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Growing liquidity in the whole loan market mitigates the subprime market implosion

The unravelling of the US subprime mortgage market, combined with the subsequent rising yields in both the US and Europe, has suspended the international securitisation market. If this window remains closed for a prolonged period, financial institutions in Europe and abroad are likely to have a substantially more difficult time managing their balance sheets. Heavy reliance on the securitisation market for many institutions is causing management real concern now that this balance sheet tool is temporarily not available.

The good news is that while financial gridlock may have shut down the preferred option for many financial services companies, another door has opened for institutions willing to consider an increasingly effective alternative: the market for whole loan portfolios, either individually or through pools of loans.

Because of the unique set of circumstances in the securitisation marketplace, it is an opportune time for buyers and sellers to look at trading all or parts of whole loans in the emerging secondary market for residential and commercial debt. This whole loan market offers many of the same benefits as securitisations, but with low cost, greater flexibility and superb price execution. For buyers, the ability to purchase and close

exactly the piece of debt they want is particularly attractive in this kind of turbulent market.

A market melts down

To appreciate the benefits of portfolio transactions, it's instructive to look at how the securitisation market operates. Traditionally, securitisations have only been as good as the institution's ability to sell all of the component parts of the securitisation. When that occurs, financial institutions in a single stroke can recognise profits from loan originations and create an annuity from the associated servicing, assuming they have a servicing business.

Less attractive is selling all of the higher-rated tranches and retaining the lower- and non-rated tranches. The benefits of such a transaction are that it addresses funding concerns and potentially creates the servicing annuity. Yet, from a risk capital perspective, nothing has changed. The bank has retained most of the risk; the bank remains in the first loss position with regards to losses from the portfolio.

In fact, the secret to a successful securitisation franchise has not really changed since the business was created in the early 1980s with CMOs. If an institution can find a buyer for the unrated piece, the rated component can be structured to meet the strong demand for rated bonds. The difference between the market leaders in creating securitisations and the also-rans was the speed and effectiveness of their sales force in placing the unrated tranches.

From the investment bank's perspective, the ideal buyer is the bank that originated the loans. Assuming that the originator does not want to retain this risk, investment banks succeed only when they can sell the more volatile, unrated tranches. This has remained constant as the market has evolved from CMO to CDO to CLO.

No one will play

With the sudden volatility and opaqueness of the US subprime market, this process has stopped working. Investors willing to buy the unrated pieces are demanding spreads that make new structures unworkable. Investors who are long on these pieces are finding secondary bids unacceptably low. At the same time, those being forced to sell these tranches (potentially for margin calls) or have to mark-to-market, are feeding the headlines of the financial press.

Compounding the current problem is the fact that financial institutions are under enormous pressure to demonstrate the liquidity of their portfolios. Institutions that are illiquid are finding themselves prime acquisition targets, while those with proven liquidity have far more strategic options. Meanwhile, regulators are demanding increasing transparency to determine the real value of assets and are praising institutions that can demonstrate market value through a sale. Finally, modern credit ►►

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portfolio management techniques demand that banks dispose of credit risk either through sale or derivatives.

The virtues of owning the entire asset

So where does this leave the financial institution with a large balance sheet and a desire for liquidity?

The good news is that the buying community has gotten more sophisticated. The original arbitrage for CMOs was for higher rated paper. The option of buying the underlying portfolio was not particularly attractive. High quality, third-party servicing did not exist. Analytics and third-party models to evaluate residential and commercial real estate portfolios were simply not available. The net effect was that the average investor faced insurmountable obstacles to buying the underlying asset.

With the emergence of a liquid secondary market for debt over the past few years, all that has changed. Put bluntly, investors are now finding that they would rather own a portfolio of commercial real estate mortgages where they have a direct line to the asset instead of a share in a SPV that owns the same mortgages. The servicing industry has also matured and can now shield investors from the operational complexity in managing loans. Financial modelling for these portfolios has become infinitely better and more effective.

For institutions, an increasingly liquid secondary market provides both buyers and sellers with an opportunity to execute transactions quickly and securely. The growing efficiency of this market is enabling buyers and sellers to achieve much of the results that securitisations usually deliver.

In addition, a portfolio transaction avoids the time and expense associated with the typical securitisation. With a portfolio sale, sellers avoid extensive due diligence by third parties, regulatory filings, prospectuses, the establishment of a trust and appointment of a trustee, distractions from the core business, uncertainty in deal execution, and a potential contingent liability to the business operation. With the market as volatile as it is, that's significant.

No one really knows when the window will open again for securitisations. At the same time, many European banks are seeking to adjust their balance sheets against real or perceived changes in the economy. The next few months will be an interesting test to see whether the whole loan market has matured and can take up the slack created by the temporary halt of the securitisation industry. ■

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