NOMURA

ABS Gold Coast Report 2004:

Coverage of Selected Sessions of ABS East 2004

21 October 2004

The general mood at the recent ABS East 2004 conference in Boca Raton, Florida was exuberant. Market participants expressed strongly optimistic views about the overall prospects of the ABS market in 2005. The event hosted about 2600 registered attendees. It's anyone's guess how many unregistered professionals simply crashed the party.

Market participants have ample reasons for optimism. Interest rates have remained fairly low. Recent home price appreciation has been strong. The credit performance of consumer debt has been generally good. The ABS market did not experience any new "blow-ups" during 2004.

Amidst the general optimism, however, some panelists noted specific areas where they are concerned. Interest-only sub-prime mortgage loans were the most frequently cited example. Many panelists also noted the possibility that rising interest rates or stagnant home price appreciation could suppress activity in the sub-prime mortgage sector.

Meanwhile, the securitization industry is still wrestling with a raft of tough issues on the legal, accounting, and regulatory fronts. The SEC disclosure proposal provided new grist for the discussion mill. FIN 46 and FAS 140 have been jointed by EITF 03-1 on the menu of accounting issues. Predatory lending laws remain a headache. Basel II was released in late June, but the market won't know its full impact for years.

And, of course, the market must continue waiting to learn the final outcomes in the cases of alleged fraud: NCFE and DVI. Television litigation is so much more satisfying…

The following summaries reflect remarks of the panelists who participated in selected sessions at the ABS East 2004 conferences sponsored by Information Management Network. 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. 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 organizers in hosting the conference.

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

Sessions Covered Page

Please read the important disclosures and analyst certifications appearing on the last page.

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8:15 am – Election Year 2004: Are Your Deals Better Off Now Than they Were Four Years Ago

Global structured finance issuance is estimated to reach nearly $1.6 trillion for 2004. Growth in the U.S. has been driven by residential MBS and student loan ABS. Growth of the asset-backed commercial paper (ABCP) sector has leveled off due to regulatory and accounting constraints. Issuance of home equity loan-backed ABS (HEL ABS) this year will be greater than all ABS issuance in 2001.

It's the Economy Stupid: Strong investor demand continues to put pressure on spreads and to sustain strong liquidity in the ABS market. Many European investors have increased their allocation to ABS. CDOs have strong demand for ABS mezzanine and subordinate tranches and supply liquidity in those areas. From the supply side, the U.S. housing market has remained strong. Economists predict 5% housing price growth in 2005. Overall, ABS spreads are tight. However, some sectors remain troubled: MH, aircraft, franchise. Market participants have learned that it is necessary to focus on seller/servicer risk when analyzing ABS.

From a national perspective, the housing market is strong. Home price appreciation is robust and housing affordability remains satisfactory. However, home prices in a few metropolitan areas may be overheated. Lenders' underwriting practices have adjusted to reflect regional concerns. In addition, some new products, such as interest-only sub-prime mortgage loans, are controversial.

Another panelist feels that technical factors – particularly heavy demand – are the main drivers of today's ABS market. Trouble in the housing market or a scandal affecting an ABS issuer could cause demand to wane. In addition, new loan products such as ARMs and interest-only ARMs may partly explain why recent home price appreciation has been strong. That appreciation may prove to be only "temporary."

Transparency: One investor panelist wants to get loan level information on every deal. In contrast to the CMBS area, ABS investors usually do not get loan tapes. Averages (summary statistics) do not tell the whole story; understanding outliers is very important. Loan level data is important not only for a security's primary offering but also for secondary trading. Some issuers are more willing than others to provide loan level data.

There is a major trend toward improved transparency and the SEC is partly responsible for it. The SEC wants ABS investors to be as informed as possible. Over the past year, there has been a trend for servicers to report additional data. For example, GMAC has done a great job of providing information (on its website) about the franchise loan deals that it services. Loan level data may not be the most helpful in certain kinds of deals, such as where there are very large numbers of borrowers.

In the home equity area, FICO score information is very helpful because investors can use it as a predictor of future default rates. The credit card area is far behind because credit card issuers generally do not disclose the FICO scores of the credit card holders.

Regulatory: The SEC's disclosure proposal for ABS[1] is very comprehensive and probably will make more information available to investors. The rule calls for disclosure of static pool data, which investors badly need. FICO scores examine the following borrower characteristics: payment history, debt ratio, length of history, propensity to apply for new credit, and credit mix (revolving vs. other).[2] FICO scores provide a first blush indication of how a borrower will perform over time. Research from some securities dealers has demonstrated that borrower FICO scores are statistically significant indicators for the performance of home equity loans.

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[1] Securities and Exchange Commission, Asset-Backed Securities, Release Nos. 33-8419, 34-49644, 69 Fed. Reg. 26650 (13 May 2004) [hereinafter "ABS Disclosure Proposal"]. The release is available online from the SEC's website at http://www.sec.gov/rules/proposed/33-8419.htm or http://www.sec.gov/rules/proposed/33-8419.pdf.

[2] *See generally* http://www.myfico.com/myfico/CreditCentral/ScoreConsiders.asp.

One investor panelist hopes that the SEC will require issuers to disclose static pool data and FICO scores for most kinds of consumer ABS.

From an issuer's perspective, recent dialog with the SEC has been a good process involving the exchange of meaningful information. Issuers have been making progress in improving disclosure and they are providing somewhat more information.

FAS 140 and FIN 46 have been the big issues on the accounting side.[3] New accounting standards and re-interpretations of old ones have created challenges for issuers. The industry was active in trying to shape the final outcome of Basel II.[4]

One issuer panelist questions whether investors will differentiate (tier) between issuers that provide better (more) information and those that do not. Predatory lending is still a hot topic. There have been several bills floating around the House and the Senate but nothing has come to fruition. A third regulatory area that can affect ABS is the GSE's; if they stop buying senior HEL ABS it could affect the market.

One investor panelist challenges the notion that investors do not differentiate based on information. The panelist posits that the ABS market temporarily has become a "sellers' market" and that investors at the margin are less demanding and much less sophisticated ("stupid money") than the major ABS investors.

Malfeasance & Fraud: Moody's is looking very carefully at non-investment grade seller/servicers. Moody's is focusing increasingly on seller/servicer risks.

Although the market has gained experience with fraud, there is no sure fire way to prevent fraud. However, market participants can minimize fraud by following common sense procedures. (1) An underwriter should become thoroughly familiar with an issuer that it represents. The underwriter should examine several years' worth of audited financial statements and sometimes should conduct a security background check. (2) All types of market participants should focus more closely on structural issues and on how information flows within a deal. (3) ABS deals should include a greater degree of independent review and auditing during their lives.

Fraud is very difficult to detect. Business practices have become much more conservative than they were in the late 1990s. In dealing with new issuers today, investors will ask more questions and probe more deeply than they would have in the 1990s. Investors will exercise the greatest scrutiny over a new issuer that is a private company.

Underwriters have learned that it is less acceptable to do deals for small specialty finance companies that could not exist without securitization as a primary means of financing. In the 1990s, ABS underwriters arguably did not perform sufficient due diligence. Underwriters have become much more cautious about what issuers they will bring to market.

A critical area is conflicts of interest. For example, there is a potential conflict where a servicer holds a residual interest. The servicer may have an incentive to mis-report pool performance so that cash flow to residual interest can continue. Investors want to understand whether a servicer manipulates reported performance – even in legal ways, such as repurchasing delinquent loans – so that residual cash flow can continue. The key is disclosure about whether the servicer is taking such actions.

But, conflicts of interest can be much worse. In NCFE, the borrowers and NCFE (the lender) had many common directors.

[3] FASB, Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (Sep 2000) (available at http://www.fasb.org/st/). Information about the status of the FASB project to amend FAS 140 is available at http://www.fasb.org/project/qualifying_spe.shtml.

[4] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards, A Revised Framework* (June 2004) [hereinafter "Basel II"] (available at http://www.bis.org/publ/bcbs107.htm)

The SEC may become a watchdog over the public ABS sector. The 144A/private placement market may have to develop alternative watchdog mechanisms to address the inherent conflict between "debt" and "equity" in an ABS deal.

Deal Cops: Trustees can continue to perform their traditional administrative role or they can assume a more proactive protective role in deals. In some recent deals, trustees have the task of performing ongoing collateral testing. Trustees can provide an extra set of independent eyes. Deals can include a "trustee trigger event" that makes the trustee more involved following a deterioration of a deal's seller/servicer. Backup or successor servicing can be a problem if a deal does not have a mechanism to pay the expenses of a servicing transfer.

Asia: Asia is more stable today that in recent years. Securitization is gaining visibility in Korea and Taiwan. RMBS is strong in Australia, but home prices are an issue. Korea is coming back from trouble in the credit card area. Taiwan is active in mortgages, CDOs and autos. CMBS is booming in Singapore. Thailand should get its first credit card deal soon. China will bring some NPL deals and some performing asset deals.

Europe: UK and Spanish ABS markets have been very strong. CDOs continue to grow strongly in Europe. One area is Maastricht deals (sovereign ABS deals) by countries that have to balance their budgets, such as France and Germany.[5] European investors are increasing their allocations to ABS, which has contributed to global demand. Synthetic deals are very hot in Europe.

