NOMURA

Report from Arizona 2004: Coverage of Selected Sessions of the Winter Securitization Conferences

10 February 2004

Optimism was the defining characteristic of the two recent securitization conferences in Arizona. Numerous speakers expressed positive outlooks for the credit and for the economy. They generally expect spreads to grind tighter in the short run and for ABS issuance volume to be flat or slightly down for the year. The prospect of rising interest rates is a small dark cloud on the horizon. Notwithstanding the overall positive outlook, much attention at the conferences was devoted to unresolved issues such as off-balance sheet accounting, fraud risk, and the true strength of "bankruptcy remote" structures.

Both conferences were well attended and delivered high quality content for attendees. The American Securitization Forum débuted in Arizona with "ASF 2004." The event essentially replaced the annual symposium previously hosted by Strategic Research Institute. Attendance at ASF 2004 numbered roughly 1,000, but only a small proportion of investors chose to attend. The agenda included many general sessions (*i.e.*, sessions with no competing presentations or events) and the content was consistently valuable and informative. In a break from previous conference protocol, sessions at ASF 2004 were scheduled to last only 45 minutes, but there were correspondingly more of them.

Information Management Network hosted "ABS West 2004" at a new and larger location. Various reports place ABS West 2004 attendance in the range of 2,000 to 2,700 – a huge turnout. In addition, this year's panels delivered even sharper content than in past years. Overall, the event was a smashing success.

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

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

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ASF 2004

American Securitization Forum
25-28 January 2004, Scottsdale Princess, Scottsdale, Arizona

Sunday, 25 January 2004

2:00 p.m. – Securitization and Its Impact on the Economy

[The material in this session was previously presented to the staff of the House Committee on Financial Services.]

The securitization industry has been under attack by various Congressional committees and regulatory agencies. The crux of the problem is that securitization uses special purpose entities (SPEs) and so did the malefactors in the recent corporate scandals.

<u>Brief History of Securitization</u>: The roots of securitization trace back to Fannie Mae, Ginnie Mae, and Freddie Mac. In 1969, Ginnie Mae started issuing securities backed by pools of mortgage loans. Congress established Freddie Mac in 1970 to create a secondary market in mortgage loans. Thus, securitization got its start from government action to promote home ownership.

In 1984, Congress passed the Secondary Mortgage Market Enhancement Act[1] (SMMEA) to facilitate the securitization of non-conforming mortgage loans (*i.e.*, mortgage loans that do not meet the requirements for inclusion in Ginnie Mae, Fannie Mae or Freddie Mac pools). Other laws and regulations, such as the real estate mortgage investment conduit (REMIC) provisions of the tax code[2] and various SEC regulations,[3] were further expressions of government support for securitization.

Starting in 1985, financial professionals started applying securitization technology to assets other than mortgage loans.[4] The securitization market has become very large and represents a major portion of the whole U.S. debt capital market.[5]

Both issuers and investors like securitization. Issuers like securitization because it provides a good funding source and has other benefits. Investors like it because it offers attractive investments.

Tough issues for the securitization market right now include transparency, off-balance sheet accounting, and tax treatment. Communication and education are the keys for the industry to thrive.

What conditions favor growth of the securitization market? Key macro trends that favor growth include: risk allocation, information technology, disintermediation, globalization, and privatization. Secondary trends that support continuing growth include: changing legal regimes which accommodate and support securitization, the growth of the derivatives market, "testing" of past deals in stressful economic environments, and growing investor sophistication and militancy. On the other hand, secondary trends that challenge growth include: growth itself, limitations of the legal system (legal frameworks in some jurisdictions are insufficiently clear), information limitations (we need to make assumptions when we do not have complete information).

Who benefits from securitization? Securitization is beneficial because it improves the mobility of capital and the mobility of labor. Thus, *everyone* can benefit. Securitization dampens distortions in the economy. Securitization allows consumers to borrow more cheaply than they otherwise could. Issuers use securitization to achieve a lower cost of capital. Investors achieve safety, liquidity, and yield. The government (society) benefits from capital efficiency and a healthy financial system.

Why is the push for more transparency warranted? Two issues compel the push for more transparency: (1) sometimes people lie, cheat, and steal, and (2) people make mistakes. All parties have an interest in transparency. Greater transparency can give an issuer a lower cost of capital.

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[1] Pub. L. No. 98-440, 98 Stat. 1689 (1984).

[2] I.R.C . § 860A *et seq.*; Tax Reform Act of 1986, Pub. L. No. 99 514, § 671, 100 Stat. 2085, 2309 (1986).

[3] *See, e.g.*, 17 C.F.R. §§ 239.13 (Form S-3), 270.3a-7,

[4] In March 1985, Sperry made history when it effected the first non-mortgage securitization; the deal involved computer leases. Two months later, on May 15, 1985, Valley National and Marine Midland each closed a securitization backed by auto loans. In December of that year, General Motors jumped on the bandwagon and Chrysler followed suit in July of 1986. In January of 1987, Republic Bank Delaware closed the first credit card-backed securitization.

[5] As of the end of the third quarter of 2003, outstandings in various sectors of the securitization market were as follows:

Securitization Outstandings as of 2003Q3 ($ billions)	
Agency MBS	3,371
Agency-backed CMOs/REMICs (double counting)	989
Non-agency (jumbo) MBS	528
Commercial Mortgage-Backed Securities (CMBS)	389
Asset-Backed Securities (ABS)	1,365
Asset-Backed Commercial Paper (ABCP)	723
Collateralized Debt Obligations (CDOs)	246
Total	**7,611**

Greater transparency offers the government a more stable financial system and provides consumers with greater job security and safety for their pensions and investments. Rating agencies, accountants, trustees and others should support greater transparency because it reduces reputational risk.

Virtually every dynamic aspect of the financial markets has an impact on the liquidity of the securitization market: fiscal and monetary policy, interest rates, exchange rates, derivative structures, government subsidies, volatility, psychology, regulations, regulatory regimes, availability of insurance, information flows, political shocks, and belief in the reliability of predictive models.

Trader's Perspective on the Market: Securitization has a key role in the continued evolution of the financial markets. It has applicability to many other sectors of the overall financial markets. Securitization is not financial alchemy. It is a tool for unlocking asset values and for creating a market for asset risk. Securitization does not create or destroy risk, but rather reshapes risk. Reshaping risk helps to unlock efficiency by creating customized exposures for different market participants.

A well-developed and mature market is one where there is: broad participation, deep liquidity, a price discovery system, information availability and transparency, capital aggregation and attraction, and a brisk velocity of risk transfer (*e.g.*, trading volume). For the securitization market to achieve the status of a well-developed and mature market, it must achieve better information flows.

Securitization technology facilitates unbundling different kinds of risk (credit *vs*. liquidity *vs*. optionality). Some market participants are more willing to take one kind of risk than another. Securitization allows the creation of securities that contain some kinds of risks but not others. Investors can select the kind of risk that they want to take without having to originate raw assets themselves.

Securitization helps separate "asset risk" from "operating risk." Investors charge less to take the two kinds of risk separately than they do to take them together. Securitization also helps an issuer improve the efficiency of its funding by matching assets and liabilities. Issuers can use securitization for separating credit and liquidity risk, as a strategic tool for financing acquisitions, or for disposing of specific business lines.

4:15 p.m. – Structural Foundations of Securitization and Current Controversies

Securitization helps companies finance themselves efficiently. This session considers the legal foundations of securitization, the use of derivatives in securitization, and the Enron case.

Legal Foundations of Securitization: Securitization entails transferring financial assets to a special purpose entity ("SPE" or "SPV"). A traditional securitization is backed by and paid from a pool of financial assets purchased by a bankruptcy remote SPE from the sponsor of the securitization in a "true sale." A "true sale" is one that would be respected by a bankruptcy court if the sponsor went into bankruptcy. A "bankruptcy remote" SPE is one that has limited powers and that is structured to minimize the chances that it will become the subject of a bankruptcy proceeding itself or become entangled in a bankruptcy of the sponsor. If a securitization is defective, the underlying assets could become trapped in the sponsor's bankruptcy estate and be subject to the automatic stay. However, to provide a back-up layer of protection, a securitization trust usually has a first-priority, perfected security interest in the underlying assets, in case the (intended) "true sale" is defective. Congress has considered protecting the true sale status of securitizations,[6] but it chose not to do so in the wake of Enron.

Article 9 of the Uniform Commercial Code (U.C.C.) applies to securitizations in two ways. First, it applies to ***pledges*** of financial assets. Second, it also applies to ***sales*** of financial assets. If Article 9

[6] *See, e.g.,* H.R. 333, 107th Cong., 1st Sess. § 912 (2001); H.R. 3211, 107th Cong., 1st Sess. § 13 (2001).

does not apply in a particular situation, common law probably applies instead (*e.g.*, mortgage loans). However, federal law preempts state common law in the areas of ship mortgages, aircraft liens, patents, trademarks, and copyrights. Under Article 9, perfection of a security interest is sometimes automatic and sometimes achieved through possession of the underlying physical assets. The most recent amendments to Article 9 are friendly to securitization. For example, the most recent amendments overturned the notorious *Octagon Gas* case.[7] Article 9 is dynamic and the legal profession has worked hard to make it responsive to the needs of the securitization industry.[8]

Derivatives: Derivatives started in 1730 with the founding of the Osaka rice exchange. The early users of derivatives used them to mitigate risk. For example, a farmer could sell his harvest under a forward delivery contract to eliminate his exposure to the risk of price fluctuations. Other users of derivatives have employed them to speculate with leveraged bets. The derivatives market has had some scandals including (1) the Hunt Brothers cornering the silver market in the 1980s,[9] (2) the 1987 stock market crash, and (3) the Bankers Trust scandal.[10]

An example of a smart use of a derivative is the use of an interest rate cap in a deal that has floating rate collateral or floating rate liabilities. The cap (or a swap) allows the issuer to trade an uncertain future exposure for a fixed, upfront cost.

Enron: Enron filed for bankruptcy on 2 December 2001. Since then, FASB and the SEC have targeted off-balance sheet accounting. This is arguably unjustified. Enron manipulated its financial statements – it committed common securities fraud. One example of Enron's wrongdoing involved the Rhythms IPO. After the price of the stock ran up tremendously, Enron used the LJM1 partnership to hedge a possible decline in price of the Rhythms stock. Enron backed up the hedge with its own stock. But this meant that there was no real economic substance in the deal. LJM1 had no real role in the deal other than to hide the real economic substance of the deals.[11] Unfortunately, all off-balance sheet SPEs – including the ones used in securitizations – became suspect.

Many different kinds of market participants must share the guilt for Enron. The accountants, the lawyers, and the investors all should have challenged the legitimacy of the arrangements. However, in the age of "irrational exuberance" each figured that if the others had voiced no objection, the arrangements must be all right.

An interesting analogy is the resurgence of dram shop laws, which impose liability on bar owners and bartenders for injuries caused by a drunk patron after leaving a bar. Today's lawmakers and policymakers are reacting to Enron by making "financial dram shop laws." The challenge for securitization professionals is to guide lawmakers and policymakers so that the new laws and policies do not curtail legitimate financing activities.

Enron triggered an unfortunate backlash in Congress. Enron killed proposed section 912 of the bankruptcy reform bill,[12] which would have provided a safe harbor for true sales. Also, Enron triggered the introduction of the Durbin-Delahunt[13] bill, which also would have attacked true sales. The real differences between Enron and legitimate securitizations is that the Enron structures were much more complex and that they were tainted by conflicts of interest.

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[7] U.C.C. § 9-318(a).

[8] *See, e.g.*, U.C.C. § 9-309(3), (4) (automatic perfection on sale of payment intangible or promissory note,), § 9-312(a) (permitting perfection by filing for security interest in instruments).

[9] *See, e.g.*, http://www.coin-shop.com/gold23.htm.

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

[11] *In re Enron Corp.*, No. 01-16034, Second Interim Report of Neal Batson, Court Appointed Examiner, Appendix L, Annex 2 (Bankr. S.D.N.Y. 5 Mar 2003) (available at http://www.enron.com/corp/por/examiner2.html).

[12] H.R. 333, 107th Cong., 1st Sess. § 912 (2001); H.R. 3211, 107th Cong., 1st Sess. § 13 (2001).

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

Securitization is fair to unsecured creditors. Securitization supplies a company with cash (as would other financing methods) and with lower cost funding. In fact, unsecured creditors are probably better off because of securitization.

Most companies have now embraced the view that "disclosure will trump creative accounting." That is, many companies seem to believe that they can account for transactions any way they please, as long as they disclose what they are doing.

5:15 p.m. – Investor and Market Issues

Key risks that have gained prominence include (1) seller bankruptcy risk, (2) servicing risk, and (3) fraud.

Investors should expect to get repaid in an ordinary securitization partly because a securitization SPV is intended to be an independent, limited purpose, bankruptcy remote entity. Although a typical securitization does not provide for recourse to the sponsor, investors expect that the performance of the underlying securitized assets will generate sufficient cash flow to repay them.

Years ago, the securitization market had a pristine record. Today, the market has experience with losses, defaults, bankrupt seller/servicers, and fraud. There have been some legal challenges to "true sale" and "substantive consolidation," but not many. There have not been any court rulings that have invalidated a securitization structure. *LTV Steel* is the most notorious case challenging true sale.[14] In the NCFE bankruptcy, the question of whether the transfers in the deals were true sales is on the docket.[15] In a CMBS deal in NY (probably *Kingston Square*[16]), the judge questioned the conduct of an independent director.

In the area of rate reduction bonds, the bankruptcy of Pacific Gas & Electric (PGE)[17] and the near bankruptcy of Southern California Edison (SoCal Ed) did not impair the companies' securitizations. The utilities continued to collect the charges pledged to repay the bonds. A key feature of those deals is that the charges were a separate line item on consumer bills.

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[14] *In re LTV Steel Co.*, No. 00-43866 (Bankr. N.D. Ohio). In LTV Steel went into bankruptcy on 29 December 2000. 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 debtor-in-possession (DIP) facility. In essence, the securitization investors experienced a forced exchange of their securitization paper for DIP paper. *See generally*, Alexander Dill, *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) (available at http://www.securitization.net/pdf/ltv.pdf).

[15] *In re National Century Financial Enterprises*, No. 02-65235 (Bankr. S.D. Ohio). National Century Financial Enterprises (NCFE) filed for bankruptcy in November of 2002. Previously, the company had completed dozens of purported healthcare securitizations. The company and its principals have been accused of fraud in connection with those deals. Roughly $3.35 billion of outstanding securities have defaulted, and estimates of ultimate losses to investors have run higher than 85%. The main component of the alleged fraud is that collateral for the deals either was ineligible or did not exist. The revolving nature of the collateral pools combined with the absence of meaningful third-party oversight arguably enabled NCFE to perpetrate that aspect of the fraud. A secondary aspect of the NCFE fraud involves the company's diversion of reserve funds that formed a part of its deals' credit enhancement. Investors have alleged that the trustees for the NCFE deals should have prevented the company's diversion of the reserve fund balances. *See City of Chandler et al. v. Bank One et al.*, No. CV2003-010173, (Ariz. Superior Ct. Maricopa County, *filed* 23 May 2003).

[16] *In re Kingston Square Associates*, Nos. 96-B-44962 - 96-B-46340 (Bankr. S.D.N.Y.); *see generally* Alexander Dill, *Kingston Square Associates and Bankruptcy Remoteness: A Safe Haven for Debtors?*, Moody's special report (24 Oct. 1997).

[17] *In re Pacific Gas and Electric Co.*, No. 01-30923DM (Bankr. N.D. Cal.).

Conseco's manufactured housing ABS performed badly and Conseco filed for bankruptcy.[18] The servicing fee dwindled because it was subordinated to the securities. Also, the most subordinate classes of the deals carried a corporate guarantee from Conseco. The servicing platform was sold in the bankruptcy proceeding. The holders of the subordinate classes received a claim against Conseco's estate. The company managed to convince the bankruptcy court to restructure the servicing fee. The court moved the servicing fee to the top of the cash flow waterfall and increased it to 125 basis points (declining to 115 bps). The SPV trusts were never brought into the bankruptcy proceeding. However, the judge allowed the securitization investors to argue for their interests. The biggest shock from the Conseco case was not the deterioration of the assets but rather the re-writing of the waterfall.

In *LTV Steel*, the company had two outstanding securitizations. The company challenged the true sales in its own securitizations. The issue in the case went away because of debtor-in-possession financing provided by the securitization lenders.

Many manufacturing companies that have used trade receivable securitization facilities have gone into bankruptcy. Those situations have not triggered challenges to the facilities. Thus, a possible lesson of *LTV Steel* is that challenges are more likely when a company uses offbeat financings, such as LTV's inventory securitization.

Successful servicing transfers are common in the mainstream asset classes. There are many examples in the sub-prime mortgage and sub-prime auto areas. However, in the case of specialized asset classes, it is harder to transfer servicing.

<u>The "F" Word (Fraud): An Investor's Worst Nightmare</u>: Tough fraud cases in securitization include Commercial Financial Services (CFS),[19] National Century Financial Enterprises (NCFE),[20] and Academic Management Services (AMS).[21] CFS securitized charged-off credit card receivables. It bought the receivables at a deep discount and securitized them at a projected recovery rate that was substantially higher than the purchase price. The critical trouble with CFS was "sales" of the receivables at inflated prices to an affiliated entity.

The NCFE deals involved misstatements about the value and existence of the receivables. Criminal indictments have been handed down against some of the key individuals. There were many kinds of fraud in the NCFE deals such as the non-existence of most of the receivables, the balance of the receivables (that did exist), and the movement of funds between the two trusts. Interestingly, the borrowers have sued the trusts (NPF VI and NPF XII). The receivables included unbilled amounts (this makes fraud easier) and the sales from the providers were one-step sales.

AMS was a student loan lender. The company reported in mid-July that it had mis-reported its portfolios. The portfolio had excess concentrations, which reduced the amount of "eligible" receivables. AMS was a subsidiary of an insurance holding company, which fixed the problems by dropping money into AMS. The parent company later sold AMS to Sallie Mae.

<u>Lessons from the Case Studies</u>: Focus on: (1) ability to substitute collateral, (2) ability to increase servicing fee, (3) ability to execute corporate guarantee, (4) ability to analyze the issuer, and (5) ability to replace the servicer.

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[18] *In re Conseco, Inc., et al.*, No. 02-49672 (Bankr. N.D. Ill.).

[19] For a discussion of the CFS transactions, *see* Mark Adelson et al., *ABS Credit Migrations*, Nomura fixed income research report at 20-22 (updated 5 Mar 2002).

[20] *See* note 15 *supra*.

[21] In the troubled student loan transactions from Academic Management Services (AMS), the problem was in reinvesting collections in new loans during revolving periods of the deals. In the process, AMS brought ineligible (uninsured) collateral into the deals. The problem is that there was no "second set of eyes" checking the new collateral as it flowed into the deals. *See generally*, Sharon Asch, *2003 Review and 2004 Outlook: Student Loan-Backed Securities Growth to Continue*, Moody's special report at 6-7 (20 Jan 2004).

