

# The "What if's" in ABS CDOs

PHOENIX, Ariz. — The remarkable growth in ABS CDOs and its impact on the market was a consistent topic of discussion at the Arizona conferences.

Interestingly, it was only the year prior that those conference panelists, particularly investors, began noting the spread implications of ABS CDOs and how they were rapidly changing the market dynamic. To be sure, ABS CDOs have added a significant bid to the sub bond market, which, in earlier years, was often absorbed by the underwriters. Last year, about 34 ABS CDOs were launched, packaging more than \$14 billion worth of sub bonds from the ABS/MBS/CMBS and REIT markets. This is compared to 22 deals for \$10 billion in 2000.

According to a Street firm close to this market, between 50% and 60% of the collateral comes out of the primary market. During opening panels at both the Biltmore and the Princess, Credit Suisse First Boston group co-head Joe Donovan commented to the effect that ABS sub-bonds were truly a great bargain prior to ABS CDOs, but, as arbitrage opportunists dictate, they are now priced more efficiently.

"We told you these bonds were a great deal, and priced at great spreads, but nobody stepped up," Donovan said. "So we created the investor."

ABS CDOs were really a manifestation of the spread blowout that occurred during the liquidity crisis following Russia's default in 1998. Spreads never quite returned to pre-

1998 levels, analysts have said. Interestingly, the ABS CDO bid was a main driver in the market's relative resiliency following the events of Sept. 11.

What worries some participants, however, is whether or not this new investor is creating an economically rational bid. That's because the CDOs, by their very nature, will choose the spreadier bonds, which tend to be riskier.

Although there has yet to be a credit event associated with an ABS CDO, the market is quick to note that the product is less seasoned than other CDO types, having only been issued in significance over the past two years. Also, the impressive ABS transition studies, which are often alluded to in ABS CDO commentary, are misleading, as the majority of the ABS market is triple-A. ABS transition studies will often exclude other CDOs, the sub bonds of which are repackaged in some ABS CDOs alongside the more impressive performing ABS asset classes.

Further, even in the traditional asset classes, the rapid increase in ABS CDO issuance last year has led some players to worry about adverse selection.

"These CDOs aren't, by any stretch, picking up the triple-A credit card deals," said one panelist. Of course, the structured finance sub-bond market has grown considerably since the ABS CDO has provided a bid, so perhaps the market continues to provide more subordinated bonds, and the pickings are still robust.

**"There is more liquidity in the senior and mezzanine tranches of the CDOs than was ever in the underlying collateral."**

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Credit Suisse First Boston group co-head and opening ceremonies moderator **Joe Donovan** introduced the panelists to the theme of **Bonanza**, their names rising up on each of the three staticky-yellow theater-sized screens in the conference ballroom at the **Fairmont Princess**. For example, **Chuck Skully**, director of structured finance at **MetLife**, watched his name materialize following the boilerplate *Playing the Part of Investor*.

**“Rating agencies aren’t detectives. They’re not police officers either.”**

Being Arizona, the theme was apparently *Wild West*, with audio-dubbed scenes from cinematic favorites such as *The Three Amigos* (the Amigos being the three underwriters on **Ford Motor Credit’s** \$5 billion deal in January), **Mel Gibson’s** *Maverick*, *City Slickers*, and other classic old westerns.

Apart from initial gags and chuckles, this conference was all but trite. The sessions were well-attended, well-timed, and the panelists seemed less interested in selling their names than in striking up audience response.

Of course troubles associated with **Enron Corp.** slipped into nearly every session. And as was the case during **IMN** the week prior, a debate ensued as to whether rating agencies should take action more quickly. Interestingly, investors were actually concerned that the rating agencies, in response to the **Enron** debacle, could become “trigger happy” to hedge their bets, which could act as a sort of self-fulfilling prophecy for companies that might have a legitimate chance at restructuring. The debt downgrade, essentially, could wipe out access to the capital markets for a company that might have otherwise been on the road to recovery.

“Companies that could right themselves might be forced down,” said one investor during **IMN’s** opening ceremonies.

Also at **IMN**, **Daniel Satchel**, of **State Street Global Advisors**, commented, “Why would you possibly think that the appropriate reaction would be to change ratings faster? Why didn’t they get this right the first time? Where were [the rating agencies] when these guys were forming these partnerships?”

Alluding to **Satchel’s** comments (which, by the time **SRI** began, were well known), a panelist at **Donovan’s** session argued that the rating agencies can only be responsible for the information provided to them by the companies.

“Rating agencies aren’t detectives,” a source commented after the

session. “They’re not police officers either. Should we expect to look through a company’s willful attempt to cover things up?”

**As for spreads...**

Other issues emerged as well, such as consumer credit and the economic outlook the impact of further credit weakening (or recovery) on spreads.

During a mid-morning research panel, analysts discussed the potential for further tightening in triple-A ABS. **Chip Wheeler** of **Bear Stearns**, among others, sees spreads on top-tier triple-A issuers as bottoming out. **CSFB’s** **Neil McPherson** believes there is value in subprime auto, as the triple-As trade between 17 and 20 basis points behind prime paper. **McPherson** sees this differential near its widest level, if you view the economy as recovering sharply. **CSFB** sees unemployment peaking in March. — *MG*

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**Impact on sub bonds**

However, in Arizona, most of the “what if” debates over **ABS CDOs** ended optimistically (i.e, this is not flash in the pan), it was noted several times that the impact of a sector blow-up could be several-fold. Essentially, if **ABS CDOs** dissolved, the incremental liquidity in the market could suddenly dry up.

When it comes down to it, it is really a chicken-egg type debate. If **ABS CDOs** disappeared — not withstanding a sector blowup — it would be because the arbitrage disappeared. This could happen if spreads moved out substantially on the liability side, or contracted substantially on the asset side. However, in theory, if the **CDO** bid dried up, the assets would widen, and the arbitrage would return.

“The arbitrage is, to a certain degree, locked in, in that if the mezzanine and subordinate tranches [of the **CDOs**] widen, so does the underlying collateral,” said **Phil Weingord**, head of **ABS** at **Deutsche Banc**. “There is more liquidity in the senior and mezzanine tranches of the **CDOs** than was ever in the underlying collateral,” **Weingord** added.

Essentially, some argue, the arbitrage will keep popping back up until something else — be it a natural investor base or some other arbitrage vehicle (**SIVs**?) — provide enough bid to displace the **CDO**. — *MG*