Going Forward: Watch for middle-market loans as an up-and-coming area. Hedge funds and private equity funds are moving into this area. Timeshares is likely to resurface as a hot area and manufactured housing will creep back.

Another dealer expects strong growth in the CDO area and increasing CDO activity in purchasing mezzanine ABS. The student loan sector should grow. Tight spreads may draw issuers to the term ABS market from the ABCP area. Investment banks are likely to expand principal finance activities in areas beyond RMBS and CMBS.

The housing market, spreads, and international issuance all will be up. Borrowers have many alternatives for financing.

9:30 am – Gazing into the Crystal Ball – ABS Market Trends, Developments and Future Outlook

Surprises for 2004: (1) *Growth of Home Equity ABS Sector*: Most market participants failed to predict the strong growth of the home equity ABS sector in 2004. Low interest rates were a key driver of the growth, but so were interest-only sub-prime mortgage loans and home price appreciation. Home price appreciation allowed many sub-prime borrowers to take equity out of their homes with cash-out refinancings.

(2) *Growth of the Whole Loan Market for Both Mortgage and Non-Mortgage Assets*: Originators like selling whole loans as a way to avoid retaining residual interests. Some originators like to use a combination of securitization and whole loan sales to preserve their funding options. The market for whole auto loans is in the range of $8 billion to $12 billion. Auto makers' desire for capital relief is a key driver of the market for whole auto loans. Sometimes investors buy whole loans for investment and do not securitize them.

(3) *Continued Tight Pricing*: Demand for ABS remains very strong; a flood of liquidity has hit the market. Some new demand comes from the Middle East. CDOs also create demand for new issue

[5] Under the Maastricht Treaty, the members of the Economic and Monetary Union must achieve specified "convergence criteria." Those criteria restrict national debt to no more than 60% of gross domestic product. Some countries have used securitization as a way to reduce their debt levels. However, in doing so some guaranteed their deals and those guarantees caused Eurostat to classify the full amount of the guaranteed deals as part of national debt. *See* "Convergence criteria," Glossary, European Union Online, (available at http://europa.eu.int/scadplus/leg/en/cig/g4000c.htm); "Convergence criteria," Glossary, Virtual Economy (available at http://www.bized.ac.uk/virtual/economy/library/glossary/); European Commission, *ESA95 Manual on Government Deficit and Debt – Securisation Operations Undertaken by General Government (Part V)* ¶ V.2.4 (2003) (available at http://epp.eurostat.cec.eu.int/cache/ITY_OFFPUB/KS-BE-03-001/EN/KS-BE-03-001-EN.PDF)

ABS. Despite problems in a few isolated areas, ABS have performed well overall. From a relative value perspective, ABS deliver better returns than corporate bonds. It remains to been seen whether the strong demand is temporary or permanent. Panelists disagree about whether spreads will remain tight or widen over the coming year. One issue is the potential withdrawal of the GSEs from ABS market because of recent accounting scandal at Fannie Mae.[6]

Volume Outlook for 2005: Panelists expectations for next year's growth of the ABS market range from –20% to +5%. The home equity ABS sector could shrink if home values stop rising or if personal income growth stagnates. It is unclear whether Wall Street or the lenders will be able to create and promote new products to follow on the heels of ARMs and interest-only ARMs.

Fed Funds Rate Outlook for Dec 2004 and Jun 2005: Panelists' expectations for Dec 2004 range from 1.75% to 2.25%. Expectations for Jun 2005 range from 1.75% to 3.25%. Consumer spending may be weak in 2005. Employment is somewhat weak because job growth has been anemic. GDP growth is likely to be weak. Rising oil prices are a further drain. Both consumers and the government are highly leveraged. Rising interest rates could be damaging to both household finances and government budget deficits. The Federal Reserve realizes that high interest rates could hurt the economy and should be very cautious about raising rates. On the other hand, the Federal Reserve has indicated that it intends to move rates back to long-term neutral levels.

How High Would the Fed Funds Rate Have to Be Before It Would Affect Consumers?: Panelists have very divergent views on how vulnerable consumers are to potential increases in the Fed Funds rate. The range of Fed Funds rate levels at which the panelists would be concerned is from 2.5% to 5%. One panelist expresses the view that consumers are well positioned to withstand a rate increase. On the other hand, sub-prime borrowers may be vulnerable; especially borrowers with hybrid ARMs or interest-only ARMs. Recent home price appreciation has been driven partly by the low rate environment. Higher interest rates could hurt home prices and could trigger more defaults.

Asset Type with the Most Potential for Growth in 2005: Most panelists identify student loans and CDOs as the two areas with the most potential for growth in 2005. Two panelists identify credit cards as a potential growth area. One panelist noted energy as a potential growth area and one noted insurance. In the student loan area, major growth should come from private (alternative) student loans. Credit card ABS issuance could grow simply because the area has been somewhat slow this year. The high value that Americans place on education is a driver for the student loan area. The alternative student loan sector remains poised for growth as long as parents are willing to cosign their children's student loans and as long as students are willing to take on huge debt to finance their educations. The student loan sector could get a boost from slowing home price appreciation. Parents often use home equity lines of credit (HELOCs) to finance their children's educations. However, slowing home price growth could make HELOCs unavailable for that use, giving a boost to private student loans. The monoline bond insurers expect Triple-X insurance securitization to expand. Securitization helps insurance companies address the higher reserve requirements under Regulation Triple-X.[7]

Asset Type with the Most Potential for Significant Problems in 2005 and What is the Likelihood for a Shakeout in Mortgage-Related ABS in 2005?: Panelists' estimates for a shakeout in the mortgage-related ABS area in 2005 range from 1% to 80%. Nearly all panelists feel that the mortgage-related ABS area is the one with greatest potential for problems in 2005.

Presidential Prediction: Five panelists expect President Bush to win the election. Three panelists expect that Senator Kerry will win.

[6] *Analysts Debate Impact of Fannie's Hedge Accounting As Market Assesses Fallout from OFHEO Report*, Inside MBS & ABS, 15 Oct 2004, at 8.

[7] *Compare*, Valuation of Life Insurance Reserves, 11 NYCRR 147 (available at http://www.ins.state.ny.us/acrobat/r147text.pdf) (implementation of Regulation Triple-X in New York).

Does the ABS Market Ever Learn Its Lessons?: The new rating agency interest rate assumptions for HEL deals[8] may mean that older deals could be exposed to greater risk of being downgraded if interest rates rise. Yet, much of the market seems to be ignoring the issue. A year hence, many market participants might say that such downgrades should have been foreseeable (*i.e.*, that the market does not learn its lessons). On the other hand, the securitization market is no worse than other sectors of the capital markets in being slow to learn from its mistakes.

Is Healthcare Securitization Tainted Forever?: The market is likely to remain skeptical of healthcare securitizations because the government involvement invites manipulation and gamesmanship.

11:15 am – Dynamics of the Sub-Prime Mortgage ABS Market: Market Trends, Regulatory Environment, Credit Performance and Securitization

The sub-prime mortgage market continues to be extremely strong and is poised to have another record year in 2004. Low interest rates have fueled the strong pace of activity.

Factors that Have Contributed to This Year's Record Volume?: Other than low interest rates, product innovation has been a driver of the market's growth. Interest-only loans are a key example. Another key factor has been home price appreciation. Sub-prime borrowers are "serial refinancers" who take cash out of their homes every few years. So-called "alt-B" product has further helped to fuel growth. Historically, issuance volume in the sub-prime mortgage ABS market has amounted to 8%-10% of the issuance volume of the prime-quality MBS market. However, in recent months, issuance volume in the sub-prime mortgage ABS market has amounted to roughly 20% of the prime market. Alt-B lending could be drawing business away from the prime market; for one sub-prime lender, about 7% of new loan originations have borrowers with FICO scores over 700.

Securitization has brought a better mortgage financing value to sub-prime borrowers. Before the mid-1990s, a borrower who could not qualify for a prime loan was treated as a category "C" borrower and had few borrowing options.

Trends in Sub-Prime Mortgage Loans: Over the long run, FICO scores have tended to rise in sub-prime mortgage pools. However, the rise in FICO scores has leveled off over the past few years.[9] Also, loan-to-value ratios (LTVs) have been rising in sub-prime mortgage pools. Reduced documentation loans are becoming more common in sub-prime mortgage pools.

Sub-prime mortgage origination volume will likely be around $450 billion for the year. Sub-prime mortgage ABS issuance probably will reach around $300 billion.

The three key factors driving sub-prime mortgage origination volume in 2005 will be (1) interest rates, (2) home price appreciation, and (3) encroachment from the prime-quality sector as prime-quality lenders stretch underwriting standards to sustain their origination volumes. Other potential factors include the labor market and the competition among sub-prime lenders. Additionally, the continuing participation of the GSE's as investors could affect originations.

One panelist anticipates very modest volume growth in originations for next year.

Sub-prime mortgage originations have slowed slightly over the past few months after peaking early in the year.

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[8] Osterweil, T., et al., *Criteria for U.S. RMBS Interest Rate Vectors Revised*, Standard & Poor's special report (29 Jul 2004) (effective for transactions rated after 1 Nov 2004); Kornfeld, W., *U.S. Subprime Mortgage Securitization Cashflow Analytics*, Moody's special report (17 Mar 2004).

