Nomura Fixed Income Research

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Report from Arizona 2006

Coverage of Selected Sessions of ABS West 2006

15 February 2006

The recent ABS West 2006 conference in Phoenix, Arizona followed just a week after the huge Las Vegas event sponsored by the American Securitization Forum. Nonetheless, ABS West 2006 reportedly attracted more than 2000 attendees and offered an extensive array of specialized sessions. However, the centerpiece of ABS West was the general sessions, which featured broad discussion and spirited exchanges among many of the industry's leaders. Most have a generally positive outlook, based primarily on the strength of the economy. However, many feel that spreads are too tight on some products and that the market may underestimate the likelihood and significance of potential exogenous shocks, such as terrorism and geopolitical events.

The following summaries reflect remarks of the panelists who participated in selected sessions at the ABS West 2006 conference sponsored by Information Management Network. For the most part, the summaries have been drawn from notes taken during the sessions by Nomura employees. The summaries have not been reviewed or approved by the panelists. While we have tried to capture panelists' remarks accurately, we apologize in advance for any inaccuracies and omissions. In addition, we wish to acknowledge the excellent work of the organizer in hosting the conference.

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

Sessions Covered Page

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Bloomberg: NFIR <GO>

Tuesday, 7 February 2006

12:15 pm – ABS Trends and Emerging Assets: Forecasting the Year Ahead

Last year (2005) was a banner year for both ABS issuance and collateral performance. Issuance was $790 billion, driven primarily by sub-prime mortgage (a/k/a "home equity loans" or HELs) ABS and collateralized debt obligations (CDOs). Sub-prime mortgage ABS issuance was around $515 billion. Strength in the consumer sector led to strong issuance in ABS backed by autos loans, credit card receivables, and student loans.

Strong issuance of sub-prime mortgage ABS was driven by the buoyant housing market and by new mortgage affordability products (*e.g.*, interest-only loans, hybrid ARMs, loans with negative amortization features, 40-year mortgage loans). Despite the huge volume of issuance, spreads did not move wider. In addition, there was brisk activity in synthetic ABS[1] backed by sub-prime mortgage loans.

In the auto sector, the key event was the downgrade of Ford and GM. Ford remains the number one issuer of auto ABS, but its share is slipping. The credit card ABS market continues to show strong credit performance and tight spreads. The key story in credit cards is consolidation among issuers. The big story for credit card ABS during 2005 was the change to the bankruptcy law in November,[2] which caused a temporary spike in bankruptcy filings. In the student loan ABS sector, spreads tightened on deals backed by FFELP loans[3] and widened slightly on deals backed by private (*i.e.*, non-federally reinsured) student loans.

Total ABS issuance is likely to decline by 14% in 2006 because of rising interest rates. Also, new SEC Regulation AB[4] likely will push some ABS issuance activity into the second quarter from the first quarter. CDO issuance expanded in 2005, as many new ABS CDOs included large volumes of synthetic sub-prime mortgage ABS. Spreads are at the tight end of their historical range. Auto ABS issuance should grow slightly in 2006; however, there might be less issuance from GM because of the company's greater reliance on sales of whole auto loan. Issuance of credit card ABS may decline slightly as the issuers surviving after consolidations may not refinance all their maturing securities. Instead, some will use other means to finance a greater share of their credit card receivables. Issuance of student loan ABS (SLABS) likely will increase in 2006, primarily in the area of private student loans. The reauthorization of the Higher Education Act is the big news in the SLABS area.[5]

Issuance so far in 2006 has been hot. Over 80% of ABS issuance volume in January was in the sub-prime mortgage ABS sector.

Regulation AB: Some market participants expected that Reg AB would force some ABS issuers to fund themselves through ABCP programs because they would be unable comply with the new regulations by January 1. However, activity in the ABCP conduits does not yet appeared to have received a boost from Reg AB compliance problems.

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[1] "Synthetic ABS" refers to credit default swaps (CDS) on ABS. ISDA, the International Swap and Derivatives Association, published a model form for CDS on ABS in June 2005 . That became the first widely accepted form of contract for ABS CDS. However, ISDA recently replaced the form with a newer one on 23 January 2006. The newer form also is available on ISDA's website at <http://www.isda.org/publications/docs/ISDA-Dealer-Form1.doc>.

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

[3] "FFELP loans" refers to loans with federal reinsurance under the Federal Family Education Loan Program.

[4] Regulation AB is the new SEC regulation covering disclosure standards and sales practices for ABS and MBS. 17 C.F.R. § 229.1101-.1123 (2005), Release 33-8518, 70 Fed. Reg. 1506 (7 Jan 2005).

[5] Higher Education Reconciliation Act of 2005, *included in* Deficit Reduction Act of 2005, Pub. L. No. 109-171, §§ 8001-8024 (8 Feb 2005).

Reg AB increases costs for servicers because they are required to file an assessment of their servicing operation together with an accountant's attestation. Reg AB arguably has had the largest impact in the auto ABS sector, which produced only two deals in January.

Basel II:[6] Market participants are focusing on Basel II because it will affect the cost of funding assets in ABCP programs. ABCP program sponsors need to check their liquidity facilities for compliance with the "90+" rule for eligible liquidity.[7] Anticipated changes in risk-based capital guidelines have prompted a modest amount of restructuring of deals funded through ABCP programs.

The Economy: Natural disasters and oil prices were the headline items in the fall. The hurricanes prompted some investors to investigate the proportion of the loans in their deals that was secured by homes in the affected areas. Spreads did not widen in response to the trouble.

The hurricanes affected some servicing centers. However, the affected companies had suitable disaster recovery plans and were able to continue their operations from alternate locations. The hurricanes also prompted some lenders to offer extensions/deferments to borrowers affected by the disaster. In the auto ABS sector, some servicers removed (*i.e.*, bought out) the affected loans from their deals. In certain deals (*e.g.*, deals with bond insurance) servicers had to seek waivers from the "controlling parties" to allow for granting extensions and deferments on loans in the hurricane-affected areas.

A trader panelist has a cautious outlook for the sub-prime mortgage ABS sector in 2006. Performance in that sector has been very strong for the past several years, but the surge of affordability products and rising consumer leverage are causes for concern. However, performance remains strong and there are not yet signs of deterioration. Another panelist asserts that lenders are maintaining their underwriting standards and have not let standards slip to sustain origination volumes or to gain market share.

In the auto ABS sector, strong used car prices are keeping defaults and losses low. However, at the very weak end of the auto spectrum ("buy here-pay here"), one panelist is observing performance deterioration. However, there is not yet any visible impact on spreads or trading activity in the sector. Used car values dipped temporarily during the middle of 2005, when the auto manufacturers offered big discounts on new cars.

In the card area, card issuers are selling the charged-off accounts and the buyers of the charged-off accounts are starting to consider securitization. [Note: Securitizations of charged-off credit card receivables have a poor record. Consumer Financial Services (a/k/a CFS) did a series of such deals in the mid-1990s and all of them defaulted, producing years of litigation and losses for investors. Investors ultimately achieved a reasonable recovery in lawsuits against deal participants.[8]]

Interest Rates: Rising interest rates likely will hurt credit performance of sub-prime mortgage loans because borrowers will find it more difficult to refinance out of distressed situations. Rising oil prices

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[6] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards, A Revised Framework* (updated November 2005) [hereinafter "Basel II"] <http://www.bis.org/publ/bcbs118.htm>. Basel II is an international guideline that can become effective in individual countries only when their national governments implement the guidelines with domestic regulations. Implementation of Basel II in the U.S. is being delayed because of perceived competitive inequalities that it would create, placing smaller banks at a disadvantage to larger ones. *See* Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision, *Banking Agencies Announce Revised Plan for Implementation of Basel II Framework*, joint press release (30 Sep 2005) <http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050930/default.htm>.

[7] 12 C.F.R. Part 3, Appendix A, § 3(b)(6)(ii) (2005); Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, Interagency Guidance on The Eligibility of Asset-Backed Commercial Paper Liquidity Facilities and the Resulting Risk-Based Capital Treatment (4 Aug 2005) <http://www.occ.treas.gov/ftp/bulletin/2005-26a.pdf>.

[8] *See generally* Jacob, D. et al., *U.S. Fixed Income 2006 Outlook/2005 Review*, Nomura fixed income research at 92 (15 Dec 2005).

so far are having only a slight impact on dilution of trade receivables for "energy surcharges" that companies try to charge their customers; the customers often push back and refuse to pay.

New Assets: Insurance premium finance has become a hot area. The competitive environment is tough for mainstream asset classes. One example of a new asset class is subscription obligations: the equity commitments from investors in real estate funds. Another new asset class is cell phone towers. Cell tower ABS issuers have used ABCP conduits as a bridge before executing term deals.

3:30 pm – How the New SEC Rules Affect the Investor

Offering Reform:[9] An investor panelist observes that the SEC's new offering reform rules have changed the timing of the offering process for new deals. Now an investor has a chance to examine preliminary materials while issuers and underwriters prepare enhanced term sheets and preliminary prospectuses.

Three styles of offering are emerging under offering reform. One uses "enhanced term sheets" that contain a greater level of detail and links to base prospectuses. A second uses "virtual red herrings" (*i.e.*, "virtual" preliminary prospectus), which is an almost complete preliminary prospectus, including risk disclosures. The third model uses short-form term sheets to hard circle offerings and "reconfirmations" of investor orders after disclosure materials are finalized.

Static Pool Data: The idea of static pool data is to inform investors about the performance of an issuer's prior securitizations or asset originations. However, the SEC did not give issuers bright line tests about what is material. Static pool data is just now becoming available on the deals being currently issued. Issuers that have prior securitizations of liquidating pools are required to display static pool data on their old deals. Issuers of revolving pool transactions (*e.g.*, credit card master trusts) or issuers that have not previously securitized are required to disclose static pool performance data organized around origination vintages.

Issuers are struggling with the SEC's insistence that they need to provide graphs of their static pool data. Graphs will be a bone of contention for the near term. [Note: The usefulness of graphing static pool data should be beyond dispute. ABS research routinely includes such graphs. In addition, data vendors such as ABSNet and Loan Performance feature the ability to graph static pool data in their services.]

