Nomura Fixed Income Research

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# ABS Gold Coast Report:

## Coverage of Selected Sessions of ABS East 2003

20 October 2003

Fraud risk and related issues took center stage at the October 2003 securitization conference in Boca Raton, Florida. Other types of company risk (*i.e.*¸ seller/servicer risk) and trustee risk also held the spotlight. At various points in the conference, speakers stated that bankruptcy remoteness does not work and that ABS should be viewed simply as a special form of secured debt. Other topics that attracted widespread attention included ratings volatility, the economy, the possibility of rising interest rates, and, of course, FIN 46 and off-balance sheet accounting. As in the past, the sessions posed more questions than they could possibly have answered. One thing, however, is clear: the challenges of 2003 and the continuing aftershocks of 2002 will keep the securitization industry on its toes in 2004.

The following summaries reflect remarks of the panelists who participated in selected sessions at the recent asset securitization conferences organized by Fabozzi/Information Management Network in Boca Raton, Florida. For the most part, the summaries have been drawn from notes taken during the sessions by Nomura employees. The summaries have not been reviewed or approved by the panelists or by the conference organizer. While we have tried to capture panelists' remarks accurately, we apologize in advance for any inaccuracies and omissions. In addition, we wish to acknowledge the excellent work of the conference organizer in hosting the event.

**The summaries below do not necessarily reflect the views of Nomura Securities International or any of its subsidiaries or affiliates.**

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## Thursday, 9 October 2003

### 8:15 AM – Securitization Enters Uncharted Waters: Smooth Sailing Or Taking On Water? A Global Perspective

Trustees: The role of ABS trustees has not changed in the past six months. In the aftermath of NCFE,[1] the securitization industry continues to wrestle with whether securitization trustees should have a more active role in assuring the integrity of transactions. However, one positive development from the heightened focus on the trustee's role is expanded communication when problems surface in transactions. Some argue that the role of a securitization trustee is fundamentally different from the role of a bond trustee in other areas of the fixed income market.

The contrary view is that despite a lot of talk, nothing has really improved. In some situations, the sponsor was able to divert funds from the securitization trusts. Allowing a sponsor to have access to trust assets should be viewed as a structural flaw.

A third view is that the "trustee issue" is distinct from the fraud issue. Securitization trustees are neither hired to validate deals' collateral nor are they paid enough to be able to provide such services. However, an ABS trustee should be held responsible for making sure that an issuer does not wrongfully remove cash from a deal.

A fourth view is that the market demands too much from trustees, given the level of their fees. Trustees should be required to follow a standard of reasonableness.

A fifth view is that although trustees are not be paid enough to provide comprehensive oversight, they certainly are paid enough to prevent cash from leaving a deal. Trustees sometimes try to manage distressed situations, but they are not paid enough for doing so. However, they *are* paid enough to watch the cash in ABS transactions.

A sixth view is that an ABS trustee should not exercise discretion or have to make any decisions. A trustee should simply follow the governing documents for a transaction. Deal documents do not require trustees to blindly follow instructions from ABS issuers. Documents should specify what actions a trustee should take in each kind of situation. If documents are not clear, securitization professionals need to improve them.

Policing the Securitization Industry: Investors are asking more questions. They are less accepting of the status quo. The securitization industry will benefit from guidelines and "best practices," to be published by the American Securitization Forum (ASF).

Investors can influence the market's evolution by voting with their dollars. If investors favor deals that embrace "best practices," the overall integrity of deals will improve. Investors ultimately will turn their backs on asset classes that deliver too many disappointments. Investors also can exert a strong influence on how underwriters, rating agencies, and trustees do business. Each of those groups could benefit from having its own set of best practices for the ABS area.

[1] National Century Financial Enterprises (NCFE) filed for bankruptcy in November of last year. Previously, the company had completed dozens of purported healthcare securitizations. The company and its principals have been accused of fraud in connection with those deals. Roughly $3.35 billion of outstanding securities have defaulted, and estimates of ultimate losses to investors have run as high as $2.5 billion. The main component of the alleged fraud is that collateral for the deals either was ineligible or did not exist. The revolving nature of the collateral pools combined with the absence of meaningful third-party oversight arguably enabled NCFE to perpetrate that aspect of the fraud. A secondary aspect of the NCFE fraud involves the company's diversion of reserve funds that formed a part of its deals' credit enhancement. Investors have alleged that the trustees for the NCFE deals should have prevented the company's diversion of the reserve fund balances. *See* City of Chandler et al. v. Bank One et al., No. CV2003-010173, (Ariz. Superior Ct. Maricopa County, *filed* 23 May 2003)

ABS investors have received what they bargained for. Investment-grade ABS have experienced fewer problems. Investors who stretch for yield by purchasing speculative grade ABS must understand that they are taking more risk. Speculative-grade ABS are very vulnerable when deals experience stress or when seller/servicers violate deal documents.

On the other hand, distressed ABS can offer excellent opportunities for investors. Prices on distressed ABS can be attractively cheap because so many investors are afraid to buy them. For example, the senior tranches from the NextCard credit card ABS trust had traded at 97, but now they are at 99.5. In addition, by investing in distressed ABS, investors can gain valuable knowledge and experience and test their capabilities in tough situations.

A contrary view is that it would be a violation of fiduciary obligations for a money manager to use client funds to experiment with distressed ABS for educational purposes. Moreover, the notion of testing capabilities by purchasing distressed securities arguably would be like intentionally crashing a car in order to test the capabilities of a hospital emergency room.

All industry participants have a role in guarding the market's integrity. However, market participants are not doing so effectively. Investors must recognize that triple-A-rated ABS are not all the same. Investors should invest only in ABS from issuers in whom they have confidence. It is unreasonable to rely solely on ratings.

Fraud: One view is that many revolving deals should have tough third-party oversight. However, they do not. The lesson from NCFE, Spiegel, and NextCard is that the industry's early experiences with fraud – Towers and CFS – were not merely once-in-a-lifetime events. Fraud is a real issue. It is most prominent in deals backed by revolving pools, where the issuer is facing financial distress. Such deals need tough third-party oversight to make sure that collateral is real. The industry needs a new kind of player to fill the role of "deal cop." None of the trustees, backup servicers, rating agencies, or accountants seems well suited. Sue Ellis' Murrayhill Company is an example of the kind of firm that has many of the necessary skills.

Unless and until investors demand tough third party oversight, it will not happen. Now that the securitization industry has accumulated significant experience with fraud, investors must share the responsibility for any future fraud losses that they suffer. If a few extra basis points induce an investor to buy a deal that lacks appropriate oversight, he should not later complain if fraud comes knocking on his door.

The securitization industry does not yet have a player that fills the role of "deal cop." The industry needs one. An ideal deal cop would have broad powers; just short of the right to pistol-whip an issuer's CFO to get information.

A second view is that bankruptcy remoteness is just a fiction. It does not work. The recent experience with NCFE and others proves this. No one could have learned what the companies would do under stress by performing due diligence beforehand. Investors needs to be skeptical.

Ratings Volatility: Increasing numbers of complicated deals backed by difficult (off-the-run) assets have led to greater ratings volatility. Investors' demand for higher yield accelerates the pace of such deals. Recently, the pace of downgrades has slowed, but they are still occurring at a distressingly high rate. The areas that account for the most downgrades are tobacco, high-yield CDOs, and manufactured housing. From now on, ratings volatility will be a fact of life.

Rating agencies have become more pro-active. This also contributes to increased ratings volatility.

Conflicts between agents and principals (*i.e.*, servicers and investors) only become visible after problems arise. Investors have been lulled into focusing just on credit, liquidity, and prepayment risks. Instead, investors should focus on *all the things that need to go right for a transaction to work*. Investors should question whether all parties would act properly in distressed circumstances.

Ratings volatility is here to stay. It is a by-product of the industry's evolution. At first, simple assets and highly-rated issuers dominated the securitization landscape. More recently, harder assets and thinly capitalized players have become routinely visible on the field. The evolutionary trends have forced greater reliance on certain kinds of analytic tools. The industry must remain mindful that the tools have inherent limitations. For example, a deal might be backed by an asset class for which there is little or no historical data. Or, the pool backing a deal could be lumpy and have high concentrations. In either case, traditional actuarial analysis could be ineffective. A natural alternative is to use Monte Carlo simulations to fill the gap. But, that approach can produce disappointing results if the underlying assumptions – such as the degree of correlation among assets in a pool – turn out to be wrong. The risk of issuer or servicer fraud is another area where analytic tools provide little help. To avoid unpleasant surprises, market participants need to use their imaginations in analyzing new deals. They need to broadly consider the limitations of their quantitative models and they need to scrutinize deals for *all* kinds of potential vulnerabilities.

Outlook: Lack of access to traditional sources of credit pushes new issuers to seek ABS funding and drives growth of new asset classes in the ABS market.

Events like the recent problems at the GSEs and the servicing problems at Fairbanks[2] will continue to affect the securitization market. Investors need to focus on how a servicer will operate during an economic downturn. State predatory lending laws will continue to present a challenge for the near future. The industry would benefit greatly from federal preemption of state predatory lending laws.

