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Report from Las Vegas: Coverage of Selected Sessions of ASF 2006

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The recent ASF 2006 conference in Las Vegas, Nevada attracted a record number of attendees. By some accounts, more than 4,000 professionals attended the event. The strong attendance seemingly reflects good current conditions as well as a positive outlook for the securitization industry in 2006 and 2007. Unlike past conferences, the presentations and panel sessions at ASF 2006 did not generally tackle the big picture in terms of the wide array of issues that the industry faces. Interest rates, home prices, spread volatility, Regulation AB, securities offering reform, synthetic securities, FAS 140, and Basel II each received attention in multiple sessions. However, except for the sessions titled "The Real World…" on Sunday, none attempted to pull everything together to offer a view of the whole landscape.

The following summaries reflect remarks of the panelists who participated in selected sessions at the ASF 2006 conference sponsored by the American Securitization Forum. 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 American Securitization Forum in hosting the conference.

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

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Sunday, 29 January 2006

1:35 pm – Securitization 301 - Dynamic Structuring and Analysis

Securitization is about 25 years old. It started in 1977-78.[1] It gained significant momentum during the savings and loan crisis. Structured finance is a tool for corporate finance. It allows financial companies to better control their balance sheets.

The rating agencies had a key role in developing the foundations of structured finances. The rating agencies created the paradigm of the "benchmark pool" as an adaptation of corporate financial analysis. Later, the rating agencies adopted a static, liquidation analysis of securitizations for assessing credit risk (credit enhancement), prepayment risk (and its affect on credit), and counterparty risk. Ultimately, the rating agencies replaced the static analysis approach with dynamic analyses. Of the two largest rating agencies, Moody's focuses more on cash flows while S&P focuses more on liquidation/balance sheet analysis. Newer dynamic rating agency analyses use Monte Carlo simulations to capture alternative scenarios over time.

The two dominant forms for analyzing securitizations are (1) Monte Carlo cash flow analyses and (2) "option-theoretic" valuation frameworks. Wall Street firms primarily use the option-theoretic frameworks where price and fair value are the objective. The rating agencies primarily use Monte Carlo cash flow analysis to analyze assets.

There are different measures of risk in different domains. For example, delinquencies, defaults, losses, and correlations all are measures of risk in the credit domain. Using delinquencies as well as other measures acknowledges the smooth, time-sensitive character of credit risk. Default is not an instantaneous, digital phenomenon. Delinquency precedes default and gives warning. Within credit risk, default, loss, and reduction in yield all provide alternative measures of ultimate performance. However, a given risk can appear greater or smaller depending on the measure used. Liquidity risk, market (price) risk, basis risk, operational risk, and servicer risk are other domains of risk with their own measures. Basis risk is the risk that two indices track each other poorly. Operational risk is not rigorously defined but there is growing focus on the area.

Volatility is relevant in many areas of financial analysis: credit risk, market risk, basis risk, etc. Correlation figures into credit performance volatility. Durations and convexities of callable instruments (including many securitizations) are more difficult to calculate than durations and convexities of non-callable instruments.

Valuation of contingent claims is based on options theory. It has applications for market risk and credit risk. Where a closed form solution is impossible, Monte Carlo simulation is the preferred tool for estimating value or risk.

OAS (option adjusted spread) modeling for pricing mortgage loans uses an interest rate model to simulate interest rates. Then it uses a prepayment model to simulate prepayments, conditional on the simulated interest rates. Finally, it uses a cash flow model to combine the results of the previous steps to calculate OAS. The interest rate model often is based on Vasicek's model, which includes a mean reversion mechanism.[2]

Alternative credit paradigms include structural models (a/k/a Merton default models)[3] and intensity models (a/k/a hazard rate models).[4]

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[1] Obviously, 2006 - 1978 ≠ 25. But who's counting?

[2] Vasicek, O., *An Equilibrium Characterization of the Term Structure*, J. of Financial Econ., vol. 5, pp. 177-188 (1977). Oldrich Vasicek was the "V" in KMV Corp., which Moody's acquired in 2002.

[3] Merton, R, *On the Pricing of Corporate Debt: The Risk Structure of Interest Rates*, J. Finance, vol. 29, pp. 449-470 (1974).

Conclusions: The capital markets are converging on a single paradigm: structured finance (including dynamic cash flow analysis). Securitization is moving from a regime of static analysis to one of dynamic analysis. Corporate analysis could look very different in 10 years.

2:50 pm – The Securitization Legal and Regulatory Framework

Securitization is the process of issuing securities backed by the cash flows from assets. A key step in the process is legally isolating the credit risk of the assets from the credit risk of the originator of the assets.

Key areas of law for securitization include:

- securities regulation
- bankruptcy
- commercial law (Uniform Commercial Law)
- accounting standards
- banking regulation, and
- tax law.

Securities Law: The key securities law affecting securitization are (1) the Securities Act of 1933, (2) the Securities Exchange Act of 1934, (3) the Trust Indenture Act of 1939, and (4) the Investment Company Act of 1940. The Securities Act requires registration of securities sold in primary offerings. However, there are exemptions for private placements (§4(2)), sales to qualified institutional buyers (Rule 144A), and offshore transactions (Regulation S). A private placement must not involve a public solicitation and usually is offered only to sophisticated institutional investors or to a limited number of offerees. If no exemption is available, securities must be registered by filing a registration statement with the SEC. A registration statement must contain a "prospectus," which is the main disclosure document that describes the securities being offered.

Communications: The securities laws regulate offering communications for primary offerings of registered securities. Under recent changes to the regulations, sellers of securities now can use written communications (called "free writing prospectuses" or "FWPs"), but they must file them with the SEC.

New Rule 159 specifies that disclosure liability is based on the information that an investor has received at the time when he enters into a binding contract for the purchase of a security. Information delivered afterward has no effect on determining the seller's liability. For purposes of Rule 159, the time of sale is when the investor becomes bound to purchase the security, regardless of whether the seller is bound to deliver the security.

Disclosure Requirements: Securitizations now have their own disclosure system under new Regulation AB, which took effect at the start of the year. The regulation requires disclosure about parties to a securitization transaction. The regulation also requires disclosure of static pool performance information of older assets to help a prospective investor understand how newly securitized assets are likely to perform. The static pool data can help investors observe the impact of how an originator's underwriting standards evolved over time. Static pool disclosure requirements cover delinquencies, losses, and prepayments. Static pool disclosure requirements are different for liquidating asset pools of assets (like mortgage pools) and for revolving asset pools (such as credit card master trusts). The SEC allows internet-based disclosure for static pool data.

Periodic Reporting Framework: Section 15(d) of the Exchange Act is the source of reporting requirements. That provision allows certain issuers to terminate their periodic reporting after one year. Under Regulation AB, securitizations use Form 10-D for filing their monthly distribution reports and use the other standard corporate reporting forms (10-K and 8-K) for filing other information.

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[4] *See, e.g.*, Jarrow, R. and S. Turnbull, *Pricing Derivatives on Financial Securities Subject To Credit Risk*, J. Finance, vol. 50, no. 1, pp. 53-86 (1995).

Securitizations must use Form 10-K to file Sarbanes-Oxley certifications, servicing assessment reports, and accountants attestations regarding servicing. Form 8-K applies to current material events such as (i) bankruptcy of a deal's sponsor or credit enhancer, (ii) occurrence of an early amortization event, (iii) change of trustee or credit enhancer, and (iv) failure to make a required distribution.

Investment Company Act of 1940: Securitizations generally must avoid becoming "investment companies" under the 1940 Act. Most securitizations would be classified as investment companies unless an exemption is available. If securitizations had to register as investment companies, they would not be able to operate in their regular way. Fortunately, there is a specific exemption for securitizations under Rule 3a-7, adopted by the SEC in 1992. Other available exemptions are under 1940 Act §§ 3(c)(1), 3(c)(5), and 3(c)(7).

Bankruptcy and Insolvency Law: The goal is to separate the credit risk of the assets from credit risk of the originator. The concept is called "bankruptcy remoteness." [5] Investors want bankruptcy remoteness because they want to buy the credit quality of assets rather than the corporate credit quality of the originator. Originators want to achieve bankruptcy remoteness in order to achieve desirable regulatory and accounting results.

To achieve bankruptcy remoteness, the assets must be isolated from the risk of the originator's bankruptcy. This usually requires making a "true sale" of the assets to a "bankruptcy remote" special-purpose entity (SPE). It is also necessary to minimize the risk that the SPE might become the subject of its own bankruptcy. To do that, the SPE has no operations and engages only in activities incidental to its securitization deal. Bankruptcy remoteness also requires minimizing the risk that the SPE would be consolidated into the originator if the originator goes into bankruptcy. A bankruptcy remote SPE generally must have one or two independent directors (*i.e.*, independent of the originator), a separate address, a separate phone number, and must observe all corporate formalities. The presence of independent directors is designed to reduce the chance that an SPE files itself into bankruptcy if the originator goes into bankruptcy.

If bankruptcy remoteness fails, the assets of a deal would become part of the originator's bankruptcy estate and would be subject to the powers of a bankruptcy court to substitute or reduce the level of collateral securing the securitization instruments.

In practice, most securitizations use two SPEs. The originator first transfers the assets to a bankruptcy remote SPE, which then transfers the assets to a second SPE that issues securities. The transfer to the first SPE is designed to be a "true sale" so that it will not be treated as merely a pledge of collateral (for a loan) in case the originator goes into bankruptcy. The first SPE must maintain its corporate separateness from the originator so that it avoids "substantive consolidation" in case the originator goes into bankruptcy.

Bankruptcy remoteness now is necessary for an originator to achieve "sale" accounting treatment under FAS 140 (the accounting standard that governs whether a transaction is a sale that removes assets and liabilities from a company's balance sheet).

Because banks are not subject to the Bankruptcy Code, they usually can execute securitizations with just one SPE and a single-step transfer. The FDIC issued a rule that allows banks to achieve "sale" accounting treatment with a single-step transfer. In some states, however, banks still must use two-step transactions.

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[5] Short explanation: Bankruptcy remoteness requires transferring assets away from the originator so that the originator no longer owns then and they will not be part of the originator's bankruptcy estate (if the originator goes into bankruptcy). The transfer itself must qualify as a "true sale." That means that a bankruptcy court would respect the sale characterization of the transfer and would not recharacterize the transfer as merely a pledge of collateral to secure a loan. In addition, the transfer must be made to an entity (usually a "special purpose entity" or SPE) that is separate from the originator. The SPE must have limited activities to minimize the risk that it goes bankrupt itself and it must observe corporate formalities to preserve its separateness from the originator.

Tax Law: Securitization issuers generally desire "debt for tax" treatment even though they strive for sale treatment under accounting standards. If the originator retains significant risk and rewards on the underlying assets, it usually can get "debt for tax" treatment.[6]

3:55 pm – Securitization 101 – Introduction to Securitization

What are Asset-Backed Securities (ABS)?: Most ABS are securities backed by consumer receivables such as mortgage loans, auto loans, or credit card receivables. The creditworthiness of the securities comes from the credit quality of the assets rather than from the credit strength of the company that originated the assets (the "originator"). In some cases, ABS are backed by exotic assets such as taxi medallion loans and music royalty receivables.

The first ABS deal was a computer lease deal by Sperry/Univac.[7] Auto loan ABS followed a year later.[8] ABS issuance has grown steadily, with over $700 billion in issuance in 2005.

Although the ABS market has very large issuance, the securities repay their principal rather quickly. The result is that the level of outstanding ABS is lower than the outstandings of other types of fixed income securities (e.g. Treasuries, corporate bonds, municipal bonds).

About 90% of all ABS attain triple-A ratings. Within most ABS deals, most or all of the securities issued receive triple-A ratings. By comparison, only about 20 corporate bond issuers have triple-A credit ratings. In addition, ABS suffer rating downgrades less frequently than corporate bonds.

Structure: The main objective in structuring ABS is to create securities with credit performance that is independent of the bankruptcy risk of the originator. That is, to create securities that are insulated from event risk associated with the originator. A related objective is to create a security interest in the assets. To achieve that objective, the originator sells the assets to a special purpose entity (SPE) in a "true sale." The SPE must restrict its activities and conduct its affairs so that it does not go into bankruptcy and so that it does not get entangled in any bankruptcy of the originator.

Investors: Many different kinds of investors buy ABS. ABS appeal primarily to investors that focus on investment-grade securities, though a growing faction of speculative-grade investors is taking exposure to ABS through CDOs. The investor base has become truly global, with active participation from European and Asian investors, in addition to American investors.

ABS backed by off-the-run assets (such as future flows, aircraft leases, or mutual fund fees) tend to pay wider spreads and to be less liquid.

