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Report from Arizona: Coverage of Selected Sessions of the February 2002 Securitization Conferences

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The following summaries reflect remarks of the panelists who participated in selected sessions at the recent asset securitization conferences sponsored by Fabozzi/Information Management Network and Strategic Research Institute in Arizona. 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 conferences.

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Please refer to important disclosures at the end of this report.

Fabozzi/Information Management Network Asset Securitization 2002

February 6-9, 2002, The Arizona Biltmore, Phoenix, Arizona

Thursday, 7-Feb-2002

8:15 AM – New Era in Global Securitization

Global ABS issuance in 2001 reached $426 billion, which was a major increase over 2000. International issuance grew by about 75%. Total structured issuance was $552 billion in the U.S., $149.9 billion in Europe, and $33 billion in Asia. At year-end, there was $850 billion of asset-backed commercial paper (ABCP) outstanding, which was more than the aggregate outstanding amount of corporate CP. Global structured issuance was about $1.5 trillion in 2001.

In Korea, the environment is supportive for securitization. Although spreads have compressed in Korea, they are still wide by US standards.

In Japan, securitization was most active through conduits a few years ago. But now, the term side is becoming increasingly active because of government-related deals and deals from consumer finance companies. One of the year's most significant deals was the Shinsei CLO that used a master trust structure. It is not clear how quickly that other Japanese banks will adopt the deal's master trust technology, but it is clear that there will be increasingly more term issuance activity in Japan

The past year saw some groundbreaking deals in Europe. Healthcare, diamond receivables, and utility receivables were areas that saw major deals. Welsh Water was a very large deal (£2 billion). In the residential MBS area, some of the issuers are becoming global benchmarks.

The dynamism of the European market extends beyond the UK. Sweden and Italy spawned some high profile deals (e.g., Italian state assets). There have been a large number of deals by French and German banks, motivated by regulatory capital considerations. The level of activity in the UK has been driven substantially by whole-business securitization, which is possible because of a very favorable bankruptcy system. However, it is proving difficult to export that activity to other nations.

The "size" of the European ABS market is best measured by reference to the source of the underlying assets. By that measure, the size of the European market was $145 billion 2001. Growth will moderate to 25% for 2002. The biggest sector of the market is RMBS, followed by CDOs. The third largest sector CMBS.

South Africa entered the structured finance arena in 2001. There was a residential MBS deal for about $125 million.

The structured finance market in Latin America was about $7 billion in 2001. Argentina, Brazil, and Mexico are the sources of most deals. Because of the troubles in Argentina, it is likely that there will be fewer deals from there. The Mexican market, however, should grow, resulting in roughly stable levels of Latin American issuance in 2002.

Interest rate cuts and predatory lending litigation were key themes in the U.S. securitization market in 2001. September 11 and the CDO bid were also significant factors, as was the implementation of FAS 140. Also, the LTV Steel bankruptcy case cast a shadow over the market for a time.

The U.S. ABS market benefited from the softening economy and the flight to quality following September 11, proving its is strength and resiliency by providing liquidity during difficult times. 79%

of credit card issuance was floating rate in 2001, which was the highest percentage ever. A key theme in 2001 was a focus on servicer risk.

September 11 created a one or two day blip for some ABCP programs. Even after the attack, it took only a few days for everything to get back to normal. The attack temporarily pushed a few term deals that had been near completion into the ABCP market. Spreads for term ABS widened by only a small amount, and term ABS were viewed as a safe haven.

On the other hand, immediately after September 11, the Fed pumped liquidity into the economy. Accordingly, it may be too optimistic to view the most difficult consumer issues as having passed. We could experience a double dip recession driven by weak consumer balance sheets.

Spreads on auto-backed ABS kept getting tighter in January. Part of this was driven by a view of on-the-run ABS as a safe haven. Widening spreads in the corporate market keep pushing spreads tighter in the ABS market.

However, not all issuers have experienced the benefit of tighter spreads. Infrequent issuers or issuers of deals backed by off-the-run assets have not realized a benefit.

Part of the result of the Enron debacle has been increasing scrutiny on the requirements for partnerships to receive off-balance sheet treatment. Disclosure and conflicts of interests are the backdrop against which surrounding issues will be highlighted. The whole situation raises questions about where other problems may develop.

Headline risk and servicing risk are key potential problems. Market participants now seem to have swept the LTV Steel situation under the rug and to view it as a "blip." Will Enron come to be viewed as a "blip" and essentially be ignored by market participants in the future?

The market could be damaged if the rating agencies over-react to the Enron situation. A related problem is that the accounting profession has moved from applying judgment and common sense toward operating under a regime of rules. If an issuer can figure out a clever gimmick under the minutia of a rule, it will achieve the desired result even if a partner at an accounting firm would have nixed the plan in the past. Reliance on rules has pushed out judgment and arguably is damaging for the markets.

In recent testimony to Congress, a key player from Anderson Consulting recommended increased disclosure of (1) off-balance sheet assets, (2) valuation assumptions for financial assets, and (3) time series data on key performance measures. It turns out that existing disclosure practices of many active securitizers already address these issues.

Panelists' predictions for 2002 (from various panelists):

- global securitization: $525 billion
- global securitization: more than $525 billion
- a double dip recession
- 40% growth in European ABS issuance
- increasing reliance on securitization markets by companies that need stability
- global securitization: $525 billion
- U.S. public ABS issuance $325 billion
- U.S. public and 144A $400 billion
- Europe: €180 billion
- tighter spreads
- 15% U.S. securitization growth, 20% global securitization growth

9:30 AM – The Brave New World of Securitization

Where are we in the recovery process? Have we bottomed-out yet? The consensus among the panelists is that we will have sluggish growth in the near future.

In a weak economy, the ABS market remains the market of choice for investors seeking safety or quality. The major issuers in the main sectors continue to extend their dominance and the underlying fundamentals point toward continued issuance and continued quality. A "sputtering recovery" or "growth recession" could be a very positive situation for the ABS market because the ABS market is viewed as safe and stable compared to the corporate bond market.

Consumer portfolios showed increasing delinquencies before September 11. The attack generated a small spike, but now performance is showing some improvement. However, experience varies across products and strata/segment within the consumer population. Lenders who never relaxed their credit standards have continued to achieve strong performance in their consumer credit portfolios. They were not seriously impacted by the recession.

Corporate/Commercial Current Condition and Outlook: The trucking industry is hurting as sales are down and users are extending the service life of the equipment. Airlines are hurting and lease residuals are under intense pressure. Healthcare has had problems for the past 18 months, driven by overbuilding caused by a period of easier permitting. Manufacturing is soft; there has been no rebound. Auto suppliers are weak but stable. Steel is in trouble. Agriculture has excess capacity and rising costs. Farms going out of business have created a glut of used equipment. The leisure industry is hurting because travel is way down. Commercial real estate is OK, but it is a sector whose experience lags the general market.

Much of the pain in the manufactured housing sector is behind us because lending standards recently have improved. Likewise, the worst is probably behind us in the franchise sector. Much of the trouble in the CDO area stems from the 1996 and 1997 vintages. There are still good CDO deals to be done, and the key to doing successful deals will be the manager. In CDOs, lower returns for the equity will signal better quality for the more senior paper. Investors will have a more sober mood in 2002 and this will have the impact of boosting quality (within each rating level) across many asset classes.

Manufactured housing is an alarming sector, but there are issuers and vintages whose deals offer excellent value.

Consolidation of issuers within an asset class can be a strongly positive force for improving quality. The issuers with the better practices will absorb the others, thus providing a boost to the quality of newly originated assets.

Compared to a few years ago, the markets have learned to discriminate between quality and its opposite. For example, trouble in Argentina has not diminished demand for Brazilian and Mexican deals.

Panelists expressed the most concern over the CDO sector in 2002.

Spread outlook for the next six months:

- for cards and autos spreads are as good as possible; HELs can tighten a bit more; a move back to corporate bonds could cause a widening
- spreads have started to tighten and the trend could continue; if volatility declines, we could observe some extreme compression
- the consensus is that spreads will be tighter in six months

The aircraft sector has been through a round of downgrades and it is still under pressure. If we do not see marked increases in air travel, the situation will just continue to worsen. However, there is some good news. Fleet expansion plans in the 1990s were more modest than prior rounds of fleet

expansions. Fuel costs are down. Production cuts at the aircraft manufacturers will help boost values of used aircraft. Also, retirements of old aircraft further reduce supply and help to support residual values of units in service. Structure is key for investors in the aircraft sector: bullets and amortizing bonds could have very different exposure to extension risk, even though both may have been rated double-A.

