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# Report from Arizona: Coverage of Selected Sessions of the February 2003 Securitization Conferences

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Several key themes emerged at the February 2003 securitization conferences in Arizona. Although the market has been badly battered by the events of 2002, it has survived and will bounce back. Regulatory and accounting issues were in the spotlight. Servicer risk, trustee responsibilities, and fraud risk also grabbed center stage. Market participants broadly expect tiering among issuers to be an increasingly important feature of the securitization landscape. Some key players from the troubled sectors (CDOs, manufactured housing, aircraft, and franchise loans) continue to be in denial about the difficulties in their areas. That is somewhat disappointing. Problems cannot be solved until their existence is acknowledged.

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.

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

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# Fabozzi/Information Management Network Asset Securitization 2003

February 5-8, 2003, The Arizona Biltmore, Phoenix, Arizona

## Thursday, 6 February 2003

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

Global securitization issuance grew strongly in 2002 relative to 2001. This continued the growth trend of prior years. Virtually all areas except for ABCP displayed solid growth. The strong growth trend suggests that the securitization market is extremely healthy. However, the headlines of the past year give the opposite impression. But, headlines always emphasize the negative. Even in 1995 and 1996, the securitization press featured a predominance of negative headlines. Therefore, securitization professionals should avoid being overly concerned by them.

Themes: From an issuer perspective, several key themes emerged from the developments of 2002. Those themes are likely to continue driving the market in 2003. **Servicing is key**; strong collateral and a strong servicer go hand in hand. Corporate event risk was more pronounced in 2002 than ever before, and it will continue to be an issue in the securitization arena. **Regulatory risk** pushed spreads very wide for a while. **Tiering of issuers and servicers increased in 2002 and will likely remain a feature of the landscape in 2003**. Following the NCFE debacle, "**trustee risk**" is now in the spotlight and will remain there for some time. In 2003, investors will try to minimize their exposure to headline risk by doing more "equity-like" due diligence. The market is learning that **the financial health of all parties to a transaction can be critical**.

Another take on 2002 is that the securitization market proved itself extremely resilient in the face of great adversity. Tough challenges included: (1) the FDIC action disallowing early amortization of the NextCard credit card trust when the bank went into receivership,[1] (2) harsh new capital standards proposed by the Basel Committee,[2] (3) the FFIEC's position that all borrowers with FICO scores below 660 must be classified as sub-prime and that banks must hold extra capital against loans to such borrowers,[3] and (4) the SEC certification requirements[4] stemming from the Sarbanes-Oxley Act.[5] Some of those events caused disruptions, but the overall market held up very well. **One result is greater tiering among issuers.** The events of 2002 should prompt securitization professionals to exercise greater scrutiny of back-up servicing arrangements, disclosure, and trustees' responsibilities.

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[1] *FDIC General Counsel Statement on NextBank* (14 February 2002, *available at* http://www.fdic.gov/bank/individual/failed/nextbank.html); Interagency Advisory on the Unsafe and Unsound Use of Covenants Tied to Supervisory Actions in Securitization Documents (23 May 2002, *available at* http://www.occ.treas.gov/ftp/bulletin/2002-21a.pdf); *NextBank Failure: The FDIC Perspective*, Asset Securitization Report 16 (30 September 2002).

[2] The Basel Committee on Banking Supervision sponsors the international framework for setting minimum capital levels for banks. *See* www.bis.org.

[3] *See, e.g.*, Capital One Financial Corporation, S.E.C. filing on Form 10-Q at 28-29, 35 (30 September 2002, filed 14 November 2002); *see also* Proposed Agency Information Collection Activities; Comment Request, 67 Fed. Reg. 46259, 46252 (12 July 2002).

[4] *Certification of Disclosure in Companies' Quarterly and Annual Reports*, SEC Release 33-8124, 67 Fed. Reg. 57275 (9 September 2002) (*available at* http://www.sec.gov/rules/final/33-8124.htm); *Statement by the Staff of the Division of Corporation Finance of the Securities and Exchange Commission Regarding Compliance by Asset-Backed Issuers with Exchange Act Rules 13a-14 and 15d-14* (27 August 2002, *available at* http://www.sec.gov/divisions/corpfin/8124cert.htm).

[5] Pub. L. No. 107-204, 116 Stat. 745 (2002).

From an investment bank perspective, the securitization market has proven itself extremely resilient. So far, the market has survived the challenges posed by (1) the new FASB interpretation requiring consolidation of certain SPEs (**FIN 46**),[6] (2) SEC certification requirements, (3) tax regulations that threaten to classify ABS deals as tax shelters,[7] (4) difficult servicing transfers, and (5) fraud and violent "event risk" in the NCFE incident. However, amidst all these "growing pains" there is much opportunity. ABS issuance may soon surpass corporate issuance. "The ABS market is undergoing a healthy evolution."

The investor perspective is that each year the ABS market is driven either by fear or by greed. This year, the market will be driven by fear. For an investor, a market driven by fear is generally better. Investors face a tough job understanding all the risks that attach to particular ABS. Especially for buyers of subordinate ABS tranches, there are now many new dimensions of risk beyond simply asset credit performance and prepayments.

ASF: The American Securitization Forum started its real operations in July 2002. It has established various committees and has hired an executive director. An investor heads the Market Practices committee. The ASF's objective is to get involved early on important issues so that workable solutions can be found.[8]

International: Securitization issuance in Europe was up only about 2% last year. However, the CDO component of European securitization grew to $183 billion. The U.K. and Italy dominate European securitization activity, accounting for 34% and 32% of the action, respectively. Synthetic deals account for a substantial share of European securitization activity. European ABCP outstandings grew a whopping 30% to €178 billion.

Securitization activity in Japan reached ¥4.5 trillion. The 10% growth there is clouded by the continuing recession. Korean securitization issuance reached nearly $6 billion, with most of it wrapped by bond insurance. Australian securitization activity grew by 17% and remains dominated by residential mortgage deals. Continued growth of roughly 15% is anticipated in Australia for 2003.

Enron, FIN 46: Enron is still with us, except that now we refer to it as FIN 46 (the new interpretation from FASB requiring companies to consolidate certain off-balance sheet SPEs). Public pressure compelled FASB to act against SPEs. There is still no consensus among industry experts about how FIN 46 will actually work in practice. Also, there is some risk that FASB will reconsider FAS 140, which could force companies to consolidate even more of their SPEs.

Another view is that FIN 46 is just another move in the "arms race" among issuers, investment bankers, and regulators. One of the best things to have appeared recently was Moody's press release that "terrorized" the market.

The market needs to embrace a higher level of transparency. Ultimately, solutions will be created that allow the securitization business to continue.

NCFE, Fraud: NCFE presents an interesting challenge with respect to "performance problems." The market will need to address the fact that servicer strength can decline over time. Despite the recent WSJ article stating that individuals with strong quantitative skills make the best ABS traders, the NCFE debacle illustrates the continuing need for institutional investors to have experienced professionals who understand the practical business issues surrounding how issuers make money and how cash flows through accounts within a securitization.

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

[7] *Tax Shelter Disclosure Statements*, TD 9017, 67 Fed. Reg. 64799 (22 October 2002); *Requirement To Maintain a List of Investors in Potentially Abusive Tax Shelters*, TD 9018, 67 Fed. Reg. 648079 (22 October 2002).

[8] Interestingly, the ASF has not yet become active in developing safeguards to prevent a repeat of the NCFE debacle. It remains to be seen whether the ASF will try to tackle that challenge.

We have not seen the last instance of NCFE-type events. We can minimize them with stronger due diligence and auditing. However, even when we do everything right, situations change over time: A company's management and strategy naturally evolve.

One of the problems with the market is the "volume culture." Investment banks and rating agencies receive their fees at the inception of a deal. This encourages them to promote high issuance volumes and reduces their focus on problems that will not appear until years after a deal's closing. For example, the bankers and rating agencies should have been able to spot the potential for trouble in the NextCard credit card deals. The company's principals had previously been unsuccessful in trying to operate an internet credit card bank. Their previous failure should have been a warning sign that NextCard had a high chance of failing. However, nobody focused on that history.

The securitization market is starting to pay for its past sins. How the market faces the current challenges will determine its ability to grow. The good times and strong economy of the 1990s caused the securitization community to overlook the significance of "weak links" such as trustees' roles and ethics. Today's challenges prompt the question: Should the market confine itself to only familiar asset classes, or is there room for continuing expansion and innovation?

The Conseco situation (*i.e.*, the proposal to increase the servicing fee on Conseco/Greentree manufactured housing deals from 50 bp to 125 bp) is a defining moment for the securitization market. Five investors are at the core of the workout negotiations, yet hundreds potentially will be affected. Investors need to become more involved; they need to take an active role.

Investor Confidence: **Potential loss of investor confidence is the biggest threat to the securitization industry.** Investors need to be able to understand the full scope of risks to which they are exposed. Disclosure must identify non-credit risks. Structural risks can be the most important ones. The potential for an increased servicing fee on the Conseco MH deals illustrates this. Investing without a full understanding and appreciation of the relevant risks turns a "liquidity premium" into a "stupidity premium."

Some argue that bankruptcy remoteness has not survived as a viable concept. It is not functioning to provide isolation of asset risk from company risk. Similarly, trustees' behavior is disappointing investor expectations.

NCFE and the Enron accounting fallout may temporarily dampen the flow of deals backed by esoteric assets, but the flow of such deals will eventually bounce back to its former level. The role of trustees needs to be better defined and, arguably, expanded. Investors, rating agencies, and other market participants need to conform their expectations of what trustees do to reality. For trustees to do more, they must be paid more.

The securitization market needs a better model for investor advocacy. For example, it is sometimes difficult for investors to get the indentures for the bonds they hold. Some feel that indentures ought to be readily available through the internet.

Tough issues like fraud and servicer malfeasance are not confined to unknown or financially weak issuers and servicers. The business fortunes of a financially strong company can decline. Unless ABS deals from such a company include all structural safeguards, the deals may decline right along with the company – asset risk may not be effectively separated from company risk.

### 9:30 AM – "Market Trends, Developments, and Future Outlook for the U.S. ABS Market" Asking and Answering the Tough Questions

Is the ABS market losing its luster? Who is to blame for the problems that plagued the market in 2002? Is it investment banks, trustees, or others? The truth is that all types of market participants fairly share in the blame.

A great strength of the ABS market is its ability to overcome problems. The troubles of 2002 have dimmed the market's luster and made future growth less certain, but they have hardly killed the market.

From an investment banker's perspective, the lesson of NextCard is that investors need to focus more intently on events that could force a transfer of servicing or an early amortization. Moreover, the risk of servicing transfers and lack of liquidity are the core issues for the "off-the-run" sectors of the ABS market. Many deals need a good backup servicer because servicing transfers usually are not easy. Investors must remain mindful that even liquid deals can become illiquid when problems emerge.

From an issuer's perspective, the difficulties of 2002 have a slightly different flavor. They highlight the importance of having a good investor relations department. An issuer must make sure that investors understand it and its business. Investors are now more sensitive to the corporate credit rating of an ABS issuer. A banker agrees, noting that investors today have lower tolerance for risk and exercise greater scrutiny of their exposure to seller-servicer risk.

The rating agencies may deploy enhanced screening procedures for deals backed by new or exotic asset classes. Naturally, they would like to avoid experiences such as the NextCard incident. The rating agencies will strive to improve their modeling and surveillance. Within the rating agencies, structured finance groups will push to maintain closer ties to the corporate and financial institution rating groups.

<u>The Economy</u>: It is hard to tell whether the U.S. economy is in a recession or whether it is experiencing a sputtering recovery. Consumer confidence is down. GDP growth is low. Interest rates are very low. Unemployment rates are relatively low. Personal bankruptcy filings are at an all time high. It remains to be seen how long economic stagnation will continue before we see real improvement. On the other hand, after the likely war with Iraq, the price of oil probably will fall below $20 per barrel. Also, companies have already made so many cutbacks that it seems reasonable to expect conditions to improve by the end of the year.

In the auto finance sector, 2003 will resemble 2002. Price incentives on new cars will continue to exert downward pressure on used-car prices. Loss severities may trend higher on repossessed vehicles. Deteriorating performance in the sub-prime auto sector may spur tighter underwriting standards by sub-prime auto lenders in 2003.

The prime credit card sector has not yet felt the brunt of the recession. There has been only a very slight deterioration in credit performance. Further deterioration is unlikely.

Student loans have performed well for the past few years. Performance is closely correlated with the job market. If new graduates do not get jobs, they will not be able to pay their student loans.

Sub-prime consumers did not receive as much benefit as did prime consumers when the economy was strong. A smaller proportion of sub-prime consumers own their homes and, therefore, only that smaller proportion could take advantage of mortgage loan refinancing opportunities as interest rates declined. Homes prices are reasonable across much of the country, but not in California. Home price levels in California are above the level of the last cyclical peak.

<u>FIN 46</u>: There is not yet a general consensus on whether FIN 46 will require banks to consolidate most or all of their asset-backed commercial paper (ABCP) conduits on their financial statements. An

investment banker who focuses on term ABS transactions anticipates that FIN 46 will require U.S. banks to consolidate all of their multi-seller ABCP programs on their balance sheets.

FIN 46 does not change the credit risk to which banks are exposed through their ABCP programs. However, if FIN 46 forces banks to consolidate their ABCP programs on their balance sheets, the associated increased capital charge will make them more selective in providing financing. If funding through ABCP becomes a scarce resource, banks will make it available only to the customers with whom they have the strongest relationships.

FIN 46 could eliminate the "regulatory arbitrage" that U.S. banks have exploited for a long time with their multi-seller ABCP conduits.[9] This could give foreign banks a competitive advantage over U.S. banks.[10] The market has yet to figure out all the wrinkles in FIN 46, but some speculate that it may have even harsher consequences for single-seller ABCP programs than for multi-seller ones.

FIN 46 also potentially affects CDOs and CDO managers. It might require a CDO manager to consolidate the assets backing its managed CDOs even if the manager does not own equity in the CDOs. CDO managers who want to avoid consolidation have been pushed to the sidelines. Only those managers who are indifferent to consolidation are still actively creating new CDOs.

