

Dead Calm: No One Trusts You

A Letter to Certain Investment Banks and CDO Managers

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It's Not the Rating Agencies, It's YOU

Some market pundits say that "disclosure" is the answer to the "dead calm" of a securitization market adrift in the doldrums. That is not it guys. It is one thing to have documents that disclose risks—many of the documents of death spiral collateralized debt obligations (CDOs backed by private-label residential mortgage backed securities) in 2007 disclosed eye-popping risks—it is quite another to bring deals to market that you knew or should have known were overrated and deeply troubled the day the deal closed.

The real issue is timely, complete and continuing disclosure. If you knew or should have known your "triple-A" tranches deserved a junk rating on the day the deal closed, that should have been specifically disclosed, no matter what the rating agencies, or your attorneys, said. As the investment bank securitizing the deal and selling the securities, it was down to you. You thought the disclaimers in the documents protected you—well how is that working out? You are now suffering some of the consequences. The SEC may say you were within the "rules" (let's see what happens), but the market is holding you responsible. Investors shun you.

"Disclosure" of Loan Data Answers the Wrong Question

The reason no one trusts securitizations is not "disclosure" of loan data. The reason is that you, the securitization departments of several investment banks and the "friendly" CDO "managers," that "managed" their death spiral CDOs, have no credibility. If securitization professionals failed to perform appropriate due diligence, they have a problem. If they performed due diligence, but suppressed the reports, they also have a problem. Going forward, investors may not even trust "disclosures" of due diligence, because loan data can be manipulated. Your current lack of credibility means your former customers will be reluctant to believe your data and your documents in future.

You Didn't Know the Gun Was Loaded—Oh, Really?

Investment banks have a huge credibility problem when trying to explain that they "didn't know the gun was loaded," because people like me began putting their concerns in print early in 2007. You may recall that I wrote an article for *GARP Risk Review*¹ saying risk managers who had a hard time doing their jobs should get out and short these deals. I used Merrill as an example, but the same applies to many other investment banks.

So, how did the CDOs that Merrill Lynch brought to market in 2007 perform? As expected, they are dreadful. (See Table 1) All of the deals I captured are in serious trouble at the "triple-A" level. All have one or more originally "triple-A" rated tranches downgraded below investment grade (junk) by one or more rating agencies. Of the 30 CDOs shown, 27 have even the topmost original "triple-A" tranche now ranked as junk by one or more rating agencies.

As of June 10, 2008, of 30 CDOs totaling more than \$32 billion in notional amount, 19 have declared an event of default, are in acceleration, or have been liquidated. Ten others are "toast," as evidenced by downgrades of their "triple A" tranches to junk status, yet I could find no record of a declared event of default (EOD). The remaining CDO has "triple-A" tranches downgraded to junk, but the two topmost tranches are still rated investment grade (the topmost is Aa1 neg/ AAA neg and the formerly "triple-A" tranche below that is Baa2 neg/ BBB+ neg). The EOD may be

undeclared due to documents that avoid that declaration so that investors cannot trigger acceleration or liquidation (or the declaration may be pending).

Other investment banks deserve to be in the Hall of Shame, but the most they can hope for is to match Merrill's 2007 record; they cannot beat it. (And if I inadvertently missed a Merrill CDO in this 2007 cohort, and if it is performing well, we would all like to hear about it. Inquiring minds would love to know.)

Merrill had pieces of other investment banks' deals embedded in many of the CDOs, and likewise other investment banks had pieces of Merrill's CDOs in their deals. And, of course, their credit derivatives desks bought and sold protection on each others CDOs.

If I knew there was a serious problem with buying and selling these securitizations, then investment banks knew or should have known. I run a boutique consulting firm in Chicago. My intellectual capital is the product. If I can figure this out, how is it that the army of securitization professionals and their management did not? Or did they?

As far as I can tell, disclosing loan data is not the problem. The problem is that investment banks knew or should have known they packaged damaged product to sell to unwary investors. Granted, some of these investors were sophisticated and should have known better; investment banks and "sophisticated" investors, like the bond insurers can slug it out with each other. But there is a difference between an account with a lot of money and a "sophisticated" investor. Many smaller municipalities and other retail-like accounts may have been saddled with dodgy products. Investment banks and the rings of highly paid managers, securitization professionals, and lax CDO managers have an enormous amount of responsibility for the collateral damage done to the U.S. housing market and "insured" bond markets.

Investment Banks Owe U.S. Taxpayers

One can argue that the bond insurers were willing victims, but municipalities paying higher funding costs were not. One can argue that some homeowners knowingly overextended themselves, but many others were victims of predatory lending practices. U.S. taxpayers are unwilling victims, paying either directly or indirectly for housing market assistance, turmoil in municipal bond markets, frozen auction rate securities, and bailouts of errant mortgage lenders and investment banks.

