Where is the Real Risk in the Subprime Debacle?

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By John Mauldin

This week we continue to look at an alphabet soup of problems: RMBSs, CDOs, Alt-A, BBB and – a new acronym to put on your radar screen – the very useful CDS. When does an AAA rating not mean an offering is ready for prime time? What type of contagion are we seeing from the Bear Stearns blow-up? I survey my friends in the hedge funds space, trying to find some evidence of cracks in the foundation, and let you know what I hear. We will again look at a wide variety of items and see if we can discern some connections.

Honey, I Bet the Farm

I was writing last year that the subprime investment market would end in tears, as loans were being securitized as investment-grade that clearly were going to have problems. We are now witnessing the beginning of those travails, and the lawyers are gathering.

Let's review what I wrote in early January:

"We live in a world where there is an increased appetite for yield by investors at all levels; and armed with growing liquidity, they chase those yields down to a point where traditional risk-reward measures would suggest the potential for problems.

"Let me give you a preview of a coming scandal, just to illustrate the chase for yields. In the US, about 25% of the mortgages on new homes are what is known as subprime mortgages. These are mortgages that are slightly less creditworthy and therefore offer higher interest rates. In the beginning this was a good thing, as first-time owners and those just starting out in life were given an opportunity to own their own homes.

"But then came a world of liquidity looking for yield. Investors demonstrated a large appetite for these mortgages. Investment banks would buy those high-yielding subprime loans and package them into something called Residential Mortgage Backed Securities (RMBS). Now, a subprime loan is not considered an investment-grade security. But when you put a group of them together into a pool and break them up into various sub-groups or tranches, through the alchemy of high finance you turn lead into gold. You create high-grade bonds from subprime debt. In fact, 80% of those grouped

together get an AAA rating, because that tranche gets the first monies paid back to the debt pool. And it probably is pretty safe money. No problems yet.

"Then the investment bank starts slicing smaller parts of the pool and eventually ends up with the final 4% getting a below-investment-grade BBB rating. Again, this is all a good thing as it allows investors to buy the risk they want and makes for a more liquid real estate market. But then we start to get cute with alchemy. Not content with turning lead into gold, we start trying to do the magic on sewage.

"Investment banks pool all these BBB tranches into yet another pool called a Collateralized Debt Obligation or CDO. The rating agencies have sophisticated models which tell them that with the increased diversification, 87% of these former BBB bonds can now be sold as AAA or AA investment-grade bonds. Only 4% is considered actual BBB debt. So we have taken an original security that is not investment-grade and turned all but less than 1% into an investment-grade bond.

"Again, if all those mortgages pay off like they have in the past, then not too much problem. But recent research suggests that as many as 20% of these mortgages sold in 2005 and 2006 are going to default or foreclosure. But the CDOs assume that less than 1% will default. If the number of defaults is even half of that predicted, then someone is not going to get their full capital back, let alone the interest. And we are seeing home foreclosures at record levels in every part of the United States due to the large number of subprime mortgages."

As I wrote, there will be lots of finger pointing. And I think, with some justification, those fingers (or maybe just a finger) will be in the general direction of both the investment banks that securitized and sold the subprime mortgages and the rating agencies which made it possible for them to do so.

Let's first look at the rating agencies. Moody's, Fitch, and Standard and Poor (S&P) all are in the rating business. If you have a bond offering and want to sell it into the institutional market, they assess the ability of the borrower to pay the note and assign a risk level or rating, the highest typically being AAA, which pays only a few basis points over that of similar US government paper. There are only a handful of corporations which can get an AAA level for their bonds. In 2005, there were only nine companies, including GE, Berkshire Hathaway, Johnson and Johnson, Exxon and Toyota, who got the coveted rating, which means they get to borrow at very cheap levels. An AAA rating is hard to get and means something.

And the rating agencies monitor those bonds and often downgrade (or upgrade) them. Investors have grown to be very comfortable with the general reliability of those ratings.

