

Distressed Investors Dig in for the Long Haul

Another year of crisis has done much to change the outlook of investors in troubled mortgages and asset-backed securities. They see more opportunities as more assets fall into the distressed category. But they also sound more cautious. They're not expecting the juicy returns of 20% or more that many foresaw last year — and they advise being wary of anyone who says they can hit that. And calls are growing for investors to take a more proactive stance not just with servicers and lenders, but with Washington, too. *American Securitization* sat down with some of the market's top investors and advisors to discuss the challenges facing distressed investing.



The Panel:

The Moderator

Antony Currie — American Securitization

The Servicer

Richard Cimino — iServe

The Advisor

Brendan Keane — First American CoreLogic

The Lawyer

Steve Kolyer — Clifford Chance

The Bank Portfolio Manager

Michael Psyllos — Citi

The Investors

Dan Castro — Huxley Capital Management

Ron D'Vari — NewOak Capital Management

Mike Flynn — ICP Capital

Jeff Kaplan — DellaCamera Capital Management

Antony Currie: How would you define what makes an ABS asset distressed?

Ron D'Vari: It's quite simply wherever there is a large disparity on valuation between the holders and the potential buyers, whether because of complexity, sensitivity to credit performance or sensitivity to the outcome of government responses. Anything that generates huge ambiguity in views about the performance of the security over its life for a number of investors to put a different valuation on it.

Antony Currie: That's pretty broad. Are there other ways to assess it?

Steve Kolyer: In legal terms you would measure distress by way of the various tests and circuit breakers that may be installed in the legal documentation. That is one rather bright line set of standards that you could utilize to measure whether something has fallen into the category of what you colloquially refer to as distressed. Depending on the product, there could be amortization event triggers, coverage test breaches and the like.

Brendan Keane: If there's a gap in price, is that in and of itself distressed these days, or is it more about performance? Or is it both?

Ron D'Vari: The price gap has a lot to do with cost of funds. For example, banks' cost of funds is below Libor, and so they're looking at cost of opportunity. If they sell the asset, what are they going to put the money into and what are they going to earn on that? Whereas investors consider what they need to offer to their ultimate investor, who is the sponsor of the funds, and what they see in terms of opportunities.

Perhaps a year and a half ago there was a disparity in what the loss severities were going to end up being. People would argue home prices won't drop by X amount, and others would say it's going to be twice X. But now you're seeing more convergence of views about the realities for the next three to four years. It comes down to: what do you discount it at and what are you willing to give up?

Jeff Kaplan: The distressed buyer usually has a skill set and risk appetite that is markedly different from the original par owners. These original par buyers are generally looking for some rate of return, some par-based yield, whereas a distressed buyer is looking for something much greater.

Michael Psyllos: There's a distressed seller, and then there's a distressed asset, so we should always differentiate between them. I focus on commercial real estate and right now we have a unique scenario: assets that are performing fine, will continue to have cashflow, to have what traditionally has been strong debt service coverage ratios and will not have any issues until maturity.

But then, they will not be able to refinance if the current market conditions and the current assessment of valuation persist. There's a big differential between LTVs that

were in place two years ago when the loan was originated versus LTVs that are persisting now. In other words, especially in commercial real estate, the definition of a distressed asset has evolved to encompass refinancing risk that has nothing to do with the underlying credit performance.

Antony Currie: So how many distressed assets do people think are out there? This time last year, the figure was around \$1 trillion. Is that still in the ballpark?

Dan Castro: I don't know if \$1 trillion is a good number, but it's somewhere up towards that, probably, at the high end.

Ron D'Vari: We're talking about semantics here. The rally that we've seen and the rally that we're going to see, perhaps, over the next two or three years doesn't make these assets not distressed. We're just talking about the price ranging from 35 to 45 cents on the dollar. Look at the CMBS market: A4s moved down from the 60s then up to the 80s and then gave up half of that in a matter of a couple of days. So even though they're still triple-A's and a lot of people believe that they're not going to be downgraded, it is still a distressed asset. And if it's on the balance sheet of a financial institution, the investors are going to question whether that asset is carried at the right price.

In my view, there are a lot more distressed assets than people are advertising and there is a lot less capital than the actual distressed assets available. Take residential loans: anything non-agency is distressed. You're never going to get par price on it even if you have all the records that the borrower is good.

Now, we believe that one in four borrowers in residential is underwater. But we're seeing about one in nine delinquencies. So either home prices rise, which I don't believe anybody believes is going to happen in the next year or two, or you're going to have to have the delinquencies match what's underwater. Looking at the size of residential mortgages in the U.S., that easily could mean \$3 to \$4 trillion. And agency mortgages can be distressed too because ultimately what's going to happen is that Fannie and Freddie will have to foreclose on properties or they're going to have to sell that loan to somebody else.

Add another \$750 billion for commercial real estate: leases in New York went from \$150 per square foot for offices like the one we're in to \$50 per square foot for a five-year lease. So that puts valuation to a third of the peak on a cash flow basis. How do you then justify assuming a 5% or 10% loss assumption in CMBS? And add on all the other consumer loans and corporate credit that ultimately have to default. Unless we have a magic wand to flush the system with new credit and new jobs, distressed credit is going to be with us in size for some time. That means we have to question whether these peaks and valleys in the market are real.

Richard Cimino: I agree. We haven't yet seen a lot of the delinquencies that are coming our way. Take residential mortgages: a lot of the problem loans were 10s, the interest-onlys, the adjustables, the 2/28s and the 3/27s. But the biggest piece is option ARMs and a lot of those are not triggering yet. On an interest-only, as an example, if you're at a 5% interest right now and it adjusts, your rate will probably drop down to 4% or less. But your payment is going to go up, because now you're amortizing principal and interest. A lot of borrowers don't understand that and don't know that. When it occurs, there's going to be a lot of delinquencies. Those loans were never originated to adjust, but to be taken out by another product before that happened. The big problem is there are no products out there to take those out. I've heard delinquency forecasts as high as \$3 trillion when that starts to happen.