Having a trustee as a "cold" backup servicer is virtually meaningless. For a backup servicing arrangement to provide any meaningful protection, it must be "hot" or "warm." A "warm" arrangement is where the trustee is involved each month in checking calculations and will inform investors of discrepancies so that they can take action, if they choose.

Securitizations can be made structurally stronger: (1) disallow substitution of delinquent receivables, (2) eliminate inclusion of unbilled amounts, and (3) limit ABS issuance only to issuer's "basis" in the assets.

Third-party Oversight: A deal's trustee should have the ability to check critical calculations. The idea of a "deal cop" recently has gained some popularity. However, most deals have nobody in that role. In fact, the division of responsibility – where no single party other than an issuer focuses on the big picture of a deal – is sometimes viewed as a strength of securitizations. The problem is that an issuer can run renegade if no one is watching. Originators do not want to pay for having deal cops. On the other hand, at least one issuer has brought in Murray Hill Corp. as a deal cop in order to achieve better execution.

Monday, 26 January 2004

7:50 a.m. – Opening Remarks (Vernon Wright)

Last year (2003) was great year for the ABS market. It was the fourth straight year of double-digit growth. The home equity sector led the growth, and the buoyant economy was a key driver. Consolidation of players was a key theme in 2003.

The American Securitization Forum (ASF) has accomplished much in its first 18 months. It has published four newsletters. It achieves regular coverage in the securitization trade press. It has conducted "sunset" seminars in New York. It developed its "securitization institute" for educating lawmakers and Congressional staff about securitization. Over a hundred organizations have become members of the ASF. A key challenge for the ASF is that regular people do not understand what securitization is and, consequently, they fear it. The ASF's legal and regulatory committee filed nine comment letters and participated in 14 meetings with policymakers.

Although the ASF has approved and issued two "best practices" standards – one on syndicate activities and one on ABCP reporting – it has not yet managed to convince market participants to embrace those standards.

8:00 a.m. – The View from the Capital (Congressman Spencer Bachus)

The House of Representatives has made a good start this year toward addressing the issue of assignee liability for predatory lending violations. Congress expanded the fair credit reporting law in 2003.[22] The House Financial Services Committee was able to convince members on both sides of the aisle that the American system for granting consumer credit is the best in the world. It implicitly endorsed the practice of using standardized reports from credit bureaus. A key difference between America and other countries is that low- and middle-income individuals can get credit. America has achieved the "democratization of credit."

Just as the system of credit bureaus and credit reports has fueled the growth of consumer credit in America, so has securitization. Securitization has been a key engine driving the growth of consumer credit by providing a source of funding. It is amazing how few Americans default on their mortgage

[22] Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159 (2003) (amending the Fair Credit Reporting Act, 15 U.S.C. § 1681 *et seq.*).

loans.[23] Securitization helps to lower the cost of mortgage loans, credit cards, and auto loans for all Americans. Securitization has helped low- and middle-income individuals and families realize the American dream of homeownership.

The next task for Washington is to preempt state predatory lending laws. Congress arguably should embrace the view that the consumer credit market is a national, inter-state market over which Congress should exercise jurisdiction. Congress should recognize that the securitization industry does not want or intend to securitize loans originated in violation of predatory lending laws.

This year is an election year. The voters will decide whether they like the direction in which the country is moving or if they want it to change. The deficit is scary. Spending is increasing at a rate of 8%. Part of the budget deficit is due to Iraq, but part is due to just too much spending; Republicans are acquiring a taste for spending like Democrats. The prospect of rising interest rates makes the deficit scarier.

The chances for federal preemption of state predatory lending laws will be better in a non-election year. Many members of Congress fail to differentiate predatory lending from sub-prime lending. That problem needs to be solved. About 10% to 14% of all mortgage loans are sub-prime mortgage loans. Those mortgage loans are socially beneficial because they increase the rate of home ownership.

Undocumented aliens are not the primary force undermining the loss of jobs by Americans. Rather, changing technology is costing Americans their jobs. Americans need training and education to be able to fill the jobs that are now available. Unemployment benefits should be conditioned on the recipients' willingness to be retrained for a different kind of job. The Enron debacle scares Americans because they realize that they easily might have been one of the victims if it happened at the companies where they work. In addition, ordinary Americans resent the tremendous loss of wealth from the recent wave of corporate scandals, including Enron.

8:50 a.m. – The State of the Industry

Last year (2003) was a great year for ABS. Most ABS sub-sectors posted strong excess returns above U.S. Treasury securities, according to the Lehman fixed income index.

This year (2004) should be another good year for ABS. Credit fundamentals are positive. Rising rates are the potential cloud on the horizon. Supply of new ABS should be roughly flat and demand should be strong as foreign demand and crossover demand (from corporate bond investors) grows. Tight spreads will favor subordinate ABS and ABS from off-the-run sectors.

The ABS market is susceptible to influences from other markets. Spread movements and other events in the corporate bond market have spillover effects in the ABS market. Likewise, the equity market and the ABS market influence each other.

Straight Corporate Debt: Unsecured bondholders really started to pay attention to securitization in 2002. As unsecured debt became increasingly expensive for some large issuers, securitization became a more important component of their overall funding. GMAC and Ford were completely shut out of unsecured floating rate debt issuance in 2002. Issuers claimed that the securitization market was going to be the answer to their funding problems. As the issuers proved that they could get efficient funding through the securitization markets, the spreads on their straight debt started to tighten.

For 2004, the scheduled debt maturities for the major finance companies amount to roughly $150 billion.

[23] The speaker may have been unaware that mortgage borrowers in certain other countries, such as Australia, display markedly lower default rates than U.S. mortgage borrowers.

A key question for 2004 is the breadth and sustainability of the economic recovery. A positive factor is large pools of capital waiting on the sidelines. Inflation and rising prices are a potential problem. The declining dollar is a positive, but there has to be foreign demand for American products. Credit quality is improving in both the consumer and commercial areas. Although consumers are highly leveraged, they have been so for years, and it should not be a problem. On the other hand, the high level of consumer leverage suggests that consumers cannot increase their spending by much.

The events of the past two years have shown that many companies had too much debt. In other words, their leverage was too high. Some companies are trying to reduce their leverage.

Over the past 10 to 12 years, consumer lenders have taken on greater consumer risk. This is shown in the long-term trend of rising losses and delinquencies in the credit card sector. This is also partly explainable by the rise of sub-prime lending along with the growth of the ABS market.

<u>Equities</u>: Bank and finance company stock prices advanced strongly in 2003. The vast bulk of consumer debt is for financing homes. The rate of homeownership in the U.S. has advanced from roughly 60% to 69% over the past 20 years. Credit card debt composes slightly more than 3% of all consumer debt (including mortgage debt), and a third of that 3% represents the use of cards merely as a cash substitute.

A continuing wave of consolidation will help boost bank equity values for the near future. The consolidation is apparent not only among commercial banks generally, but also in the credit card sector in particular. In a few years, fewer than half a dozen companies may dominate the whole credit card sector.

Equity investors follow ABS trust reports very closely and push stock prices up and down based on performance of the trusts.

9:30 a.m. – Enron: The Examiner's Perspective (Neal Batson)

On Sunday, 2 December 2001, Enron filed for bankruptcy. Enron had been ranked as the seventh largest company in the world. The bankruptcy courts appointed Batson as the examiner to report on the use of off-balance sheet SPEs and partnerships by Enron. Ultimately, the Enron investigations culminated in four reports, totaling thousands of pages and over 14,000 footnotes.[24]

The examiner's investigation uncovered roughly $10 billion in claims.

When Enron filed for bankruptcy, its stock was virtually worthless and its debt was traded as junk. A short while earlier, it had a high stock price and its debt had been rated investment grade. How can a company fall so far so fast?

Enron started as a gas pipeline company, but it quickly expanded into other areas. In 2000, the company reported revenues of more than $100 billion and had more than 20,000 employees. To finance its enormous operations Enron turned to innovative financing structures and aggressive accounting techniques. The company was reluctant to sell more stock or to issue more debt, which might have hurt its ratings. Through off-balance-sheet transactions, Enron borrowed billions of dollars. At the time of its bankruptcy, $14 billion of Enron's $38 billion of debt was attributable to off-balance sheet transactions. In addition, mark-to-market accounting was a source of problems for Enron. Enron recognized earnings on some contracts long before realizing any cash. The mark-to-market accounting practices could have triggered earnings volatility. Enron used other off-balance sheet transactions to dampen potential volatility associated with mark-to-market accounting and to produce cash flows that would match reported earnings.

[24] The four reports are available at http://www.enron.com/corp/por/supporting.html. The reports are included among the supporting documentation for the disclosure statement regarding Enron's reorganization plan.

Enron also used off-balance sheet transactions to mask the impact of bad business decisions, including bad investments in its merchant portfolio. The problem was so severe that Enron created a "Special Assets Group" to deal with the troubled assets. The troubled assets were parked in off-balance sheet entities.

The last two weeks of 1999 illustrate the extent to which Enron relied on SPEs to achieve financial statement results. In that period, the company executed 11 deals. In none of them were the repayment obligations reflected as debt on Enron's financial statements.

Enron used six accounting techniques to improve the appearance of its financial statements:[25]

- <u>FAS 125/140 Transactions</u>: Enron would transfer assets to an SPE partnership and would characterize 97% as debt and 3% as equity. The debt would be guaranteed with a total return swap from Enron. Also, Enron would often guarantee repayment of the equity. The assets rarely produced cash flow to repay the debt. The guarantees undermined the true sale character of the transfers. Enron characterized the cash from the asset transfer as income from operations rather than as proceeds from borrowings. Often, the very assets transferred to a partnership would be re-transferred to Enron and would later become the subject of another similar arrangement.

- <u>Commodity Prepay Transactions</u>: Enron would use offsetting forward delivery contracts to create the economic equivalent of a loan. Enron booked the cash flow as cash flow from operations rather than as cash flow from borrowings.

- <u>Share Trusts</u>: A complex off-balance sheet structure would issue debt and use the proceeds to purchase assets from Enron. Enron would guarantee the debt with a pledge of its stock and with a straight guarantee.

- <u>Minority Interest Transactions</u>: Minority interest transactions allowed Enron to report exposures in-between liabilities and equities on its balance sheet.

- <u>Tax Transactions</u>: Enron used some transactions to generate accounting income even if doing so created substantial tax liability.

- <u>Non-Economic Hedges and Other Related-Party Transactions</u>: Enron wrote hedges on assets and backed the hedges with its own stock. The deals were not true hedges because Enron was essentially hedging with itself.

Enron engaged in extensive self-dealing in connection with each of the accounting techniques that it used. A key warning sign arguably should have been the absence of outside third parties dealing with Enron on an arms-length basis. Enron's demise came from bad investments combined with overly aggressive use of improper accounting methods (which used SPEs). However, the improprieties could not have occurred absent the highly charged competitive environment at the company and the failure of oversight by the company's board of directors or by its outside lawyers or accountants.

The Enron debacle should remind corporate officers that they are not working for themselves, but rather for the owners of their companies. An officer's duty is to create real value, not merely the appearance of value. The false appearance of success is no substitute for a truly functioning business operation. Management must not give way to manipulation and integrity must not give way to illusion. An officer's goal should be to achieve real economic results rather than managing the appearance of the financial statements. It all may come down to simply establishing a sound

[25] *See In re Enron Corp.*, No. 01-16034, Final Report of Neal Batson, Court Appointed Examiner at 18-20 (Bankr. S.D.N.Y. 4 Nov 2003) (available at http://www.enron.com/corp/por/pdfs/examinerfinal/NBFinalExecutiveSummary.pdf).

corporate culture. Enron encouraged "deal junkies" who focused on reported results rather than real results. Enron did not support a climate of candor, either within management or between management and the board of directors. Additionally, public companies have a legal obligation to be candid with the marketplace. Compliance with technical accounting rules is not sufficient if it does not give a clear picture of the company. If the financial statements do not give a clear picture, the MDA (management discussion and analysis) portion of the company's reports must do so.

Directors of a company must have a real understanding of their company's operations and finances. A board of directors should include members who possess expertise in relevant areas.

Structured finance transactions are innovative financial products that produce real benefits. The securitization industry will continue to be in the forefront of financial innovation for years to come. However, Enron reveals that the tools of structured finance can be used for fraud and manipulation. Enron's use of structured deals differed from regular securitizations because Enron's deals transferred neither the risk of nor control over the underlying assets. Enron's deals did not reduce borrowing costs. They were not disclosed. They were motivated to obtain funding that was not reported as debt. They were motivated to manipulate reported financials.[26] Legitimate structured financings are those used for legitimate corporate purposes and that have real economic purpose.

Enron's abuse of structured finance probably was an aberration. On the other hand, Enron's use of aggressive accounting techniques and its inadequate disclosure may be representative of a trend among large corporations. Accounting abuses appear to have been widespread, even without using SPEs. The present rules-based accounting framework arguably promotes aggressive accounting and abuse.

Enron will not be the last story of its type. There will be more. Nonetheless, the reaction must not be to stifle financial innovation.

Businesses must be built on foundations of integrity. Only then will Americans' confidence in business be restored.

10:45 a.m. – Off-the-Run Assets

Deals backed by off-the-run assets are tougher than other deals. Having to resolve difficult and unusual issues is a common occurrence in working on deals backed by off-the-run assets.

Securitizations of operating assets are susceptible to fluctuating economic conditions and the ability of management. Focusing on management fees is very important. The management role is much more important than in a conventional deal (*i.e.*, one backed by financial assets with predetermined cash flows). In a deal backed by operating assets, it is necessary to try to predict the level and variability of maintenance expenses and capital expenditures. Most attendees at the session feel that management fees (including fees to an affiliated servicer) should have a high priority in a deal's cash flow waterfall.

Only a few items will rank above management fees and servicing fees in the cash flow waterfall of an operating asset deal. One example of such an item is taxes (or reserves for taxes) in cross-border deals.

Subordinating servicing or management fees partly undermines the arguments against substantive consolidation if the seller/servicer goes into bankruptcy. Also, if a management fee is subordinated, it could be viewed as a dividend rather than as an expense for tax purposes.

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[26] The speaker may have been unaware that certain mainstream securitizations (1) transfer only a trifling a degree of risk (2) do not transfer control in a practical sense, (3) do not reduce the sponsors' borrowing costs, and (4) are motivated primarily to obtain funding that is not reported as debt.

Gross management fees for operating asset deals are in the 20% ballpark, ±10%. For film deals, distribution fees are in the range of 12% to 15%.

Operating asset deals generally use a combination of four mechanisms to improve the credit quality of their securities: (1) overcollateralization, (2) triggers, (3) reserves, and (4) structured repayment profiles. Modeling overcollateralization in an operating asset deal requires modeling the operating aspects of the subject business. In essence, it seems as though the process essentially reduces to a classical exercise of making financial projections. In the context of a film deal, a trigger can be based on the reliability of the sponsor's past estimates of actual cash flow on the subject films. If past estimates were overly optimistic (*i.e.*, too high), then the advance rate for new films or new receivables would be reduced.

When a deal breaches triggers, several remedies are possible. One possibility is to accumulate reserves. A more drastic remedy is to start rapid amortization of the securities.

About half of the attendees at the session believe that acceleration or other remedies based on financial covenants or ratings of the manager should be *mandatory*. Almost as many believe such trigger events should be used selectively. Fewer than 10% of the attendees feel that such triggers or acceleration events should not be used. A key element missing from the question is the nature of the remedy. The split views among the attendees may reflect different presumptions about what the remedy for trigger breach would be.

Inter-creditor agreements come into play when a company securitizes a large proportion of its operating assets. If a company is in financial distress, its other funding sources may be jeopardized. The loss of other funding could kill the company and impair its ability to service a deal. Each group of the company's creditors reasonably should expect to get paid from the assets or activities that it financed, but not from other assets or activities.

11:40 a.m. – Selected FASB Activities (Leslie F. Seidman)

Leslie Seidman was appointed to the FASB in July 2003. Therefore, she was not one of the members who voted for FIN 46[27] or for re-examining FAS 140.[28]

FASB is the organization that establishes U.S. accounting standards. The goal is to improve the transparency of financial reporting. FASB is independent, private sector, and not-for-profit. The SEC and the AICPA officially recognize FASB's standards. FASB has seven members. At least four must vote in favor of a standard for it to become policy.

Two key developments in 2003 were (1) FIN 46 and "variable interest entities" and (2) the proposal to amend FAS 140 and its focus on securitizations. FASB created the term "variable interest entities" in FIN 46 to deploy a new consolidation paradigm.

A major area of focus in financial reporting is off-balance sheet transactions. Recent corporate scandals have cast a spotlight on such transactions. Questions were raised about both the adequacy of existing standards and corporate compliance with those standards. FASB has tried to improve transparency of such transactions.

[27] Financial Accounting Standards Board (FASB), *FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51* (17 Jan 2003) (available at http://www.fasb.org/fint46.pdf); FASB, *FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51* (revised Dec 2003) (available at http://www.fasb.org/fin46r.pdf).

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

Current Accounting Landscape	
Type of entity	**Accounting Policies**
entities with voting equity and adequate capital	ARB 51
QSPEs	FAS 140, FIN 46
entities that lack meaningful voting rights or adequate capital	FIN 46

QSPEs are a special class of entities involved with transfers of financial assets. ARB 51 addresses the traditional case involving regular corporate subsidiaries.[29] FIN 46 was created as an interpretation of ARB 51 to address the situation where an entity lacks meaningful equity voting rights or is inadequately capitalized.

FIN 46 requires the "primary beneficiary" of a "variable interest entity" to consolidate the entity on its financial statements. The primary beneficiary is one that holds "variable interests" that expose it to a majority of the expected losses or expected residual returns.

A variable interest is an interest that absorbs economic variability in the entity. Examples include subordinated liabilities, derivatives (*e.g.* interest rate swaps), and guarantees. Any liability issued by a securitization entity has the potential to absorb losses.

FIN 46-R (the revised version of FIN 46 that was published in December) removed the bias that would have made all asset management fees count as variable interests. FIN 46-R changed ¶ 8(c) and ¶ 8(d). If a management contract meets certain criteria, the full amount of the management fee does will not count as a variable interest. However, the variable portion of a management fee still may count as a variable interest.

FAS 140: FASB issued an exposure draft in June 2003.[30] Subsequently, FASB returned to its prior approach. It is going to rely on ¶ 9 as the criteria for transfer.[31] There will be new explicit limits on a transferor bypassing a QSPE and dealing directly with the beneficial interest holders. In re-issuance structures that involve a QSPE, no entity will be permitted to have a combination of interests that give it a non-trivial advantage or effective control. But some open issues remain: One is the treatment of transfers of partial interest in financial assets. That issue potentially affects loan participations. Recently another new issue arose concerning whether a consumer's right of setoff on a transferred

[29] Committee on Accounting Procedure, American Institute of Certified Public Accountants, *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (1959).

