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MARKET DYNAMICS

Disintermediation, deregulation, and disintegration?

BY DEBORAH HICKS MIDANEK

Recent turmoil driven by developments in the US subprime mortgage markets has regulators and investors all over the world wringing their hands. What makes it more intense this time is a function of policies and practices supporting disintermediation, movement of money out of the banking system and thus out of regulatory oversight, for over 30 years.

The simple issues: First, much of mortgage lending is about lending long and borrowing short; when liquidity stops, so does the company. Second, no amount of risk diversification will protect against weak underwriting that often accompanies easy access to money.

The more complex: First the alphabet soup of recently introduced special purpose investment vehicles represents a now huge global market, and no one can have an integrated view of the whole. Second, the supply of related derivatives contracts and special purpose vehicles can go on proliferating as long as the parties will sign contracts. Third, the complexity of many of the instruments, or derivatives of derivatives, defies the ability of a human being to actually understand them, so humans default to machines, models, and the mythical guy in the next office who gets it.

I cannot resist a trip down memory lane. In 1970, the first money market fund was established, creating safe places to earn interest outside of a bank. As interest rates rose in the post oil shock era of high inflation, money moved rapidly out of banks and into money market accounts. Concerned about deposit flight, Congress allowed the first interest bearing deposit accounts to be offered by savings banks in the late 1970s. Thrift institutions at the time were a protected species, given their special role in making home mortgage loans, deemed critical to the nation's interest in promoting stability through home ownership.

To help the thrifts who now had to pay depositors high interest but could afford neither to sell their current loans nor fund new ones at high rates, Congress allowed them to write off sale-related losses as 'goodwill' over a long period of time. In doing so, however, Congress all but wrote the death knell for the thrift industry. With the huge new influx of secondary product the mortgage market per se finally took off in the early 1980s. Ironically, the thrift industry, no longer uniquely useful, was bypassed.

Suddenly, the Street's bond trading floors, historically sleepy backwaters controlled by local guys, became places where huge amounts of money were made due to the volatility of interest rates, historically low. Trading in mortgages became the hottest game in town, as the analytical complexities of valuing mortgages could be used to advantage by a savvy street dealing with slower sellers and buyers. Trading floors attracted MBAs drawn by the earning potential, and rocket scientists by the great puzzle of valuing pools in which each mortgage included 360 possible prepayment dates, and each pool included thousands of mortgages. Option valuation thinking bloomed.

In another response to volatility, the swap (derivatives) markets were born, allowing borrowers and issuers to separate principal repayment risk from interest rate or currency risk. A simple contract entered into by two or more counterparties, the swap contract was free of any regulatory involvement, and allowed a borrower who could borrow in one market at attractive fixed rates but preferred floating rate payments to agree to make fixed payments to another borrower, who preferred fixed rate payments but could not access such financing directly.

As the supply of both new and seasoned mortgages continued strong, the teeming hordes on Wall Street continued to seek ways to build a broader market for the product. The growing ability to analyse options and rearrange cash flows led in 1984 to the first large Collateralised Mortgage Obligation, or CMO. The CMO allowed institutional investors unable to accept prepayment risk to participate in the mortgage market with greater predictability of return by stratifying mortgage pools sold into a special purpose vehicle (SPV) into 'tranches' of SPV debt with various payment speeds.

Loan pools were stress tested against loan performance data collected since the 1930s to estimate their likely performance in various interest rate and credit environments. Rating agencies determined how much over collateralisation or insurance would be required to achieve high ratings for each tranche. The leftover cash flows, the cash expected after all tranches were served, was considered the equity in the deal, called the residual, and if certain conditions were met, the seller could keep the residual without having to carry the loans on the balance sheet – a 'true sale' in the eyes of accounting and law. Now, anyone could originate a loan and sell into such a vehicle, and, more importantly, anyone who followed the rules being established for off balance sheet vehicles and true sale opinions could use them. Securitisation was here to stay.

Having deferred recognition of the thrift problem for nearly a decade, Congress finally acted with the passing of FIRREA in 1989 and the creation of Resolution Trust Corporation. Banking regulators defined risk based capital standards for commercial banks, to specify capital required to support specified asset types. One by product of this initiative was an increased propensity of commercial banks to sell loans in order to manage their capital.

In 1994, the market for securitised subprime mortgages began to take off. The argument used was similar to the one used to support the high yield bond market: if borrowers with ››

poor credit were offered credit, the price they would pay would outweigh the possibly greater risk of default. Additionally, difficulty gaining credit was thought likely to inhibit borrower prepayment.

Demand was strong and originations swelled. The sub prime market had historically been a fairly local one, and the originators mostly local companies operating in a niche business, selling their product as whole loans to banks with careful underwriting criteria. Securitisation, however, gave such companies a low cost of funds, and the opportunity to originate larger volumes, selling to the Street to securitise.

As more originators got involved, borrower prepayments escalated well beyond expected levels. Subprime borrowers could now refinance without difficulty. In 1997, the first massive write downs on residual values occurred. The originators, many of them now public, shuddered and were scrutinised. The assumptions made to the data used to establish ratings, data that was not based on subprime payment histories but was instead based on assumed variations from prime borrower data, were adjusted and the market moved on to its next and near fatal test.

The events of 1998 almost stopped the subprime sector in its tracks, as in the wake of the international debt crisis and the collapse of Long Term Capital Management, liquidity dried up overnight. Absent liquidity, these companies cannot function. They typically have no borrowing power of their own as their balance sheets have few assets other than mortgage loans, which are financed by other lenders in advance of the next securitisation.