<u>New Asset Classes</u>: Was it the asset classes or issuer business models that brought down healthcare ABS, franchise loan ABS, and charged-off credit card ABS? Blame reasonably falls on both, but more so on the business models.

Is securitization appropriate for some of those asset classes? Securitization arguably is not appropriate for asset classes where risk cannot be measured accurately or where replacing a servicer is likely to create significant difficulties. One panelist suggests that only strong servicers should be allowed to securitize their assets. The market needs to set conservative advance rates that "make sense." Another panelist takes the contrary view that all types of deals (*i.e.*, backed by any asset) ought to be able to attain triple-A ratings, if they are structured appropriately. The market needs to realize that it is cyclical and that credit enhancement levels decline during good times and rise following periods of stress.

A third view is that the market must distinguish between (1) traditional asset classes and (2) situations where a securitized cash flow is tied closely to the business fortunes of the sponsor. The key here is the link between asset performance and corporate credit quality.

Another key distinction is the one between revolving deals and liquidating deals. Revolving deals are inherently more risky because there is ongoing linkage to the seller/servicer. A monoline credit card issuer will avoid early amortization of its securitizations until it is unable to stop it. Because the monoline relies on securitization for its funding, it will do *everything* in its power to avoid early amortization of its trust. Thus, when early amortization finally occurs, it will be after the company is effectively dead.

<u>CDOs</u>: Complexity is bad in a CDO. It subtracts from the value of a deal. Revolving pools can migrate over time, even while a deal is not de-leveraging. A CDO exposes an investor to risk along a large number of dimensions: credit, rate level, basis risk, and management risk.

[9] The term "regulatory arbitrage" refers to business practices that reduce or eliminate regulatory burdens that would apply if such practices were not used. In particular, the term is most often applied to financing practices used by banks to reduce their regulatory capital requirements.

[10] Some ABCP market experts feel that FIN 46 would create only a short-term disadvantage for U.S. banks relative to European banks. European regulators are likely to follow the U.S. regulatory model and mandate consolidation of European bank ABCP programs if FIN 46 ultimately is held to require that result in the U.S.

A CDO issuer must have the resources to do its job. Investors should refrain from buying a CDO from an issuer who is working outside its areas of expertise. Also, investors should not treat CDOs as buy-and-hold investments.

Outlook: In 2003, the securitization market is likely to see the following: (1) custom trades, (2) heavy activity in the traditional asset classes, (3) synthetics, (4) distressed assets, (5) safe-haven, up-in-quality trades, and (6) continuing market evolution. The economy is likely to turn around in 2004.

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

The past year brought a tremendous increase in the sub-prime mortgage business. Originations topped $200 billion. Drivers of the growth included strong home price appreciation and the increased use of automated underwriting.

Credit Quality: Overall credit quality in the sub-prime mortgage sector has been improving. FICO scores have risen and continue to rise. Securitized pools display increasing geographic diversification. Newer pools have more loans with longer terms and higher balances. Newer pools have fewer weak loans of C-minus quality.

A rating agency has observed FICO score improvements so that the average score for sub-prime ARMs is around 600 while the average score for sub-prime FRMs is around 630.

Sub-prime mortgage loan originators are improving the efficiency of their operations. They are achieving origination costs in the range of less than 2% to slightly above 3%.

Outlook for 2003: Sub-prime mortgage professionals have a positive outlook for 2003. The key variables will be the regulatory environment, the condition of the housing market, and the level of unemployment.

Regulatory Environment: More than 20 states have adopted predatory lending laws that provide for assignee liability.

Many mortgage lenders have stopped making loans in Georgia because of potentially *unlimited* assignee liability under Georgia's laws.[11] New York's new predatory lending law, which becomes effective in April, appears less troublesome.[12] Liability under the New York law works essentially as a set-off against the loan balance – damages are effectively capped at the loan balance. However, monitoring compliance with some provisions of the New York law will be difficult. Also, a new New York City ordinance has features that are especially irksome to underwriters and trustees.[13] If an underwriter or trustee is found to have participated in predatory lending (as few as 10 loans), it may be barred from doing business with the City. An underwriter or trustee could forfeit its position in one of the City's bond offerings. Fortunately, the New York City ordinance provides for a due diligence defense.

What steps can market participants take to protect themselves from assignee liability under predatory lending laws? The answer varies for different kinds of market participants. For example, warehouse lenders are likely to rely on indemnities from warehouse borrowers. Underwriters will conduct due diligence on loan pools. Due diligence will be an imperfect solution; determining whether some loans violate predatory lending laws hinges on qualitative judgments.

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[11] Georgia Fair Lending Act, Ga. Laws § 7-6A-1 *et seq.* (*available at* http://www.legis.state.ga.us/legis/2001_02/fulltext/hb1361.htm).

[12] N.Y. Banking Law § 6-L (effective 1 April 2003) (A. 11856, N.Y., passed N.Y. Assembly on 25 June 2002; passed N.Y. Senate on 2 July 2002; signed by governor 3 Oct. 2002).

[13] Council of the City of New York, Int. 67A (25 Sep. 2002), *available at* http://www.council.nyc.ny.us/textfiles/Int%200067-2002A.htm.

So far, predatory lending litigation has focused on deep-pocket defendants. Securitization trusts are likely to be defendants of last resort.

One rating agency concluded that it could not rate deals backed by Georgia loans because (1) assignee liability could potentially attach to a securitization trust, (2) the liability is unlimited and, therefore, very difficult to estimate, and (3) it is unclear which loans fall within the scope of the law.

Originators' perspectives on the new predatory lending laws vary. A thrift lender observes that it is exempt from the law because of federal pre-emption. That lender may gain a competitive advantage under the new regime. A second lender – not a thrift – decided to pull out of Georgia because of the new law.

Mortgage Insurance: Some sub-prime mortgage securitizations use lender-paid mortgage insurance as a form of credit enhancement. When this is done, the insurance covers losses "down to 60% LTV" on the loans. Recently, the proportion of deals that use lender-paid MI has declined.

One lender observes that using lender-paid MI as a form of credit enhancement facilitates the process of issuing NIM securities. That lender also observes that the mortgage insurers are reasonable about paying claims. Only about 3% of the claims submitted are rejected. A second lender refrains entirely from using lender-paid MI. That lender contends that it achieves better execution without using lender-paid MI.

In contrast to the lender that has experienced a rejection rate of only 3% on claims submitted under its lender-paid MI policies, other lenders have experienced rejection rates of about 15%

Credit Quality and Performance: The vintage years 1999 and 2000 have exhibited stable or declining delinquencies, probably due to rising home values. The 2001 vintage is not performing as well. One lender expects the 2002 vintage to be strong. The 2002 vintage had somewhat higher FICO scores compared to earlier vintages. The lender expects cumulative losses on the 2002 vintage to be in the 2.5% ballpark, certainly less than 3% in any case.

About $4.5 billion of NIM securities were issued in 2002. Total outstandings of sub-prime mortgage ABS are about $465 billion.

Servicing: One lender contends that the customary sub-prime mortgage servicing fee of 50 bp is not enough. That lender suggests that the servicing fee on a pool should start low and rise over time. That way, the fee paid would more closely track the actual work of servicing loans.

Hot Topics for 2003: Most panelists feel that predatory lending will be the main topic confronting the sub-prime mortgage market in 2003. Some panelists highlight the effect that a rising interest rate environment could have in shrinking origination volumes

NIMs: What is a NIM? A NIM securitization is a financing of the estimated stream of excess coupon plus penalties from a pool of loans.[14] NIMs are always subordinated to other securities. They are

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

A NIM securitization embodies the right to receive residual cash flows from one or more underlying securitizations. In a typical case, a NIM security might receive (1) all excess spread, (2) unused overcollateralization (OC) remaining at the termination of the underlying deal, (3) prepayment penalties, and, in some cases, (4) cash flow on classes specifically created to enhance the NIM (*e.g.*, a small "NAS IO" class). As in an equipment lease securitization, cash flows attributable to the NIM do not have inherent principal and interest components. Rather, the creation of the NIM itself artificially imputes principal and interest components to the undifferentiated underlying cash flow.

hard to price because it is difficult to estimate their cash flows reliably. There are really two NIM markets. One is for re-securitizations of residuals from past deals. The other involves the creation of new NIM securities contemporaneously with a related underlying sub-prime mortgage deal. In the latter context, the issuer uses the NIM to optimize the structure of the underlying deal. NIMs present credit risk as well as prepayment risk and sensitivity to interest rate volatility. Hedging NIM exposures is better handled with corridors than with caps.

The triple-B market for NIM securities has resurfaced in the past few calendar quarters. Investors are becoming comfortable with NIM securities rated triple-B-minus. Low interest rates have been a boost to the performance of older NIM securities. Now, the specter of higher rates means that NIM investors should consider using caps and corridors to hedge their risks.

NIMs currently trade at yields in the range of 8.5% to 9%. According to one issuer, 80% of the loans backing today's sub-prime mortgage pools have prepayment penalties. Twenty five percent of the cash flow on that issuer's NIMs comes from prepayment penalties. That issuer collects 98% of prepayment penalties. The recent changes to OTS regulations[15] under the Alternative Mortgage Transaction Parity Act[16] will have a negative impact on NIMs. The recent changes may cause fewer loans to be originated with prepayment penalties. If the proportion of loans with prepayment penalties drops from 80% to 60%, this will cause increased volatility in NIM cash flows. However, at least one investor disagrees, contending that only 15% of NIM cash flows actually are attributable to prepayment penalties.

Servicer strength is critical for NIMs, just as is the originator's origination process. NIM investors should favor deals from servicers that have received strong evaluations from the rating agencies. A strong servicer has a good collection process and an effective loss mitigation system.

Sub-prime mortgage ABS issuers should always compare execution through securitization against whole loan sales. If NIM securitizations become more difficult, whole loan sales may become relatively more attractive. On the other hand, loan originators must be careful in selling loans to Wall Street firms because the Wall Street firms use the loans to back ABS issues of their own.

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

There are important differences between NIMs today and those of several years ago. Today's NIMs are much safer because they include *prepayment penalties* on the underlying loans. If prepayments are faster than expected, cash flow from the prepayment penalties serves partly to offset reductions in cash flow on the excess spread. Older NIM deals did not include prepayment penalty cash flows.

Other features of today's NIM deals further distinguish them from the weaker NIMs of years past. Today's NIM transactions employ lower advance rates against the projected future cash flows. This amounts to greater cushions against errors in projections. In addition, some of today's sub-prime mortgage securitizations are structured to permit cash to flow to their related NIMs right from the start. This is accomplished by creating the OC for the sub-prime mortgage securitization at the inception of the deal, so that excess spread can be released immediately to flow to the NIM.

Structuring a NIM requires separately projecting the timing and amount of losses and prepayments and choosing a suitable discount rate given the uncertainties of estimation. In the 1990s, many of the leading sub-prime mortgage ABS issuers went bust because they had been too optimistic in estimating slow prepayments on their originated loans. When actual prepayments were faster than the projections, the issuers were forced to take crushing write-downs on the value of their residuals.

Today's NIMs routinely achieve investment-grade ratings. In fact, some are wrapped with bond insurance and carry triple-A ratings. The rating agencies have promulgated standards for structuring NIMs to achieve investment grade ratings. Those standards include conservative assumptions concerning the level and timing of losses and prepayments.

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

[16] 12 U.S.C. § 3801 *et. seq.*

An important recent innovation associated with the current generation of NIMs is the use of caps to reduce interest rate risk. Another innovation is the strategy of combining a triple-A-rated WAC IO with a NIM.

NIMs have good value. They provide some of the best cash flows on the whole structured finance landscape. Few other alternatives provide short-duration, high yield, stable cash flows. The good days for NIMs were from 2001 until now. The past two years have demonstrated that prepayments on sub-prime mortgage loans are more sensitive to movements in interest rates than was previously thought.

## 11:15 AM – Recent Regulatory Developments, Accounting Changes & QSPE Consolidations and Implications for the Market

FIN 46: Understanding FIN 46[17] starts with "expected losses." The concept of expected losses is central to identifying a variable interest entity (VIE) and to identifying who is the primary beneficiary. According to one interpretation of FIN 46, "expected losses" refers to the probability-weighted average outcome of below-average results, and "expected residual returns" refers to the probability-weighted average outcome of above-average results plus fees (on a gross basis) and premiums for a guarantee.

The traditional view of consolidation is that a consolidator is one who has a controlling interest evidenced by voting stock. FIN 46 broadens the basis of consolidation with a bias toward consolidation based on exposure to losses and the power to control.

An entity is not a VIE if it has sufficient equity to absorb its expected losses without other subordinated financial support. Likewise, an entity is not a VIE if there is equity that has decision-making control.

If a company holds variable interests in a VIE that expose it to a majority of the VIE's expected losses, then the company is the primary beneficiary and must consolidate the VIE. If no company holds variable interests that expose it to the majority of expected losses, a secondary test is whether the company holds variable interests that entitle it to a majority of residual returns. If so, the company is the primary beneficiary and must consolidate the VIE.

In FIN 46, FASB was continuing a project that it had been pursuing for years. Although FIN 46 "feels" like a new rule, it is an interpretation of a rule from 1959. Although the FASB seemingly has abandoned reliance on the form of voting equity interests, it has adhered to the underlying concepts from which the 1959 rule was forged. Behind the idea of expected losses is the notion of discerning whether the subject entity has "sufficient" equity.

The major exception to FIN 46 is FAS 140.[18]

FIN 46 does not yet address the question of how to deal with the presence of more than one decision-maker.

The mere presence of subordinated debt does not automatically lead to the conclusion that an entity is a VIE. However, subordinated debt suggests that an entity is a VIE. To avoid being a VIE, an entity will have to pass several tests.

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

[18] Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Sep 2000).

In the context of a CDO, the first question in identifying the presence of a primary beneficiary is whether any single person holds a majority of the expected losses. Since CDO equity is well dispersed, it is likely that analysis will proceed to the next level: the determination of whether any person holds a majority of the residual returns. If so, that person will be the primary beneficiary.