[30] FASB, *Exposure Draft, Proposed Statement of Financial Accounting Standards Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140* (10 Jun 2003) (available at http://www.fasb.org/draft/ed_qspe.pdf)

[31] FAS 140 ¶ 9 states as follows:

> **Accounting for Transfers and Servicing of Financial Assets**
>
> 9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than **beneficial interests** in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:
>
> a. The transferred assets have been isolated from the transferor — put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 27 and 28).
>
> b. Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29−34).
>
> c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47−49) or (2) the ability to unilaterally cause the holder to return specific assets, other than through a **cleanup call** (paragraphs 50−54).

loan undermines the sale character of the transfer. Another tough area with which FASB is grappling is the limitation on QSPEs' ability to hold derivatives.

For 2004, the pipeline of key issues and projects includes Phase 2 of the liabilities and equity project.[32] Convertible debt and put-able stock create issues here.

1:45 p.m. – Mortgage Update

The convergence of the sub-prime and alt-A areas is a key trend. Collateral backing deals from RFC's RAMP program contains a large portion of so-called "alt-B" collateral.

Key trends in 2002 were an increase in average FICO scores[33] of sub-prime mortgage pools and an increase in the proportion of adjustable rate loans. Likewise, loan-to-value ratios (LTVs) are rising slightly and the share of limited documentation loans is rising. The proportion of first lien loans with "silent seconds" (*i.e.*, simultaneously originated second-lien loans) is rising and the share of sub-prime loans being made to first time homebuyers is increasing. First-time homebuyers are riskier than other borrowers because they do not have experience with handling the obligations of home ownership and mortgage payments.

One issuer changed its definition of "cash out refinancing" and another changed its definition of "full documentation." Definitional drift is a potential problem. However, market participants now seem to be smart enough to see through definitions to the underlying facts.

One panelist feels that automated appraisals are not as reliable as traditional appraisals (which include an inspection of the home's interior) or drive-by appraisals. A second panelist takes the opposite view. He feels that automated appraisals are very useful tools and allow a lender to focus attention on directing its scrutiny to the riskiest loans. A good use of automated appraisals is for quality control rather than for primary appraisals. Market participants need to remain mindful that traditional appraisals can be biased if a lender or mortgage broker pressures the appraiser to deliver a specified value so that a loan can close. The biggest shortcoming of an automated appraisal is that it does not reflect the condition of the subject property.

Lenders need to focus closely on compliance with predatory lending laws. Gauging compliance with predatory lending laws has both qualitative and quantitative aspects. For example, some laws require that a borrower achieve a "tangible net benefit," which can be hard to ascertain.

Predatory servicing was a hot topic during the year. Fairbanks experienced a wave of negative publicity.[34] The whole industry has now been exposed to greater scrutiny. The interests of a special servicer should be aligned with investors' interest. The servicing process needs to have quality control and audits.

According to one panelist, underwriting of ARM loans takes into account the fully indexed interest rates. Some lenders use a hypothetical rate shock in calculating debt ratios. Another panelist asserts that most ARM loans are underwritten to their initial interest rates and that this partly explains why the default rate for ARMs is 15% to 20% higher than for similar fixed-rate loans. Interest-only loans are riskier than ARM loans and need 15% to 20% more credit enhancement, all other things

[32] *See generally* http://www.fasb.org/project/liabeq.shtml.

[33] Generic credit scores based on data compiled by the national credit bureaus are often called FICO scores. The acronym FICO is derived from the name "Fair Isaac & Co.," which produces the statistical models that generate the credit scores. Many lenders use FICO scores as part of their lending processes and some incorporate FICO scores as part of their own proprietary scoring models. FICO scores are optimized to rank the relative risk of consumers defaulting or becoming seriously delinquent on their obligations over a two-year horizon.

[34] *See, e.g.,* Federal Trade Commission, *Fairbanks Capital Settles FTC and HUD Charges*, FTC press release (12 Nov 2003) (available at http://www.ftc.gov/opa/2003/11/fairbanks.htm); *United States vs. Fairbanks Capital Corp.*, No. 03-12219 (D. Mass.)

being equal. IO loans seem to make more sense in the prime mortgage area than in the sub-prime mortgage sector.

Rising interest rates could reduce excess spread in sub-prime mortgage deals. Moody's stresses interest rates with a 300 bps shock. Moody's is considering adopting a stress case where interest rates rise 425 basis points over four years.

An important structural trend in 2003 was the growing use of fixed-rate loans to back floating-rate certificates. Moody's has a concern about this because excess spread can be squeezed if interest rates rise.

2:30 p.m. – Credit Card Update

A big challenge to credit card securitization earlier this year was the exposure draft of FAS 140, which might have eliminated off-balance sheet accounting treatment for credit card securitizations. A second challenge during the year was the OCC's action in changing the servicing fee on the Spiegel/First Consumers deals.[35] Last year also brought a huge wave of consolidation in the credit card sector.

FAS 140 (and its predecessor, FAS 125) have been subjected to many amendments.[36] One issuer has become accustomed to continual change. The latest word seems to be that the FASB does not intend to preclude credit card master trusts from qualifying as QSPEs. FASB seems not to view reissuing term credit card deals (or even ABCP) as a re-issuance of beneficial interests. A question remains on how the FASB will view extendible short-term note programs.

Industry consolidation will probably continue for the next few years. The same forces that pushed consolidation of consumer finance companies through the 1980s and 1990s will push consolidation in the credit card sector. Consolidation is a positive force because larger players can achieve greater economies of scale and stronger brand recognition. It will become increasingly difficult for smaller credit card issuers to survive on a landscape dominated by super-large players. The rating agencies may be promoting the wave of consolidation by giving little (or less) credit for continuing purchases (*i.e.*, maintaining the "open to buy" or the so-called "non-declining pool" assumption) on credit card ABS issued by smaller players.

On the other hand, distressed credit card portfolios probably will not get swept up in the wave of consolidation. Many market participants have a keen interest in distressed cards. A problem with the NextCard[37] portfolio is that the accounts and receivables were tied up in securitizations and could not be extracted.

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[35] In the matter of First Consumers National Bank, Beaverton, Oregon, Consent Order, Dept. of the Treasury, Office of the Comptroller of the Currency (15 Apr 2003) (available at http://www.occ.treas.gov/ftp/eas/ea2003%2D39.pdf); Spiegel, Inc., Current Report on Form 8-K, Exhibit 99-2, Independent Examiner's Report (12 Sep 2003) (the Independent Examiner's Report was prepared in connection with *S.E.C v. Spiegel, Inc.*, No. 03 C 1685 (N.D. Ill. 5 Sep 2003)).

[36] *See* note 28 *supra*.

[37] NextCard issued two series of securities from its credit card master trust, series 2000-1 in December 2000 and series 2001-1 in May 2001. In the fall of 2001, the regulators forced NextCard to reclassify as "credit losses" certain losses that it had previously booked as "fraud losses." The reclassification of losses made NextCard's securitizations ineligible for "low-level recourse treatment" under bank capital regulations. The result was that, as of 30 September 2001, NextCard became a significantly undercapitalized institution.

NextCard's situation failed to improve over the following months and, on 7 February 2002, the Office of the Comptroller of the Currency (OCC) closed the bank and appointed the FDIC as receiver. The FDIC promptly notified the trustee for NextCard's securitizations that an "early amortization based solely on the insolvency or the appointment of the FDIC as receiver is not enforceable against the FDIC." The FDIC's stated purpose in not allowing the early amortization was to "buy time and find a buyer for the portfolio."

Ironically, the NextCard deals entered early amortization anyway in July 2002. Weak performance of the underlying portfolios tripped the main performance-based trigger. The FDIC responded immediately by shutting-off the accounts. That is, cardholders could no longer use their cards to make purchases. After the FDIC closed the accounts, the "good" cardholders paid-off their accounts, leaving only the weaker credits in the pool.

When card issuers merge, combining their actual operations is a daunting task. Management must have the skill to determine which of the two merging operations is stronger in each area and to embrace the stronger practice. Also, merging securitizations can be a challenge. A credit card ABS issuer must communicate with investors so that they will understand what is happening to their master trusts because of the merger.

One major credit card ABS issuer carefully integrates purchased portfolios into its existing master trust. However, in doing so, it carefully scrutinizes the performance of the purchased portfolios because it does not want to jeopardize the broad market acceptance of its main master trust. The issuer also maintains a separate master trust for financing acquired portfolios that do not qualify for the main master trust. The separate master trust for acquired portfolios issues variable funding notes, which are financed through ABCP programs.

Credit card ABS issuance probably will grow slightly in 2004. Many credit card ABS are maturing (and will need to be refunded) and the Sears portfolio likely will be the source of some issuance (even after having been bought by Citi). Additionally, organic portfolio growth likely will contribute to rising issuance.

Investors are more confident because of the strong economy. However, the prospect of further regulatory actions, as in the Spiegel/First Consumers case, is a worry. Investors are also concerned about credit cards co-branded with airlines that may be in financial distress. Investors want more static pool performance data and they want breakdowns of FICO scores in securitized portfolios.

3:45 p.m. – Auto Update

One "Big Three" captive finance company provides a wide spectrum of lending programs for its dealer community and for its consumers. The programs must always make economic sense, in that the finance company must try to make a profit to pay a dividend back to its parent. The servicing model relies both on technology and on judgment. The company has a servicing portfolio of more than $180 billion and uses securitization in conjunction with traditional corporate finance tools.

A stand-alone specialty finance lender focuses on financing used cars. A substantial portion of the auto loans made by the stand-alone lender is made through franchised dealers. The company's loan underwriting relies primarily on a computer score card and the company relies very heavily on securitization for its funding. The company experienced liquidity stress last year when losses increased because of declining used car values. The increased losses breached triggers in the company's outstanding securitizations, cutting off cash flow to the company. As a result, the company reduced its reliance on securitization as a funding source and has heightened its servicing efforts to curtail losses. Also, the company is now targeting customers of higher credit quality in order to reduce losses on new originations.

The Big Three captive finance company plans total 2004 security issuance to be between $20 billion and $25 billion, including both straight debt and ABS. For 2004, it plans to issue $10 billion to $15 billion of auto loan ABS. The company also has an ABCP program and an extendible note program for floor plan assets. It has strong liquidity in the form of facilities with ABCP programs and it can sell whole loans as well.

Delinquencies and charge-offs grew dramatically. As noted in the text, the FDIC never found a buyer for the NextCard portfolio. The mezzanine and subordinate tranches of the NextCard deals have been downgraded into deep speculative-grade territory:

Ratings of NextCard Credit Card ABS

Tranche	A	B	C	D
Moody's (1/17/03)	Baa3	B3	Ca	C
S&P (5/2/03)	BBB-	B-	CCC-	CC

In rating auto ABS, a rating agency should consider the financial strength of the seller/servicer. Smaller and unrated seller/servicers can be vulnerable if they rely on too few sources of funding. Over-reliance on ABS is a red flag. The use of a hot backup servicer can address a variety of problems; on the other hand, the presence of a hot backup servicer suggests that the original servicer may not be around for the life of the deal.

It is difficult to predict what level of subvention the automakers will use in 2005. Subvention can be key for supporting new vehicle sales. Several years ago, subvened loans were made only to the highest quality borrowers. Today, a greater proportion of all borrowers can get deeply subvened loans.

Longer loan terms increase the risk of newer auto loans. The Big Three captive finance company contends that it restricts the availability of loans with "very long" terms to customers of the highest credit quality. [It's hard to believe this point.]

Recoveries on repossessed cars have been roughly 40%. This reflects the weakness of the used car market and is lower than the 50% recovery rate of a few years ago. The consensus expectation is that recovery rates will remain stable, but weak, for the foreseeable future.

Subordinate tranches of auto ABS are very hot right now. Investors are drawn to seasoned subordinate pieces that both (1) have a performance track record and (2) benefit from de-leveraging. The bond insurers are taking some of the opportunities (risks) that regular investors would be willing to take if they were available.

4:30 p.m. – Student Loan Update

A few years ago, capital was leaving the student loan industry. Today, capital is returning to the industry. Two companies in the industry have done IPOs in the past year. The capital inflow to the industry (arguably the industry's re-capitalization) has both benefits and risks. The state of the industry is a factor in the credit analysis of student loan ABS. Each ABS issuer's individual business model is a factor in rating its deals. The recent increase in student loan ABS issuance is a positive development. The greater the number of rated entities in the industry, the better. In addition, transparency is improving. Sallie Mae has set the standard for reporting.

On the other hand, the recent influx of capital to the student loan industry raises the risk that some of it will not be used wisely. Lenders could be making riskier loans, which would be prone to higher default rates. It is somewhat unclear how the new crop of consolidation loans will perform.[38]

Twenty five percent of defaults occur because a student does not graduate.

One institutional investor analyzes student loan ABS in the same manner that it analyzes other ABS deals. First, it considers the *participants* in a deal. The investor considers whether the originator is organized for profit or not-for-profit; whether it is profitable; whether it has an established track record; and whether it has other sources of funding. Next, the investor considers the servicer. Servicing is key because it preserves the integrity of the government insurance. The investor wants to examine a SAS 70 report[39] (on controls and operations) of the servicer and any available third party audits. The institution considers the servicer's claims rejection rate. Third, the investor considers the guarantor. It makes sure that the guarantor is approved by the Department of Education and that its claims rate is less than 5%.

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

[39] American Institute of Certified Public Accountants, Reports on the Processing of Transactions by Service Organizations – Statement on Auditing Standards No. 70,

After considering the participants to a deal, the institution considers the *collateral*. The mix of loan type is important. There can be loans to students in different types of schools (2 year vs. 4 year) and loans from different programs. The repayment status of the pool (levels of deferment, forbearance, and delinquencies) is also important. All these elements affect the level of excess spread and the necessary level of credit enhancement for the unguaranteed portion of the pool.

Structural considerations are the third major area of analysis. Deals may use a senior-subordinated structure and may finance the loans at a premium. They may use a wide variety of credit enhancement devices and may use derivatives (such as swaps).

One panelist expects state agencies to become a larger presence in issuing student loan-backed securities. Traditionally those players were active in the auction rate market but they did not issue ABS. Thus, the state agencies often do not have long-term performance data on their loan pools, which may be an obstacle to their issuance of ABS.

A joke in the student loan business is that once you get in you cannot get out. The business is somewhat unusual because it is about making unsecured loans with people who have no income and no credit history. Thus, the student loan industry relies on the continuing availability of the government guarantee/re-insurance. The industry is waiting for re-authorization of the Higher Education Act,[40] which would implement a routine extension of the FFELP program.[41] Lobbyists are pushing for higher loan limits for freshman and sophomores. On the other hand, some politicians are pushing back to help control spending. Another lobbying effort is for expanded repayment options for borrowers, such as extended repayment terms for those with large loan balances. In addition, some politicians are pushing loan forgiveness for borrowers who take "social purpose" jobs.

Tuesday, 27 January 2004

8:15 a.m. – Investors' Perspective

The ABS market experienced strong growth all through the 1990s but the pace of downgrades started to increase substantially in 2001. During the market's first 15 years, the only two major blow-ups were *Towers Financial* and *Commercial Financial Services* (*CFS*).[42] More recently, there has been an increasing number of problems. Now, we can consider how well the market has done over the past few years and give ourselves an "ABS Report Card."

<u>Issuers</u>: The panel gives issuers an overall grade of "improving" (*i.e.*, "average"). One investor is dissatisfied with issuers because they have not provided better disclosure about their underwriting standards and about FICO score distributions. In addition, issuers have not yet embraced the "best practices" standards promulgated by the ASF. The concern is that the ASF may be selling "vaporware" to investors if issuers do not come on board with best practices. So far, not even one issuer has adopted one of the ASF's best practices standards.

A second investor shares the concerns of the first but is willing to give home equity ABS issuers a higher grade for the improving credit quality (higher FICO scores) of their underlying pools. The investor observes that home equity ABS credit quality may decline in 2004 as issuance volume shrinks.

A third view is more positive. Home equity ABS issuers have delivered good returns to ABS investors and have generally met investors' needs.

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[40] 20 U.S.C. § 1001 *et seq.*

[41] *See* note 38 *supra*.

[42] For a discussion of the of the Towers Financial and CFS transactions, *see* Mark Adelson et al., *ABS Credit Migrations*, Nomura fixed income research report at 20-22 (updated 5 Mar 2002).

The audience gives issuers an average grade of "B."

Bankers: The panel gives bankers an overall grade of "improving" (*i.e.*, "average"). Bankers are very good at providing data to investors. They are very responsive to investor questions and have shown a strong willingness to work with investors in structuring deals. One area that is a problem is the new issue syndicate process. There is no consistency in how long new deals are left open (*i.e.*, how much time investors have to place their orders for new issue ABS). The industry needs an electronic platform for secondary trading. It is impractical for investors to work with separate inventory sheets in Excel from each dealer. An electronic secondary trading platform would improve transparency of pricing. Another problem is that bankers too often will not bid on securities that they previously sold if the securities have become distressed.

One panelist notes that the interests of a mezzanine holder and the residual holder in a given deal may be in conflict. Some of the "abuses" of the CDO market, such as ascribing par value to bonds purchased at a deep discount, are potentially present in home equity ABS. This happens in home equity ABS when loans that would have a market value of only 50% or 60% of par are counted at 100% in the pool.

The audience gives bankers an overall grade of "C."

Rating Agencies: The panel gives rating agencies an overall grade of "not satisfactory." Rating agencies have let too many problems slip through undetected. They have failed to spot structural problems that have caused deals to get into trouble. Rating agencies have not been sufficiently sensitive to servicing issues. On the other hand, "most of the time" the rating agencies do a good job.

Another panelist expresses concern that rating agencies have failed to keep their methodologies up-to-date. For example, the rating agencies should aggressively stress interest rates when they rate home equity ABS. Rising rates would compress excess spread and could result in too little credit enhancement. The panelist proposes using an "option adjusted" approach to stressing interest rates in home equity ABS transactions.

The other side of the coin is that rating agencies should not have to bear the whole responsibility for policing the securitization market. Rather, all groups of market participants should participate in the policing role.

Another panelist feels that it is entirely improper to view rating agencies as police because they make the vast majority of their money from issuers. Investors are kidding themselves if they think that rating agencies – whose income is roughly proportional to the volume of rated issuance – will stand tough on issues that would reduce issuance volume.

The CDO market provides an example of a systemic failure by the rating agencies. They failed to understand some of the relevant factors, including the degree of correlation among the underlying assets. Rating agencies have also finally come to realize that deals are more sensitive to the business fortunes of their issuers than had been previously thought.

The audience gives rating agencies an average grade of "C."

