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Report from Boca Raton 2005: Coverage of Selected Sessions of ABS East 2005

20 September 2005

The recent ABS East 2005 conference in Boca Raton, Florida reflected the generally positive outlook of most market participants. However, different panelists expressed concern about several of the same issues that may be clouds on the horizon. First, panelists considered the question of possibly overheated home prices. Second, panelists noted the potentially damaging impact that rising interest rates could have on consumer credit and consumer ABS. The impact of CDOs on the ABS market was a third topic noted with concern by many panelists. Lastly, several panelists observed that the market is growing increasingly dependent on ratings as CDOs and other arbitrage vehicles account for a rising share of all ABS investment.

The following summaries reflect remarks of the panelists who participated in selected sessions at the ABS East 2005 conference 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

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Tuesday, 13 September 2005

1:15 pm – Regulatory Update

Early Results from the SEC's Reg. AB[1] Pilot Program: Although the SEC's pilot program required participating issuers to submit filings by June 22, the SEC staff has only recently provided comments. Many of the comment letters were more than 15 pages long and included more than 100 comments. Disclosure materials form ABS issuers not participating in the pilot program appear to have influenced the thought process of the SEC staff and the comment staff's recent comment letters. Many comments were simply requests to explain material that is unclear or vague.

In many comment letters, the staff asked for cross-references to the specific line items of Reg. AB. An ABS issuer should consider providing a cross-reference table in its filings to show the SEC staff where each line item of Reg. AB is covered in the materials. This would be similar to the cross-reference tables customarily provided for trust indentures.

Another frequent staff comment was requests for confirmation that an issuer understands particular aspects of the new rules. The staff requested deletion of disclaimers for information provided by third parties. In addition, the staff requested elimination of conflicts and inconsistencies between base prospectuses and prospectus supplements. The staff urged greater specificity in base prospectuses with respect to (1) asset types, (2) structural features, (3) credit enhancement, and (4) interest rate mechanics and indices. Greater specificity would mean less flexibility in prospectus supplements.

The staff pushed for greater disclosure about the role of trustees and trustees' oversight responsibilities. The staff asked about outsourcing arrangements: whether service providers may be servicers. The staff asks for greater specificity about credit scores and about derivatives used in deals.

Issuers should make sure that they have covered every line item of Reg. AB. Issuers need to provide more time in their filing process because the staff has announced its intention to review as many new filings as possible. As of August 31, new ABS registration statements must comply with Reg. AB. However, issuers have a little more time to amend existing registration statements to comply with Reg. AB

Offering Reform:[2] [Note: On June 29, the SEC adopted a new regulatory framework for the offering of public securities in the U.S. The so-called "offering reform" regulations likely will prompt significant changes to the process of offering securities. The new regulations greatly streamline the process for most issuers to sell securities. However, controversial Rule 159 arguably increases a dealer's liability for written materials that it supplies to an investor in connection with selling a security. The offering reform regulations become effective on December 1.]

Under offering reform, ABS issuers can be "seasoned issuers" but they cannot be "well-known seasoned issuers." This means that ABS issuers do not get the quite the same degree of flexibility as some corporate issuers."

Under offering reform, an issuer can do an immediate take-down from its shelf registration. Under the prior rules, doing an immediate take-down could sacrifice the benefits of shelf registration. Under offering reform, an issuer can register a greater amount of securities than it can issue in two years, but it must file a new registration statement every three years.

Offering reform will require issuers to make new undertakings. An issuer must acknowledge that information in a prospectus is deemed to be part of a registration statement for purposes of

[1] 17 C.F.R. §§ 229.1100 et seq., 70 Fed. Reg. 1506 (7 Jan 2005) (http://www.sec.gov/rules/final/33-8518fr.pdf).

[2] Securities Offering Reform, Release 33-8591, 70 Fed. Reg. 44722 (3 Aug 2005) (http://www.sec.gov/rules/final/33-8591fr.pdf)

Section 11 liability. Issuers must also acknowledge that they are "sellers" of securities for purposes of Section 12 liability.[3]

Offering reform liberalizes communications. There will be a safe harbor for regularly released business information. Information released more than 30 days before the filing of a registration statement gets a safe harbor.[4]

Offering reform creates the concept of "free writing prospectuses." Unless an issuer is an "ineligible issuer" (*i.e.*, missed required filings in the past year) it will always use free writing prospectuses. A free writing prospectus is a written communication that is not a statutory prospectus. There are no requirements regarding the form of a free writing prospectus.

ABS issuers can chose whether to treat written selling materials as "free writing prospectuses" (Rules 164 and 433) or as "informational & computational materials" under Reg. AB (Rules 167 and 426).[5] In most situations, it will be advantageous for an issuer to treat written selling materials as free writing prospectuses rather than as informational & computational materials. Free writing prospectuses must include certain legends and usually must be filed. Free writing prospectuses are not part of registration statements so there is no Section 11 liability, but there is still Section 12 liability.

The biggest issue under offering reform arguably is Rule 159, which establishes liability based on the content of written materials at the time of pricing a deal. Misstatements or omissions cannot be remedied in a final prospectus. Some issuers say that they will start using preliminary prospectuses. For many issuers of repeat deals, there is only slight variation from one deal to the next. Rule 159 may prompt issuers to focus their disclosure on overall statistics that describe an asset pool generally. They may lean toward less specificity on things that can change between the pricing and closing of a deal. Term sheets are likely to contain more details.

2:15 pm – What's Happening to FAS 140?[6]

Right now, under FAS 140, sale treatment requires legal isolation, right of buyer to sell or pledge transferred assets, and limited calls. A QSPE must be distinct from the transferor and its activities must be limited.

FASB is considering four groups of changes to FAS 140. The first one, FSP 140-c, would change the treatment of derivatives under FAS 140.[7] FSP 140-c would clarify that unanticipated prepayments should not undermine the status of a QSPE.

Legal Isolation: The second group of proposed change to FAS 140 comes from the "transfer of assets" exposure draft.[8] That proposal would change the legal isolation criteria by requiring legal true sale opinion — a major change (¶ 27B). The proposal would require accountants to consider arrangements made after the transfer in assessing whether sale treatment is appropriate (¶ 9(d)). In addition, the proposal would treat any arrangement between a transferor of assets and the holders of the beneficial interests in those assets as if it were between the transferor and the SPE (¶ 9(e)). Under the proposal, setoff rights are not an impediment to sale treatment of a transaction (¶ A14). The legal isolation standard applies to participation interests as well as other financial assets.

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[3] 17 C.F.R. § 229.512(a)(5), 70 Fed. Reg. at 44800 (3 Aug 2005).

[4] 17 C.F.R. §§ 230.163A, 230.168, 230.169, 70 Fed. Reg. at 44806-08 (3 Aug 2005).

[5] *See* 70 Fed. Reg. at 44751-52 (3 Aug 2005).

[6] Financial Accounting Standards Board [hereinafter "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/).

[7] FASB, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*, Proposed FASB Staff Position No. 140-c (21 Jul 2005) (http://www.fasb.org/fasb_staff_positions/prop_fsp_fas140-c.pdf).

[8] FASB, *Accounting for Transfers of Financial Assets—An Amendment of FASB Statement No. 140*, exposure draft (11 Aug 2005) (http://www.fasb.org/draft/rev_ed_qspe_amend_st140.pdf).

QSPEs: Under the "transfer of assets" exposure draft, a QSPE cannot own equities, other than temporarily from collections (¶ 45A). The standard needs clarification to tell whether it includes NIMs as equities. In addition, under the exposure draft, a QSPE is not permitted to rollover beneficial interests with synergy (combination of rights and obligations better if held separately).

QSPEs would not be required for sale treatment on a transfer of a *pro rata* participation interests (*i.e.*, without subordination). However, if there is any form of subordination, then a QSPE would be necessary for sale treatment. This could affect CMBS, where lenders split large loans into senior and subordinate participation interests. Under the exposure draft a new QSPE would be required to make the split qualify for sale treatment.

The transfer of assets exposure draft would eliminate the allocation of basis based on fair value (¶ 11). The exposure draft would require a transferor to book retained interests in transferred financial assets at their market values at the time of sale. This is a significant change from current practice; it would change the calculation of gain on sale.

Servicing Exposure Draft: The third group of proposed changes to FAS 140 comes from the "servicer" exposure draft.[9] Under that proposal, a servicer would be required to make an irrevocable election to carry servicing at either (1) amortized historical cost or (2) market. Changes to the value of servicing rights would be booked as income. A servicer must make a separate election for each category of assets that it services (¶ 13). Marking to market makes sense for a servicer that hedges its servicing portfolio because it may allow simplified accounting for the hedge under FAS 133.

Hybrid Exposure Draft: The fourth group of proposed changes to FAS 140 comes from the "hybrid" exposure draft.[10] Under existing standards, companies must bifurcate all securitization derivatives under FAS 133. The "hybrid" exposure draft would provide the option of carrying an instrument at fair value in lieu of the need to bifurcate (FAS 133 ¶ 14). Fair value is a fall back.

There will eventually be a project for international convergence of accounting standards. International accounting standards are much different from U.S. standards and make it harder to get assets off balance sheet.

3:30 pm – Static Pool Reporting[11]

Reg. AB is a boon to investors and securitization attorneys, but it creates challenges for issuers. Before Reg. AB, disclosure of static pool performance data had not been the norm in the ABS world. Many issuers had taken the position that static pool data was not material. The SEC resolved the issue of materiality in favor of investors, based on the Supreme Court's materiality standard of what a normal investor would consider material in making an investment decision. However, it is likely that some issuers will continue to take the position that static pool data is not material for their specific situations.

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[9] FASB, *Accounting for Servicing of Financial Assets—An Amendment of FASB Statement No. 140*, exposure draft (11 Aug 2005) (http://www.fasb.org/draft/ed_servicing_financial_assets_amend_st140.pdf).

[10] FASB, Accounting for Certain Hybrid Financial Instruments—An Amendment of FASB Statements No. 133 and 140, exposure draft (11 Aug 2005) (http://www.fasb.org/draft/index.shtml).

[11] Item 1105 of Regulation AB (17 C.F.R. § 229.1105) specifies the requirements for disclosing static pool data. Item 1105 focuses on static pool data from a transaction's sponsor. It specifies different disclosure requirements for amortizing asset pools and for revolving pools. For amortizing asset pools, Item 1105 calls for up to five years of static pool data covering cumulative losses, delinquencies, and prepayments. If available, Item 1105 calls for static pool data about past deals. Otherwise, Item 1105 calls for static pool data about vintage originations.

For revolving pools, Item 1105 calls for data covering delinquencies, cumulative losses, prepayments, payment rate, yield, and standardized credit scores. Performance measures should be organized based on the date of origination of the pool assets (i.e. vintages).

Item 1105 directs an issuer to disclose alternative performance data if it would be material and if the specified disclosure items would not be material.