Securitization of non-performing loans (NPLs) will continue to grow in Korea and other areas. Activity in Japan may slow. Taiwan has passed securitization laws and may become more active. Australia remains active and more MBS issuance can be expected from the country's regional banks. Singapore has seen increases in CMBS and whole business securitizations.

The outlook for the auto loan ABS sub-sector is stable. Trading of whole auto loans has increased because aggregators can securitize purchased loans. Auto lenders desire clarification from the rating agencies about how securitization helps their corporate ratings.

The outlook for credit card ABS is stable.

This year has been a very good one for investing in subordinate tranches of ABS.

There is opportunity for ABS investors in securities that trade below their fundamental values because of illiquidity. This is true for certain investment-grade ABS as well as for many speculative-grade ABS. For example, there are some triple-A-rated franchise loan ABS that mature in a year and that yield 400 basis points over swaps. Investors should focus on special situations and on ABS that have low dollar prices.

### 9:30 AM – Market Trends, Developments & Future Outlook for the U.S. ABS Market

The ABS market seemingly has come full circle from its early days. It started with just three main asset classes: credit cards, auto loans, and home equity loans. Then it went through a phase in which it supported more than twenty asset classes, including many exotic ones. Now, just four asset classes dominate the ABS market: the three from the early days and student loans.

Most ABS investors are drawn to the market by safety and liquidity. They are different from the investors who seek out exotic asset classes, such as intellectual property, and from those attracted to "risk transfer" deals.

[2] Fairbanks attracted the government's attention because of its aggressive servicing practices.

Investors face the question of whether it is worthwhile to devote the time necessary to learn about exotic asset classes. Some investors conclude that it is better to focus solely on the main asset classes and to shy away from exotic sub-sectors and from issuers that might produce only a single deal. On the other hand, "one hit wonders" sometimes grow to be major issuers and they are the source of incrementally higher yield. For example, stranded costs is an example of an asset class that grew impressively and produced a substantial volume of deals. Student loans is another example of such an asset class. Healthcare and mutual fund fees are examples of assets classes that have not enjoyed the same degree of success.

The Economy: Based on a variety of criteria, the current economic recovery is weak relative to the average of the past seven economic recoveries. There may be a risk that the U.S. economy will fall into another recession. One view is that the risk of a double-dip recession is low. Although conditions in the labor market could be better, consumer confidence and productivity are both strong and economic growth likely will be in the 2½% to 3% range. Most panelists feel optimistic about the economy. However, fixed income investors need to be prepared for the possibility of bad times; they have just one or two points of potential upside on their investments, but 100 points of potential downside.

Rising mortgage rates might cause sharp reductions in mortgage origination volumes. If origination volumes decline, mortgage lenders will be too slow to trim their staffs. In that case, lenders will loosen their credit standards (*i.e.*, will extend loans to lower-quality borrowers) to boost origination volumes and to justify their over-inflated staff levels. This could produce a vintage of MBS and mortgage-related ABS that performs worse than earlier vintages. Industry participants will be slow to adapt to the change in quality. Subordinate tranches of deals backed by tomorrow's weaker loans might perform poorly.

Despite very high volumes of ABS issuance during 2003, spreads on ABS have not been pushed wider. In one banker's view, spreads will move tighter over the next six months and tiering of issuers will remain pronounced.

If mortgage rates rise, the likely decline in sub-prime mortgage volume will be less pronounced than the decline in the prime mortgage market. There may be a 10% to 15% drop in HEL volume in 2004. Student loan activity will remain strong in 2004. Total ABS volume will grow 10% to 15% in 2004.

FIN 46:[3] Not all market participants affected by FIN 46 have changed their strategy in response to the interpretation. FIN 46 has slowed the pace of new asset-backed commercial paper (ABCP) program formation. For sponsors of ABCP programs, selling an expected-loss tranche is the preferred strategy for avoiding consolidation.[4] However, there are unresolved issues with respect to (1) sizing the expected-loss tranche and (2) not ceding control of a program to outsiders.

FIN 46 seems to have "failed." Most banks that sponsor ABCP programs will manage to avoid consolidating their ABCP programs on their financial statements. Many banks will avoid consolidation by selling expected-loss tranches, but some will use other devices.

[3] Financial Accounting Standards Board, FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 (17 Jan 2003) (available at http://www.fasb.org/int46.shtml).

[4] FIN 46 requires a company to consolidate certain SPEs that formerly did not have to be consolidated. One of the tests for consolidation is whether the company's interest in an SPE will require it to absorb a majority of the SPE's expected losses. A company can avoid consolidation under that test if it sells interests that will absorb the expected losses to a third party. However, as simple as this solution appears, it is complicated by ongoing debate about how to measure or estimate expected losses. *See generally*, Rosenberg, Hilary, *Longer Paper Routes*, CFO Magazine (1 Oct. 2003); Pilcer, Sam and Nathan Trier, *ABCP Market Overview: first Quarter 2003 – All Talk and No Action*, Moody's special report, at 4 (18 June 2003); Kaur, Manjeet, et al., *FIN 46, Regulatory Relief, and U.S. ABCP Conduits*, Standard & Poor's special report (5 June 2003); Roglieri, John and Deborah Seife, *FIN 46: An Enigma Wrapped in a Puzzle*, Fitch special report, at 3 (13 May 2003).

One panelist expressed frustration with the FASB's[5] process of "interpreting" FIN 46. FIN 46 was itself an interpretation and was supposed to have been principle-based. However, the FASB's weekly meetings and pronouncements are converting FIN 46 into a rules-based standard. In the meantime, the S.E.C. is pushing FASB to force consolidation, and this drives FASB to adopt asymmetric formulas (loss vs. gain) for calculating expected losses (for the purpose of determining the necessary size of an expected-loss tranche). If FASB pushes the calculation of expected loss up to 40 or 50 basis points, bank sponsors of ABCP programs will find it uneconomical to sell expected-loss tranches as a device for avoiding consolidation.

FIN 46 has not caused a drastic slowing of CDO activity.

Asset Class Issues: The credit card sector is free of troubling issues.[6] Credit card ABS volume should reach the same level as last year and should rise slightly in 2004. Portfolio credit quality is stable to improving.

Issuance of auto loan ABS is down 22% from last year (measured year-to-date), driven by decreased issuance from the Big Three U.S. automakers. The Big Three have been using alternative funding sources, including ABCP. Portfolio credit quality is improving. Both default frequencies and loss severities have improved recently. The auto finance ABS sub-sector is not facing tough issues. However, investors should be mindful of potentially higher risk in 84-month and longer loans. The Wall Street Journal recently reported that six-year loans have grown from less than 10% to 28% of all new production.

On the student loan ABS front, there are proposals to allow borrowers to more easily refinance their loans. This could spur a wave of prepayments in the coming years. Volumes will remain strong.

Problems and Issues: In the troubled student loan transactions from Academic Management Services (AMS), the problem was in reinvesting collections in new loans during revolving periods of the deals. In the process, AMS brought ineligible collateral into the deals. The problem is that there was no "second set of eyes" checking the new collateral as it flowed into the deals. Trustees potentially could be the ones to provide third party oversight, but it might be others parties as well.

The credit card ABS from First Consumers National Bank provide an interesting example of a servicing transfer in the credit card context and an example of the wind-down (*i.e.*, liquidation) of a portfolio of closed accounts. The regulators acted very aggressively, moving the serving fee to the top of the waterfall and raising the fee to an incredible 700 basis points. Another problem with the deals is that transfer of the servicing required unanimous consent of investors. Nonetheless, the deals managed to achieve transfer of servicing, which is moderating losses. The servicing transfer occurred in July. The First Consumers portfolio is now performing much better than the Spiegel retail portfolio.

The Lesson – Company Risk: The problems in various sectors illustrate that the performance of securitization transactions often retains a significant linkage to the corporate credit quality and

[5] The Financial Accounting Standards Board (FASB) is the body responsible for defining generally accepted accounting principles (GAAP).

[6] This view seems to ignore the recent troubles affecting credit card ABS issued by NextCard and Spiegel/First Consumers National Bank. Both cases arguably challenge the common assumption that regular Visa and MasterCard portfolios will continue to be replenished even after a credit card ABS deal enters early amortization.

In both NextCard and First Consumers, regulators had a hand in stopping purchases of new receivables. But, the regulatory actions were just part of the story. Poor performance was also a factor in why the portfolios were not purchased by other card issuers.

If the so-called "non-declining pool" assumption is wrong – that is, if investors need to anticipate that there might not be any new charges replenishing a pool – some views about credit card ABS will have to change. Most importantly, unless credit card deals get more credit enhancement, the industry will need to think about a strong credit linkage between credit card ABS and their corporate issuers. For better or worse, that is not how many market participants want to think about credit card ABS.

business fortunes of seller/servicers. ABS has been an attractive investment because it has offered investors more yield and better rating stability than similarly rated corporate bonds. If ABS become more closely linked to corporate credit, ABS will lose a key dimension of its appeal to investors. The degree of linkage between a pool of assets and a seller/servicer can vary substantially from one type of asset to another. New deals arguably need to have higher servicing fees in order to assure that successor servicers can be hired, if necessary. However, building-in higher servicing fees, or servicing fees that rise after an initial low period, might be very burdensome to issuers. Servicing fees that are too high could entirely crush ABS issuance.