Trustees: The panel gives trustees an overall grade of "not satisfactory." Panelists have widely divergent views about trustees. Some found trustees to be generally helpful and responsive and some did not. One problem is that issuers decide what level of services trustees provide in a given deal. The fact that trustees receive a small fee on each individual transaction does not relieve them of responsibility. Competitive market forces determine the fees that trustees charge.

ABCP Program Sponsors: The panel gives ABCP program sponsors an overall grade of "satisfactory." Sponsors deserve credit for providing a strong flow of product for investors. The major difficulty is that periodic reports are hard to understand and do display information in a manner that is consistent with the related liquidity facilities.

Investors: The panel gives investors receive an overall grade of "B+." Investors are guilty of not being sufficiently demanding. Investors need to recognize the information that they need and to demand it from issuers and bankers.

9:00 a.m. – FIN 46, FAS 140 and Other Accounting Issues

FASB issued FIN 46 in January 2003 and issued a comprehensive revision (FIN 46-R) in December 2003.[43] The most significant change in FIN 46-R was the removal of the requirement to treat the full amount of CDO management fees as a "variable interest." Just the variable component of CDO manager fees must be counted. Interestingly, FIN 46-R may permit a bank to de-consolidate an SPE used for issuing trust-preferred securities, while consolidation seemingly was required under the original version.

FIN 46-R emphasizes the use of a qualitative assessment for determining whether an entity is a "variable interest entity" (VIE). If it is not possible to qualitatively determine whether an entity is a VIE, then a quantitative approach must be tried.

FIN 46-R leaves many unanswered questions about how to calculate "expected losses" and "expected residual returns." The calculation is made more difficult because of continuing uncertainty about identifying the variable interests.

There are different proposed ways of calculation "expected losses" and "expected residual returns." The "top down" approach is to start with the cash flow waterfall of a deal and to model a whole entity. The "bottom up" approach is to start with the cash flow from the underlying assets.

There are conflicting views about the treatment of interest rate swaps as variable interests. A swap provider who receives fixed and pays floating arguably has a variable interest because the "fair value" of the fixed cash flow fluctuates as rates move. On the other hand, a swap provider who receives floating and pays fixed arguably does not hold a variable interest because the fair value of the floating cash flow arguably does not fluctuate.

FIN 46-R might affect asset-backed commercial paper (ABCP) conduits that have sold "expected loss tranches" as a means of avoiding consolidation with their sponsoring banks. The office of the Chief Accountant of the SEC recently expressed a positive reaction to the concept of expected loss tranches, but also noted the need to scrutinize an actual case and not merely an abstract idea.

In the hypothetical case of back-to-back swaps, one proposed approach is to consider whether there is a *de facto* agency relationship (or some relationship other than an arms length commercial relationship) between the counterparties on the first and second swaps.

The new exposure draft to FAS 140 has been delayed.[44] New issues keep cropping up and causing delays. The treatment of mortgage servicing rights is such an issue (whether to give them "market value" treatment or "lower of cost or market" treatment). There is a question about whether mortgage servicing rights should be treated as financial assets at all. There is also a question about the treatment of derivative instruments embedded in securitizations (a coordination issue with FAS 133). There is an issue about a depositor's potential right of set off with respect to an asset transferred by a financial institution.[45]

[43] *See* note 27 *supra*.

[44] *See* note 28 *supra*.

[45] *See Hibernia National Bank v. FDIC*, 773 F.2d 1403 (10th Cir. 1984); *FDIC v. Mademoiselle of California*, 379 F.2d 660 (9th Cir. 1967); *Seattle First National Bank v. FDIC*, 619 F.Supp 1351 (W.D. Okla. 1985); *Northern Trust Co. v. FDIC*, 619 F.Supp. 1340 (W.D. Okla. 1985); *Chase Manhattan Bank v. FDIC*, 554 F.Supp. 251 (W.D. Okla. 1983).

More broadly, FASB is wrestling with whether there is a difference between an "undivided interest" and a "beneficial interest."[46] FASB seems to be reaching toward greater degrees of legal isolation and legal certainty as a condition for achieving derecognition.

FASB seemingly has placed paramount emphasis on legal isolation of the transferred assets. If lawyers will opine that assets have been isolated, the transferor can even provide a guarantee on the assets.

The original exposure draft of the FAS 140 revision has onerous limitations on the re-issuance of beneficial interests. However, the FASB has given solid indications that it did not intend to attack revolving master trust structures.

The original exposure draft would have required two-step transfers (with the second one to a QSPE) in order to achieve sale treatment. It is not clear what the next version will bring on this score.

A new proposed amendment to IAS 39 considers whether serving has been transferred. IAS 39 uses a "three bucket" approach: (1) full derecognition, (2) no derecognition, and (3) partial derecognition based on "continuing involvement."[47]

Panelists have divergent views about the prospects for U.S. and European accounting standards to converge. One feels that, in the long-term, the U.S. will probably move away from the QSPE (qualified special purpose entity) model of FAS 140 and toward tougher standards for derecognition. Another feels that although the goal of accounting should be to make financial reports meaningful, fully grossing up corporate balance sheets (*i.e.*, keeping securitized assets on a company's financial statements) would not be a good solution. Another view is that it will be a very long time before the basic U.S. framework changes. Whatever results from U.S.-European harmonization should not be more stringent than existing U.S. standards. However, the international community just does not accept the QSPE concept. One panelist would favor a "master linked presentation."

10:15 a.m. – Securities & Exchange Commission Update (Jeff Minton)

All market participants want the securitization market to function well.

There is an ongoing staff review of 1934 Act[48] filings for ABS transactions. The SEC's industry group that covers ABS has been reviewing a significant number of ABS issuers and particularly 10-K filings by ABS issuers. The certifications required by the Sarbanes-Oxley Act[49] are an area where the SEC staff has some concern. The staff's 10-K review encompassed ABS from all asset classes. The staff found an unacceptable rate of failures to file 10-K reports. A key point: ABS issuers are subject to the 1934 Act and must file reports (even though some may suspend their reporting obligation after one year). ABS issuers are allowed to use modified reporting, based on no-action letters that have been issued to them or to others who are similarly situated. The SEC staff found a surprising lack of compliance with respect to both content and timeliness.

The SEC staff has found problems in virtually all the ABS-related 10-K filings it has reviewed. This is astounding. One key problem area is issuers' failure to file servicers' compliance reports or accountants' reports. If a deal has multiple servicers, the master servicer should provide the servicer's compliance report.

In order to enforce the 1934 Act filing requirements, after 31 January 2004, the staff will delay effectiveness of new shelf registrations of ABS issuers who are delinquent on their 1934 Act filings.

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[46] *See* FAS 140 ¶ 364.

[47] International Accounting Standards Board (IASB), *International Accounting Standard 39, Financial Instruments: Recognition and Measurement* (rev. 17 Dec 2003) (*see generally* IASB web site at http://www.iasb.org.uk).

[48] Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.*

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

An ABS issuer should specifically identify the no-action letter that it has relied on in preparing its 10-K.

The SEC staff has recently been disappointed to find that sales desks at many securities firms routinely distribute materials designated "for internal use only" and so-called pre-sale reports. This practice occurs not only in connection with sales of ABS, but also with respect to sales of corporate bonds. This practice is a violation of 1933 Act§ 5 and gives an investor a put on the security for one year.

A securities dealer cannot disclaim responsibility for the content of computational materials. Computational materials are prospectuses under the 1933 Act. Disclaimers are ineffective to insulate dealers and issuers from 1933 Act liability.

Every distinct ABS trust is a unique issuer and must make its own filings. Each trust must have its own serial number and be uniquely identifiable.

The Rulemaking Project: The staff's philosophy is to examine the current structure, to codify what works, and to move forward from there. A large part of the current problem is the absence of rules to guide securitization issuers. The Commission last acted in 1992, with the definition of "asset-backed security."[50] The goal is to craft rules that are specific enough to give issuers guidance while also giving investors confidence. Additionally, the staff wants the new rules to provide flexibility, which is the hallmark of securitization.

As noted above, there will be a move to link timely 1934 Act reporting to the use of Form S-3. The present definition of "asset-backed security" is solid and should work for some time to come. However, it might be expanded to include more kinds of deals.

A core objective is to establish a principles-based set of disclosure rules. Last year the staff issued a report primarily directed at disclosure of GSE MBS and private label MBS.[51] It is not clear how detailed the new rules will be for other ABS asset classes. One problem with many prospectuses nowadays is that they contain mostly legalese boilerplate.

Prospectuses probably need to have more disclosure about the parties involved (*e.g.*, seller and servicer) and need to reflect the newly acknowledged linkage between the financial health of a seller/servicer and the performance of its deal.

In a 10-K report for an MBS issuer, the accountant's report generally refers to the USAP[52] for mortgage bankers as the applicable standard for measuring compliance with minimum servicing criteria. However, outside the mortgage setting, there is not a uniform standard. Defining the role of the accountant will be a key focus item in the rulemaking project. The SEC may consider a significant substantive expansion of the scope of an accountant's review of servicing activity.

The staff has started several enforcement actions regarding ABS.

On December 2, representatives of The Bond Market Association (BMA) and of the American Securitization Forum (ASF) met with the SEC staff to discuss communication issues. A key issue is that analytics are now done by Bloomberg and Intex, rather than by the issuer or the underwriter. However, the underwriter ordinarily supplies the file that defines the structure and the assets of a

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[50] *See* Securities Act of 1933 Form S-3, General Instruction I.B.5 (available at http://www.sec.gov/about/forms/forms-3.pdf), 17 C.F.R. 239.13(b)(5) (2003).

[51] Dept. of the Treasury, Office of Federal Housing Enterprise Oversight, and U.S. Securities and Exchange Commission, *Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Markets* (Jan. 2003) (available at http://www.ofheo.gov/Media/Archive/docs/press/mbsdisclosure.pdf and http://www.sec.gov/news/studies/mortgagebacked.htm).

[52] Mortgage Bankers Association of America, *Uniform Single Attestation Program for Mortgage Bankers* (1 Jan 1995)

proposed deal. Sometimes an underwriter supplies a ".cdi" file to an investor. Underwriters and investors would like investors to be able to get detailed loan-level data. The SEC staff understands these issues, but has not yet taken a position.

The Commission is expected to act soon to expand the 8-K reporting obligations for ABS issuers. In particular, ABS issuers will have to report extraordinary events.

11:00 a.m. – CDOs New Trends

CDO issuance in 2003 was larger in some key areas than in 2002. Issuance of multi-sector CDOs, commercial real estate CDOs and CDOs of CDOs all grew in 2003. Issuance of CLOs backed by *loans* (high yield or investment grade) grew. Issuance of CBOs backed by *bonds* shrank. Issuance of CDOs backed by middle market loans was flat.

New deals backed by high yield bonds are much stronger than older deals. The hard experience of recent years has forced issuers of newer deals to use lower leverage.

Defaults in the leveraged loan market dropped from a 7% rate at the start of 2001 to a rate of roughly 2% recently. The ratio of debt to EBITDA among high yield loan and debt issuers has declined significantly since 1987. It is now around 4×. CDO issuance should grow by about 17% in 2004. Growth likely will be driven by growth across all sub-sectors.

The use of short-term money market instruments to fund the most senior tranches is a strengthening trend. The funding cost is low. However, the equity of a deal bears the risk that the short-term paper cannot be rolled-over. A key example is the new H2 deal, which uses the repo market for short-term financing.

In some deals, a senior tranche is divided into a mezzanine triple-A tranche and a super-senior tranche, which may become the subject of a credit default swap.

CDO equity has been packaged for high net worth individuals. Sometimes it is combined with a form of principle protection. Underwriters sometimes package together the equity from many CDOs that they have underwritten. There is a huge hunger for yield from Asia and Scandinavia. Pension funds with significant unfunded liabilities are drawn to the yield of CDO equity.

The most value and the most volatility are likely to be in the mezzanine tranches. Such tranches are the most difficult to sell, but there are some investors who are comfortable in this area.

A bone of contention in some deals is the provision for de-leveraging the highest yielding classes if the issuer elects not to exercise an optional call. From the perspective of the senior holder, it may be distressing to cash distributions to subordinate holders just when the issuer has decided *not* to call the deal.

The rating agencies have done a good job in the CDO sector, especially for triple-A investors. The new restrictions imposed by the rating agencies, such as limitations on triple-C-rated buckets and limitations on discount securities, generally are positive for senior investors. On the other hand, the rating agencies should not impose restrictions that are so stringent that they prevent a manager from being able to exploit superior skills.

As long as market participants use credit ratings as a proxy for the probability of default in a CDO (instead of using market data, which may be more current and more accurate), there will always be an arbitrage in CDOs. It is encouraging that rating agencies have either purchased other firms (such as Moody's purchase of KMV) or developed their own market-based technologies to serve as a double-check on their ratings in the CDO context.

11:45 a.m. – Emerging Markets

The volume of Latin American cross-border deals increased by 45% in 2003. Much of the activity was from Brazil. Brazil is likely to be a key factor going forward. From an investor perspective, 2003 started slowly because it followed 2002, which had been a very rough year for Latin America (and 2001 had the been the year of the Argentine banking crisis). However, over the course of 2003, investors regained their comfort with Latin America. Low interest rates in the U.S. were a contributing factor in boosting U.S. demand for Latin American deals.

The proportion of cross-border deals that carried bond insurance dropped significantly in 2003. The likely reason is greater investor confidence and higher issuance volume, both driven by deals from Brazil.

Depending on the particular phase of the credit cycle, insurance company investors may have a much stronger appetite for wrapped deals than unwrapped deals. Some panelists speculate that a large proportion of the unwrapped issuance was purchased by CDOs.

The *Avianca* bankruptcy involved a challenge to the company's securitization of its airline ticket receivables.[53] The company filed for bankruptcy protection in the U.S. and advanced two theories for why the securitization investors should not receive future cash flows. The first theory was that there had not been a true sale. The second theory was that the whole securitization transaction was an executory contract that it could reject.

Myths about the *Avianca* case: The Avianca deal represented a flaw of structured finance technology. All future flow structures have ratings that are dependent on the ratings of the related corporate issuers. The rating of the Avianca was explicitly linked to the company's rating. Additionally, the securitization creditors continued receiving payments for longer than other creditors.

The deal used a one-step transfer to a U.S. trust. It should have used an offshore entity. Doing so might have prevented the applicability of U.S. law.

Avianca was eligible to file as a debtor under the U.S. bankruptcy code because it had substantial operations in the U.S., including 20 employees and real estate. Future flow deals by foreign banks generally do not involve a sponsor that can be a debtor under the U.S. bankruptcy code.

In a future flow deal, § 552 of the bankruptcy code limits an investor's security interest in future assets. This means that there is much greater reliance on achieving a true sale in a future flow deal than in other securitizations.

The presence or absence of a difference between a deal's rating and the rating of the related corporate sponsor is an indication as to whether the deal is a true structured deal or just a disguised corporate debt deal.

PDVSA's (Petróleos de Venezuela S.A.) output dropped from roughly three million barrels per day to just 25,000 barrels per day because of labor strikes. Even so, PDVSA's securitizations backed by forward delivery contracts did not default because the deals had ample reserve funds. A key lesson is that no matter how strong the structure, it cannot protect against fundamental shocks or deterioration of the corporate credit. Reserve funds provide a strong safety net that can keep a deal from defaulting even when the sponsor encounters a hiccup.

Export deals (*e.g.*, a deal backed by receivables from oil exports) are inherently more susceptible to diversion risk than the financial flow deals (*e.g.*, a deal backed by overseas worker remittances to their home country).

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[53] *See generally* Gregory Kabance et al., *Under Pressure: Structured Transactions in Emerging-Market Stress—Update 2003*, Fitch special report, at 12 (5 Aug 2003)

Currency risk in cross-border deals is a tough issue. Cross-border deals from Chile and Mexico will likely occur in 2004. One investor takes the view that it will only purchase "existing asset" deals (*i.e.*, deals where the assets are denominated in local currency) if they are wrapped by bond insurance.

Wednesday, 28 January 2004

8:15 a.m. – Economist Update

The majority of the audience for the session expects the yield on the 10-year Treasury note to be in the range of 4.25% to 4.75% by the end of 2004.

This year (2004) will be a year of good growth. The recovery appears secure. The economy really is out of recession. The 8%+ GDP growth in the third quarter of 2003 was a firm indication. Businesses are back in balance; they are not running on borrowed money. Household spending is likely to slow.

The Federal Reserve Board is unlikely to raise interest rates until 2005, or later. There is spare capacity in the economy and the Fed would not likely tighten until the excess capacity is absorbed. The Fed has embraced a "reactive" rather than "preemptive" posture with respect to monetary policy.

This year (2004) should be a good year for bonds. The speaker feels that the 10-year Treasury note should close the year at a yield of roughly 3.90%. The secular bull market for bonds is ending.

The dollar is likely to depreciate further, perhaps by as much as 30%.

The equity markets should perform well in 2004, with industrials outperforming consumer stocks because of the weakness in the household sector.

Most of the time, the private sector (both households and businesses) supplies funds to the credit markets. However, from the mid-1990s through 2003, the private sector was a net user of credit.

Companies can now finance their investments without borrowing. They are in a strong position. In contrast, the consumer sector – particularly the labor market – is weak. Real wage growth is very weak and is inversely proportional to the unemployment rate. On the other hand, tax cuts have provided a huge boost in consumers' real disposable income. But the effect of the tax cut will not extend into 2005. Home mortgage refinancing activity rose sharply during the low interest rate environment and it prompted consumers to withdraw huge amounts of equity from their homes. Consumers withdrew roughly $550 billion of home equity in 2003 and roughly $500 billion in 2002. The housing sector is in balance; there is not an overhang of unsold inventory.

The Fed is more interested in seeing interest rates move up than down. The main driver of inflation is the presence of spare capacity in the economy. Commodity prices and currency exchange rates are only secondary factors. When capacity utilization is high, inflation rises. Unit labor costs are falling, which is another expression of excess capacity.

It would take a year of GDP growth at 5% or two years of GDP growth at 4% for the Fed to tighten monetary policy.

The rising federal budget deficit likely will keep the yield curve steep. The deficit will pull long-term rates up while the Fed keeps short-term rates lower.

If the dollar strengthens substantially, it would hurt the current account deficit and would impede growth. Economists generally support the practice by U.S. companies of outsourcing some operations overseas because doing so "increases efficiency."

The Chinese economy has attracted more attention than it really deserves. It is an important factor, but not the most important one. The Chinese economy is one of the ones that benefits from the transfer of jobs from the U.S. A key issue concerning the relationship between the Chinese and U.S. economies is China's policy of pegging its currency to the dollar (1 U.S. Dollar equals roughly 8.3 Chinese Yuan Renminbi). The Chinese government must eventually abandon the fixed exchange rate policy.

9:00 a.m. – Research Panel Discussion

One panelist is optimistic about corporate bond spreads for 2004 and possibly into 2005. For relative value, the panelist favors subordinate tranches of student loan ABS deals and single-A-rated tranches of home equity ABS deals. He recommends trading down in credit and down in liquidity and he recommends issues from Advanta, WFS, and Capital One.