Static pool data disclosure should start after the end of the year. It is likely that more than three-quarters of issuers will incorporate static pool data by reference to information on a web site. If they do so, the information must have a fixed URL (*i.e.*, an unchanging internet address) and be available free of charge.

Reg. AB requires issuers to generate historical data for the past five years. If they have not already done so, just collecting the data can be a major challenge.

Reg. AB encourages tabular presentations, flow charts, and design elements to aid understanding. Reg. AB will compel some issuers to create or expand data warehouses to capture and retain static pool data.

Reg. AB requires static web pages that contain the specific static pool data that is material for a given deal. Some ABS issuers go far beyond the minimal requirements of Reg. AB and provide extensive analytics and stratifications through their web sites.

For static pools established after the end of the year, the related data will count as part of new prospectuses and will carry all the associated liability. [Data on deals from 2005 and earlier does not count as part of a prospectus and, therefore, carries liability only for fraud.]

One issue under Reg. AB is the required disclosure regarding proprietary credit scores (such as those used by the major auto lenders). Some lenders use proprietary credit scores instead of generic FICO scores.

Panelists expect ABS issuers to use disclosure materials that far exceed the minimum requirements specified by Reg. AB. Many issuers are waiting to see what others do before they make final decisions about what they will include in their static pool disclosures.

Wednesday, 14 September 2005

8:15 am – ABS Wars: Will Asset Backed Securitization Crumble to the Power of the Darkside or Will the Force of the Market Remain Strong? May the Ratings Be with You…

Introduction: In general the structured finance market is very strong. The CMBS market had particularly strong issuance growth in 2005. Issuance of credit card ABS has somewhat moderated due to consolidation. With the exception of the CMBS sector, spreads on triple-A-rated securitizations have tightened during 2005. CMBS spreads have widened. Structured finance sectors appear to be doing very well from a credit perspective. In the CMBS area, the ratio of upgrades to downgrades is now 7 to 1. The home equity (HEL) ABS and CDO sectors are also displaying strong credit performance. However, credit weakness persists in the manufactured housing (MH) ABS sector.

New investors have entered the securitization landscape in force: CDOs buy substantial volumes of ABS and MBS. Most buy higher-yielding lower-rated tranches (*e.g.*, triple-B HEL ABS), but some high grade CDOs buy the senior tranches. Hedge funds are important buyers of both distressed ABS and synthetics. Foreign investors and U.S. pension funds also have become increasingly active.

But not all is fine…

The Housing Bubble: One panelist argues that it is difficult to decide whether there is a housing bubble. Some mortgage bankers now argue that homeowners are foolish or financially irresponsible if they borrow heavily against their homes. Growing acceptance of high consumer debt levels has helped boost home prices. A Federal Reserve study from May compared home prices to the annual cost of renting. The study found that home prices used to be roughly 20 times the annual cost of

renting. However, home prices have now risen to the level where they are around 25 times the cost of renting. Since 2000, home prices have climbed 18% faster than residential rents: another sign that the real estate market is overheated. The rate of home ownership in the U.S. is at an all time high. The market arguably should start to question whether "everyone" should own his or her own home. Similarly, home affordability is at all time lows.

According to the index of housing affordability in California, only 16% of families can afford the median priced home with a traditional mortgage loan. A year ago, 19% of California families could afford the median-priced home. In the mid-1990s, about 40% of California families could afford the median-priced home. The previous cyclical low for the index was 21% in 1989.

However, new products such as interest-only mortgage loans and so-called "option" adjustable rate mortgage loans (option ARMs) enable more families to afford homes than they would not be able to with traditional, 30-year fixed-rate mortgage loans. In addition, borrower debt-to-income (DTI) ratios are climbing as borrowers allocate an increasing share of their total income to cover their mortgage payments. Loans with reported DTIs as high as 45% are common today, whereas few loans had DTIs higher than 36% as recently as the late 1990s. Moreover, reported DTIs may understate how far borrowers have had to stretch because DTIs on many hybrid loans are calculated based on low starting interest rates that likely will rise when the loans' fixed-rate periods expire. Based on the fully-indexed level of rates on many of today's mortgage loans, the true DTI would be in the range of 50% to 60%.

Another factor that boosts home price appreciation is the widespread availability of "piggyback seconds" (*i.e.*, a second lien mortgage loan originated contemporaneously with first lien mortgage loan on the same property). Piggyback seconds allow borrowers to purchase homes with tiny down payments and, in some cases, no payment at all.

The economic environment of the past few years has been very positive. Low interest rates, low unemployment, low inflation, and strong home price appreciation have combined to create conditions that could hardly be better. In fact, the probability of such an environment occurring is probably 15% or less. The exceptional character of the recent environment increases the difficulty of predicting how mortgage loans would perform during "normal" times. Additionally, the wide prevalence of new and untested mortgage products is a further factor that makes predictions even more difficult and less reliable. Quantitative risk models may not be predicting risk correctly. Given the current good conditions, it is hard to imagine that the housing bubble – if there were one – would actually pop.

A second panelist feels that the bubble question is really a regional one rather than a national one. Home prices in California have reached levels that arguably warrant concern of a bubble there. However, there is no more land to build on in the urban areas. Given finite supply, can the market really expect home prices to decline? In practical terms, an MBS or HEL ABS issuer can partly address investors' bubble concerns by creating geographically diverse pools.

A third panelist observes that investors properly understand the risks in MBS and mortgage-related ABS. Investors are sophisticated and competently use analytic systems. They have ready access to market data and economic data upon which to base decisions. In addition, innovations in the capital markets, such as CDOs and credit default swaps (CDS), allow investors to act decisively on either positive or negative views. Traditional buyers of subordinate and mezzanine tranches have given way to CDOs, which allow investors to apply leverage to acting on their views. CDS allow hedging. Another way for investors to control risk is to frequently mark their positions to market.

Like investors, homeowners have become very sophisticated. Many homeowners have fully transferred price risk on their homes to the capital markets by making no down payment. Homeowners are more sophisticated – they have no risk. Risk has been transferred from home owners to the capital markets. Bankruptcy is no longer the stigma that it once was.

With daily mark to market, investors are able to see how their bonds are viewed by the market. The CDS market has provided investors with a way to hedge risk. They can hedge performance while

remaining in the market. A fourth panelist somewhat disagrees: Some borrowers are very sophisticated and some are naïve. The most sophisticated ones strategically select mortgage products based on how long they expect to live in the same home and on the relative interest rates charged on different products. Interestingly, the same facts can support the conclusion that a borrower is either sophisticated or naïve. Consider a borrower who takes an option ARM to buy a home in a hot market with a tiny down payment. On the one hand, the borrower might be naïve in not understanding the payment shocks to which he could be exposed. On the other hand, the borrower might be sophisticated and not care about defaulting because he realizes that he has transferred substantially all the risk of the home's value to the lender or to the capital markets.

Most investors clearly understand the nature of the key risks: overheated home values and potentially rising interest rates. However, it is debatable whether they have quantified those risks correctly. Even if the most likely outcome of today's housing bubble is a soft landing, the potential for severe price declines is big enough that investors should not dismiss it. This warrants a defensive posture with respect to real estate risk. For example, investors arguably should favor either agency MBS or home equity ABS over private-label MBS. The reason for this is very thin credit enhancement levels on private-label MBS. New private-label deals backed by hybrid ARMs have about 4.5% credit support. In contrast, HEL ABS have about 23% credit support. They have a much bigger margin of error. Within HEL ABS, investors should favor tranches higher in the capital structure and deals with strong geographic diversification. They should favor deals from issuers with good track records and stable or moderately growing production, such as Option One. Investors should be wary of deals from issuers that may have grown too fast. Remember the ill effects of rapid uncontrolled growth at ContiMortgage in 1998.

Models and Model Risk: One panelist observes that the complexity of models continues to increase. Rising complexity of models is partly a reaction to rising transactional complexity. Securitization professionals need to ask themselves whether they fully understand both the math and the assumptions underlying the models that they use.

Rating agencies increasingly rely on models for their rating analyses. Investment banks deploy armies of quantitative analysts to develop their own models that exploit the weaknesses and limitations of rating agency models.

Today's markets react quickly to new developments. If errors or deficiencies appear in widely used models, how quickly will the market react? Many market participants appear to use similar models (and similar assumptions) and, therefore, seem to act the same way at the same time. Commonality of models among many market participants fosters "herd"-type behavior, if not a herd mentality. Tight spreads and low spread volatility in today's capital markets arguably reflect the high degree to which market participants generally hold similar views. Commonality of models likely is a key driver of why market participants seem to hold similar views.

The bottom line is that market participants need to exercise greater caution in using models. Models are not a substitute for common sense. Professionals need to fully understand the math and the assumptions behind every model that they use.

A second panelist generally agrees with the first: Model risk and liquidity risk are continuing challenges for market participants. The aftermath of S&P's auto sector downgrades was a blunt force reminder. Models failed to predict the wild spread movements on standardized tranches of the CDX investment grade index. Many hedge funds went long the index equity tranches and shorted the mezzanine tranches. After the downgrade, they attempted to unwind their positions by selling the equity tranches and covering the shorts. The price of equity tranches plummeted while mezzanines outperformed. The hedge funds got whipped on both sides. The event illustrated how technical factors – like finite liquidity – remain a powerful force in the structured credit markets.

Two things missing from how some professionals use simulation models are confidence intervals and stress testing. Confidence intervals are how engineers and scientists express the reliability of their models. For example, when a hurricane is coming, the weather service releases maps that show the

hurricane's predicted path as well as a range around that path where the hurricane might hit. Some financial models would be more helpful if they provided realistic confidence intervals. Certainly, most of us would use pricing models differently depending on whether their prices were reliable to within 2 ticks or 20 ticks. Whenever using a financial simulation model, it pays to understand the real limits of its accuracy.

Another weakness of some models is that they rely too heavily on historical averages and de-emphasize historical extremes. Stress testing provides a reality check on simulation models by showing whether a model-driven structure would have survived real-world challenges from the past. Think of it like this, rocket designers rely on mathematical models when they design and build rockets. Yet, they routinely conduct real world tests on their designs before making them operational. Here's the bottom line, using a simulation model without stress testing is like climbing aboard for the maiden flight of a rocket that's never been test fired on the ground. It's just asking to get burned.

Spreads, Pricing, and Liquidity: One panelist observes that a key driver of strong demand for ABS by CDOs (*i.e.*, the strong "CDO bid") is the fees that CDO managers and investment bankers earn from CDO activity. The CDO market arguably is just a way for managers and bankers to boost fees and its demand for ABS may not be sustainable.

A second panelist interjects that CDOs may enhance the value of ABS by partly insulating investors from market value risk on ABS positions.

