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Inverting the Private ABS Pyramid

The Inverted Pyramid

The “inverted pyramid” is a popular metaphor for the investment decision process. The idea is to maximize the volume of potential investments at the top, and filter out the less attractive securities to finish with a select group of value-added transactions at the narrower bottom of the pyramid. In theory, the larger the volume of investment choices, the easier it should be for portfolio managers to cherry-pick the “best of the best” in their perpetual quest for superior “Alpha.”

Where is the Private ABS Market?

The private, off-the-run (“OTR”) ABS market is not what it used to be, at least for its traditional investors—especially U.S. insurance companies. Once one of the foremost buyers of OTRs, insurers have seen their investment volume in these esoteric investments drop off significantly.

The Gun-Shy Investor

The decade leading up our new century saw an explosive growth in OTR asset classes being securitized and gobbled up by institutional investors. But the OTR honeymoon ran into rough waters when one asset class after another suffered a series of rating downgrades, precipitous drops in market value, and defaults. Notorious operational breakdowns and even fraud further wounded the market. Many investors chose to shift their focus to more liquid and predictable publicly traded securitizations. Simultaneously, the more aggressive rating agencies were also compelled to tighten their credit standards.

Efficient Funding Alternatives

Losses on old bonds notwithstanding, demand for funding from originators with suitable collateral did not diminish. Bankers responded by effectively “internalizing” OTR credit exposure through a variety of relatively efficient funding vehicles and credit enhancement products—specifically: the already well-established bank-sponsored multi-user asset-backed commercial paper programs (ABCP); the newer structured investment vehicles (SIVs); collateralized debt obligations (CDOs); and monoline financial insurance guarantees. Hedge funds have also been steady buyers of OTR investments. Traditional term investors have not been cut out of the business completely. They still fund a large portion of the market through their investments in CDOs and monoline “wrapped” securitizations—albeit at a lower return.

Relative(ly) (Less) Value

The current market structure has produced a strong sellers’ market. Predictably, these conditions have compressed OTR spreads. Formerly, wider spreads justified the extra time and effort required for the proper review of “story credits.” Now, the discriminating investor is facing ever-narrower credit spreads.

Seller Motivations & Investor Incentives

With term debt direct-placement growth stalled, many traditional OTR investors are asking how this market can be revitalized. “Selling the sellers” by stressing the benefits of funding diversification, lower costs, capital markets name recognition, and direct investor relationship building could be parts of the solution. Many buyers are counterattacking by setting up their own CDOs to compete directly with other asset-hungry vehicles. Others are also asking if a more proactive approach to transaction generation should be implemented. Only time will tell.

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