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Fed Sinks Subprime-Mortgage Bonds With Auctions: Credit Markets

By Jody Shenn

May 11 (Bloomberg) -- Subprime-mortgage bonds are slumping by the most in a year as the Federal Reserve Bank of New York auctions about $31 billion of securities it assumed in the U.S. rescue of American International Group Inc.

Floating-rate debt backed by subprime or home-equity loans lost 0.64 percent in April as the sales began, after falling 0.23 percent in March, the first back-to-back declines since the period ended in May 2009, Bank of America Merrill Lynch index data show. The securities have dropped an additional 0.11 percent this month as sales have approached about $6 billion.

The New York Fed's disposal of mortgage bonds that helped cause the worst financial crisis since the Great Depression and contributed to the failure of AIG is reversing a 43 percent rally in subprime securities from record lows in June 2009. The central bank decided on regular auctions for the debt from a vehicle called Maiden Lane II after refusing a $15.7 billion offer from New York-based AIG to buy back the pool.

"The decision to sell this portfolio in dribs and drabs is weighing on the market," said Bryan Whalen, the co-head of the mortgage-backed bond group at Los Angeles-based TCW Group Inc., which oversees $120 billion in assets.

The rally in home-loan securities without government backing had been driven in part by a contraction in the size of the market, which declined to about $1.2 trillion from a peak of $2.3 trillion in 2007 as homeowners defaulted and refinanced their loans, Federal Reserve data show. Subprime-backed bonds now total about $400 billion.

'Maiden Lane Fatigue'

The sales are leaving investors with little motivation to look through "distressed" floating-rate subprime bonds in dealers' inventories for potential purchases, said John Sim, an analyst at JPMorgan Chase & Co. in New York.

"There is already some 'Maiden Lane fatigue' evident," analysts led by Sim, the top-ranked team for real-estate asset-backed securities in Institutional Investor's 2010 poll, wrote in a May 6 report.

Elsewhere in credit markets, the extra yield investors demand to own company bonds worldwide instead of similar-maturity government debt fell 1 basis point to 147 basis points, or 1.47 percentage points, Bank of America Merrill Lynch's Global Broad Market Corporate Index shows. Yields averaged 3.82

percent.

General Mills Inc., the maker of Cheerios and Lucky Charms cereals, plans to sell $600 million of bonds to pay down short-term debt.

Markit CDX Index

The Minneapolis-based company may issue three-year fixed- and floating-rate notes as soon as today, said a person with knowledge of the transaction. The commercial paper it's seeking to repay had a weighted average annual interest rate of about 0.35 percent as of Feb. 27, General Mills said in a filing that didn't specify the size of the bond offering.

The cost of protecting U.S. company bonds against default was little changed. The Markit CDX North America Investment Grade Index, which investors use to hedge against losses on corporate debt or to speculate on creditworthiness, decreased 0.09 basis point to a mid-price of 88.4 basis points as of 11:31 a.m. in New York, according to Markit Group Ltd.

The index, which typically falls as investor confidence improves and rises as it deteriorates, is at the lowest level since April 29. Credit swaps pay the buyer face value if a borrower fails to meet its obligations, less the value of the defaulted debt. A basis point equals $1,000 annually on a contract protecting $10 million of debt.

Ratings Downgrades

About 90 percent of subprime-mortgage bonds granted AAA grades when created in 2006 and 2007 were later cut to junk status, according to a Senate investigative panel.

Today, Standard & Poor's said it may downgrade 7,077 classes of U.S. home-loan securities after updating its loss projections for deals issued during 2005, 2006 and 2007.

The S&P review covers bonds from 1,384 securitizations of prime, subprime and so-called Alt-A mortgages, the New York-based ratings company said a statement.

The New York Fed sold $427.5 million of $458.5 million of mortgage securities offered yesterday in its sixth auction of bonds owned by AIG until its 2008 bailout, according to its website. The central bank will accept bids on $2.1 billion of bonds on May 12.

It completed auctions for $6.1 billion of securities through last week, accepting bids on $5.3 billion. The weighted average price was at least 49.27 cents on the dollar, according to Empirasign Strategies LLC, a New York-based data provider that tracks the second-best bids that dealers share with investors. Winning bids aren't typically disclosed. AIG's offer represented about 51 cents on the dollar.

Subprime Bonds

Maiden Lane II held $9 billion of subprime bonds, based on market values, as of year-end when the New York Fed valued the portfolio at $16.5 billion, according to its website. Alt-A adjustable-rate mortgage bonds represented the second-largest category at $4.8 billion. Alt-A loans were often granted to borrowers who didn't document their income or bought investment properties.

"The New York Fed is continuously evaluating the disposition process of the Maiden Lane II assets and its impact on market conditions, which to date has been measured, and may adjust that process as necessary," Jack Gutt, a New York Fed spokesman, said in an e-mailed statement. "Given the consistently strong market response, the New York Fed will continue disposing of the assets through an open and competitive process as market conditions warrant."

What's Suffering

As the New York Fed sells mostly floating-rate subprime debt, the markets for other types of non-agency home-loan bonds aren't suffering the same type of losses.

Typical prices for senior securities backed by Alt-A fixed-rate mortgages are unchanged over the past month at 84 cents on the dollar, while similar Alt-A ARM bonds are steady at 67 cents, according to Barclays Capital data.

While some dealers and investors are hoping the New York Fed reconsiders selling off the bonds it took from AIG in bulk sales, it's unlikely to do anything more than "temper the pace" of the smaller sales, Sim said. That's because it's been able to find acceptable bids on about 80 percent of the debt offered, compared with about 40 percent to 50 percent in typical investor auctions, according to the analyst.

Also weighing on subprime bonds is investor preference for fixed-rate mortgage debt with higher coupons to floating-rate bonds with lower payments as the Fed holds its target for short-term rates at a record low, said Paul Norris, a senior money manager at Dwight Asset Management Co. in Burlington, Vermont.

More than 60 percent of outstanding subprime securities carry floating rates, FTN Financial data show.

Servicer Roles

Investors are also growing more concerned that difficult-to-predict decisions by loan servicers, such as whether to end their advances of borrowers' missed payments, will affect realized yields, he said.

Three subprime deals serviced by Ocwen Financial Corp. didn't pay any cash last month to investors as the company recouped its past advances from collateral payments as it modified loans, according to an April 29 report by Nomura Securities International.

The West Palm Beach, Florida-based company's practices have been "consistent" with its contracts and it has an "obligation" to rework loans when doing so will benefit bondholders more than foreclosures, said Paul Koches, Ocwen's general counsel.

With the New York Fed's supply challenging demand, it may make sense for the auctions to slow or end, Norris said. "At some point, maybe you're just going to have to realize you have to go back to the deep pockets of a dealer or AIG," he said. "I don't think they can pump out a billion here or $500 million there of stuff that guys are getting full up on."

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