

August 7, 2007

AHEAD OF THE TAPE

By JUSTIN LAHART



How Street Rode The Risk Ledge And Fell Over

August 7, 2007; Page C1

Like Wile E. Coyote finding out that he hasn't been running on solid ground, but over a cliff edge, Wall Street is now realizing its footing hasn't been so firm.

A recurring characteristic of the recent trouble in financial markets is that many lenders, funds and brokerages were following statistical models that grossly underestimated how risky the market environment had become. The term for this is "model error."


The genesis of the problem begins in subprime mortgages, or loans to risky borrowers. Wall Street had limited experience with subprime, which until the late 1990s was a much smaller fraction of the mortgage market. With the development late in the housing boom of subprime mortgages where borrowers needed to provide little or no documentation, and no money down, the market entered uncharted territory.



The models lenders and others used to determine the likelihood of default, which depend on standard credit ratings known as FICO scores, didn't adequately distinguish between loans where borrowers had put money down and those with no down payment. Nor did the models take into account what would happen if housing prices fell to the point where the amount owed on some mortgages exceeded the value of the homes they covered.

As default rates rose, bonds backed by subprime mortgages got hit. That threw collateralized-debt obligations -- pooled-together debt instruments -- that held subprime-mortgage-backed bonds into turmoil. CDOs are cut into slices, known as tranches. The higher-rated tranches run into trouble only if a relatively high proportion of a CDO's assets get hit. Many CDO-valuation models showed little chance of that happening. But then that happened, too.

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The entire basis for valuing CDOs may be flawed. Because highly rated CDO tranches only run into trouble when a large number of loans start defaulting, but fail spectacularly if that happens, they are basically "catastrophe bonds," Harvard University's Joshua Coval, Jakub Jurek and Erik Stafford argue in a recent paper. That means that holding CDOs is like selling deep out-of-the-money puts on the S&P 500-stock index -- that is, options that give their holders the right to sell the index at a price far below the current price.

Investors tend to look askance at such put selling -- which unscrupulous fund managers sometimes use to boost returns -- because the losses can be catastrophic. But the authors found that the performance of highly rated CDO tranches tend to mimic the performance of a put-selling strategy -- and make less money, to boot.

Because some investors hurt by CDOs were forced to sell other assets to make good on their losses, and others began to wonder if other, similarly structured products were riskier than the models said they were, financial markets in general got rockier.

Making matters worse, value-at-risk, or VAR, models that Wall Street firms use to determine how much they could safely lend to investors had assumed that financial markets would remain quiescent. When volatility picked up, firms found that they had extended more credit than they should have. They demanded more collateral for their loans, forcing even more selling.

In other words, splat.

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