A second panelist has generally similar views. He expects spreads on below-investment-grade tranches to exhibit the greatest spread tightening. There is not much more potential for spread tightening in the areas that already have single-digit spreads. ABS spreads should not tighten through swaps or LIBOR. The way to get better value is to move toward non-mainstream areas. Sub-prime auto ABS could do well.

A third panelist expresses strong optimism about the consumer sector. The corporate bond sector is exerting a strong influence on ABS, driving ABS spreads tighter. On a relative value basis, the ABS market has probably reached fair value. Spread tiering is likely to diminish over the year. Investors can benefit from moving toward lower-tier names. Fixed rate home equity ABS should perform well in 2004. Structured finance CDOs are another way for investors to get exposure to the ABS market. It is very hard to identify any sectors that will bring problems. Even the manufactured housing sector is turning around, though investors need to be very careful and scrutinize every bond.

Credit enhancement for some triple-B-minus home equity ABS is too skimpy. The tranches are very thin and their excess spread could be squeezed if rates rise.

Rising rates could also pressure the ABS market by curtailing home price appreciation and by squeezing excess spread in credit card deals. However, rising rates are unlikely for 2004 (echoing the economists views from the previous session).

Off-the-run ABS sectors will be more active in 2004, particularly the intellectual property sector. In dealing with off-the-run sectors, market participants need to ask themselves how well they understand the underlying businesses and how well they know the issuers. An investor bears the ultimate responsibility for understanding the securities in which it invests. It is unfair to simply heap blame on rating agencies and trustees when something goes wrong in a deal.

Another panelist echoes the view that extra care must be exercised in dealing with off-the-run sectors. Understanding the subject industries is key. A third panelist favors wrapped deals from off-the-run sectors but urges caution in dealing with assets that require highly specialized servicing skills.

When a manufacturer and a finance company are linked (*e.g.*, an automaker and its captive finance subsidiary), investors must be wary that the manufacturer will dictate credit policy in order to boost sales. A captive finance company is not inherently problematic; rather investors must understand the parent manufacturer's business model and its potential impact on the subsidiary's securitizations. Investors should be careful with ABS from companies that rely on securitization as their sole or primary source of funding. However, the practical reality is that many small issuers are in exactly that situation.

Investors should be wary of situations where an issuer repurchases delinquent loans from its securitization pools. Loan repurchases are not a reliable form of credit enhancement and they can distort reported pool performance. Ideally, investors should receive reports that describe how a pool would have performed had loan repurchases not occurred.

The experience of the recent years has increased awareness about the degree of corporate risk embedded in ABS deals. One structural method that could partially mitigate corporate risk would be to establish triggers based on the performance of all loans originally included in a pool – including, particularly, loans that had been repurchased.

The new BMA guidelines for fixed income research may reduce communication between researchers and bankers. Some researchers expect that they will need to visit issuers separately from their bankers. ABS researchers no longer participate actively in road shows. One researcher feels that the BMA guidelines are too restrictive.

Spreads between triple-B-minus and triple-B-flat tranches have varied between 25 bps and 500 bps over the past 18 months. One view is that some triple-B-minus tranches are strong and that they are attractive at a current pick-up of roughly 175 bps. However, an investor must be wary that a security rated triple-B-minus could slip to double-B, in which case the investor might have to sell it at a loss. Another panelist favors triple-B-minus home equity tranches based on his positive outlook for housing in general. However, the "available funds" cap present in sub-prime mortgage deals is another risk for triple-B-minus tranches.

The present sub-prime mortgage structure that permits cash flow to mezzanine and subordinate tranches if asset performance meets certain tests (*i.e.*, triggers) is likely to continue. It is appropriate given the nature of the assets and the additional efficiency that the structure brings compared to what a simple sequential structure would provide. Auto ABS deals and CMBS deals generally use basic sequential-pay structures where mezzanine and subordinate tranches receive no cash flow until senior tranches are repaid. However, some newer auto deals use a pro rata structure.

A structure that provides for a rising servicing fee is a rational response to the recent problems that have surfaced with inadequate servicing fees (*e.g.*, Conseco, Spiegel-FCNB).[54] Obviously, the "standard" 2% servicing fee for credit card ABS was not the right answer.

Structured finance CDOs were built to provide liquidity, not to purchase overpriced assets. Some problems in the CDO sector can be ascribed to the purchase of assets at very wide spreads that suggested that the ratings on the assets might have been wrong.

It may not be possible to tell beforehand what the theoretically correct servicing fee would be to assure that a successor servicer could be found to take over a portfolio in a distress situation. The best that can be done at the inception of a deal is to pick a servicing fee based on reasonable estimates.

10:25 a.m. – Traders' Panel Discussion

The ABS market had a great year in 2003. Spreads moved broadly tighter, after having been generally wide for the prior two years.

One panelist notes that a few months ago he would have predicted a 15% decline in home equity ABS volume for 2004. However, in light of new expectations for generally stable interest rates, he no longer expects a reduction in volume. Auto ABS issuance should be strong in 2004. Mitsubishi will return. The Big Three could be a wild card because they have plenty of cash and, therefore, might not need to issue a large volume of securities. Credit card ABS issuance could be flat to slightly higher. Consolidation in the credit card industry likely will boost issuance.

Another panelist notes that foreign RMBS will be a bigger factor in the U.S. ABS markets, especially Australian and U.K. RMBS.

[54] *See* notes 18 and 35 *supra* and accompanying text.

Given the rally in corporate bonds, more crossover investors likely will buy ABS in 2004. They will likely be attracted to credit card ABS and auto ABS, which have less optionality (*i.e.*, negative convexity associated with prepayment risk) than mortgage-related ABS. The crossover corporate buyers may be drawn to lower-rated tranches.

The syndicate process for the ABS market is still evolving. New deals are heavily over-subscribed and often are sold out in just minutes. However, securities on bid lists sometimes take days to trade in the secondary market. Some paper, such as mainstream credit card ABS from major issuers, can be bid in minutes in the secondary market. However, bids on ABS from distressed issuers or backed by troubled assets take much longer. When a trader bids on such securities, he must individually model the deals and consider issues such as whether the servicing fee might be increased (as in Conseco MH deals and First Consumers credit card deals).

One panelist proposes a syndicate process where an underwriter shows a deal and announces price guidance but does not accept any bids until several hours later. Such a procedure would allow each investor to do the level of credit work that he feels is appropriate. On the other hand, such a procedure would exclude an investor who needs more than several hours to perform credit work for the deal. An answer for some investors is to submit an indication of interest "subject to credit work."

For mortgage-related ABS, the general practice is to price new issues to call. Dealers avoid pricing issues "to worst" (*i.e.*, the worst of call or maturity). One panelist says the call issue is subsumed within the issue of available funds caps and excess spread. The issue of pricing "to worst" is heightened in the case of last cash flow triple-A-rated tranches (because their weighted-average lives vary greatly depending on whether or not the issuer calls them).

What is the appropriate liquidity premium for home equity ABS issued from a dealer's shelf? In the past, the premium was 6 bps or 7 bps. More recently, the premium has been compressed and even disappeared. One panelist contends that there should not necessarily be any premium; rather, each deal should be priced by reference to the characteristics of its underlying collateral.

Fixed-rate collateral has increasingly been used to back floating rate home equity ABS, which creates additional basis risk in a deal's residual and increases the implicit cost of an available funds cap. One panelist feels that the recent rally in triple-B-minus and triple-B-flat tranches has ignored this risk. If a home equity ABS deal fails its triggers, the subordinate tranches will extend and become much more vulnerable.

NIMs[55] (net interest margin ABS) have rallied strongly over the past year. One panelist feels that there is room for NIMs to tighten further because of the improving economy.

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

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

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

There are important differences between NIMs today and those of several years ago. Today's NIMs are much safer because they include *prepayment penalties* on the underlying loans. If prepayments are faster than

Swap rates are a significant barrier for ABS spread tightening. It is unlikely that card and auto ABS spreads will tighten through swaps. Investors' cost of funds is a critical factor.

The concept of bankruptcy remoteness has been challenged in the card ABS area. NextCard[56] and Spiegel[57] are tough cases. The NextCard case was a unique situation. In other cases, such as NCFE,[58] the role of trustees has been called into question. Revolving structures, which necessarily involve pools that can change over time, require that investors really understand the assets.

The consolidation trend in the credit card sector is likely to continue. There are likely to be more retail card issuers in the market this year.

The off-the-run area of the ABS market has been besieged. The area is not likely to experience strong growth over 2004. The off-the-run area will not disappear, but it will not be a major factor.

Liquidity has returned to the manufactured housing ABS sector. Within 18 to 24 months, there ought to be increased consolidation and activity levels in this area. Moreover, the present overhang of troubled collateral will work its way through the system.

The problem with many of the distressed sectors, including aircraft, franchise loans, manufactured housing, and distressed credit cards, is that they are enormously labor intensive for investors and dealers. Even though there is a significant quantitative aspect to analyzing securities from the distressed sectors, the greater portion of the analysis must be based on judgment about the relevant credit fundamentals and about the outlook for the subject sectors. Investors, who commit resources to doing careful analyses, can find opportunities and can earn a return for their efforts.

Hedge funds have become a major group of ABS investors. More generally, the proportion of leveraged money invested in ABS appears to be rising. Additionally, some investors appear to be simply investing in the steepness of the yield curve.

One panelist favors foreign RMBS (*e.g.*, U.K. and Australian) as a strong relative value. He also favors distressed assets and distressed deals for investors who are willing to do the credit work. ABS are cheap compared to CMBS.

Another panelist favors off-the-run names and less-liquid names because of the improving economy. There is good value in the home equity sector; particularly in tranches with weighted-average lives of five years and longer. Premium-priced fixed rate home equity ABS offer opportunity because prepayments likely will slow when (if) rates rise later in the year.

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expected, cash flow from the prepayment penalties serves partly to offset reductions in cash flow on the excess spread. Older NIM deals did not include prepayment penalty cash flows.

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

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

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

[56] *See* note 37 *supra*.

[57] *See* text accompanying note 35 *supra*.

[58] *See* note 15 *supra*.

11:25 a.m. – Workouts and Restructurings: For a Few Dollars More

The best defense against getting into trouble is to fully understand both the assets and the business model of a potential ABS issuer. An investor (or trustee or rating agency) should develop expectations about how a deal should perform over time and the investor should act promptly if actual performance diverges from expectations.

Many deals produce warning signs of potential trouble (*e.g.*, breaches of specified servicing procedures, erroneous calculations, advancing the wrong amount, or failure to make advances). The challenge is distinguishing an insignificant or immaterial "technical" default from a sign of real trouble.

One panelist says that even a seemingly minor calculation error should be pursued until it is fully explained and corrected because it may be the sign of a larger problem.

An investor should not simply assume that a trustee or backup servicer will properly follow-up after having been informed of a breach or potential breach. The investor should notify all the parties that have a responsibility to take remedial action and should follow-up with all of them.

Transferring servicing is a drastic step because it can be very expensive. Also, it is not always clear whether a replacement servicer will be able to service better. In a bankruptcy situation, it may be impossible to transfer servicing. One useful technique is to convert the servicing relationship to a month-to-month contract after the first material breach. The month-to-month contract would not have to be renewed if the servicer goes into bankruptcy. It is not always necessary to transfer servicing if the problem is "mere incompetence." However, it is always necessary to transfer servicing if the problem is crookedness or dishonesty.

Ideally, the governing documents for a securitization should include a detailed protocol for transferring servicing.

A deal's governing documents may include some specifications about how servicing should be done. However, documents generally do not specify a maximum number of accounts per collector or a minimum number of calls or letters that must be made or sent each month. Instead, bottom line performance triggers can supply indications of whether the servicing operation is running properly.

"Fraud is when one's greed exceeds one's fear." Negligence and mismanagement can be cured, but fraud must be dealt with firmly and immediately. Fraud is very hard to detect and very hard to remedy after the fact.

The "enemy" is the party that is not fulfilling its obligations. A real danger in a distressed situation is that innocent parties start blaming each other. All the innocent parties should instead work together to focus on the "enemy."

A good technique in a distressed situation is to switch "teams" within a company. The team that put a deal together should not be the one to handle a workout. A new team for the workout will not be distracted by efforts to exculpate itself and will provide a fresh set of eyes on the problem.

In an ABS issuer's bankruptcy, ABS investors should immediately focus on the cash collateral order and the DIP financing order. It is too difficult to "unscramble the egg" if the debtor gets to use funds or assets of a securitization.

One of the rating agencies has started to focus on voting rights. Voting rights raise difficult issues. For example, should subordinate investors be able to hold up a restructuring? Additionally, swap providers, whose cash flow is at the top of the waterfall, are now starting to ask for voting rights in deals. One view is that senior investors should have full control because subordinate investors can buy them out if they do not like the seniors' decisions.

ABS West 2004

Information Management Network
2-5 February 2004, Desert Ridge Resort, Phoenix, Arizona

Monday, 2 February 2004

2:15 p.m. – ABS/MBS Accounting and Regulatory Issues

FIN 46:[59] FIN 46 establishes an alternative framework for financial statement consolidation. Instead of relying solely on voting rights as the basis for consolidation, FIN 46 uses a risk and reward approach for consolidation.

FIN 46 does *not* apply in certain important cases. It does not apply to QSPEs under FAS 140.

If an entity does not meet the requirements for applying the traditional "voting interest model," then it is a "variable interest entity" (VIE) and the determination of whether its sponsor must consolidate it on the sponsor's financial statements turns on FIN 46.

A party is the "primary beneficiary" of a VIE if it holds "variable interests" that receive a majority of the entity's expected losses or a majority of the entity's residual returns. Many different kinds of arrangements can be variable interests: guarantees, service contracts, total return swaps, other derivative contracts that absorb risk, and (in some cases) fees under service contracts.

Calculating "expected losses" and "expected residual returns" is difficult. The "top down" approach considers an entity's cash flow waterfall for allocating expected losses and expected residual returns to an entity as a whole. The "bottom up" approach considers expected losses and expected residual returns to the entity as a whole.

Companies that use SPEs must apply FIN 46 as of 31 December 2003. Public companies must adopt FIN 46 for other VIEs as of 31 March 2004. Private companies must adopt FIN 46 for other VIEs as of the end of 2004.

FIN 46 disclosures must be combined with (or next to) FAS 140 disclosures. Reporting companies can combine disclosure for multiple SPEs.

FIN 46 includes elements of both form and substance. All components of a structure must be evaluated as a whole.

FAS 140:[60] FAS 140 covers transfers of financial assets. FAS 140 requires (1) legal isolation, (2) buyer's right to sell or pledge the assets, and (3) limited calls on the assets. Legal isolation usually is documented by true sale and non-consolidation legal opinions. Two exceptions to the limitations on calls include (i) a servicer "clean up" call and (ii) a contingent removal of accounts provision (ROAP).

A QSPE under FAS 140 is not consolidated by its transferor (FAS 140 and FIN 46) or by other parties (FIN 46). A QSPE can be a trust or other legal vehicle. It must be demonstratively distinct and it must have limited activities. To be demonstratively distinct, at least 10% of the fair value of the QSPEs beneficial interests must be held by parties other than the transferor or it must be a guaranteed mortgage securitization. In addition, the transferor must not have the unilateral right to dissolve a QSPE.

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[59] *See* note 27 *supra*.

[60] *See* note 28 *supra*.

There is currently a FASB project to amend FAS 140. FASB initially intended to publish a new exposure draft in the first quarter of 2004 and a final statement in the second quarter of 2004. However, there was some indication that FASB would delay the new exposure draft until the fourth quarter of 2004 and the final statement until 2005. Now it is not exactly clear what FASB's timing will be.

FASB is focusing on the issue of legal isolation. It is pushing for stronger legal opinions that cover more scenarios such as guarantees by the transferor to beneficial interest holders (*i.e.*, around a QSPE).

A QSPE cannot own equity instruments or total return swaps. In addition, a QSPE's ability to rollover beneficial interests is limited. A QSPE will lose its "Q" status if the determination of rollover specifics is made by a party that holds a combination of rights and obligations that provide more than trivial benefit than if held separately.

FASB is considering the question of whether a sale of "undivided interests" or participations requires a QSPE. FASB probably will decide that a QSPE is not required for sales of *pari passu* participations. However, sales of senior or subordinated participation interests probably will require the use of a QSPE. This will create a burden for banks that buy and sell loan participations.

FASB is considering the effect of rights of offset by bank depositors/borrowers. The issue involves a depositor's right to offset the amount of its deposit against the amount of its loan. FASB may conclude that the depositor's right of offset undermines the legal isolation for true sale.

Other issues associated with the FAS 140 project are the treatment of derivatives and mortgage servicing rights.

Tuesday, 3 February 2004

8:15 a.m. – The ABS Market in Adolescence: Mature Young Adult or Troubled Teen?

The U.S. ABS market has matured significantly. The rate of growth will slow and the market may see its first year of lower issuance volume in 2004. Contraction of the home equity sector is a real possibility if interest rates rise. The level of outstanding asset-backed commercial paper (ABCP) has leveled off.

Improving Disclosure and Transparency: One panelist notes that the SEC's securitization disclosure project finally seems to be moving forward. It is not yet clear exactly what the rules will be, but a few items that could help improve transparency would include the following:

- disclosure of historical static pool or vintage performance data, including frequency and severity of losses
- disclosure of FICO score stratifications by credit card issuers
- disclosure of seller/servicer financial information and business outlook

In the absence of regulation, investors generally have been unable to compel better disclosure by issuers. Weak disclosure is so prevalent that investors cannot meaningfully "vote with their dollars," except by leaving the securitization market entirely. Few investors would be willing to take that drastic step. Thus, as long as an issuer can sell its deals with its current disclosure, it has little incentive to improve transparency.

Another panelist feels that servicers should be required to disclose whether they have retained an interest in a deal, giving them "skin in the game" and aligning their interests with those of investors.

A third panelist notes that investors may need different kinds of disclosure for different kinds of assets and deals. In addition, investors should receive disclosure about servicing fees and the details of servicing practices in order to gauge the adequacy of servicing fees.

Websites of issuers, trustees, and rating agencies provide much useful information on certain deals. However, performance information is not readily available for all deals.

Standardizing disclosure for ABS could have both positive and negative consequences. For example, emphasizing cardholder FICO scores in the NextCard transactions might have caused investors to overestimate the credit quality of the receivables.

Where are the Chaperones?: Last year many market participants unfairly blamed trustees for problems that had occurred in certain deals. Many market participants seem to want trustees to play an augmented role in collateral testing and compliance testing. However, the market cannot reasonably expect trustees to play a larger role without charging higher fees.

One possible approach for expanding the role of trustees would be to use trigger events that would cause a trustee's duties to expand when slightly adverse events have occurred.

