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Moody's International Policy Perspectives

INTERNATIONAL ECONOMIC AND FINANCIAL POLICY RESEARCH

From illiquidity to liquidity: The path toward credit market normalization

Table of Contents

This is the first paper in a series which will address macro issues related to the subprime problem and associated market dislocations. Next in the series will be a paper which discusses systemic problems revealed by the crisis ("Financial innovation and its discontents: Initial lessons from the 'Panic of '07'"), to be followed by a paper on rating agencies in relation to the subprime problem.

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The complete evaporation of liquidity in certain market segments of the US securitization market has made it impossible to value certain assets fairly regardless of their quality or credit rating. -- BNP Paribas

Problems of appropriately marking to market are likely to be systemic, at least in the credit derivatives arena. And therein lies the problem. If Ben Bernanke was right in alluding to subprime losses at $50bn - $100bn, then only a small percentage appears to have surfaced so far, and since he made those remarks, losses have likely extended across a much broader credit universe than subprime. -- Alan Ruskin, chief international strategist at RBS Greenwich Capital.

Executive Summary

Due to the credit market dislocation that has followed the subprime crisis, normal functioning of the credit markets will require a new consensus on pricing (credit spreads), a slow process likely to play out over the next six months.

This special report discusses how the markets can recover their footing when secondary market prices rise or inventories are marked down enough to sell. It points out how, rather than liquidity, what's missing from the market is fluidity, a readiness to engage and trade.

The depth of the secondary market for structured product has varied significantly by asset class. In the current market, one characterized by little correlation between intrinsic value and price, liquidity has all but disappeared. While a secondary market for some structured assets is returning, it is likely to operate for some time at levels below current marks as some players are being forced to sell high-grade as well as below-investment-grade securities at tremendous discounts in order to create enough liquidity meet certain payment obligations.

For now, there is no standard for market pricing as even good collateral cannot be sold or financed at anything approaching its true value. In a time when marking to "market" is meaningless, marking to model does not produce realistic information.

In order to create a more liquid secondary market, there is a need for greater transparency and consensus around the models used to price structured finance securities and universally available information that will allow investors to compare and assess value across securities.

The report also outlines the responsibility of the monetary authorities to maintain financial stability and to ensure that the financial markets can perform their important role in enabling the real economy to function.

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The repricing of risk

We are in the midst of a flight to quality and a somewhat disorderly repricing of credit risk in a number of fixed income markets. Before the credit markets can resume normal functioning, the creation of a new price consensus between (and among) buyers and sellers of risk instruments will be required. This will not be a quick process because many leveraged capital market participants are facing inventory problems with respect to certain structured finance securities, including subprime and Alt-A related RMBS and CDOs, as well as certain leveraged loans. In many cases they are electing to hold on to their inventories, and the current marks most likely exceed the market clearing level as downward pricing momentum has been so steep and unexpected. Consequently, both the primary and secondary markets for these asset classes are not operating well, if at all. Most holders are unwilling to offer at "fire sale" prices, and potential buyers aren't bidding close to the offered price because they fear that prices have yet to stabilize and could deteriorate further.

How liquidity will return

The markets will reopen when secondary market prices rise or inventories are marked down enough to sell. There has never been a very deep secondary market across structured product. For liquidity to return, such a market will have to develop, operating at levels below current marks.

The practice of marking illiquid assets to model-derived prices in a market in which downward cash price momentum has been so great has proven to be unsustainable because prime brokers and repurchase counterparties are ratcheting up financing margins and are refusing in some cases to finance certain kinds of collateral at any margin level. This is forcing some levered players to sell whatever assets they can to meet margin calls, counterparty repayment demands, investor redemptions and maturing debt repayments. Unable or unwilling to sell structured finance assets at low prices, some pressured borrowers have sold other assets, such as loans to satisfy margin calls, creating contagion among historically uncorrelated asset classes.

Additionally, some funds and structured vehicles backed by RMBS and CDO collateral have begun forced liquidations of a portion if not all of their portfolios, much of which are high grade securities. This forced selling should result in the creation of a more liquid secondary market, but once again, at prices below their current carrying value. Those parties with the ability to understand the true intrinsic value of the securities and the liquidity to purchase them are in a perfect position to take advantage of this price dislocation. In fact, we are starting to see these bargain hunters buying liquidation assets at attractive discounts relative to their marks.

