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Credit Markets

Surviving the subprime debacle

By Alice Ratcliffe with Stefan Muheim

Everybody calm!
Don´t panic.
Keep together…

In 2004, Kostas Iordanidis, who at the time was head of asset allocation for a Zurich-based bank, was seeking safe ways to employ excess cash. He became curious when he received a list of commercial paper programs auctioned daily by another bank in Frankfurt.

"I noticed there was a company on this list that was paying more than others to borrow for two weeks. I thought that was interesting. So, I called the guy who sent me the list, and asked him, 'what's this?'"

The answer made Iordanidis even more curious. The company selling the paper, Rhineland Funding Capital Corp., was what is known as a conduit. In the bland language of markets, it was a special purpose entity called a structured investment vehicle (SIV). Rhineland, a company registered under Delaware law, invested in structured credit portfolios called collateralized debt obligations (CDOs) including those with exposure to U.S. subprime real estate loans. It refinanced its operations by issuing asset-backed commercial paper.

"From now on, when you send me this list, you are going to do me a big favor. Each time you send it, you will highlight Rhineland in red." Kostas Iordanidis

In Iordanidis's brain, a warning light began to flash. "Commercial paper backed by subprime CDOs?" Iordanidis, now co-chief investment officer at Olympia Capital Management in Paris, didn't have to think about it very long. Looking back, he likened the risk attached to Rhineland and vehicles like it to a game of musical chairs. An investor would get a few basis points more than ordinary commercial paper by buying the securities. It may be a lucrative way to get a bit more performance for weeks, months, maybe even years. But what happened when the music stopped?

"From now on," Iordanidis told his contact at the German bank, "when you send me this list, you are going to do me a big favor. Each time you send it, you'll highlight Rhineland in red. That will warn people here to stay away from it." Iordanidis wanted to make sure that even when he was out of the office, nobody in his team would ever buy Rhineland´s commercial paper.

Back in the U.S., Thomas Vivaldelli, founder of Distressed Real Estate Solutions in Scottsdale, Arizona, was also getting worried by what he was seeing in the U.S. mortgage market. As a former mortgage financier, who started his career at the Federal Reserve Bank of Chicago, Vivaldelli thought the market was becoming "almost destructively competitive." His concerns included an increasing number of mortgages granted without any documents to show the borrower had an income. Not even a bank statement was required. With such alt-A mortgages, "a person could buy 100% down without income verification. I thought that was preposterous." Vivaldelli, like Iordanidis, also was worried about the low risk that investors were attaching to CDOs. Some of these weren't even based on actual mortgages, but on synthetic securities.

"In 2001, you paid a spread of 800 basis points for risks that were tied to paper that was below investment grade. By mid-2007, it was only 100 to 200 basis points. People were buying junk without being compensated," Vivaldelli said. He expected the mortgage market to start having difficulties in late 2007. Some others he spoke to thought it would take longer. Perhaps things would be okay until late 2008. In fact, things happened much quicker. The market began to show signs of serious stress in July 2007, when Düsseldorf-based IKB Deutsche Industriebank, a mid-sized German lender, turned to its largest shareholder for funding after IKB found itself unable to meet liquidity needs at an investment fund. The fund in question was none other than Rhineland. IKB said its ties to Rhineland were those of an advisor, earning it about 50 million euros in "advisory fees" in 2006, according to its annual report. On July 30, IKB issued a statement saying state-owned KfW, set up as a reconstruction bank in 1948, was assuming all risks related to Rhineland. KfW, IKB's largest shareholder, agreed to take over a 8.1-billion euro credit line as part of the agreement. IKB blamed the problems on what it called "a crisis in confidence." It ousted its Chief Executive Stefan Ortseifen, replacing him with Günther Bräunig, a board member of KfW.

Other banks also were being forced into the same uncomfortable spotlight cast by supposedly safe investments. BNP Paribas SA, France's largest bank, was forced to temporarily freeze three funds with exposure to asset-backed securities because it could no longer value the holdings in the funds. Barclays provided emergency financing for a fund managed by Cairn Capital, when that fund had to close an asset-backed commercial paper program.