Issues for Next Year: Next year, the securitization industry is likely to face some of the following issues: (1) how the sub-prime mortgage sector handles the recession and flat or declining home prices?, (2) how quickly the Federal Reserve raises interest rates, (3) credit fundamentals in the sub-prime mortgage sector, (4) labor market fundamentals; (5) how uneventful the year has been, and (6) FIN 46 and its implications for the securitization industry.

## 11:15 AM – Dynamics of the Sub-prime Mortgage ABS Market: Recent Events, Origination, Servicing and Securitization

Background: This year will achieve a record level of issuance of sub-prime mortgage/home equity (HEL) ABS. About $160 billion has been issued through the third quarter of 2003. One panelist estimates that sub-prime mortgage originations will exceed $250 billion by the end of 2003. More than 32 issuers have tapped the HEL ABS market this year. The top ten issuers account for only 58% of the whole, a lower proportion than in past years. Eighty six percent of this year's HEL ABS have used subordination for credit enhancement.

One important trend, which is helping to drive the growth of HEL ABS issuance in 2003, is the inclusion of *prime*-quality loans in sub-prime pools. Another trend (arguably) is the segmentation of "alt-B" or "near-prime" loans (*i.e.*, loans in the gap market in between prime and sub-prime). Sub-prime mortgage originators are pushing up-market rather than down-market. That is, sub-prime mortgage originators are striving to attract borrowers of higher credit quality. Most sub-prime lenders have stopped making loans to borrowers who have FICO scores below 500. Most sub-prime lenders have become more proficient at identifying and differentiating near-prime and sub-prime borrowers. Rising home values have been key driver of this year's high level of sub-prime mortgage originations.

The volume of sub-prime mortgage originations has been so large that pace of growth is unlikely to continue in 2004. In fact, lower origination volumes are a distinct possibility. Lenders may target new immigrants as a group that could be the source of new volume. Piggyback seconds[7] are another possibility for supporting activity levels in 2004.

Lenders are very cost conscience. One originator has worked to educate its sales force and its brokers so that they pursue the kinds of loans that the company wants to originate. This improves the lender's pull-through rate (*i.e.*, the rate at which applications become closed loans). In one lender's view, sub-prime mortgage lenders should approach origination costs as if they were manufacturing companies. Technology and automation are essential for trimming costs. One the other hand, compliance costs are rising because of diverse predatory lending laws.

The estimated total amount of outstanding sub-prime mortgage loans is $550 billion to $600 billion. The top ten servicers service about two-thirds of the total.

[7] A "piggy-back second" is a second-lien mortgage loan that is originated contemporaneously with the first mortgage loan on the underlying property. A home buyer who cannot afford to make a down payment of 20% may choose a piggy-back second instead of having an LTV higher than 80% on his first mortgage loan. By avoiding an LTV greater than 80% on his first mortgage loan, the borrower may avoid having to get primary mortgage insurance and may get a lower interest rate on his first mortgage loan. Although the interest rate on the second mortgage loan may be substantially higher than the rate on the first mortgage loan, the borrower may be able to repay the second loan more quickly than the first and, therefore, achieve substantial savings in the long run.

Servicing: The Fairbanks situation has reverberated throughout the whole sub-prime mortgage servicing industry. It has made servicers focus on compliance issues in servicing as well as in originating loans. There is potential that industry-wide "best practices" will emerge for sub-prime mortgage servicing. The best practices will have to balance the need to maximize recoveries against the need to treat borrowers reasonably and fairly. Right now, each major lender is working to develop its own "best practices" for sub-prime mortgage servicing. It is likely that the sub-prime sector's best practices will be stricter than those of the prime mortgage market. The evolution of best practices is likely to produce a higher proportion of modified loans and of forbearances. However, in dealing with a delinquent loan, a servicer must be careful not to create a "new loan" (by modification) that would have to be removed from the REMIC in which it had been securitized. Another problem with modifications is that they may simply push off the final day of reckoning on a troubled loan.

Predatory Lending: More than 20 states have adopted or proposed predatory lending laws that provide for uncapped assignee liability. One panelist mentions Georgia,[8] New York,[9] and New Jersey[10] as examples of states from which certain loans must be entirely excluded. However, there is a continuing concern that a lender might mistakenly include a prohibited "high cost loan" in a securitized pool. Some legislation helps. NJ, for example, has a due diligence safe harbor. Using outside due diligence firms and technology appear to be the best ways to determine whether a lender is properly identifying and excluding prohibited loans. One lender has elected not to originate any loans that would be high cost loans under either federal or state standards. The lender's origination systems will prevent such a loan from being originated by the lender's staff.

Parity Act and Pre-emption: The elimination of Parity Act[11] preemption[12] pushed one lender to stop making loans in sixteen states. The burden of complying with diverse state laws is too high. The industry needs some kind of federal preemption that puts all lenders on equal footing. Right now lenders that are subsidiaries of federally regulated financial institutions have a distinct advantage.

Performance: The 2000 vintage of HEL ABS has the weakest performance. None of the lenders represented on the panel indicates that it is making any changes to its underwriting standards or practices.

The poor performance of the 2000 vintage of HEL ABS is attributable to: (1) borrower FICO scores below 500 and (2) the occurrence of the recession shortly after that vintage was created. Also, around that time, both of the GSEs became more active in skimming off the cream of the crop. The weak performance of the 2000 vintage is understandable from the generally low FICO scores of that vintage and from the low average balances of the loans.

NIMs:[13] Around 200 NIM deals have been issued. Some HEL ABS issuers have been heavy users of NIMs while others have not used NIMs at all. One lender explains that it did not use NIMs in the

[8] Georgia Fair Lending Act, Ga. Laws § 7-6A-1 et seq. (2003).

[9] N.Y. Banking Law § 6-*l* (2003).

[10] New Jersey Home Ownership Security Act of 2002, N.J. Stat. §§ 46:10B-22 *et seq.* (2003)

[11] 12 U.S.C. § 3801 *et. seq.*

[12] Office of Thrift Supervision, *Alternative Mortgage Transaction Parity Act; Preemption*, 67 Fed. Reg. 60542 (26 Sep. 2002).

[13] Some sub-prime mortgage ABS issuers routinely securitize the residual interests in their sub-prime mortgage ABS deals. Such residual securitizations are called "NIM" deals or "net interest margin" securitizations because the excess spread component of a sub-prime mortgage ABS residual is similar to the "net interest margin" reported on the financial statements of a traditional finance company (*i.e.*, one that does not securitize its loans). Today, certain sub-prime mortgage ABS issuers execute a NIM transaction alongside each of their regular transactions.

A NIM securitization embodies the right to receive residual cash flows from one or more underlying securitizations. In a typical case, a NIM security might receive (1) all excess spread, (2) unused overcollateralization (OC) remaining at the termination of the underlying deal, (3) prepayment penalties, and, in some cases, (4) cash flow on classes specifically created to enhance the NIM (*e.g.*, a small "NAS IO" class). As in an equipment lease securitization, cash flows attributable to the NIM do not have inherent principal and interest components. Rather, past because it did not want the additional leverage. However, that lender recently executed a NIM transaction to demonstrate to its shareholders that it had an untapped source of liquidity. Performance of recent NIMs has been better than expected. Fitch downgraded two NIMs issues in 1999. A NIM from 1998 defaulted. Downward moves in LIBOR have been driver of strong NIM performance.

Expectations for 2004: Issuance of HEL ABS either will be about the same or there will be slight growth. Home equity lines of credit (HELOCs) will be a hot product in 2004.

### 1:45 PM – Kiss & Tell: Confessions about Buying in the 144A and Public Market

Relative Value: Despite heavy issuance volume during the year, spreads have remained impressively tight for residential MBS backed by prime-quality loans or alt-A loans. Both areas are "well priced" (*i.e.*, not cheap and perhaps slightly rich). However, alt-A pools arguably are being contaminated by so-called "alt-B" and "alt-C" paper. Triple-B-rated tranches of sub-prime mortgage ABS command spreads in the low 300s (basis points) over LIBOR. CMBS is well priced. It remains unclear whether prices on manufactured housing (MH) ABS have bottomed out. Over the past two years, the MH ABS sub-sector has repeatedly disappointed investors by delivering further unpleasant surprises each time that it seemed to have hit bottom.[14]

Another panelist feels that CMBS spreads are too tight and that subordination levels on CMBS have become too thin. He favors CBOs backed by leveraged loans and those backed by high-yield bonds. He likes middle market CLOs that contain unrated loans. He favors floating-rate securities.

A third panelist feels that credit enhancement levels are too thin on jumbo MBS. It is hard to predict exactly how much losses would increase if home prices fall (*e.g.*, because of rising interest rates). However, even if one makes optimistic assumptions, today's credit enhancement levels for jumbo MBS deals provide only a very small margin of protection. The panelist is also skeptical of the MH ABS sub-sector.