Michael Psyllos: To respond to one of Ron's points: yes, rents have fallen and thus valuations have fallen, but fortunately for the sector underwriters, ratings agencies and investors were not underwriting these office buildings with \$150 rents or \$100 rents. We were looking at what's actually in the building. Leases are typically five-, seven-, 10-year leases and most of the tenants in the buildings have leases at much lower dollar prices. That means there wasn't that baked-in upside that could have been there.

Antony Currie: So the pool of distressed assets, it seems, will keep rising. What about funds for buying them? Last year the figure allocated to distressed funds was said to be around \$100 billion. A panelist on our other roundtable, Denise Crowley, reckons that's now \$40 billion. What's your impression?

Dan Castro: I'd say it's at least \$100 billion.

Ron D'Vari: \$100 billion allocated to distressed assets? I'm going to go on your road trips from now on!

Dan Castro: There's a lot of money outside of the U.S., in particular. They won't call them distressed assets, but they will say: "We want to put X to work in mortgage products." I read that as distressed.

From our perspective we've recently seen the risk appetite returning in a significant way for a tremendous amount of money that has been on the sidelines. We'd been talking to investors for the previous 12 months in the Middle East, Europe and the U.S. and a lot of them were sitting on their hands. Then suddenly, towards the end of March, the phone starts ringing as people slowly come back in. Then, by early May an immense amount of folks were saying: "I want to come in here, there." Some of them are going to the less distressed assets, wanting new issue traditional ABS via Talf. Other folks are going into the more interesting stuff on the residential side, whether it's subprime or Alt-A.

Brendan Keane: What's the reason behind the renewed interest, Dan?

Dan Castro: People believe that we're getting near the bottom on some of this stuff, and if you really want to do well, you need to get involved before you get to the bottom. Because if you get to the bottom and everybody realizes that things are better, you've missed the best part of the trade.

The other thing is, for a lot of this product, you need to find very smart investors who



Brendan Keane of First American CoreLogic

understand that on a mark-to-market basis things may yet get worse. But if you can get the money locked up, preferably for three or more years, which is kind of the target for the distressed assets we're looking at, then you can ride through that and get to a place where you know you're going to be better off. But they need to understand upfront that they may be down in three months or six months, or even nine months from now, before they start moving in the other direction.

Mike Flynn: That's true. And specifically on the residential market, although the markets rallied a lot recently, I think the investor community saw that up to 95% of the pool could suffer 60% of losses and still give you 20% yields on cash flows. That message became more and more compelling and many people saw that we were getting towards the bottom. There's been a lot of price correction and from a risk return perspective, it's much more compelling.

Richard Cimino: I'm in the servicing end of this and what has to be developed to get things moving is risk transparency. There's an evolution among investors in understanding what the risks are, because the various tranches are not what they used to be. In order for investors to start buying a lot of these pools and to get things moving, you need to understand the underlying risk. A lot of that starts with understanding that the loans that are delinquent are taking the loss at loan level, not at pool level.

Dan Castro: I'll put a plug in for ASF here as one of the Board members. We're organizing a risk transparency committee to be a standing committee and soliciting members right now. We think that's a critical element to get as a necessary precondition to restore liquidity in the market.

Richard Cimino: That's important and will help with pricing. When dealing with these pools at loan level, probably one of the most important things to do is to benchmark that value in a declining market, because that's how your loss is going to be measured. You have to understand that you may have to get right down to the zip code to understand what's happening. And you just don't look at comparables. Your servicer has to be able to look at what's happening to the demographic geographically. So if you have a large portfolio in certain areas of Detroit right now, that's an obvious scenario to be worried about. But what about all the vendors, the suppliers, even the truck drivers that deliver the products to that area?

Steve Kolyer: For all the talk about credit stress and performance, cash flow performance of ABS or MBS and talk about price and depressed pricing, haven't we seen an extraordinary example of how illiquidity for external reasons becomes a credit problem? I'm not the expert on pricing, but haven't we seen so much price depression come from illiquidity of the product on the market that's separate from credit performance?

So it seems that that has been an extraordinary factor, has it not, in the past 12 months? And maybe that will start to dissipate, and maybe pricing will revert to correlate more with credit. But it seems that the illiquidity component of all this has been the big surprise and has caused the credit problems

Jeff Kaplan: As a buyer of those assets, if there is additional unknown risk or risk that the rules will possibly change or that timelines will become elongated, I have to back up my bid, so I have to reduce my price in order to compensate my investors to get the return they demand. So I agree with you that illiquidity is creating that, but it's also the risk of the unknowable.

Steve Kolyer: Of course, and that goes back to the point Michael was making, that a CMBS may be performing perfectly fine in terms of current cash flow, but whether you're the owner of the CMBS or whether you're the shareholder looking at a Reit's holdings, you're starting to ask questions about what's going to happen in 24 months when you're not going to refinance and you'll back into a value from that.

Michael Psyllos: If you look at CMBS cash prices versus the CMBX index prices, CMBX has within it inherent leverage, and that leverage has actually kept the CMBX prices lower than or spreads tighter than cash levels, and

part of that is the inherent leverage in the index as opposed to a cash bond, where a lot of investors have not been able to go and get leverage.

Historically, if you went back two years pre-dislocation, you would have been able to get 95% leverage on a triple-A bond. That is not available in today's market. Even for Tier 1 accounts, as some primary dealers would call them, leverage levels are much less than that. The basis has widened on cash bonds. The investors are demanding more spread for cash bonds as opposed to the index. And the index is a lot more speculative. A lot of people are using it as hedges against other investments that they may have.

Brendan Keane: We've heard so much about what is anticipated to happen in the commercial space. Do you think that it's overblown in terms of the anticipated illiquidity because the underwriting was better relative to residential mortgages, for example?

Michael Psyllos: The illiquidity is an issue of the capital markets and will remain until the markets recover. Much rests of course on programs like Talf and PPIP that are meant to bring leverage back to the market.