If the equity of a CDO is enough to absorb the expected losses, the CDO will not even be a VIE. This would eliminate the need to look for a primary beneficiary – there would be no consolidation under FIN 46.

For ABCP conduits, the VIE issue potentially affects both sellers and sponsors. Sellers will need to assess whether they need to consolidate the receivables pools that they finance through an ABCP conduit. Separately, conduit sponsors will need to assess whether they must consolidate their conduits. Because of solid collateral cushions on the receivable pools financed through ABCP programs, the level of expected losses at the conduit level usually is very small. Therefore, exposure to only a small amount of expected losses could constitute the majority of expected losses and, therefore, make the sponsor the primary beneficiary of an ABCP conduit.

Although FAS 140 tightly restricts what a QSPE can do with its assets, it does not seem to materially constrain a QSPE's ability to manage its liabilities. Now FASB is likely to take up the issue of how much discretion a QSPE can exercise over its liabilities without forfeiting its QSPE status. FASB is unlikely to liberalize the constraints on what a QSPE can do.

From a regulatory perspective (the FRB), consolidation resulting from FIN 46 will not alter the risks to which banks are exposed. Nonetheless, the existing capital rules would mandate higher levels of capital because of consolidation. The banks have been lobbying for months, asking for capital relief if their ABCP conduits ultimately must be consolidated on their balance sheets. However, it is unlikely that the bank regulators will grant relief based on the arguments presented so far. Regulators will put the burden of proof on the industry to demonstrate that the ABCP conduits cannot operate under a regime of consolidation or that they cannot be structured to avoid consolidation.

The new Basel documentation[19] is much more complicated than FIN 46. The last document was 800 pages long and generated extensive comments. Basel plans to release another document for comment at the end of the second quarter of the year. The U.S. regulators intend to issue a notice of proposed rulemaking by the end of second quarter. The release will be the U.S. implementation of the Basel rule. A final U.S. rule will be released around the end of 2003 or the beginning of 2004. The Basel rule is to become effective at the start of 2007. The U.S. implementation might become effective sooner.

The Bond Market Association and the American Securitization Forum have submitted a no-action letter request to the SEC permitting reliance on third parties in certifying as to the accuracy and truthfulness of reported information. A key issue for the industry is what level of due diligence will become the norm for making certifications on securitizations and for relying on third parties.

The second Basel paper on securitization generated many comment letters. The comment letters argued that the risk weights on both approaches are too high. The risk weights on lower-rated tranches are too high. The industry argues that deducting dollar for dollar capital for positions that fall below $K_{IRB}$ is too harsh.[20] The industry argues that there should not be capital floor of 7%.[21] The industry also argues that the formula is too complicated.

[19] The Basel Committee on Banking Supervision sponsors the international framework for setting minimum capital levels for banks. *See* www.bis.org.

[20] *See* Basel Committee on Banking Supervision, *Second Working Paper on Securitisation,* ¶ 14 (October 2002) *available at* http://www.bis.org/publ/bcbs_wp11.pdf

[21] This probably refers to a proposed minimum risk weight of 7%. *Id.* ¶ 40.

The industry commented that the capital charge for synthetic securitizations would be higher than the charge for traditional securitizations.

Liquidity facilities in the top-down approach: There are issues concerning the definition of what is a liquidity facility. There is also the issue of what is the appropriate capital charge for a liquidity facility.[22]

## 1:45 PM – Predatory Lending and Its Consequences in the Secondary Market

Before the Georgia predatory lending statute,[23] it was possible to avoid triggering the application of state predatory lending laws by keeping fees below the **HOEPA**[24] fee levels. The difficulty with the Georgia statute is that it has a middle-tier that gets triggered at points and fees of just 3%. The new New York City ordinance is tough.[25] Also, the new New York State statute is very tough.[26] It has slightly higher triggering levels than the New York City ordinance but it has strict assignee liability.

The new Georgia predatory lending statute is likely to be the template for things to come.

The three rating agencies have announced that they will not rate deals backed by loans covered under the Georgia law. The law covers all loans in amounts above conforming loan limits and all other loans that have fees and points above its trigger levels. The law requires that a borrower receive a "reasonable tangible net benefit" in certain refinancing situations.[27]

The Georgia legislature is considering possible amendments to that state's predatory lending statute. The state senate amendment narrows the definition of a "purchaser" by excluding a secondary market investor.[28] However, the amendment still exposes secondary market purchasers to all payment defenses by borrowers.[29]

Georgia's law has potential implication beyond that state. New Jersey's legislation closely follows the Georgia model with troubling ambiguities regarding both "reasonable tangible net benefit" and "points and fees."[30]

OTS regulations exempt federally chartered thrifts from the application of the tough new state laws. However, it remains unclear whether assignees of loans from federally chartered thrifts would get the benefit of the exemption.

The growing threat of assignee liability is increasing the due diligence burden for intermediaries. In performing due diligence on an originator, intermediaries must apply greater scrutiny to the originator's compliance practices.

In screening for predatory lending practices at an originator, the first step is understanding the applicable laws and breaking down requirements into "black and white" elements. This means screening the triggering levels of points and fees so that software can detect loans that trigger

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[22] *Id.* ¶¶ 43-50.

[23] Georgia Fair Lending Act, Ga. Laws § 7-6A-1 *et seq.* (*available at* http://www.legis.state.ga.us/legis/2001_02/fulltext/hb1361.htm)..

[24] 15 U.S.C. § 1639, Home Ownership and Equity Protection Act of 1994 (contained in Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. 103-325, 108 Stat. 2160).

[25] Council of the City of New York, Int. 67A (25 Sep. 2002), *available at* http://www.council.nyc.ny.us/textfiles/Int%200067-2002A.htm.

[26] N.Y. Banking Law § 6-L (effective 1 April 2003) (A. 11856, N.Y., passed N.Y. Assembly on 25 June 2002; passed N.Y. Senate on 2 July 2002; signed by governor 3 Oct. 2002).

[27] Georgia Fair Lending Act, Ga. Laws § 7-6A-4.

[28] Ga. Senate Bill No. 28 (2003) (proposing amendment of Ga Laws § 7-6A-2(7))

[29] Interestingly, even under the amendment proposed by the Georgia Senate, purchasers arguably still could be subject to substantial liability under § 7-6A-6(b) which provides: " Notwithstanding any other provision of law, *any person who purchases* or is otherwise assigned a high-cost home loan *shall be subject to all affirmative claims* and any defenses with respect to the loan that the borrower could assert against the original creditor or creditors of the loan." [emphasis added]

[30] N.J. Assembly Bill No. 75 (2002) (*available at* http://www.njleg.state.nj.us/2002/Bills/A0500/75_I1.PDF)

application of the predatory lending laws. In addition, experienced due diligence personnel can determine whether a borrower has the reasonable ability to repay his loan and whether the loan produces a benefit to the borrower. Due diligence personnel check for compliance with TILA[31] and Reg. Z[32] simultaneously with checking for compliance with predatory lending laws.

Rapidly changing predatory lending laws make it impossible for an originator to manage compliance without using continuously updated computer systems. Even the largest lenders may fail to properly manage compliance in jurisdictions where they do only a small amount of business. Supporting the necessary software systems requires a substantial investment in manpower to handle updates, testing, and quality control. A good originator maintains a log of all system updates to reflect changes in the laws.

It is not practical for an originator to try to avoid predatory lending issues by embracing over-arching (multi-state) rules. Instead, it is necessary to actually deal with all the diverse legal requirements that apply in different jurisdictions. In that connection, the originator must deal not only with the particular trigger levels in each statute but also with disclosure and reporting requirements. Some of the laws are too tough to work with because they are vague. Colorado prohibits loans that are "unconscionable"[33] while Toledo prohibits making a loan based on unreasonable appraisals.[34]

For now, the issue of assignee liability is keeping loan purchasers from buying loans covered by the predatory lending laws.

The New York City ordinance includes a due diligence safe harbor.

It is critical to limit assignee liability. It should be limited to the amount owed under a loan. It is also critical that violations of predatory lending laws should not undermine a loan's validity.

There has been a challenge to the OTS revocation[35] of the **Parity Act**[36] preemption of prepayment penalties but it is unlikely that the challenge will succeed.

The New York State law has a low threshold of 5% on points and fees. An intentional violation of that law renders a loan null and void. There is also monetary assignee liability. The present New Jersey law does not cap civil liability for assignees.

There has been little reported litigation of suits against deal trustees under theories of predatory lending. There was some litigation stemming from First Alliance and from FirstPlus.

Ambiguity in the laws is a key threat.

## 2:45 PM – Are We Ready for 2003? Non-Real Estate ABS: A Research Analyst's Roundtable

<u>Metris (MXT)</u>: It remains unclear whether Metris will survive. The company's ability to survive may depend on whether its deals enter early amortization. Losses are high and will stay high. One thing that the company can try to do to forestall early amortization is to re-price the portfolio to generate higher yield.

The Metris portfolio was always recognized as a weak portfolio; that is reflected in the higher enhancement levels that the Metris deals received from the rating agencies. The catch is that when those enhancement levels were set, early amortization events were thought to be stronger than the

[31] Truth in Lending Act, 15 U.S.C. § 1601 *et seq.*

[32] 12 C.F.R. part 226

[33] Col. Rev. Stat. § 38-40-105.

[34] Toledo Municipal Code § 795.21(a)(1) (*enacted by* Toledo Ordinance 291-02).

[35] 12 C.F.R. § 560.222, Office of Thrift Supervision, *Alternative Mortgage Transaction Parity Act; Preemption*, 67 Fed. Reg. 60542 (26 Sep. 2002, removing designations of §§ 560.33 and 560.34 as appropriate and applicable to state housing creditors).

[36] Alternative Mortgage Transaction Parity Act, 12 U.S.C. § 3801 *et. seq.*

market now knows them to be. After the NextCard experience, the market doubts whether a bankruptcy or insolvency of the company would trigger an early amortization.

Metris management recently has taken a positive tone on the company's prospects. There is no explanation for why they recently experienced a slight improvement in performance. The key question is whether the company can renew its financing arrangements.

Under one analysis, the excess spread on the Metris trust is likely to drop to zero next month. Nonetheless, the senior classes are still very well protected and could withstand defaults of up to 50% under a declining pool scenario.

The only way Metris will survive is if MBIA and the ABCP conduits that supply some of the company's funding together enact some form of "Marshall Plan" to rescue the company.

Metris arguably is a "panic situation." Therefore, there may be opportunity for investors who are willing to do their homework. For 2003, there is a good chance that Metris *will* be able to survive. The company will do whatever is necessary to prevent triggering an early amortization of its deals.

Overall, the panelists disagree as to whether the company will survive and whether its deals will enter early amortization.

<u>Reserve Funds</u>: Speculative grade credit card ABS issuers should be required to pre-fund reserve accounts so that the accounts do not have to rely solely on excess spread. The rating agencies probably will revise their thinking about triple-B tranches of credit card deals based on the lessons of recent experience. It takes about 2½ to 3 years for a reserve fund to build-up. In contrast, excess spread can deteriorate by 100 bp per month.

By saying that reserve funds need to be fully funded up-front, some panelists essentially are suggesting that the deals are under-enhanced.

In the olden days, all reserve funds in credit card deals were fully funded at the inception of the deals. After many years of strong performance, the rating agencies came under irresistible pressure to allow funding over time.

<u>NextCard</u>: There is a strong correlation between corporate and ABS spreads. Early amortization triggers are subject to interpretation. In two recent cases, involving deals from Conseco and Mitsubishi, the issuers sought investor consent to delay early amortization.

Beware of any sector where the regulator is not on the side of investors. The regulators are the guardians of deposits. If the bank regulators could go back in time and send all sub-prime lending activities back to the finance company sector, they probably would. Regulators handling a distressed bank (*i.e.*, one that is in receivership or conservatorship) care very little about helping ABS investors.

NextCard has contributed to the serious fear factor that now infects the credit card ABS sector. Fear has caused significant spread widening, only a portion of which is warranted. Securitization professionals recognize that corporate risk is embedded in credit card ABS.

Card ABS issuers are less able today to save troubled deals than they could years ago.

<u>Linkage</u>: A growing theme for investors is the linkage between the ABS market and the corporate market. [There was always linkage but now it is more widely recognized]. The key question for investors is whether the structure and collateral available in the ABS market justify the reduced spread that investors receive in ABS. In some cases, it may be better to take unsecured triple-B-rated corporate debt over triple-B-rated credit card ABS from the same monoline issuer. The triple-B ABS might be equally vulnerable to default but would pay less yield.

<u>AmeriCredit (ACF)</u>: UAC (Union Acceptance Corp.) is in Chapter 11 and AmeriCredit is not far behind. Should the market now question whether sub-prime auto lending makes sense? Defaults are high and recovery values on used cars are low. These are artifacts of the economy and not AmeriCredit's fault. The company probably will be able to execute wrapped deals. It is likely to survive and probably will manage to bounce back. One view is that the market is over-reacting to the poor performance on AmeriCredit deals because of NextCard-generated fears. AmeriCredit has funding flexibility, including $7 billion of committed facilities. Moreover, AmeriCredit's deals have plenty of excess spread. The company will probably cut its issuance by half in 2003 relative to 2002. The company has started originating higher quality collateral that will show better performance than the collateral backing recent deals. Situations like AmeriCredit arguably offer investors the best opportunities.

<u>Bond Insurers</u>: The ABS market will not be the undoing of the bond insurers. Rather, the bond insurers might be vulnerable to a general business slowdown that drives them to reach for new business in other areas. The bond insurers probably have their greatest exposure in the CDO area. Some of the high yield CDOs from the 1996-1999 vintages could be problems for the bond insurers if the economy continues to deteriorate. However, the actual magnitude of the bond insurers' exposure is much less than was recently implied in press reports.

<u>Consumer Credit 2003</u>: One panelist is pessimistic about consumer credit for 2003. Consumer debt levels are very high (14%). The refinancing boom will start to taper off, which will exacerbate stress on consumers. Another panelist's view is "downright bleak." There is no relief in sight in 2003. Sub-prime consumers are in trouble. Losses and delinquencies on prime quality pools also are likely to rise. The only thing holding the economy together is the mortgage market.