Reporting: Reg AB makes reporting more comprehensive on an ongoing basis. The introduction of Form 10-D for regular monthly servicing reports will make it easier for users of reports to navigate the database of SEC filings. Also, the new requirement for servicing assessments and attestations arguably will help boost the quality of servicing. Reg AB expands the scope of reportable events for ABS deals; under the new rules, a registrant must report legal proceedings or governmental actions against any parties to the deal. Also, information about significant obligors or credit enhancers must be reported. However, after 12 months, most ABS/MBS issuers can terminate their reporting obligations under the securities laws. It is unclear whether ABS/MBS issuers will reduce the level of information that they supply to investors after they terminate their reporting obligations.

Under Reg AB, Form 8-K is for unusual events such as amendments or terminations of key agreements, bankruptcies of transaction parties, early amortization events, and amendments to the rights of security holders. Form 8-K generally must be filed within four days of the event that triggers the reporting obligation.

Form 10-K is the annual filing. It must include assessment of servicing and an accountant's attestation on the assessment. The 10-K must include a disclosure of any non-compliance with the servicing standards.

[9] Securities Offering Reform, Release 33-8591, 70 Fed. Reg. 44722 (3 Aug 2005).

4:30 pm – What's Happening to FASB 140?[10]

Introduction: FASB issued FAS 125 in 1997. Four years later, it was completely re-written and replaced by FAS 140 in 2001. Some professionals thought that the issue of derecognition would calm down. Then came Enron, and off-balance sheet treatment returned to the spotlight. FIN 46(R)[11] and international accounting standards have placed FAS 140 under stress. Also, with the changing FASB, today's Board was not involved in the original decision to adopt FAS 140 and takes a dim view of FAS 140.

The *servicing project* and the *hybrid financial instruments project* likely will be finalized in the next few weeks. The *transfers of financial assets project* needs more work.[12]

Current Rules: In order to get sale treatment, a transfer must (1) achieve legal isolation of the assets, (2) be a QSPE or other transferee that can pledge or exchange the assets, and (3) not give the transferor control over the assets through a call or otherwise. The key provision is paragraph 9 of FAS 140.

Transfer of Financial Assets Proposal: Under the proposal on *transfers of assets*, sales of participation interests would need to use QSPEs to get sale treatment (proposed ¶ 8). This could require changes to the customary structures used for participations funded through ABCP programs and for A/B note structures for commercial mortgage loans. Also, Freddie Mac and Ginnie Mae participations arguably would require QSPEs (Fannie Mae does not use naked participations).

The *transfer of assets* proposal would require a true sale opinion as the basis for concluding that legal isolation had been achieved. In addition, the proposal would require considering changes that occur after the transfer (proposed ¶ 9(d)). Also, arrangements between holders of beneficial interests in a QSPE and the transferor of assets would be treated as being between the QSPE and the transferor (proposed ¶ 9(e)). A right of setoff has no impact.[13]

The *transfer of assets* proposal would apply to old deals. Old deals might not comply with the legal isolation criteria (proposed ¶ 9(a)) and, therefore, might come back onto issuers' balance sheets. A problem with the proposal is that it requires getting hypothetical legal opinions that treat arrangements between a transferor and holders of the beneficial interests of a QSPE *as if* those arrangements were between the transferor and the QSPE (proposed ¶ 9(e)).

Change in QSPE Criteria: FASB is moving toward completely eliminating equities from permissible assets for QSPEs (proposed ¶ 35(c)(1)). FASB is also moving toward prohibiting beneficial interest

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[10] Financial Accounting Standards Board [hereinafter "FASB"], Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (Sep 2000) <http://www.fasb.org/st/>. FAS 140 is the key accounting standard that controls whether a securitization counts as a "sale" for accounting purposes. If so, the company effecting the transaction can remove the assets (and their associated liabilities) from its balance sheet.

[11] FASB, *FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51* (revised Dec 2003) <http://www.fasb.org/fin46r.pdf>.

[12] FASB has released three proposals for amending FAS 140. One relates directly to the criteria for treating transfers as sales. The second proposal relates to the accounting for servicing rights. The third proposal relates to the accounting for hybrid financial instruments. Info on the three proposals is available on FASB's website at the following links:

Transfers proposal	<http://www.fasb.org/project/qualifying_spe.shtml>
Servicing proposal	<http://www.fasb.org/project/servicing_rights.shtml>
Hybrid proposal	<http://www.fasb.org/project/hybrid_financial_instruments.shtml>

[13] During 2004, FASB wrestled with the issue of whether an account debtor's "right of offset" is an obstacle to transferring a financial asset so that it is removed from the transferor's financial statements. For example, suppose that a consumer maintains deposits at a financial institution and also gets a mortgage loan from the institution. If the institution goes broke, the consumer can offset the amount that he owes on the mortgage loan by the amount of his deposit. If the FDIC insures the deposit, it will be subrogated to the consumers right of offset (i.e., the FDIC would have a claim against the mortgage loan equal to the amount it had to pay on the insured deposit). The right of offset can survive the sale or securitization of the mortgage loan by the institution.

rollovers. Third, FASB is scrutinizing the use of derivatives in QSPEs. FASB is considering allowing the use of derivatives to *introduce* risk into a QSPE.

Toughening the restriction on equity in QSPEs would impact securitizations of limited partnership interests and might impact net interest margin (a/k/a NIM) securitizations. Prohibiting beneficial interest rollovers would disqualify ABCP conduits from being QSPEs. Likewise, warehouse structures likely would fail to qualify as QSPEs under further restrictions on beneficial interest rollovers. The FASB has emphasized that it does not intend to eliminate QSPE status for credit card master trusts. However, it is not clear how new restrictions on rollovers would be compatible with preserving that treatment.

Derivatives: Paragraph 35(c) would limit the notional size of a derivative contract in a QSPE to the amount of beneficial interests. But, FSP 140-2, might allow for introducing credit risk to QSPE through derivatives. [Note: On its face, FSP 140-2 does not address the issue of using derivatives to increase credit risk in a QSPE. The document is only five pages long.[14]]

Gain on Sale: The trend in the evolution of accounting standards is toward a "fair value" approach for valuing financial assets, including retained portions of transferred assets. Such an approach would replace the practice of allocating the book value of a transferred asset between a sold portion and a retained portion based on the "relative fair values" of the two portions.

Transition Rules: The transition rules for changes to FAS 140 will be very complicated. The *servicing project* and *hybrid financial instruments project* should be finalized soon, but the *transfer of assets project* will not be finalized for several months, at earliest.

CMBS, Servicer Discretion: The FASB acknowledges that servicing CMBS requires some discretion. But there must be a limit. Three activities are at the center of attention: (1) an ability to waive due on sale clauses, (2) a right to substitute collateral, and (3) activities related to foreclosed real estate.

Servicing Proposal: The *servicing project* would allow a servicer to make a one-time election to carry servicing rights either at amortized cost or on a fair value basis. Allowing for fair value treatment would facilitate hedging activities on servicing rights.

Hybrid Instruments Proposal: The FASB previously issued temporary guidance not requiring bifurcation of securitizations. However, the proposed changes to FAS 133 (the primary accounting standard on the treatment of derivatives) would repeal that guidance. The proposed changes would require bifurcation of all hybrid financial instruments, including securitizations. However, the proposal offers relief from the bifurcation requirement by allowing a company to make an irrevocable election to account for an entire instrument on a fair value basis.

Wednesday, 8 February 2006

8:00 am – The Real World ABS: No Acting, No Script, No Props. See What Happens When ABS Market Leaders Stop Being Polite and Start Getting Real…

You know what really ticked me off in 2005…: An investor panelist was frustrated by deals "pricing at talk"[15] but in reality trading at a discount, or not at all. He questions dealers' pricing

[14] FASB, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*, FASB staff position, FSP-FAS 140-2 (9 Nov. 2005) <http://www.fasb.org/fasb_staff_positions/fsp_fas140-2.pdf>.

[15] "Talk" refers to the suggested pricing levels proposed by a dealer before the dealer determines the final pricing levels. "Talk" represents the pricing that a dealer hopes to achieve for a deal. If a deal receives negative

practices for new deals. The market is plagued by complacency. Investors should be very careful. The days of all new deals pricing at talk are over. Investors should make sure that they really understand where deals are trading and decide carefully what they are willing to buy. Investors should be careful about the information flow that they receive.

An issuer panelist counters, arguing that the previous panelist's remarks are wrong. However, he notes that if the previous panelist's remarks were correct, they would reflect a serious problem.

A third panelist comments on the collapse of prices (*i.e.*, tightening spreads) for taking risk. Additionally, while the price of credit risk is dropping, actual credit terms also are becoming looser. The trend is unlikely to end until there is some event that triggers a contraction of liquidity (*i.e.*, an exogenous shock and a flight to quality). The world is awash with capital right now and that is the key driver behind the pricing.

Volume Outlook for 2006: Most panelists feel that ABS volume will be down by 5% to 10% in 2006. One panelist expects volume to be flat and one expects volume to decline by 20%. The key driver likely will be home price appreciation, which encourages cash-out refinancing activity. There is likely to be some home price *depreciation* in certain key real estate markets, including southern California and southern Florida. However, there is not likely to be any nationwide decline in home prices.

Interest rates are a key factor driving volumes. The ABS market cannot fight rising interest rates forever. Eventually, rising rates would make issuance contract.

In the auto sector, the weakening condition of the auto manufacturers argues for possibly increasing reliance on ABS issuance. However, whole loan sales may supplant securitizations to some degree. In student loans, there likely will be a wave of consolidation loans before the end of June.

Consumer Credit: Most panelists feel that consumer credit health will remain steady through 2006. However, two panelists feel that sub-prime consumers are vulnerable. A pessimistic view of current conditions focuses on levels of consumer debt, consumer leverage, and home prices. However, history has shown that consumers are very resilient and competent at managing their debts. For prime consumers the outlook seems positive. Employment, consumer confidence, and corporate investment are all strong.

On the other hand, sub-prime consumers are more vulnerable. Roughly $250 billion of ARMs should reset soon. Sub-prime borrowers may be pushed past their limits by even small changes in their monthly payments.

Another view is that the economy is even stronger than most statistics show. If so, the outlook for the consumer is very positive.

Threats to the Market: Panelists generally agree that the possibility of rising interest rates is one of today's main threats to the ABS market. However, they generally differ about the significance of other challenges facing the market. One panelist feels that the ABS market has become too heavily concentrated in mortgage-related products. He expects the Fed to tighten credit and liquidity in 2006. Another panelist feels that "hyper-competition" is a significant threat. He perceives potentially irrational pricing in the sub-prime mortgage sector, though the auto and credit card sectors do not seem to have fallen prey to the problem yet.