Brendan Keane: Putting aside market illiquidity, I'm talking about credit performance.

Michael Psyllos: There is an expectation that delinquencies will continue to rise in this sector and there typically is a lag between delinquencies and commercial real estate and the market's performance. We've seen that based on historical trends. It's not atypical for delinquencies to continue to rise even after the economy has started to recover. That's just because it takes time to work commercial real estate delinquencies through the system, because the leases are longer and so forth. So the expectation is they'll rise. But if you look at super-dupers which have 30% subordination on triple-As, S&P came out with an announcement two days ago that has impacted the market dramatically: we've lost a lot of the tightening that had occurred over the previous month because of announcements in Talf. We'll have to see where that plays out, because there's an expectation, certainly at S&P, that there will be downgrades in the triple-As.

Are we expecting more delinquencies? It's highly correlated to the overall market. Office space is heavily linked to what's going on in the macroeconomic conditions. Multi-family is heavily tied to what's going on in terms of employment. Industrial space in commercial real estate is heavily tied to macroeconomic conditions. The commercial real estate issues right now are linked to the market, unlike what happened in the '80s, where it was an oversupply. Even though the economy may have been performing fine, commercial real estate markets were not performing.

Ron D'Vari: One of the biggest uncertainties right now is the securitization market itself, because there is really no alternative for refi-

nancing these assets four or five years down the road. We know the banks are burned pretty badly and none of the new management is going to be stepping in front of this in a few years from now and saying: "We're going to do the same thing."

Brendan Keane: But I don't think we know how badly they've been burned yet.

Ron D'Vari: True, not yet. A prudent investor should really be looking at what the state of the world five years from now is going to be like. The availability of funds is going to be probably less than half of what was available in 2000, even 2002. Banks were very willing to lend to commercial real estate even after 9/11, with loan-to-values probably in the 70% to 80% area, then put it on their own balance sheet and look at debt service coverage that was in the 140% area. Not in the future. People are going to stress the current contracts by 30%, 40%, even the leases, because the triple-As are not going to be sustainable.

When I look at the investment world, I see a lot of cowboys, people who are assuming we're going to go back to a rosy world. That's one of the reasons I believe there will be mistakes made and people are going to burn themselves again, and worse than the first time. Unless we find a real clear alternative to how the securitization market is going to reopen for regular, well-underwritten assets, we're going to have an issue, especially if you take Talf away at the end of 2009.

Steve Kolyer: An observation and a question for the group. No matter how the regulatory structure changes for the banking system, in any normalized deleveraged economy, the proposition that we come to is that the collective capital of the banking system will never be sufficient to provide the resource for consumer finance needs. Therefore whatever percentage securitization had constituted in the overleveraged or highly leveraged economy that we just came out of, some 50% or so, there will still be a need for securitization to fund that consumer finance need. And if you accept that as a proposition, then a lot flows from that. There will have to be external mechanisms. Mechanisms that we all became very familiar with will have to be pulled off the shelf.

One perspective is that the tools work but the products were broken. A lot of these tools are already being used again. If you look at Talf 1.0, a rather simple training wheel securitization format, who thought that we would be using 10 to 1 leverage on pools of ABS as part of the solution to the problem? Only two, three years ago, it was 10 to 31 leverage on pools of triple-A ABS that was part of the frailty that caused a lot of problems, and we're back using the same tools again. Securitization finance is going to be key as part of the solution. I'm very curious to see if there are divergent views on that.

Mike Flynn: I think securitization can exist.

The problem is that the basis between the bid on the super senior right now, which is the government, and the private investor is so wide that it can't be repriced to where it would need to be for securitization to work today without that sponsorship. But at some point the securitization market will come back and the government won't need to be the big sponsor. What needs to happen, though, is some reflation in the underlying assets and we're not seeing that.

The rally in the residential market is more of a technical rally. The fundamentals continue to be bad. Home prices continue to be down. New delinquencies are still rolling in. Severities are climbing. There are a lot of other uncertainties with regard to government policy. All of which makes it very hard to price assets. Once these diminish and asset base reflation kicks in, the private investor will be more willing to step in and take that super senior position. But it will come in at a higher cost of capital and you can effectively price that out right now at where the bid was from the private investor before Talf 1.0 came out, or before the expectation of Talf in the CMBS and RMBS market appeared. That's effectively your pricing point for what the cost of capital is for these assets.

Antony Currie: Dan, how does all this negative sentiment play into the uptick in investor interest you've seen recently?

Dan Castro: Well, generally I share it. But for investors it puts the emphasis even more squarely on knowing what your exit strategy is and understanding the lock-up period. And that depends on your time frame. Property and casualty insurance investors, for example, might need liquidity if there's some event that they have to pay out on, so they're often reluctant to accept lock-ups.

What we say to folks who we're trying to get three-year or more lockups from is that the exit strategy is that you're buying the cash flows. Assume no liquidity. If there is a chance, opportunistically, to liquidate at a profit, we'll do that. But that doesn't look too likely in the next couple of years right now on the distressed side. Maybe two or three years from now we can get out of it at a profit when there's some liquidity in the market.

Antony Currie: That seems to be a marked shift from a year ago, when our panelists assumed securitization as the exit strategy.

Dan Castro: Well, our approach now is to say to people that unless you're willing to lock up the money for a period of time and accept that it's the cash flows alone that pay you back, then you probably shouldn't play here.

Jeff Kaplan: As a manager for investors in whole loans, we've seen similar interest in the last month or so, where people want to align themselves with servicer types like Richard's group that have the potential for an exit strategy either on the REO disposition side or on the mortgage origination side. So if the servicer

can get that portion of the portfolio re-performing, you're collecting the cash flow that Dan was talking about and you can get a decent cash-on-cash return. Getting those off your balance sheet and recycling the money with a refinance is the ups.