So, when investment banks wanted to sell Residential Mortgage Backed Securities composed of subprime debt, they would go to the rating agencies and get a rating. But as it turns out, not all ratings are equal.

Ohio Attorney General Marc Dann is investigating the rating agencies. "Dann and a growing legion of critics contend that the agencies dropped the ball by issuing investment-grade ratings on securities backed by subprime mortgages they should have known were shaky. To his mind, the seemingly cozy relationship between ratings agencies and investment banks like Bear Stearns only heightens the appearance of impropriety. In addition to receiving fees from bond issuers that want ratings, S&P, Moody's, and Fitch do not vet data provided by these customers – information the agencies use to make their credit assessments. It's a bit like a take-home final. Or as Moody's puts it in its own code of conduct, 'Moody's has no obligation to perform, and does not perform, due diligence.' The other two agencies have similar provisions." (Fortune)

But due diligence is precisely what investors thought the rating agencies were doing, and they were being told that by those who sold the funds (see more below). Let's quickly review what they did.

An investment bank would pool thousands of subprime mortgages together into a Residential Mortgage Backed Security. They would then break it into multiple tranches. The highest-rated tranche would get the first monies back, and so on down to the lowest-rated tranches.

Now this is key: the investment banks would give the rating agencies the payment and foreclosure data, etc., based on past performance, and the agencies would then calculate the risk of any given tranche losing money or not paying its interest and principal. As noted above, the agencies do not vet the data.

Not Your Mother's AAA

When a corporation gets a rating there are audits, not to mention regulators that are there overlooking the data upon which the ratings are based. But no one was looking at the data used to create the ratings on RMBSs and CDOs, to make sure there was some type of reasonable similarity or standard of the securities being rated and the databases used to do the risk analysis.

Subprime loans made in 1999 or 2002 were significantly unlike those made in 2004-2006. At the end of 2006, many subprime loans were defaulting in only one or two months from the date of the loan. No-documentation "liar's" loans were common. Adjustable Rate Mortgage (ARM) loans, made where the applicant could clearly not make the payments when the interest rate reset, were common. Thus, the past performance the ratings were based on was significantly different than for the crop of then-current loans, and was substantially misleading. We are talking an apples and cumquats type of difference here.

So, the rating process was not the same as the ratings that were used in the corporate world. But the problem is that the ratings used the same designations. Instead

of creating a whole new type of rating standard (say, using numbers like "CDO rank 1-10"), they used the same designations that bond investors were used to.

I think it is disingenuous for a rating agency to explain the difference in paragraphs 457-503 in 7-point type and dense legalese in their disclosure document. Investors had (and should have) a certain level of expectation when the designation "AAA" is used. GE and Exxon types of expectations.

I am not expecting infallibility here. Let's make it clear that the rating agencies have made mistakes in the past and will make them in the future. You do your best, and in general I think they do an excellent job given the pressures and the vagaries of the business. (I certainly have made a few mistakes here and there in my career that I would not make today. And I will make more in the future. We live and learn.)

The problem is in allowing the confusion of rating a CDO as you would a GE or Exxon. I think Dann has a point when he says the rating agencies aided and abetted the investment banks. And that point gets even bigger when we are talking about CDOs.

When you pool BBB tranches into a CDO and now turn 80% plus into AAA at the touch of an algorithm, based on faulty assumptions, someone somewhere should have raised an eyebrow.

This is not going to end up pretty. You can bet that 20-20 hindsight is going to kick in here as the regulators and various attorneys general get involved. The rating agencies may be able to justifiably say that they were doing exactly what they said they were doing in the disclosure documents. But then someone at the investment banks (especially those that owned subprime mortgage brokers and should have been able to see the deteriorating quality of the loans) should maybe have thought that the default rates would change and therefore should have used different assumptions.