A third panelist takes the contrary view. Top-tier card and auto portfolios are doing much better today than they did at a similar point in the 1990-92 recession. The trillion-dollar wild card right now is housing. There is likely to be a "correction" in the housing market because housing corrections have accompanied virtually all prior recessions.

A fourth panelist is cautiously optimistic but agrees that the housing market is the key wildcard. Low rates have been extremely important in keeping the housing market buoyed. Geopolitical issues will be a key factor in 2003. There may be more cause for optimism as 2004 approaches.

It is a mistake to talk about "the housing market" as a homogenous whole. Home price appreciation is not uniform in different sectors. It has been slower for homes backing sub-prime mortgages. Accordingly, values of those homes are not over-inflated, as were the values of many homes on the West Coast immediately prior to the 1990-1992 recession. Sub-prime mortgage loans in general are less exposed to bubble-bursting home devaluations than are prime-quality mortgage loans.

## Friday, 7 February 2003

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

The problems that the market experienced in 2002 are part of the natural process of maturation.

Distressed issuers were the source of innovative deals in 2002. Providian brought an innovative deal backed by sub-prime credit card receivables: PACCT 2002-1A.[37] ANC Rental Corp., the parent of

[37] *See generally Groundbreaking Securitizations, ABS Provided Relief to Distressed Issues in 2002*, Asset Securitization Report 10 (6 January 2003).

Alamo and National, brought a deal to provide it with financing while it is in bankruptcy: ARGF 2002-2A.[38]

Following Providian's lead (from PACCT 2002-1A), other issuers of sub-prime credit cards may now try to sell their portfolios. The investment banks in Providian's deal purchased a portion of the sub-prime account pool. Similar purchases on a principal basis will become an important part of the landscape.

The future of the manufactured housing sector will be a subject of interest in 2003.

This year (2003) will be the year of distressed assets. Market participants will find the best opportunities in purchasing assets in a principal capacity, thereby gaining maximum control over the assets.

The handling of servicing fees in the Conseco bankruptcy is most troubling.[39] It is not clear how the industry should respond to the problem. One possibility is expanding the role of trustees in such situations. An investor contends that documentation for securitizations is flawed; that it permits too little flexibility for parties to a deal to take corrective action in distressed circumstances. There ought to be a mechanism that allows the parties to have greater flexibility.

One approach for addressing the risk that servicing fees might have to be increased is to "assume" that they have to be increased when analyzing different tranches of a deal.

Underwriters must perform better due diligence to prevent situations like NCFE. Some securitization professionals are unrealistically expecting trustees to take an active role in preventing fraud of the type that occurred in NCFE. Trustees cannot be expected to provide that service for the meager 1 bp fee that they often receive.

A possible response is to increase the fees built into transactions so that they are sufficient to cover an increased role for trustees and potential servicing fee increases (like what happened in the Conseco deals).

The recent troubles highlight the need for investors to understand issuers' business models. Sub-prime lending is near the edge of viability. At present interest rate levels, the margins in many sub-prime lending businesses are just 1% to 2%. When interest rates rise, those business models may no longer work and many sub-prime lenders may become unprofitable. A lender's collapse can hurt its outstanding ABS.

Going forward, the securitization market should expect to see three or four distressed situations each year. The negative impact of such situations could be mitigated with better structures. For example, manufactured housing ABS might be improved by trapping residual cash flows to build up a cushion against losses (*i.e.*, building up overcollateralization). Similarly, home equity ABS could be made stronger by having higher target levels of overcollateralization. Many deals have target levels of only 2%, which is not enough. With that target level of overcollateralization, subordinate tranches (rated triple-B) are vulnerable to losses. With today's structures, the securitization market may be courting disaster. Safer structures would trap residual cash flows for longer periods – five or six years – before releasing cash to holders of residual interests. But, safer structures will not come unless investors demand them. Safer structures will make deals less "efficient" from an issuer's perspective. This could dampen the level of ABS issuance and end the market's impressive record of year-over-year growth. On the other hand, most investors do not care about record-breaking issuance; they just want the deals they buy to pay off.

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[38] *Id.* at 11.

[39] The Bankruptcy Court allowed servicing fees to be increased temporarily to 125 bp from the 50 bp level specified in the pooling and servicing agreements.

Investors who hold 50 or more ABS positions should use tools such as Intex to track key performance measures on a monthly basis. They should track changes in subordination levels, net losses, and other measures. Such tracking is especially important for subordinate ABS. Tracking performance trends is an essential step in managing risk.

A key innovation in the credit card ABS sector is the increasing use of the "master note" structured pioneered by Citibank.[40] That structure allows a credit card issuer to issue senior, mezzanine, and subordinate classes at different times. The issuer can issue each class at the most opportune time, when the market is most receptive and the pricing most advantageous. The master note structure also has helped investors.[41]

Securitization professionals should continue to push structural advances forward. One such advance would be a mechanism for continuous offerings, like MTNs. Doing so will require some changes, such as in how rating agencies determine their fees for each deal, but the necessary changes are achievable and could allow for smaller deals to satisfy reverse inquiries from investors.

The monthly volume of sub-prime ABS deals is in the range of $10 billion to $15 billion.[42] It takes a lot of work for securitization professionals to handle such a heavy flow of new sub-prime activity.

From a legal and structuring perspective, the securitization market is in "a period of tremendous uncertainty." It will be some time before the market achieves clarity on some of the vexing regulatory and accounting issues that it now faces. For mortgage-related products, predatory lending is a key issue. Disclosure and transparency are issues in the forefront because of the Sarbanes-Oxley Act. These issues should not prevent transactions from getting done. However, in light of recent accounting changes, issuers should re-think the need to do deals on an off-balance sheet basis.

Potential liability for predatory lending violations is a tough issue for the alt-A (alternative-A) mortgage sector. The laws from Georgia, New York State, and New York City have changed the landscape. It is not even clear how Freddie Mac and Fannie Mae will react to the changing legal environment. Using representations and warranties to "cover" predatory lending liabilities is an incomplete solution because some predatory lending laws impose criminal penalties.

A bond insurer reacts to the challenges in today's securitization environment by observing that there is better opportunity focusing on the ultra-low risk deals than on riskier ones. For example, it is better to earn 25 bp wrapping an underlying triple-A risk than to earn 35 bp wrapping an underlying triple-B risk. In the CDS (credit default swap) area, trouble is brewing around the definition of "credit events." Some companies engage in activities that skirt the fringes of the definition.

FIN 46 will cause an increase of trade receivable deals in the term ABS market. Because of the NCFE debacle, issuers of healthcare ABS will face very hard challenges in executing new deals. Intellectual property deals will grow, as will timber deals.

<u>Looking ahead to the rest of 2003</u>: One panelist feels that there is a lot of value in the market right now. Investors and money managers can find the best values in seasoned deals. There can also be opportunity in market moves caused by factors other than the fundamentals. Three sets of factors drive market moves but no single set dominates all the time: (1) supply and demand, (2) fear and confidence, and (3) the fundamentals.

[40] Steve Macy, *Note to Investors: Credit Card-Backed Securities Are Changing Color*, Moody's Special Report (22 September 2000).

[41] The master note structure arguably helps investors by making issues of mezzanine and subordinate classes larger and, therefore, more liquid. In addition, mezzanine and subordinate classes become eligible for ERISA plans under the master note structure.

[42] Issuance of home equity ABS, most of which is backed by sub-prime mortgage loans, averaged more than $10 billion per month in 2002. Issuance of sub-prime ABS averaged roughly $2 billion per month.

Liquidity is the key for 2003. Wall Street will produce new creative structures that will allow more deals to happen. In the esoteric ABS market, there will be new asset classes but the advance rates will be conservative.

The troubling experience of the MH sector reveals that securitization professionals failed to anticipate key flaws six to eight years ago. Unless we can address that failure, investors may loose confidence in the market.

FIN 46 brings rationality to accounting that has been lacking from the standards formulated 10 or 15 years ago. Also, an important and beneficial new trend is the use of common sense as an acid test for whether the business models of potential ABS issuers are rational. Tiering credit card ABS spreads by only one or two basis points is irrational if the long-term business prospects of the various issuers are very different.

The greatest cause for concern is surprises that we cannot now predict. We need to worry the most about what we don't know.

## 9:15 AM – Mortgage Related ABS: Where Do We Go from Here

Trends in new sub-prime mortgage loans production include rising loan balances and slightly rising delinquencies. Another panelist reports rising FICO scores and LTVs, combined with a slight increase in second-lien loans.

The strong housing market has partly masked the impact of the weak economy on sub-prime mortgages. Additionally, the high origination volumes have allowed originators to be more selective and have driven FICO scores higher. Future pools may have lower FICO scores as originators vie for market share by loosening standards in a contracting market. Having control over the appraisal process is a key factor for originators to be able to maintain strong loan quality.

One servicer contends that it has already been servicing in a bad economy for the past two years. The company cannot further accelerate its servicing timelines without running into potential trouble with regulators.

A stepped servicing fee may be good thing (*e.g.*, a servicing fee that starts out at 20 bp for the first year, then rises to 30 bp in the second year, 40 bp in the third, and so on). The problem is that the industry has not yet been able to justify the appropriate level of fees for each year.

Trustees are unwilling to sign the certifications called for under the new SEC regulations.[43] Much of the sub-prime mortgage industry has petitioned the SEC for relief, asking that the regulator allow certifying parties to rely on underlying certifications from third parties. The SEC has indicated that it is unlikely to handle the issue through the no-action letter process. Instead, the SEC is expected to promulgate a new form of certification, with new guidance permitting reliance on underlying third-part certifications. Depositors may end up making the primary certifications and relying on underlying certifications from trustees and bond administrators.

From an investor perspective, mortgage-related ABS issued by Wall Street firms are more acceptable than they used to be. The Wall Street firms have managed to stay in business, whereas many mortgage companies have disappeared. In addition, the Wall Street firms bring the benefit of additional due diligence on the underlying loans. A negative feature of deals from the Wall Street firms is the absence of an originator retaining a residual interest (*i.e.*, an originator that keeps "skin in the game").

[43] *See* note 4 *supra*

The Parity Act[44] will be a problem for the future flow of NIM[45] deals. NIM deals now offer investors very good value. Wrapped deals tend to be somewhat incompatible with NIM structures because of the triggers that bond insurers use. The sub-prime mortgage sector has become less attractive to bond insurers because of competing credit enhancement from the GSEs and from a strong CDO bid for mezzanine tranches. In response, the bond insurers have moved into closely related opportunities such as wrapping NIMs and HELOC deals.

Fourth quarter spread widening seems to have become a regular seasonal phenomenon for the mortgage-related ABS sector.

<u>Predatory Lending</u>: It is tough to analyze the effect of the Georgia Fair Lending Act.[46] The hardest part is understanding the impact of violations on loss severities in securitized pools of loans.[47] There are examples of litigation in which courts have awarded millions of dollars to plaintiffs claiming to be victims of predatory lending. The unlimited assignee liability makes it to difficult to assess the severity component of the necessary loss analysis. Accordingly, rating agencies and other market participants are pulling away from loans backed by properties in Georgia.

Federal preemption of state predatory lending laws is highly unlikely.

Virtually all lenders have pulled out of lending in Georgia. Georgia is likely to change its laws to bring lenders back.[48]

An investor recounts a story of having been subjected to assignee liability in connection with FirstPlus loans.[49] That incident is disturbing because the issuer had collapsed and there was no responsible party to make the investor whole.

Another investor is organizing a group to represent ABS investors' interests in the Conseco workout. The Conseco workout is setting precedents that will shape the ABS market for years to come. Conseco's effort to raise the servicing fee to 1.25% and to make the entire fee senior to certificateholder distributions is objectionable. The investor feels that the fee level is slightly too high. There is less objection to the fee's senior status. The Conseco workout creates a dangerous precedent. The trustee of any ABS deals may now perceive that it has more freedom to raise servicing fees if a servicer must be replaced.

The high LTV mortgage loan market is small and likely to shrink further.

## 10:15 AM – "Scratch and Dent" Mortgage ABS: An Overview of Re-performing and Sub-performing Mortgage Loan Securitization

Standard & Poor's uses the following terminology and procedures for working with certain specialty mortgage loans: "Outside guideline" loans are loans that do not adhere to the originator's guidelines. S&P applies the LEVELS model without adjustment to such loans. "Doc deficient" loans have missing documentation. S&P adjusts the LEVELS model for such loans. "Non-performing" loans are delinquent by more than 90 days and are not producing cash flow. S&P uses a separate model for analyzing such loans. The main emphasis is on the liquidation value of the loans. The timing of projected cash flows is based largely on the locations of the underlying properties. A "re-performing"

[44] Alternative Mortgage Transaction Parity Act, 12 U.S.C. § 3801 *et. seq.*

[45] *See* note 14 *supra* for an explanation of NIMs.

[46] Ga. Laws § 7-6A-1 *et seq* (*available at* http://www.legis.state.ga.us/legis/2001_02/fulltext/hb1361.htm).

[47] The law permits damages to exceed the amount of a loan. Therefore, the "loss severity" on a loan that violates the law could exceed 100%. Ga. Laws § 7-6A-7(a), (c).

[48] Both houses of the Georgia legislature are considering bills to amend the state's predatory lending law.

[49] This probably refers to borrower suits in Kansas in 2000.

loan has been delinquent by 90 days within the past year but is currently producing cash flow. A "sub-performing" loan is one that is contractually delinquent but that is currently producing cash flow. S&P uses the LEVELS program with adjustments for re-performing and sub-performing loans.

Fitch applies the term "scratch and dent" to loans that fall outside of guidelines or which have documentary deficiencies. Fitch does not use the term in relation to re-performing and sub-performing loans. Documentary deficiencies can influence both the expected frequency and severity of loan defaults. Non-performing loans are delinquent by more than 90 days and most will go to REO (*i.e.*, the servicer will foreclose on the underlying property with the result that the property becomes "Real Estate Owned"). Re-performing loans are ones that have made some, but not all, of their recent payments. A sub-performing loan is one that is 30-90 days delinquent and either is not producing cash flow or has erratic cash flow.