Richard Cimino: Identifying your profit on the way in is part of that plan. Different servicers are in different spaces and are having different challenges, but right now servicers need to



iServe's Richard Cimino

understand what the investor wants to happen with a particular pool. Is it an exit strategy pool, or is it some type of a workout strategy? And it has to be very specific so that the servicers can customize whatever the result is for that specific investor, and I think those are some of the challenges in servicing right now and some of the risk transparency that needs to be part of the discussion with the investors — to clarify what your intention here is. There has to be quite a bit of education with the new investors and with some of the existing investors.

Antony Currie: What do investors expect as a return? Last year people were talking IRRs of perhaps 25%. Has that changed at all?

Ron D'Vari: It depends. Take new issue Talf, which of course isn't really a distressed strategy. Investors there would like a minimal amount of tail risk and are happy to lock up between 10% and 15%. And simple Talf has been more marketable than, for example, riskier strategies with a fatter tail. We're finding that a 10%, 15% IRR on a whole loan pool of RMBS is actually all you can really promise, because even at the prices you're buying, if you're looking at a two- or three-year exit, you have to have at least double the recovery of what you've paid. And it's unreasonable to expect that your workout magic can actually produce that.

Jeff Kaplan: If you're buying from a distressed seller, you can generate some nice returns.

Ron D'Vari: Exactly. It depends on the edginess of the asset. But anybody going into this

expecting a 25%, 30% return is going to end up at minus 25%, minus 30%. By over-promising yield, all you're doing is disappointing. Investors should go in with a scenario which actually produces a solid 10% to 15% return and has a potential upside beyond that.

Brendan Keane: That's also a function of the investor's time frame. That mixes things up quite a bit in terms of expectations. Then you layer that into what the market environment is like now or will be some years from now. That's going to continue to play in the mix and upset that normal return assumption of what may usually be 20% or so.

One other thing that I would add to that is investors' demand for a certain return relative to what they can see in the underlying asset, particularly on the residential side. So if they have the right data, or at least what they perceive to be the right data or the right information, and maybe some predictive modeling, they'll be more realistic. If they don't have that transparency, they're going to demand that 20%-plus return.



Steve Kolyer of Clifford Chance

Ron D'Vari: Let's assume we give the same portfolio to everyone at the table. Based on assumptions of what they can do with that portfolio and what they think they know is going to happen in the future, return expectations will probably vary from 10% to 40%. And none of it has to do with facts. It has to do with assumptions. So the question is: what is your expected outlook? The prices are what they are. Nobody can get better prices than the others. Forced sellers are only going to show up in a specific situation, like an M&A situation, where you're providing a lot of liquidity in one shot. Think of \$3 billion-type liquidity, as opposed to, say, \$300 million. If you can take a large portfolio down, you can set your own price.

Aside from that, anybody who is getting it through the regular channel in the market, believe me, it's already marked up, so it's the same price for almost all investors. Then returns come down to assumptions and that's where you have to think about promising the high or low.

Jeff Kaplan: I'll disagree with some of that,

only because in this environment some sellers are more interested in surety of closing than price. There are a lot of either brokers presenting themselves as buyers or fly-by-night guys who are throwing stuff against the wall to see if it will stick. A lot of sellers have gotten burned and as a result are not putting pools of whole loans out for competitive bid, but instead are receptive to direct one-on-one discussions with you — if you've performed repeatedly. As a buyer, if you win at auction you actually lost, because you paid the highest price.

Ron D'Vari: That's the typical rule.

Jeff Kaplan: Right. So we try to avoid the auction process, because we don't want to pay the highest price. We can't avoid not participating in some of these things. But if we buy at the right price and we think we can execute — if two people have the same pool, but one has one servicer versus another servicer and we think we can do a bit better on timelines as well as execution prices — that difference in acquisition price and timelines can mean anywhere from two to 10 points in recovery. That can make or break you. That's our bet and we've done pretty well so far.

Michael Psyllos: To echo what Jeff said, I head up our efforts at Citi to sell off commercial real estate whole loans, B notes and mezzanine loans, at least from within the institutional client group. We prefer privately negotiated trades as opposed to auction processes, although occasionally we will run an auction when it's right for that specific asset.

We've seen a transformation of our investors that is worth noting. For all of 2008 through the third quarter, buyers were your traditional IRR-driven real estate debt funds. They fell away pretty quickly come the volatility that hit commercial real estate in the fourth quarter of last year. Now there's an emergence of equity investors, those used to owning and operating office buildings, multi-family buildings and hotels.

They were not able to get a lot of trades done in the fourth quarter of last year because there was a big bid-ask spread on the equity side, so the sellers and owners of those assets were not willing to sell at deep discounts. But now they are the vast majority of our buyer base. Clear path to ownership is very important to owner-operators. When they see that, these equity investors will come in and buy debt. And they bring more certainty of execution, which is important to us.

Ron D'Vari: But you agree that traditional real estate equity funds are under a lot of stress because their equity is wiped out in other properties? They'd rather support their existing properties as opposed to buying brand new ones and getting in more trouble.

Michael Psyllos: I wouldn't disagree, but it's fund specific. Last year a lot of those equity fund teams were shoring up their debt, getting

extensions, locking in additional time for maturities and after they succeeded in doing that they would raise another fund or top off one of their existing funds with a new investment at a big discount. And it's not only funds. Family offices or individual investors may own 10 hotels and now they're going out and buying another five hotels because they have capital and they were not over-levered to start with.

Antony Currie: Have the sellers are changed? Don't the stress tests of U.S. banks potentially remove a huge swath of them? After all, why should they sell now that they have or have raised, at least according to the test, enough capital to weather two years of losses? They surely have little or no incentive.

Michael Psyllos: I'm not qualified to respond to how the stress test impacts my segment of Citi. What I will say is that I'm a market seller because as the vast majority of my book has been mark-to-market, I'm not disincented like some of my competitors that are holding their assets potentially at par or are only taking credit write-downs or credit impairments.

I've been selling through this dislocation, at a healthy pace that has been hindered at certain points because of buyers being impacted by the volatility, but not because of where we are. We'll always evaluate our own book and determine whether at the current mark the IRR to maturity means we're as good a holder as a potential buyer.