[9] A recent CREDIT SIGHTS article that the average FICO score has drifted upwards over the past 10 year:

> While average FICO scores typically ranged in the mid-600s 10+ years ago, now it seems that it hovers around and above 700. Like the phenomena of inflated SAT scores for college bound students in an effort to get more kids in to more schools, and even the Olympics where gymnastics scoring is range bound in the "9"s that used to be almost unattainable in the 1970s. FICO scores have become more accepting of the myriad and diverse spending and debt service habits of Americans.

Hendler, D., and Hofman, R., *Consumer Credit Scoring: Is FICO Fixed?*, Credit Sights (24 Aug 2004).

Competitive Landscape: How do lenders measure or calculate their origination costs? One lender includes all the costs of the organization (other than servicing costs), plus yield spread premiums, fees and commissions to third parties. That lender estimates that its costs are around 2.15% to 2.30%. For that lender, commissions are the largest components of origination costs and yield spread premiums amount to just 10 bps. A second lender uses a similar methodology for gauging its origination costs and it estimates its all-in cost in the range of 1.85% to 2.10%. A third lender uses the same approach and notes that its cost is about 50 bps higher than the others', but that much of the difference is attributable to yield spread premiums for purchasing loans with higher interest rates.

Are Lenders Pricing Loans Irrationally?: Some lenders have cut their offered interest rates in order to gain market share. The potential problem is that they are cutting their margins. Some lenders seemingly are more focused on market share than on profitability. Those lenders may have large cost structures that they need to support with high-volume originations.

Servicers: Today's servicers are better capitalized than those of several years ago. Many are REITs or public companies, which improves transparency about servicing risks. From a rating perspective, it generally is desirable for a servicer to hold a residual so that it has "skin in the game" with respect to the performance of the loans. Pure third-party servicing arrangements may lack the benefits of feedback loops to promote strong originations and strong servicing.

Is 50 bps a Sufficient Servicing Fee for Sub-Prime Mortgage Loans?: One lender uses a servicing fee structure that steps-up over a loan's life.[10] In the "scratch and dent" area, servicing fees sometimes are structured at a fixed price per loan.

REIT Conversions: A REIT conversion by a company that routinely securitizes and retains residual interests is not a significant event. A conversion by a company that has not routinely retained residual interests may be a more significant event. The REIT structure offers tax advantages but it creates complexities for a company. "A REIT becomes an owner of its loans."

Predatory Lending: The rating agencies do not all agree about whether to allow loans secured by properties in New Jersey into securitization pools. The next state to have a tough law is likely to be Massachusetts. The Massachusetts law[11] is likely to be as tough as the Georgia law was.[12] At the federal level, some lawmakers are pushing for a federal standard, but some of the proposals would be very strict. Some of the proposals for a federal standard would be more strict than most of the state laws. If Senator Kerry wins the Presidency, we might see a very strict federal standard that does not explicitly overrule state laws. One lender states that predatory lending laws have made it decide to stop lending in certain states.

Future Credit Performance: The key drivers of future credit performance will be interest rates, home price appreciation, and the mix of loan products. Interest-only loans may be particularly vulnerable to slowing home price appreciation. California home prices have climbed so sharply that the potential for stagnant appreciation is substantial.

Spreads: Triple-A spreads have recently widened, but credit spreads generally have remained strong. Technical factors were a key factor in the recent widening, after the tightening earlier in the year. Demand remains strong from the CDO sector and from outside the U.S. It is unclear whether Fannie Mae's recent problems have been a cause of the recent widening for triple-A sub-prime mortgage ABS. One investor feels that triple-B spreads are excessively rich right now.

1:45 pm – ABS Relative Value Outlook: Lessons Learned in 2004 and Opportunities for 2005

Has the Economic Recovery Affected Investors' Allocations to ABS?: One investor says that its general strategy is to overweight structured product. Although the economic recovery did not

[10] For example, 0.30% for the first 10 months, 0.40% for months 11 through 30, and 0.65% for all subsequent months.

[11] Chapter 268 of the Acts of 2004 (available at http://www.mass.gov/legis/laws/seslaw04/sl040268.htm).

[12] Georgia Fair Lending Act, Ga. Laws § 7-6A-1 et seq. (before being amended by Ga. S.B. 53 (2003)).

precipitate the investor's general strategy, it has prompted the investor to participate more actively in deals backed by esoteric assets.

A second investor challenges the notion that there has been an economic recovery – recent spread tightening just makes is seem as though there has been one. The experience of the past few years arguably shows that consumers are more willing and more able to pay their debts than the market had anticipated. Now that there is only minimal degree of tiering among ABS deals, there are opportunities for investors to trade into stronger structures and into deals from stronger issuers without sacrificing much yield. The strength of the economy has not prompted the investor to increase its allocation to deals backed by receivables from sub-prime consumers (and away from deals backed by receivables from prime-quality consumers)..

A third investor has increased its allocation to sub-prime auto deals. That investor particularly favors deals from issuers that can supply abundant data.

How Does the Prospect of Rising Interest Rates Affect ABS Investment Strategy?: One investor observes that the entire market made an incorrect prediction about the movement of interest rates earlier this year. The lesson is that it is hard (impossible) to predict movements in interest rates. The investor tries to be duration-neutral and to add alpha (outperformance relative to an index) by careful security selection. The investor tries to stay more positively convex than its benchmarks and favors NAS bonds from home equity ABS deals.

Rising interest rates arguably pose two threats for mortgage-related ABS. One is their impact on home prices and the second is payment shock on ARMs and interest-only loans. Flat or falling home prices can increase defaults if home owners in financial distress feel that their homes may not be worth as much as their loans.

Another fixed-rate investor favors NAS bonds but also considers last-cash flow HEL ABS in order to get extra yield.

What About Differences in Pricing Speeds on New Issues Compared to Speeds Used for Pricing Secondary Trades?: One investor, who focuses on mezzanine and subordinate tranches, examines deals under a range of prepayment assumptions including both flat speeds and vectors. Another investor notes the issue of pricing deals to call or to maturity.

What Are the Top Three Concerns of ABS Investors?: One investor identifies three main concerns as (1) a downturn in the mortgage sector from either rising interest rates or home price declines, (2) declining consumer credit quality, and (3) exogenous shocks. A second investor perceives consumer credit quality as concern with a time horizon that starts in 18 to 24 months. Investors cannot afford to simply hold cash; therefore, they must not exaggerate their concerns about the prospects of the ABS sector. A third investor expresses concern about the recent dearth of non-mortgage product and about how tight spreads have been.

Investor Due Diligence on ABS Seller/Servicers: According to one investor, the hardest risk to quantify is the absence of information about a seller/servicer. The investor refuses to buy deals for which it lacks adequate information. When adequate information is available, the investor tiers deals based on the strength of the seller/servicer, demanding wider spreads on deals from weaker issuers. A second investor echoes the view that the right move is to walk away from a deal where the issuer cannot supply adequate information. Equipment ABS is a tough sector because collateral substitutions cloud the true performance of the securitized assets. Tiering has become more complex than it was in the past. Investors have to decide for themselves about pay-ups (tighter spreads) or premiums (wider spreads) that they will accept or demand for deals from different seller/servicers. A third investor states that it demands premiums for deals from financially weak seller/servicers and for retail credit card deals (relative to bank card deals). The investor also demands premiums for deals backed by off-the-run (esoteric) assets that require specialized servicing skills.

Healthy vs. Unhealthy Growth of the ABS Market: Consolidation of seller/servicers makes the industry stronger and promotes healthy growth. Origination should remain strong as ARM credit curing keeps borrowers refinancing. Expansion of hybrid ARMs and the growth of interest-only mortgage products has helped to sustain growth in the sub-prime mortgage area. The products introduce certain risk elements, but unless loan characteristics generally become weaker there should not be a problem (this view seems to be the minority position).

Issuer Exposure Limits: One investor focuses on both originator and servicer exposure limits. The investor is wary of high concentrations.

Collateral Trends: Rising FICO scores in sub-prime mortgage pools are a positive development.[13] However, loan-to-value ratios (LTVs) also have been rising. In addition, newer pools contain higher proportions of cash-out refinancing loans and loans underwritten with reduced documentation, both of which are somewhat riskier than standard loans. Interest-only loans account for up to 20% of some sub-prime mortgage pools. Sub-prime mortgage lenders are investigating even riskier loans products, such as loans with ***no payments*** for the first year. In the auto loan sector, lenders are also pushing to make riskier loans.

A second investor feels that sub-prime mortgage loan originations have gotten riskier over the past year. The rising prevalence of interest-only (IO) loans is an important development because there is no performance history on IO loans. The investor has pulled back from deals that contain high proportions of IO loans.

Another investor observes that sub-prime mortgage deals often lack disclosure about "piggyback seconds."[14] When the investor asks about piggyback seconds or about first-time homebuyers issuers usually cannot provide answers.

