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ML II: pushing Government Inventory Out the Door

AIG Sales and the Govt.'s Show of Flexibility

The government is a month into selling its **AIG** holdings. Despite the bids for the auctions being pre-announced, the sales are causing a commotion in the RMBS secondary market, and the reaction from securitization players is not entirely positive.

Yes the series of sales is helping price discovery, but it is also crowding out non-agency securities. The Alt-A and non-subprime portions of the portfolio have achieved better pricing, clearly demonstrating that RMBS investors remain averse to risk.

The policy of inundating the market with constant supply isn't working. So as **Nora Colomer** reports in this month's cover story, the government has decided to postpone the next auction until June 6 and will hold the subsequent one in July. It's also making bid lists larger than the small, weekly installments we saw before.

The sales, if anything, have underscored the market's unwillingness to digest a large supply of collateral, even though this is government sponsored. Bad assets are still a very hard sell, as investors remain fearful given the country's still-fragile economic condition.

This trial-and-error exercise has its good side: it shows that government is listening to market sentiment. We can only hope that regulators will keep the lines open with participants as well.

Clamoring to be heard right now are the smaller rating agencies, which are leery of the rules the **SEC** proposed on May 18. Mandated under the *Dodd-Frank Act*, these regulations would severely hamper their business model. In his article, **John Hintze** argues that implementing what's on the table would strengthen the hand of the big three agencies, precisely what regulators have said they don't want.

Bill Berliner talks about how the *Dodd-Frank Act* mandates that deals include premium-capture cash reserve accounts. This provision, according to Bill, requires issuers to set up a cash account that prevents them from attempting to monetize excess spread. He says the proposal can be highly damaging to consumer mortgage lending and raises another impediment to the revival of non-agency RMBS.

The government's stated objective is to stimulate private label RMBS, so they can recede from the primary market. But it seems to be doing just the opposite by pursuing rules that kill issuers' ability to monetize excess spread through the sale of IOs and premium securities.

There's one market, however, that's faring much better than RMBS despite government regulation: commercial real estate. In turn, CMBS has made a comeback. Fueling the trend is **Cantor Fitzgerald & Co**, which issued its first CMBS last April. I went to their offices last month to interview CEO **Shawn Matthews** and **Anthony Orso**, CEO of affiliate CCRE. My story on them examines their strategy of targeting middle-market lending and their plans to become a regular fixture in CMBS.

Finally, **Felipe Ossa** covered the securitization market's best known annual gathering of players devoted to Latin America. He found that the tone's improved since last year and deal-making is on the rise, especially in Brazil. But risks are rearing their head as well.

—*Karen Siabayan*, Editor

ML II: pushing Government Inventory Out the Door

It has been a month since the **Federal Reserve Bank of New York** began selling off its Maiden Lane II (ML II) BWIC list.

However, the combination of consecutive months of housing price declines, a softer GDP number, and the big question of what will happen to the economy and rates when the **Federal Reserve**'s second round of quantitative easing (QE2) ends has made pushing the government inventory out the door extra tricky.

by Nora Colomer

The $1.7 billion weekly ML II supply, according to market reports, has accounted for 43% of the $4 billion weekly BWICs and liquidations in the market between February and March. Up to ML II's sixth bid list, bonds traded at or above expectations and were net positive for the customer.

At its seventh auction, however, the Fed only sold 34 of the 53 bonds as a result of prices not meeting reserve levels. Traders said that of the $2.08 billion listed, roughly 34% did not trade, 43% traded below talk, 12% traded above talk and 11% traded near talk.

List number six, comprising a smaller number of bonds worth $458 million that went out just two days earlier, traded significantly better: 93% were sold — 31% above price talk, 12% below talk and 50% near talk. The Alt-A portion priced the strongest while the subprime bonds traded the weakest.

Mixing Lower-Quality Paper

What the seventh list in the series of sales has so far highlighted is the relative weakness in subprime versus other sectors. As the sales go on, the asset mix has increasingly incorporated more of the 2006/2007 paper with generally ugly profiles.