The first panelist continues, arguing that the development of CDS on ABS may further distort ABS spreads by creating synthetic trading flows that overwhelm the real, cash market. The market has experienced numerous instances where sudden disruptions triggered severe imbalances of supply and demand and associated spread volatility. Examples include (1) the demise of Long Term Capital Management, (2) the 1998 HEL liquidity squeeze following the Russian debt default, and (3) the 1999-2000 shakeout of HEL lenders who used aggressive gain-on-sale accounting.

A third panelist argues that demand from CDOs and hedge funds is generally good for the ABS market. However, no ABS sectors appear cheap right now and hedge funds may be investing unwisely in areas that they do not fully understand.

A fourth panelist observes that the rising level of CDO purchases of ABS increases the importance of ratings in the ABS market and reduces the degree of tiering among securities at the same rating level in the same sector. Investment decisions by CDO managers are more likely to be driven primarily by ratings.

Trustees: Have trustees effectively dealt with market concerns? One panelist argues that communication between trustees and other market participants has improved. Trustees prove their value in handling tough situations like transfers of servicing. The ABFS bankruptcy arguably was such a case.

Dealing with the effects of Hurricane Katrina will pose challenges for trustees. Trustees will have to be proactive with servicers and bond insurers to make sure that insurance payments and advancing are properly handled. Trustees are working hard to get ready for Regulation AB.

[Note: The trustee discussion did not address whether the role of trustees has expanded to include greater oversight responsibility to deter fraud. That became a major topic at securitization conferences starting in 2003, after the default of the ill-fated NCFE healthcare securitizations.[12]]

Regulatory Developments: One panelist remarks that Regulation AB[13] responds to investors' demand for more information. However, it is possible that Reg. AB will end up flooding investors with

[12] For a further discussion of the defaulted NCFE deals, see *ABS Credit Migrations 2004*, Nomura fixed income research, at 26-28 (7 Dec 2004).

too much information. Who will interpret and analyze the information for investors and deduce its full meaning?

ABS/MBS issuers face tough challenges in preparing for full compliance with Reg. AB by the January 1 deadline. Some issuers will have all the information that they need for complying with expanded disclosure obligations and some will not. Issuers will be required to furnish more information about originators, servicers, and other entities involved in securitization deals. Complying with Reg. AB is expensive and time consuming for issuers.

Because of liability concerns, ABS/MBS issuers cannot simply refer investors to the existing web sites as sources of static pool data. Rather, issuers will need to make specialized web sites that aggregate the specific disclosure data for each deal and preserve it as a permanent record. Reg. AB possibly could produce a tiering among issuers based on the quality of their disclosure.

Another important regulatory development is "offering reform."[14] New Rule 159 poses challenges for issuers and dealers. It could create delays in bringing deals to market. It will impede the reverse inquiry process (*i.e.*, where an investor asks a securities dealer to create a security with specific attributes).

A second panelist adds that a theme running through both Reg. AB and offering reform is accountability. Although some issuers have already been providing static pool data on their web sites, they have not been accountable for the accuracy of the data. Under Reg. AB, issuers will be accountable for the accuracy of static pool data starting with deals issued in 2006. Similarly, Rule 159 will make issuers and dealers accountable for the accuracy of information that they have furnished to an investor at the time that he makes his investment decision. Accountability is a good thing for investors. The only potential negative is that fear of liability might deter issuers and dealers from providing some of the information that they do now.

Conundrum of Sticky Long-Term Interest Rates: One panelist observes that the interest rate "conundrum" (*i.e.*, long-term interest rates remaining stable while the Federal Reserve has been raising short-term interest rates) clearly exists and has garnered much attention. However, it does not seem to have slowed down the structured finance markets at all.

A second panelist expresses a somewhat pessimistic view: long-term economic prospects for the U.S. may not be as strong as some economists project based on the level of long-term interest rates. Perhaps market participants should be concerned about the condition of the economy in three to five years.

New Products for the Future: One panelist remarks sarcastically that the market might develop a mortgage loan that has a 0%, interest-only loan with a five-year interest-only period.

9:45 am – "What Lurks Around The Corner?": Market Trends, Developments and Outlook for The US ABS Market

One panelist expects ABS issuance volumes to contract in 2006 because of reduced alt-A MBS issuance. The volume decline is unlikely to be driven by any specific event, but rather by normal, cyclical factors. Short-term interest rates are a much more important driver of refinancing behavior than long-term interest rates.

Another panelist focuses on the impact of Hurricane Katrina on energy prices. He believes that the impact will be somewhat slower growth than otherwise would have happened.

[13] See material accompanying note 1 supra.

[14] See material accompanying note 2 supra.

Potential Problems: Several panelists feel that rising interest rates pose the most significant threat to today's ABS market. One panelist feels that economic factors, such as the real estate and labor markets, are even more important. In the very near term, energy prices are a key factor.

Rising interest rates could eliminate refinancing opportunities, which could squeeze borrowers by preventing them from taking more cash out of their homes.

Regulation: Reg. AB[15] and offering reform[16] are the big items on the regulatory front. They change 70 years of practice and precedent. The rules liberalize and modernize the way issuers and dealers will sell securities to the public. Offering reform will strip away some of the old silliness and allow the U.S. market to enjoy the benefits of technology that other countries use. Offering reform eliminates virtually all restrictions on what can be included in computational materials.

Interest Rate Outlook: Most panelists expect the Fed Funds rate to be around 4.25% at the end of 2005 and around 4.5% at mid-year 2006. One panelist feels that the Federal Reserve will aggressively raise rates to try to cool off the housing market and to try to steepen the yield curve.

Most panelists feel that the Fed Funds rate would have to rise to 5% or higher before it would have a material negative impact on consumers. One panelist highlights the strong conditions in the labor market, noting that the economy arguably is still in the early stages of job expansion. He notes that the economy created roughly five million jobs since 2000 and that up to 10 million new jobs are likely to be created over the next five to seven years. Employed homeowners should not default on their mortgage loans. The combination of low interest rates and low unemployment is a great combination for U.S. consumers.

Hedge Funds: Most panelists feel there is only a small risk of a major problem with hedge funds in the next 12 months. Following S&P's downgrade of the U.S. automakers in May, some hedge funds were burned, believing that equity and mezzanine tranches of the CDX index would move together. They were burned along the same lines with respect to GM debt and equity. Another panelist feels that the events of May show that hedge funds are sufficiently durable to withstand challenges but that capital may slowly start to leave the hedge fund sector.

Readiness for Reg. AB: Panelists have sharply divided views on issuers' readiness for Reg. AB. An issuer panelist and an attorney panelist feel that issuers have done less work than they should have for preparing for Reg. AB. Other panelists feel more optimistic. Many issuers are waiting to see results from the SEC's pilot program before they create systems and collect data. Smaller issuers cannot afford to be trailblazers in Reg. AB compliance.

Home Equity (HEL) ABS: Panelists have sharply divided views about the likelihood of a major problem in the (HEL) ABS sector. One panelist notes that today's HEL ABS issuers have better access to liquidity and are better able to sell-off risk than ever before. In addition, investors seem to have a virtually insatiable appetite for HEL ABS. However, over the next five years, there is likely to be consolidation among HEL (sub-prime mortgage) lenders (similar to what already has occurred in the credit card sector).

Mortgage Affordability Products: Panelists disagree in their views about mortgage affordability products, such as interest-only mortgage loans and "option ARMs." One panelist notes that affordability products can exacerbate bubble conditions in overheated real estate markets. They ultimately increase loss severities on mortgage loans that default.

Relative Value: Most panelists feel that mortgage-related ABS offer the best relative value.

[15] See material accompanying note 1 supra.

[16] See material accompanying note 2 supra.

11:15am – ABS Relative Value Outlook: Lessons Learned in 2005 and Opportunities for 2006

Three key macro issues affect relative value: (1) impact of rising interest rates, (2) the real estate bubble, and (3) the state of consumer credit.

Interest Rate Risk: One investor panelist focuses on interest rate risk and the available funds caps (AFCs) in HEL ABS deals. Although U.S. real estate valuations arguably are reasonable on a macro level, the panelist considers stress cases. With luck, the U.S. housing market will follow the lead of the U.K. and Australian housing markets, which cooled-off without crashing.

Another investor panelist also focuses on AFCs as a dimension of interest rate risk. He generally does not purchase triple-B-rated tranches of HEL ABS deals (where AFC risk is the greatest). Whether or not there is a real estate bubble, it is undisputable that the recent rate of home price appreciation is unsustainable. Some researchers have predicted that losses on mortgage loans would increase dramatically if the rate of home price appreciation merely slows down without becoming negative.

A third investor panelist focuses on interest rate risk through prepayments. Faster or slower prepayments can shorten or extend the average life of a security and alter its duration. Some of the innovative new mortgage products seemingly transform interest rate risk into credit risk.

A fourth investor panelist favors floating rate securities. He has a positive outlook for U.S. consumers.

Panelists observe that most deals have higher geographic concentration in California than they would like.

Affordability Products: One investor panelist is trying to limit his exposure to interest-only loans and to silent (piggyback) second mortgage loans. The investor is also wary of sub-prime loans with no documentation or limited documentation of the borrowers' incomes. The alt-A mortgage loan sector has established a limited but measurable record of success with stated income loans but the sub-prime sector has not.

Another investor panelist expresses skepticism about affordability products and questions whether the market prices them correctly. She is concerned that lenders determine whether a borrower is qualified based solely on the level of the initial payments on a loan without regard to increases that are likely to occur. The panelist applies caps to the level of affordability collateral that she will accept in deals that she purchases, including a 10% cap on interest-only loans.

A third investor deals with affordability products by requesting additional information about them.

Supply and Demand: One investor feels that the ABS market is vulnerable to demand shocks. Change in demand from the GSEs or from CDOs could have a major impact on ABS spreads. CDOs are sustaining much of the demand for subordinate and mezzanine ABS. As long as CDOs continue to buy ABS at tight spread levels, the current conditions will persist. Foreign purchases of ABS also are significant.

If CDOs stopped buying subordinate and mezzanine ABS, spreads on triple-B-rated home equity tranches could double (*i.e.*, widen to twice their present levels above LIBOR or swaps).

Structural Issues: Investors sometimes overlook structural features. Intex is a necessary tool because it shows the effect of structure on cash flow. Payment windows are very important – tight windows are better. Clean-up calls are important. If the economy slows, issuers might not be able to call their deals.

Commodity Assets: Spreads have gotten so tight on auto, credit card, and student loan ABS that "all the fun is gone" from those sectors. One panelist favors buying ABS in secondary trades rather than through new issues. He likes the last-cash-flow triple-A tranches of auto ABS deals. He sometimes likes triple-B-rated subordinate tranches where credit enhancement has grown over time.

Another investor views commodity ABS as a favorable alternative to federal agency debt securities and corporate bonds.

A third investor likes auto ABS with short weighted-average lives (WALs).