Spread Trends: Technical factors exert a strong influence on home equity ABS spreads. Strong demand from the GSEs is a key factor for spreads triple-A-rated home equity ABS. Demand from CDOs is a key factor for spreads on triple-B-rated home equity ABS. A second investor expects that the GSEs will remain active investors in home equity ABS. However, market participants should not simply dismiss the possibility that the GSEs might be forced to withdraw from the sector. If the GSEs were to withdraw from the sector, spreads on triple-A-rated home equity ABS likely would widen.

Structure: An investor in fixed-rate home equity ABS focuses closely on triggers. Breaches of trigger tests can cause the weighted-average lives (WALs) of front-cash flow tranches to lengthen and can cause the WALs of back-cash flow tranches to shorten. A possible strategy for investors is to buy the back-cash flow tranches from deals that are about to fail their trigger tests. An investor can benefit from the shortening of such a tranche's WAL caused by a trigger breach.

A second investor notes that servicers exercise "clean-up calls" in only about half of all deals. Some investors can gain an advantage from the fact that most new deals are priced to call. Intex allows an investor to test many alternative scenarios. [The holder of a subordinate certificate can benefit from a deal not being called because the ongoing flow of excess spread may partly offset past shortfalls. Likewise, an investor who purchases a security at a premium benefits from a deal not being called].

Down in Credit: Tiering has become compressed along both the issuer and vintage dimensions. Older home equity ABS deals, which used the easier rating agency interest rate assumptions,[15] should offer wider spreads. A second investor echoes the point that tiering by issuer financial strength now seems to be absent. That investor favors trading down-in-credit on collateral (*e.g.*, pools with lower FICO scores) but up-in-credit on issuer quality. Deals rated by only one rating agency can be very attractive, but investors need to do their homework to find the value.[16] Although markets always tend toward efficiency, inefficiency is what allows an investor to achieve superior performance.

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[13] *But see* Hendler, *supra* note 9.

[14] A "piggyback second" is a second-lien mortgage loan originated contemporaneously with the first-lien loan on the same property. The presence of a piggyback second may make the reported loan-to-value ratio of the first-lien loan a misleading indicator of the loan's probability of default.

[15] Osterweil, *supra* note 8; Kornfeld, *supra* note 8.

[16] Our studies have shown that deals rated by only a one rating agency are much more likely to suffer adverse credit migrations than deals rated by both Moody's and Standard & Poor's. *See*, Adelson, M., et al., *ABS Credit Migrations*, Nomura Fixed Income Research (updated 5 Mar 2002).

Panelists' Picks and Pans for 2005	
Picks	**Pans**
available funds cap floaters	manufactured housing ABS
long WAL triple-A home equity ABS	ABS from distressed sectors
single-A-rated credit card ABS and non-prime auto ABS	triple-B-rated home equity ABS
5-year sequential and NAS tranches of home equity ABS	
3-year tranches of home equity ABS from second tier issuers	
single-A-rated credit card ABS, fixed-rate home equity ABS, and floating rate home equity ABS backed by floating rate amortizing loans (*i.e.*, not interest-only loans)	equipment ABS
ABS rated by only one rating agency	manufactured housing ABS

2:45 pm – Student Loans

Introduction: This year will be a record year for the student loan ABS market. Roughly $49 billion in 75 deals has been issued through September 30. Not for profit entities accounted for 84% of issuance in the first nine months of the year. Issuance for the full year is estimated to reach $65 billion. Sallie Mae's issuance accounts for slightly more than half the market. Roughly $6.7 billion of ABS backed by alternative student loans has been issued through the first nine months of the year. About 70% of the $6.7 billion issuance comes from for-profit entities.

Market participants anticipate continued growth in 2005, but at a slower rate. The wind-down of the Sallie Mae GSE is a factor because a substantial portion of Sallie Mae's recent issue was for refinancing the GSE's debt. Over a longer horizon, growth prospects for the student loan ABS sector depend on continuing developments with the FFELP program, such as possible reconsolidation of previously consolidated loans (a low probability scenario).[17]

Reauthorization of the Higher Education Act has not yet happened.[18]

In 2004, student loan ABS displayed some new structural features. There were more LIBOR floaters, as opposed to auction rate notes. State agencies and not-for-profit lenders are starting to use LIBOR floaters instead of auction rate paper. The SEC investigation of auction rate deals[19] has caused some student loan ABS issuers to want to diversify their funding into instruments other than auction rate notes. Sallie Mae has issued Baa1-rated tranches this year (SLM Student Loan Trust 2004-A, Class C).

The Department of Education has designated seven student loan servicers as tier one servicers, which means that they receive full reimbursement for 12 months following designation.

Panelists expect to see new innovative structures later this year and early next year.

GSE Wind-Down: Part of the rising volume of student loan ABS over the past few years has been a result of the efforts to wind-down the Sallie Mae GSE (SLMA).[20] As of now, there are no student loans left in the GSE. Much of Sallie Mae's student loan ABS issuance was associated with

[17] Consolidation loans are one of several types of federally insured FFELP loans. *See* Higher Education Act, 20 U.S.C. § 1071 *et seq.* FFELP stands for Federal Family Education Loan Program. FFELP loans include (1) subsidized federal Stafford loans (§ 1077), (2) unsubsidized federal Stafford loans (§ 1078-8), (3) federal PLUS loans (§ 1078-2), and (4) federal consolidation loans (§ 1078-3).

[18] Although the Congress has not reauthorized the Higher Education Act (HEA), it did extend the HEA through the 2005 fiscal year. *See*, Higher Education Extension Act of 2004, H.R. 5185, 108th Cong. (2d Sess. 2004) (presented to President 10/13/2004). Full reauthorization appears to have been stalled by partisan squabbling. *See*, Democratic Staff, Committee on Education and the Workforce, U.S. House of Representatives, *Update on Reauthorization of the Higher Education Act* (available at http://edworkforce.house.gov/democrats/higheredinfo.html#info).

[19] *See, e.g.*, *SEC Probes Deception in Bond Auctions*, Associated Press, (24 Jun 2004) (available at http://www.forbes.com/feeds/ap/2004/06/24/ap1432727.html); *SEC Probes Brokers' Ties to Bond-Auction Investors, People Say*, Bloomberg (19 Jul 2004) (available at http://www.xak.com/main/newsshow.asp?id=34608).

[20] SLM Corporation, Quarterly Report on Form 10-Q for the Quarterly Period Ended 30 Jun 2004, at 12.

refinancing loans that had been in the GSE. Going forward, Sallie Mae's issuance volume will depend on new business volumes.

SEC Developments: The SEC did not tailor proposed regulation AB to specific assets.[21] For student loans, the proposal created some problems. For example, the 20% delinquency limitation did not reflect the deferment and forbearance features of student loans. Likewise, servicer disclosure requirements arguably go too far and would require information about collection agencies. Static pool data requirements on FFELP loans may be irrelevant.

Reauthorization: Reauthorization will not happen in 2004. In September, lawmakers extended the Higher Education Act through November. Recently, Congress passed a bill to extend the Act to 30 September 2005.[22] When reauthorization happens, it likely will provide for $1,000 increases in loan limits for freshmen and sophomores. Reauthorization may provide for floating rate consolidation loans. Congress has passed legislation to eliminate the 9½% minimum yield paid to certain student loan lenders.[23] The legislation is waiting for the President's signature. Any changes to the "Single Holder Rule"[24] could affect rate of prepayments by changing the requirements for consolidation. There is only a slight chance that reauthorization will provide for a shift back to a direct loan program. However, if that happens, it would reduce supply of FFELP loans.

Private (Alternative) Student Loans: The small expected increases in FFELP loan limits should continue to drive growth in private student loan activity. Alternative student loan securitization activity through the first 10 months of 2004 should exceed activity for all of 2003. Alternative student loan securitizations increasingly use senior-subordinate structures with excess spread trapping, instead of bond insurance. Most use alternative student loan ABS are LIBOR floaters, rather than auction rate notes. The main issuers of alternative student loan ABS are: Sallie Mae (50% market share), First Marblehead, Keycorp, and Access Financial. Smaller issuers include Northstar, Education Loans Inc. (EdLinc), and Minnesota Higher Education

Tax Exempt Issuance: Non-profit issuers have had to confront reduced limits (*i.e.*, caps) for their tax exempt issuance. Not-for-profit entities are likely to issue more "rate reset notes." After an initial floating rate period, the notes can be converted to an ordinary auction rate mechanism or they can be reissued for another 3-, 5- or 7-year floating rate period.

European Investors: European ABS investors, including SIVs, have strong appetite for U.S. student loan ABS. Some large fund managers are re-allocating their portfolios to ABS and, in particular, student loans. Seven-year WAL paper is particularly appealing because spreads have tightened on 3-year and 5-year ABS.

4:15 pm – Real Estate ABS Researchers' Roundtable

Home Price Appreciation: One panelist feels that it is not meaningful to view the housing market as a whole. Rather, it is more useful to examine housing markets locally. For example, the housing market in Southern California experienced severe stress in the early 1990s. At the same time Northern California experienced only modest stress. Conversely, the decline of the "dot coms" placed stress on Northern California, but not on Southern California. In real terms, home prices are not far from where they were 15 years ago (using CPI as the deflator; which is somewhat circular

[21] ABS Disclosure Proposal, *supra* note 1.