Scott Buchta, managing director at **Sandler O'Neill & Partners**, said the credit curve has steepened as prices on higher-quality bonds (i.e., fixed-rate prime and seasoned Alt-A bonds) have increased while prices on lower-quality assets (i.e., 06/07 subprime and pay-option ARMs) have pulled back somewhat.

However, Buchta said that while ML II supply has compounded the negative technicals in the dented residential space, the fundamentals in the distressed non-agency markets have been weakening for some time.

"Extensions in the liquidation timelines, rising severities and falling home prices have all played a part in the weakening of this sector," he said. "From a broader perspective, the housing market continues to struggle. Longer liquidation timelines and higher severities have had an impact on the prices, especially for subprime and pay-option ARMs."

Subprime also has more price/credit volatility these days as a result of servicing advance issues and the future of servicing practices — post-dual tracking.

"We have had many discussions surrounding which servicers specific clients like when buying bonds, which ones they hate and which ones they can't form an opinion on quite yet," a market trader said. "I think this will continue to be a prime topic, as there have been no major surprises in terms of the pure market fundamentals. The surprises have occurred in the speed of liquidations and the number of servicing advances and modifications happening, and this is simply determined on a servicer-by-servicer basis."

All these factors combined make the future less certain and affect risk taking across spread sectors.

"If it were one of improving fundamentals then people would forget about it and welcome the supply. The supply only matters because people are getting concerned about the economic backdrop."

"We are in a period of the year where technically equities fall under some pressure. Equity markets reflect the economy as a whole, and so people have become more concerned about that and QE2, and then you have a big seller," said **Dan Nigro**, chief executive of **Warfield Consultants** in Montclair, NJ. "On the other hand, for the first six lists you also had big buyers like **AIG** moving into the marketplace."

What is undeniable is that during the ML II auctioning process prices have slipped and there has been more credit tiering — good quality bonds are now tighter and the stuff that is weaker is now off by five to 10 points.

Excess Volume and Euro Sovereign Debt Crisis Pressure Spreads

Increased supply, both in the primary and secondary markets via BWICs, and weaker market sentiment have pushed spreads wider.

On the supply side, more European banks are looking to unwind their legacy position and clear up balance sheets in the run up to Basel III. This trend can lead to tens of billions of dollars worth of assets flooding the capital markets. Some of the legacy paper are risky residential RMBS.

Barclays Capital last month announced the unwind of its Protium vehicle, which was originally set up in 2009 to hold mainly U.S. structured credit assets. This move comes on the heels of a very similar action take by **Citi** recently, which readied the sale of some $13 billion of credit assets by shifting these back into trading books, according to **Royal Bank of Scotland** analysts.

As reports of more of Europe's 'bad-bank' constituency emerge, RBS analysts said that "any sales currently are likely to make most obvious sense only in the case of liquid, senior ABS but potentially also in the case of low or unrated downgraded bonds, for which exit economics will not be limited to pricing alone given the benefit of saving on otherwise punitive capital that must be held against such risks under the new Basel regime."

A wide-scale sell-down of legacy assets could impact market clearing prices, but RBS analysts said that risk will be outweighed in the longer term by the liquidity discovery that comes with such flows. A recent *Wall Street Journal* report said that persistent talk about more paper hitting the market comes with reports of increased appetite from hedge funds and private equity shops cashing in on the opportunity created by the flood of assets, which are now priced at a discount.

A pick-up in new securitization volume at the end of May can additionally pressure pricing on the secondary side.

Supply-wise, the primary market saw a new deal from Spain via **Volkswagen** Driver Spain 1. The pipeline also includes **NIBC**'s Dutch MBS 16, **Cassa di Risparmio di Cento**'s Guercino, **Credit Suisse**'s ALBA 2011-1 and **Yorkshire Building Society**'s new Brass 1 deal. According to market traders, on the BWIC front, the market saw a decent-sized Spanish and an Irish lists up for bid simultaneously.