Another panelist feels that even slow home price appreciation would allow sub-prime borrowers to remain healthy and to continue taking value out of their homes through cash-out refinancings. However, if interest rates by 125 basis points or more, then home prices might be completely flat or decline and, accordingly, sub-prime borrowers would do worse.

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feedback in response to its initial pricing talk on a deal, the final pricing may be somewhat wider (*i.e.*, more favorable to investors).

Mortgage Originator Consolidation: Most panelists expect to observe consolidation among mortgage lenders in 2006.

I am Sick and Tired of Hearing Complaints about…: (1) underwriting fees, (2) pricing on new deals, (3) rising interest rates, (4) Regulation AB, and (5) home prices.

Possible 2006 Headlines: Most panelists feel that the likely headline for 2006 will be that "ABS shows immunity to problems in the housing market." Interest rates are a key factor. The federal funds rate almost certainly will rise to 4.75% and probably will reach 5%. However, it is unlikely that long term interest rates will rise very much – indeed, it seems unlikely that the yield on the 10-year Treasury note will rise to 6% or even 5.5%. Therefore, contraction in the housing market is unlikely unless GDP growth is below 2%. Significant housing contraction is unlikely unless GDP growth is 0% or less.

Many panelists feel that a possible headline for 2006 could be that corporate credit problems and housing market problems cause problems for CDOs.

Mortgage Affordability Products ("Borrower Solution Products"): Most panelists expect that mortgage affordability products ultimately will be a major problem affecting many deals. Products that increase payment shock pose significant problems for sub-prime borrowers. However, the rating agencies understand the issue and arguably have assigned appropriate credit enhancement levels for the products. A second panelist feels that option ARMs[16] are a riskier product than interest-only loans. Most interest-only loans do not begin to amortize for five years, which provides enough time for the borrowers to get through a market cycle.

9:30 am – A Deep Dive: Market Trends, Developments and Outlook for the Structured Finance Market

The Economy, Housing, Consumers, and Interest Rates: Most economists feel that business investment will be the key engine of economic growth in 2006, but many panelists feel that consumers will be a greater factor.

One panelist explains that consumers always are the key driver behind the economy. A softening housing market would produce a decline in consumer spending because of both the wealth effect and the reduced employment in the housing and construction sectors. Other factors, such as energy prices, the threat of terrorist attacks, and the housing bubble, are also important, but somewhat less than consumers. Real estate is a regional market and, therefore, there should not be a national real estate crisis. According to the Office of Federal Housing Enterprise Oversight (OFHEO), Phoenix had home price appreciation of 34%, which was the highest of any metropolitan statistical area (MSA).[17] According to PMI, there is a 26% chance of home price declines in the next two years.[18] The most affordable places in the U.S. are North Dakota and South Dakota. The least affordable are California, Massachusetts, and Florida.[19] The bottom line is that some places are expensive and some are not. Although there are regional bubbles, there is not a national one.

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[16] "Option ARM" refers to an adjustable rate mortgage loan (ARM) that gives the borrower several payment options, including an option to that allows for negative amortization of the loan. *See generally* Dunlevy, J., J. Manzi, and J. Garfield, *MBS Investors: Beware Option ARMs Are Coming!*, Nomura fixed income research (13 May 2005); Dunlevy, J., J. Manzi, and J. Garfield, *Option ARMs: Rating Agencies Getting Tougher*, Nomura fixed income research (28 Jun 2005).

[17] Office of Federal Housing Enterprise Oversight, *House Price Appreciation Slows from Record-Setting Pace, But Remains Strong – OFHEO House Price Index Shows 12 Percent Annual Increase*, press release, at 2 (1 Dec 2005) <http://www.ofheo.gov/News.asp?FormMode=Releases&ID=258>.

[18] PMI Mortgage Insurance Co., *Local Economic Patterns and MSA Indicators*, Economic & Real Estate Trends at 3 (Winter 2006) <http://www.pmigroup.com/lenders/media_lenders/pmi_eret06v1s.pdf>.

[19] Dunlevy, J., J. Manzi, J. Garfield, E. Santevecchi, and D. Berezina, *RMBS: How Affordable Is Housing, Really?*, Nomura fixed income research (24 Jan 2006).

A second panelist notes that the outlook for the subordinate and mezzanine segments of the sub-prime mortgage space is "path dependent." The key factors are employment and interest rates. A third driver is housing prices, which have been fueled in certain markets by mortgage affordability products. Employment is strong. There appears to be little risk on the jobs front. On the other hand, there appears to be greater risk from the potential for rising interest rates. Interest rates are rising already, which is a problem. Either the Federal Reserve or foreign investors could push rates higher. Sub-prime lenders are finding it difficult to make money because of the rising rates. At the same time, housing demand is marginally declining. There is potential for slowing growth of home price appreciation and, consequently, slowing consumer spending.

There is pricing pressures in the sub-prime mortgage sector. Sub-prime mortgage lenders are struggling to make profitable loans in the current environment. Consolidation among sub-prime mortgage lenders is likely. If sub-prime lenders let their underwriting standards or business practices slip then investors – especially triple-B investors – may pull away from the market. That could cause spreads to widen and place further stress on lenders' profitability.

Rising home prices over the past few years have been the key element of the wealth effect. Government measurements of disposable income do include capital gains and, therefore, underestimate consumers' spending ability.

For the housing bubble to burst, the economy would first have to slip into decline. Absent a deteriorating economy, the bubble should not burst. Another view is that there is a strong possibility that today's benign conditions might not persist. Investors in triple-B securities should carefully scrutinize deals to differentiate which triple-B tranches could withstand deterioration from those that could not.

A panelist from a bond insurer feels that the market is mis-pricing risk at the triple-B for sub-prime mortgage ABS. Today's spreads are too tight to justify the risk. Another panelist agrees, stating that pricing all over the fixed income landscape seemingly dismisses the potential for problems. In the area of triple-B-rated sub-prime mortgage ABS, strong demand from CDOs is the main factor keeping spreads at their tight levels.

Energy prices are a wildcard. Although energy is a smaller part of the economy than it was in the past, rising energy prices could put a major dent in consumers' pocketbooks.

Biggest Risk for 2006: Panelists' views: (1) declining consumer spending, (2) the Federal Reserve raising interest rates too far, (3) a potential energy crunch, (4) the consumer, and (5) the consumer.

Supply and Spreads: Compared to each other, investors in non-Japan Asia are less risk averse , while those in Japan are more risk averse, in their appetite for fixed income products. For 2006, a recommended strategy is to trade up in credit. The natural orientation of fixed income investors is more toward protecting against downside than toward stretching for upside. An up-in-credit strategy simply reflects the ordinary progression of the credit cycle. Foreign demand for U.S. fixed income product seems solid and should help keep long-term rates from rising. However, the flattening of the yield curve is important because it eliminates the profitability of the carry trade (*i.e.*, funding longer-term investments with shorter-term liabilities to capture a favorable spread between long-term and short-term rates).

Another panelist feels that as soon as problems emerge in the housing sector, investors will stop investing in ABS CDOs. Additionally, today's spreads on sub-prime mortgage ABS are too tight for CDOs to achieve attractive arbitrage.

Transparency is an issue with the ABX index.[20] In contrast to corporate indices, it is not practical to get prices on each of the index constituents. Also, the market needs to see what happens when one index rolls-off and is replaced by another. ABS CDS are a very valuable tool for CDO managers because it allows them to ramp-up quickly (*i.e.*, rapidly accumulate a portfolio of securities) and to choose securities that they like rather than simply securities that are available. Trading in synthetic ABS[21] should be as liquid as the underlying ABS themselves. A second panelist slightly disagrees, stressing that synthetic ABS might not be perfect mirrors of their corresponding cash products and, therefore, might be less liquid. The first panelist adds that synthetic ABS are useful because they allow an investor to act on a negative view by taking a short position (*i.e.*, buying protection through the credit default swap).

Market Evolution: The market seems to have evolved from an issuers' market in the 1980s and early 1990s, to an investors' market in the late 1990s, to a traders' market in the 2000s. In a traders' market, investors should think about trading strategies that maximize returns rather than focusing on simply buy-and-hold strategies.

A successful investor needs both quantitative tools and fundamental analysis. Unfortunately, the quantitative tools are very expensive. Intex is an essential tool. Loan Performance is becoming an essential tool. A second panelist agrees emphatically that both quantitative tools and fundamental analysis are necessary.

Regulation AB: During the first month of issuance following the effective date of Reg AB, different issuers took different views about how to comply with the regulation. A trustee panelist anticipates that practices among market participants are likely to converge during the first half of the year.

Key Issues for 2006: Panelists' views: (1) spreads and how to take advantage of exogenous shocks. (2) jobs and housing, (3) geopolitical events, terrorists, natural disasters, (4) same as #3; (5) model risk, competitive pressures among issuers, originators, investors. Panelists (3) and (4) emphasize that the toughest issues for managing a portfolio or a business are the ones that cannot be analyzed or controlled. It is reckless to ignore such issues, but hard to decide how to protect against them.

11:15 am – Investing in ABS/MBS Subordinates: An Investor Roundtable

The environment is very good right now, but many professionals worry that conditions could deteriorate.

The strong housing market and low interest rates have helped boost strong credit performance. There is a good chance that performance could continue to be very good, even if it is not as strong as it is today. At the collateral level, performance will depend on the general economy and the level of unemployment. Even "affordability products" should continue to display good performance as long as borrowers retain their jobs.

Refinancing of sub-prime mortgage loans is likely to continue at a brisk pace during 2006 because a high proportion of loans reach their reset dates this year. However, another panelist notes that many sub-prime borrowers may not be able to qualify for refinancing loans in today's environment of somewhat higher interest rates.

Another panelist takes a gloomier view. He feels that although the Federal Reserve will try to engineer a soft landing for the housing market, slowing home price appreciation (*e.g.*, 5%) will cause a major deterioration of credit performance.

[20] The new ABX credit index is based on outstanding home equity ABS and is conceptually similar to the CDX credit indices in the corporate credit sector. Further information in about the ABX index is available at <http://www.markit.com/abx.jsp>.

[21] *See* note 1 *supra*.

A third panelist estimates that cumulative losses on the 2003 sub-prime mortgage vintage should be around 3% and cumulative losses on the 2005 vintage should be around 5.5% or 6%, in each case assuming a single-digit home price appreciation scenario. The previous panelist disagrees, asserting that cumulative losses could be significantly higher and that triple-B-rated tranches of sub-prime mortgage ABS could suffer losses or be wiped-out.