A fourth panelist explains that offering spreads on new issue ABS rated in the single-A and triple-B categories convey information about whether CDOs are interested in the bonds. Very wide spreads on a particular issue sometimes signal special problems.

A fifth panelist explains that ABS spreads should be wider than corporate spreads because investors have to monitor a greater number of distinct securities.

A sixth panelist favors subordinate credit card ABS from issuers who also have outstanding corporate bonds. The panelist likes hedged mutual fund fee deals and senior tranches of trust preferred CDOs.

the creation of the NIM itself artificially imputes principal and interest components to the undifferentiated underlying cash flow.

In extreme cases, faster-than-expected prepayments can make a NIM default. Faster-than-expected prepayments reduce excess spread cash flow on a sub-prime mortgage ABS. Accordingly, there is less residual excess spread cash flow for a related NIM deal. Many older NIM deals got into trouble when their related sub-prime mortgage deals experienced faster-than-expected prepayments.

[14] For example, over the course of 2002, MH ABS from Conseco and Oakwood suffered a string of downgrades. MH ABS from other issuers, such as Vanderbilt, Bombardier, and United Companies also felt the rating agencies' sting. Then, on 15 November 2002, Oakwood filed for bankruptcy protection. A month later, on 17 December 2002, Conseco followed suit. In the first half of 2003, the rating agencies downgraded 307 tranches from 80 MH ABS transactions. The 2003H1 downgrades hit 46 deals from Conseco, 18 from Oakwood, eight from United Companies, four from IndyMac, and two each from Deutsche Financial and Bombardier. Also during the first half of 2003, the Conseco bankruptcy proceeding delivered a major jolt to the whole ABS market when the court ruled that the servicing fee on the company's MH ABS would be increased to 1.25% for one year and to 1.15% after that. Before the ruling, the fee had been just 0.50%. In addition, the court ordered that the increased servicing fee would be moved to the top of the cash-flow waterfall. The result is a reduction in excess spread available to absorb losses. The reduced protection, combined with generally weak performance of the underlying asset pools, precipitated many of the downgrades that hit the subordinate and mezzanine tranches of Conseco MH deals

Future Credit Problems: Rising interest rates could produce credit problems. Higher rates could create serious refinancing risk for CMBS. Similarly, the prospect of an increasing monthly payment can be like a gun at the head of an ARM borrower.

One panelist contends that floating rate tranches of HEL ABS have longer effective duration than most people realize. Rising interest rates reduce the excess spread in a deal, thereby sapping the deal's credit strength and possibly accelerating the decline in its price.

Over the past ten years, the worst performing vintages of residential mortgage loans were 1995 and 2000. Each of those two years followed a rising-rate environment. The rising rate environment likely curtailed origination volumes, which caused lenders to stretch on credit quality (*i.e.*, lower their standards).

The common practice of pricing ABS based on an assumption of zero losses on the underlying loans (*e.g.*, on Bloomberg) causes market participants to under-estimate the weighted-average lives (WALs) of the securities. Calculations on Bloomberg almost universally assume zero losses. Calculations on Intex can accommodate non-zero loss assumptions. However, Intex modeling of deals sometimes is flawed. In addition, market participants generally price securities based on the assumption that they will be called.[15] In reality, the call does not always occur.

Documentation: Investors sometimes can influence a deal's documentation. Obviously, one of the most important aspects of documentation for an ABS transaction is the cash-flow waterfall. Another key area is investors' right to get information directly from a deal's trustee, without having to go through DTC. A third important area is the mechanism for making amendments. Investors should be wary of "immaterial" amendments that can be effected without their consent. In addition, investors should focus on an issuer's potential ability to manipulate trigger tests (*i.e.*, affirmative covenants regarding the performance of the securitized assets).

Some ABS backed by franchise loans provide investors with very poor access to information about the performance of the underlying assets. Franchise deals are exceptionally weak on this score.

One panelist recommends avoiding uninsured subordinated tranches of insured deals because the bond insurer has too much control.

New Issuers: One view is that there is no place in the ABS market for small and mid-sized new issuers. Small and mid-sized issuers need to be more conservative than their larger competitors because they are less diversified.

Servicer Risk: The fact that ABS use "bankruptcy remote" legal structures does not mean that the bankruptcy of a seller/servicer will not affect its deals. It is not always possible to terminate a servicer after it goes into bankruptcy. Investors have more protection when a deal includes financial covenants that provide for servicer termination before the servicer enters bankruptcy.

ABS have less exposure to "event risk" than do corporate bonds. However, experience has proven that ABS are not immune to seller/servicer risk. A key dimension of event risk in ABS relates to whether or not the assets are real (*e.g.*, in the NCFE deals, some of the assets allegedly did not exist).

Ratings Volatility: The credit quality of a regular securitization changes monthly, as some loans prepay and others do not. Surveillance is not a profit center for the rating agencies. The rating

[15] The assumption is that the servicer will exercise its "clean-up" call at the earliest opportunity. The term "clean-up call" refers a servicer's right to redeem an ABS or MBS after the balance of the underlying asset pool has declined below a predetermined level (*e.g.*, 10% of its original amount). A clean-up call permits a servicer to terminate its administrative obligations (such as processing monthly remittances to investors and sending out monthly reports) when the related servicing fee has been reduced to a level that might not fully cover the cost of administering the transaction.

agencies are not motivated to follow every deal each month. It is frustrating that a distressed bond which will recover 95¢ on the dollar gets rated "in default" just like a defaulted corporate bond that will return only 2% of its principal. The former arguably should receive a much higher rating.

Rating agencies consider the risk that a deal's servicer will collapse. Why, then, do some deals suffer downgrades when their servicers actually fail? Rating agencies are slow to upgrade ABS but they are too quick to downgrade. If an issuer generally issues deals rated by all three rating agencies and subsequently issues a deal from which one rating agency is absent, investors should be wary and should call the absent rating agency to learn why it did not rate the subsequent deal.

Investors should prefer CDOs in which the manager retains an equity stake.

## 2:45 PM – Are We Ready for 2004? Non-Real Estate ABS: A Research Analysts' Roundtable

Although consumer debt-to-income levels are high by historical standards, the growth of revolving consumer credit has slowed. If rates remain relatively stable, consumers will be able to manage their leverage adequately. The wild card for consumer credit is potential weakness in the housing market. The bottom line is that the outlook for the foreseeable future is generally stable.

Another panelist views the labor market as the most important variable for next year. Personal bankruptcy filings will be another key factor. Additionally, consumer leverage may be even higher than reported because some of it may be invisible. Nonetheless, ABS backed by prime-quality auto loans and credit card receivables should not experience performance problems.

Credit Card Subordinate Tranches: Spreads on triple-B-rated tranches of credit card ABS experienced 50bp to 100bp of tightening over the past several months. Will that sector continue to be attractive? The most recent Chase credit card deal priced triple-B-rated securities at a spread of 92 basis points. Another view is that triple-B cards are no longer cheap. Credit cards have shown improving fundamentals for the past six months.

From a technical perspective, the anticipated flow of triple-B-rated credit card ABS issuance should not be so heavy that it will cause spreads to widen. In fact, it may even be light enough to leave room for spreads on the securities to tighten. Refinancings and expected portfolio growth will require the major credit card companies to issue triple-B-rated ABS to support their anticipated issuance of senior tranches. However, each of the major issuers will be able to meet its needs by issuing just $150 million to $200 million of triple-B-rated securities each quarter. The market can readily absorb that level.

Credit Card ABS vs. Corporate Debt: Question: Should triple-B credit card ABS be cheaper or more expensive than an issuer's corporate debt or credit default swaps (CDS)? Spreads on finance company corporate debt have been more volatile than spreads on ABS. For monoline credit card companies, the smart trade is often to buy whichever has the wider spread because the trust's performance and the company's performance are very tightly linked.

Another way to think about ABS is as a special case of senior secured debt. This view stems from the reality of linkages between the performance of securitized assets and the business fortunes of the issuer. Securitizations of revolving assets and of specialty assets have especially close linkage to the corporate credit quality of the issuer. The implications of viewing ABS as a special case of senior secured debt is that there should be greater tiering than we now observe within ABS sub-sectors.

Credit default swaps (CDS) are used in two ways in ABS. The first way is as a hedge against consumer ABS (if the corporate issuer is one for which CDS are traded). The second way is in the creation of synthetic securities that reference (1) an index, (2) a hypothetical pool of assets, or (3) subordinate tranches of outstanding ABS deals.

In the case of Capital One, CDS had enormous spread volatility while spread volatility for the company's ABS was modest by comparison. Nonetheless, spreads on Capital One triple-B credit card ABS stayed very wide. Although investors arguably could have hedged some of the imbedded corporate risk in the ABS by using CDS, most did not because it was not clear exactly how to execute the hedge.

