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Fed's Auctions Stir Up Subprime Market

By ANUSHA SHRIVASTAVA

NEW YORK—Toxic assets are back in demand, when the price is right.

The Federal Reserve Bank of New York's recent success in auctioning nearly 90 subprime-mortgage bonds acquired during the 2008 credit crisis has encouraged banks and others to try to sell similar securities, once written off as toxic.

The Fed's auctions have established real-world prices for subprime mortgages, as it plans to eventually sell about 800 bonds with a face value of around $30 billion—assets acquired from American International Group Inc. in 2008 and held in a trust called Maiden Lane II. While those prices often are well below face value, they help by demonstrating that buyers are out there.

"It has definitely spurred more activity," said Jesse Litvak, a senior mortgage-trading executive at Jefferies & Co. in Stamford, Conn. "There are definitely other sellers choosing to sell bonds and dealers buying... We see people trading around Maiden Lane II."

The Fed has held two auctions in recent days, offering $1.5 billion last week and $1.2 billion this week. It has sold most of the bonds on offer.

Private sellers piggybacking on the Fed deals have had similar success, said market participants, although anonymous bid lists make that difficult to confirm independently.

"Demand is back," said Paul Jacob, director of strategy at Banc of Manhattan Capital. "It is a sign that we've gotten past the period of no market for these toxic assets. It is functioning; it provides liquidity and is not driven by fear like it was a couple of years ago."

Dan Nigro, chief executive of Warfield Consultants in Montclair, N.J., said there has been a noticeable increase in residential mortgage-backed securities offered for sale on days when the Fed has circulated lists of assets it wants to sell. "There's 50% to 70% higher activity," he said.

Even with the supply increases, prices have held up and the Fed's auctions have succeeded, said the head of asset-backed securities trading at a primary dealer.

"If they sold $10 billion tomorrow and the bonds traded down, it could impact prices—but that has not happened," this person said. "This stuff has traded well, and there have been no surprises."

He estimated that double the amount of residential mortgage-backed securities have been trading since the Fed began its sales April 6. "There's $500 million to $1 billion trading daily," he said. "This has definitely stirred things up."

While the Fed offered some bonds for a few cents on the dollar, higher-quality assets sold for as much as 90 cents on the dollar, investors said. The Fed has made it clear it isn't obliged to sell the bonds at all unless it feels it has gotten the highest possible value for taxpayers.

Before holding its first auction, the Fed spurned a bid by AIG to buy all of the bonds for $15.7 billion. Instead, BlackRock Solutions, the New York Fed's investment manager, will handle the sales of portions of the Maiden Lane II portfolio over time.

Still, AIG's interest helped the Fed because the existence of a ready buyer meant that bidders are confident there will be demand for the securities if they want to sell them.

"There should be no fear of a huge new supply relative to demand, which would lower prices, because AIG was willing to buy the entire list," Mr. Nigro said.

One dealer put together a consortium of investors willing to buy the entire portfolio from the Fed for $17 billion, but the Fed chose to sell piecemeal in order to fetch higher prices. For similar reasons, the Fed didn't set a timetable for the auctions so as to monitor market conditions and sell only when it believes it will get the best value.

"Given the strong ongoing demand for the sector, the market is comfortable taking this paper because they believe they can sell it later," said Mr. Jacob of Banc of Manhattan Capital. "These are sizes we haven't seen trade very often in what has been a shrinking asset class for the past few years."

Insurance companies, real-money managers and hedge funds have been among the 45 bidders in the first two auctions, market participants said. "Hedge funds and others created room in their inventory to buy these bonds," Mr. Jacob said.

The Fed will publish the names of the dealers who purchase the bonds. The opportunity to publicly help the central bank has attracted many dealers, some of which have bought the securities on behalf of clients without charging their usual fee.

"The dealers are providing liquidity for the Fed, so the list of who traded the bonds is important," said Mr. Litvak of Jefferies, which has submitted bids but didn't offer the "free" option to its clients.

Issuance of new residential mortgage bonds has been spotty, creating further demand for these securities among buyers who want to diversify their portfolios. So far this year, only Redwood Trust Inc. has sold an RMBS bond in a private deal, in a $280 million offer. In 2010, Redwood sold the first RMBS deal since the housing bubble burst. That comprised attractive mortgages: loans made to wealthy borrowers.

The paucity of residential mortgage-backed securities has led to "a reasonable secondary market for these bonds," said a securitization strategist at a primary dealer. Still, "they aren't credit-card floaters," he said, indicating they are tougher to sell than higher-quality bonds backed by consumer debt.

Write to Anusha Shrivastava at anusha.shrivastava@dowjones.com