One panelist claims to have a pet peeve regarding mortgage loans secured by second homes or investor properties. He recommends diversifying away from states that recently have experienced the greatest home price appreciation. He notes that many properties in Florida are investor properties. Another panelist disagrees, noting that the areas with the greatest home price appreciation also are the ones experiencing the greatest employment growth. He argues, essentially, that fundamentals support the high rate of home price appreciation in certain areas. He is most concerned about the Rust Belt.

One panelist favors option ARMs over interest-only loans. However, he perceives that most option ARMs include other, layered risks.[22] The presence of other risks makes the loans unappealing. He feels that credit enhancement levels do not sufficiently compensate for the risk and he does not invest in deals with concentrations in such loans.

Investors do not have much power to affect pricing right now because demand is so high and deals are heavily oversubscribed. However, protection buying by hedge funds had the effect of pushing spreads much wider late in the fall. This suggests that investors ultimately have some power.

Synthetic Securities: One panelist is not yet participating in the synthetic area. CDS on tranches that carry ratings higher than triple-B are more expensive (*i.e.*, have tighter spreads) than the underlying cash securities and, therefore, are unappealing. Another panelist counters arguing that synthetics should command tighter spreads than the corresponding cash securities because they are unfunded, which appeals to hedge funds. He adds that the ability to go short is an important enhancement of the synthetics, as is the ability to gain exposure to securities that are unavailable in cash form.

A drawback of the synthetic ABS area is the wide bid-ask spread for single-name ABS CDS. The bid-ask spread is narrower for the ABX index. Spread tiering among synthetic triple-B sub-prime mortgage ABS is greater than the spread tiering among the cash securities.

Step-Down Criteria: Criteria for allowing release of overcollateralization vary greatly among deals. Structural differences offer opportunities for investors to find value. The ASF has organized a task force to promote consistency in the calculation of step-down tests. One panelist argues that the step-down criteria are too lax because they allow the release of overcollateralization creating greater risk for investors in mezzanine and subordinate tranches.

Tiering: One panelist feels that there is significant tiering based on ratings. When securities carry split ratings, they always trade to the lowest rating. He questions the value of getting or publishing any rating but the lowest. However, if a security lacks ratings from certain rating agencies, it likely will trade at the spreads for the "notched rating"[23] it would receive for purposes of being included in a CDO.

[22] "Layered risks" refers to the presence of multiple high-risk attributes in a single mortgage loan. For example, a loan that allows for negative amortization and that is secured by a second home contains multiple attributes associated with high risk. More generally, loans with high loans-to-value ratios extended to borrower with low credit scores can be viewed as possessing layered risks. *See e.g.,* Federal Home Loan Mortgage Corporation, 2 Single-Family Seller/Servicer Guide § 37.1 (10 Jun 2005).

[23] The so-called "notching" issue gained prominence in early 2003. Notching occurs when a rating agency estimates what rating it *would have assigned* to a security *based on the ratings actually assigned by other rating agencies*.

The rating agencies employ notching as part of their process for rating CDOs. In the context of rating a CDO, notching is one of several ways for a rating agency to handle underlying securities that *it* did not rate. Naturally,

Regulation AB: Reg AB should help investors in the long run. Once the market starts to observe performance deterioration in HEL ABS it will pull back from ABS CDOs. It is hard to find value in securities that carry ratings from both Moody's and S&P because CDOs bid them to tight spreads.

Picks and Pans: Panelist recommendations:

- Avoid auto loan ABS. Favor single-A-rated and double-A-rated tranches of floating rate sub-prime mortgage ABS. There probably will be more fixed rate paper this year because of the flatness of the yield curve. The economy is stronger than the numbers tell.
- Avoid layered risk, including alt-A mortgage loans and option ARMs. Those kinds of loans produce too many early defaults. Trouble likely will not come until 2007, but it might arrive in 2006. Also avoid triple-B-rated tranches of sub-prime mortgage ABS because spreads are too tight (from the CDO bid). Spreads are as tight as they can get and should widen.
- Favor non-CDO eligible bonds if you can get comfortable with the structures and with the ratings (such bonds probably lack ratings from either Moody's or S&P). Generally avoid layered risk. Avoid loans secured by investor properties and second homes. Favor some triple-B-rated securities because they offer wider spreads than they did in 2005.
- Avoid single-A-rated tranches of sub-prime mortgage ABS because the spreads are too tight. Also avoid triple-B-rated credit card ABS because consumer credit card payments could be threatened by home price declines. The performance of credit card receivables and sub-prime mortgage loans is closely linked.

Nobody on the panel likes subordinate auto loan ABS from Ford or GM. One panelist worries about the risk of a major earthquake in California. A major earthquake potentially could impact many deals in the alt-A and prime MBS sectors.

One panelist comments that surveillance of outstanding deals will be extremely important over the coming year.

1:45 pm – Dynamics of Sub-prime Mortgage ABS

Yield Spreads: Around the end of 2005, spreads in the sub-prime mortgage ABS sector widened dramatically on tranches rated triple-B-minus and lower. That widening has completely reversed in 2006. It's hard to see how spreads on double-A-rated and single-A-rated tranches will move much. Spreads on triple-B-rated tranches and on speculative-grade tranches probably will be volatile.

Another panelist predicts that spread volatility will be greater in 2006 than in 2005 because many loans are rolling out of their initial, fixed-rate periods. When some borrowers find it impossible to re-finance, they will default and the collateral pools backing some deals will fill up with REO ("real estate owned" acquired in foreclosures).

A third panelist feels that lenders should get updated credit scores (FICO scores) on sub-prime borrowers as a way to anticipate the impact of payment shock.

Home Price Appreciation: A panelist from a bond insurer states that his company adjusts its modeling assumptions for areas that have experienced rapid home price appreciation. The company adjusts both foreclosure timelines and loss severities. A rating agency panelist notes that the rating agency similarly adjusts loss severities for areas that have experienced rapid home price appreciation. The challenge is that things have been so good for so long that it is not clear how much analysts should increase the modeling stresses to compensate for rapid home price appreciation.

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the most obvious approach for handling such securities would be to rate them. However, rating agencies have to charge significant fees for doing so and must have access to the relevant information. Notching is an alternative that the rating agencies make available to CDO issuers.

Product Mix: In a flat yield curve environment borrowers are likely to favor fixed rate loans over hybrid ARMs. However, the sub-prime market is still very much about equity take out[24] and credit curing.[25] Thus, hybrid ARMs are likely to retain some appreciable share of the overall sub-prime mortgage markets. Likewise, affordability products are likely to retain a large share of the whole market. Interest-only mortgages likely will be offered with interest-only periods of 10 years or longer. Also loan-to-value ratios (LTVs) are likely to rise on new loans.

Pricing for Risk: The sub-prime mortgage market is locked into an archaic pricing system, based on a borrower's recent payment history and then adjusted for specified risk items. Risk layering is not well handled. The system uses linear pricing for non-linear risk, especially with respect to risk layering. Lenders rely too heavily on consumer credit scores. Early payment defaults (a/k/a EPD) and fraud are not priced into initial rates. Lenders do not charge a sufficiently high interest rate for the riskiest loans. Cumulative loan-to-value ratios (CLTVs) and consumer credit (FICO) scores are used too heavily as "compensating factors" to justify making a loan or offering a low interest rate despite the presence of other risky attributes in a loan. In addition, lenders increasingly use computerized appraisals (a/k/a AVMs or automated valuation models) as a substitute for traditional appraisals.

ABX Index: Synthetic ABS and the new ABX Index have become the most important factors in pricing sub-prime mortgage ABS. Synthetics allow going short and allow a CDO to rapidly ramp-up. Synthetic sub-prime mortgage ABS display greater tiering across issuers than their cash counterparts.

However, synthetic ABS and the ABX index introduce three complicating factors into the sub-prime mortgage ABS market: First, they arguably change the necessary skill set because it is no longer necessary to focus on individual bonds but instead possible to take a position on the sector as a whole. Second, it is likely that some new investors will come to the sector to express bearish views by shorting the ABX index even if they lack the skills to analyze individual bonds. Third, synthetic ABS and the ABX index allow greater trading flexibility and permit strategies that are not possible with only cash securities (*e.g.*, long-short strategies). Options on the ABX index are likely to come.

Servicer Performance: A panelist from a bond insurer adjusts its required protection (*i.e.*, higher attachment points) for new or inexperienced servicers. In many cases, a new servicer is required to have a hot backup servicer.[26] Servicing capacity is an issue: if a major ABS servicer blows up, it may be difficult to find a successor to take over a huge portfolio.

Impact of Shrinking Volumes: Shrinking volumes would cause lenders to get sloppy on verification and documentation standards. Fraud by mortgage brokers likely would increase. There could be a tendency to increase approvals on marginal borrowers. Purchase loans would increase at the expense of refinancings.

Recent Vintages and Affordability Products: Recent vintages have not seasoned sufficiently to observe the impact of affordability products. Nonetheless, it is likely that the 2005 and 2006 vintages will have higher losses than earlier vintages. Expect losses of 4.5% to 5% on new deals. [Note: The

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[24] "Equity take out" refers to a borrower refinancing his mortgage loan to monetize some or all of the appreciation in his home's value. For example, suppose a borrower starts out with a $160,000 loan on a home worth $200,000. If the value of the home increases to $250,000 then the borrower can refinance the original loan with one for $200,000. In the process, the borrower monetizes $40,000 of the $50,000 increase in the homes' value.

[25] "Credit curing" refers to the process of a borrower becoming "cured" of sub-prime status. In most cases, a borrower who makes all his mortgage payments on time for a year can qualify for a regular (*i.e.*, "prime") mortgage loan. The credit curing process allows many sub-prime borrowers to replace their sub-prime mortgage loans with cheaper prime loans. However, it also means that as a pool of sub-prime mortgage loans ages, it contains an ever increasing proportion of loans to borrowers who cannot accomplish credit curing.

[26] A "backup servicer" is an entity designated in advance to take over the servicing of securitized assets in case the primary servicer fails to perform its servicing duties. A "hot backup servicer" is one that maintains continuously updated databases and software libraries so that it can take over servicing *immediately and without interruption* if the primary servicer fails to perform.

panelist's estimate of cumulative losses in the range of 4.5% to 5% may well be overly optimistic.] The timing of losses may be pushed to later in the lifecycle of pools, as servicers switch to a "cash flow" paradigm, using loan modifications and extensions and moving away from strict foreclosure timelines.