Private Student Loans: Sallie Mae recently executed a student loan deal backed by private (uninsured) student loans. The student loan sector as a whole, including private student loans, should remain a growth sector because college tuition continually gets more expensive. Investors' key exposure in Sallie Mae's private student loan deal is to Sallie Mae's corporate credit risk. Some feel that private student loan ABS are cheap; the spreads are very wide relative to credit card ABS. Private student loans are not dischargeable in bankruptcy. Sallie Mae projected that lifetime losses would be around 5½% on its recent private student loan-backed deal.

## 4:15 PM – State of the Industries: The Real Estate ABS Researchers' Roundtable

Rising Rates: How would rising interest rates impact various product areas? Some analysts feel that rising rates would hurt while others feel that rising rates would not be damaging.

The pessimistic view is that rising rates can stress sub-prime mortgage deals by pressuring excess spreads and by causing payment shock for ARM borrowers. Borrowers may be vulnerable to payment shock because many sub-prime mortgage lenders evaluate a borrower's capacity to repay based on a loan's low initial rate (*i.e.*, a "teaser" rate). Rising interest rates can hurt loss severities by slowing down home price appreciation. Additionally, rising rates can force lenders to stretch in qualifying borrowers in order to sustain origination volumes (*e.g.*, lenders might start to push appraisals).

The optimistic view is that fear about a potential rate shock is irrational. Outstanding loans should be only minimally affected by rising rates. The likelihood of rates rising sharply is very small, according to all signals from the Federal Reserve. Moreover, if interest rates do spike sharply, the economy will likely be booming, with strong employment and firm housing prices.

An intermediate view is that the outlook for the home equity sector should have a somewhat negative bias. Many California markets are vulnerable because housing affordability is suffering. Home price appreciation could stall, which could hurt performance of outstanding deals. Flat home prices (*i.e.*, zero appreciation) would be much more negative for the sub-prime mortgage market than for the prime mortgage market. Slightly rising rates probably would not cause a major dislocation in home prices; the volume of home sales might slow down, but prices would be unlikely to fall. On the other hand, real estate is a local phenomenon and prices could fall in certain areas. The effect of payment shock would be easier to gauge if lenders disclosed whether they underwrite to teaser rates or to fully indexed rates.

In past recessions, the geographic areas with the highest priced homes experienced the greatest price declines. Conversely, the areas with the lowest priced homes experienced the smallest price declines and sometimes even experienced appreciation. Because sub-prime loans generally are secured by lower-priced homes, they should be least exposed to the risk of large price declines.

Another optimistic view is that a rising rate environment would be good for existing deals because it would reflect a strong economy. The compression of excess spread could be an issue, but probably not a major one. The risk of payment shock on slightly seasoned loans (roughly one year of seasoning) is dampened by the fact that such loans had a rate floor equal to the teaser rate at the time of their origination. The borrowers on those loans have not shared in the declining rates of the past year.

NIMs securities are highly vulnerable to rising rates. Rising rates will constrict origination volumes and will test lender business models. Securities dealers will bid less aggressively for whole loans if the yield curve flattens.

Losses would increase by 30% if home price appreciation slows from 8% per year to 5% per year. However, most home equity ABS are well protected against a slowdown in home price appreciation.

Manufactured Housing: The securitization industry was myopic. It focused too much on performance statistics and not enough on industry dynamics. At one point, during the heyday of the MH loan market, the rates on MH loans were only 2.5% higher than the rates on regular prime-quality mortgage loans. In retrospect, that was absurd. The adequacy of servicing fees is not a static number. As pools shrink, as companies leave the industry, and as performance deteriorates, the level of an adequate servicing fee increases. Investors should want to avoid bankruptcy court because it is impossible to assure that a deal will still work if the seller/servicer goes into bankruptcy. Courts can change servicing fees and, seemingly, re-write cash-flow waterfalls.

The industry-wide inventory of repossessed manufactured homes has declined by 50% over the past several months. Recovery rates should improve over the coming year as the excess supply of used manufactured homes (caused by the overhanging inventory of repossessed units) slowly shrinks. Measured on a total return basis, the embattled MH sub-sector was the best performing ABS sub-sector over the past year. It managed to recover some of the ground it had given up in its terrible performance a year earlier.

Buyers of repossessed manufactured homes have weaker credit than other borrowers who buy new units. Thus, the recent high sales volume of repossessed units carries a high level of risk. Many loans secured by repossessed units ultimately will default.

The grim experience of the MH sub-sector shows that the whole market can mis-price the credit risk of an entire asset class and that it can misjudge the necessary level of servicing fees.

Lessons to be Learned from MH: The problems with the MH sub-sector primarily reflect problems and mistakes in the MH finance industry rather than stresses from the general economy. For example, over the course of the 1990s, terms (maturities) on MH loans got longer even though the useful life of the physical units did not. Industry participants should have challenged the wisdom of making 20-year and 30-year loans backed by assets with useful lives of 15 years.

UK Prime Mortgages: UK prime mortgages offer attractive opportunities. Borrower quality is strong and home prices are sustainable. Home prices have grown significantly in recent years, but many economists feel that there is not a bubble.

Recognizing Structural Change: The securitization industry arguably gives too much credit to issuers who are viewed as being the best in their class. Examples arguably include Greentree in the MH sub-sector and Americredit in the sub-prime auto sub-sector. In both cases, there may not be a successor servicer with the capacity to take over the servicing of such an issuer's portfolio. The market arguably should impose a pricing penalty on dominant issuers.

## Friday, 10 October 2003

### 8:00 AM – The Cutting Edge of Asset-Backed Securitization – Trends Opportunities and Pitfalls

New Asset Classes: Securitization has become a mainstream financial tool. Non-financial companies use securitization as an alternative source of funding. This raises the question of how securitization fits into a company's capital structure. By this time next year, the securitization industry probably will have seen one or two "whole business" securitizations in the U.S., along the lines of the pub deals in the U.K. Intellectual property securitizations are also likely to increase over the coming year. The question is whether the original owners of intellectual property will be the driving force or whether it will be aggregators, who purchase intellectual property rights.

The mid-1990s brought a wave of expansion, where many new and exotic asset classes became the subjects of securitizations. However, by the late 1990s, many of those asset classes displayed disappointing performance. Today, exotic asset classes have a smaller presence on the ABS landscape. Today's investors are looking for new asset classes. But, they want the deals to be well structured, well enhanced, and attractively priced (cheap).

Over the past few years, commercial banks have maintained a relatively strict credit posture. This has affected ABCP programs. ABCP programs recently have had a diminished role as the proving ground for new asset classes before they enter the term ABS market.

Credit Card Innovations: Credit card ABS have been around for a long time. Deal structures evolved from discrete trusts to master trusts. Later, master trusts evolved to the de-linked structure pioneered by Banc One, Citigroup, and others. In the de-linked structures, all the classes are notes and all are ERISA-eligible. The impetus behind the de-linked structure was the support of reverse-inquiry trades. However, the documentation requirements for issuing securities from a de-linked trust are just as onerous as they were before. In addition, issuance costs are still high, which means that deal sizes must remain large. For one major issuer, the total cost of an issuance is around $400,000. Of that amount, roughly 64% goes to the rating agencies and 36% goes to law firms. The issuer wants to persuade the rating agencies and the law firms to adjust their fee structures to facilitate smaller and more frequent deals.

Student Loans: Private student loans are necessary to fill the gap between the maximum amount available under guaranteed loan programs and the full cost of a college education. There is a positive self-selection effect: borrowers who take private student loans do so to increase their future earnings potential. Most private student loan borrowers are graduate students and many private student loans have co-signers.

Some student loan deals use a resetable rate feature with a soft bullet (*e.g.*, if the securities are not redeemed on the soft bullet date, the interest rate increases). Investors have found the structure appealing.

FIN 46: Implementation of FIN 46 has been deferred until the fourth quarter. However, the whole process of working with FIN 46 during 2003 has been very expensive and burdensome. Calculating the size of a first loss piece is very complicated and is not linear (*e.g.*, the asymmetric treatment of gains and losses). There may be light at the end of the tunnel; it will be interesting to see what FASB does in 2003Q4.

Secured Liquidity Notes: The use of secured liquidity notes has doubled over the past 18 months. The reason for the growth is that such notes replace traditional liquidity facilities, which are the most expensive single feature of ABCP programs. For a top-tier ABCP program, secured liquidity notes trade a few basis points wider than the regular ABCP. Use of secured liquidity notes is likely to increase. The tough feature of secured liquidity notes is the 397-day absolute final maturity, designed to comply with the requirements Rule 2a-7, an important S.E.C. rule that controls the investments of money market funds. The essential feature of secured liquidity notes is that their maturity extends to 397 days if an ABCP program cannot roll its paper (*i.e.*, sell new ABCP to provide funds to retire maturing ABCP).

Legal and Regulatory Issues: Recent government actions threaten bankruptcy remoteness. First Consumers National Bank involved a situation where the Office of the Comptroller of the Currency (OCC) intervened in the institution's credit card securitizations. The OCC set aside legal agreements and imposed terms of its own. That action calls bankruptcy remoteness into question. Notably, First Consumers was not in receivership when the OCC acted. Previously, market participants believed that the OCC would not have acted in the manner that it did. The implied message in the OCC's action is that the company was acting in an unsafe and unsound manner by, in effect, giving away a valuable asset. The OCC has explicitly declared that subordinated servicing fees constitute an unsafe and unsound practice.