But then, that would have killed what was a very profitable business. And everyone was doing it, so to unilaterally disarm when every other investment bank and agency was doing the same thing evidently did not cross the mind. Last year there were $500 billion in CDOs sold, and half of it subprime. In June, there was only $3 billion. And you can bet there was no subprime in them.

As an aside, the rating agencies are starting to downgrade the CDOs. Of the pool of securities created from 2006 subprime mortgages, Moody's has downgraded 19% of the issues they've rated and put 30% on a watch list. That will grow.

And let's look at the investment banks. Creating and selling CDOs was a particularly juicy business. I have heard, but not verified, that sales commissions were running 5%. You can bet the banks were making at least as much. Put together a $250 million CDO and sell it to institutions, pension funds, insurance companies, and hedge funds, put some of the equity portion into your own portfolio, and you could generate substantial profits and commissions. Rinse. Lather. Repeat.

Five Cents on the Dollar

I think it will be instructive to look at the two Bear Stearns funds which have blown up, in the way that looking at a movie on lung cancer is instructive about the problems with cigarettes. (Thanks to Gary Shilling for the details. www.agaryshilling.com)

There were two funds, with the names High Grade Structured Credit Strategies Fund and High Grade Structured Credit Enhanced Leverage Fund. The first was three years old and had 40 straight months without a loss, and the second was started last August. The first used its $925 million in capital to bet $9.7 billion on the bull side and $4 billion on the bear side of the subprime mortgage market for about a six times leverage.

The "Enhanced Leverage" (what a seductive term) "had $638 million in investor capital on March 31 and borrowed at least $6 billion to make $11.5 billion in bullish bets and $4.5 billion in bearish wagers." That is ten times leverage if your shorts and longs were truly opposite each other, and a lot more if they were not.

Let's look at the implications of ten-to-one leverage. Say you are borrowing at LIBOR (which today is 5.36%) plus 25 basis points, for a total of 5.61%. If you can average 8% on supposedly investment-grade paper after costs, with ten times leverage you make about 23%, before fees.

And as long as the collateral is solid, you print money. But what happens if the total collateral drops just 2%? You are now down 20% because of the leverage. Ouch. And if the asset drops 40%, as the BBB paper has done, you can get wiped out if there was only 25% of your fund in BBB paper.

From January through April, the Enhanced Leverage Fund (which could also be called the Enhanced Loss Fund) was down 23%. The gentle margin clerks at Merrill Lynch decided they wanted some of their collateral back to sell on the market when Bear Stearns refused to pay off the loans. Where was Bear going to go to raise capital? Sell what? And to whom? Better to stall and bluff.

So Merrill tried to sell $850 million in collateral. Except there was a problem. The best stuff was getting bids of only 85 cents or so on the dollar, and others were getting bids as low as 30%. Let's review the math above. At a 15% discount of the assets, the fund would be more than bankrupt, and the lending institutions would be losing money they had lent at very low rates and very high margin on what they thought was investment-grade debt.

As I understand it, Bear has not actually made, as of yet, a loan to the Enhanced Leverage fund. That is probably because there is no actual collateral for them to make a loan on. Better to save your money to deal with the lawsuits.

And here's a side point in the banks' favor, from a culpability standpoint. All these banks were creating the CDOs and knew what was in them. Either someone forgot to tell the loan department, or they all drank the Kool-Aid and believed in the ratings.

(Historical note: we use the term "drank the Kool-Aid" because the followers of Jim Jones were all true believers and drank a flavored drink containing poison in a mass suicide. However, it was not Kool-Aid they drank, but some other similar drink. But poor Kool-Aid, a very noble potion much enjoyed in my youth, gets the bad press.)

Some investors in the Enhanced Fund have offered to sell their positions for 11 cents on the dollar. The offer is 5 cents. They should take it. And I will make you a leveraged bet that the offer comes from very litigious fund managers that are betting they can get Bear Stearns to pony up a lot more than 5 cents in settlement.