ABS Capital Structure: One panelists feels that now is the wrong time to go down in the capital structures in ABS deals (*i.e.*, buying mezzanine and subordinate tranches). Today's tight spread levels do not compensate for the incremental risk of mezzanine and subordinate tranches. HEL ABS is the area of greatest concern. She is somewhat more comfortable with credit card and auto ABS. If the CDO bid fades, spreads will widen significantly. In the future, there might be better opportunities to go down in capital structure.

A second panelist is mildly concerned about the potential impact of high oil prices. He indicates a reluctance to go down in capital structure because investors are not sufficiently compensated for the additional risk.

A third investor notes that historically it has been a bad move to bet against the U.S. consumer. Nonetheless, he is primarily concerned about the HEL ABS sector. At current spread levels, he feels that it is not worth going down in capital structure.

ABS CDS: There is still some resistance against "pay as you go" CDS because the bond insurers do not accept the standard form. Also, although liquidity is improving, it is still weak.

Panelists' Top Three Concerns:

- (i) the economy, (ii) the housing bubble, and (iii) oil prices
- (i) overheated home prices, (ii) slowing growth of home equity volumes, and (iii) general complacency
- (i) complacency (absence of long-term view), (ii) finding a successor for Federal Reserve Chairman Greenspan, and (iii) the possibility that Reg. AB will make issuers cut back information that they now provide
- (i) issuers stretching for volume, (ii) the impact of rising energy prices on consumers, and (iii) home prices
- (i) declining underwriting standards, (ii) home prices, and (iii) rising interest rates

Panelists' Picks and Pans:

- Buy triple-A-rated plain vanilla ABS for total return because their spreads are least volatile. Investors can get incremental spread in insured deals from off-the-run sectors. For deals that feature tranches at each refined rating category, favor the tranches with the "plus" ratings (*i.e.*, if a deal includes tranches rated AA+, AA, AA-, A+, A, and A-, an investor should prefer the tranches rated AA+ and A+ over the other ones). Avoid single-A-rated tranches of HEL ABS.
- Favor seasoned HEL ABS. Avoid deals from new servicers that lack proven track records.
- Buy the super senior tranches of synthetic corporate CDOs (the tranches with attachment points at 15% and 30%).
- Favor CMBS and short-WAL ABS tranches over corporate bonds. Avoid last-cash flow tranches of auto ABS deals.
- Favor double-A-rated tranches of HEL ABS over single-A-rated tranches. Be wary of mortgage underwriting standards for this year's production.

11:15 am – CDOs, Credit Derivatives and Synthetics: An Overview

Current Market Trends: Rising issuance volume is a key theme in the market for synthetic corporate CDOs. Dealers have placed between $300 billion and $500 billion of mezzanine tranches of synthetic corporate CDOs over the past several years. In 2004, dealers placed about $100 billion in mezzanine tranches of synthetic corporate CDOs. For comparison, 2004 issuance of investment-grade corporate bonds was about $300 billion. Therefore, given average leverage of five times in the synthetic area, that area now amounts to more than 150% of the cash corporate market (*i.e.*, 5 x $100 billion > 150% x $300 billion). The widespread availability of analytic models has prompted new investors to become active in synthetics. Across the capital structure, there are good two-way flows.

Another key theme is the massive re-pricing seen after May. Equity tranches in the credit indices are recovering value after declining sharply following the automaker downgrades. On the other hand, synthetic mezzanine transactions are difficult to do, even in CDOs-squared, due to lack of arbitrage.

Further, there is a shift towards new asset classes and new structures. Correlation-neutral structures such as leveraged super senior tranches and CPPIs (*i.e.*, constant proportion portfolio insurance) are becoming popular and displacing CDOs-squared and mezzanine tranches. Also, ABS CDS is growing in volume, although most are the first-generation products, rather than complex structures such as CDOs-squared. The market turmoil in May did affect the ABS CDS sector. Although the ABS CDS sector generates certain trades similar to the corporate CDS sector, the development of the ABS CDS sector is a few years behind.

Cash vs. Synthetic Structured Finance CDOs: The largest difference between cash deals and synthetic ones stems from the language defining "credit events" in synthetic deals. Depending on the definition of "credit events," the default probability and the implied correlation of underlying assets can be different between a synthetic deal and its cash counterpart. An investor panelist notes that, while he had invested in synthetic CDOs since 1997, he is currently avoiding single-tranche CDOs and CDOs-squared. A synthetic CDO is a different animal from a cash CDO. Some market participants view synthetic CDOs as derivatives rather than as bonds. Synthetic deals come with more uncertainty and less transparency.

A sell-side panelist agrees that it is worth comparing cash and synthetic CDOs. Assets may not be different, but structures are different. For example, most cash deals are managed and have complex cash flow structures. On the other hand, synthetics are easier to model. Lately, synthetic CDOs are moving from model-based pricing to capital market-based pricing, driven by demand and supply. Another sell-side panelist agrees, noting that model-based "correlation trading" is giving way to "relative value" trading.

The investor panelist questions whether investors receive fair compensation for the mark-to-market risk in synthetic CDOs, even when their credit risk is similar to that of an equivalent cash deal.

Synthetic ABS (ABS CDS): Traditional structured finance CDO managers are starting to look at synthetics. The pay-as-you-go (PAUG) documentation has been a qualified success and largely adopted. There has been a significant growth in flows. The investor panelist notes that ABS CDS allow him to hedge. However, the market is not yet mature.

Index vs. Bespoke: There is a greater volume of activity involving trades on credit index tranches than "bespoke" tranches. The main difference is liquidity. The bid-ask spread on bespoke tranches may be much wider than that of tranches from the standard index. For example, the "triple-B" index tranche (3%-7%) may be trading with a yield spread of roughly 120 bps and a 5 bps bid-ask spread. At the same time, a "triple-B" bespoke tranche may offer yield spreads in the range of 300 bps to 500 bps and a much wider bid-ask spread than the index tranche. While the index tranche is a good tool for an investor to take a "market" view, bespoke tranches allow diversification and are good tools for expressing "credit specific" views. The bespoke tranches can be more advantageous for an investor who is an expert at picking credits. Today, all synthetic ABS tranches are bespoke; an ABS credit index is not expected until 2006.

Growth Areas in Synthetics: Another new structure is the leveraged super senior (LSS) trade, which has opened up a new investor base for "super senior" tranches. Unlike CDOs-squared, LSS appear to be here to stay. In an LSS trade, an investor takes a levered position in the least risky super senior tranches of a synthetic CDO. Leverage boosts the yield that the investor earns, but the structure increases certain non-credit risks. The LSS trade allows the investor to achieve a desirable yield while avoiding exposure to the riskier subordinate and mezzanine tranches of synthetic CDOs. The popularity of LSS trades reflects the market's ability to repackage cheap assets (*i.e.*, super senior tranches currently are perceived to be cheaper than mezzanine tranches). However, super senior spreads are rapidly tightening. Supply and demand in different parts of synthetic CDO capital structures can drive the relative value, but the implied correlations must remain mathematically consistent. Therefore, new structures will evolve as value moves around the capital structure of synthetic CDOs.

Recent cash CDOs provide for larger permitted investments in synthetic securities. While these synthetic "buckets" enable the deals to accumulate securities during their ramp-up phases, some new managers may not possess sufficient expertise for synthetic exposures. Investors should evaluate managers' expertise, or they should favor deals with smaller synthetic buckets. Synthetic ABS require a measure of investor education. Also, dealers with sophisticated quantitative analytics may have an informational trading advantage over investors.

1:45 pm – Dynamics of the Sub-Prime Mortgage ABS Market: Market Trends, Regulatory Environment, Credit Performance and Securitization

The HEL ABS sector has grown 21% in 2005 compared to 2004. The rate of homeownership in the U.S. continues to climb. Home price appreciation remains strong. Affordability products account for a growing share of production.

On the other hand, loan-to-value ratios (LTVs) and debt-to-income ratios (DTIs) are rising. The proportion of loans with full documentation of the borrowers' income and assets is dropping. Margins on adjustable rate mortgage loans (ARMs) are tightening. The share of interest-only loans is rising. Consumer credit scores (FICO scores) are rising somewhat, particularly on the ARM side. The top 10 HEL ABS issuers account for about 60% of total issuance. Broker-dealer securitization programs account for about 30% to 35% of total HEL ABS issuance. Spreads are tight by 5-year historical standards, particularly on single-A and triple-B tranches.

One panelist observes that today's mortgage borrower can get a better deal on a mortgage than ever before. Margins on sub-prime loans have compressed to get closer to the margins on prime loans, luring some prime-quality borrowers to go to sub-prime lenders.

Another panelist feels that margins have gotten too low. Part of the problem is how the lenders allow loan applicants to lock interest rates at no charge. The push for market share is driving irrational pricing; lenders are not adequately pricing for the risk of their businesses.

One of the new affordability products is 40-year mortgage loans. Some 40-year mortgage loan products are fully-amortizing and some provide for amortization on a 40-year schedule but have balloon payments after 30 years. Forty-year loans are a direct substitute for interest-only loans. They are very popular in areas with high home prices. The 40-year products have supplanted much of one major originator's interest-only production. Another panelist feels that the incremental risk on a 40-year loan is only slightly greater than that of a basic 30-year loan. A third panelist agrees that 40-year loans are supplanting interest-only loans.

Fitch believes that the default probability of 40-year loans is about 5% higher than comparable 30-year loans. Another panelist feels that there is a slight decrease in risk on an interest-only loan compared to a 40-year loan.

Fitch observes that underwriting standards have become looser in recent months. That has occurred in the context of other developments with mixed implications for credit quality. First, FICO scores

have improved. However, although FICO scores are effective at sorting borrowers by *relative* risk, they do not give a strong measure of *absolute* risk. Also, the market lacks historical data for regression analysis on the performance of affordability products and limited documentation loans. Accordingly, it is not possible to tell whether the improvement in FICO scores fully offsets the other factors. Also, even though FICO scores have gone up, so have LTVs and DTIs. Many reported DTIs are higher than 45%. Moreover, because DTIs are calculated on starting rates, the "true" DTI of many loans is higher than 50% or 55%.

Origination Volumes: One panelist expects a continuing growth rate of 15% to 20% in production volumes. Another panelist expects industry production to be in the range of $170 billion for the last four months of 2005. For 2006, he expects 10% growth in production volumes. A third panelist expects volumes to be flat through the end of the year. He also expects origination volumes to be flat next year. A fourth panelist posits that rising interest rates could cause origination volumes to decline next year. A fifth panelist expects that rising interest rates would not reduce overall origination volumes, but they might cause a greater proportion of borrowers to choose fixed-rate loans.

New Product Lines: Some sub-prime mortgage lenders are entering the prime and alt-A markets as their costs to originate decline.