Some deals backed by scratch and dent loans include ones that are "foreclosure restricted." The securitization trust is prohibited from taking title to the properties securing such loans if there is a foreclosure. The prohibition relates to not undermining the trust's REMIC status. A REMIC can include only loans that the depositor reasonably expects to be repaid.

Some deals backed by scratch and dent loans include "arrearages" (past due amounts on the loans). Including arrearages can provide a source of credit enhancement for a deal.

In 1998 there was about $1 billion of ABS issuance backed by scratch and dent mortgage loans (including re-performing, non-performing, sub-performing, out of guideline, and document deficient loans). In 2002 there was about $9 billion of issuance backed by scratch and dent mortgage loans. The scratch and dent sub-sector makes up about 5% of the ABS universe.

About 60% to 70% of ABS backed by scratch and dent mortgage loans use bond insurance. Some issuers prefer to use bond insurance and some favor the senior-subordinate structure.

Scratch and dent ABS trade at wider spreads than regular sub-prime mortgage ABS. The magnitude of the difference reflects how severely scratched and dented the loans are. Scratch and dent mortgage ABS are always "story paper." The spreads on triple-A tranches can be from 10 bp to 50 bp wider than spreads on regular sub-prime mortgage ABS.

Scratch and dent mortgage loans have slower prepayments than regular sub-prime mortgage loans. Delinquency rates for scratch and dent mortgage loans are high and can be very volatile.

The performance of a scratch and dent pool is very dependant on the quality of servicing.

A problem for the sub-prime mortgage sector in general is that some servicers and special servicers characterize loans as 30-days delinquent when in fact they should be classified in more severe delinquency categories. The problem stems from lenders "re-aging" loans in forbearance and loans subject to payment plans or bankruptcy plans.

One originator maintains two scratch and dent programs. The first is for loans that violate the guidelines of the originator's regular programs. The second scratch and dent program is for re-performing and sub-performing loans.

## 11:30 AM – Developments in the Manufactured Housing Sector

Manufactured housing ABS issuance volume for 2003 will be around $3 billion, most of which will come from Vanderbilt. A smaller portion will represent repackaging of Conseco whole loan paper that is trading in the secondary market. Chase's entry into the MH ABS market is a potential wildcard.

Expected lifetime default frequencies have jumped from the mid-teens and low twenties to the 35% range. Loss severities are very high because the servicers are relying primarily on wholesale liquidations. For purposes of triple-A-rated securitizations, assumed loss severities of 100% are the norm.

It is not clear whether credit ratings on MH ABS have bottomed-out. The industry is going to continue struggling beyond 2003. Some excess inventory at the dealer level is working its way through the system.

For the MH industry to rehabilitate itself, discipline must start at the beginning, when the customer walks in the door.

What is the right business model for the MH sector? Clayton/Vanderbilt embraces a vertically integrated business model. Clayton/Vanderbilt views the point of sale as the main nexus for determining success. However, each component of the operation – manufacturing, retail sales, and financing – must be profitable on its own.

Others argue that the stand-alone finance company model can work. Like the vertically integrated business model, the stand-alone finance company business model requires discipline. If an independent finance company has a sufficiently large servicing portfolio to generate "annuity" income, it can step back from originations when loan pricing and terms become irrational. Continuing access to securitization funding is essential for the stand-alone finance company business model to work.

Shorter loan terms are better for borrowers in some cases. Loan terms of 30 years are suitable only if a financing arrangement includes land. The right target for the industry should be in the range of 15 years.

**The late 1990s were characterized by a breakdown of discipline in the MH sector. The capital markets finally supplied the discipline by backing away from the sector.** Of course, the MH industry will continue to exist, but it will not ship or finance as many units as were being pushed in the late 1990s. For now, the capital markets do not want to finance MH because of the huge overhang of repossessed inventory.

The capital markets will accept new MH ABS deals, but the market will demand very high yields to accept a deal backed by repo refis (*i.e.*, loans made to buyers of repossessed units).

The cost of servicing is a function of the quality of the loans. Conseco had represented that its servicing was profitable at 50 bp. It now seems that that claim might have been wrong. While the proposed new fee level of 125 bp for the Conseco portfolio might be reasonable for the new (weaker) vintages in the portfolio, it is unnecessarily high for the older (stronger) vintages. Vanderbilt routinely uses a servicing fee of 125 bp in its deals.

Differences in the level of servicing fees may reflect differences in the level of services actually being provided. Many servicers have indicated that their cost of servicing is in the range of 75 bp. In Conseco's bankruptcy filing, the company indicated that its cost of servicing was roughly 75 bp. Previously, the company had represented that its costs were ten to fifteen basis points lower than that.

The Conseco/Greentree servicing platform is likely to be absorbed by three or four entities.

A threat to the sector is that repossessing homes that back defaulted loans will become economically impractical because recovery rates are so low. If a servicer concludes that it does not pay to repossess homes, and therefore stops doing so, homeowners will see that there is no "penalty" for not paying their loans.

Greentree deals from older vintages are likely to outperform the newer vintages.

ABS investors need to diversify their exposure across different servicers.

Servicing fees need to be adequate for servicers to make money from servicing. But a deal also should provide incentives for the servicer to work hard, by requiring it to have skin in the game through a residual interest.

The Conseco bankruptcy arguably threatens the whole ABS market. It potentially creates a "maneuver" that any servicer can use to increase its servicing fee when it is in a distressed (or bankruptcy) situation.

For MH ABS, the weakest vintage years were probably 2000 and 2001. Underwriting policies and practices have improved over the past year and a half. Therefore, loans from the 2002 vintage are somewhat better. For older loans, the condition of the economy is the chief factor dictating performance. However, regardless of the economy, recoveries will remain low because of the overhang of repossession inventories.

Trading advice: sell right now if you would sell later because of rising losses. Losses will get worse before they start to get better. Selling production from 1999 and later production years is a good idea, even up to the triple-As. Production from 1994 and earlier is relatively predictable. Production from 1995 to 1998 is the hardest to gauge. Investors must analyze each deal individually.

Conseco series 1999-1 through 1999-4 represent a distinct vintage. The later 1999 deals, starting with 1999-5, are markedly different.

**There are senior tranches from the 2000 vintage that ultimately will default.**

## Saturday, 8 February 2003

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

The past year has been challenging, with failures of servicers and fraud. The market is looking with great caution at untested assets and servicers. Still and all, the market soldiers on.

Life Settlements: Each year, about $1.5 trillion of life insurance policies lapse. Of that amount, about 10% has real value. Buying a life insurance policy from someone with a terminal illness is called a "viatical settlement." In the past, most viatical settlements related to AIDS victims. With medical advances, the investors in viatical settlements got wiped out. Buying a life insurance policy from the "healthy elderly" is called a "life settlement." Investors who buy "participations" in life settlements are exposed to the bankruptcy risk of the life settlement companies.

Life settlement companies cannot get all the funding that they want through bank lines and sales of participations. Their desire for more funding has driven them to the securitization markets.

Life settlement contracts are not governed by the U.C.C.[50] The only way to really get control of a policy is to be the owner. Otherwise, the owner could change the beneficiary named in the policy. Life settlement financing has used a trust structure similar to the "titling trust" structures used in auto leasing.

An unusual feature of a life settlement is that it consumes cash (*i.e.*, premium payments) until it finally pays off. For a deal, there must be a premium reserve to keep the insurance policies in force until the insured individuals die.

A life settlement company uses a qualifying physician for examining the insured individuals to estimate their life expectancies. In some financing arrangements, Lloyds has issued a backstop

[50] U.C.C. § 9-109(d)(8).

policy to protect investors against the risk that the insured individuals live substantially beyond their estimated life expectancies.

Licensing requirements are a key issue in the life settlement area. "Tracking" is a critical task; the servicer must call the insured individuals quarterly to determine whether they are still alive.

There is stiff competition for policies. This is driving the price of policies up. Life settlement companies need to be careful that they buy only policies that are not defective.

Tobacco Settlement Legal Fees: Tobacco settlement legal fees arise under the Master Settlement Agreement (MSA) and certain related agreements among the major tobacco companies and the states. In addition to the amounts that the tobacco companies agreed to pay to the states, the tobacco industry agreed to pay the lawyers. State attorneys general hired outside counsel to litigate against the tobacco companies. The states' central claim related to a novel theory that smoking-related illnesses drained state Medicare funds.

Each of the major tobacco companies is severally liable for its portion of the ongoing legal fee cash flow stream. Negotiations and arbitrations produced total legal fees of roughly $13 billion. However, because of a $500 million annual payout limit, the cash flow extends for more than 20 years. Law firms found themselves having major positions in long-dated, non-interest bearing tobacco exposure. This created an incentive for them to securitize. By monetizing the stream of future cash flows, the lawyers who actually did the work can receive the reward for their efforts (instead of future partners). In addition, the securitizations facilitated estate planning by eliminating a complicated long-term asset from the lawyers' personal holdings.

Tobacco settlement legal fees are subject to the risk that one of the tobacco companies goes into a Chapter 11 bankruptcy. Chapter 7 is not really a risk because there is an annual market share adjustment mechanism that would allocate the share of unpaid fees to the surviving tobacco companies.

Securitizing tobacco settlement legal fees posed tough structural challenges. For example, the underlying sources of payment are the shifting obligations of the tobacco companies, which have varied credit ratings. In addition, the quarterly fee payments initially were payable to individual lawyers (one in each state), who then disbursed them among various law firms. Both the individuals and the law firms were subject to the risks of bankruptcy and third party claims. It was not clear that the fee payment agreements are assignable. Lastly, some lawyers wanted to securitize their portion of the fee cash flows while others did not.

The shifting obligations among the various tobacco companies are actually a structural benefit. They re-assign the payment obligations to the tobacco companies with the largest market shares. Those ought to be the stronger companies. If any tobacco company fails, its obligation shifts to the surviving companies. This creates possible extension risk but increases the likelihood of full collection over time.

To address the bankruptcy risk associated with making payments to individuals, the original payment mechanics were replaced with remittances to an institutional trustee in each state. Each state's trustee transfers the fee cash flow to an SPE. The SPE than distributes the collections to law firms or to the securitizations. All law firms covenanted to cooperate in the enforcement of the assignability of the assigned fees. The obligations of the various law firms are not cross-defaulted.

From an investor's perspective, tobacco settlement ABS and tobacco settlement legal fee ABS offer attractive investment alternatives to traditional ABS. The tobacco related alternatives allow investors to shift their exposure away from purely consumer risk. Compared to corporate bonds, tobacco settlement bonds offer "survival of the fittest" industry risk, not single company risk. The obligation to pay the tobacco settlement legal fees is an executory contract, which, if affirmed in a bankruptcy proceeding, would have priority over ordinary unsecured obligations. A bankrupt tobacco company attempting reorganization would be likely to affirm the settlements because the failure to do so would expose it to new smoking-related lawsuits.

Notable strengths of the tobacco settlement legal fees are: (1) hands-off flow of funds, (2) four years of excellent MSA payment history, (3) two years of excellent history for the issuer, and (4) the issuer's interests are aligned with the bondholders interests because it retains a subordinated residual interest.

Derivatives: Derivative products are simpler today than they were in the mid-1990s. The Bankers Trust litigation and the rise of suitability requirements dampened enthusiasm for the highly complex derivative instruments that had been popular in the mid-1990s.[51]

In a total return swap, the total return payer pays a financing fee and receives the economic return on the reference assets. The receiver receives the financing fee and pays the economic return on the reference assets.

In a credit default swap, the protection seller receives a fee in exchange for its obligation to make a contingent payment based on the occurrence of a credit event based on a reference asset. In effect, the credit default swap creates a kind of unregulated insurance coverage for credit risk.

# Strategic Research Institute
# Asset Securitization 2003 Symposium

February 9-12, 2003, The Fairmont Scottsdale Princess, Scottsdale, Arizona

## Monday, 10 February 2003

### 8:15 AM – State of the ABS Industry

Last year (2002) was another record year for ABS issuance volume, both in the U.S. and internationally. In calculating issuance volumes, the calculated U.S. volumes receive a boost from cross border deals coming into the U.S. numbers (because they include dollar-denominated cross boarder deals). Virtually all ABS asset classes displayed growth in issuance in 2002, lead by home equities.

ABS has shown steady growth in issuance, while other major components of the capital markets have shown vacillating issuance activity over the past five years. For 2003, ABS issuance could surpass corporate issuance.

Tough Challenges of 2002: Last year brought tough challenges for the securitization markets. The year started with the Enron effect. Then came the regulatory focus on sub-prime lending. Ratings volatility accelerated. Later in the year, the role of trustees and the financial strength of the bond insurers were called into question. Collectively, the challenges produced heightened tiering.

Enron precipitated a government witch-hunt which triggered a number of by-products: (1) the **Durbin-Delahunt** bill,[52] which was defeated, (2) the Sarbanes-Oxley Act,[53] which increases

[51] *See generally*, Kelley Holland, Linda Himelstein, and Zachary Schiller, *The Bankers Trust Tapes*, Business Week 106-111 (16 October 1995) (*available at* http://www.businessweek.com/1995/42/b34461.htm)

disclosure requirements but which does not exactly fit how securitizations work, and (3) FIN 46,[54] which requires consolidation of certain off-balance sheet SPEs.

Sub-prime lending developments include increased activity in predatory lending legislation, particularly the new Georgia law.[55] Also, the regulatory focus on sub-prime credit card lending led to the MOU (memorandum of understanding) with Capital One.[56]

Ratings volatility was extreme in 2002. Most of the volatility was in the high-yield CDO sector. In addition, the aircraft and manufactured housing ABS sectors displayed disappointing waves of rating downgrades. The big four asset classes – autos, credit cards, home equities, and student loans – have performed well and generally have shown more upgrades than downgrades. "If you stick to the major four, you will be OK."

The role of securitization trustees became a key issue in several settings. Backup servicing was the issue in NextCard and monitoring asset integrity was the issue in NCFE.

The perceived credit strength of the monoline bond insurers is reflected in the pricing of their credit default swaps. The pricing moves up and down with the perceived levels of stress in the ABS market. The overall proportion of insured deals is declining because fewer deals in the mainstream (*i.e.*, big four) asset classes use bond insurance wraps. On the other hand, bond insurance remains a common feature of deals backed by new or unusual assets.