Regulatory Capital: Without countervailing regulatory action, FIN 46 would have produced a huge jump in the regulatory capital requirement for ABCP program sponsors. The requirement would have jumped from roughly 0.64% to 8%. In response to FIN 46, the larger ABCP program sponsors convinced the regulators in Washington that ABCP programs do not need 8% capital. Accordingly, the regulators issued a temporary rule[16] granting capital relief through the first quarter of 2004 and proposed permanent rules[17] to the same effect. However, bank sponsors of ABCP programs still feel that the new proposed capital requirement is too high. The proposed rule calls for a capital requirement against the liquidity facilities based on a 20% conversion factor (*i.e.*, a capital charge of 1.6% in many cases, based on the 20% conversion factor applied to an basic capital charge of 8%).

FAS 140: Credit card issuers were originally concerned about the proposed amendments to FAS 140. However, it quickly became clear that FASB was not targeting plain vanilla revolving credit card trusts.

Industry Outlook and Hot Topics for 2004: The key issues on the regulatory and legal front will be the resolution of accounting and capital issues. 2004 will be a year of changes.

One bank views securitization primarily as a source of funding. The bank views "managing" its financial statements and regulatory capital requirements as secondary considerations. Investors demand transparent reporting and close contact with issuers so that they can know exactly what they are buying.

Accounting standards (FIN 46 and FAS 140) are the main issue for the next year. The outcome of the present policy-making will shape the whole securitization industry.

A growing number of companies will not bother to wrestle with off-balance sheet accounting issues and will simply include their ABCP programs on their balance sheets. In particular, sub-prime mortgage lenders who establish single-seller ABCP programs for warehouse funding are likely to carry the programs on their balance sheets.

Company risk will be a key issue for 2004. Securitization investors will need to focus on risks associated with the seller/servicers of their deals.

## 9:15 AM – Exploiting Investment Opportunities in Primary & Secondary Markets: The Traders' Roundtable

In the context of the difficulties in the Agency debenture market, the ABS market has been a relative safe haven.

Volatility in swap spreads has driven sector differentiation. Some investors used credit card ABS as a surrogate for swap spreads (as opposed to using Agency debt or swaps). However, investors buy credit cards for other reasons as well, such as liquidity. On the other hand, fixed-rate home equity paper was hurt by the recent rise in interest rates. Spreads on fixed-rate home equity ABS have widened notably.

High consumer leverage is not a big issue. Extension risk on home equity ABS is a greater issue. Many home equity deals achieve similar pricing, although their underlying pools are quite different.

[16] 68 Fed. Reg. 56530 (1 Oct. 2003)

[17] 68 Fed. Reg. 56568 (1 Oct. 2003)

Focusing on seasoned home equity ABS is one strategy for controlling exposure to extension (refinancing) risk and exposure to labor market deterioration. Prepayments on seasoned loans are less sensitive to rising rates and seasoned product has already experienced much of its losses.

An important new development in the auto ABS sub-sector is the sale of whole loans by the Big Three. Private-label issuers (securities dealers) have issued auto loan ABS backed by pools of loans from all of the Big Three automakers. Auto loan ABS are high quality and rightly viewed as a safe haven.

Prepayment speeds on auto loan ABS are a key issue. Even small fluctuations in prepayment speeds can substantially impact the yields on auto loan ABS. Longer WAL tranches have the greatest exposure to fluctuating prepayments.

An investor complaint: When dealers sell auto loan ABS they price them to call,[18] but when investors want to sell, the dealers give bids based on final maturity. One trader contends that investors should identify issuers that have an established history of calling their ABS. Another trader asserts that he favors pricing all bonds to the worst of call or maturity. A third trader asserts that if a given issuer has an established pattern of exercising clean-up calls on its securities, dealers should price the issuer's securities to call. A further point is that auto loan ABS from a dealer shelf arguably is less likely to be called than auto loan ABS from a programmatic issuer such as one of the Big Three.

Company risk is a general problem confronting ABS. Company risk is fundamentally unhealthy for the ABS market. The question of whether an issuer will exercise its option to call securities is yet another, albeit small, dimension of company risk embedded in ABS.

If the economy continues to improve, the market should experience some convergence between spreads on prime quality credit card and auto loan ABS and ABS backed by sub-prime receivables.

In the home equity ABS sector, the high prevalence of issuance through dealer shelf programs raises questions about the collateral. Additionally, the inclusion of greater amounts of alt-A collateral in sub-prime pools is creating convexity issues (*i.e.*, the average life of the securities becomes more sensitive to changes in interest rates and causes the duration of the securities to shift unfavorably as interest rates rise or fall). Investors need to demand compensation for greater convexity risk in home equity ABS that contain substantial amounts of alt-A collateral.

Prepayment speeds on loans of high credit quality are more likely to slow down than prepayment speeds on lower-quality loans. This exacerbates extension risk for home equity pools backed by higher-quality loans.

Seasoned, premium-priced home equity ABS is the area where investors have the opportunity to generate strong returns if they have a firm view on prepayment speeds. Another way to find value is to look for triple-A tranches from "bastard" issues (*i.e.*, ABS from defunct issuers or those that have left the business) that have hit or are close to hitting triggers. The effect of hitting the triggers usually will be to redirect cash flow to the senior triple-A tranches, which will somewhat offset potential extension risk. Conseco home equity deals from 2000 and 2001 are good candidates for such a strategy.

There has recently been spread compression in triple-B credit card ABS – about 40 bps since the start of the summer. Have spreads gotten as tight as they can? There might be a little bit of room for spreads to tighten further, but most of the tightening has already occurred.

Recently both MBNA and Capital One issued corporate debt at much tighter spreads than C-tranches from the companies' credit card ABS trusts. This argues that the C-tranches are attractively cheap.

[18] See note 15, *supra*.

Each panelist identifies the ABS that he finds most and least attractive right now:

- ABS from DVI are the least attractive because of too much uncertainty. Triple-B-rated credit card C-tranches from Capital One are the most attractive.
- ABS from DVI are the least attractive. Favorites are Capital One credit card C-tranches and alt-A MBS priced at slow prepayment speeds.
- Favorites are premium-priced home equity ABS because interest rates are likely to rise. Least favorite are ABS from DVI, but every security has a price
- Premium triple-A-rated credit card ABS are too rich. Subordinate auto ABS are cheap because of deleveraging. Western Financial auto loan ABS may offer opportunity because the pools include much prime-quality collateral, though the deals are lumped into the sub-prime auto category. Seasoned three-year home equity ABS are cheap. Some off-the-run (distressed) ABS is cheap: First Consumers, NextCard, and DVI. In the MH area, last-cash-flow senior tranches arguably are cheap because they have large IO components, which arguably are undervalued.
- Some downgraded senior tranches (*i.e.*, originally triple-A) of franchise loan deals offer attractive opportunities. Some of the franchise ABS have 20% losses on their underlying pools, but still are impossible to break. Investors should use Intex to test securities with extremely harsh default assumptions; if the bonds do not break, wave them in. Avoid home equity deals that have low overcollateralization (OC) target levels, such as 2% or 3%, because there is too much downside on the credit. Avoid such deals even if they are from top-tier issuers. Home equity deals with low OC target levels do not have the benefit of building up protection from fast prepayments. Home equity deals with higher OC target levels – in the 7% to 8% range – are much more appealing.
- Avoid DVI paper. Sallie Mae's private student loan deal is attractively cheap. There is plenty of room for spread tightening as the private student loan product gains a foothold.
- Avoid products with narrow spreads. Favor rate reduction (stranded cost) ABS and premium-priced credit card ABS because of their embedded IOs. Also favor mezzanine and subordinate home equity ABS.

## 10:15 AM – CDOs of CDOs, ABS and MBS: An Investor/Issuer Roundtable

One CDO manager analyzes the full capital structure of each ABS deal in which it considers investing. The manager has multiple vehicles in which it places tranches from different rating levels within the deals that it reviews. This allows the manager to get the most benefit from its research and analytic efforts. It uses Intex to stress-test securities.

The emergence of CDOs that focus on highly rated tranches from mainstream ABS sub-sectors reflects the weak experience of some off-the-run ABS sub-sectors. Diversification does not necessarily reduce risk if the quest for diversity causes a CDO manager to invest in asset classes in which it lacks experience.

A key issue is the level of resources that a CDO manager can devote to understanding the securities that it buys. A manager who focuses only on triple-A tranches might not devote sufficient resources. A large shop has the advantage of being able to invest in systems and staff. One manager asserts that his systems automatically extract data from Intex, Bloomberg, Trepp, and Conquest.

The market is evolving and investors demand more flexibility and transparency year after year. The focus seems to be on developing access to more detailed information on individual risk exposures.