Profitability: The sub-prime sector has gained much knowledge from the prime sector. The sub-prime sector has embraced innovations such as automated underwriting, and web sites for correspondents and brokers. The sub-prime sector will continue to adopt the practices of the prime sector in an effort to lower origination costs. Several panelists feel that the costs to originate can be trimmed by using technology and adapting business processes to available technology. The quest for cost reduction may become of driver of consolidation. One panelist observes that some lenders are selling loans for less than the cost of originating them.

Consolidation: Panelists disagree about the prospects for consolidation among sub-prime mortgage lenders. Some panelists believe that the more-efficient companies will acquire the less-efficient ones. Another panelist argues that consolidation is not the most likely outcome, but rather poaching of key staff by stronger companies on weaker ones.

Hurricane Katrina: Fannie Mae's standard for dealing with loans in the hurricane zone is to suspend collection efforts. Lenders temporarily will suspend collection efforts and will waive late fees. One major lender reportedly has tripled its servicing staff in order to be prepared for a major credit event (other than the hurricane). However, most lenders take the opposite view; they have not increased their staffing levels in response to vague or illusive threats.

Each successive vintage since 2000 has performed better than the one before. Part of the improving performance trend is a reflection of survivorship bias because companies that originated weak loans have gone out of business. The 2004 vintage appears to be performing very well.

Predatory Lending: State laws are increasing origination costs in particular states. The greatest challenges come when state laws do not provide objective criteria. In Illinois, the government is pushing to be able to review new loan products. Another analyst states that the sub-prime lenders need relief in the form of a federal law to preempt state law.

Reg. AB: Reg. AB is the first comprehensive attempt to codify and modernize ABS/MBS disclosure practices. Issuers will have to provide static pool data and are concerned about potential liability. Option One does not have too tough a job gathering data because it services all its own loans.

1:45 pm – New CDO Products & Trends, Market Challenges and Opportunities

The structured finance CDO market has shifted towards synthetics, both in the form of synthetic ABS CDOs and synthetic buckets in cash CDOs. Separately, commercial real estate (CRE) CDOs have been prevalent this year. These were originally backed by CMBS, but they have evolved dramatically since mid-2004. Private equity firms and hedge funds investing in mezzanine loans and real estate B-notes have turned to the CDO market for term financing.

Managed synthetics also have increased, with most major managers involved in at least one synthetic transaction. From the manager standpoint, synthetics are more efficient than cash deals. The process of portfolio management is much the same as cash deals, but there is more flexibility in the liability structure. Also, the process of acquiring securities during a deal's ramp-up phase is more efficient. However, manager fees in synthetic deals tend to be smaller than in cash deals.

Moody's closely monitors documentations when rating synthetic products. For example, in a cash deal, there is an incentive to decelerate defaults, while in a synthetic deal defaults tend to get accelerated. A PIKing ABS (*i.e.*, an ABS that has suspended payments to investors but which has not technically defaulted) is considered performing in a cash deal, while it is treated as defaulted in a synthetic transaction. Unfunded synthetic positions entail counterparty risk that an investor must evaluate.

About 80% of synthetic corporate deals are trades in leveraged super senior (LSS) tranches. This was a response to tightening spreads. The shift towards LSS also reflects a wider investor base. However, value recently has started moving out of super senior tranches back to other parts of the capital structure. Demand and supply appear to be driving the market.

The LSS structure features "explicit" leverage with unwind triggers to protect dealers from mark-to-market losses. Most LSS trades feature triggers based on the weighted-average spread (WAS). Dealers prefer triggers based on mark-to-market losses, but rating agencies prefer the WAS-based triggers because they consider them to be more transparent and easier to implement. This can create challenges for dealers because WAS-based triggers may not account for changes in market levels of implied correlation. Overall, the LSS structure may amount to moving from more remote, but severe, losses to more likely, but smaller, losses.

Moody's recently revised its correlation assumptions for structured products. Most ABS CDOs today are predominantly backed by RMBS, with potentially much fatter tails in the loss distribution. Moody's moved its former "diversity score" method to its new "Moody's asset correlation" as a measure of diversification. But, the rating agency still looks at pools and runs cash flow models as part of its analysis.

Seasoned Transactions: There are some decent values found in "seasoned" CDOs from the 2001 and 2002 vintages. They are somewhat distressed, but more diversified than newer deals. Given the heavy reliance on RMBS for the 2003-2005 vintages, the seasoning effect will likely reveal performance differences depending on asset selection, particularly if the RMBS market experiences stress.

2:45pm – Are We Ready for 2006? Non-Real Estate ABS: A Research Analysts' Roundtable

Auto Sector: Ford and GM are likely to rely more heavily on ABS issuance as a major part of their funding strategies. In 2004, 72-month loans made up about 30% of collateral for auto loan ABS. The risk of a supply flood that would push spreads wider is very small.

Investment Bank Auto Loan Securitization Programs: A market for whole auto loans has developed over the past two to three years. Earlier this spring, GM announced that it might no longer retain the risk on most of the loans that it originates. So far this year there has been about $18 billion of whole

loan sales. However, it is highly unlikely that the market for whole auto loans could ever approach the size of the whole loan HEL market. There, about 60% of the production goes through a whole loan sale. Some of the foreign automakers still have funding sources that are cheaper than securitization or whole loan sales. Some smaller banks use whole loan sales to manage profitability. Investors can get E+50 to E+80 on loan participations. Whole loan sales and securitizations by investment banks can be a boon for investors; investors can get a few extra basis points of spread for buying auto ABS from an investment bank securitization program.

According to one panelist, last year's auto loan ABS supply was about $86 billion.[17] He expects 2005 auto ABS issuance of $110 billion.

Auto ABS Credit Performance: Auto ABS credit performance has been very strong recently. One panelist feels that the key determinant of credit performance is the labor market. Employed borrowers should make their car payments. However, the housing market has implications for consumer credit broadly. Hurricane Katrina should have only a small direct impact because securitized auto loan pools contained only a small proportion of loans to borrowers in the affected areas. However, higher fuel costs over an extended period could have consequences for the general economy.

Auto ABS performance (in terms of cumulative losses) has improved each year since 2000. Today we need to keep an eye on used car prices. The Federal Reserve's monthly G.19 report provides information on auto loans.[18] The size of the average auto loan has declined 15% in the past two years because many borrowers use home equity loans to buy their cars. LTVs on auto loans have declined to 88% but loan maturities have extended to 60 months from 55 months. The auto companies will not be able to afford to give away cars. Therefore, there should be somewhat less pressure on used car values.[19]

Another view is that a slowdown in home price appreciation could dampen consumers' willingness to pay all their non-housing related bills because they will not keep on feeling richer from their homes going up in value.

Student Loan ABS: The biggest risk from reauthorization is how prepayments might affect valuation of outstanding bonds. Allowing borrowers to chose between fixed and floating rates on consolidation loans and eliminating the single-holder rule is likely to increase prepayments.[20] There is a lack of good analytic tools for market participants who want to analyze prepayments on student loans. The biggest risk is prepayments and the biggest challenge is the lack of analytic tools. Valuation of student loans is very sensitive to prepayments. Consolidation and the propensity to consolidate outweigh most other factors as drivers of prepayments on student loans.

There are specific risks with the details of re-authorization. The House Committee approved a bill with slightly higher loan limits and slightly less reinsurance coverage for lenders. But, the issue of "9½% loans" remains hot.[21] The House bill did not completely resolve the issue. The Senate bill would not grandfather outstanding 9½% loans. The real risk is not to ABS investors but to student loan lenders who have booked profits on the 9½% loans.

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[17] Moody's reports an $86 billion volume level for auto ABS in 2003 and volume of $75 billion for 2004. Caldwell, M., A. Sandback, and W. Hu, *2004 Review and 2005 Outlook: Vehicle-Backed Securities*, Moody's special report (12 Jan 2005).

[18] *See e.g.*, Board of Governors of the Federal Reserve System, *Consumer Credit*, Federal Reserve Statistical Release No. G.19 (8 Sep 2005) (http://www.federalreserve.gov/releases/g19/Current/g19.pdf)

[19] Information on used car values is captured in the Manheim Used Vehicle Value Index (http://www.manheimauctions.com/).

[20] *See* College Access and Opportunity Act of 2005, H.R. 609, 109th Cong., 1st Sess. § 425, (2005)

[21] For more information on "9½% loans" see Bartlett, E. and M. Adelson, *Student Loan ABS 101 – An Introduction to Student Loan ABS*, Nomura fixed income research at 16 (26 Jan 2005).

Competition is a challenge. Some student loan lenders are offering incentives to the borrowers. For example, they allow a lower interest rate if a borrower pays with direct withdrawal and they allow a further rate step down if he develops a good payment record. For purposes of pricing student loan ABS deals, Citibank has developed a student loan prepayment assumption that starts at 7% and rises to 20% over 120 months.

Some students have taken consolidation loans while still in school. They lose the grace period but they get the consolidation loan.

Credit Cards: The credit card ABS sector has been a casualty of the housing boom. It's cheaper to borrow money against your home than on a credit card. The credit card sector is not a growth area. The major players are likely to grow through mergers and acquisitions. The credit card sector is becoming smaller than that of any other major asset class. The ABS market has been very good to issuers of credit card ABS: tight spreads and very efficient execution. Chase managed to get a reduction in credit enhancement for its master trust earlier in the year.[22] Some other issuers are likely to follow Chase's lead. Many investors probably do not realize that credit card ABS issuers have the power to reduce credit enhancement without their consent if the rating agencies permit it to happen. Compared to other asset classes, spreads on credit cards ABS likely would have less volatility if there was a market disruption. Credit card ABS are intriguing because they allow investors to buy single-A or triple-B securities from an issuer that has a rating of double-A on its corporate debt.

ABS CDS: The desire to be able to short ABS is the key driver of growth for ABS CDS. The entry of hedge funds into the ABS market was important. So was the ABS sector's track record of good credit performance. Such a track record generally is a pre-requisite to interesting and creative evolution. CDOs have used ABS CDS to be able to accumulate securities quickly during their "ramp up" phases. There likely will be an ABS CDS index by the end of the year. The ABS CDS index will allow investors to trade the whole ABS sector and its pricing should reflect the market's outlook on a sector-wide basis (*e.g.*, ABS vs. corporate bonds, etc.).

Banks have been very active in and buyers of consumer assets because their deposits have grown more quickly than their loan portfolios. This partly explains B-of-A's massive purchase of whole auto loans from GM. Banks cannot get enough consumer assets through their own production. Because banks do not have to rely on the ABS market for funding, their influence on supply may have a dampening affect on spreads.