That said, there are a number of assets for which we are not the best holder. Citi is not in the business of owning and operating hotels, let's say. But others will see more value in it than we do, deciding that XYZ asset could be their new flagship hotel on the east or west coast, for example.

Brendan Keane: There are two disincentives for sellers. One has been the relative ease with which people have been able to deal with the stress test, which has given a level of comfort. Whether it's a false positive or not remains to be seen, but across the banking sector there is potentially a false sense of security, in certain instances, that asset performance will be good enough, that they should keep them rather than selling them to help raise capital.

Second, some of the FASB developments, FAS157, for example, give more of an incentive to rely upon internal marks and models rather than having to sell into the market if we don't have to sell into the market.

On the other hand, I have heard of a development that I would call the Jack Bauer conspiracy theory, where the government is behind the scenes pushing some of the banks to sell assets to help run the PPIP program, for example, assuming it ever takes off. Of course, that may be a good thing, because it may increase the velocity of assets transferring through the system and setting prices.

Antony Currie: What do the investors at the table think?

Dan Castro: Well, the bid-ask has gotten bet-

ter, but we're not there yet. Occasionally you'll see somebody bite the bullet, often because they're forced to move because they need cash for whatever reason.

Mike Flynn: We've definitely seen some selling into the strength of the rally. We've seen some lists come out from guys that probably haven't bought at the lows, though that's been very sporadic. Some stuff has traded, some hasn't. I don't necessarily have a view whether the stress test has affected that.

Ron D'Vari: Some 75% of U.S. bank assets are with the 19 banks that have been subjected to the test. So that's where you need to see willingness to sell to make the market move. The fact that the test came out somewhat positive means you're going to see less desire to sell and more wondering why they should. If the buyers think they're getting 20% returns or more, it would be unreasonable to expect the banks to sell if they have the losses covered already. After all, they're not going to make that



NewOak's Ron D'Vari, DCM's Jeff Kaplan, Cimino, Kolyer and Citi's Michael Psyllos

kind of a return elsewhere, so they're just going to hang on as long as the capital requirements allow.

But we have seen a willingness to sell elsewhere, particularly in cases where FDIC is closing banks. FDIC had slowed down their closing down the banks, because they were running out of budget. Now FDIC has more capital and a bigger mandate, so we expect further bank closures — about a thousand of them, according to FDIC itself. That means there should be a lot of nice auctions and those are the kind of places we like to go and scoop up assets. The seller wants to sell and the buyers are there, so it becomes a negotiated price.

Brendan Keane: Going back to what I said about the stress test perhaps being a false positive: one of the reasons is that people aren't focusing enough on the state the borrower is in. We know what's happening in the property sector. It's an absolute disaster. And we know that loan resets still have a long way to play out. But we don't know how bad matters will get for the third leg of the stool, the borrowers — and what they can or can't do relative to their credit cards and their real estate debt. Even though the stress test did try to add some type of scenario to address that, I don't

think we've necessarily addressed it enough, so we will still see some stress despite the stress test.

Jeff Kaplan: The only color I'll add is that after the stress test, the pipeline of whole loan deals that have come on to the market went from very little to anywhere from \$500 million to \$750 million worth of unpaid principal balance. I don't know if it's a direct correlation to the results of the stress test or the capital raised afterwards, but it's something that we noticed almost immediately.

Ron D'Vari: These are performing or non-performing?

Jeff Kaplan: Non-performing.

Ron D'Vari: The banks are probably looking at what can they do with those assets internally. If they're not able to squeeze the best value out of the loan package and they know this is a sure thing, then it makes sense to sell and the buyer and seller can come to a very rational decision of how much the buyer should get on return.

Jeff Kaplan: But banks were sitting on them probably for 18 months, when these loans had gone bad already.

Ron D'Vari: That was a coincidence, though, because the Obama plan on modification also happened at the same time. That's the cause of selling, because now you're talking about reducing the coupon to essentially an uneconomic level, delaying the problem for another 18 months. So you can't get access to that property maybe until two or three years down the road. Who knows what the condition of that house is going to be, so maybe even a 50% recovery is unrealistic.

Jeff Kaplan: This stuff is not fine wine. It does not age well.

Ron D'Vari: This, again, comes down to trades getting done when both sides are rational. When the banks recognize that they don't have the capacity to look at all those non-performing loans in their portfolio, they either have to hire people or they're going to sell it to somebody who has the people to do it.

Richard Cimino: Lenders are also not dealing with the borrowers who are performing. There are a couple of tidal waves coming at us. People know that when their adjustments occur, they're not going to be able to maintain that level of payment. They're in heavy credit card debt. They're maintaining their loans right now and they're wondering if they have to sell their home or get transferred, if they're going to have to do a short sale. That is not even part of the equation yet. It's the elephant in a room.

Ron D'Vari: That's what I said earlier. One out of nine is delinquent, and one out of four is

underwater.

Richard Cimino: I would say it's more than one out of four that's underwater.

Antony Currie: We've focused on working out what happens next. But are investors up to speed on what has happened with loans in their portfolios to date? Do they have access to all the relevant information and data on borrowers? I'm sure we've all heard the stories about brokers or servicers not even knowing, sometimes, whether borrowers had made mortgage payments or not. Is that changing?

Richard Cimino: I would say that a lot of information never existed. Stated loans were extended with very little information on the borrowers. Servicing platforms risk grade the portfolio monthly, quarterly, weekly, depending on what their agreed-upon policies and procedures state, such as doing tri-merge credit reports, checking Fico, looking for things that have changed. But the documentation on a lot of those loans was nonexistent. A lot of the people with stated income loans who are being called or who are calling the servicer to do mods claimed they earned, say, \$25,000 a month but it's really just \$7,000 a month. That's now a problem. S&P put out a report a couple of months ago saying that they're looking at 65% recidivism on those mods.

Jeff Kaplan: Didn't Fitch just put out a report too?

Mike Flynn: Yes, predicting 75%, I think.