ABS Risks: "Servicer risk" is the risk that the servicer of a deal's assets goes out of business. If a deal's servicer is a weak company, it may be advisable to have a back-up servicing arrangement. "Collateral risk" is the risk that the collateral (assets) backing an ABS will perform worse than

[6] Securitizations sometimes involve seemingly contradictory treatment under accounting standards, bankruptcy law, and tax law. Often, a securitization achieves sale treatment for accounting purposes and "true sale" status for purposes of the bankruptcy law while qualifying as debt for purposes of the tax laws. The different regimes have differing criteria of classifying transactions. The tax law focuses on economic risks and rewards. If the originator of assets purports to transfer them but retains the residual economic risks and rewards, the tax law will treat the transfer as simply a pledge of collateral to secure a debt. For purposes of a bankruptcy law "true sale" analysis, the main focus likewise is on the retention of economic risk by the originator. However, most lawyers feel that risk retained indirectly through owning 100% of the stock of an SPE does not count. Accordingly, securitizations can achieve "true sale" status for bankruptcy purposes even if the originator retains sufficient economic risk through an SPE so that the transaction is debt for tax. Accounting standard do not use economic risks and benefits as the basis for classifying a transfer as a sale. Rather, accounting standards use the notion of "control" over the assets as the primary criteria for deciding whether a transfer qualifies as sale or merely a pledge.

[7] Sperry Lease Finance Corp. issued $192.5 million of in March 1985 (Bloomberg ticker SPY A).

[8] Actually, auto loan securitization followed only two months after the Sperry computer deal. On 15 May 1985, both Valley National Bank and Marine Midland Bank priced securitizations backed by auto loans (Bloomberg tickers VNF A and MMCT 1985-1).

expected. Investors and rating agencies address collateral risk by analyzing (1) historical performance data on similar assets, (2) asset diversification, (3) underwriting practices, and other factors and by including credit enhancement in ABS deals to provide a cushion against unexpected losses.

New ABS disclosure rules may lead to tiering among ABS issuers in each asset class as the market gets to see each issuer's historical performance.

Reading the documents is important. The documents for a deal – including the prospectus – should give all the details. The documents reveal the representations and warranties from the originator, the payment priorities (waterfall), potential conflicts of interest, the definition of default applicable in a deal, the allocation of voting rights, periodic reporting requirements, and prefunding/substitution features. Investors should always try to understand the details of a transaction in which they invest.

Credit Enhancement: In contrast to corporate bonds, ABS have credit enhancement. Credit enhancement allows ABS to achieve better credit quality than that of the originator. Subordination is a common form of credit enhancement. It entails the creation of subordinate classes of securities to absorb losses on the securitized assets and to insulate the related senior classes from those losses. Another form of credit enhancement is excess spread (the net interest margin on a deal). One way to use excess spread is to apply it to amortize the balance of senior securities (a/k/a turboing), thereby accumulating a cushion of surplus assets relative to the related securities. Other types of credit enhancement include third-party guarantees or letters of credit from banks.

Different asset classes require differing levels of credit enhancement. For example, credit card ABS often can attain triple-A ratings with credit enhancement of 12.25%. In contrast, ABS backed by home equity loans require higher levels of credit enhancement. ABS backed by student loans require lower levels of enhancement.

S&P requires loss coverage of 4-5 times for AAA ratings, 3-4 times for AA ratings, and 2-3 times for A ratings.

Structures: Credit card ABS are the ones most like corporate bonds, with bullet maturities. Credit card ABS are backed by "revolving" asset pools. In contrast, most other types of ABS are backed by static "liquidating pools" and provide for the securities to amortize roughly in pace with the assets. Some deals involve sequentially-maturing classes of securities, where the earliest maturing class receives all principal cash flows until it is retired. Other deals use *pro rata* payment structures, where all classes receive principal proportionately on each payment date.

Prepayments: Prepayments come in several flavors: refinancings, curtailments, and defaults (a special case of prepayment). ABS professionals use several different measures of prepayment activity. "CPR" stands for "constant prepayment rate" and describes a constant annual rate of prepayment. In prepayment terms, "ABS" stands for "asset-backed speed" and measures prepayments as a constant percentage of an asset pool's *original* balance. "PPC" stands for "prepayment curve" and it uses an increasing prepayment speed that starts at a slow CPR speed and grows to a higher CPR speed.

Prepayments are very stable in auto loan ABS. Prepayments on home equity (sub-prime mortgage) ABS are less stable, but still more stable than prepayments on ordinary MBS.

ABS Features: ABS are priced to average life[9] rather than to stated maturity. The cash flow characteristics of ABS generally are like those of mortgage-backed securities (MBS). ABS prices

[9] Weighted-average life or "WAL" refers to the weighted-average time to the return of principal on a security. In calculating a security's WAL, each payment date is expressed as the interval (in years) between the time of calculation and the payment date. Each interval is weighted by the amount of principal that will be distributed on the corresponding payment date.

respond to changing interest rates. Floating rate securities experience smaller price changes in response to changing interest rates than do fixed rate ABS. Changes in the prevailing interest rate environment can influence prepayments. Trigger tests (covenants) and early amortization mechanisms[10] provide credit protection. Most ABS are callable at the seller's option when the pool balance reaches a 5% or 10% balance. ABS have some servicer risk. Most ABS investors are institutional investors rather than individual investors.

5:00 pm – The Real World: Bringing it All Together/Key Investor Topics

Advice and Recommendations for 2006: An issuer panelist recommends striving for the greatest possible transparency with investors – "WWARINTK," what would a reasonable investor need to know. In wrestling with the SEC's new disclosure regulations, members of an issuer's staff should continually ask themselves: "If you were an investor, what information would you want or need." An issuer's staff should be open to investor requests for information. An issuer's management must fully understand both its collateral and its business so that it can explain both the collateral and the business to others. Additionally, an issuer's management should understand its competitors and how they are different. Management should be involved with investors and with others in the securitization industry to promote. Lastly, securitization professionals must remember that it's a small industry and you must deliver what you promise.

A banker panelist feels that knowing the assets is critical. Sometimes other markets, such as equity markets, give signals that asset performance may change. For example, REIT stocks can signal changes in home equity loan performance. Second, know the global markets. Third, keep up with the markets. An example is the need to understand the development of synthetic ABS and how it affects the mainstream ABS market.

An accountant panelist recommends that prospective ABS issuers get accountants and other advisors involved early in the securitization process. Once the process gets started, it is hard to change direction. Second, an issuer must have historical data and adequate computer systems to achieve successful securitizations. Third, don't underestimate the time, expense, and effort of effecting a securitization.

A banker panelist cautions against trading expediency for knowledge. A banker should try to put himself in his customers' shoes to anticipate questions. Second, investors should give feedback to syndicate desks to help the price discovery process. Third, investors should be clear in placing orders – they should not say "put me down for $100 or $200 million."

A rating agency panelist cautions bankers against abusing rating analysts. Bankers and issuers should be forthright with rating analysts to avoid surprises late in a deal (*e.g.*, when the rating analyst discovers a problem right at the last minute). Investors should understand ratings so that they can use them intelligently.

A lawyer panelist recommends staying on top of legal and regulatory developments that affect the securitization industry. Lawyers and accountants need to understand their clients' objectives in order to help them achieve those objectives (*e.g.*, sale accounting treatment). Lawyers should encourage clients to read deal documents and should know documents backwards and forwards themselves.

An investor panelist recommends that investors should know the parties to a transaction. An investor should even visit issuers to understand the depth of their organizations. Investors should inquire about how much background a banker has in an asset class. Investors should get to know the

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[10] An early amortization mechanism is one that allows for the early repayment of a security in response to deteriorating credit conditions. Early amortization mechanisms are present in credit card ABS deals. As long as the receivables backing a credit card deal perform adequately, principal collections each month can be reinvested in new receivables (a "revolving pool"). However, if the performance of the receivables deteriorates beyond specified trigger thresholds, the early amortization mechanism traps the principal collections and applies them toward repayment of the securities.

trustees very well. A deal's trustee likely will be the backup servicer if one is needed. Second, monitor transactions. Inevitably, there will be some losses on securitized assets. However, if performance deteriorates significantly, sell the bonds quickly. Third, get paid for investing in off-the-run assets and for investing in deals from issuers that have little history.

A trustee panelist advises knowing the parties to a transaction. It's worth visiting transaction parties. Avoid ambiguity in transaction documents. Issuers should provide accurate loan-level information at a deal's closing.

Another investor panelist cautions investors to be alert for possible fraud. Investors should be watchful of red flags. Glibness, lack of follow-through, or mis-information from an issuer are all red flags. Also, rating agency reports and preliminary prospectuses do not always reflect the real world. In work-out situations, events will not unfold as portrayed in reports or the prospectuses. The worst statement that an issuer or banker can make to an investor is "you don't need to know that." On one notable occasion, a securitization professional working for an industry group falsely claimed to regulators that he was representing investors' viewpoints when he was not.

Investors should make their concerns known to regulators and policymakers. They should not rely on others to communicate their concerns. Investors have never been in a better position to make a difference in shaping how industry practices evolve.

Regulation AB:[11] An interesting development is issuer responses to Reg AB. Two credit card issuers have chosen different formats in which to disclose FICO scores.

Trustee panelist: Reg AB has the positive effect of removing ambiguity about the responsibilities of transaction participants.

Banker panelist: Reg AB has slowed down the transaction process because underwriters now use red herrings (preliminary prospectuses) and then a two-day delay before pricing. Reg AB has made the transactional process more involved and there is more information available.

Investor: Before the adoption of Reg AB, investors were active in the process of commenting to the SEC. Investors commented on the need to have sufficient time to absorb and analyze information before being asked to make an investment decision.

Investor: Term sheets don't include disclosure of material investment risks. Preliminary prospectuses do.

Accountant: The securitization industry is in a trial and error period with Reg AB, trying to figure out what to do. There is a major focus on what is included in preliminary prospectuses and the accuracy of that information. Also, the market is very hot. Deals come fast and furious and, accordingly, everything is rushed and investors do not get enough time to analyze new deals. Time is becoming an enemy for all market participants.

Rating Agency Panelist: Rating agencies need time as well. Issuers and bankers need to bring rating agency analysts into the transactional process at early stages so that the rating agencies can meet the issuers' and bankers' deadlines. There is no excess time left in the transactional process. For transactions to achieve rapid execution, the parties need to involve the rating agencies as early as possible.

Investor panelist: Investors and rating agencies should be given plenty of time to analyze off-the-run deals and deals from new issuers. If a deal is too complicated and an investor does not get enough time to analyze it, he should just put it aside.

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

Lawyer panelist: Reg AB arguably forces the use of preliminary prospectuses. Reg AB and offering reform together have the effect of compressing the time for execution after a preliminary prospectus is distributed.

Banker: Pricing a deal relies on the information in the preliminary prospectus. The information must be in the preliminary prospectus or the investor will have the right to return the bonds. Challenges of complying with Reg AB and offering reform created supply shortages, which partly explain the wide triple-B spreads early in January. Later the spreads tightened, but some investors got the wide spreads. If spreads had moved the other way, investors likely would have walked away from their orders. Preliminary prospectuses must disclose derivative counterparties. Deals issued under Rule 144A might suffer a growing pricing penalty as time passes.

Issuer: Reg AB has caused disruption. Issuers underestimated the actual amount of operational work necessary to comply with Reg AB. Putting the regulation into practice raised many questions and answering those questions was difficult and time consuming.

Monday, 30 January 2006

8:20 am – Globalization and Convergence Trends in the Securitization Market

From 1995 to 2005, the growth of international ABS issuance outpaced the growth of U.S. ABS issuance. Student loan ABS (SLABS) was the fastest growing ABS sector in the U.S. during that period. However, over the past *five* years, floorplan ABS has been the fastest growing sector. Of the major sectors, the fastest growing one over the past five years was home equity (sub-prime mortgage) ABS.

Synthetic[12] trades have accelerated dramatically. They have been used for risk transfer by banks and also as substitutes for cash securities.

Although the ABS market is global, most deals include assets from only one country.

European ABS issuance has grown sixfold over the past six years. U.K. RMBS (residential MBS) is the dominant asset class and accounts for 40% of European issuance. U.K CMBS also is a major asset class. RMBS is likely to continue to dominate the European ABS landscape over the next few years.

Australian securitizations account for about 3% of global ABS and 7% of global RMBS. RMBS accounts for about 95% of Australian securitizations. Australian RMBS are issued in various currencies (US$, A$, and Euros) and are sold both domestically (in Australia) and to American and European investors. The Australian CMBS and CDO sectors have grown, but from a very small base.

Audience survey: Most investors expect to invest primarily in RMBS and traditional ABS, as opposed to other securitization products. Within traditional ABS, most plan to invest primarily in home equity ABS.

Leverage is becoming a major factor in the markets. As little as $5 million can control up to $1 billion of high quality assets.

Syndicate desks see new investors coming to the market. However, the market is gaining depth, the new investors are not necessarily driving spreads tighter. However, the entry of new investors does diminish the power of the large traditional investors to dictate spreads. There is better liquidity and

[12] "Synthetic ABS" refers to credit default swaps (CDS) on ABS.

secondary trading. CDO managers exert a tightening influence on spreads in Europe. In Australia, the entry of new investors has a tightening influence on spreads.

Audience survey: Of non-U.S. markets, emerging markets present the best opportunities for 2006 (better than the U.K., Europe, Japan, Australia, and Asia). Emerging markets deals are coming from the Middle East (*e.g.*, the Emirates) and Latin America.

