The Return of the Liquidating Trust

January 17, 2012 by Rick Jones

Recently, the Wall Street Journal highlighted the arrival of "bad loan securities." If this is a trend, and I both hope and think it is, we clearly have to get a better deal name for these than "Insert Bank Name", Bad Loan Securities 2012-1. Securitization of less than ideal conduit product has been with us since the birth of securitization, but reached its apogee in the RTC series, for non-performing loans, in the early to mid 1990s. That transaction architecture is being revived, and it's about time. Both Fitch and DBRS have published criteria, or at least guidance and the other agencies are beavering away, busy working with bankers to come up with workable ratings technology.

To be clear, this is a financing tool, not a sales tool. Depending, of course, on the depths of ugliness in the pool, this is 35-55% leverage with a sponsor holding the risk piece. Nonetheless, it is peerless, durationally matched leverage that is terrifically useful for buyers of the distressed debt inventory. As the holders of non- and underperforming debt have increasingly fessed up to their marks, we're now at a point where these transactions can be done without creating massive capital charge problems for the banks and other financial institutions holding this paper.

These structures are designed to allow an active, dynamic manager to liquidate a portfolio of loans, hence: liquidating trusts. The manager anticipates selling and resolving all of these loans and reducing them to cash in a finite and relatively short period of time. The ratings models work off individual business plans for each loan, taking into account current period income, liquidation proceeds and haircutting the bankers' views both on the level of achievable proceeds and the time required to resolve the assets.

But these are not easy deals and we haven't found the magic bullet to make them easy. First, these are management intensive transactions that are dependent upon the investors' confidence in the quality and performance capabilities of the manager. Second, the quality of data available on seasoned non- or under-performing loans tends to be a bit dodgy, and that impacts the quality of disclosure and the difficulty of delivering high quality information to manager and investor. Finally, and most frustrating, is what needs to be done to achieve tax transparency. The assets typically can't be subjected to a REMIC election because they're not performing. For reasons, which for the life of me I cannot fathom, our Internal Revenue Code punishes pools of mortgage loans with corporate level taxation. Why are mortgages treated as the bad boys of the financial neighborhood such that they need to be rousted by the tax cop when they gather together on the street corner? The Code doesn't pick on other asset classes in the same way. It's inexplicable.

When mortgage loans are pooled, the so-called taxable mortgage pool rules (TMP) apply and these rules make it nigh unto impossible, in many cases, to issue more than one time-tranched class of debt. Therefore, these vehicles tend to be somewhat inefficient with only one class of equity and one class of debt. Seriously better pricing could be obtained if the debt could be both credit- and time-tranched like in most other structured finance products. Now there are ways around these problems, but none of these fixes work terribly well. So, for instance, if the loans are really bad, so that a large enough portion can be treated effectively as equity interests in the underlying collateral rather than as mortgage loans for tax purposes, you may be OK. If somehow you can be sure the loans will all be liquidated in 3 years, you may be OK. If the vehicle can be structured as a Qualified REIT Subsidiary (although watch out for dealer income that is bad REIT income in a liquidation strategy), or if the structure is entirely offshore, the TMP problems can be avoided. Each of these fixes, though, has, shall we say, material negative externalities which limit their use.

With all that said, this structure is very useful in the right situation. It's going to be used, and it's going to be used extensively in 2012. It is a way to move assets that one party does not want, or cannot hold, into the hands of those who want the exposure. It's a way to tidy up the balance sheets for financial institutions, create market velocity, move risk to investors who want it and set the table for more capital creation.

Now that's a good news story.