A contrary view is that investors should not expect either trustees or rating agencies to be effective chaperones for ABS transactions. Both trustees and rating agencies generate income in proportion to the volume/number of transactions in which they are involved. Accordingly, they are unlikely to posture themselves as chaperones because of the risk of alienating issuers.

Securitization professionals can reduce occurrences of fraud by building protective features into their deals. Unwrapped deals backed by revolving pools – other than mainstream credit card deals from major banks – should provide for an independent third party to periodically verify the existence and the quality of the underlying assets. If such a deal lacks a "deal cop," investors are likely to demand much wider spreads or to insist on bond insurance. Investors need to think in terms of protecting themselves.

Trustees and Backup Servicing: Servicing risk is a big issue. Sometimes it seems impossible to separate asset risk from the risk of the servicer. Some deals have experienced sharply rising servicing fees in connection with transfers of servicing. Compared to the corporate bond market, the ABS market has displayed a greater frequency of default of double-A-rated and triple-A-rated securities. Moreover, the severities of those defaults have been quite high. This raises the question of whether servicers' corporate debt ratings should be "ceilings" for the ratings of their securitizations.

Trustees sometimes play a very beneficial role in connection with transfers of servicing. For example, in the ill-fated First Consumers credit card deals, the trustee provided much information to investors and helped organize conference calls among investors. In addition, the trustee handled the transfer of servicing to First National Bank of Omaha (at an increased servicing fee of 425 bps).

One panelist proposes that the whole ABS market follow the example of the home equity sector and start using "master servicers" to reduce dependence on primary servicers. Another panelist counters that using a master servicer would only help if the master servicer has a very strong credit rating.

An important shortcoming in how securitization professionals execute deals is that they contemplate a static environment. Doing so is a mistake; both the environment and the players themselves are dynamic. Accordingly, market participants should recognize that servicing fees might be volatile over time.

From a banker's perspective, two key questions in considering a deal from a first-time ABS issuer are (1) how to transfer the servicing if it becomes necessary and (2) whether the deal has a backup servicer.

Ratings Volatility: There were more ABS downgrades in 2003 than ever before. On the other hand, credit seems to be improving for 2004. Rating agencies sometimes are very late in downgrading securities. Security prices move more quickly in response to deteriorations in credit quality.

The extreme ratings volatility in the ABS sector arguably should not have happened; investors have a right to be disappointed with the rating agencies. On the other hand, the real issue is not that ratings were volatile but rather that ABS credit quality has been volatile. Rating agencies were only one of several categories of market participants who expected ABS credit quality to be more stable than it has been.[61]

Rating agencies should improve their monitoring systems so that they regularly recalculate the level (or rate) of future defaults or losses that would have to occur to make each rated security default.

Issuance Volumes and Consolidation: The ABS market is not only larger than it was five years ago but also more important. Commercial banks have absorbed many of the Wall Street dealers that have been the most active in ABS. That consolidation arguably boosts ABS issuance because the institutions themselves make greater use of securitization in order not to over-saturate the capital markets with their straight debt.

The statistics on the growth of the ABS market understate its full impact on the economy and the overall financial sector. The ABS market spawned greater liquidity in the form of whole loan trading for several asset classes.

Although home equity ABS issuance volume may be down in 2004, there is still a long-term term trend of growth and strength for the sector.

Spreads: One banker feels that ABS spreads are likely to remain tight. Issuers have many choices of how to finance their assets. They can issue term ABS, sell whole loans, or use ABCP. In addition, the market has demonstrated its ability to contain "single-name disasters." Such an event does not necessarily trigger a general widening of spreads.

An investor's view is that ABS investors sometimes seem like crack addicts in their insatiable quest for spread. They start out with the "soft stuff," sampling dicey manufactured housing deals. Ultimately, they end up "free basing" risky exotics like healthcare ABS. ABS investors seem to be going crazy, providing "free money" for bonds. ABS spreads are likely to remain tight, and the ABS market is likely to remain "crack" for fixed income investors.

Another banker's view is that ABS spreads will remain range bound through 2004 and will start to widen in 2005. Research shows that spread widening generally follows Fed tightening by six months. The banker expects Fed tightening in mid-2004.

Global Update: ABS issuers are doing road shows in China and other parts of Asia.

Securitization in Asia is still slow, but activity should accelerate because there are many cheap assets.

China has huge savings invested in sovereigns and supranationals. A portion of those funds could be shifted to ABS.

[61] In one sense, the surprising credit volatility of ABS in 2002 and 2003 arguably is not different from the surprising volatility of NASDAQ equity prices in 2000 and 2001 or from the surprising credit volatility of junk bonds in 1991. On the other hand, neither the NASDAQ stock market nor the junk bond market had touted stability as one of its main selling points. In the mid-1990s, many ABS bankers routinely stated of their products: "never been a default and never been a downgrade." Accordingly, ABS investors arguably are justified in feeling that their expectations for credit stability have not been fulfilled.

Europe may shift away from synthetic transactions and toward funded deals. Europe has produced some very innovative structures. Europe now produces securitization technology itself and exports technology to the U.S. The old pattern of a one-way technology flow – from the U.S. to Europe – has disappeared.

Specific Sectors: One panelist favors downgraded bonds that have become cheap in an environment of panic selling. He favors buying into fear and running against the herd.

A second panelist likes NIMs.

A third panelist expresses optimism about the auto sector.

A fourth panelist selectively favors pre-1998 manufactured housing ABS. In particular, M2 classes may present a better risk-return profile than M1 classes given that neither class may recover principal but the price of the M2s is much lower.

A fifth panelist notes that demand for short-term instruments remains hot. The ABCP sector remains very large and even some CDOs now offer money market tranches.

A sixth panelist observes that the credit card sector still needs further innovation to permit reverse inquiry MTN-style issuance.

9:30 a.m. – Market Trends, Developments & Future Outlook for the U.S. ABS Market

Issuance Volumes: Panelists have differing views about whether 2004 ABS issuance volume will grow or decline. Some expect issuance volume to grow by 5%, some expect it to be flat, and some expect contraction of up to 10%. The area of contention is the home equity sector, where the volume of issuance likely will depend on interest rates. However, despite their differences, all the panelists' volume predictions are relatively close and none predict the high rate of growth that the market has experienced in prior years.

Manufactured housing ABS volume will remain suppressed because Berkshire Hathaway, which acquired Vanderbilt and Oakwood, will not need to use ABS for funding new production.

Interest Rates: All panelists expect the federal funds rate to be 1.0% at mid-year. All but two of the panelists expect the federal funds rate to be 1.5% at the end of 2004. One feels that the Federal Reserve is unlikely to raise interest rates during an election year and while the consumer sector remains weak.

Spreads: Panelists have divergent views about whether spreads will be wider or tighter at the middle of 2004 and at the end of the year. One panelist feels that spreads are too tight right now, especially on subordinate tranches. He contends that the present situation is reminiscent of the "irrational exuberance" of the equity markets a few years ago. Another panelist holds the opposite view because of the strong condition of the economy and the fact that spreads have tightened in other markets (*i.e.*, a relative value argument for further tightening). Additionally, immigration trends and population growth likely will drive continued growth of housing and housing finance, while foreign investors (particularly from Asia) likely will be a source of growing demand for U.S. ABS. A third panelist argues that strong investor demand will be the primary driver of further spread tightening in 2004.

A bond insurer observes that for the past few years it has written policies on generally low risk asset pools. The low risk of the pools has been a reflection of originators applying tougher credit standards during a stressful economy. During a more positive economic environment – as we are experiencing now – originators' credit underwriting standards are likely to slip.

Most panelists do not expect 2004 to bring an instance of regulatory intervention similar to what the market experienced in the NextCard[62] and First Consumers[63] situations.

Potential Disasters in 2004: Panelists have divergent views about whether the ABS market will experience another disaster like NCFE,[64] Hollywood Funding,[65] or NextCard. One panelist feels that investors have all stepped up to the table and "are ready to drink the Kool-Aid" (*i.e.*, investors are ready to poison themselves by purchasing bad deals). He cites the trend of fixed rate assets backing floating rate securities as an example of eroding standards and structures. A second panelist shares the view that the ABS market is overheated and that investors are buying securities without fully understanding the risks. He shares the view that there has been a trend toward structural easing. A third panelist observes that the market may have forgotten that competition among issuers (with respect to underwriting standards) can become fierce during a good economy.

Trustee Roles: Most panelists feel that the role of trustees will not really change during 2004. However, one panelist feels that the role of trustees is already changing and that rating agencies are driving the change. Some deals now have a "verification agent" and strong triggers related to servicing.

An issuer representative notes that he would be willing to pay for an expanded role for the trustee in his deals, but only if the market demands it and rewards it. A banker observes that different levels of trustee involvement will be appropriate in different situations. One approach is to use trigger events to increase the level of trustee involvement if adverse events occur.

An investor expresses grave skepticism about trustees' willingness to act, regardless of what their contractual obligations are. The investor panelist expects trustees to demand unreasonable indemnities before being willing to act.

Student Loan Issuance Likely to Grow: Most panelists pick the student loan sector as the one that will experience the greatest issuance growth in 2004. A moderately high level of unemployment keeps people in school longer. Also, tight state budgets may drive increased volumes of private student loans. The "echo boom" (an aftershock of the post-WWII baby boom) is now boosting college enrollment. If interest rates stay low through the middle of the year, there could be another wave of consolidation loans. Another panelist feels that student loan volume could reach $50 billion, driven primarily by private student loans.

Potential Problem Sectors: Panelists have differing views about which sectors are likely to show significant problems in 2004. One investor feels that many subordinate and mezzanine home equity ABS are vulnerable to rising interest rates. Another investor feels that multi-sector CDOs may be vulnerable because of their heavy exposure to the home equity ABS sector. He feels that performance risk may be highly correlated among securities in the underlying portfolios. He echoes the concern about fixed rate assets backing floating rate securities (and making the securities vulnerable to rising interest rates). He feels that the structures may not support the level of embedded systematic risk. A third investor feels that spread widening could be a problem for the auto ABS sector. Weakness in the consumer sector, combined with very long loan terms (*e.g.*, 72-month and 84-month loans) could be a recipe for problems. Naturally, the auto issuer disagrees.

Company Risk: A seller/servicer's financial strength can have a large or small impact in rating a securitization. The degree of linkage tends to be greater in off-the-run asset classes. In addition, servicing misconduct has occurred more frequently when small, unrated, and unregulated seller/servicers experience financial distress.

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[62] *See* note 37 *supra*.

[63] *See* note 35 *supra*.

[64] *See* note 15 *supra*.

[65] For a discussion of the Hollywood Funding transactions, *see* Mark Adelson et al., *ABS Credit Migrations*, Nomura fixed income research report at 22-23 (updated 5 Mar 2002).

Appetite for Risk: The market's appetite for risk has returned. Even so, market participants have learned that they must be more careful in analyzing risk.

ABS vs. Corporate Bonds: ABS investors reasonably demand a spread premium over comparably rated corporate bonds for two primary reasons. First, some types of ABS display negative convexity because of prepayment risk (*e.g.*, real estate-related ABS). Second, many ABS are less liquid than comparably rated corporate bonds.

Sleepless Nights: The main reasons for an investor to have sleepless nights are the prospect of a jobless recovery and the risk of fraud. One investor notes the challenge of managing for yield in a low interest rate environment.

Captive Finance Companies: Most captive finance companies do not sacrifice credit discipline in order to encourage sales. Mitsubishi's disappointing experience was a lesson not only for the company but also for the whole auto finance industry.[66]

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

The sub-prime mortgage ABS market had a great year in 2004, posting a 48% volume increase over 2002. Aggregate sub-prime originations exceeded $300 billion. Low interest rates were a key driver of the high issuance volumes. However, the sector faced tough challenges in the form of anti-predatory lending initiatives in the States. The sector also benefited from strong inflows of capital during 2003.

One issuer expects its originations to grow by 10% to 15% in 2004. Another issuer comments that all issuers are projecting growth by 10% to 15%. However, he notes that big picture projections call for the sector as a whole to potentially contract during 2004.

New products, such as interest-only loans and piggyback seconds (for lenders who have not yet used them), could help to support the volume of originations in 2004. One lender cautions against lenders becoming too creative with new products. He encourages lenders to stick to the basics. He has heard about a resurgence of 125% loans but his company is not originating that product. Another lender expresses skepticism that new products will be an important driver of volumes in 2004.

One lender strongly favors 3/27 loans over 2/28 loans because of the longer period of fixed rate payments and the longer prepayment penalty.

Is the push for lower origination costs driving irrational loan pricing? One lender has focused on lowering costs by "improving its process" rather than simply by boosting volume to lower fixed costs per loan. A second lender seems to embrace a strategy of maximizing its margin and its profitability rather than volume. The push to reduce costs started around the end of 1998 when gain-on-sale accounting lost its credibility. Since that time, sub-prime mortgage originators have had to focus on costs.

The Fairbanks situation[67] prompted many sub-prime mortgage servicers to re-examine their fee structures and to develop written servicing procedures ("best practices"). It seems likely that that the whole industry will end up with a uniform set of best practices. The restrictions on incidental fees raise the question of whether the standard 50 bps servicing fee is enough. One issuer responds that

[66] Mark Risi and Mark O'Neil, *Various MMCA Auto Owner Trust Ratings Lowered, Affirmed and Off Watch; Others Still On Watch*, Standard & Poor's press release (9 Jun 2003); Mark Risi and Mark O'Neil, *Various MMCA Auto Owner Trust Ratings Lowered, Affirmed and Off Watch*, Standard & Poor's press release (21 Oct 2003).

[67] *See* note 34 *supra*.

the increase in average loan size makes the standard servicing fee workable. In addition, the issuer has adopted a stepped servicing fee, which starts at 30 bps and rises over time.

One investor focuses on corporate credit risk when considering home equity ABS from new or small issuers. The investor asks for audited financial statements from the seller/servicer and carefully considers whether the company will remain in existence for the life of a deal. The investor expects to be able to pick up the phone at any time to have the servicer explain its monthly servicing report.

Predatory Lending: A New York court has thrown out the New York City predatory lending ordinance.[68] The court found that federal and state law preempted the New York City ordinance. One rating agency will not rate residential MBS transactions that contain high cost home loans from New Mexico.[69] Another rating agency has announced that it will not rate deals backed by certain loans in Los Angeles after a new city ordinance becomes effective.[70] All the rating agencies have reacted strongly to New Jersey's anti-predatory lending law.[71] It is extremely burdensome for originators to work with a hodge-podge of inconsistent state laws on predatory lending. The OCC has issued a regulation preempting state predatory lending laws for national banks.[72] The OCC has provided a safe harbor for an originator that performs customary due diligence.

Dealing with predatory lending laws requires first trying to figure out what the law is in a particular jurisdiction. The next step is figuring out how to comply with a jurisdiction's law. In some cases, the best decision is not to do business in a given jurisdiction. Some lenders go half way and program their systems to prevent origination of high cost loans in the difficult jurisdictions.

One investor's approach to dealing with the potential risk of assignee liability for predatory lending is to completely avoid Section 32 loans.[73] That is, the investor will not buy a deal if it has any Section 32 loans in its underlying collateral pool.

Credit Performance: Sub-prime mortgage pools from 1999 and 2000 have performed very well. The credit losses have been modest and the pools have mostly paid-off. The 2000 vintage has performed slightly worse than the 1999 vintage, but the difference is not significant. On the other hand, the recent vintages did not experience stress from a period of rising rates, which might have produced much weaker performance. Adjustable rate borrowers have not been challenged in recent years. It will be a much different market when interest rates go up.

Spreads: Spreads on triple-B-rated floating rate subordinate tranches have tightened by 125 bps to 150 bps over the past six months. Much of the tightening is attributable to demand from CDOs. One investor feels that the tightening is primarily due to technical (supply and demand) factors. He feels that spreads will continue to grind tighter through the summer for tranches at all rating levels. However, the GSEs account for a substantial amount of aggregate demand for home equity ABS and it is unclear how much spreads would widen if the GSE bid disappeared.

[68] *Mayor of the City of New York v. City of New York*, No. 400583/2003 (N.Y. Sup. Ct., New York County 26 Jan 2003) (nullifying Local Law 2002-36 (available at http://www.council.nyc.ny.us/pdf_files/bills/law02036.pdf)).

[69] *Fitch Ratings Addresses New Mexico Predatory Lending Legislation*, Fitch press release (15 Jan 2004); N.M. Stat. § 58-21A-1 *et seq.* (2003)

[70] Natalie Abrams and Maureen Coleman, *Standard & Poor's Addresses Los Angeles, CA Anti-Predatory Lending Ordinance*, Standard & Poor's press release (10 Nov 2003); Anti-Predatory Loan Ordinance of the City of Los Angeles, Los Angeles Municipal Code § 181.00 *et seq.* (2003).

[71] Henry Engelgen et al., 2003 Review and 2004 Outlook: Home Equity ABS – A HEL of a Year!, Moody's special report at 8 (20 Jan 2004); Natalie Abrams and Maureen Coleman, *Standard & Poor's Clarifies Covered Home Loan Criteria Under NJ State Predatory Lending Law*, Standard & Poor's press release (8 Oct 2003); Fitch Ratings Responds to New Jersey Predatory Lending Legislation, Fitch press release (5 Jun 2003); New Jersey Home Ownership Security Act of 2002, N.J. Stat. §§ 46:10B-22 *et seq.* (2003).

[72] Office of the Comptroller of the Currency, Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904 (13 Jan 2004) (amending 12 C.F.R. § 34.4).

[73] "Section 32" loans are ones that are subject to section 32 Regulation Z, 12 C.F.R. § 226.32 (2003).

NIMs: A representative from an issuer says that his firm generally refrains from executing NIMs. The issuer is a portfolio lender and strives to minimize its funding costs rather than to maximize proceeds from its securitizations. One investor strongly prefers senior interest-only securities to NIMs. In contrast, a second issuer feels that its NIMs are extremely attractive securities. Overall, NIMs have performed well from a credit perspective; most have repaid their principal faster than expected.

1:45 p.m. – ABS Relative Value Outlook: Lessons Learned in 2003 and Opportunities for 2004

One investor feels that the economic and consumer outlook is improving. Moody's credit card performance index shows improvement, but bankruptcy filings are still high and consumers may be over-extended. Additionally, the sub-prime consumer sectors may lag. Accordingly, one investor is increasing its allocation to securities backed by commercial assets. Rising interest rates should help some CDOs because reinvestment rates likely will improve.

A second investor also feels that the overall economic picture is positive but that weak employment is potentially a dark cloud. The overall level of consumer debt has increased, but low interest rates have made the debt burden manageable for investors. Technical factors for ABS are positive and the investor is increasing his allocation for ABS. The outlook for rising interest rates is causing the investor to increase his allocation to global markets.

A third investor recommends avoiding manufactured housing ABS, even though the fundamentals of the sector are improving.

A fourth investor feels that spreads already reflect the impact of the improving economy. The ABS market arguably has dodged credit challenges in the home equity sector because of fast prepayments over the past few years.