The sub-prime lending industry arguably has pushed too far toward making risky loans to weak borrowers. The industry should use refreshed consumer credit scores and AVMs in analytics.

Shocks: Shocks from oil prices or regional unemployment could create problems for the sub-prime mortgage sector. Sub-prime borrowers are more leveraged today than they were before.

AVMs: Automated property appraisals are suitable for testing and validating regular appraisals, but they are not a substitute for regular appraisals in the origination process.

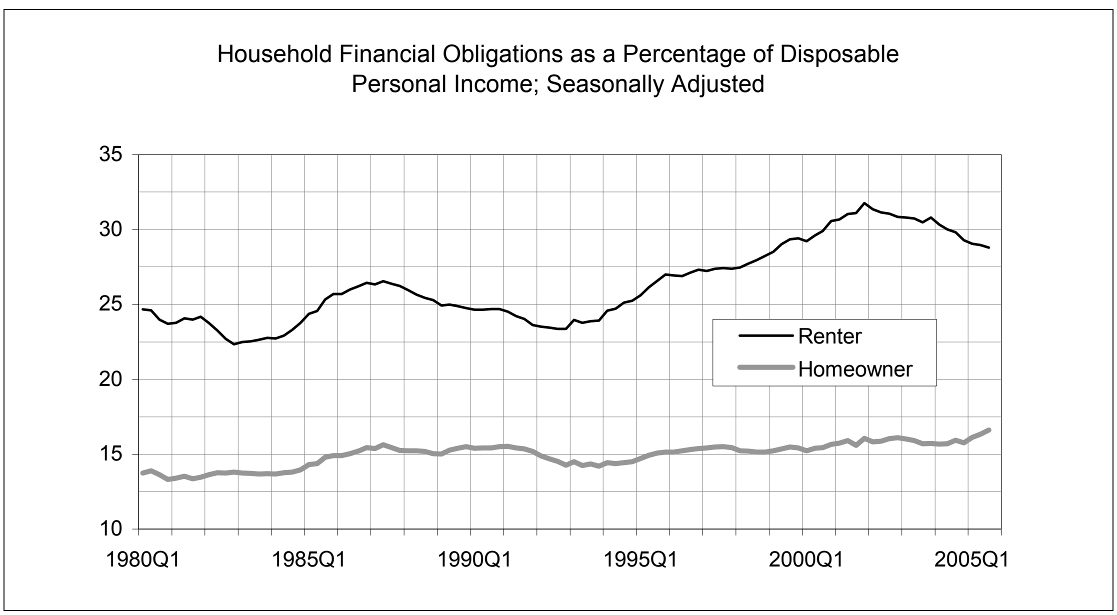
2:45 pm – Non-Real Estate ABS: A Research Analysts' Roundtable

Consumer Credit: We already have started to see the beginnings of a slowdown in the housing market. Homeowners cashing equity out of their homes was a key driver of consumer spending and provided an important boost for GDP growth.

Consumers are highly leveraged, but not necessarily over-leveraged. Consumer debt and leverage have been rising consistently for 20 years. Leverage is not much higher today for homeowners than it was just a few years ago. In fact, debt levels and leverage for renters are actually down slightly from the levels that they were at just a few years ago.[27] Thus, the consumer is not necessarily over-leveraged. If consumers can slow down their consumption, there should be no credit problems. Even if they cannot, trouble should not come until 2007. Also, if home price appreciation slows and prevents consumers from again cashing out equity from their homes, they might increase their consumer debt in order to sustain their consumption.

Professionals arguably are overemphasizing the issue of payment shock. Loans from two years ago that are scheduled to reset this year have the benefit of two years of home price appreciation.

[27] The Federal Reserve reports household debt service ratios and financial obligations ratios quarterly at <http://www.federalreserve.gov/releases/housedebt/default.htm>. The chart below shows financial obligation ratios for homeowners and renters:



The Federal Reserve also reports consumer debt levels in its monthly G.19 report at <http://www.federalreserve.gov/releases/g19/Current/>.

However, an area that might be under-appreciated is the "reloading" of consumer debt after consumers use home equity loans to consolidate their credit card debt.

ABS Volumes: Issuance of ABS in 2006 should decline to $670 billion, of which roughly $75 billion should be autos. GMAC is likely to rely somewhat less on securitization because it has arranged whole loan sales for roughly $10 billion per year. In credit cards, issuance likely will be around $60 billion, which is roughly the level necessary to refund maturing deals. A greater proportion of credit card issuance in 2006 likely will be at the triple-A level because the master trusts have surplus subordination available to support additional triple-A issuance. Student loan issuance should be around $75 billion, driven largely by consolidation loans (60%). Roughly 24% of expected student loan issuance should be backed by Stafford loans and the remaining 16% by private loans. Sub-prime mortgage ABS issuance is likely to be around $480 billion, with a growing share of affordability products.

Credit Cards: JP Morgan, Bank of America, and Citibank account for slightly more than half of all outstanding credit cards. Bankruptcy reform encourages repayment rather than extinguishing debt. After an extreme spike in bankruptcy filings right before bankruptcy reform became effective (on 17 Oct 2005), new filings have slowed down markedly. After conditions calm down, bankruptcy filings likely will stabilize around the levels of 2001 or 2002.

Compared to other sectors, credit card ABS arguably offer value. Recently, triple-A-rated credit card ABS offer a spread of Libor+4, which is attractive compared to the spreads on double-A-rated corporate bonds from banks or securities dealers. Spreads on those corporate securities are only about 10 basis points wider than the spreads on triple-A-rated credit card ABS. Credit card ABS also are more attractive than agency debt (*e.g.*, corporate debt of Fannie Mae or Freddie Mac). Credit card ABS offer very low volatility along both credit and spread dimensions. The supply of credit card ABS is regulated by the issuers, most of which have other funding sources. Triple-B-rated tranches of credit card ABS also are attractive.

Auto ABS: The big story in the auto sector is the possibility that either of the U.S. automakers could go into bankruptcy. One view is that spreads on auto ABS from the U.S. automakers are too close to the spreads on the auto ABS from stronger issuers. Prepayments are an issue if U.S. automakers stop offering incentives to help support vehicle sales. Additionally, there may be "excessive" supply of ABS from the U.S. auto makers. The spread differential of just 3 basis points is not enough to justify the incrementally higher risk. Investors should favor insured sub-prime auto ABS over auto ABS from GM.

Another view is that auto ABS from the captive finance companies of the U.S. automakers are pricing at levels very close to the levels for specialty finance auto ABS. At those pricing levels, ABS from the captives arguably represent a buying opportunity because even if the automakers (and their captive finance companies) go into bankruptcy, they would reorganize rather than liquidate.

Compared to home equity ABS issuers, issuers of auto ABS are not as precise or mathematical about exercising the call options in their deals. Their tendency is to exercise the options because that is what the market expects.

A sale of GMAC by GM arguably would strengthen floorplan deals in the short run but might weaken them in the long run. The sale would give GM roughly $15 billion in cash but would make the company more vulnerable to auto operations in the long run.

Regulation AB: Reg AB is a good thing but not a great thing. Disclosure of consumer credit scores allows investors to compare deals and issuers. However, the disclosure is not sufficiently granular. In auto ABS deals, issuers supply the average credit score but not the range. On the credit card side, issuers supply the range of scores and the range of outstandings balances, but not the credit limits or the available lines. New data will allow for comparisons over time but it should not ultimately have a large impact on how investors invest in consumer ABS.

Another panelist generally agrees, adding that required disclosure under Reg AB likely will dissuade some issuers from engaging in "funny" practices.

Student Loans: The President has signed the Deficit Reduction Act, which re-authorizes the Higher Education Act through 2012.[28] The act increases the rate for PLUS loans (§ 8006(a)). The guarantee percentage drops to 97% for regular loans and 99% for exceptional performers (§§ 8014(a)(1), 8014(j)(1)). The act eliminates in-school consolidation and reconsolidations (§ 8009). It allows PLUS loans to graduate students (§ 8005(c)). The act does not change the existing rate formulas on Stafford loans or consolidation loans.[29] The impact will be an increase in credit enhancement or lower ratings on subordinate tranches.

Eliminating in-school consolidations and reconsolidations should cause prepayments to drop after July 1. The availability of PLUS loans to graduate students will pull some volume away from private student loans. New Stafford loans with fixed interest rates of 6.8% will have minimal incentive to consolidate. Stafford loans already have the right to extend to 25 years. PLUS loans will have interest rates of 8.5%. The availability of 8.5% PLUS loans may draw weaker credits away from private loans, thus improving the quality of private loan pools.

Synthetics: Synthetics are becoming a more important part of the ABS market and have had visible effects on the cash market. Synthetic ABS allow investors to take short positions and the ABX index allows taking a view on the whole sub-prime mortgage sector. However, it seems unlikely that synthetic ABS and indices will develop for auto loan ABS or for credit card ABS. To have synthetics develop, a market must have both buyers and sellers of protection. So far, there are no natural buyers of protection for auto loan and credit card ABS. It would be very challenging to create an "index" for auto loan or credit card ABS because the number of major issuers is so small.

Picks and Pans: Panelists' recommendations:

- Favor student loan ABS backed by FFELP loans because they offer long tenors, have government-guaranteed collateral, and carry wider spreads than credit card ABS. Also consider ABS backed by private student loans because the loans are not dischargeable in bankruptcy and half have co-signors. Favor auto fleet rental ABS over credit card ABS.
- There are pockets of value on the ABS landscape. Favor triple-A-rated credit card ABS. Favor triple-B-rated credit card ABS with short weighted-average lives. Favor insured sub-prime auto ABS and avoid auto ABS from Ford or GM, unless spreads widen. Favor student loan ABS tranches with long weighted-average lives because prepayments are likely to slow down (borrowers on new Stafford loans are less likely to consolidate because their loans have fixed interest rates). Student loan prepayments likely will settle into the range of 20% to 25%. For autos and student loans focus on prepayment speeds. Expect spreads on corporate bonds to widen in 2006.

4:15 pm – The Real Estate ABS Researchers' Roundtable

Key Themes: Panelists identify key themes:

- A bearish view on credit is warranted. Emphasize security selection.
- Housing appreciation will drive credit and prepayments. Smaller lenders may have to struggle for profitability.
- Getting comfortable with synthetics and surveillance.
- Originator tiering, affordability products, slowdown of origination volume.

