CDO investors debate morality of spread environment

Allison Pyburn. **Asset Securitization Report**. New York: May 9, 2005. pg. 1

Full Text (685 words)

Spreads on structured finance CDOs tightened another two basis points last week, to 30 basis points on triple-A rated notes, landing at historically tight levels - 10 basis points tighter than six months ago, and 20 basis points tighter from a year ago according to Morgan Stanley. Strong investor demand continues to fuel the tight spreads, despite the argument by some that investors are not getting compensated for the risk in the underlying collateral.

Louis Lucido, a managing director at TCW Group who helps oversee $10.9 billion in structured finance assets, said he's seeing increased interest from "nontraditional buyers," and that opportunities in the market still exist for the prudently minded investor.

Scott Simon, a managing director at PIMCO, added that he thinks any ripple effect from his firm's decision to pull out of the CDO market will be "minimal, as others will simply step in to manage new deals."

"It's too profitable for the managers." Simon said. "People will do whatever they can do to make more money."

PIMCO, the fourth-largest cashflow CDO manager as of year-end 2004, has substantially scaled back this year as a CDO manager and confirmed last month that it will not manage any new deals because of the tight spreads and deterioration of credit quality in subordinated home euity ABS. Simon said the combination is "not a good bet."

Simon could not cite a specific number on how much wider spreads should be to justify the credit risk, but emphasized that investors are not adequately compensated - pointing to rating agency methodology that he said should be more stringent, and new loan types in the subprime mortgage market with little-to-no historical performance data.

"There is an awful lot of moral hazard in the sector," Simon said. "You either take the high road or you don't - we're not going to hurt accounts or damage our reputation for fees."

Armand Pastine, a managing director at CDO issuer Maxim Group, said that with tighter spreads and cost of funds, it's harder to get a deal done - but it's happening, and "managers who are sticking in this business are doing it right," he said.

"To suggest that CDO managers would pull out of an economically viable deal for moral reasons - that's a cop-out," Pastine added.

Comparing delinquency and default characteristics of ABS collateral from the late 1990s to early 2001 isn't an appropriate comparison upon which to base how the new deals will perform, according to Pastine. Structured Finance CDOs from those vintages were tagged by the rating agencies with the highest number of downgrades in the first quarter, due primarily to weaknesses in manufacturing housing and the airline industry (see article p. 11). But as of the fourth quarter, subprime default and delinquency rates were at 9.88%, down 165 basis points from the same time period in 2003, according to the Mortgage Banker's Association.

"There have been an array of investors who have echoed some concerns on the state of the residential mortgage market, but I think that the one thing I would say with respect to those concerns is that some of the investors are underestimating the stamina and resiliency of the residential mortgage market in the U.S. - particularly in light of the new products available to more residential consumers along the entire credit spectrum," Pastine added.

Subprime lender New Century Financial Corp., for example, offers borrowers with a credit score down to 660 a 10-year interest-only loan, before turning into a one-month Libor indexed ARM, and borrowers with a FICO as low as 500 can get a two-year ARM with an interest-only option.

"To the extent that some investors drop out, others will come in to pick up the slack," said TCW's Lucido, "Everyone is entitled to their own point of view, but it is history and the evolution of history that will be the ultimate provider of who was right."

Lucido said TCW has increased its commitment to research staffing, and spends a "significant amount of time visiting servicers" to ensure they purchase quality assets.

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