Spreads on credit card and auto ABS have remained stable and tight compared to spreads on the corporate debt of industrial and financial companies. Spreads on home equity ABS have been wider and more volatile than spreads on credit card and auto ABS. But, home equity spread volatility is not any worse than the volatility of spreads on corporate debt.

**Tiering is a more important factor today than ever before.** Now the market looks at "everything." Market based inputs, such as the trading levels of an issuer's straight debt and equity, can affect ABS pricing. Rating volatility engenders tiering. There is more focus on liquidity: how vulnerable is an issuer to rating triggers and continuing access to the ABS market for funding. Investors seek absolute avoidance of headline risk. The result is that some "hard case" issuers, such as Metris and Providian, experienced drastic spread widening when they were in financial distress.

<u>Good Developments</u>: The past year brought record volume in the "big four" asset types which account for 75% of the whole market. Of the non-CDO universe, the "big four" account for roughly 80%. There is better issuer stability today than before. Of the top 15 issuers from 1997, seven are gone today. More of today's top issuers are likely to exist in five years. In a similar vein, transactions are becoming larger: 47% of last year's deals were sized larger than $1 billion.

The ABCP market is very important. Its ability to persist and function during the FIN 46 process is evidence of its strength and durability.

Within the CDO universe, the proportion of deals backed by ABS and MBS is growing substantially. That area of the CDO market has suffered less credit quality deterioration and ratings volatility than other areas. Almost all CDO rating volatility was concentrated in other areas.

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[52] Employee Abuse Prevention Act of 2002, H.R. 5221, 107th Cong., 2d Sess. (2002), S. 2798, 107th Cong., 2d Sess. (2002).

[53] Pub. L. No. 107-204, 116 Stat. 745 (2002).

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

[55] Georgia Fair Lending Act, Ga. Laws § 7-6A-1 *et seq.* (*available at* http://www.legis.state.ga.us/legis/2001_02/fulltext/hb1361.htm).

[56] *See, e.g.*, Capital One Financial Corporation, S.E.C. filing on Form 10-Q at 34 (30 June 2002, filed 13 August 2002)

Projected Activity for 2003: ABS issuance in 2003 will reach $460 billion, with continuing growth in the home equity ABS sector and issuance to replace substantial run-off in both the credit card and auto ABS sectors. MBS issuance might decline somewhat if interest rates stop dropping.

ASF: This year is the first year of the American Securitization Forum. The ASF was formed last March and now has about 70 member firms. The membership includes banks, issuers, underwriters, rating agencies, accounting firms, and law firms. The organization's focus is on regulatory and accounting issues that have confronted the securitization market. The organization's primary mission is to build consensus among industry participants.[57] The organization's secondary role is advocacy. The ASF was active in working against the Durbin-Delahunt bill and in meeting with the Basel committee.[58]

Investors' Outlook: One investor took an "up-in-quality" strategy during the past year. Twenty-five percent of the securities that the investor bought carried ratings of single-A and lower. For 2003, the investor expects to maintain the up-in-quality strategy and expects to observe continued growth in ABS issuance. Investors will continue to be drawn to ABS as a way to diversify away from corporate risk. Although the investor has been active in off-the-run collateral in the past, it now plans to focus primarily on the "big four" asset classes. For 2003, the economy and the sub-prime mortgage sector are continuing areas of concern. The investor will continue to be active in the home equity sector on an up-in-quality basis. The investor is concerned about the risk that housing price increases will slow down or stop. Home equity structures allow too much excess spread to leave the deals before losses are realized. Subordinate tranches of home equity ABS are too expensive. Also, there is too much sub-prime mortgage origination capacity; competition will erode standards.

A second investor expects to invest more in ABS in 2003 as a way to avoid some of the "messiness" in the corporate bond market. Last year may have been better than 2001 for corporate credit but it was still a year of pronounced weakness. That makes ABS appear more attractive. Also, 2002 was a year of heightened focus on liquidity. The focus on liquidity brought more issuers to the ABS market. In 2003, the past "inconsistency" of diligence will be a key issue.

The lower spread volatility in the ABS market compared to the corporate bond market reflects the strength of the ABS market. The greatest danger to the ABS market is new regulations based on ignorance or incomplete knowledge of how the ABS market works. The Durbin-Delahunt bill will resurface this year and will present a potential danger to the securitization market.

Student Loans: Student loan demographics are very strong. The children of the baby boomers are now reaching college age. College tuition costs have continued to rise and college enrollments are expected to continue growing by 7% to 10% annually. Thus, the fundamentals of the student loan business are very strong. Although spreads on student loan ABS are tight, trouble in the off-the-run ABS sectors has driven investors back to student loan ABS. Corporate governance is now an issue for ABS investors (*e.g.* certificateholder voting rights) as well as for equity investors and corporate bond investors.

In the face of constrained ability to issue corporate bonds and straight CP, ABS funding became an important aspect of one issuer's overall financial management. The issuer sees challenges in

[57] The ASF's stated mission of building consensus is an especially tough one. The interests of different industry participants are not always aligned. For example, federally regulated financial institutions have little to gain from fighting state predatory lending laws. Other mortgage lenders have much to gain. Federally regulated lenders arguably ought to support tough predatory lending laws that might damage their unregulated competitors. Similarly, FIN 46 potentially will damage the ABCP sector. Companies active in that sector have a stake in promoting an interpretation of FIN 46 that causes the least damage. However, other market participants might benefit from having financing activity migrate to the term ABS sector. Those market participants might favor an interpretation of FIN 46 that creates the most problems for ABCP.

[58] The Basel Committee on Banking Supervision sponsors the international framework for setting minimum capital levels for banks. *See* www.bis.org.

(1) being able to maintain investor confidence in the ABS market and (2) maintaining access to ABCP funding, both through its single seller programs and through multi-seller conduits.

## 9:50 AM – A Global Overview of Regulatory ABS Developments

Summary of FIN 46: The concept of "expected losses" is central to FIN 46.[59] It is central to identifying whether a special purpose entity (SPE) is a "variable interest entity" (VIE), and it is central to determining when the status of a variable interest entity must be re-evaluated. In addition, expected losses are central to determining whether a VIE has a "primary beneficiary" that must consolidate the VIE on its financial statements. A second important concept, related to expected losses, is "expected residual returns."

Qualified SPEs (QSPEs) under FAS 140[60] are exempted from the application of FIN 46 and, therefore, no transaction participants are required to consolidate QSPEs. However, FASB is about to reconsider features of FAS 140 and it seems unlikely that it will embrace more liberal standards allowing companies to avoid consolidation of SPEs.

Within the framework of FIN 46, "expected losses" means the probability weighted-average loss that an SPE experiences across all of its below-average outcomes. Based on some calculations, "expected losses" are smaller than many professionals would have subjectively expected. Accountants ought to be willing to accept reasonable calculations that produce low values for expected losses.

Expected residual returns are not an exact mirror image of expected losses. Expected residual returns include fees.

To determine whether an SPE is a VIE, the first step is assessing whether it has sufficient equity to absorb expected losses. If there is sufficient equity to absorb expected losses, the SPE will not be a VIE if a few other conditions are satisfied: (1) equity holders collectively can control the SPEs activities through voting rights and (2) equity holders have rights to residual returns.

If any company holds variable interests that expose it to a majority of a VIE's expected losses, that entity is the VIE's "primary beneficiary" and must consolidate the VIE on its financial statements. If there is no such company, the second test is whether any company holds variable interests that enjoy a majority of the expected residual returns. If there is such a company, then it is the primary beneficiary of the VIE. If there is no such company, the VIE has no primary beneficiary.

FIN 46 supports the notion of silos. A silo is an isolated pool of assets that is treated as a separate "mini" accounting entity of its own. For example, a receivable financing that is on-balance sheet for the borrower/seller that finances its receivable through an ABCP program arguably ought not be counted as a part of the assets of the program if the program ultimately must be consolidated as a VIE by its sponsor (as the primary beneficiary).

FIN 46 threatens CDOs because CDO equity often is not large enough or equity holders do not have sufficient control. Thus, a CDO may be a VIE. If a CDO is a VIE, the collateral manager may be the primary beneficiary even though it may not be exposed to a majority of expected losses. Because residual returns include fees, the collateral manager may have variable interests that represent a majority of the expected residual returns.

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

[60] Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Sep 2000).

The first loss credit enhancement (*e.g.*, overcollateralization) of receivable pools financed through ABCP programs is excluded from consideration under FIN 46. Thus, the providers of program level credit enhancement are the ones who likely bear the majority of "expected losses" within the contemplation of FIN 46.

From a regulatory perspective, consolidation of VIEs under FIN 46 does not actually change the risk exposure of regulated banks. However, if FIN 46 requires the consolidation of ABCP conduits, banks' capital requirements could rise. Bank sponsors of ABCP programs started lobbying the bank regulatory agencies for relief from potentially increased capital requirements even before FIN 46 was released. The banks are likely to argue that they cannot operate their conduits profitably without relief. In a comment letter, the Fed expressed concern that requiring consolidation would constrain the availability of commercial financing and could place U.S. banks at a competitive disadvantage relative to foreign financial institutions.

Basel Committee: The Basel[61] regulators have just finished reviewing the comments to their last publication. The target date for publication of the next proposal is June. The target date for issuance of final rules is December 2003. The target date for full effectiveness is December 2006. Some of the rules require banks to use three years of data in making their calculations. Thus, the December 2003 target date is significant.

Two recent roundtables, one in New York the other in London, gave rise to heated debate between the Basel representatives and securitization industry professionals. The securitization industry argues that the Basel committee is using risk weightings that are too high in the ratings-based approach. The regulators have been using CDO historical performance, which has been weak, while the securitization industry is pushing for the use of historical data for each asset class, which would produce lower risk weightings. The most advanced version of the Basel frameworks involves very complex calculations.

U.S. Regulation: In the U.S., regulators and the securitization industry disagree on the capital requirements for synthetic securitizations. The capital levels for synthetic securitizations are higher than those for cash transactions. Regulators also propose to impose harsher treatment on liquidity facilities.

[Notes for this session end at 10:40 a.m.]

## 1:30 PM – Traders' Roundtable Discussion: Exploring Parameters and Volatility of ABS Markets

Last July the ABS market had come through a period of spread tightening. ABS spreads reached historically tight levels across asset classes. Investors had high confidence in the ABS market and viewed it as a true safe haven. However, that view has been undermined by a steady flow of credit events over the past few months. Those events have served to highlight structural risk and seller-servicer risk. Spreads widened and tiering became more pronounced. **The market observed an unexpected degree of linkage between seller-servicer risk and asset performance risk.**

The recent widening of ABS spreads was most pronounced in (1) lower-rated ABS tranches, (2) ABS from lower-tier issuers, and (3) home equity ABS in general. In the home equity ABS sector, oversupply was a contributing factor. Also, in that sector there is potential for collateral quality erosion because of competition among issuers.

[61] The Basel Committee on Banking Supervision sponsors the international framework for setting minimum capital levels for banks. *See* www.bis.org.

Most recently, however, spreads have started to tighten again. **Tiering is here to stay.** The risks that came to light at the end of 2002 are also here to stay. The market must learn to deal with them. Over the months ahead, the economy also will present a tough challenge for the ABS market.

The ABS market was tested harshly in 2002. Fortunately, it is possible to find pockets of value on the landscape. Sometimes the best values are in sectors that have experienced the greatest stress. For example, the generally wide spreads on manufactured housing ABS offer good opportunities in securities from certain deals.

**Investors should focus on the financial strength of a seller-servicer when they make the decision to invest in a particular ABS. Tiering is here to stay and will remain pronounced. Investors who carefully pick their shots will find some great opportunities.**

<u>Credit Cards</u>: Credit cards will continue to represent a safe haven, but there is not much more room for them to tighten. Sub-prime cards present substantial risk. Investors will do better favoring insured sub-prime card ABS. Sub-prime cards are risky because the underlying portfolios can deteriorate quickly. There is opportunity in premium-priced credit card ABS. Premium-priced credit card ABS also are the best place to make the down-in-credit trade by buying mezzanine and subordinate tranches.

Triple-B-rated tranches of credit card ABS have a wide trading range. Securities from different trusts command substantially different spreads. Investors can find better opportunities in secondary trading than in primary offerings.

<u>Autos</u>: Insured sub-prime auto ABS offer a healthy spread pick-up compared to prime auto ABS. The bond insurance wrap is sufficient to offset the credit risk of weaker loans. The widening of spreads on the wrapped AmeriCredit paper was an opportunity for investors. Spreads on the securities widened substantially and have now started to tighten.

Spreads in the prime auto sector have done well. There is still some room for tightening. The presence of high quality loans backed by physical assets is a source of comfort for investors. One challenge is the anticipated flood of issuance in 2003, which may create an oversupply condition.

<u>Home Equities</u>: The home equity ABS sector arguably is the most under-appreciated sector of the ABS universe. There is not a national housing bubble. Triple-A-rated tranches are the best opportunity right now because the economy poses risk for the lower-rated tranches.

Much of the widening of home equity ABS spreads during the fourth quarter of 2002 was unwarranted, and simply due to oversupply and the weak credit environment. There is good opportunity in triple-A-rated tranches, and in mezzanine tranches with ratings of double-A or single-A. Recent prepayments imply that sub-prime mortgage loans exhibit more negative convexity (*i.e.*¸ a greater propensity to prepay because of falling interest rates) than previously thought. However, the 10 bp to 15 bp spread premium for each percentage point of price premium is likely to shrink. This offers investors a good chance to capture spread tightening if rates rise and premium-priced securities converge toward par.

There is likely to be little supply of rate reduction bonds (stranded cost ABS) in the future. There is much more demand than supply in the secondary market.

Exogenous forces besieged investors in 2002. This year will be one of "coming out" for investors. Investors will do well to focus on the main asset classes: credit cards, autos, home equities, and student loans. The challenging issues of 2002 will continue to burden the market. Investors will be rewarded for doing their homework. **Tiering will continue, and so will regulatory risk.** ABS from the top-tier (benchmark) issuers will continue to trade very well, but they will trade at very tight spreads.