Bear does have other problems. They were planning on doing an IPO of the fund management group, which was going to be owned 25% by the manager of the two busted funds. The offering memorandum said very nice things about the talents of the manager and the risks of the funds. Enter lawyers, stage right.

So, Where's the Problem?

So, since the Bear fund problems have come to light, what have been the effects on the market? There have been a few other funds which have either stopped meeting redemptions or have shut down. But actually quite few. Though I would expect more over the next few months.

I spent a good deal of time this week talking with friends who spend their waking hours analyzing hedge funds, running funds of hedge funds, looking at hedge fund databases, and so on. The interesting thing is that there has been very little spillover to the normal hedge fund world, which has very little exposure to the subprime problems.

Now maybe it is like the man who jumped off the Empire State Building and noted as he passed the 87th floor, "So far, so good." But so far there does not seem to be a problem in the normal hedge fund world. And certainly nothing to indicate anything close to systemic risk. Even hedge funds that deal in non-subprime mortgage debt are only slightly down, due to volatility as much as anything. Funds which specialize in loans are doing well. All in all, it was not a bad month given the potential problems that were making themselves evident mid-month.

And a credit crunch? What credit crunch? In a talk with Jim Bianco, he noted that we have seen record issuance of high-yield bonds in the past two weeks, with much more being issued in the coming months.

So where are the problems? Is this just another Amaranth, where investors lose $6 billion and the market yawns? In one sense yes, but I think there is a difference. The

problems are still the same ones we saw at the beginning of the year, plus a new one I will briefly discuss.

Credit Default Swaps? Who Is the Counter-Party?

Let's assume for a moment that the highest estimates of subprime mortgage defaults are correct. That would suggest losses of $250 billion. But these homes will not go to zero. Even if they drop by 40% for a total market loss of $100 billion, that is going to get absorbed by thousands of funds and investors. No one will be happy (except the lawyers), and a few banking institutions will end up being taken over as their balance sheets decline and make them vulnerable, but the mortgage losses will not directly put the system at risk.

It will mean that home valuations are likely to drop more than most market forecasters are projecting, and thus cash-out financing is going to drop, but in the grand scheme of things that is not a severe blow to the overall economy.

The one true risk that is simply not knowable at this point is in the Credit Default Swap (CDS) market. Basically, the CDS market allows an investor to pass on the risk as well as the returns of a loan or a basket of loans. It is a form of insurance. If you are a bank and need to clean up your balance sheet, you simply go to a CDS dealer and find someone who will take your risk for a price. A fund, trading desk, or bank can make a nice premium selling CDSs and show very steady returns, somewhat like selling naked options. The CDS market is huge, in the hundreds of trillions of dollars and growing dramatically.

There is said to be about $1 trillion in CDSs for an underlying $20 billion in GM debt. There are institutions which both buy and sell CDSs, trading them for an arbitrage profit. As long as there is adequate collateral, there is no problem. The game can go on.

And it is an important game. There is a reason this market has become so large so quickly. A CDS can be a very useful risk management tool. It is one of the reasons that the markets are so liquid. If there is a hiccup in this market, it could cause serious problems in a very short time. And the hiccup could be caused by a few institutions or funds not being able to honor their Credit Default Swaps. There is no agency overseeing counter-party risk. This is the one true systemic risk that I see.

How probable a risk is it? Not very, but the problem if one developed would be so huge that it is worth paying attention to.

Notice that the major investment banks are sporting P/E ratios of around 10, as compared to many financial institutions with no exposure to the subprime or CDS markets, who are often in the range of 20. That would lead some analysts to suggest the risk is already priced in the market.

I disagree. If you cannot know the risk then you cannot price it, and you can guarantee it is not priced into the market. Something may be priced, and maybe it is the right amount, but no one can know for sure. And we do not know the exposure of the major investment banks to the subprime and CDS markets. I note that Bear Stearns announced today that they were going to increase their risk controls. Watch for all of the banks to do the same. Reminds me of something my father used to say about locking the barn door after the horses were already in the north 40.

