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CDO machine? Managers, mortgage companies, happy to keep fuel coming

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NEW YORK - In a panel on the effect of CDOs on the fixed-income market, Bear Stearns traders said mortgage issuers and CDO managers are playing off one another. While one group provides the fuel - borrowers induced by new mortgage products to buy a new home or refinance - the other supplies the structure as well as the investors, replenishing liquidity through securitization. Whether that cycle is a so-called "shell game" was a bone of contention among the traders, but all seemed to agree that as long as investors are willing to pay, there will be managers willing to do deals.

"Until there are credit issues, we're going to continue to push the envelope," said Tim Koltermann, managing director principal in Bear Stearns' credit derivatives group, at the investment bank's Global Credit Conference held here this week.

"There is a machine going," said Scott Eichel, a senior managing director in Bears Stearns' collateralized mortgage backed securities group. "There is a lot of brain power [working] to keep this going."

Eichel said the innovation surge in the mortgage industry, such as subprime IO loans, the 40-year mortgage, and a slew of so-called option ARMs, is needed to create more and more structured finance CDOs. Product innovation will likely continue as the mortgage industry, sated after the refinance boom, prowls for untapped markets - such as borrowers without a social security number - to keep volume high amid rising interest rates.

As long as there are investors willing to purchase the product, the market will continue to grow more and more levered, said Jeff Zavattono, senior managing director in the CDO group at Bear. And demand right now is very high.

Some industry analysts are beginning to raise eyebrows at the residential mortgage sector, which, they say, seems to be yawning at rising short-term interest rates, creating a flat yield curve that could be detrimental if home price appreciation grows flat or declines in certain areas, and borrowers are unable to refinance when interest rates reset on their hybrid products.

One REIT executive recently said that CDOs are simply a machine that must be fed to keep going, noted Bear traders. But to some degree, they disagree with that sentiment. "It's a natural progression. It's not some kind of a shell game," said Jonathan Weiss, senior managing director at Bear's ABS group.

But spreads both in structured finance CDOs and their underlying mortgage collateral remain at historic tights, meaning that investors aren't given much of a shelter from default risk on the new products. Adam Siegel, managing director principal at Bear, said it's important for investors to take a step back and look at the track record of the managers of the deal before buying.

Traders added that even though it is more difficult to get a deal done now, given the tight spreads, they anticipate that another willing participant will quickly fill any space leftover from managers exiting the market. PIMCO accounts for at least one manager that has decided to scale back on the structured finance deals for now, while spreads remain tight. PIMCO executives cite the spreads as at an inappropriate level to provide compensation for the risk inherent in the collateral.

Any meltdown in credit similar to events of 2000 and 2001 will likely result in re-priced assets, but not a massive sell-off, they said.

"We're not going to get to the point where we're giving away triple A tranches as party favors," Siegel said. "I do think there's money there. I do think some dealers will exit the business, but there will be new levels. It is a much broader, deeper market than it was before."

"There is so much demand for real estate CDOs, I don't think we'd pull back at all," Koltermann agreed.

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