Many originators were liquidated, and the quality of their loans discovered to be much lower than expected. Whole loan buyers, for example, would not buy much of the product that had been originated for securitisation, because they evaluated every loan on its merits, whereas securitisations were based on aggregate loan pool parameters with limited re-underwriting of individual loan files. Many companies had gotten stuck on a vicious treadmill: they had to originate in ever greater volumes to keep their perceived earning momentum high, for the same reason they were aggressive in valuing residuals held on their books, and their underwriting standards became more and more generous as competition increased. Until the music stopped.

In 1999 Congress repealed the Glass Steagall Act, enacted in 1933 to separate investment banking functions such as underwriting securities from commercial banking activities such as accepting deposits and extending loans. The basic argument was that consumer deposits must be protected and should not be subjected to the risks that investment banks, operating with capital deployed explicitly to make money from taking risk, wanted to take.

US commercial banks could now trade on a level playing field with investment banks. Perhaps facing pressure to diversify, banks increasingly began seeking to free up the capital required to do so by originating loans and syndicating them or selling them into CDOs (Collateralised Debt Obligations) and CLOs (Collateralised Loan Obligations), a variation of the securitisation vehicles used in the mortgage markets. Investment banks, wanting to compete with banks' lending power had also been originating loans and syndicating them to others or creating CDOs, to allow both sets of institutions to originate in volume and create new fee income to boost returns on capital.

With Enron and WorldCom's collapses, corporate scandal seemingly proliferating CDO investors were concerned about corporate credit quality. In 2002, originators introduced asset backed securities, including mortgage related securities, to CDOs as they were regarded as being less risky and more liquid. The CDO market, then estimated at about half a trillion dollars in size, reached an estimated size of over $2 trillion by the end of 2006, according to Celent. The CDO had become what some sceptics call an investment landfill, much like the subprime securitisations of the mid 1990s. While initially intended for corporate debt obligations, the structures were also useful for commercial real estate (CRE), for mortgages, and even for hedge fund collateral.

By 2006, over half of the CDOs issued were based on structured finance collateral, and the great majority of that is estimated to be subprime collateral. It appears that many more difficult to place, lower rated tranches went into CDOs, making it much easier to place the senior tranches and keep originating more new deals, again with ever weaker collateral. Unfunded, synthetic CDOS were introduced, with derivative contracts used to replicate the cash flows expected by various pools of collateral. CDOs were introduced that invested in other CDOs: CDOs squared.

So what went wrong and caused the stumble in credit markets this summer? Where can we begin?

First, in simple terms, loans are no longer made by entities that have to live with whether they get repaid or not. Commercial banks like thrifts before them can be bypassed, replaced by structured vehicles with no dedicated capital that can greatly increase the availability of financing, but are not organised to work with a borrower to revise credit terms or to manage a workout or foreclosure and learn from the experience. Mortgage originators are by definition originating product for others to distribute. Banks as corporate lenders play a greatly reduced role compared to banks as deal originators.

Second, low interest rates for the first few years of the decade fuelled both demand for loans, especially mortgage loans, as consumers sought to own their home, and investor demand for low duration, higher yield investments. Securitisation of mortgage loans made it easy to meet this demand on both sides, and more and more paper was originated to feed the investor market. As the events of the late 1990s in the sub prime market showed us, the volume of loans far outpaced the underlying credit or actual asset quality, and overwhelmed the systems apparently analysing the risk.

Third, securitisation markets and derivative markets are not self limiting but are limited only by the ingenuity of the creator and the willingness of the counterparty. There are no brakes built into the system until defaults oc-

Those companies unable to refinance their way out of difficulty will have to pursue other means – perhaps with unexpected results.

cur. Little capital is required to create these vehicles; only willing buyers.

Fourth, much of the activity does not fall under any regulator's responsibility, and regulatory bodies are largely based on old business models and not based on understanding securitisation and derivative instruments and their global proliferation. No one entity can see what is happening in national markets, let alone international markets.

Fifth, every cog in the system is doing his job as he knows it. Originators originate loans that can be sold. If buyers buy what they originate, they have been trained by that act to originate more of it regardless of whether the underwriting was good or bad and the asset value actually there. The Street is doing its job as an intermediary, originating product and structuring it into forms that meet the needs of the investors. The rating agencies, roundly criticised for falling down on the job, are also in business, and have long been paid by the issuer, which clearly presents a bit of a conflict. The buyers are putting money to work in structures they believe sound though their ability to do due diligence on the underlying collateral is limited. Everyone is getting paid.

Sixth, as the complexity of instruments and derivatives of derivatives continue to grow, ever more specialised skills are required to think about them. Specialists may be deeply immersed in a particular aspect of a securitisation without understanding the whole thing. Each player in a specialised area may be thinking that someone else understands the 'why' of what he is doing; he is just doing the 'what' part as well as he can. Silos form.

Seventh, the complexity of some of these instruments may well be beyond the ability of any human being to understand, and the market may basically run on momentum until a shock occurs. Complexity forces reliance on machines and models and removes ability to make judgement calls. A giant kind of keeping up with the Jones's may be fuelling the whole market, where each player wants to perform better than his neighbour: the index of all players.

Eighth, compensation models in many cases emphasise fee income over income based on overall results. Personal accountability is reduced as players increasingly look to 'get theirs'.

Finally, throughout the time period reviewed above, economies have grown, employment has grown, inflation has remained relatively low, and adverse market developments have apparently corrected themselves. Do securitisation and derivatives markets developed over the last few decades promote risk management and allow broader distribution of known risk to players ready to accept that risk, or do they merely move risk around, in a giant game of chicken? Is it best for free market forces to ruthlessly prevail when the complexity is so great and regulatory oversight is non existent? Will our commercial banks follow the thrifts into pleasant irrelevance? No single person can answer these questions, but exploring them in the context of a little history may be illuminating. ■

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