Mark-to-model will not go away; rather the models will have to be recalibrated to make their outputs more reflective of the cash secondary market. This can only happen with more transparency and widespread availability of information among a larger share of market participants, effectively bringing about greater price consensus.

Diminished primary market?

The need for a liquid and transparent secondary market for structured product may delay a recovery in primary issuance as investors will avoid purchasing an asset in the primary market if a similar asset can be purchased in the secondary market at a lower price. Therefore, greater transparency will be required of the secondary market as well as lower prices (or better protection) in the primary market. The liquidity risk premium is going to be higher and investors will be reluctant to buy these products unless there is some degree of standardization and secondary market liquidity. Marked to market actors may be reluctant to buy customized product, and higher risk premia could temporarily reduce the economic attractiveness of securitization for certain classes.

The challenge for the authorities

Given the ongoing repricing of credit risk, what can the authorities do to engineer a soft landing? The immediate problem facing the financial system is a general blow to confidence which has brought the credit markets to a virtual standstill. This lack of confidence extends to both asset classes and counterparties. In a context of opacity about where risk resides, valuation challenges, untested financial innovations and leverage, a general distrust has contaminated many asset classes. What had once been liquid is now illiquid. Good collateral cannot be sold or financed at anything approaching its true value. In the view of many investors, the worst-case scenario has become the central scenario.

From a policy standpoint, what can be done before a new consensus emerges on more realistic prices for this asset class? With the market clearly lacking anchors, central banks can frame the macroeconomic scenario. Central banks can influence expectations and reestablish a reasonable macroeconomic scenario as a central point of reference. They can also assist in easing liquidity constraints. It would perhaps be more precise to talk about fluidity than liquidity. There is a lot of liquidity already in the banking system; what is missing is fluidity and readiness to engage and trade.

It is the responsibility of the monetary authorities to maintain financial stability and to ensure that the financial markets can perform their important role in enabling the real economy to function. The challenge now for the monetary authorities is to restore confidence, which, as a psychological condition, is not a simple mechanical exercise. The authorities have begun to take steps to restore orderly markets with three apparent principal objectives, including:

1. To make it possible for both banks and non-banks to finance good collateral at reasonable valuations.

By throwing open and aggressively promoting use of the discount window, the US Fed is seeking not only to provide liquidity to banks but, more importantly, to non-banks sitting on difficult to finance collateral. It is noteworthy that the list of eligible collateral is quite comprehensive, including ABS, CDOs, CLOs, CMBS, RMBS, commercial real estate loans, corporate bonds, residential mortgages and even home equity loans. Additionally, the posted collateral margins appear quite generous when compared with anecdotal data about cash market values. Some central banks, such as the Bank of Canada, have broadened the list of collateral to include ABCP. The challenge will be to induce banks to use the window despite its historical stigma and, more importantly, to induce the banks to be as liberal with non-banks as the Fed is with them.

2. To allow creditworthy non-banks to have normal access to bank and counterparty credit against good collateral.

Due to the widespread dispersion of subprime risk and the opacity of disclosure, counterparties have tightened up their credit standards, which is squeezing both banks and non-banks. By the combination of open market activity, the discount window action, and jawboning, the Fed is trying to lean against this tendency and induce counterparties to be more liberal with each other.

3. To facilitate the reintermediation of ABCP programs unable to roll their commercial paper.

It has been widely reported that a number of ABCP programs (as well as some corporate CP programs) have been unable to roll and have had to draw upon their liquidity back-up facilities. To maintain confidence, the authorities will seek to ensure that this occurs smoothly and without incident.

In sum, the authorities are beginning to take steps to restore stability and liquidity. Additionally, it should be reiterated that while banks may, from time to time, require assistance, they very seldom are allowed to default. The authorities have the tools and the resources to prevent such defaults from happening. We do not expect any large banks to default, and indeed we view the possibility of any bank of any importance or visibility defaulting during this crisis as very unlikely.

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