Securities Laws: Audience survey: Regulation AB has either discouraged or not affected issuers' propensity to issue in the U.S. On the other hand, most investors feel either (1) that the SEC's new rules have improved the investing environment or (2) that it is too soon to tell what the affect will be.

From a dealer's perspective, the SEC's new offering reform regulations are producing inconsistent practices among underwriters. Resolving the inconsistencies will require an iterative process before market participants converge on a consensus of "best practices." Investor panelist feels that new static pool data disclosures are valuable and allow better analysis. An investor panelist even insists on the format in which data is delivered, so that it can analyze the data more readily. But, offering reform is somewhat delaying the offering process. It can take days or weeks between the time when a an underwriter has received soft circle indications of interest for all the securities in a deal and the time when the deal actually prices. Australian and U.K. issuers are grappling with Reg AB in order to be able to continue issuing their securities in the U.S.

Accounting: The audience is evenly divided about whether U.S. or international accounting standards for securitization are more "right."[13] The audience expects delays before the Basel II standards for bank capital requirements become effective. From a European's perspective, the U.S. seems strange because professionals discuss securitizations without talking about Basel II. In Europe, Basel II is the number one issue for all securitization professionals. However, for U.S. professionals, accounting and regulatory changes remain significant. From a U.S. investor's perspective, Basel II may change the call feature in ABS. Also, spread relationships among different asset classes likely will change as the relative capital charges for different asset classes changes.

Panelist Predictions for 2006: (1) Issuance will be flat to down. The market's focus will be on credit trends. Market will embrace indices.

(2) Issuance will be down. There will be a shift from floating to fixed rate issuance. Floating rate issuance will be scarce. More countries will come to the global market in 2006. Repeat issuers from emerging markets countries will return. Investors will have greater interest in deals backed by new asset classes from other countries.

(3) Australia: 2006 volume like 2005. 2007 is unclear. Spreads on Aussie RMBS will continue to track spreads on U.K. RMBS master trusts.

9:20 am – CDS of ABS: The Future Is Now

Credit default swaps (CDS) of ABS are the most exciting development in the ABS market. They change how market participants hedge and transfer risk by allowing then to go long or short on specific securities or whole sectors. Over 80% of the ABS CDS activity to date has involved CDS on securities rated triple-B or triple-B-minus. A key driver of the rapid growth of ABS CDS was ISDA's release of a standard ABS CDS document that gained broad acceptance from both dealers and investors.[14] Second, dealers presented the product as an actively traded two way product, which helped to encourage rapid growth in the level of trading activity.

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[13] The key difference relates to the criteria for achieving sale treatment. The U.S. standard, FAS 140, focuses on control over the subject assets. The international standard, IAS 39, focuses on the transfer or retention of economic risks and benefits.

[14] ISDA, the International Swap and Derivatives Association, published a model form on 21 June 2005 titled "Credit Derivative Transaction on Asset-Backed Security with Pay-As-You-Go or Physical Settlement (Dealer

Big users of ABS CDS include CDOs, which have been the largest buyers of triple-B exposure over the past several years (*i.e.*, the CDOs sell protection on specific ABS that carry triple-B ratings). Macro hedge funds have been buyers of protection. Their demand for protection pushed spreads wider last year. Traditional investors have not been the key drivers in the synthetic area.

An investor panelist notes that his firm can use the new ABX index[15] to add exposure for many accounts at once, without having to struggle to get allocations in new issues.

From a CDO manager's perspective, the synthetics allow rapid ramp up (*i.e.*, rapid accumulation of assets for a CDO's portfolio) as well as providing broad flexibility in choosing exposures to specific vintages and issuers. In addition, synthetics allow creating par positions in premium bonds. Synthetics further allow an investor or CDO manager to act on perceived quality differences among securities when the pricing of the securities fails to reflect that difference (*i.e.*, there is no "tiering").

Rating agencies generally have a positive view toward including synthetic ABS in CDOs. Synthetic ABS greatly facilitate the ramp-up process for a CDO.

A trader panelist asserts that dealers should prefer trading synthetics because doing so avoids the need to hold inventory and the need to bear the risk of market movements.

Monoline bond insurers have been active in synthetic ABS by helping banks transfer away risk. They have provided insurance on super-senior tranches. The monolines have played an important role in getting the market started. However, an investor panelist asserts that the documents may be unfairly biased to favor protection sellers. Panelists disagree about whether the documents are fair or not to both sellers and buyers of protection.

CDS-Cash Basis: The basis is the difference between the spread on a CDS and the spread on the corresponding cash instrument. Synthetic ABS can be favorable because they usually are "unfunded" positions.[16] Apart from funding issues, pricing of synthetics has been strongly influenced by macro hedgers.[17] The basis was very wide, but now it is very tight (synthetic spreads are 25 basis points tighter than spreads on cash instruments).

CDS are driving spreads in the market. Panelist feels that CDS spreads will lead cash spreads and should be tighter than cash spreads in the long run.

CDS allow investors to take short positions and allow dealers to hedge their production pipeline of new home equity ABS deals. Using synthetics, a CDO manager can ramp-up a CDO in just one day. Synthetics have made the ABS market more efficient and added volatility by allowing market participants to more readily express their opinions (by shorting). That is a key point. All triple-B-rated home equity ABS are ***not*** interchangeable; synthetics allow investors to pick when to be long and when to be short on specific triple-B positions.

Form)." That became the first widely accepted form of contract for ABS CDS. That form is available on the ISDA website at <http://www.isda.org/publications/docs/ISDA-CDS-on-ABS-settlement-Dealerform.doc>. However, ISDA recently replaced the form with a newer one on 23 January 2006. The newer form also is available on ISDA's website at <http://www.isda.org/publications/docs/ISDA-Dealer-Form1.doc>. In between, ISDA released another form specifically designed for ABS, as opposed to MBS. The third form was released on 19 Dec 2005 and is available at <http://www.isda.org/publications/docs/CDS-Transaction-ABS-PAYG-Confirm-FormII.doc>.

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

[16] For example, the seller of protection under a CDS contract receives the spread payments under the contract just as like a bond investor receives interest payments on a bond. However, the protection seller does not have to tie up principal while the bond investor does. Thus, the bond investor receives LIBOR *plus* the spread while the CDS protection seller receive *only* spread (and not LIBOR).

[17] "Macro" hedge funds reportedly purchased large amounts of protection on triple-B-rated home equity ABS. That may have pushed spreads to very wide levels in late 2005.

Although the fixed cap feature in many synthetic ABS is not a perfect match to cash ABS, it is favorable to a protection seller and, therefore, helps CDOs (because they take slightly less risk in a synthetic ABS than they would in the corresponding cash instrument).

ABX Index: The ABX indices entered the market on January 19. The index includes 20 home equity ABS deals. A new index will be introduced roughly every six months. On the first day of ABX index trading, volume was very high and the bid-ask spread was very wide. However, the bid-ask spread quickly narrowed. The spread on the ABX index arguably should be wider than the equivalent cash portfolio because CDOs generally will not use the ABX index (CDO managers create value by picking specific bonds). On the other hand, an advantage of the index is that it allows an investor to take unfunded positions.

During the first week of trading, about 70 accounts traded the ABX index. Some CDO managers used the ABX index to gain exposure quickly before the market moves unfavorably, even though they had not managed to analyze and select individual bonds that they could have acquired synthetically.

An investor panelist plans to use the ABX index as a way to bring mortgage exposure to many accounts. He expects the current index to become illiquid after a newer one replaces it in roughly six months. The absence of a coupon step up is an undesirable feature.[18]

Vintage trades and curve steepener trades are great opportunities that can be exploited through the ABX index.

Documentation remains a sore point for investors. The pay-as-you-go CDS structure helps a lot. Counterparty risk is an issue. A second issue is the cash settlement option under the standard form. In addition, it is not clear who the "natural" buyers of protection will be (other than the macro hedge funds and dealers hedging pipeline risk). See what happens if you ask the Street to make two way markets in a CDS on a seasoned security. (liquidity issue). In a long-only market, everyone knew where everyone else stood. But now, the presence of high notional amounts of synthetic exposure can motivate a servicer to improperly manipulate the performance of the reference deals.

The market for ABS credit risk arguably is overheated. Triple-Bs trading at four tick bid-ask spreads is crazy. The market environment seems too much like 1998. Too much leverage may be happening. Liquidity evaporates when the Street does not have a place to move the bonds.

Housing & Sub-prime Spreads: Home price growth will slow. The bigger potential issues are consumers, job creation, and income growth. Not every triple-B-rated home equity ABS is the same. The Street will sell protection on good names and will buy protection on weak names. An investor panelist has a positive outlook on mortgage credit and expects home prices to be flat to slightly up. A trader panelist feels home prices will be flat to slightly down. Panelists agree that rating agencies have correctly gauged the credit risk in home equity subordinate tranches. The audience feels that home prices will likely rise between 0% and 10% in 2006 and that spreads will move wider in 2006.

Outlook: An investor panelist feels that that outlook for ABS CDS is positive but that there will have to be a cash settlement option. A trader panelist feels that customized ("bespoke") tranching of ABX indices will develop. A CDO manager panelist expects that synthetic notional volumes eventually will exceed the amount of the underlying reference instruments. Another panelist notes that banks sometimes can achieve more favorable regulatory accounting treatment by selling protection synthetically than by purchasing cash ABS.

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[18] Most home equity ABS include a feature that increases the coupon on the securities if the issuer fails to exercise its right to call the securities once the balance of the asset pool has declined to less than 10% of its original amount. The ABX index does not include a step-up on spread paid to a protection seller if one or more of the underlying reference obligations becomes the subject of a coupon step-up.

10:40 am – Survival of the Fittest: The Future of Mortgage Origination

The Gathering Storm (Risk Factors): The audience feels that there is either "way too much" (41%) or "a little too much" (39%) origination capacity in the prime mortgage market. The audience feels that there is either "way too much" (51%) or a "little too much" (30%) origination capacity in the non-prime (sub-prime and alt-A) mortgage market. One panelist feels that more borrowers will fall into the sub-prime category in the future as economic times become harder. A mortgage banker panelist feels that there are way too many originators. The prime business began to deteriorate in 2004 and personnel levels started to adjust. Now the sub-prime sector has to contract its staffing levels. Prime and sub-prime lenders are likely to start colliding as each reaches into the other's space in order to sustain origination volumes. The surviving lenders will be active across the whole spectrum of borrower credit quality.

An equity research panelist feels that there is extreme overcapacity in the sub-prime mortgage sector. Capacity will have to leave the market. The sub-prime market is more fragmented than the prime market. There is room for low-cost originators to thrive and to consume their competitors.

Some sub-prime lenders have already started to trim their staff levels. In the prime market, the cost to originate is in the range of 40 to 80 basis points. In the sub-prime sector, the cost to originate is at least 240 basis points *plus* a subsidy of roughly 75 basis points to brokers. In principle, the high cost activities should be replaced by lower cost methods. However, the sub-prime origination process involves more work and more risks (*e.g.*, compliance, predatory lending). Arguably it requires higher origination costs.

Audience survey: The audience feels that the greatest challenges facing the mortgage origination industry in 2006 are credit quality deterioration (47%) and excess capacity (32%). Only a small proportion of the audience feels that inappropriate origination practices will be one of the industry's major challenges in 2006. Today's disclosure of yield spread premiums[19] to borrowers is weak. To control predatory lending exposure, lenders now must be able to prove a tangible net benefit to the borrower on each loan.

Too often, outsiders to the industry confuse affordability products with sub-prime lending. The sub-prime sector includes only a small portion of affordability products like negatively amortizing loans. A problem in the sub-prime sector is that compensation to account executives is too high compared to what it is in the prime space. Following the Ameriquest settlement,[20] the sub-prime mortgage sector will have reduced ability to charge high fees to borrowers.

The alt-A sector was originally for borrowers with high credit scores (FICO scores) but who did not meet basic debt-to-income ratio tests of the GSEs.[21] Now, much of the alt-A space is for borrowers who do not have sufficient income to support their loans; the borrowers seek loans in which they do not have to document their income. It is for "fraud" by borrowers with high credit scores. The mortgage lending industry is giving people too much capacity to borrow without income verification.

Cumulative losses on sub-prime mortgage loans likely will be in the range of 4% to 6%. Cumulative losses likely will be much less for pools for alt-A mortgage loans. Bank mortgage loan portfolios,

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[19] "Yield spread premium" refers to a payment to a mortgage broker for attracting a borrower willing to accept a an interest rate on his loan that is higher than the lowest rate that a lender is willing to offer.

[20] Ameriquest agreed to pay $325 million to settle claims that it had engaged in predatory lending practices.

[21] This arguably is an oversimplification of how the alt-A mortgage loan sector formerly operated. The speaker's remarks emphasize "no income verification" loans, which composed a portion of the alt-A universe. While the boundaries of the alt-A market are faint and vague, they encompass a fair wider range of mortgage products than just loans with little or no documentation of a borrowers income or assets. Indeed, today the alt-A space is so broad that can fairly be defined as including any loan made to a borrower of "A" credit quality and that includes features that enable the lender to change an interest rate at least 60 basis points above the rate for standard loans to "A"-quality borrowers.

composed of a mixture of standard, prime-quality loans and alt-A loans, should experience losses in the range of 12 to 24 basis points.