They are all increasing the margin requirements for loans on subprime and all types of mortgage-related debt. You are going to see lenders start balking at so-called covenant light loans in the high-yield space, and making fewer PIK loans. (PIK loans are Payment In Kind, which means that the debtor can pay the interest on the loan by sending the lender more debt paper. Great if you can get it. You get what you deserve if you make the loan.) Just for the record, these covenant light loans are going to be the next scandal.

Frankly, other than the potential problems with the CDS market, I see the return of the adults to the loan desks as a good thing. I prefer normal, sustainable growth to the bubble-like credit creation we have seen the past few years. Losses like the ones at Bear Stearns and their lenders helps focus the mind, as it hits the annual year-end bonus pool.

Finally, and one more reason not to own the large financials, is that it is not clear how much of the CDOs they sold they have on their own books, or how much they are going to have to take back in legal settlements. They are all required to maintain a set amount of net capital. The compliance officers at the various firms will start pounding the table to write down the CDOs to market as opposed to model, because they know the regulators will be coming in to look at their “net capitalization” and asking very pointed questions.

And it is not just CDOs. Bear Stearns and its affiliates are listed as buyers of at least 53 homes so far this year in San Diego County, California, 48 in Maricopa County, Arizona, and 40 in Cuyahoga County, Ohio, according to a search of property records.

JPMorgan, the third-largest US bank, and its subsidiary Chase Home Lending acquired at least 194 homes this year through foreclosure in Wayne County, Michigan. Merrill, the third-biggest securities firm by market value, and its mortgage unit, First Franklin, took possession of at least 87 homes this year in San Diego County, California. Citigroup and affiliates are the new owners of at least 47 homes in Clark County, Nevada. (Bloomberg)

How much is the exposure if they have to mark their CDOs and subprime holdings to market? Who knows? The answer is no one, yet. My guess is that there will be accountants who are not going to get to go to the Hamptons this summer.

This is a developing scandal every bit as big as the Savings and Loan scandals of what seems like another era. We will end up with new regulations that are going to make it hard on the subprime borrower to actually get a loan, even when they should. Such is

the way of rules. It is sad, in a sense, as it will now get harder for those starting out to get that starter dream home.

La Jolla, London, and Denmark

It's time to hit the send button. My sons are waiting for Dad to get home so we can go get our testosterone fix by watching the latest version of *Die Hard.* I will admit I did not have to have my arm twisted very much to agree to go.

Next Tuesday, July 10, I will host a very interesting online debate/discussion between good friends Rob Arnott and Professor Burton Malkiel of Princeton. Rob is the creator of the fundamental index, and Burton is often considered the father of indexing, thanks to his seminal work in *A Random Walk Down Wall Street.* They will be debating the merits of indexing and whether cap-weighting can be improved upon with a Fundamental Index approach. I will let you know more about this in later letters.

Next weekend I will fly with son to La Jolla to meet with my partners at Altegris Investments. We will have time to meet with some clients on Monday the 16th. If you are interested, let me know.

As a reminder, I write an occasional e-letter called the Accredited Investor E-letter on issues concerning hedge funds and alternative investments. If you would like to find out more, or see about how such alternative investments would fit into your portfolio, you can go to www.accreditedinvestor.ws and sign up for the letter. (In this regard, I am president and a registered representative of Millennium Wave Securities, LLC. Member NASD.)

I will be speaking at a conference in Denmark in mid-August, and am thinking of going to London about the 20th before heading on to Copenhagen, if there are those who would like to meet with me and/or my London partners.

And finally, my good friend and doctor Dr. Mike Roizen (mega best-selling author of *YOU: The Owner's Manual* and Friend of Oprah) is helping to host the 2007 Medical Innovation Summit at the Cleveland Clinic. This promises to be a very interesting and high-powered conference. For those of us interested in where the cutting edges of medicine are, this is a must-attend conference. You can find more at http://www.clevelandclinic.org/innovations/summit/.