The Federal Reserve Bank is now providing liquidity for many investment banks either directly or indirectly. Investment banks may not be "borrowing," but the Fed's willingness to accept "triple-A" assets in exchange for treasuries is a back-door bailout.

Investment banks — and their all-powerful lobbyists, including the Mortgage Bankers Association and the American Securitization Forum —should be told: you helped break it; you help pay for it.

¹ Janet Tavakoli, "Subprime Mortgages: The Predator's Fall," *GARP Risk Review*, March/April 2007 Issue 35.

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Source: Tavakoli Structured Finance - June 10, 2008

ABS CDOs Underwritten by Merrill Lynch in 2007				
Estd Closing	Deal Name	Manager	Appx. Size (\$MM)*	Status June 10, 2008
1/11/2007	Lexington Cap Fundg III	Harding Advsy	1,212.00	Toast**
1/24/2007	Port Jackson CDO 2007-1	Basis Capital	350.00	Toast**
1/25/2007	Highridge ABS CDO I	ZS Structured Credit Cap Mgt	1,500.00	Acceleration**
2/21/2007	Maxim High Grade CDO I	Maxim Capital Mgt	2,000.00	EOD**
2/27/2007	Broderick CDO 3	SCM Advisors	1,500.00	Acceleration**
2/27/2007	Kleros Real Estate CDO IV	Strategos Capital Mgt	1,000.00	Undeclared EOD
3/1/2007	Norma CDO I	NIR Capital Mgt	1,500.00	Acceleration**
3/8/2007	Maxim High Grade CDO II	Maxim Capital Mgmt	2,000.00	EOD**
3/8/2007	Newbury Street CDO Ltd.	Mass. Fincl Svcs. Inv.	2,000.41	EOD
3/9/2007	South Coast Funding IX	TCW Asset Mgmt	540.00	Toast**
3/27/2007	Euler ABS CDO I	Babcock and Brown	675.00	Toast**
3/27/2007	GLACIER-V	Terwin Money Mgmt	498.50	Toast**
3/29/2007	Lexington Capital Funding V	Harding Advisory	615.00	Toast**
3/29/2007	Libertas Preferred Funding IV	Strategos Capital Mgt	500.00	Toast**
3/29/2007	Silver Marlin	Sailfish Structured Inv	1,250.50	EOD
4/3/2007	Kleros Preferred Funding VII	Strategos Capital Mgt	1,498.00	EOD**
4/5/2007	NEO CDO 2007-1	Harding	300.00	Liquidation**
4/11/2007	Forge ABS High Grade CDO I	Forge ABS LLC	1,503.50	EOD**
4/12/2007	IMAC CDO 2007-2	Ivy Asset Mgmt	500.00	Liquidation**
4/18/2007	Mars CDO I	Chotin Group	618.50	Acceleration**
4/26/2007	Brookville CDO I	Petra Capital	499.00	EOD**
4/26/2007	Fourth Street Funding Ltd	N.I.R. Capital Mgmt	500.50	Acceleration**
4/26/2007	Western Springs CDO	Deerfield Capital Mgt.	495.60	Acceleration**
5/3/2007	Jupiter High Grade CDO VI	Harding Advisory	1,501.10	Toast**
5/10/2007	Tazlina Funding - II	Winter Group	1,500.00	EOD**
5/25/2007	West Trade Funding CDO III	N.I.R. Capital Mgmt	2,500.00	Toast**
6/1/2007	Robeco HG CDO-I	Robeco Investment Mgt	1,100.55	Toast**
6/7/2007	Durant CDO 2007-1	SCM Advisors	400.00	Liquidation**
7/26/2007	Biltmore CDO 2007-1	ING Clarion Capital	1,000.00	EOD**
8/28/2007	Bernoulli High Grade CDO-II	Babcock and Brown	1,500.00	Acceleration**

* Total Notional Amount is approximately \$32.6 billion

** Means the original topmost "triple-A" tranche has been downgraded to below investment grade, i.e., junk by one or more rating agencies. Note that all CDOs shown above have one or more originally "triple-A" tranches downgraded below investment grade by one or more rating agencies.

An event of default (EOD) usually means failure of an overcollateralization test usually related to a par "haircut" as defined in the prospectus. Senior noteholders and/or other parties to the transaction may choose acceleration (making the principal and interest immediately due and payable), or liquidation (selling the underlying portfolio collateral). Acceleration may be followed by liquidation. Liquidated portfolios have had poor recovery value. "Toast" means the originally "triple-A" tranches have all been downgraded to "junk" by one or more rating agencies that rated the deal, and there is an undeclared EOD. Undeclared EOD means that one or more originally "triple-A" tranches is downgraded below junk status, yet there is an undeclared EOD. The undeclared EOD may be due to no provision in the documents or the declaration is pending.

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