[22] Higher Education Extension Act of 2004, *supra* note 18.

[23] Taxpayer-Teacher Protection Act, H.R. 5186, 108th Cong. (2d Sess. 2004) (cleared for White House 10/9/2004); Committee on Education and the Workforce, U.S. House of Representatives, *House Passes GOP Bill to Shut Down Excess Taxpayer Subsidies for Loan Providers, Use Money to Help Teachers and Poor Schools*, press release (7 Oct 2004) (available at http://edworkforce.house.gov/press/press108/second/10oct/teacherloans100704.htm); Democratic Staff, Committee on Education and the Workforce, U.S. House of Representatives, *Congress Shrinks, But Doesn't Stop, Student Loan Swindle*, press release (7 Oct 2004) (available at http://edworkforce.house.gov/democrats/releases/rel10704.html); Committee on Education and the Workforce, U.S. House of Representatives, *Republican Bill Does Not Leave "40 Percent" of Excess 9.5% Subsidies Intact; Any Subsidy Cuts Beyond Those Made in GOP Bill Will Hurt Non-Profit Student Aid Providers*, press release (6 Oct 2004) (available at http://edworkforce.house.gov/press/press108/second/10oct/40percent100604.htm).

[24] 20 U.S.C. § 1078-3(b)(1); 34 C.F.R. § 682.201(c).

because housing accounts for about 25% of CPI).[25] Lower priced homes have gained value faster, in real terms, than higher priced houses. Compared to household incomes, home prices are about where they were fifteen years ago. Affordability is starting to be tested on the coasts. A crash in home prices is unlikely, but it is also doubtful that we will observe double-digit growth. Home price appreciation of 2%-3% is most likely.

Another panelist observes that the cost of expecting a bubble to burst is very high. The baseline assumption for housing should be positive. Even if home price appreciation slows down, it will take some time for the slowing to be observable. The panelist expects baseline growth in the range of 3% to 4%.

A third panelist feels that too much emphasis has been placed on the flat (0%) growth scenario. Any slowdown in home price appreciation should tend to increase delinquencies and losses in home equity ABS deals.

A fourth panelist counters that sub-prime borrowers have more debt today than ever before and that the high debt levels could heighten performance challenges for home equity ABS.

<u>How Has the Evolution of Mortgage Products Contributed to Home Price Appreciation?</u>: ARMs are becoming a growing share of the whole mortgage market. However, in the sub-prime mortgage sector, 2/28 hybrid ARMs are the most common and their reset after only two years may pose challenges for many borrowers. It seems likely that 2/28 hybrid products have artificially stoked home prices. The panelist feels that home prices are generally overheated.

<u>Payment Shocks</u>: Payment shock risk is hard to quantify. Recent history through a period of declining rates is unhelpful. However, there is evidence that coupon resets on hybrid ARMs tend to trigger higher defaults. When a borrower's debt-to-income ratio exceeds 45%, he may be particularly vulnerable.

Another panelist agrees that many borrowers are over-leveraged. He also expresses a cautious view of interest-only loans. Borrower debt-to-income ratios on interest-only (IO) loans tend to be about four percentage points higher than for regular amortizing loans. That is a sign that IO loan borrowers are stretching for leverage. He is undecided as to whether the rating agencies have added sufficient credit support for interest-only loans.

<u>Loan Attributes</u>: Borrower FICO scores have been rising over the past few years. Fixed-rate loans to high-FICO borrowers have greater call risk that other loans (more prepayments when rates drop). However, it is debatable whether extension risk on such loans also is greater. Loss severities are very high for low balance loans. All other things being equal, higher FICO scores should mean fewer

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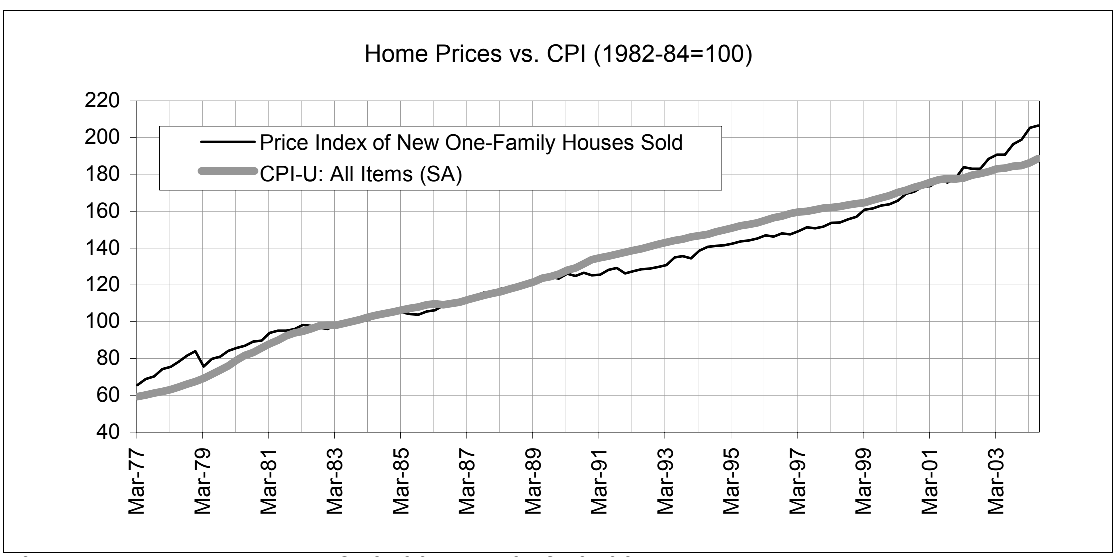
[25] The statement comparing of home prices to the consumer price index seems somewhat inaccurate:



Source: Haver Analytics (HPDEX@USECON and PCU@USECON) defaults. However, all is not equal; today's sub-prime mortgage loans with high FICO scores often have somewhat higher LTVs than did loans originated a few years ago. In addition, more of today's sub-prime mortgage loans were underwritten with reduced documentation. Interest-only loans tend to have higher balances and, correspondingly, to be secured by higher-value home. Many interest-only loans are to first-time homebuyers.

Prepayments on low-FICO agency pools reached 60% CPR on the recent rally. Prepayments on sub-prime mortgage loans only reached about 40% CPR. At the other extreme – on a sell-off – sub-prime mortgage loans have some extension risk, but less than conforming loans.

Strong home price appreciation has motivated some borrowers to refinance their loans in cash-out refinancings, even though they incur prepayment penalties in doing so. A borrower may be motivated to do such a transaction because the "cash-out" amount can be substantial, even after paying the penalty. However, if home price appreciation slows, those kinds of refinancings might stop — the amount of "cash-out" from home price appreciation might be insufficient after paying prepayment penalties or it might not even cover the penalties.

Available Funds Caps: The risk of available funds caps arguably is overstated. The cost of an available funds cap generally is in single digit basis points. However, excess spread compression is an issue and rising interest rates could leave some bonds under-enhanced. Rising rates could simultaneously squeeze excess spread and increase losses by reducing prepayments.

The rating agencies have strengthened their interest rate assumptions.[26] This is a step in the right direction. However, the rating agencies' action arguably reflects the fact that the market is reaching the analytical limits of using a single interest rate assumption for rating deals. Instead, the rating agencies should use a dynamic approach in their credit analyses. In particular, rating agencies should consider using OAS-type approaches (*i.e.*, analysis Monte Carlo simulations in which a model predicts performance under numerous interest rate scenarios).

Available funds cap risk varies across the classes in a deal. Triple-A tranches are unaffected by 200 bps moves in forward LIBOR. Mezzanine tranches are slightly impacted at a 100 bps move in forward LIBOR.

Information Content of Ratings: The fact that new interest rate assumptions go into affect next month (for S&P) makes it difficult for investors to understand how to interpret (S&P's) ratings right now. Rating agencies have not sufficiently explained how the new assumptions will change the necessary credit enhancement in new deals.

Prepayments: Prepayments have been faster than expected. Most of the "better" sub-prime borrowers who can prepay are doing so. This arguably produces a significant adverse selection phenomenon, leaving a pool with mostly weaker loans after three or four years. One the other hand, wishing for slower prepayments may pose a Catch-22: rising rates or slowing home price could slow prepayments and extend securities while creating additional credit stresses.

Innovation in loan products likely will continue to drive high levels of prepayments.

Fixed rate securities from the 2000 vintage have been hurt by adverse selection. Tail risk is the issue. Some of the deals have been downgraded and more downgrades may come in the future. Some of the deals have 60+ delinquency rates of 40% while still allowing their overcollateralization to step down (arguably reflecting weak structures). Newer deals have cumulative loss triggers (in addition to delinquency triggers) but servicers can manipulate the triggers by repurchasing loans or by recasting delinquent loans.

Disclosure: A deal's prospectus sometimes fails to accurately describe the provisions of a its governing documents. Market participants generally must rely only on prospectuses; they cannot get pooling and servicing agreements. For example, in a recent deal the description of the last-cash flow bond in the prospectus made it seem to have a weighted-average life (WAL) of roughly three years but, according to the mechanics of the pooling and servicing agreement, its real WAL was roughly

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[26] Osterweil, *supra* note 8; Kornfeld, *supra* note 8.

four years. Disclosure of a servicer's policy for advancing is sometimes too vague. Loan repurchases and their impact on performance measures are not sufficiently reported.