Relative Value Recommendations:

- Spreads could get tighter in credit card ABS, especially in mezzanine and subordinate tranches that CDOs like to buy. The housing market shows signs of peaking, so don't overweight the housing sector.
- Buy subordinate tranches of student loan ABS. The challenge is in estimating prepayments for pricing the classes. Buy dealer floorplan ABS. Subordinate tranches from GM and Ford auto ABS deals may offer better opportunity than subordinate tranches of auto ABS from other issuers.
- Buy short-WAL HEL ABS tranches but avoid longer-WAL tranches. Buy three-year auto ABS. Consider mezzanine and subordinate auto ABS.

Outlook: Slowing home price appreciation is very scary. It is likely to be gradual rather than sudden, but predicting the timing of it is impossible. The housing market risk has potential spillover to all other consumer ABS asset classes.

[22] Chase reduced the credit enhancement on the Chase Issuance Trust on July 7. *See e.g.*, Sun, R., *Chase Issuance Trust, CHASEseries, Class B(2005-2) Notes*, Moody's new issue report (1 Sep 2005).

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

Hurricane Katrina: The impact of the hurricane should be modest. Loan pools with higher concentrations of exposure to the affected area tend to be composed of weaker loans. Last year, Hurricanes Charlie and Frances produced spikes in delinquencies that did not subsequently evolve into losses. Flood insurance is relevant in New Orleans, but not all areas affected by Katrina were in federally designated flood zones. However, the affected properties in areas that were not federally designated flood zones amount to just a few basis points. It is the role of a deal's master servicer to make sure that flood insurance has not lapsed.

Housing Market: Most panelists agree that home prices are high in heavily populated areas. There is greater pressure for home prices to decline than to rise further. However, there should *not* be a melt-down scenario in which home prices decline 10% per year for the next two year. A fair base case expectation is for slow to modest home price appreciation. However, over recent years, loans in areas with moderate home price appreciation have performed much worse than loans from areas with the highest home price appreciation. The difference should be a warning that simply a slowdown in appreciation – without actual declines – could have a significant impact on credit performance.

A second panelist notes that prepayment speeds should slow down if home price appreciation slows down. He predicts that if home price appreciation slows by 6 percentage points, cumulative losses on some HEL ABS deals may increase by amounts ranging from 1.5% to 5%. Thus, there is downgrade potential on some triple-B tranches.

Origination Trends: One panelist feels that the sub-prime market has experienced positive evolutionary trends, such as higher FICO scores, larger loans balances, greater discipline in the origination process, and greater due diligence. However, credit risk today ties into interest rates. New origination embeds a bet that the borrowers will be able to refinance out of the loans when they reset at much higher interest rates.

Loan Characteristics: One panelist asserts that debt-to-income ratios (DTIs) and type of verification of borrowers' incomes and assets (documentation type) are becoming increasingly important factors to ABS professionals. Loans with no documentation of the borrowers' income arguably are the Trojan Horse of credit because market participants cannot reliably estimate the DTIs on the loans.[23]

[23] "Reduced documentation" refers to situations where either a borrower's income or his assets are not fully documented. For example in a "stated income" loan, the borrower discloses his income. However, the lender does not verify the amount of income, though the lender might verify the source. In a stated income loan, the lender would verify the borrower's assets and would use the stated (unverified) income amount to calculate qualifying ratios. The following table summarizes some of the frequent permutations for reduced documentation loans.

Loan Documentation – Common Permutations

Documentation Type	Full or Alternative Documentation	Reduced Documentation						
		Stated Income	Stated Assets	Stated Income/ Stated Assets	No Income	No Asset	No Ratio	No Doc (NINA)
Income Disclosed	✓	✓	✓	✓		✓		
Source of Income Verified	✓	✓	✓	✓	✓[1]	✓	✓[2]	
Amount of Income Verified	✓		✓			✓		
Qualifying Ratios Calculated Based on Income	✓	✓	✓	✓		✓		
Assets Disclosed	✓	✓	✓	✓	✓		✓	
Assets Verified	✓	✓			✓		✓	

[1] "No Income" loans usually have a verbal verification of employment (VVOE)
[2] "No Ratio" loans rarely (but sometimes) have a VVOE

However, weak documentation of borrowers' income and assets is somewhat offset with higher FICO scores.

Within the category of "stated income" loans there are two sub-components: loans to self-employed borrowers and loans to wage earners. A stated income loan to a wage earner is really about lying – the borrower lies about the level of his income in order to qualify for a larger loan that he should get. The panelist expresses concern that lenders have become too optimistic about "no doc" loans. Reduced documentation loans are about 40% riskier than comparable fully documented loans. Lenders have started charging higher interest on "low doc" loans to wage earners. HEL ABS investors should starting insisting on information that identifies a deal's exposure to such loans.

Alt-A and Alt-B: Alternative-A loan programs now produce many loans with negative amortization features. This raises the question of whether loans with negative amortization features will start to become common in the HEL sector. Today more than 80% of alt-A loan originations are affordability products. There is some reluctance from investors and dealers to include high percentages of interest-only loans in sub-prime mortgage pools. California represents significant regional risk. A very high proportion of new loans secured by properties in California are interest-only loans. In addition, loans from California tend to have somewhat higher DTIs that other loans. A high proportion of interest-only loans has piggyback (silent) second mortgage loans, is concentrated in California, and has high DTIs.

Option ARMs are really loans with deeply teased interest rates and negative amortization features. A somewhat positive feature of interest-only loans is that borrowers tend to have higher incomes. One panelist expects many loan modifications of interest-only loans when they hit their reset dates. It would require annual income growth of 8% to 11% to hold DTI constant after reset. However, the rate of growth necessary to preserve *disposable* income is much lower and reasonably achievable.

What about deals closed right before the rating agencies toughened their interest rate stresses for valuing excess spread? The rating agencies did not downgrade tranches of those deals when they toughened their criteria. Some of those seasoned securities are trading at premium prices and have found their way into CDOs. Separately, home price appreciation since the change in policy arguably offsets the fact that the bonds originally were rated with softer stress tests.

One panelist argues that the difference in credit quality between double-B-rated tranches and triple-B-minus-rated tranches is very small. The double-Bs are a better value because they have wider spreads. Both would likely be wiped out in an environment of flat home price appreciation.

ABS CDS: An ABS CDS that provides for "pay-as-you-go" settlement resembles a total return swap without the funding leg. Pay-as-you-go settlement eliminates the need for the buyer of protection to deliver a physical security. This sidesteps the problems of limited supply of physical securities. The "implied write-down" provision of the standard form is an issue for CDOs. ABS CDS will be a tool for investors to take positions based on their view of spreads in the overall market. Synthetic CDOs are likely to become just as important as cash CDOs. The presence of ABS CDS should help to reduce spread volatility by reducing purely technical factors that cause wide spread swings in the cash market.

Relative Value Recommendations:

- Favor senior and subordinate tranches over mezzanine ones. For senior tranches, use repurchase agreements or other financing methods for leverage.
- Buy double-B-rated tranches and sell tranches rated triple-B-minus. Alternatively, trade up in credit.
- Buy tranches rated single-A or triple-B-plus. Buy seasoned deals.

- Buy double-B-rated tranches. Buy triple-A-rated tranches with average lives of three years. For deals with tranches rated at each refined rating category, favor the "pluses" over the "flats" within each generic rating category (*i.e.*, favor A+ over A, favor Baa1 over Baa2).
- Buy triple-A-rated tranches on a leveraged basis. The best value arguably is in the tranches rated double-B and triple-B.
- Favor double-B-rated tranches over ones rated triple-B. Do not take an uncovered short position in triple-B-rated tranches. Tranches rated single-A are expensive compared to ones rated double-A. Go long on equity tranches and short the mezzanine tranches of synthetic CDOs that hold large portfolios of triple-B-minus HEL ABS.

Thursday, 15 September 2005

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

New Asset Classes: Insurance is an area where opportunities for growth remain. Both premium finance and catastrophe risk deals have the possibility for growth. Another area is intellectual property. The third area is municipal (project?) finance.

In asset-backed commercial paper (ABCP), growth may come from the mortgage area. The ABCP sector may see greater volumes of activity involving (1) mortgage warehousing deals, (2) deals to finance servicer advances, and (3) homebuilding financings. In addition, the ABCP sector may see greater activity in deals to finance capital calls for private equity transactions.

The "cutting edge" is being redefined. Today, the cutting edge of securitization is less about new asset classes and more about how risk is allocated and transferred through deals. The "asset class thing" arguably has moved to the end of its lifecycle. The growth of the derivatives business and CDOs is clearly part of the cutting edge. Right now, CDOs purchase a very high volume of MBS and mortgage-related ABS. Moreover, a high proportion of new CDOs have heavy exposure to residential real estate. Professionals should ask whether that is a stable situation.

ABS itself arguably constitutes a new asset class. This is because such a large volume of ABS ends up being resecuritized through CDOs. Resecuritizations amplify ratings dependency and sensitivity to rating migrations. Some CDO structures now allow the manager to take short positions — this too is part of today's cutting edge.

The CDO equity market has changed dramatically. There is now large number of participants in the CDO equity market.

Expertise in securitizations (MBS/ABS/CMBS/CDOs) has become increasingly widespread among financial professionals. In all kinds of firms, many of today's senior managers have fifteen to twenty years of experience with securitizations. Indeed, one of the largest mutual funds in the country buys primarily ABS and CDOs. Intex allows professionals to analyze and price securities much more quickly than in the past, but some risks (*e.g.*, model risk) continue to be overlooked. In general, the securitization market is larger and healthier than it has ever been.

The flattening of the yield curve makes it hard to do new deals. It makes hedging more expensive for mortgage originators.

CDS: CDS allow CDO managers to trade more easily and to buy protection (*i.e.*, to short credit risk).

New Risks: In the early days of the ABS market, securitization transactions were simpler. Several attributes characterized most deals: (1) stable cash flows, (2) well-known issuers, (3) long positions in risk, and (4) committed sources of financing for the issuers. Today the market is more complicated and there are new types of risk present. For example, there are definitional risks – it is not always clear what constitutes a "synthetic" asset or security in the context of a deal. There is basis risk in the

(slight) mismatch of corresponding cash and synthetic positions. Today securitization professionals call the rapid evolution of synthetic technology "dynamic." However, if it later blows up, they would call it "unstable." Do all of today's securitization professionals need to become experts in derivatives?

Bankruptcy Reform: Bankruptcy reform[24] helps the securitization business by expanding the definitions of swap agreement and securities contract to provide greater protection to creditors/buyers. A securities contract can cover mortgage loans. However, sellers providing interest rate swaps to their deals make it harder for lawyers to give true sale opinions.

Evolution: The market was first an issuer-driven market in the 80s and early 90s. Then it became an investor-driven market in the late 90s. Now it arguably has become a trader-driven market. Today issuers have so many options for funding: ABS, ABCP, whole loan sales, and secured borrowings. ABS investors too have more options for how to invest: ABS, synthetic ABS, and CDOs of ABS.