11:00 AM – The Role of Securitization in an Issuer's Overall Funding Strategy: The Impact of Securitization Capital and the Costs Involved in Getting the Deal Done

A major credit card issuer has entered the auto lending business and now auto lending in the U.S. accounts for 12% of the company's business. U.K. credit cards and other activities account for 5% and 3% of the company's businesses, respectively. The company is rapidly growing and has achieved strong EPS growth as well. The company carries triple-B ratings and, therefore, it focuses on rating-insensitive funding. It uses securitization for about 55% of its funding, with deposits for about 25%. Deposits and securitization have about the same all-in cost for the company.

A second company is in the equipment leasing business, specializing in leasing big-ticket medical equipment. 85% of the company's managed assets are domestic and 15% are international. The company has single-B ratings and, therefore, relies heavily on securitization. The company has done many securitizations and uses securitization for about 65% of the funding. The remaining sources of funding are warehouse lines (17%), unsecured loans (8%), and equity (10%). The company does about two deals per year and its last deal was for roughly $425 million.

A third company is a captive finance company of a truck and engine manufacturer. The company has used securitization since the early 1980s (with its banks) and it entered the public ABS markets in the early 1990s. The company's largest asset classes for securitization are retail and wholesale notes. The company likes securitization because it match funds the assets. The company is split rated: two rating agencies assign investment-grade ratings to the company's corporate debt and one rating agency assigns a speculative-grade rating.

Unrated and low-rated seller/servicers have the most to gain from securitization. Securitization provides low cost funding and greater availability of funds. Early stage issuers tend to be capital constrained. They often do not have the equity that they need for working capital or even to meet the haircut requirements on their warehouse facilities. By using securitization techniques, it can be possible to "over-advance" against receivables and thereby to alleviate capital constraints.

The leasing company is motivated to grow its balance sheet. The company believes that investors should be indifferent regarding whether a financing is done in an on-balance sheet or off-balance sheet format. Similarly, the truck company does place a high priority on whether a deal is done in on-balance sheet or off-balance sheet format. The companies recognize that the choice of format can affect the stability of reported earnings by generating gains on sale.

The leasing company focuses on the cost and the benefit of generating competition among service providers (banks, trustees, lawyers, &c.) when using securitization. In contrast, the credit card company and the truck company focus on market access, liquidity, and continuity of funding as more important considerations than cost. For first time issuers, there are incremental costs, such as wider spread demanded by investors. In addition, other costs, such as legal fees, can be much higher for first time issuers. On the other hand, first time issuers are somewhat less cost sensitive at the margin.

Risk transfer is not a goal of securitization for the truck company.

Some of the companies have expanded their distribution efforts to try to reach foreign investors. Both dollar and euro denominated securities can be used.

Accounting/regulatory issues are a consideration for the leasing company; in particular, FAS 140 was very significant. The disclosure requirements were burdensome. The credit card company has not encountered difficult issues from FAS 140 but it remains wary that new disclosures could make investors skittish.

1:15 PM – The Impact of Risk-Based Capital and Bank Regulatory Issues on Securitization

The new U.S. risk-based capital rule equalizes the treatment of "recourse" and "direct credit substitutes." The rule provides for dollar-for-dollar capital to be held against retained interests that are not rated at least double-B. Capital for ABS holdings is determined by ratings in most cases.

The new rule probably provides a benefit for banks that invest in ABS, but probably imposes additional burdens on banks that issue securitizations. The rule will help securities dealers sell highly rated ABS. The rule may eliminate banks' issuance of ABS backed by subprime mortgage and high LTV securitizations (except for the very largest banks). Over time, the rule probably will deter smaller banks and mono-line banks from using securitization. The rule eliminates the opportunity to use gain-on-sale accounting because the capital requirements on retained interests would be too onerous.

The OCC's top examination issues are:

- Expertise of management team and line staff: understanding the accounting, risk-based capital rules, and interagency guidance.
- Valuation of residual interests: back-testing projections and assumptions.
- Management information: know the quality of the portfolio and its vulnerabilities (pressure for earnings expectations can lead to greater risk taking or risk masking, such as inappropriate re-aging).

Implicit recourse is when a bank provides credit enhancement beyond its contractual obligation to support a deal. If an institution supplies implicit recourse, the regulators may require that the assets securitized in all past deals be brought back onto the institution's balance sheet. Within 60 to 90 days, the regulators will issue guidance on implicit recourse.

Although the recent rule did not impose a capital charge for managed assets, that issue remains on the forefront of the regulatory agenda for 2002.

In January 2001, the Basel Committee issued a large document, which did not address securitization. In October, the Basel Committee issued a securitization document. The regulators have proposed 1.6% capital for ABCP liquidity facilities and the industry has come back asking for 0.8%. It remains unclear how many banks would actually use an internal ratings based approach. The regulators were thinking in terms of about 10 institutions but others were estimating about 45. Another issue with which regulators are struggling is the application of the internal ratings based approach to ABCP liquidity facilities. Another issue is synthetics: bilateral transactions raise a particular concern because there is not third party involved and there is no transparency. The internal ratings based approach probably will not be implemented until 2005 or 2006.

4:45 PM – Research Analysts' Roundtable (Non-Real Estate ABS)

Where is the best value right now?:

- MBNA and Capital One triple-B credit card paper
- diversify away from consumer credit and into rate reduction bonds; also consider catastrophe bonds

- on-the-run sectors have done well recently; stranded costs will be good; second liens to high FICO borrowers; RMBS subordinates
- stay in consumer debt but swap from cards to autos; the modest down-in-credit trade is good; for the more adventurous, Household and Americredit subprime auto are opportunities
- hold a core position of credit cards, autos, and student loans; long triple-A home equity; wrapped subprime auto; top tier triple-B credit cards
- there is not strong value in on-the-run asset classes; must look off-the-run; NCFE is an opportunity; Chevy Chase prime auto is an opportunity; pooled aircraft offers select value in senior amortizing classes
- economic recovery is still shaky, so stay with on-the-run product; risk is at the seller/servicer level rather than at the asset level; credit cards, student loans, autos, Ausie MBS are traditional defensive plays; selective subprime autos; some good value in home equities; MH is still in the throws of a vertical integration crisis and is only for the most long-term buy-and-hold players
- there should be only modest tightening going forward; there is not much more room for tightening; keep portfolio liquid and carefully move into off-the-run names; long-term rate reduction bonds offer opportunity and should tighten through cards; long home equities and premium auto paper; prefer mezzanine paper over both AAA and BBB paper
- a positive feature of ABS is low spread volatility compared to corporate bonds; therefore, there is room for even more tightening; stay in highly liquid sectors which are the prime beneficiaries of the flight to quality; use "liquidity plays" instead of "credit plays" to get value in off-the-run sectors; wrapped Americredit is a good buy

If the recession continues into 2002, it will put particular pressure on the subprime sector and on unsecured assets. However, triple-A ABS would remain very attractive.

The sectors that will suffer the most in a bad recession are subprime consumer receivables, assets for which servicing is difficult to transfer.

Subordinate ABS will lag over the coming year.

The bread and butter asset types are arguably over-enhanced. Historically, all ABS were over-enhanced. But, over the years, the rating agencies have gone through waves of lowering enhancement levels – and sometimes raising them. Credit cards have always been over-enhanced because the early amortization mechanism provides protection. The true-up mechanism in rate reduction bonds provides nearly complete protection. Student loans have lots of protection from the nearly complete government guarantee.

The only real negative news last year came from Providian and NextCard. Heilig-Meyers was the only real blow-up. For 2002 the private label credit card sector is at risk. Spiegel is a name that seems particularly risky. Fingerhut (which recently closed the business) is another name associated with deals that could get into trouble. Larger institutions could acquire some of the smaller, regional credit card issuers, which would be positive for the small institutions' outstanding deals. Another view is that the troubles at Providian and NextCard were from regulatory issues and were not related to the assets or the portfolios.

One of the most interesting trends over the past view years is the investors' increasing demand for due diligence and transparency. Nonetheless, it will be tough to avoid the bad apples because issuers always have a pat explanation when the numbers start to show a negative trend. Can an investor really trust those explanations?

Credit risk in the prime auto sector is very low. The situation is similar in the subprime auto sector; although losses are high, the volatility of losses is very low (and wraps provide much protection as well).

