Drought of CDO collateral tops concerns; [1]

BOCA RATON, FLA. - In addition to searching for CDO collateral, asset managers are searching for word on the next trouble spot in the CDO market, panelists speaking at Information Management Network's ABS East said last week. While overall the market appears much more stable than just two years ago, sources agreed, in the wake of the now frenzied search for cheap collateral and rising interest rates, a lack of transparency across many metrics isn't exactly stopping investors from having market discipline.

As a result, ABS CDOs were brought under the microscope at last week's gathering, given their multifaceted abilities to source several collateral types. But, thanks to spread compression, more demand this year has smacked heads with a lack of arbitragable CDO collateral. The search for CDO collateral has impacted nearly all parts of the asset-backed market. Even the subprime mortgage market is feeling the heat of the search.

For example, David Harrington, managing director at WestLB said, "there seems to be demand in the high 30s from the CDO bid and strong bids coming from outside the U.S.," in a panel covering pricing activity in the subprime mortgage ABS market.

ABS CDOs have come into their own as they can source multiple product types, a very useful ingredient for arbitrage-starved managers. But with a mature market in place, it's time to start looking at collateral liability, said Steve Kahn, a director at FSA. "Second-lien secured, DIP loans, etc., we don't have any issue with sub collateral types, we just want to know more about what's in that portfolio," Kahn said.

"Leverage is inherent in ABS CDOs," said Mark Klipsch, a director at Orix Capital Markets. "I think with some seasoning, we'll see some problems down the road."

"I agree - in two to four years there's a strong possibility [of that]. Asset-backed CDOs take more time to get your arms around," said United Capital Markets CDO analyst Steve Finnk, "There is volatility in high yield bonds and mezzanine. And mezzanine classes are so thin," he added.

As is the case in many ABS-related discussions these days, much of the concern around ABS CDOs were tied to the real estate market and rising interest rates.

For instance, the much debated growth of IO mortgage product, and discussion within the residential mortgage market is cause for investors to pause, noted Dee Dee Sklar, executive director, WestLB.

With the possibility that IOs are being packed into subordinate tranches of deals, the potential rise in delinquencies by borrowers caught unguarded by higher monthly payments could spell trouble for CDOs that sourced IO collateral.

"It's possible that a rising interest rate environment happens faster than the market anticipated. That can go through our market all the way down to subordinates," noted Sandy Szakach, senior managing director at PPM America Inc. "When you look at ABS CDOs, the market has really driven liquidity for subprime home equity. When rates go up, excess spreads in CDOs get squeezed."

"You have to look carefully at the hedges and swaps and make sure you understand what happens in a rising interest rate environment," said Anthony Thompson, managing director in the research group at Deutsche Bank Securities.

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