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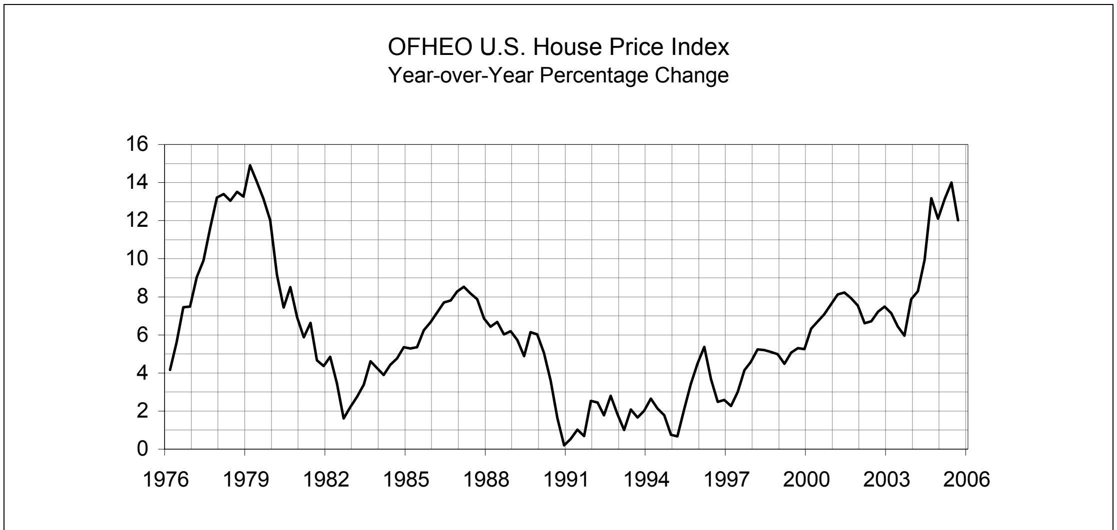
[28] Higher Education Reconciliation Act of 2005, *included in* Deficit Reduction Act of 2005, Pub. L. No. 109-171, §§ 8001-8024 (8 Feb 2005).

[29] The rate on Stafford loans originated on or after 1 July 2006 will be 6.8%. 20 U.S.C. § 1077a(*l*)(1). The rate on consolidation loans is a fixed rate equal to the weighted-average of the rates on the loans consolidated, rounded up to the nearest eighth and subject to a cap of 8.25%. 20 U.S.C. § 1077a(*l*)(3).

Housing Prices: Employment may not be as important in this cycle as in the past. Affordability products have helped buyers afford bigger homes.

Indications are starting to emerge that home prices have peaked. This current wave of home price growth is the largest in U.S. history. It is synchronized across the country. It also is a global phenomenon, affecting many countries. We have gone up one side of a very large mountain and now we may be looking down the other side.



Two other panelists estimate that home price appreciation will be in the range of 5% to 8% for 2006. One says that losses would increase 1.5 times and another says that losses would double. Additionally, losses might occur later in the lifecycle of the deals.

Triple-B Demand: The CDO bid has made spreads on triple-B-rated sub-prime mortgage ABS very tight. Investors must be very selective and push back. Another panelist feels that spreads will be range-bound, even though he has a bearish view on credit. He feels that there may be opportunities for investors to find value in situations where their views disagree with the rating agencies' views on the relative riskiness of different products.

Spread Volatility: Spread widening on triple-B synthetic sub-prime mortgage ABS around the end of 2005 may have been driven by investors from outside the fixed income market (equity or macro hedge funds). Indeed, traditional ABS investors have not been the most active players in synthetic ABS. The synthetics have drawn "fast money" outsiders into the area. Another panelist observes that derivative markets generally are more volatile and move faster than their underlying markets for securities, commodities, or currencies.

Hedge funds are adept at capturing benefit from spread volatility. They move quickly to buy when spreads widen and they move quickly to sell when spreads tighten.

Spreads likely will be tighter around the end of the second quarter. Spreads have room to widen after recently issued CDOs finish their ramp-up processes.

Subordinate (triple-B) tranches are not particularly well protected against a scenario of 5% annual home price appreciation over the next several years. Prepayment speeds on hybrids likely will be 25% to 30% after their interest rate resets.

Most borrowers on loans originated several years ago should be able to refinance because they have the benefit of home price appreciation. However, loans being originated today may not get the same benefit if home price appreciation slows or stops. On the other hand, interest rates may be low two years from now and GSE programs may develop greater appetite for sub-prime borrowers.

One panelist argues that home price appreciation could fall well below 5% and even could be 0%. Slow prepayments extend deals significantly and increases investors' exposure to credit deterioration as the mortgage loans remain outstanding for longer.

High concentrations in California arguably are exposed to greater volatility of home prices. Investors should receive compensation just for the volatility.

Prime vs. Sub-prime: One panelist does not strongly favor prime or sub-prime over the other, despite the difference in credit enhancement levels. Geographic concentration can be a risk in either prime or sub-prime deals. He is skeptical of the alt-A sectors and slightly favors sub-prime over prime. A second panelist favors sub-prime over prime and prime over alt-A. A third panelist takes the same view. He is concerned about the very thin subordination levels in prime (jumbo) MBS. A fourth panelist favors sub-prime. A fifth panelist likes super-senior tranches of deals backed by option ARMs or alt-A loans.

Option ARMs: Option ARMs have been so maligned that the product arguably receives more than enough credit enhancement and can represent a good value. Option ARMs seems to produce the same level of losses as alt-A mortgage loans but deals backed by option ARMs offer wider spreads than alt-A MBS. On the other hand, an option ARM essentially gives the borrower a credit option on the home. Borrowers self-select for the product. The problem is that option ARMs may not be restricted to the best borrowers and full documentation. One panelist describes option ARMs as dicey because they are not offered to a broader population of borrowers than just the best prime-quality ones.

40-Year Mortgage Loans: Some lenders have essentially replaced interest-only mortgage loans with 40-year mortgage loans. Some investors and rating agencies have ascribed less risk to 40-year loans than to interest-only loans. Proponents of 40-year loans argue that the product reduces payment shock compared to interest-only loans. Interest-only loans trade at worse spread levels than 40-year loans because the rating agencies require higher credit enhancement for interest only loans. On the other hand, borrowers on interest-only loans tend to have higher credit scores (but that is partly counterbalanced by higher cumulative loan-to-value ratios). Interest-only loans tend to prepay faster than 40-year loans, but that could change in the future.

Thursday, 9 February 2006

8:00 am – 2006 Structured Finance Outlook: The Vantage Points of Originators, Intermediaries and Investors; Views Across a Complex Landscape

Key issues for 2006 include interest rates, home prices, synthetics, and Reg AB.

Loan Originations: Low rates, strong consumer confidence, and good economic conditions have fueled strong origination volumes. Will originations continue to grow and in which areas?

One panelist expects about a 15% decrease in prime mortgage origination volume. Most professionals expect contraction in the range of 10% to 20%, but each lending firm expects to sustain its own production levels. Competition among lenders will be a tough issue as total originations contract. Some firms may loosen standards and cut corners in an effort to sustain production levels.

Another panelist expects that most of the contraction of mortgage origination volume will be concentrated in the prime sector. He asserts that sub-prime mortgage originations will receive a strong boost from refinancing of 2003-2004 vintage loans that reach their resets. This year will be one of tough competition for sub-prime lenders and some originators will not survive. Those with lower origination costs likely will be the survivors.

Mortgage affordability products probably will continue to represent a large (and possibly growing) share of mortgage originations. Separately, slowing home price appreciation likely will slow prepayments, which would increase the length of credit exposure on the loans and produce higher cumulative losses.

In the student loan area, the latest development is the signing of the Deficit Reduction Act by the President.[30] Consolidation loan volumes should increase until July and then start to slow down. Stafford loans will have fixed interest rates (6.8%), which removes one of the main reasons for consolidation. Graduate students will be able to get PLUS loans (§ 8006(a)), which may affect the amount of graduate student borrowings in the private loan market. Overall, student loan originations likely will remain very strong.

Volatility (Variability) of Home Prices and Interest Rates: Although home prices have risen sharply, on average, ABS suffer specifically from loans secured by homes that have not gone up in value. Professionals have conflicting views about the rate of home price appreciation for 2006. Some expect home price appreciation as high as 8% and some as low as 3%. One panelist expects that cumulative losses on the 2003 and 2004 vintages of sub-prime mortgage loans will be in the range of 3% to 4%. For the 2005 vintage, cumulative losses likely will be somewhat higher at roughly 6%.

One panelist cites a research report by UBS that examined losses on sub-prime mortgage loans in geographic areas that have experience different rates of home price appreciation. The key conclusion is that losses rise sharply in areas where the annual rate of home price appreciation is 5% or less. According to a research report from Bear Stearns, the 2005 vintage of sub-prime mortgage loans should experience performance similar to the 1999 vintage, which had cumulative losses of 6%.

There are many undocumented silent seconds today. This may mean that risk is greater than in the 1999 vintage.

A second panelist disagrees. He asserts that very rapid prepayments are producing low loss levels. On the other hand, slowing home price appreciation should increase losses somewhat. A countervailing factor is that consumer credit scores are rising as the sub-prime area encroaches on the "alt-B" space. Layering of risk is prevalent (*e.g.*, reduced documentation and interest-only loans). As the economy moves through the down side of the credit cycle, servicing will become even more important in determining performance.

A third panelist focuses on dispersion (bar-belling) of portfolios.

For the past five years, investors in triple-B-rated and triple-B-minus-rated tranches of sub-prime mortgage ABS have seen only great performance. The new investors in that area, including CDOs, may get their first taste of poor performance from the 2005 and 2006 vintages. A panelist from a sub-prime mortgage lender argues that the rating agencies require sufficient credit enhancement to cover the risk appropriately for triple-B and triple-B-minus tranches.

ABCP: The asset-backed commercial paper market grew significantly in 2005 from the creation of new single-seller programs for mortgage warehousing. Rising interest rates and fears about the housing bubble likely will lead to lower issuance of ABCP in 2006. ABCP offers the advantage of greater flexibility than term deals. ABCP provides stable funding for sub-prime lenders, which makes them less vulnerable to a potential liquidity crisis like the one in the summer of 1998.