Conflicts of Interest: Rating agencies arguably should require independent calculation agents so that the holder of a deal's residual (often the servicer) is not the one deciding how to perform the calculations, such as trigger tests, that may control the cash flow to the residual.

Relative Value: The ABS market commands a premium for complexity. The real estate ABS market is fundamentally cheap to almost anything else out there. The best value is 3-year floating rate home equity ABS.

Panelist relative value picks:

- triple-A-rated floaters are the only cheap opportunity right now
- triple-A-rated floaters backed by prime-quality credits
- for down-in-credit investors: synthetic triple-B-flat exposure made from combining triple-B-minus and triple-B-plus tranches (*i.e.*, a triple-B-flat credit butterfly)
- double-B-rated tranches and back-end NIMs may offer spread tightening opportunity
- triple-A-rated floaters, 3-year and 5-year fixed-rate tranches, single-A and triple-B floaters, single-A and double-A fixed rate tranches, NIMs that yield more than 5.5%
- single-A-rated tranches; avoid triple-A floaters because of potential spread widening
- avoid triple-B-rated tranches
- triple-A-rated floaters and short fixed rate triple-A-rated tranches, tranches with a "plus" credit rating modifier (*e.g.*, A+, A1, BBB+, or Baa1) are cheap to tranches with "flat" ratings (*e.g.*, A, A2, BBB, Baa2), double-A-rated and single-A-rated tranches; avoid 5-year fixed rate triple-A-rated tranches.

Thursday, 14 October 2004

8:00 am – The Cutting Edge of Asset-Backed Securitization – Trends, Opportunities, & Pitfalls

Hot Asset Types: *Student Loans*: S&P expects to rate more than $60 billion of student loan ABS this year.

Growth prospects for student loan activity are positive. One driver is demographics; high school graduating classes are getting larger. The children of the baby boomers are now reaching college age. In addition, the cost of attending college is rising.

Sallie Mae started issuing student loan ABS in 1995 in anticipation of winding down the GSE. Investors have become very comfortable with the asset class, partly because of its credit stability. Sallie Mae's student loan ABS issuance has grown substantially over the past few years. The company's marketing and investor education initiatives have been key ingredients to sustaining liquidity and investor appetite while issuance has been growing rapidly. European demand for student loan ABS is quite strong.

Home Equity ABS: Lenders create new loan products, such as interest-only loans, which help maintain origination volumes but which may create credit challenges. Originators now have greater access to the capital markets than ever before; they can sell farther down the capital structure than ever before (double-B-rate tranches and NIMs). Sequential NIMs are coming on the scene.

Insurance Triple-X Securitizations:[27] The new regulation was intended to close prior loopholes. However, it is too strict and, according to some, it increases regulatory reserves to be eight times larger than reasonable economic reserves.

Investor Appetite: Investor appetite for home equity ABS has been strong in 2004, as evidenced by the huge volume of issuance that the market absorbed at tight spread levels. CDOs create strong demand for home equity mezzanine tranches. Investors also have displayed strong appetite for non-mortgage mainstream ABS (credit cards and autos) because supply has been only moderate. In off-the-run areas, investor appetite varies. Investors are not clamoring for deals backed by healthcare receivables or charged-off credit card receivables.[28] Triple-B home equity ABS trade in a notably tighter range than they did a few years ago, largely because of strong demand from CDOs. Nonetheless, a panelist emphasizes that the ABS market is not experiencing "irrational exuberance."

Asset-Backed Commercial Paper (ABCP): The ABCP market has shrunk slightly over the past few years. U.S. ABCP outstandings are now roughly $640 billion. Outstandings had been up to $740 billion a few years ago. Extendible ABCP accounts for more than 10% of all ABCP and the proportion is growing. The impetus for extendible ABCP was new capital rules that increase the cost of liquidity. There are about 240 active ABCP issuers in the U.S. Outstandings of euro-ABCP stand at roughly $104 billion.

In extendible ABCP structures, one way to repay the notes (if they cannot be rolled-over) is from *cash flow* on the underlying assets. Often, there is a partial liquidity facility sized in the range of 10% to 30% of the amount of the notes. Other extendible ABCP programs use the *sale* of the assets as a way to repay notes that cannot be rolled (*e.g.*, a mortgage warehousing program). A third approach is the placement of a new security to a committed purchaser.

Innovation: The student loan area displayed much innovation in 2003. About 85% of all ABS have weighted-average lives (WALs) of less than five years. Accordingly, it is a challenge to make appealing securities out of student loans that have average lives in the range of 12 to 13 years. The solution was "reset rate notes," which provide for resetting their interest rates after specified periods. Sallie Mae has started issuing securities denominated in foreign currencies and also has started issuing some very long-term floating rate securities.

In other areas, innovations are attracting new investors to ABS. Investors have rejected some "innovations," such as proposals to change the mechanics of clean-up calls. The next major wave of innovation is likely to come in the area of synthetic securities.

SEC Disclosure Proposal:[29] The SEC is listening to comments and appears intent on avoiding unnecessary disruption to the market. Nonetheless, the final proposal will increase disclosure and reporting burdens for issuers. The final rule might come by year-end, but the first quarter of 2005 is more likely. The SEC probably will give a 12-month transition period. The most important change on the disclosure side is the requirement to disclose static pool data. The SEC will put the onus on issuers to determine what static pool data is material. There may be a tendency to over-disclose. New types of disclosures will apply to servicers and originators. The proposal does not require disclosure of loan level data, but it permits it and even seems to encourage it. Ongoing reporting requirements will cover loan modifications and loss mitigation efforts. An important change that the proposal would force on the industry is imposing oversight (through assessment and attestation) over the whole servicing function.

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[27] *Compare* Valuation of Life Insurance Reserves, *supra*, note 7 (implementation of Regulation Triple-X in New York).

[28] The panelist was alluding to areas with a history of problems. The ill-fated healthcare receivable deals from National Century Financial Enterprises (NCFE) were the worst ABS defaults ever. The charge-off credit card receivables deals from Commercial Financial Services (CFS) arguably were the second worst ABS defaults.

[29] ABS Disclosure Proposal, *supra*, note 1.

Basel II: Implementation of Basel II in the U.S. will not happen until after another quantitative impact study is done in the U.S.[30] Banking agencies likely will release implementing regulations in 2005. Under Basel II, most liquidity facilities will incur a capital requirement greater than zero.[31]

Outlook for 2005: More of the same… The market seems to have a "limbo mentality" as spreads keep getting lower (*i.e.*, how low can you go?). Absent a disruptive event, crossover buyers should stay in the market and spreads should remain tight. The Sallie Mae GSE probably will be gone by the end of 2004.[32] Sallie Mae's issuance volume likely will decline, as it no longer needs to refinance GSE debt. The reauthorization of the Higher Education Act is important and probably will happen in 2005. Economic fundamentals appear strong and the credit performance of mainstream ABS has been strong. Spreads may continue to compress.

9:15 am – Traders' Roundtable

What Layers of Deals' Capital Structures Are Most Vulnerable to Spread Widening?: Demand from CDOs has largely eliminated tiering among issuers and structures. Spreads on triple-A-rated ABS have widened somewhat because of declining demand from the GSEs. Mezzanine and subordinate tranches have greatest exposure to widening risk.

Tight nominal spreads on triple-A tranches of non-mortgage ABS are pushing some investors to purchase lower-rated tranches of the deals. CDO demand for mezzanine and subordinate tranches has kept spreads tight.

Panelists disagree about how much widening would be caused by GSE withdrawal from the non-mortgage ABS sectors.

Low interest rates have fueled heavy supply in the HEL ABS area. Issuers have built huge infrastructures over the past few years and they will try to expand into other areas, such as alternative-A mortgage loans, if rising interest rates slow growth in the sub-prime mortgage area.

After the peak of any refinancing wave, credit quality can suffer as lenders compromise underwriting standards to sustain volumes. CDOs favor home equity ABS subordinate tranches. Other investors, such as insurance companies, are frequent buyers of non-mortgage ABS subordinate and mezzanine tranches.

CDOs arguably are quite vulnerable to a downturn in the sub-prime mortgage area because they have exposures of up to 60% to the sector. Some CDOs are essentially repackagings of home equity ABS.

Eighty percent (80%) of the outstanding mezzanine tranches of manufactured housing ABS will lose their entire principal!! Distressed sectors can offer opportunity. There are not any newly distressed areas right now. High delinquencies in Long Beach deals from the 2001 vintage may foreshadow difficulties in the rest of the industry. Some sub-prime mortgage servicers may be "managing" delinquencies and losses in order to make sure that cash flow continues to the residuals that they hold.

Most home equity ABS issuers limit the interest-only (IO) proportion of their pools to the range of 10% to 20%. For a securities dealer, the IO product is a positive because it drives refinancings and the production of new loans and new deals.