Today's credit environment is interesting because inflation may provide a cure to past mistakes. It is possible that interest rates will stay low *and* that home prices will decline. The sub-prime sector is not effective at risk-based pricing. Lenders should normalize their pricing around documentation type. The capital markets pay a premium for NIV (no income verification) loans because such loans display slower prepayments (and despite the fact that the loans have greater credit risk).

The Secret Sauce: According to the audience survey, the capabilities most important for an originator's success are: technology (33%), risk management (29%), and capital market access (26%). In contrast, *panelists* feel that "people and culture" are the keys to success for a mortgage lender.

According to the audience, mortgage originators need to have all origination channels: retail, broker, and correspondent. One panelist feels that correspondent and retail channels are too inefficient and not sufficiently profitable. Another panelist feels that it is necessary to have all origination channels in order to be able to reach the greatest number of customers in the greatest number of ways.

According to survey results, the audience generally feels that an originator gains advantage by having servicing operations, a loan portfolio, and securitization capabilities. The audience feels that the loan portfolio is the least important of the three.

The Future: A shake-out in the mortgage market likely will come over the next 12 to 18 months.

The boundaries of the alt-A sector will continue to get increasingly gray and fuzzy as the prime and sub-prime sectors encroach on it from both sides.

Large lenders are likely to grow at the expense of small- and medium-sized lenders in 2006. Of the different types of lenders, mortgage banks are likely to gain share at the expense of brokers. Banks and thrifts eventually should gain market share as well. Mortgage banks may have some advantage in terms of less regulation compared to banks and thrifts.

11:40 am – Consumer Credit Trends: If I Securitize It, Will You Pay?

Economist's Overview: Consumer credit is a complex question. Today, trends in both the economy and financial markets add further complications. The Federal Reserve likely will continue to increase interest rates. Yield curve inversions have been consistent precursors of recessions. The housing market also is an area of concern.

Yield curve inversions consistently precede recessions. The average lag between the initial inversion and the start of a recession is four to six quarters. Yield curve inversions have been very reliable signals of recessions. Thus, in about two years, we likely will experience recession. Credit difficulties should become most visible at that time.

Record levels of consumer debt and high consumer leverage are causes for concern. Consumer debt and leverage has been rising steadily for nearly 50 years, through both good and bad times. Thus, high and rising levels of debt and leverage are not by themselves a cause of concern. Meanwhile, initial fees and charges on loan originations have declined from roughly 3% to about 0.5% over the past 25 years. This has made it cheaper for consumers to borrow and has further helped to boost both consumer debt and leverage.

Household wealth relative to GDP is near record highs over the past 50 years. Only during the tech bubble of the late 1990s was household wealth a higher multiple of GDP. The wealth position arguably gives protection from a downturn, but if wealth depends on home prices, it might not really provide protection from a housing downturn. Although consumer consumption levels are very high (producing a negative savings rate), household wealth arguably supports the high level of

consumption. The cost of homeownership is low by historical standards (measured as the cost of homeownership as a percentage of income). However, if mortgage interest rates rise by 2%, then the homeownership costs would be somewhat expensive compared to historical norms. Overall, the outlook for the housing sector is positive.

Sub-Prime Consumers: Broad generalizations about "consumers" can be misleading for thinking about ABS because roughly 70% of ABS are backed by obligations from *sub-prime* consumers. Thus, the economist's rosy outlook for consumers as a whole might be overly optimistic with respect to sub-prime consumers. On the other hand, the debt burden arguably is less of an issue than the economist feels that it is.

The audience expects home prices to increase by 0% to 5% in 2006. An essentially flat real estate market likely will deny homeowners the ability to take cash out of their homes (*i.e.*, using their homes as ATMs). That could lead to an increase in unsecured consumer borrowing, including increased credit card borrowing.

The audience has mixed views about what factors pose the greatest risk for 2006: 25% say rising interest rates, 34% say payment shock from rate resets on loans, 19% say energy prices, and 22% say unemployment. One panelist explains that the performance of home equity ABS will primarily depend on the borrowers' ability to refinance at their loans' reset dates. Declining origination volumes will enable marginal borrowers to refinance because sub-prime lenders will "stretch" to sustain their origination volumes. Increases in first payment defaults are a strong indicator of fraud.

According to the audience survey, 61% of the audience feel that "the economy" would be the key driver of asset performance in a recession, while 39% feel that "underwriting quality" would be the key driver. [Note: The distinction between the two seems somewhat vague.] One panelist disputes the sentiment of the audience, arguing that underwriting quality is extremely important because it addresses the issue of whether the specific assets in a deal have enough credit enhancement to cover their risk in an adverse environment.

Market fundamentals do not explain the home price appreciation that has occurred in many areas. Affordability products are not the explanation; less than 20% of originations are affordability products.[22] One explanation may be autocorrelation. Another explanation may be low "user costs" from the low interest rate environment.

Regulators have expressed skepticism about affordability products.[23] Regulatory actions likely will influence further product evolution.

1:30 pm – Mortgage Credit Outlook

One view is that mortgage credit performance will remain strong in 2006, though delinquencies and foreclosures might increase slightly. The macro drivers of mortgage credit performance should revert toward their long-term means and exert a corresponding influence on credit performance. In the short-run, though, credit performance in 2006 should remain strong.

Job growth over the past two years has been strong, adding about two million jobs. If current economic conditions continue, the economy would add another two million jobs this year. The hurricanes had a strong impact, but it probably was a one-time shock.

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[22] We disagree somewhat. Depending on how one defines "affordability products" the percentage may be significantly higher than 20%. In any case, the rising prevalence of affordability products (however defined) must have some marginal effect of boosting home prices or sustaining them at high levels.

[23] *See, e.g.*, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration, *Credit Risk Management Guidance for Home Equity Lending*, joint release (16 May 2005) <http://www.federalreserve.gov/boarddocs/srletters/2005/sr0511a1.pdf>.

Reset of sub-prime ARMs could become an issue in 2006, but many loans do not reach their reset dates until next year or later..

Interest Rates: Mortgage interest rates are low today compared to the last 35 years. However, rates reasonably could rise over the next few years. A withdrawal of foreign investment in U.S. bonds could drive rates higher. Mortgage interest rates likely will reach 6.5% in 2006 and 7% in 2007. ARM pricing was extremely attractive for a time, but the demand for ARMs may decline because of the flattening of the yield curve. The 40-year fixed rate loan may be a great product to entice borrowers into the market, but the payment difference is only $25 per month for $100,000 principal balance.

Foreclosures & Jobs: There is a strong inverse relationship between jobs and foreclosures. Although the absolute level of foreclosures is at an all time high, the foreclosure *rate* is not. Foreclosure rates rise during and after periods of job contraction. The measurement of foreclosure is based on the foreclosure inventory statistics compiled by the Mortgage Bankers Association. That statistic may be somewhat unreliable because lenders might delay liquidating foreclosed properties in the hope of avoiding a loss by waiting for real estate markets to improve.

Loan Level Analysis: A company measured the performance of seven million loans with first payments due in 2000 through 2005. Consumer credit scores (FICO scores) turned out to be a very important variable. Loans with 510 FICO scores displayed seven times the 90-day delinquency rate as loans with FICO scores of 670. The relationship of delinquency odds to FICO score is monotonic and convex. Roughly 45 FICO points doubles the odds of serious delinquency for prime loans and 65 points doubles the odds for sub-prime loans. Loans with FICO scores of 810 displayed one fifth the delinquency rate of loans with scores of 670. The prime and sub-prime loan populations overlap in the FICO score range from roughly 580 to 670. Prime goes down to a score of 580 and the sub-prime range goes up to a score of 670.

The odds of serious delinquency were more sensitive to collateral coverage, as measured by cumulative loan-to-value ratios (CLTV), in the prime sector than in the sub-prime sector. Likewise, the odds of serious delinquency are more sensitive to loans size in the prime sector than the sub-prime sector (larger loans displayed higher frequencies of serious delinquencies).

Odds of serious delinquency displayed minimal sensitivity to borrowers' repayment capacity, as measured by debt-to-income ratios. However, the odds of serious delinquency displayed greater sensitivity to the absolute level of a borrower's monthly income.

Documentation of borrowers' income and assets exerts a strong influence on serious delinquency odds. Compared to the odds of serious delinquency on a loan with full documentation of a borrower's income and assets, the relative odds for other types of documentation is as follows

- Streamlined …1×
- Preferred (lender driven low doc) … 1.6×
- NIVA (income not disclosed or verified, assets verified) … 1.9×
- SIVA/reduced doc (income disclosed but not verified, assets verified) … 2.2×
- SISA (both income and assets disclosed but not verified) … 2.6×
- NINA (neither income nor assets disclosed) …3.5×

Compared to loans on owner occupied primary residences, loans secured by non-owner occupied homes displayed twice the odds of becoming seriously delinquent, and loans secured by vacation home and second home displayed 1.1 times the odds. Likewise, compared to purchase loans, cash-out refinancings displayed 1.4 times the odds of becoming seriously delinquent.

Interestingly, the number of borrowers on a loan appears to be significant. Compared to loans with two borrowers, loans with only one borrower displayed 2.1 times the odds of becoming seriously delinquent. A possible explanation is that single borrower loans occur frequently when one spouse has a bad credit record and stays off the application.

Compared to regular amortizing loans, interest-only loans display 1.3 times the odds of becoming seriously delinquent.

Compared to fixed rate mortgage loans with final maturities of 15 years, fixed rate loans with 30-year maturities displayed 1.8 times the odds of becoming seriously delinquent. Most other product types displayed serious delinquency odds in between FRM15s and FRM30s.

Somewhat surprisingly, loans secured by single family detached houses displayed higher odds of becoming seriously delinquent than loans secured by various other types of loans. Loans secured by houses with two to four units displayed slightly higher delinquency odds than loans secured by single family homes. Loans secured by manufactured homes displayed much worse odds.

The odds of serious delinquency on a loan increased dramatically if it is secured by a property located in a metropolitan statistical area (MSA) that has an unemployment rate of 8% or higher.

Controlling for other factors, the odds of serious delinquency were higher for loans secured by properties in the Rust Belt. Loans secured by properties in the Western states displayed the best odds. The impact of geography was slightly different for the prime and sub-prime loan populations. In the sub-prime population, loans secured by properties in Denver had very poor odds and loans secured by homes in Minneapolis had somewhat better odds than loans secured by homes in the surrounding area.

Economists Projections: Home price appreciation should be in the range of 4% to 8% in 2006. There are two way of looking at likely changes in home price appreciation: (1) mean reversion and (2) based on fundamentals such as demographics, the cost of construction, and the scarcity of land in some areas. From a mean reversion perspective, home prices growth should revert to a level below the long-term average of around 5%. Mean reversion produces an extremely pessimistic view of home price movements over the next five years. In contrast, a projection based on fundamentals are very optimistic. On the fundamental side, the Pacific states could have cumulative growth of 37% over the next five years.

2:35 pm – Student Loan ABS Sector Review

The student loans ABS sector achieved record issuance of $73.3 billion in 2005, up 17% from the prior year. Most of the issuance was backed by FFELP loans.[24] The big story in 2005 was the large amount of student loan ABS (SLABS) issuance backed by consolidation loans.[25] Consolidation loans composed more than 50% of the assets backing SLABS issued by Sallie Mae in 2005. The reason for the big jump in consolidation volume was the increase in floating interest rates that become effective in July 2005. Also, the Education Department clarified that borrowers could consolidate loans while still in school.

The driver of SLABS issuance growth is the for-profit sector. Growth in SLABS issuance by state agencies and not-for-profit lenders has been lower.

The Deficit Reduction Act of 2005 is not yet law. It would reduce the government reinsurance on most FFELP loans to 97% from 98%. For loans originated by "exceptional performers," the Deficit Reduction Act would reduce the federal reinsurance to 98% from 100%. The legislation also would make Stafford and PLUS loans fixed rate products with interest rates of 6.8% and 8.5% respectively. The SAP would continue to float.[26] Floor income would go to the government.[27] The legislation

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

[25] The Higher Education Act allows borrowers under the FFEL program to combine multiple federal student loans (e.g., one for each year of college) into a single new loan with one monthly payment at a fixed rate of interest for up to 30 years.

[26] "SAP" refers to special allowance payments made by the government to lender on FFELP loans. SAP assures lenders that they will receive a "statutorily specified rate of return" on loans that they hold. 34 C.F.R. § 682.302.

would eliminate in-school consolidations. PLUS loans would become available to graduate and professional students. Loan limits on Stafford loans would increase slightly. Recycling of 9.5% loans would be virtually eliminated.[28]

Dynamics of the Student Loan Market: The total cost of college attendance in 2005-06 is about $222 billion. Parent contributions account for $61 billion. Scholarships and grants account for $75 billion. Federal student loans account for $67 billion and about $19 billion comes from private education loans. College enrollments are expected to grow from around 17 million today to around 19.5 million by 2014. Tuition has increased at a very rapid pace over the past 10 years. Tuition has increased much more rapidly than the overall rate of inflation. However, the value proposition for an education is better than ever. Graduates of colleges and professional schools tend to have *much* higher annual incomes than individuals with less education. The Education Department expects FFELP loans to grow at a rate of around 8% for the next several years. Many professionals expect private loan volumes to grow at twice that rate.

