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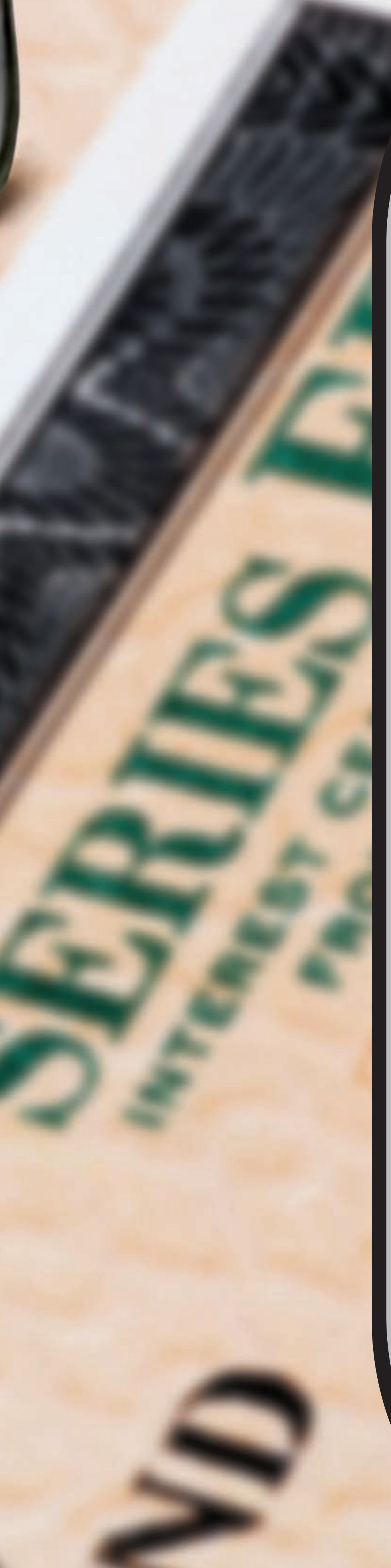

Could TRACE Bring ABS Pricing into Focus?

By John Hintze

When **Citigroup** announced on Nov. 4 that it anticipated the fair value of approximately $55 billion in subprime exposures would decline somewhere between $8 billion and $11 billion, the imprecise estimate highlighted a problem faced by participants in the structured debt market. It also underscored the need for a better way of valuing certain asset- and mortgage-backed securities.


Steve Joachim

The challenge faced by Citigroup and other brokerages, as well as their customers, is the inability to value those securities. This is partly due to their complexity and the fact that too few deals are getting done today to establish reliable pricing benchmarks. Furthermore, information about transactions is not available to most market participants, in good times or bad.

When setting out to buy or sell a security, a portfolio manager might not know whether a mezzanine or subordinated class of an asset- or mortgage-backed security should trade at a spread of one-month Libor plus 800 basis points or 1,000 basis points, said **Michael Youngblood**, portfolio manager and managing director of fixed-income research at **FBR Investment Management.**

The **Financial Industry Regulatory Authority**'s (FINRA) staff recently began to discuss whether it should apply the Trade Reporting and Compliance Engine (TRACE) standard to ABS and MBS.

The approach would provide the ABS and MBS markets with the transactional information that it longs for, some argue.

The self-regulatory agency implemented the disclosure policy for corporate bonds in July 2002. Public discussion applying TRACE to ABS and MBS officially kicked off at the recent Information Management Network's ABS East conference.

Major banks such as Citigroup and **Merrill Lynch** have been top underwriters and secondary-market dealers in asset- and mortgaged-backed securities (ABS and MBS), but even they are privy to only a portion of overall activity. As a result, news about transactions is sporadic and limited, especially in the currently volatile market, prompting fears that securities bought or sold today could be dramatically re-priced tomorrow.

Youngblood said other sources of volatility include credit fundamentals, such as the incidence of default and the potential loss on obligations, and the uncertain ratings status of certain debt securities.

Those factors are largely outside the control of brokers and their customers. A security's price, however, is determined by supply and demand. Consequently, broader dissemination of transactional information should promote that dynamic as well as market participants' confidence that they are carrying out transactions at an accurate market price. In fact, it may even help mitigate the other two causes of volatility.

Former **Securities and Exchange Commission** Chairman **Arthur Levitt**, at a panel discussion at the ABS East conference in Orlando, said that his Wall Street experience and recent market history pointed to the corporate bond market's opaqueness fostering insider trading and exacerbating market volatility. Levitt began to raise the issue within the agency as early as 1998. At that time, corporate bonds—like ABS and MBS today—had no mechanism by which to report prices on specific transactions. That sort of information was unavailable to investors not directly involved in the specific transactions.

The SEC's analysis resulted in several insider trading investigations. Furthermore, the 512-point drop in the Dow Jones Industrial Average on Aug. 31 that year resulted in a severe retrenchment of liquidity for corporate bonds, especially for high-yield bonds. That hurt other financial markets, such as mutual funds investing in high-yield debt, because they could no longer accurately price their portfolios or buy or sell assets to make adjustments.

> *"It has worked very well with respect to corporate bonds, and I think its introduction into [the ABS and MBS] arena is a logical and necessary step."*

Launching the first phase of TRACE provided pricing information on 520 corporate bonds, including 50 high-yield issues, and it has since been extended to more than 99% of U.S. corporate bond activity. At the conference, Levitt strongly endorsed expanding TRACE to the ABS and MBS markets.

"The reforms begun in 1998 to improve fixed-income disclosures should continue, and TRACE is the bedrock of those reforms. It has worked very well with respect to corporate bonds, and I think its introduction into [the ABS and MBS] arena is a logical and necessary step," Levitt said.

