that as of June 30th, CalPERS Fixed Income Unit had $139 million in three CDO investments, or 0.06% of the total fund market value of $247.7 billion. "That's a very small exposure to CDOs. We made the initial investments in early 2004 to take advantage of attractive conditions in the credit market. Investment returns in the three deals ranged between 16% to 27%, with no write-downs of our investment as defaults were low."

CalPERS also owns about $2.5 billion in securities that are backed by subprime loans. They were all AAA-rated. Overall the fund's value has gone from $247.7 billion on 6/30/07 to $254.8 billion, according to Read, who sees the "recent market turmoil as a necessary repricing and tightening of liquidity that favors long-term investors like ourselves who don't need to borrow heavily to make deals. We're looking for opportunities in the current market that will pay off later. Would-be competitors who don't have our resources also have dropped out of the bidding."

At Payden & Rygel, a Los Angeles-based money manager with more than $50 billion under management for institutional clients, □investment intermediaries and individual investors worldwide, Dave Ballantine agrees the crisis can present opportunities. "There's opportunity in the markets now for anyone who can distinguish high quality mortgage collateral from the not so good," notes Ballantine, the principal responsible for the global firm's structured products.

Has he taken advantage of openings? "We have already, but not so much in the Alt-A," he says. "Before, we didn't get paid much to distinguish sub-prime from Alt-A. One of the problems in the marketplace today is that investors in addition to ourselves are able to get the spreads we think will add value to our clients' portfolios without having to go down in quality to that Alt-A area.

"We'll see Alt-A and sub-prime deals originate again," Ballantine says hopefully. "But in the last couple of months, I think we saw a pool of eight or nine sub-prime deals. It's really fallen off the cliff."

What kept Payden & Rygel primarily out of the CDO and CLO (collateralized loan obligations) market was the lack of transparency. Also, says Ballentine, the model didn't make sense. "Many of the assumptions going into these models that the rating agencies used in hindsight were specious assumptions that just didn't hold water. We found that underlying assumptions ultimately led to risk correlations to be higher than originally expected, a fact that surfaced as the deals began to unwind."

Rahl agrees. "Assumptions are a key component of any structure; in other words correlations, length of history used, will the future be like the past, etc. Understanding how sensitive a structured product is to the assumptions is a critical but often overlooked component of risk assessment and risk management," Rahl told Global Investor.

Questionable oversight, in hindsight, was also a contributing factor. "Many of the entities bringing the CDOs worked with the underwriter along with the rating agency to construct the product," charges Ballentine. "The question originators posed to rating agencies was How much subordination do I have to have, to get the AAA-rating?"

The close relationship has provoked scrutiny from the US Securities & Exchange Commission. Chairman Christopher Cox told the US Senate Committee on Banking, Housing and Urban Affairs, on September 26, "...the Commission is examining whether these nationally recognized statistical rating organizations (NRSROs) were unduly influenced by issuers and underwriters of RMBS (Residential Mortgage-Backed Securities) to diverge from their stated methodologies and procedures for determining credit ratings in order to publish a higher rating. The examination is also focusing on whether the NRSROs followed their stated procedures for managing conflicts of interest inherent in the business of determining credit ratings for RMBS."

How does a manager, even one who hasn't been a major player, go forward in this market? "It's not affecting our CDO strategy," says Ballantine. "But anyone who says they're not affected by it, we'd be skeptical of. (The credit crisis) is affecting just about every area of the marketplace."

Caution

People are still trying to do transactions to try to decrease their risk exposure. The trouble is, everyone is trying to do the same thing. "There's only a finite amount of balance sheet available," says Ballantine. "The demand for all these assets has been slashed. So you have to find a clearing level for where this is going to be, and that clearing level is reflected within the price," which may not reflect its real value, he notes.

Ballantine has a word of caution about when equilibrium may appear to return to the market. Significant players meet their fiscal quarter at the end of November and another batch at the end of December. They'll have to meet capital ratio requirements to balance the risk they're carrying.

"That will put pressure on them to shed risk positions," he says. Add to that the recent downgrading of some bonds and that's another hit to the balance sheet, he contends. And, he's not enamoured of the Master-Liquidity Enhancement Conduit (M-LEC) or the Structured Investment Vehicles (SIV). There's no quick fix.

Recently, two major credit market players, Deutsche Bank and Credit Suisse, sold off huge lots of CLOs that they'd been holding back during the market frenzy. Deutsche Bank sold a discounted fee a $2 billion bundle and Credit Suisse sold a batch worth $1.7 billion. The underlay was loans without buyers that were seen to be keeping loan prices down. News reports say more such sell offs are expected.

What was that Chawdry closed with last year? "In the event of a hard landing in US housing...," he wrote, "it's more likely than ever that CDOs pose a risk to the system due to the sheer size of the market. It would be worthwhile to examine such products with a lot of caution rather than invest with gay abandon."

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