The pending legislation should have only a minimal impact on SLABS market growth and credit quality. The legislation could produce a slight increase in FFELP activity because of a slight increase to loan limits. The elimination of in-school consolidation and two-step consolidations should reduce prepayment speeds. However, rising interest rates may produce a partially offsetting boost to consolidation activity.

Student loan ABS likely will account for an increasing share of all non-real estate ABS issuance and, because SLABS have such long average lives, an even faster-growing portion of non-real estate ABS outstandings.

Recent Activity: So far this year there have been only two SLABS deals. Regulation AB has been a factor in delaying issuance by some issuers. So far, Sallie Mae is the only Reg AB-compliant SLABS issuer that has come to market. Other issuers seem to waiting to issue on their regular schedules. Some issuers that are not yet compliant with Reg AB are effecting private placements under Rule 144A or are warehousing their assets in commercial paper conduits in the meantime.

There has been notable prepayment volatility in Stafford and PLUS loans. The change in the rules for consolidation loans likely will help reduce the volatility by stopping in-school consolidations and two-step consolidations (reconsolidations). However, there probably will be a large spike in prepayments before July 2006, when the rules will change. If students consolidate before July, they will be able to lock in a 4.7% rate, but starting in July the rate will be 6.8%.

Private Loan Focus: Private loans have no federal guarantees or subsidies. Private loans are necessary because the loan limits on FFELP loans have not increased at a pace to keep up with the rising tuition. Private student loans help to bridge the funding gap for many students and their families. Although private student loans account for only a small portion of all higher education funding, the sector has experienced faster growth than any other source of educational funding.

Competition among student loan lenders is driving down profit margins. Lenders no longer can afford to price private loans as loss leaders for their federally reinsured loans. Competition is increasing as lenders from outside the sector are entering. Private student loan lenders have had to become more

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That rate of return is based on the three-month commercial paper rate, plus a margin. When the rate on a FFELP loan is less than the "statutorily specified rate of return" the government pays SAP to the lenders. The SAP formula changes periodically for new loans.

[27] "Floor income" is the opposite of SAP. It is the excess of the interest rate on a FFELP student loan over the "statutorily specified rate of return." Paying floor income to the government is a change that would help taxpayers at the expense of student loan lenders, but it should have little effect on SLABS.

[28] So-called "9.5% loans" became the subject of controversy after the government released a report finding that the loans were unjustly enriching student loan lenders at the taxpayers' expense. *See*, U.S. Government Accountability Office, *Federal Family Education Loan Program, Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments*, GAO Rep. No. 04-1070 (Sep 2004) <http://www.gao.gov/new.items/d041070.pdf>.

sophisticated and have started to price for risk. The ability to issue SLABS has been a key factor enabling companies to succeed in the private student loan area. Lenders can get loans with higher interest rates through direct consumer channels than through the more competitive school channels.

Additional securitizers are likely to become active in issuing SLABS backed by private student loans in 2006. As the sector matures, market participants will develop harmonized expectations about asset quality and deal structures. Start-up lenders may be challenged by not having historical data. The securitization market likely will continue to evolve with triple-B and lower-rated tranches. Recently, there was a securitization of excess margin on the loans.

Investor Perspective: Investors need certain information to make informed investment decisions about SLABS. For SLABS backed by FFELP loans, information is generally uniform and consistent. Reg AB has been a positive influence. For FFELP loans, investors should examine an issuer's experience in the market and its classification as a regular or "exceptional" performer. Investors should examine the breakdown of schools and borrowers (two year or four year). Naturally, investors should examine the structure of a deal, particularly the credit enhancement. Investors should scrutinize the rating agency assumptions. For the assets themselves, investors should scrutinize (1) repayment status of the loans, (2) average borrower indebtedness (ABI), and (3) delinquency, default, and claims rates on the pool. Investor's should also focus on (a) prepayment speeds, (b) cumulative default rates, (c) claim rejection rates, and (d) excess spread. However, the latter categories of data sometimes are not available.

For non-FFELP loans investors should focus on underwriting criteria, the presence or absence of co-signers on the loans, credit scores, the breakdown of schools, ABI, excess spread, weighted-average maturity of the loans, and cumulative defaults. Investors should try to analyze an issuer's historical performance data and to assess the quality of servicing. Investors should carefully examine any guarantees or insurance policies intended to wrap the credit risk of an entire pool.

Investment challenges in 2006 will include high demand for SLABS and tight spreads. The market is consolidating so there is less competition among issuers. Also, SLABS has competition from the auction rate market. High prepayment speeds also create a challenge for investors. There are only a few securitizers of private student loans, so it is hard for investors to diversify across issuers.

4:00 pm – Challenges for CDO Collateral Managers

Commercial real estate (CRE) CDOs recently have shifted from fixed-rate high grade CMBS toward riskier floating rate whole loans, mezzanine notes and "B" notes. There was a "democratization" of the finance markets by lowering barriers to entry, so that new players could compete in the floating rate market. CRE CDOs provide financing that is much more stable than credit lines. CRE CDOs provide committed financing that cannot be withdrawn even if exogenous shocks like the 9/11 terrorist attack occur. CRE CDOs also have increased the investor base for single-B and double-B rated tranches of CRE loans. Before the advent of CRE CDOs, there were natural buyers for highly rated tranches of commercial loans and for equity tranches but there were no natural buyers for the single-B and double-B tranches. CRE CDOs have produced a tightening of roughly 400 basis points on mezzanine notes and "B" notes.

Giving a CDO manager greater flexibility can help him to achieve improved execution. Also, a manager should use different bankers from time to time to gain the broadest possible distribution. A manager should try to maintain good relations with the rating agencies in order to be able to work efficiently as new challenges arise.

The level of secondary trading activity for CDOs is increasing. Triple-A and double-A tranches may trade several times during a month. However, triple-B tranches trade "by appointment only."

This year will be one of transition for the mortgage market. There will be credit challenges and the supply of new issues may decline by 10% to 20%. On the other hand, CDOs arguably still are cheap compared to other triple-A rated structured finance investments. Accordingly, spreads could tighten

on CDO triple-A tranches, though spreads might widen on triple-B tranches. Macro hedge funds have been shorting the ABS market through synthetics. The credit curve likely will steepen in 2006 (i.e., the spread difference between highly rated securities and those with lower ratings will widen).

The development of pay-as-you-go CDS has been a positive development for the CDO market. PAUG CDS will provide a deeper source of collateral for CDO managers. It gives CDO managers much greater access to collateral than they had with only cash assets. It allows one CDO issuer to synthetically use assets that had previously included in other deals.

Other than macro hedge funds, there are few natural short players on credit. However, Wall Street potentially provides a significant amount of shorting capacity in connection with hedging its production pipeline. There probably are not any natural shorts in the commercial real estate area. However, investors might want to take short positions on specific properties or bonds.

Tuesday, 31 January 2006

8:00 am – The New Investment Disclosure Paradigm: Regulation AB and Offering Process Reform

[Note: This panel included representatives from issuers, underwriters, and their counsel. It did not include investors or representatives from the SEC. Investors discussed Reg AB and offering reform at the Sunday 5:00 pm session.]

Regulation AB: Regulation AB[29] arguably is the biggest thing to hit the securitization market since its inception. Many market participants underestimated the chore of implementing Reg AB after it was released in final form. Even now, some implementation questions remain unanswered. In addition, while market participants were wrestling with Reg AB implementation, the SEC promulgated its "offering reform" regulations,[30] which change the process of selling all types of securities, including securitizations.

Before Reg AB, SMMEA[31] gave mortgage-backed securities access to shelf registration. Later, in 1992 the SEC expanded the availability of shelf registration to include investment grade ABS. The key to availability was a definition of ABS.[32] Now, the new definition of ABS is the gateway to the whole ABS disclosure regime.[33]

Disclosure: There used to be an informal disclosure framework based on the SEC staff comment process. Reg AB creates a concrete, principles-based disclosure framework. Likewise, Reg AB provides a concrete framework for periodic reporting. Reg AB also provides a concrete framework for offering communications to replace the prior statutory scheme (that had been liberalized through no-action letters). Later, the offering reform regulations[34] liberalized the communications regime of Reg AB.

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[29] 17 C.F.R. § 229.1101 *et seq.* (2005), Release 33-8518, 70 Fed. Reg. 1506 (7 Jan 2005).

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

[31] Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (1984).

[32] The old egulatory definition of ABS, which unlocked access to shelf registration, was contained in the instructions to Form S-3. The definition stated:

> For purposes of this Form, the term "asset-backed security" means a security that is primarily serviced by the cashflows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders.

See 17 C.F.R. § 239.13(b)(5) (2003).

[33] The new definition of ABS is in Item 1101 of Reg AB, 17 C.F.R. § 229.1101(c).

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

Although the Reg AB disclosure regime is nominally "principles-based" it includes certain *per se* disclosure requirements. Reg AB requires static pool disclosure and provides separate schemes for liquidating asset pools and revolving asset pools. It also provides for alternative forms of static pool disclosure if the specified schemes are not suitable. Reg AB requires disclosures about parties to a transaction. It requires an annual assessment of servicing compliance and an accountant's attestation of the servicing assessment.

Interpretive issues: Who is a servicer? A servicer is any entity that has (1) asset maintenance responsibilities or (2) cash flow allocation or distribution functions.[35] There is a materiality standard for servicer disclosures; an entity that is a servicer may have such a small role in a deal that it is not material. The materiality determination depends on the importance of the entity's function, whether it is supervised, and how easily it can be replaced. A lockbox provider may be a servicer.[36]

Reg AB uses, but does not define, the term "originator." Based on SEC guidance, an originator is an entity that establishes standards for granting credit to an account debtor.

For reporting purposes, concentration percentages in a deal must be reassessed on a weighted-average basis in each reporting period.

The SEC has interpreted Rule 1100(b), which required reporting static pool data in 30-day buckets, as applying only to the subject assets of a deal. Therefore, the required delinquency buckets for disclosure of historical static pool data are to be determined by the principal of materiality.[37]

Reg AB specifies differing disclosures for "credit derivatives" and "non-credit derivatives." For purposes of Reg AB, most lawyers feel that a credit derivative is one for the purpose of credit enhancement. Most feel that derivatives based on non-credit factors, such as interest rates, generally would not be "credit derivatives."

In implementing Reg AB, one issuer started out by summarizing the regulation's lengthy adopting release (more than 400 double-spaced typed pages which became 127 pages of fine print in the Federal Register) in a short, tabular form. The tabular summary helped different departments within the company focus on the portions of Reg AB that would affect their operations.

The SEC's pilot program was very burdensome for the participating issuers. Other market participants benefited from the labors for the participating issuers. Now that the regulation is in effect, the pilot program is over. During the pilot program, a frequent comment from the SEC staff was a request for graphic presentations of static pool data. Issuers continue to resist including graphical presentations of static pool data. Also, another continuing issue is the time for filing the operative documents (*e.g.*, the pooling and servicing agreement) for a specific deal. Lawyers feel that if the material terms of the operative documents are properly disclosed in a base prospectus, then an issuer should have up to 15 days after the takedown[38] to file the documents. The staff has been pushing for filing of operative documents at the time of each takedown.

The staff is taking compliance with Exchange Act period reporting requirement extremely seriously. An issuer can lose its ability to execute ABS public offerings if it violates the periodic reporting requirements. The staff has grudgingly granted waivers of reporting violations, but it puts a requesting issuer through hell to get a waiver.

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[35] Securities Exchange Commission, Division of Corporation Finance, *Manual of Publicly Available Telephone Interpretations, Regulation AB and Related Rules*, § 3.01, <http://www.sec.gov/interps/telephone/cftelinterps_regab.pdf>.

[36] *Id*. § 6.01.

[37] *Id*. § 1.01.

[38] "Takedown" refers to the sale of securities under a shelf registration. Shelf registration allows delayed or continuous offerings of securities. That is, it allows for a registration statement to become effective far in advance of the actual sale of securities.

Servicing Issues: One issuer had to develop new processes and tools for implementing the servicing aspects of Reg AB. For example, the issuer created a tool to identify and track every instance where a violation of servicing procedures occurs. It can then analyze the violations quarterly to determine whether they are material. The issuer also created a tool for tracking its vendors to determine whether any of them would be "servicers" with material roles that would trigger disclosure obligations. The issuer had tentatively concluded that none of the vendors is a material servicer.

There is now a "food fight" going on among industry participants about the interpretation of the 41 specific servicing criteria in Rule 1122. One issuer requires companies with whom it does business to agree to provide all the reports and information required under Reg AB. According to an audience survey, more than a third of the audience feels that the servicing criteria under Reg AB are unclear.