The notion of expanding TRACE to structured debt is still in its infancy. However, foreshadowing resistance to that development, a National Association of Securities Dealers proposal in December 2003 to clarify the definition of TRACE-eligible securities was interpreted by Wall Street as potentially including ABS. That sent up red flags in the industry, especially among large firms that were profiting handsomely from the lucrative spreads in the opaque markets, sources say.

The **Bond Market Association** (BMA), now a part of the **Securities Industry and Financial Markets Association** (SIFMA), noted repeatedly in its comment letter that NASD had designed TRACE specifically for corporate bonds and not structured securities.

A month later, in a comment letter to the SEC, NASD snuffed the hubbub by explicitly stating that ABS was "specifically excluded from the universe of TRACE-eligible securities," adding, "NASD is not seeking to amend that exclusion with this proposed rule change."

At the conference in Orlando, **Michael Decker**, senior managing director of research and public policy at SIFMA, noted several points of concern involved in applying TRACE to structured debt. Those concerns tended to center around liquidity and the differences between structured and corporate bonds, echoing the BMA's comment letter.

Four years ago, however, ABS and MBS were the rage, and investors were desperate for their higher yields. Today, market participants may be more open to solutions that could improve liquidity.

"In terms of dealing with products that are poorly and inadequately understood, with potentially devastating consequences ... the discussion of transparency becomes enormously important," Levitt said.

To thwart the initial implementation of TRACE, the industry argued that tighter spreads resulting from greater transparency could prompt dealers to exit the market, thus lowering liquidity. In addition, the remaining dealers could be less willing to use their own capital to take positions for return. So far, that doesn't appear to have happened.

Steven A. Joachim, executive vice president of transparency services at FINRA, said at the conference panel that "We see no empirical evidence of damage to liquidity." He added that the number of dealers reporting transactions—about 500 each day and 1,600 over a year—has remained steady. He also noted that much of the industry's "prevailing wisdom" before TRACE became active was incorrect.

For example, market participants assumed that the corporate bond market was primarily institutional, when in fact 65% of trades reported were for $100,000 in par value or less—most likely retail trades.

Nevertheless, sources say, there are significant differences between the structured debt and corporate bond markets that regulators will have to consider when debating the issue, sources say. Decker noted that the ABS market is less than half the size of the corporate bond market.

However, there are 150,000 non agency ABS Cusips—the nine-digit numbers assigned to all securities issues—compared to 34,000 corporate bond Cusips, suggesting far less liquidity per ABS Cusip.

In addition, said Decker, the bond markets are simply not liquid. Only 15% of TRACE-eligible securities trade on any given day. Also, the percentage for structured debt is most likely lower. He added that trading volume, one measure of liquidity, has remained fairly steady since the onset of TRACE. More difficult to measure is the time it takes to enter and exit corporate bond positions—data that's hard to come by—and how that might play out in the ABS and MBS arenas.

"If before TRACE you could get out in a day, and after TRACE it's two weeks, even if an investor is getting thinner spreads, you have to ask whether that's a benefit," Decker said.

Conference panel organizer and moderator **Joe Fichera**, CEO of New York-based **Saber Partners**, which represents buy-side and sell-side customers, asked whether SIFMA had any data to back up those concerns. Decker responded "no," although he pointed to a survey of 15 institutional investors, in which a majority expressed similar concerns.

So far, TRACE does appear to have benefited investors in corporate debt. **Kumar Venkataraman**, an associate professor of finance at Southern Methodist University and co-author of the first major study on the effects of TRACE in the corporate bond market, said his analysis showed investors' trading costs dropping by nearly 50%.

In fact, his analysis, which looked at institutional trades in 500 bonds six months before and six months after TRACE became effective, showed trading costs falling for trades in non eligible bonds as well, presumably because transparency enabled investors to negotiate more effectively with their brokers. "We found trading costs for those bonds declined by 20%, and those savings were even more for bonds similar to the 500 bonds," Venkataraman said.

Still, such comparisons may be more difficult in the structured world, say ABS professionals. Lower-rated ABS tranches may be anywhere from $500,000 to $20 million in size and trade only a few times before they mature, said **Armand R. Pastine**, COO and head of **Maxim Group**'s fixed-income unit. Another important matter to consider is that corporate bonds are simple creatures compared to ABS and MBS. In the latter, prepayment schedules, remittance reports, default rates of the underlying assets and other factors come into play over the life of the debt. "Each bond needs its own valuation and stands on its own two feet," Pastine said.

Maxim Group has benefited from TRACE so far—as did many other small and midsize broker-dealers—because real-time price data leveled the playing field with the biggest dealers, he said. A price point may not be a sufficient valuation tool for ABS and MBS, however, if transparency ends up harming, rather than helping, liquidity.

"If somebody wants to act on a TRACE price, they have to find somebody to take the other side," Pastine noted, adding that regulators must study the issue thoroughly.

In the current ABS and MBS environment, however, there is already a dire lack of liquidity, sources say. Venkataraman, who also participated in the conference panel, noted that greater transparency could give market participants a better tool to mark-to-market their securities and improve the quality of their reported numbers. That might improve investor confidence. In addition, greater transparency should give market participants, including the ratings agencies and regulators, earlier indications of fundamental credit problems.

Levitt recounted that firms profiting from the status quo usually resisted the changes he promoted as SEC chairman, including order handling and decimalization rules in the equity markets, and Regulation Fair Disclosure.

The latter, interestingly, prompted Citigroup to announce its write-downs earlier this month. Those rules all sought, whether directly or indirectly, to empower a broader swathe of investors with more information. Market sources added that most broker-dealers already have the necessary infrastructure to implement the practice.

"Experience has proven again and again that transparency is a tide that lifts all boats," Levitt said.