Jeff Kaplan: Which is why it comes to your kind of shop, Richard, to basically re-underwrite every single mod. You effectively become the loan originator.

Richard Cimino: Basically, yes. Servicing is now very different from what it was in the past. A lot of the larger servicers have legacy issues. Pooling and servicing agreements, for example, dictate their income is 50 basis points on subprime, 27 to 35 on Alt-A — you cannot run a servicer on those numbers with this level of delinquencies. So the new servicer has to be able to customize, has to be able to be very sensitive to the interaction you're having with the investors and has to have a portal of technology that will allow that investor interaction to be done in a timely manner without a lot of man-hours.

Brendan Keane: I would agree, with one clarification, Richard: you talked about documentation being nonexistent. But documentation is not the same as data, right?

Richard Cimino: Right.

Brendan Keane: The data is clearly available now, to go back to my three-legged stool analogy, covering the loan, the property and the borrower. And it's available from a lot of

providers. It may not have been as enhanced or as sophisticated, let's say, five years ago, though it was available in some way, shape or form. But underwriters and brokers of loans chose to have a product that either ignored it or just didn't take advantage of it. The burden has shifted now, if there had been a burden at the underwriters' level, to the servicers.

You can almost put servicers and investors in the same context now, because clearly the price of a loan or the net present value of a loan, whether it goes through modification or some other mitigation strategy, is going to be dependent upon what and how that borrower responds to the program.

The question is: will the prudent servicer and the prudent investor take advantage of it? A lot of them, from a capacity perspective, are overwhelmed and under pressure. If you're a distressed buyer, you'll love that. If you're a current holder of those mortgages, clearly it's not so good news, so you have to reallocate and redeploy in some way, shape or form toward your focus on servicing.

Jeff Kaplan: But as an investor in whole loans, if there is a 65% or 75% recidivism rate, that's a disaster. The servicer needs to have the same incentive as the investors, not just a fixed fee, so everyone pulls in the same direction.

Brendan Keane: You have to have a modification program or plan that's right for the borrower and right for the property. It's very difficult to monitor the longer-term effects, but the early indications are that the medium- and shorter-term results have been awful.

Richard Cimino: Well, at the borrower level, at the loan level, you have to identify some key points, like the intent of the borrower to stay in the property and the borrower's ability to pay for it, and you have to benchmark the value of the property. Without understanding those three things, you can't even begin a modification.

Ron D'Vari: The economics of servicing pools at the right level is not correct in securitization. Being part of ASF, I find it very interesting that there hasn't been a bond initiative to go back and really squeeze more value out of these securities by reorganizing the economics.

It happened in manufactured housing when GreenTree went bankrupt. Their pooling and servicing agreement was renegotiated. Subsequently once all the parameters had stabilized and the interests of investors and sellers converged, manufactured housing paper became really liquid. You could sell it in a day or two.

Right now the servicing angle is a big uncertainty and that makes the investors a little bit queasy.

Richard Cimino: That's exactly the point. How does a large servicer operating on the legacy economics of 50 basis points reinvent, struc-

ture and create mobility for investors? Because they're not interacting as a team right now.

Ron D'Vari: If you write them a check, they will. But the point is that nobody is writing those checks.

Richard Cimino: Well, the investors are managing at pool level. The loss is being taken at loan level, though they're starting to understand that now. But it does come down to writing them a check, making sure that the servicer can at least stay in business and possibly turn a profit.

Michael Psyllos: There are a couple of key differences between the residential market and the commercial market. In the commercial real estate market, traditionally the B-piece buyer also acts as a special servicer and we like to think that serves as a better alignment of interests between the investors on the senior tranches. Ultimately, the special servicer is going to work to minimize losses, because every dollar of loss is going to impact their pocket, first and foremost. And there are triggers so that you can change special servicers if you burn through all the losses of the junior tranches that the B-piece buyer owns.

Also, you talked about reporting. In commercial real estate, the CMSA has set out a minimum set of requirements for periodic reporting of borrowers to the servicers, to the master servicer and to the special servicer. They then deliver updated financials to investors on a periodic basis. Unlike these loans in the resi market, where you've done an application and there's no further reporting other than Fico scores and so on, here we can monitor the performance of these assets and know real time what the pattern is. And you can move a loan from a master servicer to a special servicer before default even occurs based on certain circumstances that are set forth in the PSAs.

That gives us an early warning detection as opposed to a loan in the residential market that all of a sudden just stops and you don't know why. In the commercial real estate market, you can follow what's going on with occupancy and rents, you can see if there's a potential deterioration in debt service, you can run your own analysis on valuation, you know who the sponsors are, you can see what else is going on with the sponsor and whether they have credit stress in other assets. Investors will underwrite all those factors when they put prices on bonds. A bond that came out two days after another in 2007 may be very different than the other one.

Ron D'Vari: That's true in a 3% or 4% loss environment, but surely not when that increases to 8% or 10% and the B-piece buyers themselves are having issues. One of the problems in commercial real estate CMBS is that you can't modify a loan unless you pull it out of the pool at par. Isn't that correct?

Michael Psyllos: You can modify the loan. The PSAs allow that.

Ron D'Vari: I was under the impression that the mortgage has to be bought by the special servicer.

Michael Psyllos: That sounds more like a CRE CDO than a CMBS. The underlying loans can be modified and that's happening a lot. What they'll ask for is a pay-down, maybe an increase in the rate of exchange for another six, 12, 18 months of term that will help a borrower get through this dislocation, but they have that flexibility both pursuant to the Remic rules and also pursuant to the PSAs.

Steve Kolyer: One of the things that I've been surprised about is how little restructuring there has been to the vast amount of product out there. Obviously the biggest immediate response participants have is, well, you'll run unavoidably into 100% holder approval issues and in a credit-tranched structure you're never going to get everybody to agree. So, why go through the effort?

Happily, we've seen up to a couple dozen major restructurings where we've gotten 100% approval because we tipped those who maybe were triple-A holders. Initially they may have felt safe and had little incentive to go along. But if there was enough juice, enough economics in the situation, they could be convinced that it was advantageous to buy into restructuring.