Regulation AB: There are two key regulatory changes: Reg AB and offering reform. In the short term, the impact of the new rules is to delay the offering process for new issues. Some issuers have

[30] Higher Education Reconciliation Act of 2005, *included in* Deficit Reduction Act of 2005, Pub. L. No. 109-171, §§ 8001-8024 (8 Feb 2005).

sold securities through 144A offerings in order to avoid the need to comply with Reg AB. To properly comply with Reg AB, all parties to a deal need to participate in the process and to coordinate their efforts. Reg AB requires disclosure of static pool data and disclosure of information about transaction parties. Market participants hope that Reg AB ultimately leads to greater certainty for all.

A panelist from a sub-prime mortgage lender notes that providing static pool data required by Reg AB was not difficult because it already compiled static pool data and had a substantial commitment to investor relations.

Synthetic ABS: Investors in subordinate ABS tranches always say that they (1) hate the collateral, (2) hate the structures, and (3) cannot get enough of it. The synthetic ABS market is supposed to decouple the market from supply constraints. Investors who do not like collateral or structures arguably should be shorting deals. However, it does not yet appear that regular investors are synthetically shorting bonds. Some insurers are starting to use synthetics for risk management.

The ABX index likely will be less useful than single-name synthetic ABS.

CDS of MBS likely will continue to grow for the next few years. Bond insurers use CDS as another form of policy.

9:00 am – The Traders' Roundtable

Supply Projection for 2006: One panelist notes that the Mortgage Bankers Association projects a drop of 20% in total mortgage originations in 2006.[31] He projects that sub-prime mortgage originations will decline by only 10%. Loan pricing is very aggressive right now. Low-cost providers have an important advantage. Direct retail production has an inherent advantage over wholesale channels. Some lenders have made poor decisions because they rely too heavily on wholesale origination channels.

Another panelist expects total mortgage originations to decline by 10% to 15%. Some lenders will achieve higher origination volumes as others are forced to contract or leave the business. Spreads are at all time tights. Gross weighted-average coupons (WACs) are rising on new deals. In 2006, there should be a trend toward more realistic gross WACs. Deals this year should be similar to deals from 2005, which was the year when many lenders experimented with new products offerings. Credit counseling will help more borrowers achieve credit curing and, thereby, refinance into lower-rate loans.

Floating vs. Fixed Issuance: The ABS product mix has changed over time. Sub-prime mortgage ABS have become increasingly important as building blocks for other structured products (*i.e.*, ABS CDOs). Thus, there is natural pressure for the creation of floating rate sub-prime mortgage ABS to fit conveniently into ABS CDOs. Trading opportunities are the greatest in the sub-prime mortgage ABS area because of greater spread volatility. Over the past several months, spreads on triple-B-minus sub-prime mortgage ABS fluctuated from a wide level of around 350 to a tight level of around 170. Technical factors, rather than fundamental ones, are the likely drivers of volatility.

Synthetics: The synthetic market is adept at identifying smaller originators that have-high cost originations. Those are the companies which may face the greatest stress when rates rise and origination volumes shrink. One way for a lender to boost its origination levels is to increase silent seconds[32] or affordability products. CDOs are choosing to reference the 2004 vintage synthetically

[31] Mortgage Bankers Association of America, *Mortgage Finance Forecast*, (7 Feb 2006) <http://www.mbaa.org/files/Bulletin/InternalResource/MBAMortgageFinance-February2006_38566.pdf>. The MBAA projects that total origination of 1- to 4-family mortgage loans will be $2.242 trillion in 2006, compared to $2.774 trillion in 2005.

[32] For background on "silent seconds" (a/k/a piggyback loans) *see* Dunlevy, J., J. Manzi, J. Garfield, and E. Santevecchi, *RMBS Second Mortgages & Piggyback Loans*, Nomura fixed income research (14 Jul 2005).

because it has less affordability product and silent seconds. Thus, tiering has become pronounced. Dealers are starting to lose their appetite for buying protection on the 2004 vintage because they cannot find natural protection buyers to whom they can lay off the protection.

Some investors are particularly drawn to subordinate tranches rated by only one rating agency. They can earn incrementally higher returns and they can use synthetics to partially hedge the positions. Some new structures are attractive to investors because they include novel caps.

Foreign Investors: A sub-prime mortgage ABS issuer must be mindful of marketing itself to CDO equity investors, who are the ones really exposed to the triple-B-minus tranches through ABS CDOs. One issuer markets itself directly in Japan.

CDOs: The growing prevalence of synthetic ABS is increasing differentiation among CDO managers. In the past, all contemporaneous ABS CDOs bought essentially the same bonds, because that was what was available. Now, CDO managers have greater selections because they can buy virtually anything synthetically. CDO investors have restricted managers from taking large exposure to option ARMs. A challenge for the ABS CDO area is that CDOs are huge natural sellers of protection on triple-B-rated sub-prime mortgage ABS. However, there are not natural buyers of protection (other than macro hedge funds and dealers to hedge their pipelines). Dealers are starting to run correlation books for triple-B-rated sub-prime mortgage ABS, allowing investors to take customized exposures.

The bane of every trading desk right now is "market wanted in comp" lists. However, it has become fairly easy for dealers to tell whether an investor or hedge fund is interested in buying or selling protection on specific names. Investors have opportunities to pick on dealers by seeking market quotes (*i.e.*, two-way "bid" and "ask" quotes) from multiple dealers. Dealers also are starting to limit the aggregate order size that they will execute in connection with supplying quotes on a whole list of names. Dealers also protect themselves by keeping a wide bid-ask spread.

CDO managers can take lots of time analyzing bonds and picking names. When they send a list to dealers for quotes, the dealers get only a few hours in which to reply. Some dealers have been clobbered by CDO managers. This is a payback for syndicates that moved too fast on new issues.

ABX Index: Trading volume of the ABX index is estimated to be in the range of $15 billion to $20 billion. Most of the trading activity has been at the triple-B-minus level, with a smaller amount at the triple-A level. Activity at the single-A and double-A levels has been very slight. Much of the buying of protection has come from dealers for hedging. The triple-B-minus tranche has a coupon of 2.67%. It traded down after the start of trading but bounced back quickly.[33] The ABX index has been trading at a cheap level compared to its constituent securities. Cash securities are now tighter than their corresponding synthetics. Other than the Wall Street dealers who need to hedge inventory, the traditional aggregators of collateral have not yet started using the ABX index as a hedge.

Trading activity in the ABX index is concentrated primarily among dealers. At first, one of the mortgage hedge funds was active, but it later closed out its protection. Some investors have done offsetting trades hedging the weaker half of the index with single-name synthetic ABS.

10:15 am – Structured Finance CDOs

Mortgage Collateral for CDOs: Payment shock is an issue. According to a recent research report, about 40% of sub-prime ARMs reach their interest rate reset dates within the next 12 months, and about 60% in the next 18 months. Refinancing of those loans should help to sustain the volume new sub-prime mortgage loan originations.

[33] *See* <http://www.markit.com/abx.jsp?Index=ABX.HE.BBB-+Indices> for the price history of the ABX.HE.BBB- Index.

Affordability products are an issue. Option ARMs are risky, but the greater challenges come from layering risk.

Synthetic ABS allow a CDO manager to accumulate desirable collateral even when the cash bonds are not available. Synthetic buckets in new CDOs have grown dramatically in recent months, and that should continue going forward.

CDO demand for cash ABS remains strong because there are many ABS CDOs from 2002 and 2003 that must reinvest primarily in cash ABS. New CDOs can use synthetics in lieu of cash securities. Activity in synthetics is producing effects on spreads of cash ABS.

S&P's new CDO criteria favor high grade collateral over speculative grade collateral. Some new CDOs use pro rata pay-down of liabilities.

One CDO manager notes that its original motivation for using synthetic ABS was for sourcing exposure to higher-quality sub-prime loans than it could get in the cash market. Using synthetics allowed the manager to pick favorable vintages and to avoid "reject" securities that were available through secondary trading.

Tiering in the synthetic ABS area is supplanting the notion of generic spread levels for the whole triple-B or triple-B-minus area.

The ABX index is a tool that managers can use. It is not a threat to managers. Managers differentiate themselves by picking specific credit exposures rather than simply following an index. The inclusion of some weaker constituents in the ABX index makes it short-friendly. The market needs to get past the first roll of the index (19 Jul 2006) to gain confidence in the process.

A pure CDO^2 is the best diversification play. However, there is a very high level of complexity and investors get paid a premium for that complexity. On the other hand, limited "CDO buckets" in ABS CDOs offers a CDO manager the ability to include CDOs from other managers that have different specialties and expertise. One panelist notes that his firm uses a full look-through analysis for analyzing CDOs^2.

11:15 am – ABS Relative Value Outlook: Investors Speak Out

Regulation AB: One panelist feels that Reg AB has not had a big impact on his investment decisions. Even before Reg AB, he maintained close contact with issuers. Improved static pool data is a plus. Some originators who sold their loans on a servicing released basis have started going back to the purchasers to find out static pool data on their loans.

A second panelist generally agrees. He maintains strong relations with issuers and feels that he had good information even before Reg AB.

There should be a slight spread differential between the public and private markets. Many investors have lower limits for investing in private deals.

Economy, Consumers, Spreads, Allocation to ABS: There should not be problems in the near term. The time to go down in credit was a few years ago, but not now. There is risk in the housing market, but home price declines are unlikely. Home prices either should continue to grow slowly or remain flat. But, affordability products combined with flat home prices could be very damaging to performance and could hurt subordinate tranches of sub-prime mortgage ABS.

The flatness of the yield curve is surprising. The long end of the curve probably should rise. Steepening trades arguably make sense. On the other hand, the economy does not seem to be displaying the strength to generate increases in long-term rates.

Another panelist notes that although consumer debt is very high, it has simply grown in pace with the economy. Moreover, consumer debt-to-income ratios have not grown as rapidly. Consumer delinquency rates continue to be low. Unemployment is decreasing and payrolls are increasing. The U.K. and Australia provide good examples for what the U.S. might experience over the next year or two. In some areas of those countries home prices have declined, but not enough to endanger MBS and ABS.

Value: The first panelist feels that spreads do not adequately compensate for risk on certain deals (particularly at the lower-rated tranches). Another panelist feels that triple-A credit card ABS have gotten stronger because of consolidation. Although triple-A credit card spreads are nominally tight, they are more attractive than the alternatives.