In the home equity ABS sector, the top-tier issues are likely to maintain their top-tier status indefinitely. The West Coast issuers (*e.g.*, Ameriquest, Option One, and New Century) have the opportunity to move up in standing within the sector. In the auto sector, hardly any names suggest themselves as candidates for stepping across "tier" lines. Sub-prime credit card deals are likely to be done on a wrapped basis going forward. MBNA's credit card ABS has room to tighten.

**The events of 2002 have made it very hard to sell ABS backed by off-the-run assets.** Now the best strategy for consummating such a deal is through the 144A or traditional private placement process. In the 144A or private placement setting, investors can become intimately knowledgeable about the seller-servicer and the underlying assets. **Securitization professionals need to work on solutions to make off-the-run deals more resistant to trouble.**

Off-the-run sectors will continue having difficulty in executing deals. Investors will have to devote resources to fully understanding structures and collateral before they will be willing to invest in off-the-run deals.

## 2:40 PM – Auto Loan and Sub-Prime Auto Securitization

The top five captive finance companies accounted for roughly half of all auto ABS issuance last year. Since 9/11/01, there has been a push for 0/0/0 financing. Securitization is an essential funding tool for a major auto finance company that has suffered downgrades. Large deals with consistent structures from one to the next attract investors because of their uniformity. ABCP programs remain a useful funding source. So are the newer extendible notes, which are similar to ABCP but which allow for extending maturities if the funding cannot be rolled over when scheduled.

From a sub-prime auto lender's perspective, the climate has been very tough for the past two years. Delinquencies and charge-offs have been rising.

From an investor's perspective, servicing is a major concern. The major focus is on being able to get reliable information.

Subvened auto loans have performed well over the past year. However, if competition among auto manufacturers intensifies, subvened loans may be offered to lower-quality borrowers, which could lead to a performance deterioration of that class of loans.

The general upward trend in losses and delinquencies in prime auto loans is a potential cause for concern for holders of lower-rated tranches.

Predatory lending initiatives may become a concern in sub-prime auto lending. In the mortgage arena, flipping, packing, and equity stripping[62] are the main abuses that corrective legislation seeks to address. In the auto sector, disclosure is more often the main predatory lending issue. There is likely to be federal legislation that imposes increased disclosure requirements on auto loans. The main threat of predatory lending laws is uncapped assignee liability, which can expose securitization trusts to punitive damages from class action borrower lawsuits.

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[62] The FTC explains the abusive practices as follows: "**Equity stripping** occurs when a loan is made based on the equity in a property rather than on a borrower's ability to repay the loan. As a general rule, loans made to individuals who do not have the income to repay such loans usually are designed to fail. They frequently result in the lender acquiring the borrower's home and any equity the borrower had in the home.

"**Packing** is the practice of adding credit insurance or other 'extras' to increase the lender's profit on a loan. Lenders often stand to make significant profits from credit insurance and, therefore, have strong incentives to induce consumers to buy it as part of a loan.

"**Flipping** occurs when a lender induces a borrower to repeatedly refinance a loan, often within a short time frame, charging high points and fees each time." *See FTC Testifies on Enforcement and Education Initiatives to Combat Abusive Lending Practices*, FTC press release (16 March 1998) *available at* http://www.ftc.gov/opa/1998/9803/subprime.htm.

One investor focuses keenly on potential headline risk. The investor gives each deal that it buys the "full treatment" in terms of review. Headline risk also matters to rating agencies. Rating agencies consider the ratings of the major auto manufacturers to be a source of comfort in rating their captive subsidiaries' auto ABS deals. Even so, the rating agencies still analyze what would happen to outstanding ABS if a major auto manufacturer suffered a sudden financial collapse.

Servicing transfers always entail the risk of rising losses and delinquencies. Insured deals help the situation because a bond insurer exercises strict supervision of the servicing transfers to minimize the deterioration.

One major U.S. auto manufacturer plans to use securitization for about two-thirds of its total funding in 2003. The company uses a combination of term ABS deals, international deals, ABCP, and short-term extendible notes. The strategy focuses on trying to tap all possible investor groups. Some investors view the term ABS deals as distinct and diversified from each other.

For a sub-prime auto ABS issuer, securitization is essential; it is as necessary as air to breathe. The company could not exist without securitization. It uses a conduit facility for warehousing originations between term deals. Documentation for sub-prime auto deals places greater controls on servicing and reporting, particularly with respect to facilitating a smooth transfer of servicing, if necessary. Rating agencies sometimes assume that if a sub-prime auto deal does not expressly provide for a back-up servicer, the deal's trustee will serve as an interim replacement servicer until the appointment of a permanent successor (or sub-servicer). Deal documents need to specify who will be responsible for back-up servicing if the original servicer fails.

### 4:10 PM – Can Fraud Be Prevented? Adjusting Your Due Diligence Process to Respond to Current Market Trends

Over the past 18 months, there has been an unprecedented level of servicer failures and frauds. Although securitization industry losses have been low over the long run, recent experience has been troubling. A common theme among all the problem situations is that there was mis-reporting of investor information.

The market cannot rely on rating agencies to "rate for fraud." The rating agencies have said that they do not provide the service of investigating for fraud and they are not paid enough to address risk of fraud. Fraud is difficult to detect. The only way to do so is to get "into" the issuer and to perform background investigations of company executives.

Another key aspect of due diligence is measuring compliance with applicable consumer protection, consumer credit, and predatory lending laws. Even major finance companies, such as Household, Associates, and Wells Fargo, have gotten into trouble for violating consumer credit laws.

Due diligence provides a basis for assessing management reporting integrity and provides information regarding portfolio characteristics.

Due diligence should occur at the start of a deal or a relationship ***and*** **periodically during the lifecycle of a financing arrangement**. A periodic due diligence process gives investors a means of reacting to performance deterioration in a deal.

Overall due diligence framework:

- Perform risk assessment
- Design procedures
- Perform procedures and react
- Perform ongoing review.

Performing a risk assessment entails different areas of focus for each asset class. In general terms, risk assessment must cover both the origination/underwriting function and the servicing/collection function. Likewise, risk assessment must cover the integrity of reporting systems and the precise definitions of items in the reports.

The two most important objectives of the due diligence process are determining the integrity of management and the integrity of management reporting. When securitization professionals can have confidence in the information that they receive, they can make good business decisions. More particularly, the information that is the most sensitive is cash reporting and reporting on the delinquency status of accounts.

**If you don't have confidence in the people that you are dealing with – if you do not trust them – other issues become almost irrelevant.**

Due diligence requires a level of skepticism. Every would-be ABS issuer has a good story to tell. The due diligence process reveals whether the company's actual operations conform to its documented policies and procedures. It shows whether the company has the necessary systems and reveals whether it has appropriate disaster recovery plans.

One area that due diligence usually does not address (but which it arguably ought to address) is the degree to which the performance of assets may be linked to the survival or business fortunes of the originator.

In conducting due diligence on a potential issuer, a key point to investigate is accounts payable. If a company is taking longer and longer to pay its own bills, it likely is cutting corners in how it services accounts.

Ongoing surveillance minimally should include annual reviews of the credit extension process, cash management mechanics, and collections. Reviews that are more frequent are better. Ongoing surveillance should also include an analysis of the accuracy of periodic reporting.

In order to assure the continuing strength of securitization structures, an annual due diligence review should include an assessment of whether the issuer has complied with "separateness" covenants to assure the bankruptcy remoteness of its securitizations. If a company fails to comply with the separateness covenants, its securitizations potentially could get swept into its bankruptcy estate if it goes into bankruptcy.

In the sub-prime auto sector, some servicers have fraudulently used the proceeds from vehicle liquidations to create the appearance that the related loans are still current. They do so by applying liquidation proceeds to make the scheduled monthly payments on the loans. The only way to detect such fraudulent activity is by testing at the account level.

In NCFE, there probably was not much testing at the level of the underlying transactions. If there had been, such testing might have uncovered the fraud sooner.

## 5:15 PM – When Workouts Don't Work Out: The Saga of Securitizers in Bankruptcy

Transactional lawyers have gained much experience in dealing with securitization workouts in the past two years. Some lessons have emerged:

- Monitor the existence and functioning of an SPE's independent director. Make sure to replace the independent director if he resigns.
- Subordinate investors should be empowered to give notices and to direct the trustee to take action following default.
- Augment servicer terminations events to include auditor resignation and the failure to deliver annual comfort letters.
- Add servicer transition expenses and investor expenses to a deal's cash flow waterfall.

- Deliver contracts (collateral) to an independent custodian.
- Establish and use lockboxes.
- Tighten grace periods for violations of contracts.
- Try to estimate whether the issuer would go into bankruptcy as a Chapter 7 or Chapter 11 debtor.
- Minimize cash commingling.
- Focus on servicer reports; identify key covenants, make sure servicer reports are delivered monthly and signed by an officer of the company.
- Audit the assets and servicer diligently.
- Contact the independent director; know his or her phone number.
- Take measured but firm action regarding rights in a bankruptcy.
- Not intended as a joke: try to avoid doing business with a company that is a likely candidate for bankruptcy. Understand the company's liquidity position, its business prospects, and its overall financial condition. Know the identities of the company's other funding sources. Know who the owners are. Know the management's background. Know personal histories of key members of the management team, including whether any of the company's principals have filed for personal bankruptcy. Seller-servicer risk is critically important and usually underestimated.
- Bankruptcy court is a hostile environment for creditors. It is debtor friendly. It is like *Alice in Wonderland*.
- Exploit your relationships with other key players. Be amicable with key parties. Be proactive but not hostile. Be charming or ruthless. Create the solution for the receivables.
- Above all, hope for luck.
- Get on top of servicing:
  - Figure out who is putting together the servicing information and befriend them.
  - Find the cash and the lockboxes.
  - Focus on the servicing software.
  - Beware of servicing transfers…the devil you know versus the devil you don't know.
- Focus on the debtor's financing structure. A securitization is more likely to face a true sale attack if it is the debtor's only source of financing.
- Find out about the judge and use that knowledge to plan strategy.
- Moral hazard in securitization is problem:
  - Diffusion of responsibility is a hallmark of ABS. It is not always clear whether this is a strength or a weakness.
  - An issuer's finance and accounting staff may not have adequate knowledge of the terms of the company's ABS deals.
  - Outside counsel should stay involved to teach company personnel about how the deals are designed to work.

A company that is about to become a debtor in bankruptcy must consider whether to challenge the true sale of its securitized assets. The recharacterized status of a securitization generally is as a secured loan. For example, trade receivables financed through an ABCP conduit may have lots of overcollateralization, which gives the conduit a strong position. Accordingly, it is not common for debtors to attack the true sales of their securitized assets. Substantive consolidation also is rare. If a company does attack its own securitization, its reputation as a borrower is likely to be ruined and it will have hard time getting new sources of funds.

An ABCP conduit lender needs to consider whether it is ready to have a seller/borrower go into bankruptcy. Ideally, the lender underwrites the transaction assuming that the borrower is about to go into bankruptcy.

Immediately after the commencement of a bankruptcy, an ABCP conduit lender should assess whether a bankrupt seller-servicer has filed its securitization SPE into bankruptcy. The next key step is to find out who are friends and enemies in the bankruptcy proceeding. If the conduit was the primary reason for the seller-servicer having filed, then the conduit and the seller-servicer are natural enemies. However, if other forces brought on the bankruptcy, the seller-servicer may be friendly toward the conduit.

A third key step is determining the value of collateral. Is the collateral really worth what it is supposed to be worth? Master the legal logistics. Figure out your leverage and use it. Keep communicating – bankruptcy is communication. A conduit lender should consider filing a proof of claim to establish its unsecured claim in respect of dilution on sold receivables. A conduit lender/purchaser of trade receivables generally should not push for a transfer of servicing. The transfer of servicing is often impractical in the case of trade receivables.

A hypothetical bankrupt sub-prime mortgage company is unlikely to attack the true sale of its own securitized receivables, even if it had provided a corporate guaranty on the subordinate tranches of its deals. However, securitization professionals need to remain mindful that the "gang of 35" law professors continue to create noise on the issue of true sale.[63]

On the other hand, a bankrupt sub-prime mortgage lender might be able to sell its unsecuritized warehoused loans. In doing so, the company would need to get the consent of the warehouse lender. The bankrupt sub-prime mortgage company might be able to alter the servicing fee. This is a live issue in the Conseco bankruptcy. A bankrupt servicer could reject servicing. It is not clear whether a company in Conseco's situation could assume servicing but reject its guarantee obligation.

As a lender/investor, it is better to be exposed to workout risk through a conduit deal than through a term deal because there is much more room to negotiate in the conduit setting.

Just about every bond indenture requires unanimous consent of investors for any amendment or action that would impair the value of the collateral. This is likely to impede the ability to raise servicing fees to adequate levels to attract successor servicers. Unless a trustee has clearly agreed to do so, it cannot be forced to be a backup servicer.

[63] Early in the year, the academic legal community leveled an attack against a proposed feature of the bankruptcy reform bills. The bills would have created a true sale safe harbor for securitizations. The first volley was in the form of a letter signed by 35 law professors from around the country. Letter from Allan Axelrod *et al.* to Senator Patrick Leahy and Congressman F. James Sensenbrenner (23 Jan. 2002) *available at* http://www.abiworld.org/research/BAMfirstletter.html. The letter asserted that "[p]roposed section 912 would eliminate the ability of courts to police one form of sham sales." Four of the same academics wrote again, less than a week later, asserting that section 912 would "be good for the securitization industry specifically, but bad for the securities markets generally." Letter from Edward J. Janger *et al.* to Senator Patrick Leahy and Congressman F. James Sensenbrenner (28 Jan. 2002) *available at* http://www.abiworld.org/research/lawletter.html. One of the four wrote a third letter attacking section 912 on technical grounds, while another one wrote a fourth letter arguing that section 912 would improperly advantage "Wall Street" over "Main Street." Letter from Jonathan C. Lipson to Senator Patrick Leahy and Congressman F. James Sensenbrenner (1 Feb. 2002) *available at* http://www.abiworld.org/research/technicalletter.html; Letter from Kenneth C. Kettering to Senator Patrick Leahy and Congressman F. James Sensenbrenner (5 Feb. 2002) *available at* http://www.abiworld.org/research/nylawschoolletter.html. In the meantime, the Bond Market Association sent its own letter in support of section 912. Letter from John Vogt to Senator Patrick Leahy and Congressman F. James Sensenbrenner (30 Jan. 2002) *available at* http://www.bondmarkets.com/regulatory/ABS013002.pdf. From a public policy perspective, the law professors presented some interesting arguments against section 912. Individually, each house of Congress appeared not to have found those arguments persuasive. However, by the time the conferees discussed the separate House and Senate bills, their feelings seem to have been swayed by the unfolding Enron story. Section 912 was eliminated by the conference.

