

Viewpoint: CDO Mess Reveals a Problem in Basel II

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In the past several weeks the financial markets have been adjusting the pricing of whole classes of assets, particularly derivative securities based upon subprime mortgages and other sub-investment-grade paper.

Tens of billions of dollars in paper losses have been created on assets that only days before were considered investment grade and, accordingly, had the lowest risk-weighted bank capital requirements.

Some of these ersatz securities, known as collateralized debt obligations, or CDOs, started with double-A ratings or better but now trade as junk bonds — if they trade at all.

All the models used to price these illiquid securities, which are traded over the counter, were rendered moribund in a matter of days. Neither auditors nor investors are able to value these CDOs because there is no public market.

Though the default rates on the subprime paper inside a typical CDO have risen only modestly, the stampede for the door by "surprised" investors has caused the market value of CDOs to plummet well below 50 cents on the dollar.

It is noteworthy that my firm's estimate for the credit "haircut" on CDOs is 20% to 25%, slightly above historical default rates for sub-investment-grade paper. This implies a loss of \$200 billion on the \$1 trillion or so of subprime CDOs issued in the past five years. The disparity between the economic value of subprime collateral and that of CDOs suggests that the credit markets' illiquidity may prompt CDOs to be bought back and disassembled.

The CDO debacle reveals a basic flaw in design of the new Basel II capital accord that has grave implications for the safety and soundness of U.S. and global banks alike.

The very same models that have proven so ineffective (or maybe were moribund all along and nobody noticed) in the CDO market collapse are enshrined in the

proposed Basel II regulation. Along with an official embrace of the discredited methods of the major ratings agencies, Basel II depends on "contemporary risk management" methods such as value-at-risk, or VaR.

VaR is a general measure of risk ostensibly developed to equate risk across products and to aggregate risk on a portfolio basis. Most senior bankers readily admit that such tools as VaR have no utility for measuring the risk of specific credit or market exposures.

But the CDO meltdown raises a doubt as to whether VaR is even useful for managing an entire portfolio, much less for serving as the basis to measure global banks' capital adequacy.

So large is the damage done by the failure of contemporary methodologies and the ratings agencies' enabling duplicity that it may not be possible for U.S. regulators to continue supporting the current Basel II proposal without violating the "safety and soundness" provisions in federal law.

Consider the dilemma facing global financial regulators: Either move forward with a Basel II accord that has been badly discredited by events and is clearly unworkable from a risk analytics perspective, or try to pretend that the CDO meltdown — caused by the failure of methods like VaR and the ratings process — has nothing to do with the Basel II agreement.

The demise of the culture of "mark-to-model" on Wall Street will only be temporary, but for investors, regulators, and members of Congress, it is clear that relying on modeled risk is no longer a good idea and not in the national interest.

Investors and regulators need an empirical way to monitor risk through real market pricing, not ersatz derivative models and OTC securities where prices are not readily available to the public.

Betting the safety and soundness of U.S. banks on the discredited risk measurement tools and credit rating agencies that caused the CDO debacle is entirely reckless.

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