Risk: Securitization professionals need to be mindful of many types of risk: operational risk in CBOs, credit risk, fraud risk, complacency (from currently strong liquidity) etc. One notable category of risk is "rating agency process risk" (*i.e.*, a type of operational risk) because of the high volume of new CDO issues. Sometimes rating analysts first examine the capital structure of a CDO only days before the deal's pricing. Service providers (including rating agencies) are not able to keep up with the pace of deal flow. Likewise, deal structurers make mistakes because of being rushed. For example, some CDOs have violated their trigger tests before their first payment dates.

A related aspect of risk is the growing reliance on ratings. Some types of ABS investors (*e.g.*, CDOs and CDO managers) buy primarily based on ratings. Complacency poses a growing threat: How will the market perform when mortgage defaults rise and CDOs reduce their purchases of MBS? Who will pick up the slack?

Pricing (marking securities to market) is a tough issue right now. Are prices reliable?

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

Credit Card ABS: There is a smaller volume of credit card ABS today than there was several years ago. Some investors have rebelled against the tight spreads by crossing over into lower-rated tranches of credit card ABS deals and into one-year floating rate HEL ABS. The traditional investor base for credit card ABS is expanding its horizons.

Liquidity: It is extremely difficult to make money in ABS secondary trading because of very strong liquidity in the mainstream ABS sectors. The bid-ask spread is very thin.

Auto ABS: Spreads on retail auto ABS deals widened and then recovered after the downgrades of the U.S. automakers. However, the ABS deals backed by dealer floorplan loans are a different story. Floorplan deals necessarily entail exposure to the corporate credit risk of the manufacturers. Right now, the automakers are subsidizing auto sales at prices that are 10% to 15% below dealer invoice. Also, when a dealership fails, the franchising manufacturer transfers the financed inventory to another dealer at the dealer-invoice price. That fully insulates dealer floorplan ABS from the effects of dealer failures. But, if the automaker failed that process would end. Then, the failure of an auto dealer would produce losses for dealer floorplan ABS.

Another panelist feels that all triple-A-rated dealer floorplan ABS are "money good" (*i.e.*, will ultimately return 100% of principal and accrued interest, but possibly with delays). However, the deals are exposed to prepayment risk if there is an early amortization event.

[24] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

HEL ABS: Many ABS professionals have not focused sufficiently on prepayment and extension risks. They have incorrectly viewed the whole ABS universe as composed of short WAL product.

Another panelist emphasizes the need to run multiple "prepayment vectors" and "loss vectors" in pricing securities.[25]

Credit Enhancement & Spreads: Tightening spreads in the ABS market seem to indicate that the market accepts the credit enhancement levels of today's deals as adequate. The rating agencies arguably have managed to stay ahead of the curve in sustaining adequate credit enhancement levels. However, declining home prices could be a spoiler. The structured credit community (*e.g.*, CDOs) seems to accept ABS spreads at their current levels, as reflected by the high levels of ABS purchases from structured credit buyers.

Bid Lists: The high volume of bid lists requires traders to trade bonds with incomplete information and analysis. Analytic systems help, but they provide only an incomplete solution. Traders need to anticipate bid lists and to develop views about sectors and the impact of key developments *before* they see a bid list. ABS CDS create additional challenges because a securities dealer that creates a synthetic ABS is likely to have the position (*i.e.*, its leg of the swap) for a long time.

NIMs and Rising Interest Rates: NIM[26] trading illustrates rapid trading with limited information. Some investors purchase NIMs with the idea of keeping them for just 12 months before selling them. Only some players have the ability to correctly analyze NIMs on Intex. The analysis may be highly sensitive to assumptions about collateral performance over the several most recent months. Thus, investors can have an advantage over securities dealers in trading out of NIMs after 12 to 16 months.

Housing Bubble: The availability of low-cost real estate financing has accelerated home price appreciation. However, there could be a shake-up in the structured finance market during the next year. That could affect home prices by reducing the availability of funds. Inflation could put the housing market into a "correction" that might last two or three years.

ABS CDS: CDS has transformed the typical ABS trading desk by allowing traders to hedge and to take short positions. ABS CDS provide great flexibility for traders. Traders can express bearish views with spread-neutral strategies. ABS CDS allow traders to take or shed very large positions very rapidly. However, traders must treat ABS CDS trades as long-term trades because there is less liquidity for getting out of a position after it is created. This requires traders to have firm views about the longer-term macro issues and trends.

Trading of ABS CDS has amplified the amount of ABS credit risk that moves around the market on each trading day. Large volumes of credit risk at the triple-B risk level move daily. This arguably reflects a strong improvement in the liquidity of ABS credit risk since the late 1990s. However, the high volumes create challenges for operations and risk management at many firms.

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[25] "Prepayment vectors" and "loss vectors" refer to the assumptions used for pricing securities through a computer model. A prepayment vector specifies the rate of prepayments at different times during the lifecycle of a deal. Likewise, a loss vector specifies the rate of losses at various times.

[26] Some HEL ABS issuers routinely securitize the residual interests in their HEL deals. Such residual securitizations are called "NIM" deals or "net interest margin" securitizations because the excess spread component of a HEL 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 HEL ABS issuers execute a NIM transaction alongside each of their regular HEL transactions.

A NIM securitization embodies the right to receive certain 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 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. Cash flows attributable to the NIM do not have inherent principal and interest components. Rather, the creation of the NIM itself artificially imputes principal and interest components to the undifferentiated underlying cash flow.

Most flows in ABS CDS are in triple-B (Baa1 to Baa3) HEL ABS. CDOs sell protection (*i.e.*, take credit risk) and hedge funds buy protection.

A challenge for many trading desks is managing counterparty risk. Managing the risk associated with stripped interest cash flows remaining from customized ABS CDS trades (*e.g.*, a synthetic par trade against a premium cash position) is also a challenge.

Some investors use ABS CDS to express their views of particular vintages of HEL ABS. Some take long positions in triple-B-minus tranches from the 2003 and 2004 vintage and take short positions in triple-B-minus tranches from 2005. The market may start to observe price tiering of vintages.

Because of the need to hold positions for potentially a very long time, ABS CDS trading requires a trading desk to be in the "storage" business, not just the "moving" business.

CDOs: Older distressed CDOs sometimes offer great opportunities to investors who thoroughly analyze their structures and their distressed underlying collateral. Many CDOs-squared accumulated distressed CDO tranches for repackaging. The challenge is that CDOs take a tremendous amount of work for analysis and for due diligence. That creates opportunity because it is impossible for all market participants to look at all the bonds. Seasoning is important because it greatly improves the ability to project cash flows.

The volume of the ABS CDS market for HELs is in the range of $25 billion to $50 billion.

The HEL ABS market is priced very optimistically by historical standards (*i.e.*, spreads are very tight). Tiering among issuers is absent right now.

Biggest Concerns of the Panelists:

- There is pressure on HEL originators to maintain their origination volumes and to raise interest margins. Originators may sacrifice loan quality in order to achieve those goals in an environment of rising interest rates.
- Home prices and affordability mortgage products are the big concerns.
- The big concern is the volume of risk being traded and the potential volatility that it could produce. Do Street firms have the systems to handle these risks over time horizons that could span years?
- Home prices are the main concern, but market participants now have the tools to express views in either direction (*e.g.*, with ABS CDS).
- Too many market participants seem to share the same views. The commonality of views makes risk premiums too thin. Back in 1999, there was a fierce intellectual debate about the high LTV (125%) mortgage loans. That debate created opportunity.
- Deteriorating underwriting standards in the mortgage sector are encouraging consumers to buy homes that they cannot afford.
- Same as the previous panelist and also payment shock on adjustable-rate and interest-only loans.
- The real estate market is a key concern. What does it mean for CDOs that buy HEL ABS and MBS at high prices. There is too little opportunity to make money trading.

10:15 am – State of the Alternative/Private Student Loan Market[27]

FFELP-focused lenders tend to be older and well established.[28] They offer alternative loans[29] to promote their FFELP business. However, their servicing operations are geared around preserving the FFELP reinsurance rather than on actually collecting money from borrowers. They may originate alternative loans as a loss leader for the FFELP business.

Lenders of alternative student loans take a consumer finance approach, but they are young companies. Standalone alternative lenders focus on risk-based pricing and do not create alternative loans as loss leaders.

Student loan lenders can offer loans either through school channels or direct to consumers. Alternative lenders can push for school channels but there is evidence that it produces adverse selection and a lower average FICO score. Offering loans directly to consumers tends to produce a somewhat higher FICO score but there is greater risk of borrowers over-borrowing because schools are not involved in the process as gatekeepers.

In the Senate re-authorization bill, graduate students would be allowed to use PLUS loans (they could be their own parents).[30] Allowing expanded availability of PLUS loans to graduate students could somewhat reduce the volume of alternative loans to graduate students.

Collateral Performance: Key performance measures for student loans include the following: (1) 90+days delinquency rate, (2) cumulative default rate, (3) claim submissions and rejections, and (4) deferments and forbearances. Performance measures become most revealing when they are stratified by FICO score ranges. Alternative student loans reasonably can be compared to other consumer loan products. Most data on alternative student loans suggests that performance will be stable. Some pools show rising delinquencies, but this is likely just a seasoning effect. Defaults have been generally low on alternative student loans. Some student loan borrowers use HELs to prepay their student loans. Student loan performance has been good on virtually all fronts, but it might not be so in the future.

A factor that will influence future performance will be the starting salary for new college graduates. If the economy slips, starting salaries may drop. Deferments and forbearances could rise. Servicing strategies also drive performance. Those who use FFELP servicing strategies may produce much worse results in a stressful environment. Skip tracing is very important because young borrowers are highly mobile. It is often desirable to maintain contact with a young borrower via e-mail and the internet.

Over time, some lenders have progressed from underwriting at the school level to underwriting at the borrower level. The latter is a better approach. Every school has good borrowers, but not all have the same proportion of good borrowers.

A lender should not manage alternative loans in the same manner as FFELP loans. For alternative loans, it is necessary to focus on the borrower's credit and on the credit of the co-signer, if there is one.

One alternative student loan lender views the alternative student sector as consisting of four segments: (1) parent loans, (2) graduate loans, (3) undergraduate loans, and (4) proprietary school

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[27] For background on ABS backed by student loans see Bartlett, E. and M. Adelson, *Student Loan ABS 101 – An Introduction to Student Loan ABS*, Nomura fixed income research (26 Jan 2005).

[28] The Federal Family Education Loan Program (FFELP) offers student loans that are financed by private lenders. State guarantee agencies guarantee the loans and the federal government reinsures the guarantees.

[29] Alternative/private student loans are unsecured consumer loans that are not reinsured by the federal government.