Static Pool Data: Aggregating static pool data from multiple sources becomes necessary under Reg AB. Issuers have amended their agreements with originators to obligate the originators to deliver necessary static pool data. An issuer panelist feels that disclosure of an originator's static pool performance data is required at the 20% concentration level (although Reg AB does not explicitly say so).

ASF Model Loan Purchase Provisions: The ASF has promulgated model provisions for mortgage loan purchase agreements to address issues stemming from the disclosure and reporting requirements under Reg AB.[39] The model provisions are intended to provide a starting point for negotiations. The impetus for the model provision was to address the overwhelming diversity of mortgage loan purchase agreements that originators encounter in selling loans to MBS issuers.

The model provisions define the term "qualified correspondent." The term is designed to capture the correspondent-lender relationship. The correspondent should not be considered the originator because it uses the lender/buyer's underwriting criteria. The model provisions require a loan seller to provide narrative disclosure about itself. The model provisions also require a loan seller to provide static pool data upon request by the buyer. In addition, the model provisions address reporting obligations, servicing assessment and attestation, and indemnifications.

Offering Reform:[40] Offering reform dramatically increases the freedom to communicate with investors during the offering process. Offering reforms allows written communications (called "free writing prospectuses") during the offering process. Offering reform also changes the liability scheme: liability for disclosure depends only on the information given to an investor up to the time when he makes an investment decision. Rule 159 is the key provision. Technically, it is an interpretation of § 12(a)(2) of the Securities Act. Rule 159 does not affect liability under § 11 of the Securities Act.

An issuer panelist remarks that single-pricing deals (*i.e.*, deals where all tranches are priced simultaneously) are replacing the use of term sheets with preliminary prospectuses.[41] For deals with iterative pricing (*i.e.*, deals where tranches are priced at different times), offering reform basically shut down the market from Thanksgiving to New Years. When an ABS issuer sells a deal to a Wall Street

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[39] The model provisions are available at <http://www.americansecuritization.com/uploadedFiles/RegAB_Model_Provisions_final.doc>.

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

[41] A "prospectus" is the traditional disclosure document for public offerings of securities. The U.S. securities laws require filing prospectuses with the SEC as part of most public offerings. The prospectuses used in most securitizations are divided into two parts: a "base prospectus" and a "prospectus supplement." When a securitization issuer executes a series of deals, information that remains constant from one deal to the next is included in the base prospectus and information that changes is included in the prospectus supplement.

A "preliminary prospectus" is essentially a draft version of a prospectus. A preliminary prospectus usually contains nearly all the text of the corresponding final prospectus, but some or all numerical information may be left blank.

A "term sheet" is a summary of a deal's economic characteristics. It includes numerical information as well as key information about deal's structure. It does not include a description of risk factors or the lengthy textual disclosures found in prospectuses.

underwriter, the issuer delivers a "free writing prospectus."[42] The underwriter can then create additional materials (such as yield tables), which can be used as a separate free writing prospectus.

Issuers and underwriters are wrestling over the allocation of potential liability under Rule 159. The processing of creating accurate and complete disclosure materials has delayed the sale of some deals. For deals with iterative pricing, investors now receive more information than they did before. Now, in such deals, investors receive a "term sheet supplement" that provides virtually all the textual information that they would have received in a preliminary prospectus.

Issuers and underwriters are challenged by the new requirements to include appropriate legends on free writing prospectuses and to preserve all communications with investors. One company has instituted the role of "deal document administrator."

According to a survey of the audience, the offering reform regulations reduced trading in the non-agency MBS market for between two and six weeks after the rules took affect.

A lawyer panelist comments that issuers and underwriters generally are allocating liability for communications to investors based on which party controlled the communication and its content.

Law firms generally are willing to give a negative assurance letter on a preliminary prospectus or on a "term sheet supplement" that has virtually all the content of the preliminary prospectus, but they are not willing to give negative assurance letters on just a term sheet.

It remains to be seen whether the ASF model provisions for loan purchase agreements will gain acceptance to be included in loan purchase agreements for 144A deals.

9:30 am – Securitization Accounting Developments – The Bottom Line on the Balance Sheet

Servicing Discretion: Servicing discretion is a hot issue in the CMBS area.[43] How much discretion can a servicer have in servicing assets that are isolated in a "qualified special purpose entity" (QSPE)? One issue is a QSPE's ability to substitute one borrower for another (e.g. assumption vs. due on sale). A second issue is a QSPE's ability to allow a borrower to substitute collateral. Substitutions of borrowers and collateral are more common in commercial mortgage loans than in residential mortgage loans and the criteria for allowing substitution are not mechanistic. A third issue is a QSPE's ability to exercise discretion in other areas such as working out troubled loans or holding foreclosed real estate for a long time.

The FASB seems to feel that commercial real estate loans may not be suitable for QSPEs.

The FASB is likely to address the servicer discretion issue with an FSP (FASB staff position) early in the second quarter and to finalize the issue in the third quarter. The possible interaction between the servicer issue and the transfer of assets issue is scary because more transfers are likely to need to use QSPEs to achieve off-balance sheet treatment.

If the FASB disqualifies commercial real estate from QSPEs, the market should hope that it allows for grandfathering of old deals or for a sufficiently long transition period that allows market participants to adapt.

The FASB has set up a resource group for gathering information. The FASB wants to adopt a principles-based approach to servicer discretion:

[42] "Free writing prospectus" refers to most kinds of written communications in connection with a securities offering. The term does not include traditional prospectuses or so-called "tombstone" announcements.

[43] Financial Account Standards Board, Minutes of the December 20, 2005 Board Meeting (Servicer Discretion), <http://www.fasb.org/board_meeting_minutes/12-20-05_servicer_discretion.pdf>.

FAS 140: Last August, FASB released exposure drafts for three proposals to change FAS 140.[44] Deliberations on servicing and hybrid projects almost done. The hybrid project should be finalized in the next few weeks and servicing project shortly afterwards. FASB plans to finalize the transfer project in the second quarter. According to the audience survey, most audience members do not expect FASB to finalize the transfer project in the second quarter. Some feel that the transfer project will be finalized late in 2006 and some feel that it will be rolled into the "convergence project."[45]

Panelist feels that it is too early to tell how the FAS 140 transfer re-deliberation will end. FASB feels that FAS 140 is basically not working correctly. However, it would be highly disruptive (and arguably a waste of effort) to overhaul FAS 140, making changes that would apply for only a short time (several years) before convergence occurs. The outcome of the re-deliberation of the transfer issue may depend on the views of a new FASB member who joins after mid year.

If the transfer proposal gets finalized in its present form, it would require use of QSPEs in participation transactions.

The hybrid proposal is potentially beneficial to the securitization industry because it will allow "bifurcation" of hybrid instruments into their underlying derivatives and "host contracts." However, the hybrid proposal may require analysis of every purchased securitization interest in order to determine whether it includes a derivative instrument that would require bifurcation.

The servicing proposal would allow servicers to carry servicing rights at fair value. Doing so can be advantageous for a servicer that hedges the value of its servicing portfolio.

Convergence: IAS 27 (consolidation) and IAS 39 (derecognition) are the key international accounting standards for securitizations.[46] IAS 27 uses the notion of control as the basis for consolidation. Control can take many forms other than equity voting rates. The revised standard is likely to be based on residual risks and rewards. It will require consolidation of most securitization vehicles. Some CDOs might escape consolidation because risks are spread among many holders. IAS 39 allows derecognition even if an entity is consolidated. IAS 39 kills off-balance sheet treatment if derivatives are involved. IAS 39 uses a risks and rewards paradigm but it is not clear whether risks and rewards should be measured on a cash flow or fair value basis. Most securitizations under international standards are on-balance sheet. The standard gives some scope for partial derecognition but it is somewhat unclear. The accounting issue is not a key one for Europe because European issuers often do not seek sale treatment and regulatory capital requirements do not follow accounting treatment in Europe.

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[44] FAS 140 is the key accounting standard that controls whether a securitization counts as a "sale" for accounting purposes. If so, the company effecting the transaction can remove the assets (and their associated liabilities) from its balance sheet. One of FASB's three proposals from August relates directly to the criteria for treating transfers as sales. The second proposal relates to the accounting for servicing rights. The third proposal relates to the accounting for hybrid financial instruments. Info on the three proposals is available on FASB's website at the following links:

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

[45] FASB and the International Accounting Standard Board (IASB) are slowly working to achieve "convergence" of U.S. and intentional accounting standards. Information on the convergence project is available at <http://www.fasb.org/intl/convergence_iasb.shtml>. A key area of difference between U.S. and international standards is the criteria for achieving sale treatment in a securitization. The U.S. standard, FAS 140, is based on control over the subject assets. The international standard, IAS 39, is based on economic risks and rewards. Most securitizations can achieve sale treatment under U.S. standards but not under international standards. Regulated financial institutions in the U.S. care about achieving sale treatment because their capital requirements are based on their accounting assets. Conversely, financial institutions outside the U.S. care less about achieving sale treatment for securitizations because their capital regulations often are not tied to accounting classifications.

[46] For summaries of IAS 27 and IAS 39 see the web summaries at the IASB website:
<http://www.iasb.org/uploaded_files/documents/8_63_ias27-sum.pdf> for IAS 27 and
<http://www.iasb.org/uploaded_files/documents/8_63_ias39-sum.pdf> for IAS 39.

FASB and IASB have created a joint project on derecognition.[47] Both Boards probably realize that derecognition may be the toughest area in which to achieve convergence. The joint working group has tentatively decided to abandon the use QSPEs and the associated control paradigm.

Some market participants have proposed using a "linked presentation with a full mark to market." In that approach, the reporting company reports only a net number on the asset side of the balance sheet. Current U.S. criteria for derecognition probably will not survive convergence. However, the current international standard also is unlikely to survive because it is impractical. Convergence is coming faster than panelists previously had expected; securitization panels will not be talking about QSPEs for that much longer.

FIN 46(R):[48] How to determine "variability": FASB says to use a "by design" approach for assessing variability to determine who must consolidate under FIN 46.[49] Accountants do not have clear guidance on whether to use a cash flow or fair value methodology and market participants engage in hedging based on cash flows and fair values. The proposed FSP implies that market participants should be able to spot variability when they see it. The FSP does not explain its examples, so accountants do not understand the reasoning. FASB seems reluctant to provide an expansive explanation. The proposed FSP clarifies that senior derivatives do not count as variable interests.

Exposure draft for "fair value option" was released last week.[50] The proposal would permit accounting for any financial asset or liability on fair value basis.

11:00 am – New Players and their Impacts on the CDO Market

[Note: This panel was composed of managers of cash CDOs and one rating analyst.]

From a rating agency perspective, an important development over the past year was the growing prevalence of unrated collateral backing CDOs. Examples include commercial real estate and middle market loans. For staffing purposes, the rating agency focuses on adding new analysts with experience in the underlying assets.

Barriers to entry are very low for new CDO managers. Investors find it hard to differentiate between managers. One view is that a manager really proves his value when the market is not doing well and (therefore) he must display expertise in picking assets. The rising number of CDO managers has made it more difficult to source assets because there is more competition for the available flow of triple-B assets.

The entry of hedge funds into the CDO space is interesting because the hedge funds have extensive experience with synthetics. Managed synthetic CDOs require CDO managers to become familiar with the ISDA pay as you go documentation. The recent launch of the ABX index and Bear Stearns' tranche trading on the ABX is interesting.

Investors express concern about getting appropriate monthly reports from new CDO managers. Investors also want to understand how new managers staff their operations. One rating agency ascribes a lower default rate to managers that it rates highly. In other words, successful managers can get lower credit enhancement.

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[47] *See*, International Accounting Standards Board, *Financial Instruments* (18 Jan 2006), <http://www.iasb.org/uploaded_files/documents/16_99_FinancialInstruments-long-termobjectives.pdf>.

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

[49] FASB, *Determining the Variability to Be Considered In Applying FASB Interpretation No. 46(R),* proposed FASB staff position, FSP-FIN 46(R)-c, ¶ 7 & n.3 (30 Nov 2005) <http://www.fasb.org/fasb_staff_positions/prop_fsp_fin46r-c.pdf>.

[50] FASB, *Exposure Draft, Proposed Statement of Financial Accounting Standards, The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115*, (25 Jan 2006) <http://www.fasb.org/draft/ed_fair_value_option.pdf>.

It takes a substantial volume of issuance for a manager to be able to cover the basic fixed costs of having a CDO business. This can create a potentially harmful incentive for a new CDO manager to issue deals faster than its operational abilities can keep up.

Because CDOs can have long average lives, there is a question about whether a manager can achieve staffing stability over a sufficiently long time horizon.

CDOs got into trouble in 2001-2002 by purchasing ABS backed by aircraft leases and other difficult asset classes. The managers of those CDOs arguably did not properly understand the assets that they were buying. [Note: Could this be happening today with other asset classes?]

Some managers branch out of CDOs and create other kinds of managed investment vehicles such as hedge funds.