Now, some of those came during periods when sales forces on the Street were still intact and banks could go out and approach customers. Some of that has fallen away, so there's a little more opacity to who these buyers and owners are and a little more skepticism about being able to reach them and convince them to go along.

In many cases it may come down to a portfolio manager being more apt to look at raising new capital for new investment strategies than to look at the old and start spending time trying to restructure it.

Brendan Keane: There's so much pressure being put on the residential servicers that is far different than, for example, what's being put on commercial servicers. For the government, it's a policy situation. You're as close to the voter as you're going to get. Not that they're just trying to garner votes, but they are listening to what's happening at the popular level.

Ron had suggested, theoretically, if someone had the money, you could write a check. So in the absence of a check, what do you do? You write legislation, you write a safe harbor into some of the house bills that provide for indemnification against servicers from some of the modification programs.

Mike Flynn: But the checks have been allocated. Treasury has about \$9.9 billion sitting on the sidelines allocated out of Tarp to pay servicers for modifications. And they've also increased the payment that they'll do for Hope

for Homeowners. The investor community would support more of a Hope for Homeowners push, and I think that you can go to investors and get that payment. That is a much better resolve for the situation.

The high recidivism rate in modifications is largely a function of how these loans are being modified. By and large, those modifications that have occurred have been a recapitalization of out-of-pocket expenses that servicers have incurred and lumped that on to the balance of the loan and then lowered the rate. So you lower the borrower's monthly payment, but you raise his indebtedness.

So what's happening is that people are actually losing more equity vis-à-vis the market and vis-à-vis the modification, so people are re-defaulting. What the investor wants is basically to re-underwrite the loan, do a Hope for Homeowner. The investor community is definitely willing to put up some money to pay for that and to get that program going.

Richard Cimino: Absolutely. When you're doing modifications, you're taking those out of delinquency, so as the servicer, you're stopping advances. The advance lines are really stressed — servicers are using their warehouse credit lines for advances.

But there is another issue: the ability of the investor to understand on a day-to-day basis what's happening with their loan in their pool at loan level. A lot of the larger servicers are having issues trying to build that transparency. That's what we have in place right now and we're hoping to get the communication back to the investor, who is of course the owner of the risk, and actually work with the investors like they do in the commercial mortgage marketplace.

Ron D'Vari: **Richard, can you address the conflicts of interest in servicing? The government wants to reduce the headline number of defaults. The servicers want to stop the hemorrhaging of advancing and obviously there's political pressure for them to show more modification. But these modifications have been a failure rather than a success, leading to re-defaults. So investors are not confident that these modifications are done economically for the right reasons.**

Richard Cimino: Ron, that's a really good question. That is probably at the heart of it. Addressing whether or not a servicer is doing modifications for whatever reason is specific to servicers. But that's where the portal comes in when investors are dealing with a servicer, allowing them to interact with the servicer. In other words, explaining why are we doing a mod on this, why aren't establishing an exit strategy and so forth.

Jeff Kaplan: As a whole loan buyer there's a huge difference. Our servicer has set up an account whereby we're funding those advances, basically taxes, insurance and things like that.

Ron D'Vari: You also have a degree of freedom

to reduce the balance. And that, by the way, motivates the borrower to hand you the key, use the free rent for six months — I call it free rent, because it's a substantially reduced rate — extend it as far as they can and leave the property. They're no longer owners, they're really just there to use the occupancy as much as they can.

Richard Cimino: That's what we're talking about, risk transparency. Does the investor in the security or in the whole loan understand what the loss is going to be? Is there some communication, some understanding among securitization or whole loan holders of what the worst-case scenario is, of what the strategy is servicers are recommending or using? It's very hard to do that right now.

Ron D'Vari: Richard, you have to recognize a lot of these assets were bought by people, sometimes two or three years out of college, who could buy triple-A RMBS like candy. They would have billions of dollars committed to this asset class, which they regarded as not risky, and two or three people essentially owning \$20 billion and really not being equipped today to come back and ask for transparency from you. They're deer caught in the headlights.

Richard Cimino: We offer services to deal with that.

Ron D'Vari: But there are no takers. That's the problem. You know, monitoring is expensive.

Richard Cimino: It is expensive and that's the new generation of servicing, where are you spending your money. The government has come up with some success-based modification workout programs, but it costs you that much, and more, to do a modification.

Mike Flynn: But you get paid before the success. You get paid just to modify.

Richard Cimino: \$1,000 and \$1,500 a year. It's very hard to mod a loan for \$1,000.

Mike Flynn: On a \$200,000 loan, that's what you would make in a year on a 50 basis points servicing contract

Richard Cimino: It is, but it can take anywhere from two-and-a-half to four-and-a-half hours, numerous phone calls to mod that loan, and how many are you successfully modding?

Mike Flynn: So you're saying \$9.9 billion is not enough?

Richard Cimino: It's more than enough, but where do you spend your money? Do you spend it on the technology now? Do you take some of that money into larger servicers, spend it on the technology to build the portals? Or are you just paying to keep the wheels turning?

Mike Flynn: That's a question that the investor looks to you to answer since you're being allocated \$9.9 billion. That's a substantial sum of money for a substantial problem. The investor would like more transparency, especially with what's going to happen now with modifications. The trustee reports that we receive, at least on securitized assets, do not give a clear look into what's going on with modifications.

Ron D'Vari: Of course, we're assuming that



AmSec's Antony Currie, ICP's Mike Flynn and Huxley's Dan Castro

this ideal investor is out there. But one of the problems is that we don't have informed investors. These assets are in the wrong hands, whether they're held by relatively unsophisticated banks or by asset managers that viewed this as a non-risky asset. All the subs are gone, so we're essentially talking about senior classes held in accounts with very little risk tolerance. Until we get these securities transferred to a new breed of managers who demand activism, who are going to work with these assets and squeeze the best dollar out of them, you're seeing a lot of what I consider deer in the headlight investors who think a combination of government and servicers will do their magic and they'll get their cash.