[30] Higher Education Amendments of 2005, S. 1614, 109th Cong., 1st Sess., § 1003, (2005).

loans. The bank focuses strongly on consumer credit and uses both standard FICO scores and proprietary scores. It has sufficient data to be able to analyze each product category independently. It is important to have a "long" database because a borrower's first payment often is not until four years after his loan was originated.

From the perspective of a bond insurer, measuring the performance of defaulted student loans requires netting out collection costs. It is necessary to look for any changes to a loan program or to the school population over time. In the past, alternative loans were associated primarily with the most expensive schools – mostly elite institutions. Today, however, students at virtually all four-year colleges need alternative student loans. Alternative student loan lenders need to be very careful about forbearances and deferments because they can easily become defaults.

FICO Scores: There has been strong focus on FICO scores, but alternative student loan lenders need to remain mindful of their limitations. Bad scores *do* imply bad future performance but good scores *do not* necessarily imply good future performance. Co-signers' FICO scores arguably are more important than the FICO scores of the primary borrowers. In addition, a FICO score does not reflect the borrowers DTI; is a borrower over-leveraged? Another challenge: many borrowers' FICO scores migrate significantly over time. Using the average FICO score of a portfolio can be misleading if there is wide dispersion around the average. Low FICO scores hurt more than high FICO scores help. Despite their weaknesses, FICO scores remain a very important and valuable tool.

Rating Alternative Student Loan ABS: There are likely to be new entrants to the alternative SLABS market in 2006. Lenders are getting the message that private loan borrowing is not the same as FFELP lending. One of the barriers to entry is the technological sophistication necessary to build an origination platform and effective servicing systems.

Good historical performance data on student loans is available from some state agencies and from some of the largest private lenders. However, data does not tell the whole story. Another approach that rating agencies use is to start with an idealized benchmark and to develop stress scenarios around it.

Most lenders' databases are not deep enough to allow firm conclusions about the relative quality of loans to borrowers at different types of schools or in different geographic regions. The ability to make distinctions along those lines will come only after it is possible to combine data sets from multiple lenders. Graduation rates and academic disciplines may also be a basis for risk scoring in the future, but not today.

Friday, 16 September 2005

9:00 am – A Re-Emerging Asset: Utility Ratepayer-Backed Bonds, New States and New Opportunities

Stranded cost ABS[31] have very simple structures: (1) Put a charge on electric bills. (2) Pass it along to the trustee to repay the bonds. (3) If there is not enough money, raise the charge for future periods.

Stranded cost ABS are essentially government guaranteed. They are authorized by special statutes and have an additional state "pledge" supporting the securities. Utilities from 12 states have issued about $33 billion of stranded cost ABS. Utilities from three new states have issued stranded cost ABS in the past six months: Florida, West Virginia, and Idaho. Nationwide issuance volume has been

[31] "Stranded costs" refer to investments by a power company that become unrecoverable because of deregulation and the consequent competition from out-of-state competitors. Following deregulation of the electric business, some states allowed their power companies to recover stranded costs by collecting a "competitive transition fee" from their customers. Stranded cost ABS are securitizations of the "competitive transition fee" cash flows.

erratic since 1997. One panelist expects issuance of stranded cost ABS to be in the range of $4 billion to $5 billion over the next 18 months. Stranded cost ABS represent a substantial share of all fixed-rate ABS with maturities longer than five years.

According to a Nomura study from December 2004, stranded cost ABS is the only ABS sector that has been completely free of adverse credit migrations.

Stranded cost ABS have no prepayment risk and the risk of extension is statistically insignificant. Stranded cost ABS arguably are more attractive than credit card ABS along many dimensions.

Stranded cost ABS have a different form of credit enhancement than regular ABS. The "credit enhancement" is the ability to increase the monthly charge to consumers in order to be able to collect enough money. The real risk is political risk; that ratepayers may resent the incremental charge on their electric bills and may elect legislators who will change the law to eliminate the charge.[32] The charge is usually less than 10% of consumers' electric bills. [Note: The charge has exceeded 25% in some deals (*e.g.*, SPPC Funding LLC 1999-1).] A mass migration out of a particular area could reduce overall power usage. Stranded cost ABS deals have performed generally as expected and it has rarely been necessary to significantly raise the level of charges supporting any of the deals.

All the deals include legal opinions concluding that the related state is *contractually* bound not to take any action that would impair the bonds. If the state takes such an action, the trustee for the bonds could sue. But, if there are "cataclysmic circumstances," the courts might allow a state to break the contract, just as the Supreme Court allowed states to impose moratoriums on enforcement of mortgages during the Great Depression.[33]

From a regulator's perspective, the key issue is the public interest. A state would annul or suspend its contractual obligations only in extreme or drastic circumstances. Legislation provides that the transition charges are property rights and not subject to any setoff, defense, or diminution of their value.

Competitive transition charges allow electric utilities to recover their investments in power plants that had to be written down when competitive barriers were lowered. Issuing stranded cost ABS allows a utility to pay down other debt (and equity) to reduce its overall cost of funds. The legislation for stranded cost bonds got passed because there was something in it for both the power companies and the public.

Stress testing of stranded cost ABS structures reveals that they could withstand roughly a 75% drop in electricity usage before the bonds would default. A key feature of some structures is that principal is not required to be paid until two years after the expected maturity. There has never been a case where power delivered by a regulated electric utility dropped by more than 50%.

Given the extremely strong credit characteristics of stranded cost ABS, they arguably should price at tighter spread levels than credit card ABS. However, the credit card sector is a benchmark and some investors are concerned about liquidity of stranded cost ABS. Spreads on stranded cost ABS widened briefly when there was a grassroots initiative in California to overturn the competitive transition charges in that state.

States have started using arrangements similar to stranded cost financing for other purposes. For example, Wisconsin is using such an arrangement to finance pollution control activities. Florida is

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[32] *See* Fabrikant, B. et al., *California Proposition 9 – Lights Out for the Stranded Utility Costs ABS Markets?*, Moody's special report (16 Oct 1998); Jamil, T., *Stranded Costs: A Resilient Asset Class*, Moody's special report (3 Jan 2005).

[33] During the Great Depression, 25 states enacted moratoriums on mortgage foreclosures. In normal times, the governmental impairment of private contracts would have been unconstitutional. The Minnesota moratorium was challenged and the case ultimately reached the Supreme Court. The Court allowed the moratorium to stand. *Home Building & Loan Assn. v. Blaisdell*, 290 U.S. 398 (1934).

using one to replenish the hurricane fund. Idaho has authorized securitization for any cost with respect to which a public utility could issue debt or equity. The IRS has created a safe harbor for stranded cost-type deals issued by public utilities. The Florida legislature recently passed a law enabling utilities to issue "hurricane recovery bonds" to restore the level of reserves that they are required to hold for making emergency repairs after storm damage.

Stranded cost ABS qualify for 20% risk weighting under foreign capital regulations.

10:00 am – New Life Insurance Products

The life insurance industry has become more competitive. Margins are tighter. This has forced insurance companies to focus on funding and capital management. The insurance industry has several ways to use securitization: (1) raising money by using future profits or fees as collateral, (2) risk transfer, and (3) statutory reserve funding needs. In addition, a secondary motivation is deals centered on individual policyholders.

There are several types of insurance securitizations: (1) closed block deals, (2) separate account deals, (3) catastrophe bonds, (4) premium finance deals, (5) life settlement deals, and (6) deals for relief from Reg. XXX reserve requirements.

Reg. XXX Securitizations:[34] Since the last conference in February, there have been five or six insurance securitizations totaling about $2.5 billion of financing. Reg. XXX securitizations finance "redundant" reserves. Those are reserves required by regulation but which exceed reasonable economic reserves. In Reg. XXX deals, the special-purpose vehicle (SPV) is a regulated insurance company. In a Reg. XXX deal, a specific block of business is isolated from an insurance company's other business in the deal's SPV.

The investor base for Reg. XXX deals continues to expand. Originally, the Reg. XXX deals were sold with short-term Dutch auction remarketing structures but now they have also been sold as medium- and long-term securities.

The convergence of the insurance market and capital markets will continue. Warehousing deals already have been done. The next step may be deals that allow small insurance companies to band together in a single deal so that they can get XXX reserve relief. Reg. AXXX is essentially the counterpart to XXX for universal life policies. There likely will be deals designed to address the AXXX capital requirements. Also, unwrapped XXX/AXXX deals are likely to happen.

So far, all the captive SPVs for Reg. XXX deals have been formed in South Carolina. That state has a statute called the "special purpose financial captive law" that codifies all the steps for creating a proper SPV for a Reg. XXX transaction.[35] However, there are other captive friendly jurisdictions and there are transactions in the pipeline that use SPVs in other jurisdictions. In a Reg. XXX deal, the sponsoring company cedes the subject business to the captive SPV. In some deals, multiple affiliated insurance companies have ceded business to a single SPV.

The proceeds of issuing "surplus notes" is intended to count as surplus by the issuing insurance companies. Payment of surplus notes requires regulatory approval. For many deals, it is necessary to get advance approval covering a year's worth of payments.

Actuarial Perspective: Reg. XXX requires statutory reserves that are far higher than necessary. The key question, though, is just how much higher than necessary is the Reg. XXX level. That is an

[34] *See generally*, Cummins, J.D., *Securitization of Life Insurance Assets and Liabilities*, Wharton Financial Institutions Center, Working Paper No. 04-03, at pp. 39-40 (3 Jan 2004) (http://fic.wharton.upenn.edu/fic/papers/04/0403.pdf); Valuation of Life Insurance Reserves, 11 NYCRR 147 (http://www.ins.state.ny.us/acrobat/r147text.pdf) (implementation of Regulation Triple-X in New York).

[35] S.C. Code § 38-90-10 et seq. (2004).

actuarial question. There are two key issues: mortality and lapse. The two are interrelated because less-healthy policyholders arguably are less likely to lapse. Another key question is which policyholders will retain their policies after the end of the level-term periods of their policies. Life insurance premiums increase so dramatically at the end of level-term periods that it is reasonable to expect a significant lapse rate among healthy policyholders.

Policy Finance/Life Settlements: The viatical business was the origin of today's life settlement deals. While an insurance company is the sponsor of a Reg. XXX deal, the sponsor of a premium finance deal would likely be a specialty finance company. Insurable interest is an issue in life settlement deals. Investor interest in the sector is coming from many areas, including German funds. At the retail level, Germans can benefit from investing in life insurance policies. Hedge funds also are interested in life settlements. In contrast to past deals, future life settlement deals are likely to have 1,500 to 2,000 lives with smaller, off-the-shelf life policies. Most underlying policies likely will be universal life policies, though there may be some term policies. Life settlement deals look for life expectancies in the range of eight to twelve years. The effect of such deals on the lapse risk is an issue for the relationship with the insurance companies. Somewhat surprisingly, the insurance companies are sometimes supportive of life settlement deals because the deals provide greater certainty about the lapse rate and about the premium cash flow that the insurers will receive.

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