One panelist observes that the "separation" of asset risk from company risk has been the "big lie" of the ABS market. Another feels that the rating agencies have not been sufficiently proactive in publishing information when servicers suffer deteriorating financial condition. The Fairbanks experience is a disappointing example.[74] Investors face a growing challenge in distinguishing solid servicers from those who will get into trouble.

One investor looks for servicers that are financially strong, well capitalized, and that have access to multiple funding sources. The investor favors rated servicers and generally focuses on only prime collateral (except for home equity ABS). The investor relies heavily on its own due diligence to gain comfort with servicers.

Another investor feels that trustees view their roles as purely administrative and that they fail to accept proper responsibility for backup servicing on troubled deals. Without a reliable way to transfer servicing, it is not possible to separate asset risk from company risk (which is what the ABS market is supposed to do). ABS have experienced higher loss severities than comparably rated corporate deals and this poses a challenge for investors. The investor prefers to stay "up in credit" for off-the-run assets (*i.e.*, the investor prefers highly rated senior tranches of off-the-run deals) but is willing to move "down in credit" for mainstream assets.

Another investor echoes the observation that loss severities have been much higher than expected in ABS deals that have defaulted.

One investor says that spread tightening is likely to occur in off-the-run sectors. Investors' seemingly insatiable appetite for yield likely will draw them to off-the-run the deals and cause spreads to tighten. Careful investors will focus on getting as much "color" (*i.e.* qualitative information about a seller/servicer, its practices, and its business prospects) as they can and will not simply rely on

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[74] *See* note 34 *supra*,

running numbers on Intex. The investor particularly likes mainstream sectors right now. Some off-the-run bonds represent good value. In the manufactured housing sector, value is present on specific bonds but it is not possible to generalize. It is too soon to tell whether DVI (bankrupt issuer of equipment lease ABS) or Metris (distressed issuer of sub-prime credit card ABS) paper represents good value.

Credit Cards ABS: Investors would like to see disclosure of vintage analysis and FICO score distributions for credit card portfolios. Investors would also like credit card issuers to disclose what they (issuers) view as the key drivers of performance.

Triple-B-rated tranches of credit card deals have tightened significantly over the past few months. The tightening has mirrored the tightening of issuers' corporate bonds. The prospects for continued tightening of triple-B credit card ABS depend on how corporate bond spreads move.

Metris management needs to demonstrate that it knows how to run its business. Guidance on losses and delinquencies has missed the mark. Although the collateral pool has improved lately, it is not clear whether the company will survive. There is probably more upside in the "C" (subordinate) tranches than in the "B" (mezzanine) tranches of Metris deals.

Auto ABS: Loan level loss data would help investors in sub-prime auto ABS. Investors need to understand the dispersion of credit quality among the assets backing a deal so that they do not have to rely on mere "averages." Investors would benefit from loss models that Wall Street dealers might develop.

Investors are not particularly worried about 72-month loans. A bigger factor is poor credit underwriting.

Home Equity ABS: One investor feels that even if there is a "housing bubble," it is not severe and certainly nothing like the NASDAQ bubble. He feels that investors can mitigate the risk of regional bubbles by diversifying their exposures geographically. He feels that rising rates are a greater risk. He is moving up in quality within the home equity sector (*i.e.*, trading out of triple-B-rated tranches).

Spread tightening in the home equity ABS sector has brought a reduction in tiering among home equity ABS issuers. Tiering makes sense conceptually, but the market does not implement it correctly. Spread differences between securities do not seem rationally connected to differences in the riskiness of different deals.

Investors need better data on issuers' repurchases of delinquent loans. They also need more research on the credit quality of limited-documentation loans.

One investor favors triple-B-flat tranches over triple-B-minus ones. She notes that there are important differences between dealer shelves and that investors should receive a yield premium for securities from dealer shelves generally. Some dealers maintain standards that are stricter than others'; some dealers create pools that have better diversification than others'.

Rating agencies generally are not guilty of "rating inflation" in the triple-B home equity area, but investors arguably are guilty of driving price inflation there.

Spread tightening in the home equity sector has diminished the potential for arbitrage in the CDO sector.

Manufactured Housing: There are isolated pockets of value in the MH sector. Investors also must confront the risk that rating agencies will downgrade securities below investment grade even though the securities have a fair chance of eventually paying off.

Panelists' Research Requests and Trade Recommendations		
	Research Requests	**Trade Recommendations**
1	research on limited documentation loans and models to evaluate convexity	triple-A and double-A home equity ABS floaters
2	a handbook of profiles on CDO managers	equipment ABS and seasoned CDO floaters
3	continue doing a good job of deal surveillance	short sequential floating rate home equity ABS (about one year WAL)
4	research on optionality of home equity ABS and prepayment ramps	trade up in credit quality and up in liquidity
5	more reports about rating inflation and about entire sectors; fewer reports about specific bonds that dealers are trying to push	avoid manufactured housing ABS
6	model for "credit adjusted" spreads (to gauge value of double-A and single-A tranches)	selective opportunities in manufactured housing and aircraft
7	method to rank servicers	home equity ABS and student loan ABS

4:15 p.m. – State of the Industries: The Real Estate ABS Researchers' Roundtable

Home Prices: One panelist feels that everything has gone right for the housing market. Income is rising on an after-tax basis. Interest rates are low. There is increased homeownership among immigrants. There is not a housing bubble. Home prices have risen in line with incomes and interest rates. Rising interest rates should dampen home price appreciation but this should not precipitate a crisis because incomes should continue to rise. On the other hand, home prices have become overheated in certain MSAs.

A professor at UCLA has devised a kind of P/E ratio for housing (based on rental prices).[75] He contends that a housing bubble can develop if home prices advance more quickly than rents for an extended period. However, a problem with that analysis is that there may not be rental properties comparable to many homes (*i.e.*, more expensive homes).

If interest rates rise by one or two percentage points, there will be no crisis in home values. The high population states are the ones where there is extensive sub-prime mortgage lending to immigrant borrowers. Investors should focus on those states.

Short-term interest rates are important to HEL credit performance because of possible compression in excess spread. An increase in short-term rates, combined with a modest increase in losses, could cause defaults on triple-B tranches. Estimating the relative value of triple-B tranches requires estimating the credit sensitivity to rate moves.

The clean-up call feature of home equity ABS is equivalent to a short position in a binary option. One investor observes this is essentially the reason why market participants should calculate yields on home equity ABS based on the "worst of maturity or call." An investor can factor a large basis mismatch into his analysis to reflect the possibility that a servicer might not exercise its clean-up call option.

[75] Edward Leamer, *Bubble Trouble?, Your Home Has a P/E Ratio Too*, UCLA Andersen Forecast (June 2002) (available at http://www.anderson.ucla.edu/research/forecast/forecast/2002/June/Articles/Bubble.pdf); Edward Leamer, *UPDATE June 2, 2003 Bubble Trouble? Your Home Has a P/E Ratio Too*, (2 Jun 2003) (available at http://www.anderson.ucla.edu/research/forecast/forecast/2003/June/Articles/PE_ratio_update.pdf).

One analyst estimated that if home price appreciation slowed to just 3% to 4% from 7% per year, defaults and losses would likely double.

Rating Agency Assumptions: It is sometimes hard to figure out what assumptions the rating agencies are using in stressing home equity collateral and deals. For example, it is not always clear what assumptions the rating agencies are making with respect to potentially rising interest rates.

On a risk-adjusted basis, subordinate home equity ABS are a good value. The outlook for the consumer sector is positive. Lenders have been moving up in credit. Subordinate home equity ABS are still cheap compared to fixed income investment alternatives. The market is dynamically over-enhancing the securities by giving them discount prices in secondary trading.

On the other hand, now is the first time that ABS investors are being forced to bet on interest rates with the credit protection on their home equity deals. For an investor who wants to bet on interest rates, there are more direct means of doing so.

Two of the rating agencies use interest rate stress scenarios that are much less stressful than the rate volatility of 1994. It is helpful to understand that the rating agencies may not be using the most realistic or appropriate assumptions.

There is a broad consensus that similarly rated bonds could exhibit varying sensitivities to interest rate moves. In fact, one panelist ventures that the rating agencies have reduced the efficiency of the market by not acknowledging that variation.

One panelist feels that the most subordinated pieces of deals are fully priced, but that there is room for further spread tightening in the double-A-rated and single-A-rated tranches. Those tranches have stayed just below CDOs' radars.

Tiering: Tiering arguably presupposes a strong degree of linkage between the performance of a pool and the business fortunes of the servicer. Accordingly, tiering should not be a strong force in the home equity sector because it is usually a small matter to change the servicer of a home equity pool.

Extension Risk: Panelists have divergent views on extension risk. Some feel that extension risk is significant while others feel that it is not a major issue in the current environment. Views differ about whether five-year triple-A tranches are attractive.

Manufactured Housing: Citigroup recently brought a $200 million manufactured housing (MH) deal from Origen (Origen MH Trust 2004-A). The rating agencies required more credit enhancement for the deal. One panelist questions whether the rating agencies have "got it right" this time. Another view is that the MH sector is going to turn around slowly. It will be hard for the industry to sell a lot of paper because triple-A investors may feel "once burned, twice shy." A lesson from the MH sector's recent experience is that investors should want to avoid repossessions of manufactured homes because the recovery rates are so low. A corollary lesson is that if an investor is strongly optimistic about MH, he should consider an equity investment in the sector. One panelist contends that Berkshire Hathaway ultimately will regret its equity investment in the MH sector. The fundamental problem of the MH sector is that lenders finance the homes for terms longer than 20 years, but the homes depreciate more quickly than that. On the other hand, the MH sector did show improving performance over the past year.

Manufactured housing is susceptible to important regional economic effects. Rating agencies arguably warned about the key risk factors in the late 1990s. However, during the late 1990s, the interest rates on MH loans converged toward the interest rates on conforming mortgage loans. Ultimately, rates on MH loans come within 200 bps to 250 bps of the rates on conforming loans. At that point, the MH lending business model was clearly mis-priced. However, that does not necessarily mean that the MH business model was fundamentally flawed; there is a price level (interest rate) at which the economics of MH lending work.

NIMs: One panelist view NIMs[76] as generally cheap. Some investors still have a negative view of NIMs from the bad deals of 1998. However, the newer NIM deals are much stronger and receive cash flow right from their inception. New structures, including the use of caps and the allocation of prepayment penalties, have made the newer NIMs stronger. On the other hand, rising rates could squeeze excess spread, which is the main source of NIM cash flow. Slower prepayments could supply greater aggregate cash flow to NIMs. A deal backed by second liens or seasoned collateral – which might experience defaults during its first 12 months – could be a problem for NIMS.

5:15 p.m. – Transaction Oversight, Monitoring & Surveillance

Transaction oversight arguably starts at the due diligence phase, before a deal closes.

Investors need to focus on value creation through transaction oversight. The key question is whether an "oversight agent" creates more value than it costs in fees. There is a key difference between an oversight agent who focuses on performance issues relating to securitized assets and one who focuses on the *existence* of the assets.

One panelist doubts whether introducing another party into deals would be the best solution. Rather, he argues that it would be preferable to simply get trustees and servicers to do their jobs better.

One panelist suggests that the underwriter or placement agent of a deal should take a role in providing ongoing oversight for the deal and for making sure that the deal's trustee and servicer are doing their jobs correctly.

Holders of subordinate and mezzanine tranches bear the greatest risk that a servicer or trustee fails to maximize the recovery on a loan or fails to properly apply recoveries.

One panelist feels that even if servicers and trustees can be motivated to do a better job, third party transaction oversight can still have a role in promoting best practices and quality control.

One panelist feels that information from the oversight process should be available to all market participants. Another view is that the person who pays for transaction oversight should have control over the information. However, it is somewhat unclear who pays for transaction oversight. In one sense, an issuer pays. In another sense, all classes of investors pay. In a third sense, the mezzanine and subordinate investors really pay.

Information overload can be just as unhelpful as too little information. There is a role for an oversight agent to consolidate and condense voluminous information. Some of the Wall Street firms have developed good systems for consolidating and condensing information because they often own risky securities and need to process voluminous information.

In CMBS, the lowest bond in the waterfall gets to direct the servicer in a deal.

Wednesday, 4 February 2004

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

One panelist has concentrated on buying mezzanine and subordinate ABS that have "fallen from grace" and that are illiquid. On-the-run products have experienced a huge amount of spread tightening and are not attractive. Investing in sub-prime credit card ABS was a good trade over the past year. Downgrades, bad news, and uncertainty caused mainstream investors to dump senior

[76] *See* note 55 *supra*.

ABS from troubled names such as First Consumers,[77] Metris, and NextCard.[78] A trader can find value by focusing on fundamental value when the rest of the market panics because of negative headlines. The panelist feels that the best investments are ones that are far off the run and that have the greatest room to experience spread tightening

Another panelist feels that the strengthening of the economy is a key force behind the recent tightening. Although ABS spreads are at the tight end of their range, he does not expect them to widen in the near future.

Another panelist feels that triple-B-rated credit card ABS have room to tighten further.

The tight spreads in the corporate bond market make ABS attractive, even at the currently tight spread levels.

Liquidity: Liquidity will remain strong in the ABS market. The only thing that would be likely to hurt liquidity would be a blow up of a major mainstream issuer.

On the other hand, the market has already withstood the late 1990s meltdown of the home equity issuers and the subsequent problems with sub-prime credit cards. The market has demonstrated its ability to rationally respond to problems and to work through them. Additionally, hedge funds and special situation funds have developed a keen interest in distressed ABS and they implicitly provide a floor for ABS prices. There should be steady growth and there is plenty of money to provide liquidity.

Some high yield corporate bond investors have crossed over to ABS. They are interested in the ABS issued by the companies whose corporate bonds they have bought. Those investors have developed sophisticated analyses based on the performance of securitization trusts and they have sought opportunities by switching between a company's straight debt and its securitizations.

Distressed selling of ABS by fearful investors can provide a great opportunity for an ABS trader.

The CDO bid has been a strong factor in the tightening of ABS spreads. However, there has also been strong demand – including demand for home equity ABS – from "real money" accounts.

Investors increasingly recognize the correlation between corporate credits and the related ABS, and they see opportunity in switching back and forth between the two.

Panelists disagree about how likely it is that the ABS market will revert to using Treasuries (instead of swaps) as a pricing benchmark.

Pricing: This year is likely to bring one or two blow-ups of major leveraged investors (hedge funds). Part of the problem is that they have mis-priced their positions. SEC scrutiny likely will force some leveraged investors to re-price some positions. The consequence could be that the investors will blow up. The risk is greatest with the highly leveraged accounts (*e.g.,* 5 to 1). For example, some pricing services, such as IDC, have greatly overpriced certain premium securities. Sometimes prices from the pricing service are wrong by as much as 20 points.

The investor community is deeply concerned about pricing. There is demand for someone to produce a reliable pricing service.

Although only a small percentage of bonds are mis-priced, the mis-pricing is significant. Automated services often miss whether home equity deals have hit their triggers.

[77] *See* note 35 *supra*.

[78] *See* note 37 *supra*.

Investors should consider buying convexity in anticipation of rising rates. This argues for shifting away from home equity ABS. On the other hand, everyone already expects interest rates to increase before too long. Long, fixed rate assets with negative convexity arguably are unattractive because of the likelihood of rising rates.

One panelist especially favors home equity ABS right now, including triple-B-rated tranches. He feels that distressed ABS was last year's trade, although there will be isolated areas of opportunities in distressed ABS (including manufactured housing) this year.

Manufactured housing ABS are harder to figure out than the NextCard credit card ABS. Analyzing the value of many manufactured housing ABS requires making long-term projections and implicitly valuing long-term options. For NextCard credit card ABS, the performance of just a few simple variables in the near term will drive the performance of the securities.

Auto ABS will continue to be an important asset class but there may be less supply in 2004. Sales of whole loans will not diminish ABS supply because the loans eventually end up in securitizations. However, strengthening corporate credit at the automakers may curtail auto ABS issuance. On the other hand, non-prime auto ABS issuance could grow because the non-prime lenders will continue to rely heavily on securitization.

A problem with a buoyant market is that tiering diminishes and the market stops distinguishing between first-, second-, and third-tier issuers. In addition, the buoyant market has driven a tightening of spreads on sub-prime autos compared to top tier prime auto ABS.

Secondary trading prices on home equity ABS from lower-tier issuers can be very cheap if the losses on the underlying pools exceed 2%. Those securities trade at deep discount prices and can represent a better value than new issue double-B-rated and triple-B-rated tranches.

The franchise loan ABS sector got into trouble because too much money flowed into the sector and produced extremely unrealistic valuations. Some franchise deals have very high delinquencies and some have more bad loans than enhancement. Some tranches of those deals have value, but many do not. Some of the ratings on franchise loan ABS are very wrong. A sophisticated buyer can synthesize credit enhancement by purchasing a security at a deep discount price.

10:15 a.m. – "Scratch and Dent" Mortgage ABS: An Overview of Reperforming and Sub-Performing Mortgage Loan Securitization

Some view the scratch-and-dent category as having two parts. The first is composed of loans that have experienced significant performance problems (*i.e.*, sub-performing, reperforming, and non-performing loans). The second is composed of loans that have documentary or file defects or that have underwriting exceptions or compliance issues (*e.g.*, Truth in Lending violations).

One lender re-securitizes FHA/VA loans that still carry government insurance/guarantees. For other reperforming loans, the lender executes non-government scratch and dent deals and uses a cash flow velocity test.

Many scratch-and-dent loans come from underwriting defects. There has been a lot of pressure on the scratch-and-dent sector, as more and more players want to enter it. Originators have gotten smarter and have realized that they can cure scratch and dent loans by re-originating them or by re-papering files.

Scratch-and-dent loans come from (1) government agency auctions, (2) representation and warranty repurchases, (3) business closures, and (4) mergers and acquisitions of lenders.

A tough challenge for the scratch-and-dent sector is figuring out how to deal with loans that have predatory lending "compliance problems" (*i.e.*, loans originated in violation of predatory lending laws). Some lenders have taken the position that dealing with such loans is not worth the risk.

Companies that buy scratch-and-dent loans usually try to get representations and warranties from loan sellers. One company offers its highest price for full representations and warranties and offers lower prices for reduced representations and warranties.

In some scratch-and-dent deals, the representations and warranties regarding origination defects are enforceable only if the securitization suffers a loss. Otherwise, all the loans with origination defects would be subject to immediate repurchase.

One aggregator generally does not make a seller repurchase scratch and dent loans because of defects of which the aggregator was aware at the time of purchase and which were factored into the purchase price. Another aggregator generally avoids the use of future indemnification for origination defects because so many sellers are small, unrated entities that might not be around at the time the subject loans default.