Problems that began as an isolated phenomenon in the U.S. subprime mortgage market had thus begun to spill over into other areas. Investors worried what other problems tied to subprime debt might still be waiting to come to light. Banks, hedge funds and others nervous about growing scarcity of credit began to sell liquid assets.

From mid-July to mid-August, major stock indices were hit by extreme volatility, in some cases losing more than what they'd gained since the start of the year. Prices of base metals dropped on worries about a U.S. housing slump. Hedge funds needing liquidity unwound leveraged carry trades set up to profit from higher-yielding currencies.

Photo: Alexander Sauer

Stefan Muheim
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The Turkish lira lost 11% against the dollar in a single week in August. The yield on U.S. two-year Treasury bonds dropped to the lowest level in a year and a half as investors scrambled for safety. Countrywide Financial Corp., the biggest U.S. mortgage lender, began in August to draw $11.5 billion in credit lines.

As liquidity started to dry up in the interbank market, sending the cost of short-term borrowing soaring, central banks led by the European Central Bank and the U.S. Federal Reserve pumped in nearly $300 billion funds into the markets on just two days, August 9 and 10. On Friday, August 17, when major U.S. and European stock markets were threatening to end the week down by as much as 3% – Tokyo's Nikkei lost nearly 9% on the week – the U.S. Fed cut its discount rate by 50 basis points. On September 18, it cut the fed funds target 50 basis points to 4.75%, citing concern market turmoil may hurt growth.

Of course, what goes down can also come up. Some investors may already be sifting through the rubble, seeking value. "Distressed funds will have substantial opportunities," says Iordanidis. "Perhaps 20 percent of the subprime CDOs still have value. The challenge will be to find that 20 percent."

"Markets will calm down again, provided short-term borrowing costs return to normal and the commercial paper resumes proper functioning," said Stefan Muheim, senior credit specialist at Clariden Leu Investment products. "But spreads are not likely to return to the very tight levels we saw in earlier in the year." Spreads reflect the premium investors get for owning a riskier bond versus low-risk government bonds.

Factors likely to keep spreads wider than what was seen at the start of 2007, at least for the foreseeable future, include a drop in demand for complex structured credit products such as CDOs and CLOs. Credit fundamentals – i.e., debt-to-EBITDA or so-called interest coverage ratios – also were starting to deteriorate even before the crisis, contributing to wider spreads. After the selloff, corporate bonds, which in some cases lost up to 15% percent of their value, may start to appear interesting again. These could surprise with performance on the upside in the latter part of the year, once investors overcome their risk aversion, Muheim said. "At levels of 350 basis points over swap rates, European high-yield bonds appear to be close to fair value, based on fundamentals. Less risky investment grade corporates, in particular some of the European retail banks that have little exposure to high-risk areas, even look cheap now."

John H. Burbank, founder of Passport Capital LLC, a San Francisco hedge fund, had also been watching what was going on in the U.S. subprime market. Starting in 2005, the company's Global Master Fund had begun to short mezzanine tranches of U.S. subprime mortgages. Burbank saw a "misallocation of capital" in emerging markets, especially Asia. These countries were exporting reserves that were flowing into "the weak link" and place the liquidity "never should have gotten to – subprime mortgage holders," said Burbank. His fund gained 36% in July and returned 101% in the first seven months of 2007, according to Bloomberg. Burbank,