Friday, 8-Feb-2002

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

Consolidation is a key issue when looking at new asset classes. The regulatory environment is another issue. A third issue is the recognition of asset sales, especially after Enron. We must not forget Heilig-Meyers, LTV Steel, or Hollywood Funding when we focus on new asset classes. We must try to avoid having an "Enron" in the securitization market.

The challenge for market participants is to find new opportunities for applying securitization technology. It is getting harder and harder to find such opportunities.

Apart from new asset classes, there will continue to be opportunities in structures and in bringing the technology into new geographic regions.

Who would have thought that the sleep-inducing bankruptcy reform bill could have created such controversy? The Enron debacle probably has derailed the bill. The bill would have eliminated "recourse" as a relevant factor for determining whether a transfer of assets constitutes a "true sale." The bill would have helped to boost securitization activities but some law professors have written a scathing letter attacking the bill, arguing that it would prompt a string of Enron-type situations.

The newly formed American Securitization Forum will allow the industry to speak with one voice on developing legislative and regulatory initiatives.

Over the past three or four years there has been an emphasis on creating complicated new products with triggers for protecting the most senior classes. This has increased the need for a liquid secondary market in the subordinate classes of those deals. In trading subordinates, one must consider three factors: (1) liquidity, (2) fear, and (3) fundamentals. The fundamentals do not necessarily drive pricing and spreads. Technical factors, such as supply surges can exert strong forces on the thin market for subordinates, causing notable spread volatility. Spread volatility can cause some investors who have bought subordinates in the past to turn away from the product. This causes a need for dealers to continually find new investors for subordinate classes. Triple-B high LTV classes are vivid examples. The bonds arguably are very safe and yet their spreads have fluctuated widely because of fear, lack of liquidity, and technical factors.

When investing in new asset classes or deals from new issuers, an investor must really do his homework. An investor should be especially wary of aggressive, complicated structures. It is better to focus on simple single-tranche deals when initially dealing with a new asset class. The ABS market can learn from the CMBS market, which has achieved an important degree of standardization under the auspices of the CMSA. [This panelist discusses the Nomura's report titled How the Events of 9/11 Affect Thinking about Risk.]

Operating asset securitization offers stability because the asset values are usually stable. This applies to containers, truck chasses, and aircraft. However, an important hurdle is getting a reliable back-up servicer. Another hurdle is the inherent linkage of the rating of an operating asset securitization to the rating of the sponsor.

Whole business securitization will be one of the hot areas for the next few years. It will be used for infrastructure financing, leverage, and M&A. It has the potential to replace large portions of corporate debt. Market participants should look for situations where there is strong operating cash flow and minimal operational risk. The difficulty in transferring this technology from the U.K. to the U.S. is the structure of the U.S. bankruptcy system (*i.e.*, the U.S. bankruptcy system is too debtor friendly). In Europe, the concept of operating asset securitization is being applied to film libraries, lottery receivables, and membership sales of soccer teams.

Enron, Kmart, Tyco, and Ford are all recent examples of corporate credit volatility. This is putting pressure on the corporate debt-backed CDOs. The pressure is particularly acute on the mezzanine and subordinate classes of CDOs backed by high-grade corporate debt because those deals have very thin subordination levels. This highlights one of the fundamental flaws of the CDO sector: the manager is supposedly managing for all participants in the deals but really the double-B and triple-B investors' interests are ignored. Those investors are particularly disadvantaged in deals that allow for purchasing deep discount assets and those that allow for large triple-C buckets.

There is now recognition that it is in the interests of all participants to take a rational, cautious approach to structuring CDOs. It does not pay to jeopardize a deal's safety just to squeeze out a few more dollars of proceeds or a few more basis points of equity returns.

Capital preservation will be a key theme in the CDO sector. However, equity investors are likely to continue demanding higher and higher returns.

Trading of CDO subordinate classes is impeded by the difficulty that prospective buyers face in getting remittance reports. Although the deals are done as 144As, information is very hard to get compared to other 144As. This has a detrimental effect on the liquidity of the CDO subordinate sector.

Small business loan securitization consists of two categories: (1) the unguaranteed portions of SBA loans, and (2) middle market finance company loans. A few CDO-type deals have been done with finance company loans. This could be an area of growth over the next year.

Synthetic execution is a way to transfer credit risk. It is faster, simpler, and cheaper to use for most asset types. Banks will use it as a means to manage risk in lieu of actually selling assets.

ABCP is funding more and more of the new/esoteric assets. It has the potential to further supplant term deals.

Wackiest asset classes:

- English pub deals
- entertainment cash flows (Pullman group)
- Haitian power plants
- cattle, diamonds, model homes
- bonus receivables of Japanese workers; greenhouse gas credits
- fleet of natural gas compressors (operating asset)

9:15 AM – Traders' Roundtable

Traders now have to use more tools beyond Bloomberg (YT) and Intex for trading bonds. Now some traders are using the rating agency information and other sources as a basis for spotting opportunities and pitfalls. A couple of years ago, when asked to price a bond, a trader might have only checked the Bloomberg YT screen. Now the trader will almost certainly use other sources. Trading MH securities based on Bloomberg YT is absolutely wrong now. It is now necessary to run scenarios with loss and prepayment assumptions. Some Green Tree bonds offer value now as do some Providian credit card securities. On Providian, a trader should consider and model early amortization risk in addition to considering spread.

The market over-penalizes some sectors because of headline risk (really investors' fear of headline risk). This makes some sectors – especially off-the-run sectors – attractively cheap right now.

Some see excellent opportunity in the home equity sector. This results, in part, from the recent tightening in the card and auto sectors. The home equity sector is priced very conservatively right now (*i.e.,* with very conservative prepayment assumptions). HELs offer both good carry and the opportunity for tightening.

The manufactured housing sector arguably offers value. However, in the coming year, the game will be security selection as opposed to sector selection. In the MH sector, there has been very significant widening, even for triple-A paper. Single-As are at 400 over and there are B2-rated securities offering 20% to 25% (equity-type) yield.

Liquidity and fear are even more important factors than fundamentals in driving spreads. The opportunities lay in areas where investors are afraid and where liquidity is absent. Another strategy is to focus on seasoned paper because there is the chance to analyze several years of collateral history. Seasoned Conseco paper is cheap right now; that vintages from '93, '94, and '95 are safe.

The commoditized sectors are attractive because they have good technicals compared to the unsecured corporate market and spreads are not really too tight right now compared to what they were when Treasuries were used as the pricing benchmark.

Prepayment volatility in the auto sector is created trading opportunities. It was advantageous to buy auto paper in November when prepayment speeds were fast. The right approach is a common sense, conservative approach. Advice: use the more advantageous of (1) the pricing speed or (2) the recent prepayment print.

Subprime autos offer a convexity advantage over prime autos. There will be a good bid for the prime on-the-run names, which will leave some value on the table. Triple-A ABS of all types are great investments compared to unsecured corporate debt right now.

Recent rate reduction bonds have been priced very aggressively and have not been as well subscribed as earlier deals. There is not much room for spreads on these bonds to tighten further.

Predictions for 2002:

- issuance will be up in 2002; issuers will have continuing incentive to issue ABS; demand for ABS will continue to outstrip supply
- issuers are very sophisticated and will try to reach investors of all types (fixed and floating); spreads will tighten because of positive technicals

Traders have not yet come to appreciate the upgrade to downgrade ratio in the ABS sector (compared to corporate bonds). There is a heightened focus on how rating agencies will behave with regard to ratings volatility. The rating agencies should be required to use Intex to enable them to run future cash flows and spot ratings that are too high or too low. The market tends to be ahead of the rating agencies, especially on mezzanine and subordinate bonds.

Franchise deals require more work to analyze than other kinds of deals. The Deloitte & Touche model that all the bankers used for structuring franchise deals was way off. An investor must be very careful of mezzanine and subordinate tranches, which now are trading at very deep discounts.

High LTV without the CDO bid is still safer than top-tier home equity. In fact, triple-B home equity deals are very exposed because the target overcollateralization (OC) levels are quite low and excess spread is lean. HEL deals would be better if the OC targets were higher. Given their structures and target OC levels, the bonds could drop from 95 to 50 if their OC suffers material erosion.

Small ticket equipment deals are risky because of low residual value recoveries. Some such deals were priced with low levels of subordination. Also, watch out for black box CLOs. Some have Enron and Kmart exposure.

10:15 AM – Finding Relative Value in the CDO Marketplace: The Research Analysts' Roundtable

Right now the primary valuation tool for outstanding CDOs is net asset value (NAV). This arguably is a mistake because the structures are based on cash flows and are supposed to be substantially insulated from fluctuating valuations.

