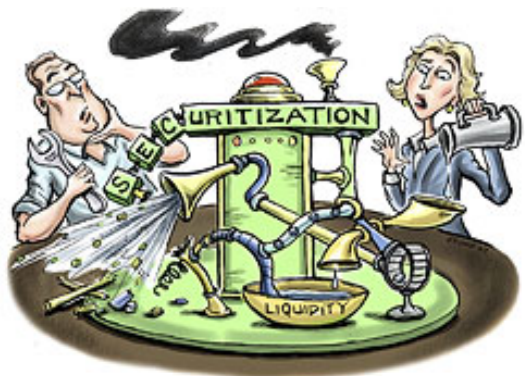


Can the Financial Markets Make a Comeback?

By ETHAN PENNER

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What happened? There was so much liquidity, where did it all go? And what the heck do subprime residential mortgages have to do with commercial real estate?



Chad Crowe

These are some of the questions asked these days. Their answers underscore how incredibly important the global financial marketplace is to all asset categories and businesses, and how, without an understanding of the interconnectivity of all markets, even the soundest investments can quickly go asunder. And how securitization is at the core of the current markets.

During the current credit turmoil I've spoken with many market participants, including issuers, lenders, borrowers, traders, investment bankers, bond buyers and distress investors. While uncertainty and guarded optimism is common, some question whether securitized debt will survive, and *if*, not *when*, bond buyers will ever return to buying it. Clearly, these questions reveal the severity of the current "hiccup" -- and force those of us who believe in the securitization model to thoughtfully consider what modifications are required to put it back on a healthy and sustainable path.

As a quick primer, securitization is the aggregation of large pools of assets by Wall Street firms such as Lehman Brothers and Goldman Sachs, as well by the securities divisions of major banks such as Wachovia, Citigroup and Bank of America, which sell securities backed by those pools as collateral, primarily in the form of rated bonds. At the core of the enormous growth of securitization is the huge growth of the these firms' balance sheets. The equity values of these companies have grown in the past two decades from the neighborhood of \$1 billion up to levels ranging from \$20 billion-\$75 billion for those unaffiliated with bank parents -- and those affiliated with banks now have access to balance sheets supported by equity accounts ranging up to \$225 billion.

These security firms have morphed from brilliant corporate advisors, and pure intermediaries to the capital markets, into huge providers of debt and equity capital through the use of their own balance sheets. And their balance sheets, dependent upon the faith and trust of those who buy their commercial paper and other financing vehicles, are the cornerstones of the securitization markets.

Any fragility in the balance sheets of these securities firms, or in the market for the paper they issue, can create a mighty dislocation, mighty rapidly. And, vice versa, any diminution in liquidity for the securities these firms underwrite will create a sense of real unease about the strength of their franchises. Witness these past weeks.

For the past 25 years securitization-based finance (gather, package, carve up into different risk categories, and resell) has been replacing the portfolio-lending model (invest in a single class of debt and hold to maturity, funded by deposits or the like) as the dominant means of financing in the United States.

While all of this started and has been focused in the U.S., the mechanism has become global, taking hold and growing rapidly in both Europe and Asia.

Michael Milken, a pioneer of this movement, coined the phrase "the democratization of capital," to describe its benefits. It's an apt term. Securitization allows investors to better target where they want to be on the risk/return spectrum, and it provides borrowers with greater access to credit from global markets. However, securitization is relatively new, especially in its now very broad applications, and was probably due for a hiccup, providing its practitioners an opportunity to tweak and improve the model.

The place one might start is with accountability and governance. Unlike the portfolio finance model, with regulatory oversight of insurance companies, banks and pension funds, the securitization model has little government regulation. That, I would argue, is a great strength. However, it's become apparent in these last months that the free market, combined with a complete dependence upon the three main bond rating agencies, may not, in its current format, be the perfect answer either.

Securitization may be the only business in the world where the appraiser is hired by, paid by, and thus works for, the seller rather than the buyer. It would be unthinkable, for example, in a real estate transaction for the seller of a property to expect that the buyer would accept a seller-provided appraisal as the basis of their valuation.

Yet, this is exactly what transpires in the bond market, where the sellers, Wall Street firms that aggregate assets and pool them into carefully "sliced and diced" securities, hires and works carefully with the appraiser, the rating agencies, to maximize their arbitrage. Importantly, appraisers at the rating agencies are paid a small fraction of the pay of the investment bankers they work with, and many aspire to work at one of the firms that they are representing, thereby creating a heightened conflict.

It's imperative to note here that I have worked with many rating agency analysts, have hired some and remain friends with others -- and they are mostly talented and knowledgeable, and trying to do the best job they can to balance their corporate objectives to maximize market share and revenues, the investment banking community's desire to find the arbitrage between assets and securities, and the needs of the bond-buying community, who invest their trust in the integrity of the ratings that are provided.

However, these people are only human. The potential for conflicts and misaligned incentives are more potent over time than even the best of intentions.