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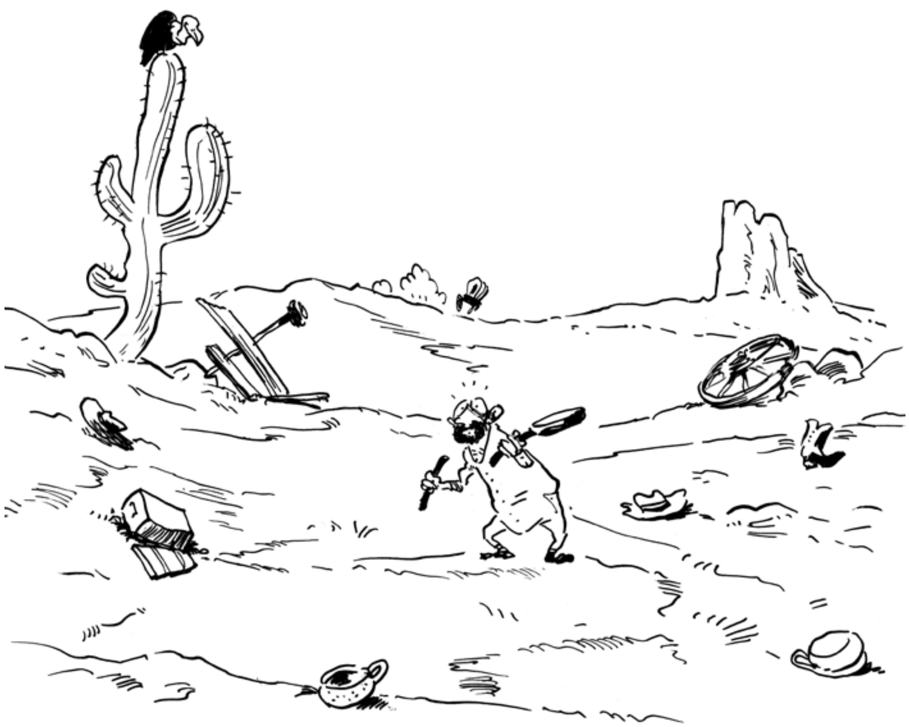
> Stefan Muheim, Clariden Leu Investment Products

whose company manages about $2.4 billion, says it is still to early to go long subprime mortgages. "It's going to take some time. A lot of things have to unwind first." The process will include ratings agencies completing a process of downgrading debt, while housing prices also will likely fall. While Burbank believes problems in stock markets can be resolved fairly quickly, "credit problems are deflationary and take years to resolve."

"If you want to find opportunity in this, you must understand where the excess reserves are going to be held by sovereign wealth funds and others. Where will these be putting their capital for the next 10 years? We believe it will be put into commodities, including energy and metals, as well as emerging markets such as China and India," he said.

Vivaldelli believes the Fed's decision to offer money through the discount window means it is trying to limit availability of credit to non-banks that made subprime loans.

"The Fed is choosing sides. It will be much tougher for firms that made subprime loans to do business in future," says Vivaldelli. He sees "tremendous opportunity" in debt portfolios yet to be liquidated that eventually will be "purchased at a discount."



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It may be useful to recall that after the U.S. savings and loan (S&L) debacle of the 1980s, the U.S. government created the Resolution Trust Corp, (RTC), which oversaw about $400 billion in impaired assets of 747 S&L banks. The RTC helped to get the asset-backed market off the ground with sale of these impaired loans.

After the RTC closed for its doors on December 31, 1995, the U.S. Government Accounting Office (GAO) calculated that winding up the S&L assets cost U.S. taxpayers $132 billion. At the time the RTC closed, it also faced about 120 lawsuits connected with the closures, the GAO said.

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About Clariden Leu

Clariden Leu is an independent and exclusive Swiss private bank which can look back on a long private banking tradition. Following the merger of the four Credit Suisse private banks Clariden Bank, Bank Leu, Bank Hofmann and BGP Banca di Gestione Patrimoniale together with Credit Suisse Fides on January 26, 2007, with retroactive effect from January 1, 2007, Clariden Leu is now one of the five largest providers of private banking services in Switzerland with 519 years experience in private banking.

About Distressed Real Estate Solutions

Distressed Real Estate Solutions' expertise is in working with real estate, financial, and lending organizations to maximize the return on investment on non-performing assets. With over twenty years of experience in banking, real estate development, mortgage brokering, and direct mortgage lending, our principals have the business savvy your institution needs to effectively manage its distressed properties.

Distressed Real Estate Solutions will research and identify your property's key issues, quantify all problems, and develop the innovative strategies and tactics needed to address your unique business challenges. Then we will carefully oversee the execution of your customized solution, including the structuring of all necessary transactions, and enlisting support for -- and closing -- the most profitable deals possible. We analyze opportunities, and generate creative, "win-win" results. We are committed to helping you keep your costs down, while scaling your profits up.

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