The CDO market has evolved in important ways. One is the increasing proportion of ABS CDOs. These arguably reflect the credit developments that have impacted the corporate-backed CDO sector.

The right way to manage exposure to CDO equity is on a portfolio basis.

With the exception of market value deals, CDOs are very much a vintage product. Thus, there is validity in piling on new CDOs now because the new deals will not suffer as some of the earlier vintages did.

One of the main determinants of success or failure of a CDO is the manager. A key aspect of a manager's success is its ability to balance the interests of the equity and the debt. Most managers own between 25% and 49% of a CDO's equity. If a deal is performing poorly, the interests of the debt and the equity conflict. Some managers of high yield corporate CDOs do not sell downgraded bonds when they should (from the perspective of the bondholders) because they do not want to cut off the cash flow to themselves. An indication that this is happening is that the triple-C bucket has grown substantially. Alternatively, synthetic credit default swaps can create perverse incentives if the manager has retained the upside on an asset but has sold the risk. Therefore, investors should scrutinize how managers have behaved on their outstanding deals.

A manager who manages a quality portfolio with a long-term perspective will do better than one who continually tries to squeeze out a few extra basis points for the equity by chasing the most volatile, highest-yielding assets.

Dealers need to be able to supply valuations in addition to firm bids. To do this, one of the dealers uses rating agency methodologies for "re-rating" each tranche of a deal and then looks at market spreads for similarly rated CDOs. Then the dealer adds a discount margin and may apply other adjustments.

The challenge for the market is to come up with a consistent, accepted way to aggregate a collection of high-yield credits and to estimate the rate of defaults.

An underwriter can influence the success of a deal by working with the manager to adjust the structure in order to accommodate the manager's strengths and weaknesses. In addition, the underwriter plays a key role in supplying collateral during the ramp-up period. Another capacity in which the underwriter can influence the success of a CDO is by post-closing support; not only supplying secondary liquidity but also promptly posting monthly reports to the internet and otherwise promoting transparency.

Yet another dimension along which an underwriter can help a CDO is by providing ongoing consultations and trading suggestions to the manager. Finally, if a CDO faces the possibility of a downgrade, the underwriter can help by participating in the interaction between the manager and the rating agencies.

Outlook/advice for 2002:

- timing is not the right strategy for investing in CDO equity
- huge growth in the synthetic markets, particularly managed synthetics; ABS CDOs will be the largest asset class (because they have had better credit performance).

The triple-A plus triple-B barbell trade is very attractive relative to buying higher rated mezzanine classes. An alternative trade is to buy the triple-Bs and the equity.

Saturday, 9-Feb-2002

8:30 AM – Operating Asset Securitization (in the U.S.)

The paradigm for operating asset securitization in the U.S. is as follows: An operating company transfers its income producing properties into various SPEs and retains the role of servicing the asset.

In an operating asset securitization, the role of the servicer is greater than in a more "traditional" securitization of purely passive financial assets. For example, in the Arby's franchise deal, Arby's had the job of delivering beef to the franchised restaurants. Such an obligation is different than the normal servicing obligation to collect money.

Operating asset securitizations are very challenging and tend to take a long time. There is a high failure rate in such transactions.

Operating asset securitization can be used in an M&A context. The challenge is that operating asset securitizations require long lead-time and M&A opportunities tend to move very quickly. For an operating asset to securitization to really work in an M&A setting, it is advantageous for the circumstances to be as simple as possible.

From a rating agency perspective, the reason that many proposed operating asset securitizations "fail" (to be consummated) is that the sponsor obtains alternative financing. An aspect of operating asset securitization that some would-be sponsors initially overlook is relinquishing control over the assets. In an operating asset securitization, the sponsor really must cede control over the assets; if the sponsor does not service the assets properly it will be replaced. Upon the consummation of deal, the assets will no longer be the property of the sponsor.

Notwithstanding the challenges and the pitfalls, operating asset securitizations are the next frontier for structured finance.

For a sponsor that really believes in its business and is confident in its ability to run the business better than anyone else, the potential loss of control is more than offset by the opportunity for high leverage and the upside on the retained residual.

Some feel that the rating agencies have been very cooperative and have done great jobs in rating operating asset securitizations. The rating agencies have not been the source of the long time frame required for operating asset securitizations. Rather, sponsors have been the primary source of delays.

The need to have a backup servicer has been another tough issue for operating asset securitizations. In some areas, the most natural backup servicer would be one of a sponsor's main competitors. A solution that sometimes works is to designate an industry consultant or a trustee as the backup servicer, with the responsibility to identify an appropriate sub-servicer if the need arises.

From a rating agency perspective, operating asset securitizations present three species of risk: legal, operational, and performance. Legal risk refers to the risk that the structure will crumble under a legal assault. Operational risk refers to the servicing issues and the ability to replace the servicer if necessary. Performance risk refers to the risk associated with the performance of the assets, assuming that servicing has not become a problem. In the area of performance risk, the analyst must consider the case that the whole franchise or concept "blows up."

An issue that affects some proposed deals is the question of whether the sponsor can actually transfer the core asset that relates to the cash flows (*e.g.,* the patent, the original print of a film, or the original master mixing tapes of a song). At the start of a proposed transaction, it is necessary to determine that the assets are transferable. In the Arby's deal, the franchise agreements clearly were transferable, but parts of the agreements were obligations to develop franchise rights in the future. This required the issuing trust to be licensed as a franchisor in 14 states. In addition to the franchise agreements, the deal had to include the core intellectual property: the Arby's name. Covering the core intellectual property helps to mitigate risks from having control over merely executory contracts.

An important innovation in the Arby's case was the introduction of an "SPV administrator" to make sure that all the corporate formalities (for corporate separateness) would be observed.

9:45 AM – Entertainment Intellectual Property Securitization of the Past, Present, and Future

Filing with the federal copyright office perfects title in copyrights. However, it is also advisable to make U.C.C. filings to perfect claims in related contract rights. New revised U.C.C. Article 9 has the added benefit of invalidating most anti-assignment clauses (§§ 9-406, 9-408).

The U.S. is unique in having a central registration office for copyrights. For copyrights in other countries, it can be more complicated. In the U.K., it is necessary to take a fixed charge over all the assets of the transferor. In Germany, it may be necessary to transfer ownership of the company. Sweden is also a difficult jurisdiction.

A key feature of music assets is that there is an infrastructure of associations and societies that administer the collection of royalties on musical works. This arguably is a big advantage over other asset classes where collections mechanics have to be established for each deal. On the other hand, publishers remit royalty collections to artists only twice a year.

A tough aspect of music royalty securitization is the valuation of the assets. Music publishers often pay 15 or 20 times the cash flow on assets. This seems very high, but it keeps happening.

Music is not the only intellectual property to enter the securitization arena. There have been private deals backed by fragrance trademarks, and sports team future receipts. Most deals get ratings in the triple-B to single-A range and the ratings are about a grade higher than the unsecured ratings of the music publishers.

There have been about $400 million of music royalty securitizations and about $8 billion in film securitizations. Some film securitizations were done to move assets off balance sheets or for income smoothing.

One record company securitized its catalog to augment bank lines that did not really give the company credit for its intangible assets. The securitization unlocked substantial value and permitted the company to establish a "war chest" for strategic acquisitions of additional music assets.

There has been one securitization of the patent on a drug for treating AIDS. The deal got a single-A rating. Obsolescence risk is a material consideration in a patent securitization.

Section 9-109(e) of the Texas U.C.C. provides true sale comfort on sales of chattel paper or accounts. Delaware has just enacted a similar provision (on January 17).

Artists and entertainment companies are reluctant to "sell" their intellectual property. Therefore, in dealing with such companies, it is necessary to describe proposed deals in terms of "mortgaging" the assets. In the structured finance context, the advance rate will be 5 to 10 times annual cash flow, while the owner of the asset will view it has being worth 15 to 20 times cash flow.

Growth in this sector will come from major corporate owners of intellectual property who are seeking to finance acquisitions of new assets.

10:45 AM – Timeshare Securitization

Timeshares arguably represent a good value for consumers in light of the high price of hotel rooms. Timeshare sales are estimated to have exceeded $8 billion in 2001. There are an estimated seven million timeshare owners. There were $820 million of timeshare securitizations in 2001 and the same level is expected in 2002. Over 73% of timeshare owners drive to their resorts. The exchange companies cover over 3,000 resort locations. Although timeshare occupancy declined following 9/11, it has fully rebounded, while hotel occupancy continues to lag last year's levels. Timeshare exchanges are at higher levels than a year ago, as families prefer to visit "drive-to" locations as opposed to "fly-to" locations.