Sub-prime Mortgage ABS: One panelist recommends focusing on a lender's management to understand how the company handles layered risk. The move from interest-only loans to 40-year loans is significant. The original move to interest-only loans was accompanied by higher consumer credit (FICO) scores. Now, the move from interest-only loans to 40-year loans arguably represents a shift to a stronger product, but it is accompanied by a weaker consumer credit scores. The downward shift in consumer credit scores with 40-year loans may create a credit problem.

Competition among lenders is another big issue. Some lenders already have moved into the alt-B area with greater layering of risk. There do not seem to be any more product areas into which sub-prime lenders can move to sustain origination volumes.

Sub-prime Mortgage ABS Issuers: One panelist likes collateral from Ameriquest, Option One, and Countrywide. Those companies have done a great job of telling their stories. Each one creates separate securitizations for different kinds of risk, which makes pool performance more predictable.

Another panelist agrees with the first regarding Ameriquest and Option One, but disagrees somewhat about Countrywide because of the performance of the company's option ARMs. The panelist leans away from Bear Stearns deals because of high proportion of second lien loans and away from Credit Suisse deals because the collateral is hard to model.

The first panelist feels that Long Beach pools have been disappointing. The pools have not achieved what the company represented they would. The servicing transfer of a few years ago is not longer an adequate explanation for performance. Investors do not get compensated for the higher uncertainty and volatility in Long Beach deals.

It is easier for investors to take advantage of tiering in the synthetic ABS market than in the cash market. The cash market is an offer-only market – at the tightest offer out there. In contrast, the synthetic market is about bids as well.

Vintages: One panelist likes the 2003 and 2004 vintages because there has been strong home price appreciation. There should not be problems as the loans from those vintage reach their reset dates. The 2005 vintage likely will be worse, but still not bad in absolute terms. The 2006 vintage may be worse than the 2005 vintage as issuers stretch to sustain volume.

Breakpoints: One investor focuses on the constant default rates (CDRs) at which different securities suffer losses. He favors the ones that withstand higher CDRs for similar collateral. Rating agencies arguably over-emphasize an issuer's track record in determining the necessary credit enhancement levels for new deals.

Step-Down Criteria: One panelist states that he does not focus directly on triggers, but simply relies on Intex models to correctly reflect triggers. A second panelist argues that triggers should not be standardized across issuers because different issuers have different performance track records. The second panelist comments that he usually runs scenarios so that triggers fail.

Servicing Visits: One panelist feels that the most productive aspect of visiting a servicer is talking to the collectors and service representatives — the people on the front line. Talking to those personnel reveals the "culture" of an organization. For example, at one servicer, collectors feel that they are *helping* people who cannot make payments on their loans. A second panelist agrees that talking to the front-line staff at an issuer is most revealing.

[Left session early.]

Friday, 10 February 2006

8:30 am – New Synthetic Credit Product Innovation

Product innovation comes along two main dimensions: (1) structural innovation and (2) expansion of underlying collateral types.

Last year (2005) there was a trend toward deals with full capital structures. Dealers had greater incentive to sell off larger shares of the capital structures of their deals. The "leveraged super-senior" structure was hot in Europe in spring and summer.[34] The technologies of both cash and synthetic ABS are converging. Professionals increasingly focus on credit risk and market risk together.

Leveraged Super Senior and ABS CDOs: Bond insurers are wary of ABS CDOs. They do not like the "pay-as-you-go" (PAUG) template for synthetic ABS. The leveraged super-senior structure is based on selling a slice of the senior tranche with a levered coupon. However, there are market value triggers that can force a deal to unwind or to de-lever. The deals also include triggers based on losses. For example, if a deal has 10 time leverage, a market value loss of 5% can lead to a loss of 50% in an unwind.

Some deals use loss triggers by themselves and some combine loss and spread triggers in a matrix. From one perspective, a loss trigger is easy to monitor, but it has the disadvantage of uncertainty about the magnitude of margin calls (to de-lever a deal so it does not unwind) and it does not capture rating migrations.

Fitch models spread movements with a mean reverting Vasicek process.[35] The three key parameters are (1) the mean reversion speed, (2) mean spread, and (3) spread volatility. Fitch uses the following parameters:

Fitch Modeling Parameters for Spread Triggers in Leveraged Super Senior Deals		
	AAA ABS	BBB Corporates
mean reversion speed (α)	91%	30%
mean spread (β)	37 bp	121 bp
spread volatility (σ)	42%	30%

CPPI – Constant Proportion Portfolio Insurance:[36] The current environment has low default rates, low interest rates, and low spreads. When the credit cycle turns, defaults will rise and spreads will widen. The CPPI structure provides limited and adjustable principal protection on a leveraged

[34] For a brief explanation of the leverage super-senior structure *see* Jacob, D. et al., *U.S. Fixed Income 2006 Outlook/2005 Review*, Nomura fixed income research at 122 (15 Dec 2005).

[35] Osako, C., *Modeling Rating Transitions and Spread Migration in Leveraged Super-Senior Portfolio CDS*, Fitch Ratings global CDO special report (6 Sep 2005).

[36] For background on CPPI structures *see* Whetten, M. and W. Jin, *Anatomy of Credit CPPI*, Nomura fixed income research (8 Sep 2005).

portfolio. An SPE (issuer) issues "CPP" notes to investors. The SPE invests in high quality (double-A-rated) floating rate collateral (*e.g.*, ABS). The principal of the CPP notes is protected by the quality of the collateral. The issuer then enters into a swap under which it pays the coupon on the collateral in exchange for the coupon on a leveraged portfolio. The present value of the future interest cash flow on the collateral is the "reserve" against losses on the leveraged portfolio. The size of the leverage of the leveraged portfolio is adjusted so that its "maximum one-day loss" (under very harsh assumptions) is less than the amount of the reserve. If the levered portfolio produces losses that consume the reserve, the CPP coupon will be 0%. However, if the levered portfolio performs well, the reserve can grow allowing greater leverage in the portfolio. Leverage usually is capped at a reasonable level (*e.g.*, 20×).

The CPPI product can produce attractive returns. The "expected return" on a seven-year, zero coupon deal is in the range of LIBOR+250 and the expected return on a seven-year coupon deal is in the range of L+150. A 10-year zero coupon deal has an expected return in the range of L+300.

Outlook: Synthetic CLOs may be a developing area in 2006.

The lifecycle of new structured credit products has become very rapid. Today, it may be only a matter of months between when a product is first introduced and the time that it falls out of fashion.

ABX Index: The index is creating liquidity for the actual constituents of the index and may be sucking liquidity away from other securities. Some professionals believe that liquidity for ABS will generally improve because of the index.

9:30 am – Bankruptcy Issues: Working Out and Restructuring Troubled Deals

Structures and documents often include constraints that can create challenges for servicing financial assets. In contrast, deals backed by operating assets (*e.g.*, leased aircraft or railcars) generally give a servicer greater discretion.

The amount of securities issued against operating assets is based on an advance rate applied to the estimated liquidation value of the assets. The amount of securities is not necessarily based on the cash flow from short term leases on the assets. Therefore, the manager/servicer of the assets must constantly remarket the assets as they come off-lease in order to keep generating cash flow. Parties to deals based on operating assets generally understand that the manager/servicer must have very broad discretion and must be free of constraints in managing the assets. In contrast to deals backed by *financial* assets, deals backed by non-financial assets are not subject to FAS 140. Additionally, in hard asset deals there generally is a greater degree of linkage between the credit quality of the ABS and credit quality of the servicer/manager.

In contrast, documentation for a deal backed by consumer loans usually restricts a servicer from granting extensions (above a modest amount). When the hurricanes caused payment disruptions, servicers sometimes were not able to get waivers from restrictions, which led to high delinquencies and defaults. Servicers are restricted in working-out consumer loans, and this can hurt recoveries.

Bond insurers use the right strategy in taking the role of "controlling party" in deals that they insure. Bond insurers retain maximum flexibility to control the disposition of collateral backing a deal.

A panelist from a backup servicer would like deal documents to contain more provisions granting flexibility to a backup servicer. This would allow it to achieve the maximum recovery on the collateral.

Bankruptcy § 1110: The concept of § 1110 is to assure that a lessor of aircraft and aircraft engines can repossess the assets if a lessee goes into bankruptcy and does not promptly affirm the leases. In practice, there always ends up being a negotiation and the lessor's rights are less than they "should be" according to a simple reading of § 1110.

From a bankruptcy lawyer's perspective, a structured financing is nothing but a secured loan that is trying to get special treatment. That is also how a bankruptcy judge views a structured financing. The *LTV Steel* case[37] was a tough one because it involved a traditional industrial company that had used securitization to finance virtually all of its assets (both inventory and receivables). All the panelists feel that *LTV Steel* is very different from the typical securitization case, which involves a finance company that routinely uses securitization as the method for selling its originations.

In many defaulted deals (both CDOs and ABS), an investor is virtually powerless unless it is willing to buy all the collateral from the deal.

— END —

[37] *In re* LTV Steel Company, Inc., No. 00-43866, (Bankr. N.D. Ohio) (voluntary petition filed 29 Dec 2000). In LTV's bankruptcy, the company challenged the "bankruptcy remoteness" of its own securitizations. Years earlier, LTV had used two securitizations to finance its trade receivables and inventory. Standard & Poor's had assigned a rating of AAA to the trade receivables financing and Fitch had assigned a rating of BBB to the inventory financing.

LTV's attack against its own deals raised quite a fuss within the ABS community because it challenged the fundamental principles of securitization. The use of securitization techniques failed to keep the deals out of the company's bankruptcy proceeding. For better or worse, the controversy was settled without any judicial resolution of the issues. LTV withdrew its attack when the securitization investors (lenders) agreed to supply replacement financing through a DIP (debtor-in-possession) facility. In essence, the securitization investors experienced a forced exchange of their securitization paper for DIP paper. *See also, The LTV Bankruptcy Case and Its Threat to Securitization - Is it Over or Just Beginning?,* Nomura fixed income research (7 Mar 2001); *True Sale Assailed: Implications of In re LTV Steel for Structured Transactions*, Moody's structured finance research (27 Apr 2001); Mayer Brown & Platt, *An Update on the Treatment of the Securitization Facilities in the Chapter 11 Bankruptcy Cases of LTV Steel Company, Inc., et al.*, (7 Mar 2001) <http://www.securitization.net/knowledge/article.asp?id=346&aid=422>.

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