New entrants try to poach staff from established players. This allows new CDO managers to start out with experienced staffs. CDO managers need to avoid relying too heavily on the skills and knowledge of one person because staff can get bid away by competitors.

The low barrier to entry for CDO managers arguably should facilitate innovation in the business.

One manager uses synthetics if they are cheaper than cash securities. The objective is to put the asset pool together as cheaply as possible.

International investors have become increasingly interested in gaining exposure to U.S. assets through CDOs. The international investors are acquiring tools such as Intex and Trepp to help them better understand the underlying collateral.

S&P's release of an update to its CDO Evaluator program offers new advantages for managed CDO transactions.

The ABS CDO area has migrated from a diversified model to one that is concentrated in MBS and residential ABS. Managers need to continually ask themselves whether they have taken sufficient steps to protect their portfolios from potential shocks to the housing market. Likewise, the recent corporate credit environment has been very benign. Now that leverage has increased within corporations, CDO managers need to double-check their views on corporate credit quality.

Many new deals allow managers to take short positions. A challenge in using short positions is that the correlation desks at the Wall Street dealers have their own agendas and this can be a complicating factor in trying to find the right instruments in which to take short positions.

Established CDO managers continually learn about new managers by being shown their deals as potential investors.

12:05 pm – Trading and Liquidity: The Secondary CDO market

2006 Issuance Outlook: In 2005, there was $155 billion in CDO issuance, making it the second largest ABS asset class, after home equity ABS. For 2006, CDO issuance volume likely will be much larger. Demand from investors remains strong. Many new CDO managers are entering the market, as are more dealers. ABS CDO issuance should continue to be strong even if cash ABS issuance declines. Synthetic ABS would provide a suitable substitute for reduced supplies of cash securities.

Structured product CDOs should continue to dominate in 2006. CLOs likely will be the runner up. There will also be CDOs backed by trust preferred securities (TruPS) and single-tranche synthetics CDOs

Synthetics are the key driver of volume growth. Synthetics allow managers to ramp up quickly. In ABS CDOs there is growing prevalence of static pool deals.

Hedge funds are accessing the market. Anemic CDO equity returns are being marketed (in the 10% to 12% range).

Secondary Liquidity: The bid-ask spread for CDOs has narrowed. The opportunities for finding value in distressed situations have been exhausted. The collateral mix in secondary trading is primarily in recently issued deals. Investors view CDOs as tradable securities rather than as buy-and-hold securities.

Fewer triple-A and double-A tranches are trading. Most of today's trading volume is in triple-B, double-B, and equity space. More trades are occurring but the aggregate dollar volume may be declining. The landscape has changed to a more level playing field. Now, all market participants have good access to information through Intex, CDO Sentry, rating agency reports and other sources.

From the buy side perspective, liquidity is very good for selling. However, it is difficult to buy bonds in the secondary market. Another panelist questions whether the market will remain liquid during times of stress. Investors should get to know the managers of the CDOs in which they invest. Investors also should focus on documentation in order to determine whether a deal's documents create any problematic incentives for the manger.

The recently benign credit environment is likely one of the main reasons for the strong liquidity in the CDO market.

CDOs are the newest form of asset management. A CDO is a leveraged bet on the credit of its underlying portfolio. An ABS CDO investor bets that the housing market will continue to grow. Investors should work to understand the details of the underlying collateral, such as (1) overcollateralization step-downs and trigger tests in home equity ABS (2) the presence of second-line middle-market loans in a CLO.

New deals tend to have longer reinvestment periods, often lasting for seven or ten years. Therefore, the deals are likely to persist through one or two complete credit cycles.

ABS CDOs have large exposure to "scratch 'n' dent" MBS. This could become an area of trouble and investors should remain watchful. Separately, investors should watch out for exposure to second-lien leveraged loans in CLO. The exposure will last a long time so the tail risk on those asset exposures is a critical consideration.

Many managers have done numerous deals over the past few years and virtually all have performed perfectly because of the benign environment. Investors need to think about how the deals would fair in harder times.

There likely will be more upgrades than downgrades in the high yield space. ABS ratings likely will be stable in the near term, which could lead to upgrades on ABS CDOs because of deleveraging.

Deals that deleverage quickly are the most likely to be upgraded. CLOs backed by middle market loans and small business loans are likely to be upgraded. CRE CDOs are likely to be upgraded. Current subordination levels for MBS and home equity ABS already reflect pessimism about residential real estate and, therefore, ABS CDOs should avoid downgrades.

Optional Redemptions (Calls): A substantial portion of bank loan CLOs were called by their managers at the end of their non-call periods. This also could happen to CDOs backed by bank TruPS. Older vintage ABS CDO deals likely will be called in 2006. Another panelist disagrees about the likelihood the ABS CDOs will be called this year because of the weak secondary market pricing of seasoned ABS. A third view is that managers may call ABS CDOs because prepayments will force reinvestment at lower yields today compared to 2003. A possible arbitrage in distressed structured finance CDOs and distressed high grade corporate CDOs may be buying all the tranches of a deal and calling it or collapsing it.

Spread Environment: Today's spread environment is a tough one in which to find yield. Opportunities persist in one-off and highly-negotiated transactions. There also are opportunities for managers who really know the underlying assets and for CDO investors who can pick those managers. Dealers can offer customized synthetic solutions that can provide appealing opportunities for investors.

Trade Recommendations:

- CDO equity because the outlook for credit volatility is low. Especially equity from Bank TruPS CDOs and seasoned CLOs.
- Middle market and small business CLOs because their underlying motivation is financing and not arbitrage.
- ABS CDOs
- Single-A and triple-B tranches of seasoned CLOs.

Wednesday, 1 February 2006

7:30 am – The Legislative and Regulatory Policy Environment

Regulation AB[51] and Offering Reform[52]: [Note: This portion of the session addresses some of the same material covered in the 5:00 pm Sunday session and the 8:00 am Tuesday session.] Ongoing reporting is critical under Reg AB because failure to file required reports can disqualify an issuer from using the shelf registration process.[53]

A key area of change resulting from Reg AB and the offering reform regulations relates to documentation and timeframes for the offering materials. For deals that involve a single pricing, the documentation burden has essentially doubled because of the need to create a preliminary prospectus. For deals with "iterative pricing" the burden is even greater because disclosure materials need to be checked for accuracy at multiple stages in the transaction process.

A second key area of change relates to disclosure of information about third parties. There is uncertainty about whether static pool information from "originators" may be required. Likewise, disclosure may be required with respect to derivative counterparties. Accordingly, counterparties that can provide GAAP financial statements have a competitive advantage.

A third area of change is the extension of new practices for public deals over to deals executed as private placements under Rule 144A. The best practice is to follow disclosure practices from the public sector when doing 144A private placements. However, there are times when the inability to meet the disclosure standard of public deals is the driving reason for doing a deal as a 144A private placement.

One area where the securitization industry may seek interpretive guidance from the SEC is static pool data from originators that have sold their loans on a servicing released basis. Those originators may not have access to static pool data. The industry is reluctant to take the problem to the SEC but it might have to do so.

A second likely question for SEC interpretation relates to the "maximum probable exposure" measurement of derivatives for purposes of determining whether disclosure is required of derivative counterparties.[54] Some market participants are interpreting the rule in manner that arguably sets the disclosure bar too low, which may trigger problems with 1934 Act periodic reporting obligations.

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[51] 17 C.F.R. § 229.1101 *et seq.* (2005), Release 33-8518, 70 Fed. Reg. 1506 (7 Jan 2005).

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

[53] 17 C.F.R. 239.13(a)(4) (2005).

[54] *See* 17 C.F.R. § 229.1115 (2005).

A third area that may require SEC interpretive guidance relates to the standards for servicing practices. Some market participants feel that the enumerated standards are too vague.[55] Some accountants take the position that they cannot provide attestations on servicing compliance for 2006.

Bank Regulatory Developments: Basel II[56] and Basel IA[57] arguably are not linked. Basel IA addresses the perceived competitive inequity that smaller banks have associated with Basel II. It is likely that Basel IA will go forward regardless of the pace at which progress on Basel II occurs. At this point, Basel II likely will not achieve full implementation in the U.S. before 2012 or 2013.

Basel II is likely to take effect eventually. However, if something unexpectedly derails it, Basel IA likely would expand to take its place.

The notice of proposed rulemaking for implementing Basel II in the U.S. likely will appear in the Federal Register sometime in the second quarter. Regulators will try to publish the Basel IA proposal shortly afterwards, so that there would be some overlap of the comment periods for the two.

U.S. regulators received about 70 comments on their advanced notice of proposed rulemaking (ANPR) for Basel IA. The comments spanned the entire possible range. Smaller institutions want to be left alone. Somewhat larger institutions – those on the cusp of Basel II eligibility – want to have the ability to use internal ratings. The largest banks comment that they are unhappy about the burden of operating under parallel rules during a transition period. Some banks have asked to be able to continue operating under the existing rules because they do not feel the need to be more sensitive to risk.

Most banks supported the proposal to use loan-to-value ratios and consumer credit scores (FICO scores) to set capital requirements on assets.

The notice of proposed rulemaking for Basel II likely will closely track the BIS release from mid-2004.[58] However, it likely will have somewhat higher floors (*i.e.*, somewhat higher minimum risk weights) and a different definition of default. It also likely will have a more comprehensive treatment of derivatives.

The advance notice of proposed rulemaking on Basel IA was intentionally vague. It was essentially a white paper. When regulators publish a notice of proposed rulemaking on Basel IA, it will contain fewer exotic features than did the ANPR. For example, the notice of proposed rulemaking likely will not differentiate between small business loans that include personal guarantees and those that do not.

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[55] *See* 17 C.F.R. § 229.1122 (2005).

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

[57] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, *Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications*, 70 Fed. Reg. 61068 (20 Oct 2005) [hereinafter "Basel IA"] <http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20051020/attachment.pdf>. Basel 1A is a proposal by U.S. regulators to modify the existing risk-based capital framework for banks to capture some of the changes that Basel II would ultimately bring.

[58] <http://www.bis.org/publ/bcbs107.htm>

Although most banks conceptually agree with the notion that capital requirements should be sensitive to risk, they also want the capital standards to be simple. For many, the cost of complexity outweighs the benefit of increased sensitivity.

Liquidity Facilities: Under current standards, a liquidity provider for an asset-backed commercial paper program under an eligible liquidity facility cannot purchase assets more than 90 days past due or that are rated below investment grade.[59] Industry representative are discussing with regulators whether changes are appropriate.

Worries: The issue of market disruptions is one that regulators worry about. Right now, professionals have a very positive view of financial markets. Over the past few years, financial markets have admirably withstood significant challenges, including large corporate defaults. However, that makes regulators wonder about what it would take to produce a market disruption. The influence of hedge funds on the financial markets is not fully understood. In addition, regulators worry that even when credit is deteriorating, institutions will continue to stretch for earnings. Third, regulators worry about reputation risk for financial institutions.

Complex Transaction: The regulators still need to finalize and clarify their guidance concerning complex structured finance transactions.[60] Ultimately, the matter is principles-based and not suited to rigid rules. The need for finalized guidance is reduced by the fact that most institutions have become sensitive to the issues and adjusted their practices appropriately.

Bankruptcy Reform:[61] The key change for the securitization industry from bankruptcy reform is the rising prevalence of repurchase agreements to finance assets during their warehouse periods. Changes to the law provide greater protection to repo lenders.

8:35 am – Current Dynamics of Trading Home Equity Loan ABS

Relative Value: Is there better value in cash securities or in synthetics? Is there good value in the new ABX index?[62] Is value better in triple-A tranches or in lower-rated ones?

Trading in the ABX index started with a wide bid-ask spread. The bid-ask spread quickly narrowed. However, the trading market for the ABX index may not be deep and it could be difficult to execute a large trade.

Cash securities appear cheaper than synthetics or the ABX index. The absence of the coupon step-up feature in the ABX index arguably is a significantly negative feature. The market does not appreciate the importance yet.

Single-A-rated tranches are too expensive. For tranches rated triple-B or triple-B-minus, value depends on the identity of the issuer and one's view of the market. Tranches rated below investment grade are cheap right now and the rating agency differences give opportunities (some tranches offer Libor+1110, but lack a rating from Moody's).

A second panelist feels that the introduction of synthetics is a huge development because it lets investors take short positions.

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[59] 12 C.F.R. Part 3, Appendix A, § 3(b)(6)(ii) (2005); Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, Interagency Guidance on The Eligibility of Asset-Backed Commercial Paper Liquidity Facilities and the Resulting Risk-Based Capital Treatment (4 Aug 2005) <http://www.occ.treas.gov/ftp/bulletin/2005-26a.pdf>.

[60] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, *Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities*, 69 Fed. Reg. 28980 (19 May 2004).

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

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

Premium seasoned bonds offer value because (1) prepayments likely will slow as interest rates rise, (2) borrowers are inefficient at exercising the call option in their loans, and (3) pricing of the securities is calculated at high speeds. Investors also can find value in home equity ABS from top-tier issuers and in securities backed by pools with better-than-average-credit-quality assets (as reflected by lower credit enhancement). Seasoned home equity ABS deals can offer value because of paydowns and deleveraging.