One timeshare company focuses on maintaining about 80% of its resorts as "drive-to" destinations for the purchasers. The company manages to achieve a very high customer approval rating of 95%. The company maintains reserves for losses in the 5% to 8% range and achieves actual losses in the range of 2% to 3%. Although delinquencies averaged in the 2.0% to 2.5% range through 2001, gross bad debts averaged only around 0.25%. Despite the events of 9/11, the seasonal pattern of occupancy rates in 2001 was essentially the same as in 2000 and 1999.

Recently, two transactions, one from Sunterra and one from Epic, have experienced trouble. Last year was a good year for timeshare deal issuance with about $800 million in new deals. Of the top issuers, Westgate had the weakest performance: 13% losses compared to about half of that level at Trendwest. The losses were high on the Westgate deals in spite of the assets having been seasoned at the inception of the deal.

Fitch's timeshare index shows that 2001 was a great year for delinquencies but a very bad year for defaults.

Strategic Research Institute
Asset Securitization 2002 Symposium

February 10-13, 2002, The Fairmont Scottsdale Princess, Scottsdale, Arizona

Monday, 11 February 2002

8:15 AM – State of the Industry Address

The past year set new records for ABS issuance in the U.S. and around the world. Cumulative issuance of U.S. public/144A ABS has crossed the $2 trillion level. The level of auto loan ABS issuance increased a lot in 2000 over 1999 and remained fairly stabile in 2001. Home equity is the largest sector for issuance. The CDO sector is as major growth area for securitization.

Since 1998 there has been a slow but steady increase in the proportion of non-CDO ABS issued. Since 1999, the proportion of floating rate issuance has grown significantly. The increase in floating rate product is generally achieved by the use of swaps, as most of the underlying assets are still fixed rate.

One of the key drivers for continuing growth of ABS in 2002, is the widening of A2 finance company paper over the past few years while ABS spreads generally have been on a tightening trend. 2001 was a good year to be in bonds; all types of fixed income portfolios had positive returns, while equities lagged.

Key drivers for continued ABS success in 2002 include:

- issuance growth (new supply); about ⅔ of new issuance will be refinancings
- the ABCP market remains a key customer for term ABS; the ABCP market has achieved 31% a cumulative annual growth rate (CAGR) over the past 5 years (and also31% CAGR since its inception)
- CDOs backed by ABS are the ABS market's "smart money" partner; CDOs backed by ABS provide a strong bid for subordinate and mezzanine classes
- the economy: we have just had a very short recession; consumer confidence is strongly correlated to the unemployment rate; ABS are structured to withstand recessions

Recent rating agency developments:

- greater recognition of market-based inputs – this creates the risk of a "death spiral" (*i.e.*, when negative market sentiment becomes a self-fulfilling prophecy), but overall it is probably a good thing
- greater ratings volatility – a bad thing
- increased focus on liquidity as a factor in corporate credit ratings – concerns about rating triggers (*e.g.*, a downgrade of a company's debt rating triggers mandatory redemption of its outstanding bonds) and recognition that proven access to the ABS market is a source of liquidity
- downgrades have become much more prevalent in recent years than they were during the early years of the ABS market
- ABS have displayed less rating volatility than the corporate bonds

ABS has provided an important financing tool for corporations that have experienced negative developments. ABS provides a "safety net" for headline risk.

An important credit card issuer has adopted a structure to de-link the issuance of the senior, mezzanine, and subordinate classes of its master trust. The company has focused on issuing longer-term ABS (average lives over six years) in order to develop a well-spaced maturity ladder.

Issuance of student loan ABS should grow steadily as Sallie Mae approaches the date when it will shed its GSE status.

From an investor's perspective, the shrinking universe of A-1/P-1 corporate securities drives investment dollars into ABS and ABCP. The risk-based capital guidelines proposed by the Bank for International Settlements (BIS) – as well as the rules of the National Association of Insurance Commissioners (NAIC) – have the potential to change the arbitrage dynamics of so-called "structured investment vehicles" (SIVs) and, therefore, to have a major impact on the relative pricing of different instruments. In particular, the prospect of a capital charge on liquidity facilities could be a major negative development for the ABCP sector.

Also from an investor's perspective, ABS provides great safety (in the case of the triple-A and double-A classes) *and* has been an important source of yield (especially in the case of single-A and triple-B classes). However, recently, the CDO bid for triple-B classes has been so strong that double-A classes arguably have represented better value.

Following the 9/11 tragedy and the Enron debacle, issuers are increasingly turning to bond insurance as the tool for achieving best execution. From a bond insurer's perspective, the events of 2001 were well within the "stress scenarios" that ABS have been designed to withstand. As the recession continues, investors will be skeptical of subprime consumer finance companies. The tougher regulatory environment will dampen activity by certain lenders.

Not all triple-As are created equal. Some have displayed a higher propensity to ratings volatility.

Challenges for ABS in 2002

- disclosure
- Enron
- poorly structured deals producing a ripple effect (*e.g.*, Hollywood Funding, LTV Steel)
- manufactured housing; curve flattening

10:00 AM –Traders' Roundtable

Liquidity will be challenge for ABS in the coming year.

On the other hand, there is very good liquidity for securities backed by the most generic asset classes, with dealers making a market of just one or two basis points. The rate at which the economy shows signs of progress will determine how quickly liquidity improves for second-tier names. There will be increased demand for real estate ABS and off-the-run ABS sectors as investors search for yield.

The weakness of the economy will continue to impose a drag on second-tier names. Additionally, the Enron debacle is imposing a short-term cap on how far liquidity can improve for ABS in general.

Another point of view is that even top-tier ABS will face liquidity challenges going forward because of situations like Providian.

From the standpoint of repos, ABS still have a way to go before they are as widely accepted as agency paper. With more players becoming active in ABS, repo-ability will improve.

Credit Tiering: Trouble at many consumer finance companies is heightening the tiering effect in certain ABS sectors. The market is likely to see more tiering over the coming year. Tiering will pervade the equipment leasing sector in response to the Newcourt and CIT downgrades.

In some cases the market is "too liquid" in that certain bonds trade at identical levels when they should not. For Conseco MH securities, some vintages are attractive while others are not. A key question is what will happen to the Conseco MH securities if there is a disruption of servicing.

Tiering and liquidity are a real "problem" for the ABS market. For example, in the aircraft sector, there is some paper trading at 15¢ to 20¢ on the dollar and there is the risk that the securities will completely blow up and not deliver any cash flow.

The opposing point of view is that the market will compensate those who do their homework and focus on the risks and rewards of individual securities. One mistake in this environment can wipe out the gains on dozens of "correct" investment decisions.

Rating issues: Although market participants like to think of ABS as a mature market, it is continually introducing new asset classes. In such cases, the rating agencies apply a conservative bias, resulting in (1) too much credit enhancement, (2) ratings that are too low, (3) less ratings volatility than comparably rated corporate securities.

Non-U.S. investors buy mainly triple-A floaters. Money managers and insurance companies are significant buyers of fixed-rate paper. However, CDOs have pushed out the insurance companies as buyers of triple-B ABS. There is some concern that there are no "natural" buyers of triple-B ABS active right now.

ABS will become an increasingly important (large) component of fixed-income indices. Although the ABS market is $900 billion in size, it represents only a disproportionately small share of the major

fixed-income indices. The complexity of pricing ABS is an impediment to including ABS more heavily in the indices.

Spreads: Spreads on ABS backed by credit cards are tight but will continue to grind tighter for both fixed-rate securities and floating-rate securities. However, there is not much room for further tightening and, therefore, the best opportunities will be in second-tier names. Conseco triple-A home equities are very attractive right now.

The Kmart bankruptcy was a negative development for the CMBS sector. Mortgages are very cheap right now. The Fed is unlikely to tighten any time soon. Carry will be a strong component of any mortgage trade this year. The best opportunity for tightening will be in home equities from top-tier names. CMBS has lagged other sectors recently and has room to perform well in 2002.

A third view is that ABS will remain a safe haven but that ABS spreads may drift wider by a basis point or two. When the ABS market used Treasuries as the pricing benchmark, spreads were tighter than they are today. At some point we will reach the end of the tightening wave, and we may already be there. Mortgages are cheap now.

A fourth view is that commoditized products could widen by a basis point or two while floaters could tighten by a similar amount. Home equity floaters offer incremental yield and have tightened since the beginning of the year. Structured products will outperform corporate bonds.

