Truth and responsibility

*The meltdown in subprime collateralised debt obligations will affect financial markets for years. One likely result will be a renewed market willingness to reward sound credit underwriting – and therein lies a valuable business opportunity, argues **David Rowe***

In a recent speech, Václav Havel, first president of the Czech Republic, offered an interesting perspective on what constitutes truth. In effect, he said "truth is information supported by responsibility". Perhaps without fully realising it, Havel eloquently captured a central failing that led to the crisis in the subprime collateralised debt obligation (CDO) market. In the rush to capitalise on investors' seemingly insatiable thirst for yield, many banks and other mortgage originators abandoned even the pretence of careful underwriting and documentation. 'Liar loans' quickly entered the vernacular and truth was an early victim of this sorry chain of events.

I commented in a previous column (*Risk* June 2008, page 89) on the vast chasm that separates CDO valuation methods from traditional credit risk analysis. There was always something unsettling about attempting to value CDOs with little reference to the characteristics of the underlying collateral. In the corporate CDO market, this is more plausible given the availability of market-observable bond spreads and closely associated credit default swap prices. These provide issuer-specific market estimates for credit quality of the underlying collateral. In the subprime mortgage market, however, no such individual issuer information was available.

It seems likely that, in the future, much more detailed assessment of specific characteristics of the collateral underlying CDOs will become standard. This does, however, present a problem of explosive increases in dimensionality. Even a corporate CDO with 100 underlying names requires more than 5,000 correlations. Full microanalysis of a CDO with thousands of individual mortgages would be prohibitive, even if all the desired data was readily available and accurately maintained.

This is similar to the problem of estimating risk in a sizeable equity portfolio. Starting with the work of Harry Markowitz more than 50 years ago, the answer has been to relate price movements of individual issues to one or more structural drivers with appropriate coefficients. Such an approach might well hold promise for corporate obligations, where industry and geographic factors have been used to model the systemic component of changes in the credit spreads of individual companies.

The challenge is arguably greater for portfolios of mortgage loans or other consumer obligations. But even here, it is possible to visualise a way forward. If managers supplied partially aggregated data on portfolio proportions by region, loan-to-value ratio, monthly payment-to-income ratio and other relevant factors, this would significantly enhance investors' ability to develop their own views of relative value based on the underlying collateral.

There is, however, another widely applied technique used by markets to address the problem of asymmetric information and product complexity. That technique is for buyers to rely on a manufacturer's reputation for supplying a consistently high-quality product. This is, after all, how most buyers choose cars and a host of other consumer durable goods.

Financial institutions therefore have an opportunity to profit from a reputation for reliable and consistent credit risk management. In the aftermath of the recent collapse in underwriting standards, CDOs structured and managed by an institution with such a reputation might well command a premium. To assure long-term viability, however, I would propose two additional characteristics. First, the underwriter/manager would commit to hold some meaningful proportion of the entire underlying portfolio on its balance sheet. Second, in very large letters on the front of the prospectus would be written 'Purchasers of this security shall have no recourse to the underwriter'. The point is to guarantee that the underwriter will retain a meaningful participation in the collateral, but will offer no further assurance of support.

In brief, the three characteristics of such a structure would be:

- Conspicuous brand association with the underwriter/manager.
- Assurance of meaningful participation by the manager throughout the life of the security.
- Explicit and irrevocable transfer of ownership and risk to the buyer.

In the aftermath of events over the past year, investors may be ready to reward sound underwriting and reliable collateral management. If so, this could re-establish a market based on Havel's definition of truth as information supported by responsibility. ■

David Rowe is executive vice-president for risk management at SunGard. Email: david.rowe@sungard.com.
Blog: www.sungard.com/blogs/riskmanagement

[1] *www.risk.net/public/showPage.html?page=797096*