Delinquent loans are eligible for inclusion in a REMIC, but foreclosure properties are not. A REMIC needs to make sure that it has no more than 0.75% of foreclosure of loans that were 60 days or more delinquent at the inception of the deal. Such loans are "foreclosure-restricted loans." In dealing with such loans, the servicer gets greater latitude to take measures short of foreclosure. The presence of foreclosure-restricted loans makes it difficult to compare performance between scratch-and-dent deals and other sub-prime mortgage deals.

An investor in scratch and dent ABS must aggressively push to get information. The underlying loans necessarily have problems (or they would not be scratch-and-dent loans), but an investor should try to find out the nature of the problems and as much about loan characteristics (such as debt-to-income ratios) at it can. An investor in a deal backed by scratch-and-dent loans should focus on the servicer and on the structure of deal. Investors should test scratch and dent deals with customized prepayment vectors on Intex.

One aggregator generally uses discloses LTVs based on its own BPOs (broker price opinions) of the underlying properties for the scratch-and-dent loans that it securitizes.

11:30 a.m. – Rating and Structural Issues in Equipment Lease and Loan Securitizations

Aside from DVI,[79] the equipment lease and loan sector experienced a quiet year in 2003. Issuance was about $8 billion, which was slightly more than 2002, but less than the peak year of 2001. Investors have heightened their focus on sellers/originators and on the practicalities of backup servicing and transfers of servicing.

<u>Servicing Transition Issues in DVI</u>: In situations similar to DVI, a company's unsecured creditors have asked the bankruptcy courts to open up the servicing rights for bidding. The bankruptcy courts have viewed servicing rights as a valuable asset of the bankruptcy estate. The problem, though, is that the intervention of the bankruptcy court derailed, or at least delayed, the smooth transfer of servicing to the named backup servicer. This occurred in the bankruptcies of DVI, Conseco, and UCFC (United Companies Financial Corporation). This is a dangerous development for investors because they cannot reasonably expect a seamless transfer of servicing if one is necessary.

However, DVI is a somewhat unusual case because the company's financial condition deteriorated so quickly. If it had deteriorated more slowly, the servicing transfer might have been completed before

[79] Irina Faynzilberg et al., *2003 Review And 2004 Outlook: Equipment Asset-Backed Securities: Stronger Economy Benefits the Industry*, Moody's special report at 1, 3 (20 Jan 2004).

the company went into bankruptcy. Accordingly, it is still desirable to have a named backup servicer and a documented servicing transfer mechanism that can be activated based on pre-bankruptcy deterioration of a lessor's financial condition.

Insurance, Taxes, and Security Deposits: Insurance, taxes, and security deposits can become a serious threat to cash flows in equipment lease deals. Insurance is necessary to protect against a casualty of the equipment. Sales and property taxes can run from 3% to 9% on leased equipment. A leasing company bills lessees for sales tax. However, property tax is tougher. States and counties often bill the lessor. The lessor should maintain proper escrows for taxes because a state or county may have weak systems and might bill only once every three or four years.

One of the rating agencies scrutinizes a lessor's record of properly paying taxes. The rating agency wants securitization trusts not to be exposed to liability for taxes. If there is a perceived risk that deal collections could be diverted for taxes, the rating agency generally will insist on a reserve fund for taxes.

Panelists have divergent views about whether security deposits should be included in a securitization trust. The rating agency wants to exclude security deposits and requires a specific reserve account if security deposits are included.

Due Diligence: The monthly servicing reports for a deal should reflect the real activity with respect to the underlying assets. In particular, the report should separately reflect scheduled and unscheduled principal cash flow. An "agreed upon procedures" report from a third party report is necessary to make sure that the servicing report is accurate.

Reviewing servicing reports is not a substitute for really understanding the lessor's business.

Rating agencies do necessarily receive "agreed upon procedures" reports from the accountants who prepare them for deals. Instead, a rating agency may ask a recipient of a report whether the report identifies any servicing violations and, if so, what actions have been taken to remedy the violations.

The unfortunate NCFE[80] deals illustrate the weakness of "agreed upon procedures." Those deals provided for agreed upon procedures every other month. Nonetheless, the deals suffered massive fraud.

Evolving Trustee Obligations Post-NCFE: The NCFE debacle has not yet brought about any change in deal documents with respect to the responsibilities of bond trustees. Trustees are willing to do more, but they insist on additional fees for additional services. So far, other parties to the deals have been unwilling to pay for additional services.

Some investors would like trustees to have greater responsibility. Investors encounter difficulty in reaching knowledgeable individuals when they call trustees with questions. In addition, investors encounter inconvenience in demonstrating that they are owners of a security if it is registered DTC.

Trustees sometimes have the role of testing calculations performed by a deal's servicer. A trustee may sign a monthly certification that confirms the accuracy of calculations. In insured deals, the bond insurers generally receive those certifications. However, investors do not receive the monthly certifications even if they exist.

Voting Rights: A bond insurer wants to be able to increase servicing fees, if necessary. However, the increased servicing fee should not come before distributions of interest and principal to investors.

A requirement of unanimous consent to amend documents can create grave difficulties. Too often, requests for consent to amend a deal are handled by back-office personnel, who may simply ignore

[80] *See* note 15 *supra*.

them. On the other hand, if a deal is a private placement with only two investors, it may make sense to require unanimous consent for an amendment.

A rating agency recommends leaving enough residual excess spread in a deal so that the spread can be used to pay an increased servicing fee, if necessary. The problem with such a technique is that it usually results in lower proceeds from a lease securitization.

Thursday, 5 February 2004

8:30 a.m. – Australian RMBS

Australian RMBS is a major cross-border asset class. The strong credit performance of Australian mortgage loans, combined with the presence of comprehensive mortgage insurance coverage, gives comfort to international investors.

Indexes of Australian home prices primarily reflect prices in the state capitals, where most of the population lives.

Projected issuance of Australian RMBS is US$23 billion for 2004. Assuming run-off of US$7.7 billion, total outstandings of Australian RMBS are project to be roughly US$46 billion. In 2003, Australia issued US$13.66 billion of RMBS in U.S. dollars and US$1.98 billion in euros.

Macquarie Bank (PUMA) is the largest issuer of Aussie RMBS. The other major issuers, in descending order of aggregate issuance are:

- St. George Bank (Crusade)
- Australian Mortgage Securities (ARMS)
- Commonwealth Bank of Australia (Medallion)
- Members Equity Pty (SMHL)
- Westpac Banking Corp. (WST)
- Interstar Securities (Millennium)

The homeownership rate in Australia is about 70%, which is higher than homeownership rates in the U.S. and Europe. The Australian housing market has been very strong, partly because of low interest rates and a strong economy. Recently, the Reserve Bank of Australia (RBA) said that the housing market might be overheated. The RBA raised interest rates slightly. As a result, some real estate values may slip slightly (5% to 10%), but a major decline is not expected.

The strengthening global economy has helped the Australian economy and Australian home prices. However, rising interest rates likely will dampen the overall rate of home price appreciation.

Low documentation loans are becoming a larger share of loan production. In Australia, a low documentation loan is one where the borrower's income is not fully verified ("self certified"). One lender restricts such loans to self-employed borrowers and permits a maximum loan-to-value ratio of 80% on such loans. Low documentation loans get the same protection from mortgage insurance as other loans. Another lender asserts that its low documentation loans display better performance than its fully documented loans.

The rating agency's reaction to Australian low documentation loans is to impute a higher expected default frequency. The concern is that rising rates might be more difficult for low-documentation borrowers.

Home prices in Sydney have risen the most. Prices in Melbourne have risen by the next largest amount. Sydney receives the greatest influx of immigrants to Australia. Immigration and strong Australian GDP growth are key drivers of the strong growth in home prices.

Home price appreciation has been steadier in Australia than in the U.K. Although home prices in both jurisdictions have grown by roughly the same amount since 1986, the growth was much bumpier in the U.K. than in Australia. Home prices in both markets are probably sustainable, based on measures of housing affordability.

Mortgage insurance on Australian mortgage loans provides very strong protection. The government of Australia introduced mortgage insurance in 1965. The purpose was to eliminate the then-customer requirement of a 25% down payment when purchasing a home. The original Australian system of mortgage insurance was copied from a Canadian model of the 1940s. Australian mortgage insurance covers 100% of loss on an insured loan. Coverage includes: repairs, foreclosure expenses, selling expenses, closing costs, outstanding taxes, and utilities. Mortgage insurance compensates a lender 100% for any loss. Two insurers now dominate the market for mortgage insurance in Australia (there used to be several more).

Insurers' claim rates and losses have been extremely low for the past few years. The worst-ever frequency of losses was in the late 1980s and early 1990s. Then, the loss rate for the industry was about 2.5%. The mortgage insurance industry has sufficient capital to absorb that rate of loss for five straight years. It can withstand a 40% drop in home values on a four-year rolling basis and still meet every claim.

Insurance in force is about $90 billion.

Mortgage insurance premiums on low documentation loans can be four to five times as high as premiums on regular loans. However, the claims experience on low documentation loans has been just about the same as for other loans. The insurers view the environment of the past few years as having been extremely benign and, therefore, the insurers are not likely to drop their premium rates for low documentation loans in the near future.

Arrears (delinquencies) of 30 days or more on Australian mortgage loans run steadily at levels of less than one percent. In comparison, the rate in the U.K. is consistently above 1.5%. Only the Dutch produce a consistently lower rate of 30+ arrears.

One Australian mortgage lender identifies additional benefits of Australian mortgage insurance. First, it provides protection against catastrophes. Second, it provides a second set of eyes on each loan when it is originated.

Lenders pay for mortgage insurance on loans with LTVs of 80% or less. Borrowers pay for insurance on loans with LTVs greater than 80%.

Australian RMBS deals receive credit enhancement primarily from the insurance on the underlying loans. However, because the insurers do not carry triple-A ratings, the deals also use subordination to achieve triple-A ratings on their senior tranches. Some recent deals have included "over-subordination" so that the triple-A-rated tranches will be able to retain their ratings even if the mortgage insurers are downgraded from their present ratings. Australian MBS deals also contain a modest amount of excess spread (~25 bps), which arguably provides another layer of protection against the downgrade risk of the mortgage insurers.

<u>Prepayments</u>: Australian mortgage loans (like U.K. mortgage loans and most European mortgage loans) have floating rates. Changes in market interest rates are not the primary driver of prepayments. Prepayment speeds run in the range of 25% CPR to 35% CPR. Over the past few years, prepayments have increased by about 5% CPR overall. The expansion of the loan brokerage sector is partly responsible for the increase in prepayments. Loan brokers precipitated an increase in borrower sophistication and prompted borrowers to shop for loans with lower margins. Additionally, home price appreciation has prompted many borrowers to take equity out of their homes, which generates prepayments and the production of new loans.

There is a nascent sub-prime mortgage market in Australia. It appears generally similar to the U.K. sub-prime mortgage market. Australian sub-prime mortgage loans do not necessarily carry mortgage insurance. Thus, deals backed by sub-prime mortgage loans rely on subordination for credit enhancement.

9:30 a.m. – Understanding Structured Settlement Securitization

A structured settlement is a litigation settlement to compensate an individual for a personal injury. The individual essentially gets a contract backed by an annuity from a highly rated insurance company. Structured settlement companies (SSCs) provide a relief valve that allows an individual to sell his structured settlement if his situation changes. In selling a structured settlement, an individual effectively converts an annuity cash flow into an immediate lump sum.

Courts now review all sales of structured settlements by individuals.[81]

The legal landscape for structured settlement deals has changed for the better over the past few years. The court order process eliminated most of the hard legal issues that had existed before 2002. Thirty-seven states have structured settlement transfer laws. Under the typical state law, an individual files a petition asking to transfer his structured settlement and then a court review and usually approves the petition. The approval rate is in the range of 90% to 98%.

Some states create problems. In New York, some judges have questioned the reasonableness of the discount rates used for calculating the purchase price of structured settlements. In addition, they have challenged whether the structured settlement sales are in the best interests of the selling individuals. Some judges simply do not like the business. A few insurance companies (the annuity issuers) still object to the transfers.

The *Ballos* case and the *DeMallie* case address the issue of what is a reasonable discount rate for calculating the purchase price of structured settlements.[82]

Revised Article 9 of the U.C.C. covers sales of "payment intangibles." This has boosted the legal certainty associated with structured settlement securitizations.

A rating agency can work most quickly on a structured settlement securitization when it receives the following data: (1) the proposed structure of the transaction, (2) historical performance data, including static pool data, (3) pool stratifications showing any material concentrations, and (4) a cash flow model for the deal. Turnaround time for the whole rating process generally should be in the range of six to eight weeks. A rating agency will scrutinize a deal's servicer with particular focus on (1) collections and payment monitoring capabilities, and (2) procedures to address and minimize loan diversions, defaults and delinquencies, and administrative errors.

A representative from a bond insurer views structured settlements as an evolving asset class. The asset class arguably is mid-way through its life cycle (toward maturation). The assets are interesting because they have a retail component (the sellers), a commercial component (the insurers), and a regulatory component. The court order process has greatly simplified analysis.

Structured settlement ABS are well suited to bond insurance because the securities have long tenors, involve a complex story, sometimes include non-court ordered transfers (pre-2002 transfers), and have idiosyncratic servicing needs.

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[81] Recent change to the tax laws effectively deter any sales of structured settlements without court approval. *See* Victims of Terrorism Tax Relief Act of 2001, Pub. L. 107-134 § 115(a) (2002) (adding I.R.C. § 5891).

[82] *In re Petition of Settlement Capital Corp. (Ballos)*, 2003 NY Misc LEXIS 1149 (N.Y. Sup. Ct., Queens County.); *321 Henderson Receivables v. DeMallie*, 2003 WL 22945635, 2003 N.Y. Slop Op. 23888 (N.Y. Sup. Ct., Monroe County 5 Dec 2003).

A structured settlement securitization can have risk concentrations through exposure to a small number of insurance companies.

Servicing of a structured settlement is highly process-driven and detail-oriented. A servicer should have a good "corporate structure" coupled with a local presence in many states.

Because of their small size, all structured settlement ABS deals have been 144A transactions or private placements. When a securities dealer provides warehouse financing to a SSC, the dealer's interests are aligned with those of investors. An underwriter should focus on the process by which a SSC acquires structured settlement receivables.

Insurance companies are natural investors for structured settlement ABS. Structured settlement ABS appeal to investors that have an appetite for long-term, fixed rate paper. Investors focus on the predictability of structured settlement cash flows. The deals have long principal repayment windows and long tenors. Structured settlement receivables are not prepayable. However, there is extension risk because individuals sometimes try to divert cash flows, which causes delays. To date, structured settlement ABS have used turbo structures, with all collections applied to the class A securities until they are retired. Investors focus on the quality and diversity of the underlying insurers.

10:45 a.m. – The Enron Examination: Lessons for the Structured Finance Industry

The court appointed examiner focused specifically on Enron's use of SPEs and on the role of third parties (*e.g.*, lawyers, accountants, financial institutions) in Enron's demise.

The examination resulted in four reports, totaling more than 4,500 pages. The first and second reports analyze transactions and the third and fourth address potential claims of Enron's estate against third parties. The examiner considered whether there was enough evidence supporting a claim that the claim should be submitted to a judge or jury.

Enron's structured transactions arguably were different from many ordinary securitizations because Enron retained the risk and benefits of the subject assets and retained control over the assets. Enron effected the transactions to generate reported operating cash flow. Enron’s disclosure of its structured deals was inadequate and the company routinely violated GAAP accounting for the deals.

Enron used six techniques in its problematic deals:[83] (1) commodity prepay transactions, (2) share trusts, (3) minority interest transactions, (4) tax transactions, (5) non-economic hedges and other related party transactions, and (6) FAS125/FAS 140 transactions. Deals of the final category are the ones most similar and relevant to mainstream securitizations.

In a typical Enron FAS 140 transaction, Enron would form a "Sponsor" which would transfer the subject asset into an "Asset LLC." The Asset LLC would transfer a "class B" interest (representing the economics of the asset) to a "Transferor LLC" which would transfer it, in turn, to a trust. The trust would issue 3% equity and 97% debt to finance the asset. The proceeds would flow back through the Transferor LLC to the Asset LLC and then to the Sponsor. Enron would write a total return swap to the trust, to retain all the risks and benefits of the subject asset. Enron would book the transaction as a sale of the asset and would book the proceeds as cash flow from operations. Enron retained control over the asset through a "class A" interest (representing voting control over the Asset LLC). The Sponsor was the sole member of the Transferor LLC. The transactions did not reduce borrowing costs. In fact, Enron had to pay a premium for complexity. The underlying assets rarely produced any cash flow themselves.

In Enron's bankruptcy, the true sale character of the transactions was challenged. Key elements of the analysis include retention of risks and rewards, retention of control, and Enron's intent to use the

[83] *See* note 25 *supra* and accompanying text.

transactions for "balance sheet management" rather than as final and irrevocable dispositions of the subject assets. Enron's deals also were defective on the basis of substantive consolidation: (1) reliance on Enron credit rather than on performance of the assets, (2) Enron's retention of control over the assets, and (3) loans between Enron and the deals negated the position that the deals were operated separately. Enron did observe the formalities of separate phone numbers and letterhead for its SPEs, but those formalities, by themselves, are not enough to prevent substantive consolidation. Permitted investments for the deals included Enron debt securities. Enron used payments on its debt securities as a way to provide liquidity to the SPEs. However, given that Enron was insolvent at certain times, those payments can be attacked as fraudulent conveyances or preferential transfers.

Lessons for Structuring Transactions: (1) Understand the purpose of a transaction. (2) Know the history of the subject assets. Moving assets from one deal to another should raise a red flag. (3) Plan for true sale and substantive consolidation risks by taking a backup security interest. The Enron deals lacked backup security interests. (4) Watch for patterns in transactions. (5) Evaluate transactions based on current knowledge (*i.e.*, assumptions must comport with reality). (6) Note whether the economics of a transaction are consistent with disclosures and with the accounting treatment.

Enron's bankers could be liable on a theory of "aiding and abetting" because the bankers knew of the wrongful conduct by Enron's officers and directors. The same facts that would support "aiding and abetting" could support equitable subordination of claims.

Key Lessons for Issuers:

- If a transaction is too good to be true it may be; take a second look
- In accounting-driven transactions, give professionals all the relevant facts
- Compliance with GAAP may not satisfy disclosure obligations

Red Flags:

- Sales that
  - leave control of sold assets in the hands of the seller
  - leave the burdens and benefits of ownership with the seller and that make the seller responsible for repayment of debt incurred to finance the sale
- Side agreement (especially undocumented ones)
- GAAP treatment conflicts with economic reality

Banks are most at risk when they are heavily involved in structuring a transaction or when they sell a proprietary structure. Banks are also at risk when they participate in a repetitive series of transactions to achieve accounting targets. Lastly, banks are at risk when transaction disclosure is opaque.

Bottom line: Enron's abuse of SPEs and structured finance does not undermine the legitimacy of these techniques for risk management, raising capital, and asset divestiture.

Rating agencies rated the share trust deals. Enron's credit was the basis of the ratings.

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