Some new double-B-rated home equity ABS tranches have more protection and are more attractive than triple-B-rated tranches from a year ago. The greater protection comes partly from changing

[30] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision, B*anking Agencies Announce Publication of Revised Capital Framework and Describe U.S. Implementation Efforts*, joint release (26 Jun 2004) (available at http://www.occ.treas.gov/ftp/release/2004-52.htm); Office of the Comptroller of the Currency, Board of Governors of The Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, *Proposed Agency Information Collection Activities: Comment Request*, 69 Fed. Reg. 50442 (16 Aug 2004) (available at http://www.fdic.gov/regulations/laws/federal/04joint816.html).

[31] Basel II, *supra* note 4, ¶¶ 578-580

[32] SLM Corporation Form 10-Q, *supra* note 20.

interest rate assumptions at the rating agencies.[33] The 2001 vintage of home equity ABS may be the weakest. There are structural differences among deals that can make a big difference for investors in subordinate tranches. In some deals the servicer can protect his residual interest while pushing losses to the subordinate (or mezzanine) tranches.

Risk from available funds caps is greater in subordinate tranches and increases over time. According to one view, the caps can be worth from five to fifteen basis points on certain last-cash flow triple-A tranches of home equity ABS deals. Others feel that the caps are worth much less.

Deep discount (distressed) floating rate securities offer a leverage play because coupon adjustments are based on par.

Credit Default Swaps on ABS: The level of activity in asset-backed credit default swaps (CDS) is modest. However, there is potential for strong growth, just as the corporate CDS market grew quickly. One panelist uses asset-backed CDS for hedging his trading book. Rising prevalence of asset-backed CDS also should help to dampen spread volatility of ABS. Asset-backed CDS offer the important advantage of allowing traders to take short positions. However, settlement mechanisms remain a challenge. Physical settlement is tough because tranches may be small. Cash settlement is tough because of the need to have a dealer poll to measure the price decline of the reference credit. One panelist observes that "credit event" definitions in asset-backed CDS may be so restrictive that credit events cannot actually occur in the short- or medium-term. This means that synthetic CDOs that use those CDS are essentially immune to risk.

Some recent home equity ABS tranches carry split ratings because Moody's toughened its credit enhancement requirement earlier in the year but the changes to S&P's criteria do not take effect until November.[34] Those securities usually price to the Moody's rating. Some new CDOs carry only S&P ratings so that they can use the higher S&P rating while benefiting from the wider spreads.

10:15 am – Syndication of ABS

Who Does Syndicate Serve, Investors or Issuers?: Issuers want to think that syndicate desks work for them. An issuer does not want a syndicate desk to ask what the offering price for a new issue should be. From an issuer's perspective, syndicate desks get paid handsomely for conducting price discovery. Likewise, an issuer does not want one syndicate desk to ask what another one says about the pricing of a deal.

From an investor's perspective, it is clear that syndicate desks work for issuers.

The goal of syndicate is to find the "fulcrum point" at which both investors and issuers grumble, but also at which both are "happy" to consummate a transaction. Syndicate professionals note that issuers pay their fees but that they must try to satisfy both investors and issuers.

Reverse Inquiry; Shadow Books: A reverse inquiry is an order for a deal that does not yet exist. Having received a reverse inquiry can allow a syndicate desk to win the lead manager role in a deal. An issuer wants a syndicate desk to build a shadow book before a deal is committed, so that the issuer can have confidence about the level at which the deal can be sold.

Reverse inquiry gives an issuer confidence that it can consummate a deal. However, the issuer must be willing to (informally) assure the investor making the reverse inquiry that it will get the reverse inquiry order (amount and price). In home equity ABS, there is a third dimension: structure.

Issuers need to balance the desire for certainty against the risk of alienating loyal investors who would like to buy a portion of a deal but who did not initiate the reverse inquiry. The whole reverse inquiry process favors larger investors because small investors cannot make a reverse inquiry of sufficient size to provide certainty to an issuer.

Syndicate Structures: One (dealer) panelist favors 100% pot arrangements where no syndicate members have any retention. Investors arguably get better allocations in 100% pot arrangements.

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[33] Osterweil, *supra* note 8; Kornfeld, *supra* note 8.

[34] *Id*.

In a large reverse inquiry deal, where only a small amount of non-reverse inquiry bonds need to be sold, it is disadvantageous to have retention. However, retention is a good tool for making sure that co-managers actually work on a deal.

An investor panelist likes deals with one lead manager with retention to the other dealers. He feels that he gets better allocations with retention.

New Participants in the League Tables: Some large issuers are starting to handle the offering process themselves. Medium-sized dealers may feel a squeeze from issuers. However, the largest underwriters probably will be unaffected.

Developing Price Guidance: One approach for developing price guidance is to examine the pricing on recent comparable deals and to examine secondary trading spreads. Ideally, guidance should be right where a deal ultimately prices. However, there arguably should be a bias toward slightly wide guidance, because subsequent widening is harder to accept than subsequent tightening. On student loan and credit card ABS, guidance generally should be within one basis point of the final pricing. In home equity ABS, technical factors can force actual pricing to diverge from pricing guidance by as much as 5-10 bps.

Failure to offer price guidance can cause investors to lose interest in a deal. Investors want to get price guidance as soon as possible.

When Should a Lead Manager Tighten Spreads on an Oversubscribed Deal?: One syndicate professional argues that if a deal is heavily oversubscribed, the deal should be tightened so that some investors withdraw and the others can get better allocations. If a firm asks an investor whether it will accept tightening, the investor is likely to simply respond with the question: "how many more bonds will I get?"

Allocations: One (dealer) panelist notes the need to take care of accounts that speak up quickly. Accounts that are more flexible on pricing deserve special consideration.

Panelist Relative Value Picks:

- CLOs, CDOs, middle market loans
- non-prime auto loan ABS, front-pay home equity floaters
- single-A-minus NIMs, 1.5-year triple-A home equity floaters
- 3-year triple-A home equity floaters with tight principal windows, triple-B-minus NIMs
- non-mortgage product generally
- home equity ABS pass-throughs, credit card ABS

Friday, 15 October 2004

8:30 Am – State of the Alternative/Private Student Loan Market

Overview: The alternative student loan area is the fastest growing portion of the student loan sector. According to the College Board, originations of alternative student loans grew from $1.3 billion in the 1995-96 academic year to $7.6 billion in the current academic year.[35] Tuition increases have been a key driver of growth. The government has not increased FFELP loan limits since 1992. Meanwhile educational expenses have grown by 80%. Thus, the FFELP program is insufficient to meet the needs of a rising proportion of students.

Issuance of ABS backed by alternative student loans likely will be in the range of $7 billion to $8 billion in 2004. Sallie Mae, First Marblehead, Access, and KeyCorp are the main issuers of

[35] *Compare* College Board, *Trends in Student Aid 2004* at 5 (available at http://www.collegeboard.com/prod_downloads/press/cost04/TrendsinStudentAid2004.pdf) (stating that the amount of private student loans for the 2003-04 academic year is $10.6 billion).

alternative student loan ABS deals. Smaller issuers have combined FFELP loans and alternative student loans in their deals.

Each of today's major issuers of alternative student loan ABS has ample historical performance data. That data give them a substantial advantage over newcomers to the sector.

The major issuers offer a wide variety of alternative student loan products, which span the entire range of borrower credit quality. Analysis of alternative student loan ABS is difficult because different loan products embody different features. Thus, pools may be very dissimilar.

Bond Insurance: Bond insurance can facilitate execution of deals backed by alternative student loans. By using bond insurance, an issuer avoids the need to achieve triple-A credit quality on a stand-alone basis. Instead, the issuer need only attain single-A credit quality in order for a bond insurer to be willing to supply insurance to bring the deal's rating up to triple-A.

One bond insurer considers a variety of factors in evaluating alternative student loans. FICO scores provide an indicator of a borrower's creditworthiness. In analyzing a pool of loans, the bond insurer considers the whole distribution of FICO scores and not merely the average. The presence of a co-signor significantly strengthens an alternative student loan. Most alternative student loans have co-signors. The bond insurer examines the quality of servicing. Servicing of FFELP loans is "process driven" rather than "results driven."[36] A servicer that has experience servicing only FFELP loans may be ineffective as a servicer of alternative student loans. In addition, the bond insurer examines the servicer's historical performance, forbearance policies, corporate organization, and economic motivations (*i.e.*, does the servicer have a stake in the loans that it services). The bond insurer scrutinizes credit enhancement, such as third-party guarantors. For an established loan program, the bond insurer looks at static pool performance data. For a new loan program, the bond insurer tries to find a performance proxy based on other data sources and then applies a conservative bias. Other factors that the bond insurer considers include: school eligibility, school quality, exception policies, and whether loans are dischargeable in bankruptcy. If there is any sort of not-for-profit involvement in a loan (even just a guarantor), then a loan is not dischargeable in bankruptcy.

Student loan deals have lower levels of excess spread than certain other ABS asset classes.

Sallie Mae: Sallie Mae offers three types of alternative student loans. In its student loan ABS deals it includes only its higher quality loans to students in four-year colleges and professional schools (*i.e.*, "higher education" as opposed to "career training" loans). The higher education lending business works through college and university financial aid offices. Sallie Mae's higher education alternative loan products require that borrowers first exhaust their capacity under FFELP programs. Sallie Mae has started credit-underwriting borrowers in addition to just approving schools. Adding the borrower underwriting process opened up availability to more schools. Freshman borrowers must have co-signors. Sallie Mae processes all applications itself. It allows very few exceptions to its process. It services all loans itself. About 10% of Sallie Mae's managed portfolio is alternative student loans. Alternative student loans compose the fastest growing segment of Sallie Mae's portfolio. Most loans have 15-year terms and provide in-school grace periods and deferment for returning to school. Most are prime-based.