ABCP Conduits – Off Balance Sheet Treatment: There is a definite risk that bank-sponsored ABCP programs will lose their off-balance sheet advantage, especially in light of the knee-jerk reaction to Enron. This should not be an issue for the European conduits that sell their equity.

11:00 AM – Researchers' Focus Discussion

There will be moderately higher losses and delinquencies on credit card receivables. For a 1.1% rise in unemployment, there will be a 2% increases in losses. Home equity losses will jump by 80% to 100% in the recessionary environment. However, highly rated tranches of outstanding ABS deals can well withstand those levels of losses.

There is more potential for spread widening on triple-B ABS. The widening could be in the range of 25 bps but it will be checked by the bid from CBOs. There is more opportunity in buying single-A and double-A classes, which do not receive a strong CBO bid and which have more room for tightening later in the year.

If unemployment reaches the 6.25% to 6.5% range, credit card charge-offs could increase by 25% to 40%. However, much of the ABS market is over-enhanced. For the down-in-credit trade, there is opportunity for tightening in single-A and double-A mezzanine classes.

Another view is that the economy is now in a recovery and there is strong opportunity for down-in-credit trades in many areas. Too many of the popular analyses fail to reflect the strong positive influence of rising home ownership and the increasing "convenience use" of credit. The supply of new homes for sale is nearly at all-time lows and sales of existing homes remain very strong (despite home price declines on the West Coast). Things are not nearly as bad as they seem and now is the time for investors to look at second-tier issuers and off-the-run assets.

A challenge with executing the down-in-credit trade to double-A or single-A mezzanine classes is the relatively small supply of those securities. Counterbalancing the rise in losses and delinquencies has been the rising level of excess spread on many asset classes. While the coupons on ABS have declined, the interest rates on consumer credit have been slower to drop. This has been visible in both the credit card sector and in the subprime areas.

The tightening that has occurred in the top-tier names is probably finished or nearly finished. Investors are focused on carry. Many are moving out to the 5-year to 7-year maturity range. There is some value in second-tier names and those who proceed judiciously will be able to find it.

There arguably is room for credit cards to tighten relative to agencies because the 25 bps premium that agencies command is more than enough compensation for the difference between a triple-A and quasi-government guarantee. Triple-A auto ABS are cheap relative to triple-A credit card ABS.

Demand for the top quality ABS names will continue to grow as ABS continue to displace corporate securities in many fixed-income portfolios. Losses on all types of auto paper are much higher than they were a year ago but the levels of losses are still quite manageable. Supply technicals are favorable in the auto sector.

The market is split between the huge, highly rated financial institutions that dominate issuance and the smaller players. There is value to be had in some off-the-run sectors. CIT has created opportunity in the secondary market for some equipment leasing paper.

Benchmark names in second-tier sectors offer good value (*e.g.*, Americredit). Another area of opportunity is rate reduction bonds, because those securities provide a way to diversify away from consumer risk. This is a year when investors will be well compensated for doing credit work on individual names and deals.

ABS really is the safe haven among spread products. It avoids the event risk of the corporate bond market and the prepayment risk of the mortgage market. ABS backed by credit cards, autos, or student loans are good substitutes for corporate bonds, agencies, and Treasuries.

The rating performance of the ABS market relative to the corporate bond market has been very strong. Most ABS have a tremendous amount of protection; that is why there have been so few downgrades of triple-A ABS. This is what makes ABS such a strong safe haven. For example, even in the liquidity crunch of 1998, liquidity for triple-A cards remained strong.

Home equities and high LTVs are attractive (right now) because investors have priced-in unrealistically high prepayment speeds. In particular, premium bonds are attractive. Likewise, the MH sector arguably offers value because voluntary prepayments will be slow as the supply of funds for refinancing is shrinking.

The market tends to overreact to fast prepayments. This creates opportunity in premium priced real estate ABS.

MH: tremendous value or road kill? One view is that the sector is road kill. The overhang of excess inventory continues to plague the sector. The prospect of increasing participation by the GSEs will create further pressure. Many deals are failing their trigger tests and the triggers provide only modest protection to investors. And, most significantly, the sector faces the possible demise of its largest player (Conseco) and the possibility of a huge servicing transfer. However, there are select opportunities in highly seasoned deals.

The opposing view on MH: Conseco will manage to pull through. Also, the quality of the homes themselves is quite good - better than it has ever been. Some have said that Conseco has the potential to shed a lackluster insurance business to become a top-flight consumer finance company. Moreover, even for an investor that holds a generally negative view of the whole sector, the two-year and three-year classes of MH deals offer both safety and attractive spreads.

Enron arguably has had a positive impact on the ABS market, which has served as a safe haven during the flight to quality. However, some the mud being flung in the wake of the Enron debacle has landed in the ABS market. The Enron fallout is placing blame "on the tools rather than on the craftsmen" (this refers to the potential attack against the use of SPEs). Another potentially damaging

impact of Enron could be legal challenges similar to what the market experienced with LTV Steel during the past year.

Picks and pans for 2002:

- premium priced home equity because speeds will be slow; wrapped subprime auto (a virtual no-brainer); long rate reduction bonds (free of prepayment risk); it will take a lot of work to hit a home run; bonds that get downgraded once are at higher risk of being downgraded again; floaters will not tighten
- rate reduction bonds are attractive, as is the seven-year part of the curve; premium priced autos and premium priced home equity floaters are attractive; auto prepayments will slow in 2002 because of the front loading of sales in 2001Q4; use a bifurcated strategy, focusing primarily on top tier names and carefully picking off-the-run bonds which offer the opportunity to be over-compensated for illiquidity
- beware of extremely low loss stories (Heller); non-prime auto; NCFE triple-A floaters; Chevy Chase prime auto (prices like Americredit in a wrapped structure); Metris credit card ABS; retail cards such as Federated and Household; senior tranches of pooled aircraft deals; aircraft EETC
- card and auto triple-As will be stable; value might be found on the auto side in deals from the captive subsidiaries of the Japanese auto makers; Americredit is a tremendous story with its strong dealer network; Household auto is very strong; buyers of ABS CDO mezzanine and sub classes should look at SIV capital notes; retail credit cards will not do well; there will be more supply of triple-B credit card ABS as First USA and Capital One introduce new structures
- have a core position in cards, autos, and student loans augmented by selective off-the-run securities; opportunity in equipment leasing (*e.g.*, DVI medical equipment) and auto leasing; long tranches of rate reduction bonds and credit card paper; there will be a lot of supply of triple-B cards

1:30 PM – Regulatory Update

FAS 140: FAS 140 requires the elimination of discretion in the resolution of defaulted loans. The work-around adopted by the CMBS community was the use of a call option in favor of the special servicer that would allow "discretion" in the timing of the sale of a defaulted loan to the special servicer. A QSPE can engage in workout activities provided that all activities are specified in the entity's organizational documents. QSPEs can engage in foreclosures and manage the disposition of foreclosed assets. Anything not specified in the controlling documents is not allowed. A QSPE cannot extend new credit to a borrower in a workout situation.

The FAS 140-related issues were highlighted in the CMBS sector because the power to threaten a loan sale was an important negotiating tool in dealing with a defaulted borrower.

ABCP: There is some concern about the threat that the BIS proposals will impose a charge on ABCP liquidity facilities. Some contend that the BIS proposals for using institutions' internal ratings ultimately will not change the economics of financing through ABCP programs. Right now the market is overreacting to the real risk of adverse regulation. Although the final regulation probably will not retain a 0% risk weight for liquidity facilities, most banks already assign some amount of "economic capital" to their exposures through liquidity facilities. In informal conversations with the rating agencies, some banks have determined that they could get investment grade ratings for many of the deals in ABCP programs.

The intersection of FAS 140 and FAS 133 comes into play when securitizations use derivatives or have imbedded interest rate or currency swaps. Although the FASB guidance is developing, the likely outcome is that companies will be required to report a separate sub-account reflecting the position in the swap.

SPE Disclosures: The Big Five proposed rulemaking to the SEC on the issues of "related party transactions," energy trading activities, and SPEs. The SEC subsequently published the Big Five proposals as a "Commission statement." The gist of the relevant portions of the statement is to cast light on the activities of SPEs. Companies will need to make substantial additional disclosures about their use of SPEs. In particular, bank sponsors of ABCP programs will have to disclose their use of ABCP programs and their relationships with ABCP programs.

