

Distressed CDOs: Unfreezing the Credit Markets

Opportunity:

The US government has a critical interest in “unfreezing the credit markets” for certain real estate backed securities (non-GSE-backed Collateral Debt Obligations, hereafter called “distressed CDOs”). These markets are essential for real estate lending because they transfer working capital back to lenders to allow them to make new loans.

Without a way to sell these assets, banks are forced to keep the assets on their books, which prevents future lending. Even worse, as the market fails to function in an orderly manner, the banks who hold those assets for investment must revalue the impaired assets at their market value (“mark-to-market”), which further erodes their capital and has required government bailout funding to keep them solvent.

Private investors may have an unparalleled opportunity in the near term to purchase these distressed CDOs in this credit market because the market may be undervaluing these assets, and the government is currently executing a plan to encourage market liquidity by providing no-recourse loans with very favorable terms to potential buyers.

Definitions:

As a high-level description, each Distressed CDO can be composed of:

- Mortgage Backed Securities (MBS): a bundle of mortgages, sometimes with various tranches (groupings of risk and payment priority to different investors)
- Other types of loans (e.g., car, student, etc)
- Shares of *other* CDOs (again, with various asset types and tranches of risk)

For this definition, we are specifically excluding CDOs that are wholly comprised of GSE-backed MBS (e.g., Fannie Mae, Freddie Mac, etc).

Problem:

Buyers and sellers in the market for these Distressed CDOs do not have appropriate data to allow them to calculate the *economic value* of the assets.

Most often this problem is caused by the *layering* of bundles of the CDOs. In layman’s terms, some CDOs have been cut up and resold in pieces so many times that it takes days of research to figure out which shares of which assets they even own.

Solutions:

Privately funded investors don't have to react to the rise and fall of asset values – they prefer to use net present value of discounted cash flows, i.e., the value of the stream of payments that the assets are generating. So, if these investors could reliably estimate the *economic value* of a specific CDO, they could compare that value to the *market value* and decide whether to buy or sell that CDO. This would highly encourage market liquidity.

Economic value of each Distressed CDO is driven by:

- Composition of the actual loans that are bundled into a CDO
- Tranches (again, groupings of risk that drive priority of payment) of the CDO and/or shares of *other CDOs* that make up the composition of the CDO
- Current performance of the actual loans (e.g., default rate, late payment rate)
- Attributes of the actual loans (e.g., adjustable or fixed rate, prime or sub-prime)
- Expected future performance of the actual loans, which can be estimated based on loan attributes and assumptions about local unemployment, interest rates, etc

Investors could use computers to model the future performance of the actual loans if only they knew which shares of which actual loans were bundled into each CDO. Therefore, providing that information would quickly satisfy the government's need to make a market for the Distressed CDOs.

Long Term Actions:

The government could solve the problem by measuring and managing it like businesses treat a supply chain:

- Adopt regulations that require reporting of the exact assets (not just a summary by tranche – the *actual list of assets*) that underlie each and every mortgage-backed security (MBS) and collateralized debt obligation (CDO) as those securities are issued; place the data into a single registry kept by one of the regulatory agencies
- Require all past issuers of such securities to file a report in electronic format (to allow computer analysis) of the underlying assets of each asset that they issued; Secretary Geithner announced on May 13, 2009 an intention to deploy this type of registry database to track derivatives
- Keep track of hierarchy (chain of ownership) of each asset derived from others
- Require regular updates from trustees and servicers on the performance of all of the assets (e.g., loan delinquency, default, etc) within every MBS and CDO, to allow a roll-up calculation of economic value of every asset listed in the database
- Use regulatory inspection and monitoring to manage reporting compliance, and compare governmental risk ratings to the matching rating agency risk data in order to grade the rating agencies

Those simple steps will immediately create a market for the Distressed CDO assets. If potential investors can confidently calculate the economic value of an asset and compare

it to market value, they'll immediately start buying the under-valued assets and selling their over-valued ones, and the market for these securities will become liquid again. All they need is transparent data.

The existing database service provided by MERS is likely a reasonable starting point or model for implementation, but it may not contain all information needed. Recognizing that it may take substantial time and effort to implement a database with connectivity of this magnitude, we would also propose a pilot of the valuation process, in partnership with an industry-leading holder or potential acquirer of Distressed CDOs.

Short Term Pilot:

Again, following the principles of process and supply chain management, we are seeking partners who may benefit from our assistance to design and execute a process to define the structure of a given CDO (which may be comprised of tranches of other CDOs), down to a level such that the economic value of the underlying assets can be estimated. This "*CDO Economic Asset Valuation Process*" could be implemented:

1. By the CDO owner in an effort to more accurately establish the economic value in preparation for sale;
2. By an Investor desiring to better establish value prior to offering to purchase; or
3. By a mortgage-servicing company, for the purpose of working with mortgagees to assess and possibly improve their performance against the loans, thereby improving the value of the MBS or CDO

The *CDO Economic Valuation Process* is likely to have its own value as Intellectual Property for the organization designing and piloting it. And, of course, the resulting improvements in market liquidity would help everyone.

About Implementation Partners:

Implementation Partners delivers exceptional results for clients in the financial services industry, using world-class methods to drive improvements in process effectiveness, strategy activation, and organizational design. We are thought leaders in the application of data to process problems; one of our managing partners is a co-author of one of the most successful business books ever written on that topic, *The Six Sigma Way*.

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