So, the first place one may look when tweaking the securitization model would be to re-align the interests of the governing bodies, that is, the rating agencies, more precisely with those they truly represent -- the bond buyers. There are numerous ways that this might be accomplished; suffice it to say here that a change is probably healthy and long overdue.

Today's market is paralyzed with panic primarily because of a lack of faith and trust. There is still plenty of cash sloshing around, and much of that is in the hands of those who can, and ultimately will, buy bonds and make markets in them. However, these players are largely on the sidelines today, fearful of what we say in the bond market as "trying to catch a rapidly falling knife."

Among the difficult questions to answer: If rating agencies have only recently tightened their standards, are yesterday's AAA's no longer AAA, and if not, how far have they fallen? Until this question is answered, and until the market has settled into new, more stringent underwriting guidelines, it's difficult to see how liquidity will return to the levels necessary to have a healthy marketplace.

Those securities underwritten during the past few years, when standards were most lax, will have a hard time finding a bid for a while. But assets underwritten both before that period, with some demonstrable performance record, will, along with assets underwritten now, begin to attract capital in a reasonably short period of time.

Securitization itself was born out of periods of financial distress that followed periods of lax underwriting. It seems, as we reflect upon this latest period of excess liquidity, that certain important basic truths have been forgotten. It's worth restating them.

In the early 1990s, when the idea took hold to create bonds to finance commercial real estate, those of us at securities firms and rating agencies focused on existing cash flow. It was understood that debt, particularly the investment grade variety, must be repaid from in-place income, consistent with the securitization model that had theretofore been applied to other assets.

Optimistic forecasts of *improved* revenues were the domain of equity financing. Thus, if those rosy projections were attained the equity investor would do very well; and if not, the disappointment would be a natural part of the risk equation that equity underwriting is meant to take into account.

Back then, at Nomura, I used to remind borrowers seeking too much debt based upon optimistic income growth forecasts that securitization is meant to finance cash flow and not dreams. Yet this most basic tenet of finance was somehow completely forgotten by rating agencies, underwriters and bond buyers alike.

The architects of securitization also understood that improved transparency -- whereby information was to be broadly disseminated, updated and streamlined, providing for easy valuations, better internal governance capability and a liquid secondary marketplace -- were all necessary parts of the whole model. But in these past years, the pooling of all sorts of assets, including loans backed by varying collateral and existing securities of all ratings and types in CDOs, have undermined transparency by completely obscuring risk.

Of course, it is very important here to distinguish between CDOs that make sense and are a healthy part of the market, and ticking time bombs that should never have been created. As an example of the former, there are those issuers, the NYSE-listed REIT Capital Trust, who utilized the CDO structure to pool their homogeneous real estate credit assets and create a financing that matched up ideally.

This sort of CDO is not only sensible but an example of how securitization can help foster a healthy financial system -- creating a liability for the issuer, Capital Trust, that matches exactly the term of the assets.

On the other hand, many CDO issuers bought all sorts of assets and combined them into proverbial "witches brews" that they foisted onto the bond market, sucking out profits and fees at issuance in a game that was ongoing as long as the deals held up. The buyers of these concoctions, reliant upon the rating agencies' models, were unlikely to ever get their arms around the risks that they were asked to underwrite. How a trader would be able to traverse the various markets represented by the diverse collateral underlying these bonds to provide a suitable secondary market bid is beyond me.

My guess is that a healthy CDO market will return, but it will only be available as a source of financing to those few professional risk managers with real expertise and only for homogeneous asset pools. I have pity for bond buyers with the other type of CDOs, as it is difficult to imagine how liquidity will ever return to their holdings.

Finally, it's worth restating a maxim of Michael Milken, back when I was a mortgage-backed securities trader at Drexel Burnham Lambert. "Liquidity is an illusion," I recall him saying. "It's always there when you don't need it, and rarely there when you do."

How important is that to remember as we all rebuild from here? Well, how many people today claim that their assets are fundamentally sound, and yet they are suffering and in some cases teetering on the edge of disaster because of margin calls, or inability to rollover or find debt?

It wasn't asset quality that impaired those hurt in 1998's liquidity crisis (me included), or many Savings & Loan's shuttered in 1991. And it won't be asset quality that kills today. Instead, it will be a poor grasp of the fleeting nature of liquidity, and of basic asset/liability duration management.

Tremendous money has been made by hedge funds, based upon the notion that investors could redeem at any time, or at least at regular and short intervals, while those invested in private equity funds had five-to-10 year lockups. Going forward, investors should remember that liquidity can dry up all at once, rendering their redemption rights rather meaningless.

To their credit, many of the larger and better-managed hedge funds are requesting and getting lockups on their capital. This is another very healthy sign for our system of finance, and will help to prevent future liquidity crises.

In sum, I firmly believe that securitization will survive and continue to grow significantly. It just brings too many benefits for all market participants. Liquidity will return, at first selectively to those assets that are less opaque and are better underwritten, and then, thanks to the professional distress investors, ultimately to all products. The large securities firms, who now have an irreversibly symbiotic relationship with securitization, will take the time to carefully evaluate the shortcomings in the system. They, and the market, will emerge stronger as a result of this period of dislocation.

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