Consolidation Project: The FASB's consolidation project, which had been on hold a year ago, is now in overdrive. A final release is expected by year-end. Both approaches under consideration retain the concept of QSPEs. Both approaches try to define what an SPE really is. In the FASB's jargon, the notion of a sponsor is described with the term "primary beneficiary." Under both approaches, if there is active control or active decision-making by the sponsor, a SPE will have to be consolidated. Under one of the approaches (the 3% approach), deconsolidation could be achieved with a 10% outside equity. Under the other approach, the holder of the interest that has the significant variability of returns (*i.e.*, equity-like risk) would be required to consolidate a SPE unless the holder has no ongoing business relationship with the SPE. The second approach looks to both significant relations and ownership of economic equity.

Regulatory Initiatives beyond 2002: (1) an implicit recourse paper; (2) a "managed assets" rule; (3) the BIS proposal.

FAS 140 treats some call options differently from FAS 125. Clean-up calls are treated the same but "fair value" call options can be treated differently. Conditional call options are treated differently in that as soon as the transferor has the ability to exercise the option the assets go back onto the transferor's books because that is when the transferor regains control.

2:40 PM – State of the CDO Market: Trends and Issues

Last year the term "CDO" became a bad word. There were negative headlines and many rating downgrades. The fact that "not everything was rosy" reflected that the market had reached a level of maturity. Some investors experienced disappointing results and managers were not always able to deliver what they had promised. On the bright side, the negative developments create opportunities. Despite the market's difficulties, the level of issuance in 2001 was about the same as in 2000 and new sub-sectors (*e.g.,* CDOs backed by ABS) gained increased prominence relative to traditional high-yield CDOs.

The coming year will be a more critical year for the CDO market than the year past. The foremost fear in investors' minds is the risk of a double dip recession. CDOs have been taken to the brink of what they were designed to sustain; further troubles, such as an intensification of the war on terrorism, could mean trouble. Recovery rates on defaulted assets will be the key driver of performance: if recovery rates bounce back to the levels they were at years ago everything will be fine. If not, the stress could be more than the deals can bear.

Some are questioning whether there is a new paradigm for expecting how corporate assets are going to perform. If there has been a regime shift, it may no longer be reasonable to use the assumptions of the past.

Mezzanine and equity investors have shifted their focus from receiving quick returns up front toward receiving a steady return over the life of a deal. This has encouraged more conservative structures.

The credit cycle exerts a significant influence on the CDO sector. The amount of leverage that lenders will allow borrowers to have fluctuates with the prevailing economic mood.

Distressed loans motivate lenders to use CDOs as a means of removing distressed or non-performing loans from their balance sheets. Accounting developments may blunt that motivation.

In assessing a CDO manager one should consider:

- expertise in relevant asset classes
- staff depth
- commitment to the CDO business
- separate specialists for asset management, CDO administration, reporting, and investor relations
- in-house monitoring capabilities
- in-house ability to model deals

A good high-yield manager does not always make a good CDO manager. The structures and the constraints imposed by the rating agencies can create challenges for some managers. Some managers have been dragged into workout situations that are alien to them and that they would have avoided outside of the CDO setting. CDO managers have waited longer before selling weak assets (than they would have outside of the CDO context) and this has resulted in lower recoveries on defaulted assets.

The CDO market has matured to the point where deals sponsored by penny ante, would-be asset managers no longer get done. Five or six years ago such deals often happened. Most of the asset managers doing deals these days are substantial and experienced.

Many CDO equity investors want asset managers to own a portion of their CDOs' equity in order to align the interests of the mangers with that of the equity. Incentive fee arrangements also help to align interests. On the other hand, a deal needs to have a sufficiently large senior management fee to allow for replacing the manager, if necessary. Another tool for properly motivating a CDO manager is to require the manager to hold a portion of the mezzanine and subordinated debt tranches.

The Enron debacle and the SEC's reaction are going to make it increasingly difficult for managers to achieve off-balance sheet treatment for CDOs.

Nearly half of the subordinate and mezzanine classes of ABS deals are going into CDOs. CDOs of ABS and CDOs of CDOs were hot growth areas over the past year. This new sector needs to proceed cautiously in light of the lessons of the high-yield CDO area. ABS have experienced less rating volatility than corporate bonds and ABS have the advantage in inherent diversification.

4:10 PM – Cash Flow CDOs: Identifying, Contrasting and Analyzing the Categories

The investment grade corporate bond market is facing downgrades, bad press, and other challenges. Investment grade CBOs are responding by leaning toward higher-quality credits. This is reflected in higher WARFs (weighted average rating factors) in the deals. Trading activity has increased as managers strive to boost both WARF and the par amount of their bonds. The volatility in the high-grade corporate bond market is not a bad thing for a manager that has good credit analysts and good traders.

The high yield leveraged loan market is retaining good demand for reasonable-quality credits, other than telecom.

Another view is that the high yield sector has performed very poorly. There is an impact of evolving standards across cohorts. Newer cohorts have tougher definitions of what constitutes a "default," particularly with respect to grace periods. Similarly, some newer deals have tougher treatment of watchlisted assets.

Investment grade deals and resecuritizations have been immune to downgrades and watchlistings so far. Those types of deals are relatively new and nearly all are less than two years old. The pressure on investment grade corporate bonds will create stress in high grade CDOs. Already in 2001, there was some pressure. The actual rating factors of the high grade CDOs, on average, violate their

rating factor tests by 6%. Some of the deals are getting dangerously close to violating their overcollateralization tests.

CDO downgrades have been concentrated in two areas: arbitrage cash flow CBOs and synthetic balance sheet CBOs. In contrast, CLOs have been virtually immune to downgrades; only six CLOs from three collateral managers have been downgraded. Arbitrage CBOs have had a tougher time maintaining high levels of excess spread in a falling rate environment. Also, arbitrage CBOs have experienced more pressure on their WARFs because they had less initial cushion then their CLO counterparts. New CBOs are being issued with substantial WARF cushions. Also, new deals restrict the distributions of trading gains.

Equity investors place greater demands on a manager than the debt investors. Equity investors often call with questions about positions that might attract negative headlines. Managers make investors more comfortable by proactively calling both debt and equity investors to explain trading decisions.

The manager of a "CDO of CDOs" wears multiple hats. The manager is not just a manager but also a CDO investor. The manager can lend his expertise to the managers of the underlying CDOs and thereby help boost the performance of the underlying CDOs.

The attractiveness of the investment grade CDO market as a whole (*i.e.,* wide spreads) comes from picking good managers. Because there is not much cushion in investment grade CDOs, there is greater reliance on the manager to identify bonds to sell before they become deteriorating credits. Synthetic deals have an advantage over cash deals from the cost of capital standpoint. A manager can express a long position by selling protection through credit default swaps. Diversity in synthetic deals tends to be higher than in cash deals. Liquidity is an issue in synthetic deals because credit default swaps may not be broadly traded.

In contrast to the high yield sector, the high-grade sector requires a manager to be very careful in deciding to sell a bond that has lost value. The booked loss can produce substantial erosion in a deal's cushion.

One of the rating agencies has requested that proposals for the inclusion of synthetics in a deal come from the collateral manger rather than from the structuring agent (*i.e.*, the investment bank). This request was driven by the fact that in a number of cases collateral managers did not understand the proposals being made on their behalf.

One point of view is that CDOs are always structured primarily for the equity.

Recent corporate bond default frequencies and loss severities have not varied greatly from long-term historical averages. However, the ratio of downgrades to upgrades of corporate bonds is significantly higher than the long-term average. Thus, the recent difficulties experienced by the high yield CDO sector actually are attributable to bad trading decisions that the managers made in response to the deteriorating conditions.

Newer deals have more structural protections to trap cash and help steer manager behavior.

Tuesday, 12 February 2002

8:00 AM – State of the Japanese Securitization Market: Opportunities in the Far East

It is hard to track issuance in the Japanese ABS market. One estimate is that issuance was around ¥2½ trillion. The subsector that experienced the largest increase was consumer loans. The largest subsectors were CMBS and residential MBS, which accounted for 25% and 19% of the total, respectively. Underwriters are becoming increasingly active in making bridge loans to companies

that intend to securitize their assets. Another new development in 2001 was the GHLC auctions. There were four such auctions and each one achieved tighter pricing than the one before. The GHLC is supposed to be shut down within five years; the residential mortgage securitization market will have to shift to the private sector.