Granite triple-Bs and ABS mezzanine bonds from peripheral jurisdictions were most affected, with the former trading at half a point. At press time, according to market trading reports, Granite triple-As were trading down at 96.25, which is 50¢ off recent tights, with even bigger price movements in mezzanine where triple-Bs were down two points in the 65.5-basis-point area.

Similar to the U.S., it isn't just a supply deluge that is pressuring European spreads. To be sure, market players have said that the tone in Europe is turning toward risk aversion as concerns over the Continent's sovereign debt problems once again take center stage. **Fitch Ratings** cut Greece's rating three notches last month to single-B plus while **Standard & Poor's** said that Italy's rating is at risk. Political tensions also continue to grow in Spain and Germany, where ruling parties did poorly in the elections.

"Renewed European sovereign concerns weighed on broad risk appetite and spilt over into ABS yesterday," **Deutsche Bank** analysts said in a recent report. "In general and in contrast to financial debt pricing, over the past year European ABS has proved relatively resilient to the European sovereign crisis. It remains to be seen what impact if any will be had on the senior new issue market where the pipeline from core jurisdictions is building." — *NC*

"Initially in the first six list the Fed saw aggressive price talk and that has changed because buyers are more cautious," Nigro said. "The chatter isn't as aggressive and you may not have as many bids moving things up. There has been a further decline in prices and further tiering between clean bonds and dirtier bonds and dirtier bonds have fallen more in pricing."

Nigro also noted that some of the leveraged buyers have begun to pull away from the market. "The fast money has started to sell and pull away from bidding," he said. "The guys who trade faster and move in and out of the market more often are more cautious and hesitant."

ML II — Good or Bad for the Market

While it can be argued that the sales have pushed spreads wider, they have also added structure and price discovery to the market — both welcome additions to those who are not knee deep in these bonds every day.

An aspect of the equation that is not mentioned is that for the last two years, since the bottom of the market, the Street has been able to buy bonds, mark them up, hold onto them when necessary and re-sell. "They knew there was a finite supply, they had low-cost financing and they had already been deemed too big to fail, so they took the risk on trade," Nigro said. "What has happened with ML II is that all of a sudden investment firms are not the drivers of supply and control as they were in the past, and when they lose a bit of control they get funny about pricing."

The Street, he explained, when it controls supply, front runs and marks up bonds and talks about technicals. "The Street is getting noisy because they can't control/dominate the action as they did over the last six months," Nigro said. "Markets don't go in one direction forever. The market has had a very healthy run since last August's QE2, and generally in securities prices since spring 2009. A pause or retracement is healthy and shouldn't be unexpected."

Adam Murphy, president of **Empirasign Strategies**, believes that anyone complaining about how the sales have been handled is way off base.

"They announced the auctions a few days ahead of time and have been pretty forthcoming with the color," he said. "Other lists are discreet with color and give sellers only a few hours heads-up. The ML II auctions with their long lead times add structure to a very unstructured and disjointed marketplace. I think you'll find those dealers/pm's long spread product before the ML II sales started hate it, and those under-allocated love it."

"While we believe a one-/two-week pause would be a net positive for the market, the lack of true confirmation debilitates intended positive effects."

It's All in the Strategy

The Fed's strategy of selling the bonds on an incremental basis as opposed to a one-off asset sale has been met with some opposition from several ABS traders who claim that the drawn-out process has created some pressure on subprime bond spreads.

Jesse Litvak, a managing director at **Jefferies**, last month in a letter addressed to the Fed pointed out that of the assets still left to sell, the majority are similar to those assets the Fed was unable to trade in its 7th list.

If the Fed continues to pump $1.5 billion to $2 billion of ML II bonds into the market on a weekly basis, it will take another 11 to 15 weeks to unwind the remaining ML II portfolio. The concern is that it's likely to continue pressuring spreads on subprime paper.

"At this point, we think the ML II bid process has become somewhat of a burden on the non-agency market," **Bank of**

America Merrill Lynch analysts said.