The opposing point of view is that a CDO is inherently about diversification. Diversification should minimize exposure to idiosyncratic risk, while leaving exposure to systemic risk. But, the real challenge is gauging the benefit of diversification and the degree to which it has reduced idiosyncratic risk. In truth, continuing focus on idiosyncratic risk is necessary because it is impossible to tell how much diversification reduces idiosyncratic risk.

Within a poorly performing vintage of CDOs, the difference between deals that perform well and those that perform poorly is whether the manager is able to quickly detect and sell deteriorating positions.

Opinions differ on whether investors should demand that a manager hold a piece of the equity (and other layers in the capital structure) of its CDOs. A related issue is whether a CDO provides that its manager can be removed without cause. Investors should strongly favor deals where they can remove the manager because such a provision forces the manager to earn its keep every day. But, there can be a problem: Some deals provide that the equity investors have the power to remove the manager. This can create a tough conflict with the debt investors. Bond insurers feel that they must have the power to replace a manager if they are to insure a CDO's bonds.

Back to diversification: Today's trend toward less diversification may be an inappropriate reaction to recent poor performance in certain ABS sub-sectors. However, another way of viewing the current trend is as one toward greater liquidity rather than as one away from diversification. Additionally, some investors prefer and specifically seek CDOs with concentrations in specific asset classes such as MBS or home equity ABS.

One view is that exotic asset classes are too volatile and unpredictable to be included in CDOs. Experience shows that the rating agencies do not have a solid grip on how to value certain asset types (*e.g.*, aircraft), and the ratings on ABS backed by those classes may not be reliable. A variation on this view is that understanding exotic assets is simply beyond the resources of most CDO managers. The key to analyzing off-the-run asset classes is to have the staff and resources to make informed decisions. Some CDO managers may have sufficient staff and resources. To blindly exclude whole asset classes simply because they have recently performed poorly is an unjustified and unwise knee-jerk reaction.

Today's CDO spreads are cheaper (wider) and CDO structures are better than they were a few years ago. ABS CDOs are incorporating structural features from the corporate CDO side. Some structural features include:

- investment diversion
- reverse turbo – pays expensive liabilities first
- additional coverage tests
- triple-Cs counted in defaulted basket
- manager discretion to write down positions, and
- lower exposure limits to weaker credits

The market is not yet efficient in pricing CDOs of ABS and CMBS. The market arguably undervalues the diversification of CDOs. Some investors use CDOs as way to get into CMBS.

## Saturday, 11 October 2003

### 8:30 AM – Emerging and Exotic Asset Classes

What are the critical success factors for an asset class to establish itself? What assets are not appropriate for financing through securitization?

One panelist describes the emerging and exotic area by example: Latin American CMBS, future flow deals, whole business securitizations, intellectual property securitizations, and distressed and illiquid ABS.

ABS backed by emerging and exotic assets suffer from "guilt by association" with NCFE and others. On the other hand, investors remain attracted to ABS backed by emerging and exotic assets because they offer higher yields.

Many ABS backed by emerging and exotic assets are issued as private placements and many are wrapped by bond insurance. Examples of recent deals include apparel licensing (*e.g.*, Guess? jeans[19]) and pharmaceuticals (*e.g.*, Royalty Pharma Trust[20]).

Another example recently reported in the trade publications was a Latin American deal backed by cattle.[21] Whole business securitizations might not be viewed as emerging or exotic in Europe, but they still qualify as such in the U.S. An interesting U.S. example is B-of-A's synthetic securitization of the first loss exposure on Farm Credit loans.[22]

Timing is a hurdle for issuers of ABS backed by emerging or exotic assets. The long lead-time for such deals – often exceeding six months – deters many would-be issuers from pursuing securitization. However, the long lead times generally shrink as an asset class establishes itself.

Data generally is lacking about the historical performance of emerging and exotic assets. Even when such data is available, it usually is not industry-wide data and, therefore, may not address the issue of whether asset performance is closely tied to the issuer's business fortunes.

Higher yields are the reward that investors receive for investing in the first deal (or the early deals) of a new asset class. The first deal in an asset class usually pays higher returns than subsequent deals. The other side of the coin is that latent problems may not manifest themselves until after time passes (*e.g.*, the litigation problems that affected the tobacco settlement ABS).

Examples and Issues in Specific Asset Classes:

- Whole business securitizations have corporate and servicer issues, as well as legal issues.
- Intellectual property (IP) is very complex collateral. There are sometimes tough issues with respect to perfecting security interests in intellectual property. How does one protect intellectual property to avoid dilution or loss? How does one value IP? Will a given item of IP always be as valuable as it is today, especially if things do not go as planned.
- The structured settlement area is unique. The assets backing a deal are different every time. Structured settlement deals are better suited to the private placement market than to the public ABS market. Structured settlements are an asset class that has merit and that always will be present on the securitization landscape. An important feature of structured settlement ABS is that their credit quality is strongly linked to the corporate credit quality of the underlying payors.
- Standing timber is an old asset class but there have not been many deals. Timber lends itself to cash-flow modeling. However, timber is plagued by tough legal and tax issues. In addition, timber companies often have other competitive funding sources.
- Tobacco was a successful asset class, but the market probably will not see many more deals. CDOs were key investors in the sector and they require ratings from both Moody's and S&P. However, the two rating agencies have embraced conflicting criteria. It is now too onerous to satisfy both of them. At least one rating agency has concluded that tobacco ABS would have a natural rating cap at the single-A level (*i.e.*, could not attain higher ratings through tranching).
- Many bankers are now working on "life settlements" as a potential new asset class. The asset class is unfairly tainted by the troubles of the old viatical settlement deals. There is a key difference between terminally ill AIDS patients and the healthy elderly.

[19] *Guess? Zips up $75M ABS Deal*, Asset Securitization Report, 29 Apr. 2003.

[20] Gregory, Michael and Donovan, K., *Second Pharmaceutical Royalty ABS Quietly Prices*, Asset Securitization Report, 4 Aug. 2003.

[21] Ossa, Filipe, *Even Cow Deals Get the Blues*, Asset Securitization Report, 6 Oct. 2003.

[22] Graubard, David, *Innovative CDO Backed By Agri Loans*, Asset Securitization Report, 16 Sep. 2002.

- Tax liens securitization arguably is an emerging or exotic area in the context of pooling assets from multiple municipalities. Within the tax lien area, the New York City deals have performed wonderfully. However, deals from other municipalities have run into problems (*e.g.*, Jersey City[23]).

Off-balance sheet accounting is imperative for most ABS backed by emerging or exotic asset classes. It is encouraging that the securitization industry is able to develop mechanisms to accommodate new accounting standards. For example, almost immediately after the release of FIN 46, the industry developed a bid for "first loss exposure tranches" from ABCP conduits.

Investors should focus on servicer risk and fraud risk in ABS backed by emerging and exotic asset classes. Investors should conduct due diligence and should invest only when they have confidence in a servicer's integrity and capabilities.

For ABS backed by emerging and exotic asset classes, historical data may be less relevant than for established asset classes. Greater weight reasonably can be given to *projected* cash flows.

The bankruptcy of LTV Steel[24] is a major problem for whole business securitizations in the U.S. The case has made lawyers gun shy about the true sale issue in the context of whole business securitization.

Wrapped Deals: Differences in rating criteria between Moody's and S&P can make it difficult to obtain bond insurance on certain deals. Also, bond insurers are less interested in deals smaller than $100 million.

Fraud Risk and Audits/Oversight: Investors are starting to demand the right to conduct surprise audits of issuers. In the CDO area, investors are starting to require periodically updated valuations of collateral. In the RMBS area, some investors in subordinate tranches are insisting that the underwriter's modeling assumptions be updated monthly over the life of a deal.

## 9:30 AM – Emerging Market Securitization: A Look at Latin America

Examples of Securitization from Emerging Markets: Bank Internasional Indonesia (BII) securitized its future flow of Visa/MasterCard vouchers from foreigners traveling in Indonesia.[25] Despite many troubles in the country since 1997, the deal has weathered the storm. The deal's debt service coverage levels never fell below 3x. Although the issuer, BII, no longer exists in the form that it did at the inception of the deal, the deal has been able to withstand sovereign and banking crises.

[23] *Tax-Lien Investor Sues Jersey City*, Asset-Backed Alert, 17 May 1999.

[24] In LTV's bankruptcy, the company challenged the "bankruptcy remoteness" of its own securitizations. Years earlier, LTV had used two securitizations to finance its trade receivables and its inventory. Standard & Poor's had assigned a rating of AAA to the trade receivables financing and Fitch had assigned a rating of BBB to the inventory financing.

LTV's attack against its own deals raised quite a fuss within the ABS community because it challenged the fundamental principles of securitization. The use of securitization techniques failed to keep the deals out of the company's bankruptcy proceeding. For better or worse, the controversy was settled without any judicial resolution of the issues. LTV withdrew its attack when the securitization investors (lenders) agreed to supply replacement financing through a DIP (debtor-in-possession) facility. In essence, the securitization investors experienced a forced exchange of their securitization paper for DIP paper. *See The LTV Bankruptcy Case and Its Threat to Securitization - Is it Over or Just Beginning?,* Nomura Fixed Income Research (7 March 2001); *True Sale Assailed: Implications of In re LTV Steel for Structured Transactions*, Moody's Structured Finance Research (27 April 2001) (Moody’s doc. no. SF10405.PDF); Mayer Brown & Platt, *An Update on the Treatment of the Securitization Facilities in the Chapter 11 Bankruptcy Cases of LTV Steel Company, Inc., et al.*, (7 March 2001) (available online at www.securitization.net).