The RCC (Japan's equivalent to the RTC in the U.S.) is issuing a $74 million deal backed by non-performing loans (NPLs). That level of proceeds represents a recovery rate of only 10¢ on the dollar. It remains to be seen whether the huge inventory of Japanese NPLs finds its way into securitization in light of the very low recovery rate on the recent RCC deal.

A challenge to growth for securitization in Japan is that the banks continue to make loans on very favorable terms. For many Japanese companies, bank financing is a cheaper source of funds than securitization.

The CLO market is expected to grow along with the rest of the Japanese securitization market. There could be ¥1 trillion of CLOs issued and ¥4 trillion to ¥5 trillion of total ABS.

The Japanese consumer finance companies have well-established track records and generate high levels of excess spread. Japanese companies like to keep assets on their books. To keep securitized assets on their books, they use a structure called a "springing true sale." The four major Japanese consumer finance companies are Takefuji, Acom, Promise, and Aiful.

Japanese companies report losses differently than U.S. companies. In Japan, companies report losses as a percentage of the principal balance at the time that the loss is booked. This has the effect of using a larger denominator if the portfolio is growing. One difficulty relates to how the Japanese consumer finance companies service accounts. Sometimes, they are very slow in charging-off seriously delinquent accounts. This has the effect of further artificially depressing the reported loss numbers. The rating agencies have learned to deal with this by treating delinquencies beyond a certain level (*e.g.*, >180 days) as charge-offs.

Credit cards have not really caught-on in Japan. However, consumer can obtain credit at automated machines.

CDO issuance has been a relatively small part of the Japanese securitization market to date, but it is expected to grow significantly. There were three public deals in 2001 and an undetermined number of private deals. Most synthetic deals are originated in Tokyo, London, or New York. There was a prominent press report estimating that there will be ¥7 trillion to ¥8 trillion of Japanese CDO issuance in 2002. It is likely that this level could be reached only if more banks follow Shinsei Bank's lead and jump on the bandwagon to embrace the CDO master trust structure. Shinsie had several objectives in executing its recent CDO: (1) secure a funding source for the future, (2) diversify funding sources (to protect against the loss of deposits when deposit insurance is phased out), (3) reducing the bank's asset base, and (4) setting a "standard" for balance sheet CDO issuance in Japan. Shinsei's CDO had a much higher level of disclosure than is usual for Japanese deals.

Shinsei's CDO master trust affords the bank great flexibility. There is great diversity of obligors and the rating factors are based on the bank's own credit model. One key factor in structuring a CDO backed by Japanese assets is that there tend to be low recoveries following defaults. Some of the concerns in the Shinsei CDO included: (1) high concentration of government and quasi-government obligors, (2) large exposures to certain government obligors, (3) the condition of Japan's economy, (4) the risk of having to replace the servicer (but the servicing fee is sufficiently large to get a replacement servicer), (5) bullet maturity with the weighted average life (WAL) of loans shorter than the WAL of the bonds, (6) set-off risk (covered by the seller's share of the trust), and (7) low historical recovery rates (half of historical bankruptcies over the past 20 years have had recovery rates of 5% or less).

<u>Legal & Regulatory Issues</u>: The perfection law became effective in October 1998 and has become very popular. It requires registering an assignment of claims with a government office. Before the

adoption of the perfection law, it was necessary to obtain the consent of the underlying obligors or to arrange for a mechanism for notifying obligors following the occurrence of a trigger event. The perfection law fixed all such difficulties. Japan's civil code provides that the perfection law will apply notwithstanding a contractual choice of foreign law.

The SPC law now permits establishing a company with only ¥100,000 and requires only one director. The new SPC law is aimed at achieving the same results as can be achieved by using a Cayman Islands charitable trust. The SPC law was enacted in May 1999.

The new servicer law permits businesses/entities other than lawyers to engage in collecting money. Under the most recent amendments, servicers' activities are not materially restricted.

There has been a flight to quality among Japanese investors over the past several months. Even partially supported A-1/P-1 asset-backed commercial paper has been hard to sell.

9:20 AM – Buying In: Investor Methodology & Practice in Judging CDOs Prudently

There have been tough times in the corporate bond market. Lots of prominent high yield issuers have defaulted. In addition, the defaults by Enron and Argentina add to the stress. Nonetheless, as long as financial institutions need to shed credit risk, and as long as investors keep stretching for incremental yield, the motivation for doing CDOs will continue.

The wave of defaults has been very long. Healthcare, entertainment, and telecom are three sectors that have been hard hit. This has "cleansed" the market, but at the expense of equity and subordinated debt investors. The early synthetic deals have been hit by downgrades of "fallen angels."

The "holy grail" in CDO-land is equity. It is now as difficult as ever to find equity for new CDOs. Issuers sometimes can find an equity bid in Asia from Japanese and Korean life insurance companies and in Europe from German insurers and re-insurance companies.

A recent Moody's study compares the different types of CDOs on a vintage basis and concludes that the 1997 and 1998 vintages of cash flow arbitrage CBOs have performed the worst. The collateral was too expensive and too much of it has experienced trouble. However, even from the 1997 and 1998 vintages there were some deals that performed very well.

A tough issue for investing institutions is the dilemma of what to do when they have a negative outlook. For most firms, it is not realistic to simply sit on the sidelines and wait for the market to turn around. Instead, the firms consider new asset classes. Purchasing issues in the secondary market can be better than buying new issues when the market is in the midst of the weak vintage.

The recent spate of "fallen angels" has put substantial pressure on investment grade CDOs. Investment grade CDOs have had an inherent disadvantage: event risk can hit any one of their underlying credits and jeopardize the CDO's relatively thin cushion.

Market value CDOs generally have performed as they were supposed to, from the perspective of a mezzanine-class investor. The question for the future is whether new market value deals will be able to attract equity (because such deals cannot as easily distribute excess spread to the equity holders). As some of the market value CDOs reach their maturity dates, the quality of the managers will be a key factor as assets get sold to pay off maturing bonds.

Active management is a key feature of CDOs. The presence of a manager is what allows a CDO to perform better than an unmanaged bond index. On the other hand, the manager also brings risk to a deal: personnel turnover is a danger for deals. Investors have the right to expect that a manager will fully understand the documents governing a deal.

The manger plays a key role. In assessing a manager's strength, investors can focus on a manager's track record and resources, and also the manager's ability to deal with the potentially conflicting interests of debt and equity investors in the CDO. One investor focuses specifically on signs of a manager's "moral anguish" as an indication that the manager understands the conflict. In assessing a manager's track record, an investor can focus on whether the manger has made a practice of buying bonds at the edge of their rating category: the investor can examining whether the manager's investments have experienced an unusually high proportion of downgrades.

Many managers are compelled to hold a substantial share of the equity in their deals. First-time managers often have to hold 50% of the equity, second-time managers often have to hold 25% of the equity, and managers with more deals may hold as little as 10% of the equity in their deals. Only the most successful managers, those with eight or nine deals under their belts, can do deals without having to hold any of the equity.

Some market participants take a favorable view of the rating agencies' downgrades of deals that have experienced deterioration of collateral. But, from the standpoint of the ABS sector, the pace of rating transitions in the CDO sector has been stunning.

One investor compares the yield profile of different asset classes across different ranges of CDRs (cumulative default rates). The investor always considers multiple scenarios for portfolio yield, defaults, and recovery rates.

Building one's own model of a CDO helps to uncover some of the hidden assumptions used by the dealer in its computer runs.

After 9/11 there was good value in investment grade deals, with triple-B classes pricing wide of LIBOR+300. It was a time of opportunity for those who could pick managers. Recent deals have better structures that older deals; the newer deals include more tests and some allow managers to leave money in the deals to improve the cushions. There has been light activity in the secondary market because many investors do not want to be stuck selling at the bottom.

Liquidity is still an issue in the secondary market for CDOs. The bid-ask spread is too wide, according to some. It is hard to get bids on mezzanine and subordinate positions and, therefore, it is difficult to price the positions.

Although there have been cases where managers have been replaced, it is a rare occurrence. Replacing a manager generally requires a majority vote of all investors, including the most senior classes. It is hard to get the most senior investors to vote.

Before the CDO market got hot, investors were able to negotiate for innovations that went beyond the rating agency requirements. Now, again, new deals include some new tests and triggers and also sometimes permit a bit more flexibility for the manager.

In North America there are fewer than five investors who purchase CDO equity on a regular basis. It is very difficult for "Joe Blow Asset Manager" to raise equity for doing a CDO. However, if the manager retains a substantial share of the equity, that facilitates the sale of the remaining portion and, once some of the equity is sold, it is easier to sell the rest.

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