Mike Flynn: You're right. The investor community has to do a better job of having a more unified voice and reaching out to these guys and seeing what they want in terms of transparency. The investor community needs to get together and address policy changes coming out of D.C. too. A big criticism in D.C. of the investor community is that their voice wasn't really heard in a lot of what's happened so far with regard to legislation.

Ron D'Vari: Look at Global Crossing, for example: \$20 billion of debt went bad and investors worked four years to recover the best value out of that investment. Our market has more than

\$3 trillion of assets gone or going bad, but investors still haven't come to the table to form an investor committee.

Richard Cimino: I agree with what you're all saying. What I'm telling you is that investors must, in addition to getting together themselves, get together, more importantly, with their servicer and create an expectation about what happens with existing pools, whether securitized pools or whole loan pools. The servicers may tell you: "We can't do it for that." But others can.

Mike Flynn: On a whole loan pool, I agree, have one servicing agreement as an investor to the servicer. But in a securitized pool it's a different game and a different goal and the investors need to come together. What's left are senior securities, so a lot of the interests that used to be disaligned are now aligned by the fact that a lot of the other guys don't exist anymore or are worth next to nothing.

Richard Cimino: But the resolution is coming from the servicer, the direction is coming from the investor. If an investor is aware that a servicer cannot or is not doing the job that the PSA requires — and the requirements on a PSA are pretty general — then that needs to be communicated. And it might mean recasting some of the fees.

Mike Flynn: That's a conversation that investors are definitely willing to have. We're working with other investors and we're willing to spend our own money to make programs like Hope for Homeowners successful.

Richard Cimino: Does your servicer know that?

Mike Flynn: Yes. We've told servicers. And we've told Washington.

Ron D'Vari: It's not the servicers' problem. Investors need to state their case. Even in instances where there's only one single investor in a super senior — monolines, essentially — I'll guarantee you many of them have not started having a dialogue with the servicer in a monitoring. Since they're really in the controlling class, you would have expected the monolines would be all over the servicers, but even there you find that there's a lot of passivity, because that requires money — that requires you have to hire specialists to be able to even absorb that data.

In other words, we're seeing suboptimal responses to this crisis, from all angles, which magnifies rather than solves the problem. That's one of the questions: have these programs worked? The answer, around the room, probably no. At least my vote would be no.

Antony Currie: Well, let's ask: what do people think of government intervention so far?

Dan Castro: The one place the government seems to have done well is Talf. Everywhere

else there seems to be issues. The politicians need to show the voters that they've passed something, not necessarily something that's going to do anything, but they need to say: "Look, we passed this bill. What else do you want me to do?" Well, what I want them to do is pass a bill that actually makes sense and will work.

Ron D'Vari: What the Fed did to provide liquidity to the banking system was absolutely essential and it worked. And Talf has definitely worked and has helped. But one of the problems is that people qualified to come up with solutions have not been consulted. ASF should have been the key. But the politicians do not want to get too close to the securitization crowd so our body of knowledge isn't being properly utilized.

Dan Castro: It's been made clear to us by sources I can't reveal that the Administration has told Treasury, which is woefully understaffed, and some of the Fed, that they can't hire Wall Street guys because they're tainted. But those are the guys who know the answers, so it's a Catch-22.

Michael Psyllos: My colleagues and I at Citi have been impressed with how the Fed, in particular, has opened up the line of communications with the dealers and certain investors to implement Talf for CMBS — including augmenting it and pushing the term out to five years in response to dealers and investors telling them that extending the maturity for something that is typically a 10-year fixed-rate product was crucial.

Jeff Kaplan: How do you get comfortable with the government as your partner, ever, if rules change at the whim of a politician and your economics can change at the drop of a hat? It seems like a risk that our investors would not want to take. I cannot see our firm deciding to invest side by side with the government and then having your profits taken away, your paychecks slashed or what have you.

Antony Currie: Final question. When is, was or will be the best time to be a distressed debt investor in this crisis?

Dan Castro: It's always now. You've got to be very selective. Prices may still be going down. But as long as you've got money that's locked up, it's a good time.

Mike Flynn: It's good to be set up already and be able to put money to work in those parts of the residential market where you can still pick up assets and get a 15% to 20% yield. But there are no signs of a J-curve forming, or a V-shape, in housing right now, so that implies that there's probably some time to deploy assets.

Brendan Keane: If you correctly utilize the data and the information that you have at your disposal, the time is always now. But until ser-

vicers and investors are able to do that, the train will remain at the station for some time.

Michael Psyllos: We'll continue to see volatility in the CMBS market and rising delinquencies. They lag what's going on in the economy and in the overall commercial real estate market. So it's a question of where you're buying on the curve and whether or not you believe the current delinquency rate is priced into that.

Steve Kolyer: I have observed from our client base that in the last couple of months we've seen a more genuine and deeply rooted interest in entering the distressed space than over the last 24 months.

Richard Cimino: It depends on what you want to do with the portfolio, identifying a strategy, exit or workout. But it also depends on jobs, so perhaps, based on recent figures, the bottom is the third or fourth quarter.

Jeff Kaplan: There's going to be a wholesale dumping of real estate this summer, judging from the servicers I've spoken to and looking at some of the REO disposition companies and foreclosure moratoriums that are coming off this summer. That means there may be another leg down on real estate prices, which will hurt a lot of things. But I agree with Richard on jobs. If there's no uptick in jobs, there's no way to refinance or even pay for a house. Nobody is going to lend to a jobless person. So that's the third quarter, at best.

Ron D'Vari: Our view is that the real bottom would be probably somewhere in the middle of 2010. But certain investments in RMBS represent good value, despite the servicer uncertainty and the defaults and re-defaults, because you essentially have priced that scenario in.

But patient investing means you're always ready to put money to work for the right asset at the right price. It's not a shotgun approach, it's a rifle: you pick the precise target you want to hit. That's how good investing works.▼

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