[25] Bank Internasional Indonesia Receivables Trust, $140 million trust certificates due 14 July 2007. Fitch originally rated the securities BBB+, but their current rating is B-.

Pakistan Telecom securitized its future flow of monthly net settlements from American phone companies.[26] Pakistan telecom is the only provider of long-distance telephone service in Pakistan. A major stress factor for such a deal is tariff changes. Fitch originally rated the deal triple-B. Despite the change of government and the default of Pakistan's sovereign debt, the deal continued to perform, though it was downgraded. The deal matured in August 2003. The deal showed the strength advantage of securitizing offshore cash flows that are not easily diverted or controlled by the sponsor/issuer or by its government.

Avianca Airlines securitized its ticket receivables in 1998.[27] The deal's structure involved a sale to a U.S. trust. It would have been better to use a Cayman trust. In 2000, the company had to restructure its debt. Through that episode, the ticket receivable securitization continued to pay, but it entered early amortization. However, the early amortization created a liquidity crunch for the company. The securitization investors made a concession to allow cash to flow to the company so that it could keep flying its planes. In March 2003, Avianca filed for bankruptcy in the U.S. The bankruptcy court froze the assets of the trusts, including the assets of the liquidity reserve account. The securitization defaulted. A key lesson of the Avianca experience is that controlling the cash flow gave the securitization investors leverage and allowed them to receive preferred treatment for 2½ years. A key problem with the deal was the use of a U.S. trust because a U.S. bankruptcy court will not recognize the separate existence of the future flow asset as distinct from the bankrupt entity itself.

YPF securitized its future flow of oil export receivables.[28] The deal uses an offshore trust. The Argentine government has never intervened in the deal, but the higher risk of government intervention has pushed the deal's rating into the double-B range. A key lesson is that structure matters.

Grupo Mexico securitized copper export future flows.[29] Stress came from 50% declines in the price of copper.

Country risk is important. If there is trouble with a sovereign or with a country's banking system, there is an increased likelihood that future flow securitizations from the country will be affected. Also, the credit quality of the corporate issuer of a future flow deal is very important. If Avianca had not had corporate problems, its securitizations would never have defaulted. As the market for future flow securitizations moves toward weaker companies, a greater proportion of the trouble in future flow deals will be because of problems with the corporate entities rather than because of sovereign issues.

Legal Issues: A cross-border future flow deal has a different legal structure than a conventional ABS deal. The essential design feature of a conventional ABS deal is that there is always a greater amount of assets than bonds. In a cross-border future flow deal, the assets do not yet exist, but the bonds (liabilities) fully exist on the closing date. In a conventional ABS deal, structure mitigates bankruptcy risk and the automatic stay. In a cross-border future flow deal, structure primarily mitigates sovereign risk.

[26] *Pakistan Issue Downgraded*, Asset-Backed Alert, 15 Jun 1998; Albulescu, Henry, *PTCL Receivables Master Trust*, Standard & Poor's new issue report (17 Sept. 1997).

[27] Kabance, Gregory, et al., *Under Pressure: Structured Transactions in Emerging-Market Stress—Update 2003*, Fitch special report, at 12 (5 Aug. 2003)

[28] *Issue Tied to Future Oil Sales*, Asset-Backed Alert, (2 Dec. 1996); *YPF Sociedad Anonima Ratings on SENs Lowered;Oil Enterprises Ltd, Oil Trading Corp. Rtgs Afmd*, Standard & Poor's press release (23 Jan 2002); Dadina, Rohinton, *YPF, S.A., $400 Million Structured Export Notes due 2002*, Duff & Phelps international new financing report (Dec. 1995).

[29] *Grupo Mexico Export Master Trust No. 1 and Grupo Minero Mexico S.A. de C.V. Ratings Lowered*, Standard & Poor's press release (22 Aug. 2002); *Moody's Downgrades Grupo Minero Mexico's SENs and Guaranteed Senior Notes*, Moody's press release (27 Feb. 2002); *Moody's Lowers Ratings Of Grupo Minero Mexico's SENs and Guaranteed Senior Notes*, Moody's press release (10 Apr. 2002).

Avianca has argued (1) that there was not a true sale of the future flows and (2) that the sale of the future receivables is an executory contract. If Avianca wins on either theory, it will defeat the interests of securitization investors and will be able to use its ticket future flows to get new financing.

Another key aspect of the Avianca bankruptcy case is that Avianca *really* does business in the U.S. This gave the company solid grounding to conduct its bankruptcy proceeding in the U.S. In most cross-border future flow deals, the issuer does not have property or a place of business in the U.S.

True sale is an important issue in cross-border future flow deals because it boosts a deal's rating higher than the issuer's domestic currency rating. Thus, a first-priority security interest is not sufficient, by itself. In addition, under § 552 of the bankruptcy code, a security interest will not cover receivables that arise after the commencement of a bankruptcy case.

Some issuers need their transactions to be structured as true sales because they are restricted by negative pledge covenants in their corporate bonds or bank lines. Those covenants would contractually prohibit an issuer from executing a deal that was merely a financing.

Avianca's argument that the sale of future receivables is an executory contract relies on the assertion that the receivables relate to unperformed obligations.

A typical cross-border future flow deal chooses the law of the seller's jurisdiction to govern the characterization of the transaction as a sale. The seller's domicile usually is a civil law jurisdiction, which provides a high level of certainty on sale characterization. However, a deal's contractual choice of law provision might not be binding on third-party creditors. Avianca conceded in its pleadings that Columbian law contractually governed the sale. This could make it more difficult for the company to contest the sale.

## 10:45 AM – CBO Repackaging

Balance sheet CLOs are driven by a different motive than arbitrage CBO/CLO deals. Balance sheet deals are driven by a financial institution's desire to manage its capital requirements. In most cases, the financial institution sponsoring a balance sheet CLO is not primarily interested in transferring risk. It is likely that the use of balance sheet CLOs will decline as international bank capital standards evolve and make such transactions more difficult or impossible. From an investor's perspective, balance sheet CLOs generally are more benign than arbitrage CBO/CLOs. However, a major caveat is that a few institutions used balance sheet CLOs as dumping grounds for their troubled assets. Older balance sheet CLOs provided little information to investors and were essentially black boxes. In response to ratings volatility in the CDO sector, newer balance sheet CLOs provide greater information to investors about the underlying credit exposures.

Issuance of CDO$^2$s (*i.e.*, CDOs of CDOs or "CDOs squared") peaked in 2001. The CDO$^2$ area may be as active this year at it was in 2001. Some repackagings involve distressed CDO tranches. The holder of a CDO tranche that is in danger of being downgraded might repackage the tranche by adding additional credit support to avoid the downgrade.

Investors should be very careful of repackaged CDOs. There is a "rating arbitrage" game that issuers play in repackaging single-A paper into triple-A securities. Investors should watch out for PIKable (payment in kind) collateral. Investors should seek stability in collateral. Stability of ratings is important. Stability of cash flow is equally important (*i.e.*, PIKable collateral is undesirable in this respect). On managed transactions, trigger tests can cause diversion of cash flows. An investor must be wary that cash flow will be diverted away from his tranche.

Investors can repackage their own CDO holdings to extract value.

A CDO tranche can become an IO (interest-only security) if its deal has become distressed and the tranche will never receive principal, although it can still receive interest until a formal event of default occurs. The IO cash flow from a non-PIKable single-B tranche can effectively have triple-A credit quality.

Repackaged CDOs are illiquid. They are unsuitable for trading accounts or mark-to-market accounts.

Many of the CDOs of ABS have already blown-up but the industry does not realize it yet. CDOs of ABS still trade at premiums relative to their underlying collateral pools. This may be because the deals do not require periodic valuation of the underlying collateral. Such deals may contain, for example, single-A-rated tranches that trade at 62¢.

Somewhat surprisingly, investors are drawn to CDOs of ABS because they seek stability of ratings. Also, some investors purchase triple-A tranches of CDOs of ABS at LIBOR+50 because it is the highest yielding triple-A investment that they are permitted to purchase. For example, an investor who is prohibited from purchasing ABS might be able to invest indirectly in ABS by purchasing a CDO of ABS.

One of the legal issues in repackaging arises when the holder of an asset retranches it. In such a case, true sale and non-consolidation become tough issues. Some law firms will insist that the holder sell 30% to 75% of its stake in the assets. In the aftermath of Enron, law firms are more conservative in giving true sale and non-consolidation opinions. One law firm's view is that there must be sufficient third-party involvement in a repackaging that a judge would consider it unfair to ignore or nullify a structure.

— END —

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