Access Group: Access Group's alternative student loan program started in 1986 and good performance data exists from 1989. Access performs credit underwriting on borrowers. The company will not extend a loan to a borrower who has been in bankruptcy. The company restricts its business to lending to students at accredited graduate and professional schools. The company's loans provide for repayment over 20 years, and bear interest at adjustable rates pegged to 3-month LIBOR. The company charges borrowers a guarantee fee, which varies based on borrower credit quality. Students must be enrolled at least half-time. The company's original program was lending to law students, and that remains the main portion of its business. Forbearance is limited to those who

[36] In servicing FFELP loans, a servicer must adhere to a specified process in order to preserve the federal insurance on the loan. The servicer's success in getting the borrower to repay the loan does not matter as long as it follows the specified process. In contrast, for alternative loans, the servicer's success in getting borrowers to repay actually matters. Hence the "process vs. results" distinction in servicing the different types of loans.

"need help" as they go into repayment. Access permits deferments for further study in related areas only.

KeyCorp: KeyCorp started securitizing alternative student loans in 1993. Key has three product groups: undergraduate (50%), graduate (35%), and career (15%), for specialty schools and career enhancement). About 85% of undergraduate loans have co-signors and the co-signors must meet FICO score tests. In the graduate program, half the loans are to medical students, a quarter are to law students, and the remaining quarter students pursuing MBAs and other degrees). KeyCorp has performance data for the past 10 years. KeyCorp securitizes loans when the borrowers graduate from school (*i.e.*, as the loans enter repayment). KeyCorp alternative student loan deals price with a 7% CPR prepayment assumptions. In contrast to FFELP loans, which prepay at speeds in the range of 12% to 13% CPR, KeyCorp's alternative student loans actually prepay in the range of 7% to 8% CPR. Losses on the alternative student loan pools run in the range of 10% to 15%. The recovery rate on defaults is about 40%, which is somewhat lower than the 501(c)(3) entities achieve. The FICO score average is 740 (?) for undergraduate loans, 705 for graduate loans, and 695 for career loans. KeyCorp allows a one-time six-month forbearance.

Rating Agency (S&P): S&P has seen new entrants to the alternative student loan area, primarily municipal FFELP issuers. Those issuers say that schools require them to offer a full range of loan products to students. That is, schools require the lenders to offer alternative loans *in addition to* FFELP loans. For a new alternative student loan lender, S&P wants to understand the lender's orientation (profit vs. public purpose). S&P likes to see minimum FICO scores in the range of 660 to 680 for alternative student loans. In addition, S&P likes to see a maximum debt-to-income ratio (DTI) in the range of 40% to 45%, as well as a requirement that alternative loans have co-signors. S&P examines the degree to which individual underwriters must exercise judgment in underwriting loans.

In essence, alternative loans are bets on the future earnings capacity of the borrowers. At some level of educational debt, borrowers get overextended (*e.g.*, $70,000 debt with a $40,000 salary).

In rating alternative student loan ABS, S&P analyzes historical default data along the dimensions of school type and FICO band. Static pool data is the best because it shows the amount *and timing* of losses. Portfolio data is less helpful because the denominator may be growing. In some cases, S&P receives virtually no data on losses. Then, S&P either may withdraw from rating the deal or may look at underwriting criteria and perform a peer analysis. Performance of a lender's FFELP loans may provide a lower bound for performance expectations of its alternative loans. Recovery rates on defaulted loans range upward from 25%. However, S&P would be reluctant to give "full credit" to a lender that historically had achieved recovery rates in the range of 60% to 70% because of potential for a servicing transfer. Alternative student loans need to be serviced better than FFELP loans.

10:45 am – Life Insurance Securitization

Life insurance securitization encompasses a variety of different kinds of deals: (1) life insurance product securitization, (2) life-annuity arbitrage structures, (3) triple-X, A-triple-X and other "excess mortality" reserve securitizations, and (4) closed block securitizations. More broadly, life insurance securitizations can be broken into "asset" (positive cash flow) securitizations and "liability" (negative cash flow) securitizations.

Securitization of GIC/Funding Agreements: A GIC/FA-backed note is a note supported by a GIC or a funding agreement from a life insurance company. An investor in a GIC/FA-backed note has a "policyholder" claim against the insurance company (*i.e.*, the investor has higher priority in the event of the insurer's insolvency). Issuance of GIC/FA-backed notes was roughly $34 billion in 2003. Major issuers include Allstate, AIG, Met Life, Aegon, and Pacific Life. Until recently, GIC/FA-backed notes had been issued exclusively as 144A deals. However, Hartford Life, Principal Life, and Protective Life recently have issued SEC-registered deals targeted at retail investors. More companies are likely to pursue SEC-registered deals in the future.

Life-Annuity Arbitrage Structures: The life-annuity arbitrage structure is based on combining a life insurance policy and annuity based on the life of the same individual. Proceeds of a loan are used to pay (1) the first month's premium on a life insurance policy and (2) the premium for a single premium immediate annuity (a "SIPA"). The face amount of the life insurance policy must be at least as large as the amount of the loan; because the policy proceeds will be the source of funds to repay the loan. Monthly payments on the annuity are sufficient to cover both (1) monthly premiums on the life insurance policy and (2) monthly interest on the loan. When the insured dies, the annuity stops, but the life insurance policy "matures." Proceeds from the policy are used to retire the loan.

Combining a life insurance policy and a SIPA on the same individual can produce a positive residual because the life insurer and the annuity provider may use different mortality assumptions in pricing their products. Each one makes its normal "bet" in selling its product. The life-annuity arbitrage structure should ***not*** rely on providing different information to the life insurer and the annuity provider.

Risks include: (1) life insurer contesting policy, (2) annuity provider contesting annuity, (3) mis-statement of age/sex by the insured, (4) liquidity (5) interest shortfall gap from the delay in getting policy proceeds after death, (6) long final maturity, (7) missing person (8) fixed vs. floating swap breakage, and (9) current vs. guaranteed premium.

Liquidity (#4) refers to the need to have funds to pay loan interest and life insurance premiums during times when it may not be possible to prove whether the insured is alive or dead. Payments on an annuity require proof of life; payments of death benefits on a life insurance policy require proof of death. This risk is closely related to the missing person issue (#7).

The first deal was done in the summer of 2003. To date, there have been five rated deals totaling about $1 billion.[37] There are several billion dollars waiting to move into this market. Key impediments to growth include (a) lack of product on the insurance and annuity provider side, (b) insurance industry opposition, (c) resistance from re-insurance companies, (d) changing interest rates, and (e) changing views of mortality.

Many parties participate in an insurance annuity arbitrage deal: (i) accumulator to gather lives, (ii) marketing to find life and annuity carriers, (iii) capital provider, (iv) sponsor to develop structure, (v) gap risk provider, (vi) rating agencies, (vii) servicer to monitor lives and make payments, and (viii) lawyers. Other necessary ingredients include: a life insurer, an annuity provider, a sound tax strategy to prevent leakage of funds, time (9-18 months to get a deal done), and seed money (~$1 million) for legal and advisory fees.

<u>Triple-X and A-triple-X Securitizations</u>: "Triple-X" and "A-triple-X" securitizations are liability securitizations that address the need to hold "excess reserves" under U.S. regulations. The basic idea is to reduce the need for excess reserves by using re-insurance from a captive re-insurance company. However, regulators require the "non-admitted" reserves to be collateralized. One approach is to move the risk to the holding company with a guaranty of the captive re-insurer. A second approach is to issue wrapped securities, where an unaffiliated bond insurer accepts the risk that reserves will be sufficient, based on an actuarial analysis. Achieving off-balance sheet treatment generally relies on using an offshore captive re-insurer.

<u>Closed Block Securitizations</u>: Closed-block securitizations are like triple-X securitizations. There have been three closed-block securitizations and all are recent. They are backed by blocks of low ROE traditional participating ordinary life policies that represent ownership in a formerly mutual insurance company. Closed block securitizations are motivated by a stock insurance company's desire to deploy capital more efficiently after converting from mutual form.[38]

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[37] *Compare* Patrons' Legacy 2003-I ($232 million, 10 Jul 2003); Patrons' Legacy 2003-II ($171 million, 10 Oct 2003); Patrons' Legacy 2003-III ($239 million, 17 Dec 2003); Patron's Legacy 2003-IV ($188 million, 23 Dec 2003); Patrons' Legacy 2004-I ($171 million, 4 May 2004); Legacy Benefits Life Insurance Settlements 2004-1 ($70 million, 16 Mar 2004)

[38] *See generally* Cummins, D., *Securitization of Life Insurance Assets and Liabilities*, Wharton Financial Institutions Center, Working Paper No. 04-03, at 27-39 (3 Jan 2004) (available at http://fic.wharton.upenn.edu/fic/papers/04/0403.pdf).

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