There have been selective opportunities in single-name synthetic ABS, because that area of the market moves very fast in response to technical factors. The synthetics enable investors to profit from long-short strategies such as going long a tranche rated Ba1 and short a tranche from the same deal rated Baa3 (*i.e.*, buying protection slightly above the tranche where the investor is long).

Tiering: Synthetic activity is highly concentrated in home equity ABS rated in the triple-B area. The growth of synthetics has increased tiering between issuers, shelves, and specific deals. Synthetics have caused tiering in the triple-B space to expand to 25 to 50 basis points in many cases. Before synthetics, tiering at the triple-B level was only about 5 basis points. It is difficult for a dealer to exactly pair-off exposures.

Although tiering has become vividly apparent in the synthetic ABS area, it is not strongly apparent in the cash ABS market. Also, tiering changes over time as issuers go in and out of favor. For example, one issuer has high concentrations of loans secured by homes in the Midwest and, therefore, its deals have experienced higher delinquencies and losses. That issuer had been perceived as a top tier issuer but now it is viewed as second or third tier. In addition, tiering among issuers likely will change as some of them experience financial distress over the next six months to one year.

Vintages: Seasoned securities with established performance histories offer greater certainty about their future performance than do new deals. The 2004 vintage is particularly appealing. In hot home price areas, delinquent borrowers have cured by refinancing into new loans. That has produced credit curing in the deals. On the other hand, some new deals have higher enhancement levels.

Another point of view is that it may be dangerous to believe that all the loans from an older vintage have benefited from home price appreciation. Home prices have not increased at equal rates across the country. An investor in subordinate or mezzanine tranches is exposed to the tail risk of the pools. The investor should be prepared for the deals *not* to be called. This year will be very interesting for the 2003 vintage. The hybrid loans from that vintage are at or near their interest rate reset dates. Some securities from that vintage are starting to experience downgrades. There is opportunity for investors to carefully select bonds from the 2003 vintage, but taking the vintage as a whole might not be a successful strategy.

Step-Downs/Triggers: Overcollateralization step-down criteria (a/k/a "trigger tests" or "triggers") in home equity ABS arguably are flawed. Most losses come after a deal's third year, yet deals allow the release of overcollateralization starting in the third year. Cumulative loss triggers are structured better than delinquency triggers, but high prepayments can undermine the protection of cumulative loss triggers.

Also, deals use inconsistent criteria for allowing overcollateralization to step-down. Investors should focus closely on the criteria in the deals that they actually buy.

Step-down criteria in many older deals arguably were too loose. The release of overcollateralization in accordance with deals' step-down criteria recently was cited as the reason for a rating agency to have downgradied some subordinate tranches. This has happened even in deals that had better-than-expected collateral performance. Investors should consider banding together to attack this issue. Issuers and bankers arguably should use trigger structures as a basis for differentiating their deals from their competitors'. However, the issue is primarily one of concern to holders of triple-B-rated tranches, which account for only a small portion of the capital structure of most deals.

Credit enhancement at the triple-B-minus level has roughly doubled over the past few years.

Rating Agencies: Are the rating agencies requiring enough enhancement? What does it mean when a rating agency is left out of a deal?

The rating agencies generally are doing a good job and take a conservative view. The rise of affordability products has made the rating agencies' job harder. They arguably require more credit enhancement than is necessary for option ARMs. The rating agencies have a slight tendency to over-enhance strong pools and to under-enhance weak pools.

One panelist asserts that Moody's soon will lower its credit enhancement levels for home equity ABS. Investors should remain alert for this possible change.

The absence of a rating agency from a deal is not necessarily a danger signal. The absence of a Moody's rating on subordinate home equity ABS tranches can widen spreads by hundreds of basis points.

CDOs and Synthetic ABS: Liquidity may become a problem in a few years as ABS CDOs try to trade out of some synthetic ABS that they are purchasing now. CDO managers like synthetic ABS because they allow rapid ramp-up and avoid the risk of available funds caps. However, some managers of ABS CDOs may not have considered where they will get a bid if they want to trade out of deteriorating positions after several years. Arguably, it would be easier to sell a cash security because the original underwriter for the deal should supply a reasonable bid. In contrast, there is no "natural" source of a reasonable bid for a synthetic ABS that has started to deteriorate. Therefore, an investor or CDO manager that uses synthetic ABS ought to consider the possibility of having to hold the deteriorating exposure indefinitely.

In synthetic ABS, traders have ascribed value of between 5 and 10 basis points to the difference between the fixed cap and the variable cap CDS structures.[63] About 90% of the synthetic ABS trading activity uses the fixed cap. There likely will be less liquidity on variable cap contracts if an investor wants to liquidate a position in the future.

9:50 am – Home Equity Market Research Perspectives

A year ago, nobody was able to foresee the huge volume of activity that the home equity ABS sector realized in 2005. The audience has divergent views about whether the home equity ABS sector will grow, shrink, or remain flat in 2006. Margin compression is a challenge for sub-prime mortgage lenders. Margins need to widen if the lenders are going to make money. The previous refinancing boom drew many players into the industry, but now the reduction in volumes likely will produce a shakeout. The real question is whether 2006 will be like 1998, when many lenders collapsed. The *coup de grace* in 1998 was the demise of Long-Term Capital Management, which curtailed liquidity for many lenders in the sub-prime mortgage sector. A related challenge to profitability is that each lender is reluctant to be the first one to raise interest rates. Moreover, even if a lender were willing to do so, it might suffer adverse selection and attract only the weakest borrowers.

The sub-prime mortgage industry is focused primarily on volume because all the industry's players are paid based on volume.

Volume: If home price appreciation declines to 5%, issuance of home equity ABS likely will decline by roughly 10%. A factor that may dampen the issuance decline is large volumes of 2/28 and 3/27 hybrid loans reaching their reset dates in 2006; borrowers on those loans are likely to refinance if they can.

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[63] *See* ISDA, *Credit Derivative Transaction on Mortgage-Backed Security with Pay-As-You-Go or Physical Settlement (Form I) (Dealer Form)*, <http://www.isda.org/publications/docs/ISDA-Dealer-Form1.doc> (Interest Shortfall Cap Annex).

Payment Shocks: Payment shocks from hybrid resets, ARM adjustments, and resets on interest only loans should increase defaults and losses but only by about 20%. Another panelist feels that the effect of payment shock would be to increase defaults and losses by 20% to 40%. According to one view, the presence of a piggyback (silent) second-lien mortgage loan is a much more adverse risk factor than payment shocks.

Concern over interest-only loans prompted many lenders to introduce 40-year loans as a substitute product.

Synthetic ABS (CDS of ABS): Synthetics change the dynamics of the market by boosting spread volatility. CDOs are a class of investors, which all move in unison to buy securities when spreads are wide. Another class of investors is macro hedge funds, which all short in unison when spread are tight. Synthetic ABS promote tiering. However, so far, shorting has been primarily based on gross factors (*e.g.*, geographic concentrations) rather than on the unique attributes of specific bonds.

Another view is that the market is still vetting synthetic ABS. It remains to be seen whether any strategy based on shorting the housing market can succeed in the long run. Still, at least for now, CDOs set spreads in the triple-B home equity ABS space.

Liquidity: CDOs have provided a huge source of demand for triple-B home equity ABS. However, it is debatable whether demand from CDO truly provides market liquidity because it is all one-sided. The standardization of the CDS contracts and the creation of the ABX index should help provide balance and may facilitate the two-way liquidity.

Fixed vs. Floating: The globalization of structured finance is a key factor. Most of global savings are outside the U.S. Those saving are LIBOR based. This means that there is constant pressure for consumer products to be floating rate or to have short durations.

Deal Structures, Step-Downs: Step-down criteria are more than sufficient to protect senior tranches, but they arguably are not sufficient to protect mezzanine and subordinate tranches. A positive structural change would be step-down triggers that reference tranches other than the senior class and, to a lesser degree, step-down triggers that do not allow the release of overcollateralization for five years (except in the case of huge prepayments).

Adverse Selection: Some deals will have very ugly tails when the good loans have refinanced and all that remain are the weakest loans that could not refinance. It is unlikely that such deals will be called and likely that investors will have to hold the ugly stubs

Tiering: One view is that four factors drive tiering: credit, prepayments, structure, and seasoning. Originators' impact on credit tiering is decreasing over time. [Note: We feel that tiering by issuer is as important as ever.] Along the credit dimension, investors may be able to seize opportunities where rating agencies have required arguably excessive credit enhancement for cash-out and interest-only loans. Along the prepayment dimension, investors can find opportunities based on prepayment differences between issuers and pools. Some of the pay-up for seasoning is justified, but not all.

Another view is that the originator is the largest factor in tiering. This is reflected in the pricing of triple-B tranches, driven by CDO bids. Indeed, the buyers of CDO equity and mezzanine tranches focus on the identity of the home equity ABS issuers in their deals.

A third view is that *servicers* (as distinct from issuers) drive some measure of tiering in the home equity area. A servicer exerts a strong influence on the performance of securitized assets.

Bubble?: If home prime appreciation drops to roughly 5% nationwide, home equity ABS tranches rated single-A and higher should be fine. In lower rated tranches, the key factor may be the timing of losses. For double-B-rated tranches, spreads wider than 1,000 basis points are sufficient to offset some level of principal losses. Perhaps the weakest part of the tranche spectrum is the triple-B area, where spreads are tight but risk is significant.

A second view is that at the single-A and triple-B levels investors need to pick bonds carefully because there are opportunities as well as dangers.

10:55 am – Synthetic Securitization and the Emergence of ABCDS

Today's synthetic ABS grew out of the synthetic securitizations by banks transferring risk away from their balance sheets. Eventually that gave rise to correlation trading by dealers, unfunded super-senior tranches, and single-tranche synthetic CDOs. Ultimately single-name CDS on ABS emerged and, lastly, the ABX index. One estimate is that synthetic ABS volume in 2006 could be in the range of $100 billion (±$25 billion).

The key challenge in creating a ABS CDS is making sure that the buyer and the seller actually agree on the terms. The swap contract must relate properly to the underlying reference obligation. What about index changes? What about step-up mechanisms?

Trader Panelist: The advent of ABS CDS allows market participants to take short positions. There has been an explosion of trading volume driven by CDO's selling protection and both hedge funds and dealer shelves buying protection. There is excitement in the market because of the large volume of activity. On the other hand, spreads have become very volatile.

Before ABS CDS, spreads on triple-B home equity were driven largely by the CDO bid. Prices did not reflect tiering and were tied simply to ratings. Now, tiering on triple-B tranches is evident because investors can be selective and can express negative views by shorting.

ABX Basis: The advent of the ABX index arguably will boost liquidity for synthetic home equity ABS at the triple-A and double-A levels of credit quality. The index reflects a pool of 20 representative securities from the home equity ABS sector. It provides a basket of 20 exposures for each rating-level subcategory. So far, the basis has been positive. This may reflect the presence of weak credits among the representative securities. Additionally, CDOs generally will not use the index because they focus on picking bonds (however, they may use the ABX index for locking in an arbitrage when overall market conditions are favorable).

Single-name Basis: In November the basis got hugely positive and later collapsed to -50. Now it vacillates between 0 and -25 for many triple-B home equity ABS. CDOs bid up the price of synthetics because they can buy them when case securities are not available.

CDO Use of Synthetics: Synthetic ABS are very useful for CDOs because they facilitate the creation of synthetic CDO liabilities. Market participants want synthetic ABS to closely replicate the terms of the underlying reference obligations. The "implied write-down" credit event may be unacceptable to a CDO manager. [Note: Depending on the definition of credit events in a CDS contract, a synthetic ABS might be much less risky than its underlying reference obligation. That can partly explain a negative basis.]

Documentation: The standard pay-as-you-go form of CDS for ABS is effective in replicating the underlying reference instrument for a protection seller. The key is eliminating "sudden death settlement." Failure to pay principal is a floating payment event and a credit event. Other floating payment events include actual and implied write-downs. An implied write-down is when a calculation agent determines that the reference obligation is under-collateralized. Another floating payment even is interest shortfall – a difference between actual and expected interest, but not attributable to available funds caps or allowable deferrals. There are two versions of interest shortfall payments: capped an uncapped.

An alternative form of document, called Form II, is the form favored by the monoline bond insurers. It replicates being a surety rather than replicating ownership of a bond.

A third form, used in primarily in Europe, does not use a pay-as-you-go mechanism.

Monoline Involvement: The monoline bond insurers have limited their activities in synthetic ABS because they do not like the standard (dealer) form of CDS contract. However, the absence of involvement by the bond insurers should not necessarily impede the growth of the market.

CDO Market: The current CDS form arguably embodies risks other than credit risk, such as liquidity risk if there is physical settlement following a credit event. The CDO market may be a driver of further innovation to try to isolate credit risk. CDOs also may drive structural innovation and diversity, allowing CDO investors greater choice.

A possible challenge for CDO structuring may be a limited universe of potential super-senior buyers.

— E N D —

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