"There seems to be a high degree of bid fatigue on the part of investors and also a bit of hold up in the market each time a list is released, as investors take time to work up bids on the list and then wait for afterward. In addition, with the bulk of ML II bonds yet to hit the market and slated to come out over the course of the year, some investors have likely adopted the mindset "why pay up now?" analysts said.

Deutsche Bank Securities analysts said that the kind of volume that has been issued from the ML II portfolio is sufficient to dislodge the fragile balance between supply and demand in the non-agency market.

"Demand remains strong for the higher-quality assets, and yields continue to tighten in this sector," Buchta said. "Subprime and pay-option ARMs continue to offer very attractive yields relative to other high-yielding assets, but supply issues may continue to dampen prices in this sector for the foreseeable future."

According to **JPMorgan Securities** analysts, they expect to see spreads trend sideways for prime and Alt-A fixed-rate paper, but leak wider for distressed floaters, on the heels of overall market pressure from Maiden Lane II and other sellers.

Fed Revisits Strategy

Barclays Capital traders said that the ML II supply-related uncertainty has contributed to the flood of "did not trades" (DNTs).

"Rumors are starting to surface about a potential pause in ML II selling until June," they said in a commentary. "The news has yet to be confirmed by either the Fed or **BlackRock Advisors**. While we believe a one-/two-week pause would be a net positive for the market, the lack of true confirmation debilitates intended positive effects."

Litvak believes that the Fed should reconsider its strategy and instead sell off the assets in a large chunk or give other counterparties the ability to bid large pieces of what is left to sell from ML II.

"By taking the approach of pulling the bandage off nice and fast, I think what [the Fed] achieves is getting the best possible price for the remaining assets, and [the Fed] rids the rest of the market of the dark cloud that hangs over it," he said in an e-mailed comment to *ASR*.

Nigro believes that Litvak's concern over the overhang hurting the market has some validity to it, but only when placed in the context of the current economic backdrop.

"When you have a seller that is going to continue to keep coming back into the market place it's hard for people to be aggressive in bidding," he said. "The psychology behind everything is different because the backdrop is different. If it were one of improving fundamentals then people would forget about it and welcome the supply. The supply only matters because people are getting concerned about the economic backdrop."

Meanwhile, BofA Merrill analysts suggested a similar strategy and said that the Fed should consider releasing a single very large list, double-digit billions in size, and give the market two or three weeks to bid it. This process could capture the attention of the market and lead to robust execution. Yet it is unclear if given the deteriorating fundamentals, buyers would be able or would want to absorb a large auction. There is no evidence that at this point the a one-off sale would work better than a week-by-week smaller auction strategy.

"Until some change occurs or it is evidenced that the NY Fed is considering a new process, we may have to muddle through with ML II for the foreseeable future," analysts said.

New Twist to Sell Off

The good news is that the Fed has always maintained that it would base its strategy on market conditions and at its most recent sale, the eighth auction from ML II, it unveiled the newest twist to its auction strategy.

For starters, at $878 million in current face credit IOs, the latest list was significantly smaller than the $1.5 billion to $2 billion per week the Fed had been putting out. The Fed did sell 100% of the assets, but it was on the back of the low dollar price of the assets, so buyers didn't need a lot of cash to play and there was limited downside risk. "From what we can tell, the $878 million in assets generated about $50 million in proceeds," Buchta said.

However, the main indication that the government agency may now be considering another way to sell off the ML II portfolio is the Fed, sources said, held a conference call with traders that followed the eighth auction. According to market sources, the New York Fed during the call said it would offer no more bonds from its ML II portfolio until June 6. For the next two weeks the ML II asset sales will cease, giving investors more time between lists. The Fed plans one sale on June 6, and then none until after July 4.

At this revised rate of sales, one dealer projected the portfolio will not be completely unwound until the end of August.

Nigro emphasized that the latest move signals the Fed's willingness to adapt its strategy based on market conditions and its willingness to adjust accordingly. "In the end if they feel that they are hurting the market on a regular or permanent basis they will pull back because their job is to have the market function properly first and foremost. The Government's objective is to get a return to the taxpayer but to also, and more importantly, de-risk and keep a sense of market order." **ASR**