## Tuesday, 11 February 2003

### 9:20 AM – Demystifying and Parlaying Aircraft ABS

Even though the aviation industry is in the down part of its cycle, it is doing well.

An aircraft leasing business runs on three key factors: people, planes, and money. The best planes are the most liquid ones: those from the Boeing 737 and Airbus A320 families. More companies operate those aircraft than operate other types. An aircraft leasing business needs to have reliable funding so that it can ride out the rough parts of the business cycle and avoid having to sell aircraft when prices are cyclically depressed.

Aircraft *engine* leasing is less cyclical than the airplane business. Engines are non-discretionary items for operating airlines. Terms on engine leases range from 60 days to ten years. Engine values range from "a couple of million dollars" up to $16 million in the case of the large engines used on the 777.[64] Engines have longer useful lives than the underlying aircraft. Although certain engine parts wear out, those parts can be replaced. This allows the engines to be used almost indefinitely. Leased engines usually are kept as back-up engines and are used less frequently than first-string engines. Thus, leased engines experience less wear and tear than full-time engines. Engines can be moved easily from one aircraft to another. Few adjustments are necessary to move an engine from one aircraft to the next. Lease rates on engines are more stable than aircraft lease rates. Engine lease rates are *much* more stable than lease rates for older aircraft. The ability to write short-term leases permits an engine lessor to maintain a higher utilization rate on its portfolio of equipment.

Airline bankruptcies depress aircraft values. Boeing 737 classics, older 737-300s, 737-400s, and 747-400s are examples of the models that airlines are grounding (*i.e.*, parking in the desert) as they reduce capacity. Newer 737-300s are doing better. The United Airlines (UAL) and U.S. Air (UAWGQ.OB) fleets had many of the older 737-300s.[65]

The situation in the airline industry has created much uncertainty in the financial community. Lenders and rating agencies are forced to confront the uncertainty and headline risk.

Many of the United aircraft parked in the desert do not have engines. United has removed the engines and is using them as spares. However, most of those engines are nearly worn out. The same is true of the engines that are attached to some of the parked planes. Even though the current demand for older planes has dwindled, the ones that continue flying will need replacement engines from time to time. Operators will confront the choice of refurbishing nearly worn-out engines or using "newer" leased engines with less wear.

American and United have their own procedures for repairing and refurbishing engines. Although those procedures are fully approved by the FAA, many other operators do not want to take over engines that have been maintained with non-standard procedures.

Section 1110 of the Bankruptcy Code has worked the way it was supposed to in the recent bankruptcies of United and U.S. Air. There had been tough litigation over how § 1110 was supposed to work in the bankruptcies of Eastern and Continental. Section 1110 requires a bankrupt airline to affirm or reject aircraft leases within 60 days of bankruptcy. The bankruptcy process under

[64] Boeing 777 aircraft use the massive GE90 jet engine. The original version of the engine was certified at 84,700 lbs. of thrust in 1985. The newest version, the GE90-115B, will be installed in Boeing's long-range 777 models, the 777-200LR and the 777-300ER. Of note, a GE90-115B recently set the record as the world's most powerful jet engine producing 127,900 lbs. of thrust, though the engine will be certified for "only" 115,000 lbs. of thrust.

[65] US Air reportedly had 67 aircraft of the 737-300 model as of December 2002. The company had another 43 aircraft of the 737-400 model. As of year-end 2001, United reportedly owned 10 and leased 91 aircraft of the 737-300 model. In addition, United owned 23 and leased 21 aircraft of the 747-400 model.

Chapter 11 is rehabilitative. The U.S. bankruptcy regime is much less creditor friendly than those of other countries.

Almost nobody invests money in repairing older Stage 2 engines today.[66] However, many of the surviving Stage 2 engines are still flying. When they wear out, they will be stripped for parts. This creates some demand for leased Stage 2 engines for aircraft that already use them and have one wear out.

Stability of cash flows is the key to analyzing aircraft ABS. Airline risk is a greater component of the overall risk of EETCs than it is of aircraft ABS. EETCs arguably present greater risk of being forced to liquidate aircraft under distressed conditions.

There is no "generic" aircraft ABS. It is necessary to look at the specific underlying aircraft and to analyze the full capital structure of each deal to meaningfully estimate the risk of each tranche. Although the senior tranches of aircraft ABS deals have provided a better risk-return proposition in the past, mezzanine tranches are now becoming attractive. The key is to assess the lease cash flows. Lease rates arguably have hit bottom. When the current crop of leases expires, it is likely that the aircraft will be re-leased at higher lease rates.

The capital markets will remain an important part of aircraft finance. "Better" aircraft will back new deals. Investors should focus on whether an issuer retains residual risk (the deal is for financing) or whether the issuer effectively sells its whole economic stake (the deal is about realizing a gain on the sale of the aircraft).

Over the past ten years, the community of institutions that provide aircraft financing has shrunk from about 60 to roughly 30.

Although the industry is in trouble, there are some bright spots. Strong capable servicers will be able to survive the current stresses and ultimately will thrive.

United made § 1110(a) agreements for 156 aircraft.[67] It obtained agreements to extend the § 1110 timeframes for a number of other aircraft.

American operates about 340 MD80s. If American goes into bankruptcy, the value of MD80s could drop significantly. Values of MD80 would be unlikely to bounce back. The aircraft would likely end up flying in Russia and Indonesia.

## 10:50 AM – Signing up for the Student Loan ABS Tutorial

Last year was a record breaking year for the student loan industry. More students attended college than ever before and tuition reached record levels. Consolidation loans reached unprecedented levels of more than $20 billion. Student loan ABS volume reached $38 billion, which was more than twice the level of 2001. There were no T-bill floaters issued in the student loan ABS sector in 2002. About $3 billion of private student loans were originated in 2002. The default rate on student loans has been declining and is at historically low levels. Prepayments are higher on newer Sallie Mae trusts than on older ones.

The political climate was stable in 2002. The Republican administration has historically been pro FFELP.[68]

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[66] "Stage 2" and "Stage 3" refer to engines that comply with federally mandated noise restrictions. Stage 3 engines are somewhat quieter than Stage 2 engines. 14 C.F.R. Part 36 Appendix C § C36.5.

[67] As of year-end 2001, United owned 243 aircraft and leased 300 aircraft. At that time, United had leases on 91 aircraft of the 737-300 model, 21 aircraft of the 747-400 model, and 55 aircraft of the 757-200 model.

Consolidation is an important innovation for the FFELP. The consolidation offering permits a student loan borrower to refinance his or her loans at low fixed rates and with longer maturities than original student loans. The low interest rates boosted consolidation loan volume to very high levels. Some of the student loan ABS innovations of 2002 related to the development of securities to handle the longer terms of the FFELP consolidation loans. One innovation was re-settable auction rate securities, which have short durations but long final maturities. The traditional ABS structure is cheaper for issuers than the auction rate re-settable structure. Some issuers are using hybrid structures, which combine short floating rate ABS tranches with longer-maturity, auction rate re-settable tranches.

Private student loan volume is likely to increase significantly. Last year, spreads widened on student loan ABS with weighted-average lives longer than five years.

In a war scenario, student loan ABS should fare well. However, war could cause a contraction in the private placement and 144A market. Auction rate securities are less liquid and could suffer greater spread widening if there is a war.

Congress may raise the limit for student loan borrowing in 2003. However, the economy and the prospect of war are likely to occupy Congress' attention this year. If Congress does not raise loan limits, borrowers will need to use private loans to cover their borrowing needs.

The private student loan market has grown at a rate of about 30% per year. There are about 60 players with roughly 250 programs. The top three players account for about two-thirds of the volume. A greater proportion of private loans are now subjected to credit underwriting. Parents eagerly try to use the private student loan market to borrow at 5½%. The delinquency performance of signature-only loans is much worse than that of credit-underwritten loans. However, despite high default frequencies, recoveries run about 60% to 70% across an entire portfolio. But, it does take a long time to recover – sometimes as long as six or seven years.

A private student loan lender can use regular ABS, auction rate securities, and ABCP conduits. The market for ABS backed by private student loans is now about $6 billion.

Alternative (*i.e.*, private) student loans (ASLs) are almost a different asset class than government-guaranteed student loans. An ASL is an unsecured consumer receivable, but it is sometimes guaranteed by the borrower's parents or by a third party guarantor. An ASL may be dischargeable in bankruptcy, unless it was issued or guaranteed by a nonprofit institution.

A servicer of alternative student loans must be familiar with rating agency requirements and with the procedures for submitting claims under any private guarantees.

When an ASL uses a master note covering multiple draws over the years while the borrower attends school, perfection of a security interest in the note can be an issue. The new revision of UCC Article 9 allows for filing as the means of perfection in payment intangibles.

FFELP consolidation loan volume could reach $40 billion in 2003, while private loan (ASL) volume could reach $10 billion.

[68] *See* 20 U.S.C. § 1071 *et seq.* FFELP stands for Federal Family Education Loan Program. FFELP loans include (1) subsidized federal Stafford loans (§ 1077), (2) unsubsidized federal Stafford loans (§ 1078-8), (3) federal PLUS loans (§ 1078-2), and (4) federal consolidation loans (§ 1078-3).

## Wednesday, 12 February 2003

### 9:15 AM – Franchise Loan Securitization: When Will the Pain and Suffering End

The franchise loan ABS sector has always been a niche sector. FMAC and Amresco were the sector's pioneers. Starting in the late 1990s, a few more players became active in the area. Issuance peaked in 1999, when there were 10 deals. Since then, issuance has dropped off.

Until 2000, the franchise loan ABS sector showed strong credit performance. In that year, deals from three issuers started to show credit problems. The trouble seemed to have its roots in restaurant loans. In 2001, things got worse. More loans in more deals became seriously delinquent.

The final blow to the sector came in 2002. Until 2002, FFCA had been viewed as the sector's safe harbor. However, late in the year, FFCA announced that it run into trouble with loans to the convenience and gas (C&G) borrower community.

Cumulative losses on some FMAC deals have been as high as 19%. Global Franchise Trust 1998-1 has experienced losses of 13%. Franchise Loan Trust 1998-1 has lost 10%. The losses on EMAC deals have not yet reached such high levels but delinquencies are so high that disappointing losses are a virtual certainty.

Why is the franchise loan ABS sector performing so poorly? Answer: poorly underwritten loans. The sector's newer lenders were too aggressive. Lenders would consistently over-leverage the borrowers. Another mistake that the lenders made was in estimating cash flows; they failed to handle overhead and management salaries realistically. Lenders also got sloppy in documenting loans; they sometimes failed to properly perfect their liens.

The lenders killed their own borrowers by encouraging too much leverage. The "pursuit of production" (*i.e.*, loan origination) was the deadly siren song for the whole sector. The goal of increased production caused the lenders to ease their underwriting standards.

The value of C&G properties has fallen precipitously. C&G store operators have not yet come to grips with the decline in values; they are still kidding themselves.

Franchise lending is not dead. Restaurants are not going to disappear. There will be some casualties from the "burger wars," but the survivors will be stronger. Casual dining is a strong sector. The instability in the C&G industry will cause continuing pain and downgrades in 2003. Since 2000, franchise loan ABS have accounted for a growing share of ABS downgrades. Going forward, there will be more emphasis on real estate values – borrowers and issuers will be required to have more skin in the game.

One monoline bond insurer is willing to insure franchise loan ABS. However, it is interested in obtaining a triple-A "shadow" rating on the underlying risk, and it will limit itself to working with only the largest and most well established lenders. The deals will need to resemble CMBS deals, with most of the emphasis on the real estate. Real estate is the key! Also, the bond insurer will not be willing to negotiate substantially on the documents; it will insist on having strict covenants and tight controls.

The C&G industry has consolidated over the past several years. Operators started paying too much for stores. Easy access to borrowing was partly to blame. A new challenge for the industry is the growing practice among hyper-markets (*e.g.*, Wal-Mart) of selling gasoline below cost as a loss leader. Convenience store lending is made tougher by the fact that most of the properties are contaminated in one way or another. After a foreclosure, a new buyer is likely to need financing and will need to do a Phase I environmental assessment. Sometimes, before a foreclosure, the owner or employees of a failed store pile all the meat in the middle of the floor and then lock the doors. It may take months for the lender to gain entry, and when it finally does, the conditions inside are disgusting.

Franchisor support is weaker in the C&G industry than in the restaurant industry. Likewise, the real estate under a C&G store is not usable for other kinds of business until the gasoline tanks are removed and the site is cleaned-up.

From a bond insurer's perspective, real estate appraisals are much more important than "business valuations" prepared by accountants. Personal guarantees are very important because they give an operator the incentive to cooperate in a workout. Cash flow and EBITDA should be strong. Large, well-diversified pools are preferable.

Servicing franchise loans has sometimes been problematic. A number of notorious franchise loans have been the subject of *repeated* workouts. CSFB's loan to Midland reportedly has been worked-out five times. One panelist observes that the earliest/first loss is usually the smallest loss. Another panelist contends that bankruptcy and foreclosure should be the last resort. However, the first panelist focuses on restaurants and the second focuses on C&G stores. Foreclosures of C&G stores present many hazards. Not having a personal guaranty "is death" in a workout situation.

A continuing challenge for the franchise loan sector is that some lenders still price loans unrealistically. Some lenders are under-pricing credit risk to borrowers. This will be a persisting challenge for the lenders that price credit realistically.

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