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Report from Las Vegas 2008:
Coverage of Selected Sessions of ASF 2008

11 February 2008

by Mark Adelson

Introduction

More than 6,000 professionals reportedly attended last week's ASF 2008 event in Las Vegas. Although the overall mood at the event was subdued, it was far more positive than the somber tone of last November's ABS East conference.

Of course, the sub-prime situation and its effects on other sectors held center stage throughout the entire event. Many market participants were keenly focused on the issue of how the securitization industry can get back on its feet. Terms like "restoring confidence," "improving transparency," and "skin in the game" could be heard frequently in casual conversations and in almost every session. A favorite subject for many was the question of whom to blame for the industry's woes. Mortgage brokers and rating agencies were the chosen scapegoats.

There was remarkably little focus on specific, concrete changes that firms and individuals in the industry should make to prevent a repeat of the current situation. For example, topics that were not prominently discussed but which arguably should have been include the following: (i) the practice of slicing deals into extremely thin tranches that present "cliff risk" issues, (ii) compensation arrangements that fail to motivate professionals to care about the long-run performance of securitized assets, (iii) overreliance on quantitative models grounded on irrelevant or unrepresentative data, and (iv) the inherent paradox of applying "market value" accounting to illiquid instruments for which there is no active market.

Interestingly, other topics that received relatively little attention were (i) the seemingly unwarranted degree of attention on the sub-prime situation from the general media, (ii) the often distorted coverage of the sub-prime situation in the general media, and (iii) the amplified level of

political fallout. Of the 117 million households in America, about 7½ million have sub-prime mortgage loans, of which between 1 million and 3 million will face serious problems, such as foreclosure and the loss of their homes. Clearly, anything that affects more than a million families is an important issue. However, it is not the same as an issue that affects 20% or 30% of the U.S. population. Exaggerated media coverage may precipitate a disproportionate response from policymakers seeking to appease an agitated public.

On the other hand, the bursting of the housing bubble potentially affects all of the 70 million American households that own their own homes. The bubble created, and then took back, *trillions* of dollars of wealth that Americans had in their homes. But sub-prime lending was merely a contributing factor of the housing bubble. Primary credit for the bubble has to go the Federal Reserve, which kept the Fed Funds rate at or below 3% from 9/17/2001 through 6/29/2005. Likewise, the sub-prime situation unearthed, but did not cause, the serious problem of weak risk management practices at some financial institutions.

Similarly, on the securities side, the general media tends to ignore the differing impact of the sub-prime problem in different product areas. For example, in the area of first-lien sub-prime mortgage ABS, bond defaults are likely to be concentrated among subordinate tranches initially rated in the triple-B and single-A rating categories. There should be few defaults of senior securities initially rated triple-A. This outlook seems to fit reasonably well with the degree of stress caused by declining home prices and lax underwriting – stress that is severe (enough to hit triple-Bs and single-As) but not extreme. In contrast, defaults of senior securities are likely to be common among (i) second-lien sub-prime mortgage ABS and (ii) ABS CDOs. The first is a small, sub-sector of the market. Although the second area, ABS CDOs, is quite large and significant, the jeopardy of ABS CDO senior tranches should not be particularly surprising or troubling. The inherent nature of ABS CDO structures is to be very sensitive to changes in credit performance because they are made of thinly sliced tranches of the underlying ABS transactions. That has always been the ABS CDO proposition and market participants were generally aware of it.

The following summaries reflect remarks of the panelists who participated in selected sessions at the conference. For the most part, the summaries have been drawn from notes taken during the sessions. The summaries have not been reviewed or approved by the panelists. While I have tried to capture panelists' remarks accurately, I apologize in advance for any inaccuracies and omissions. In addition, I wish to acknowledge the excellent work of the American Securitization Forum in organizing and hosting the conference.

The following summaries do not necessarily reflect the views of Adelson & Jacob Consulting, LLC or its members.

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Sunday, 3 February 2008

1:00 pm – Basics of RMBS Deal Performance Analysis

The key questions that RMBS deal performance analysis seeks to answer are (1) the value of a security, (2) the timing of cash flows, and (3) the likelihood that a security will experience a principal loss. Traditional performance metrics used by investors are (a) prepayment rates, (b) delinquencies, (c) defaults, and (d) recoveries. Remittance reports are the source of the data. Remittance reports provide detailed information about prepayments, defaults, and losses. Remittance reports sometimes provide detail at the loan level.

Delinquencies reported on remittance reports are the key to understanding performance.

A remittance report is a current snapshot of the collateral. Looking through history, it is possible to tell how a collateral pool got to its current state. Given the history, it is possible to use a model to forecast where the performance of a collateral pool is going.

Andrew Davidson & Co. (ADCo) uses performance data to group loans into four categories for purposes of its analytic model:

1. **C**urrent (0-1 month delinquent)
2. **D**elinquent (2-5 months delinquent)
3. **S**eriously delinquent (≥6 months delinquent)
4. **T**erminated

Current loans are not in trouble. **D**elinquent and **S**eriously delinquent loans are in trouble. **T**erminated loans are finished. Within ADCo's model, a loan with a status of **C** can transition to **D**, to **S**, or to **T**.[1] From **D**, a loan can go to **C**, **S**, or **T**. From **S** a loan can go to **C** or **T**. From **T**, a loan goes to either prepayment (no loss) or a loss. To project loss, it is necessary to figure out severity.

C to **T** is the dominant form of termination. It corresponds to ordinary prepayments. Other terminations (*e.g.*, **D** to **T** and **S** to **T**) are either distressed refinancings or default/foreclosures.

The ADCo model predicted a higher level of prepayments than has actually occurred on 2/28 sub-prime mortgage loans. The difference is attributable to broker-driven fundamental changes in the environment. ADCo addresses the discrepancy by "tuning" (*i.e.*, making an adjustment based on qualitative factors) the **C** to **T** transition in its model.

ADCo feels that the key driver of the **C** to **D** transition is a borrower's ability to pay. ADCo uses a borrower's FICO® score as an indicator of his ability to pay.[2] When adjustable rate loans reach their reset dates, **C** to **D** transitions increase by about 25%. However, ADCo found that many loans are transitioning directly from **C** to **S**, which may signal deficiencies in reporting.

Loan-to-value ratios (LTVs) are the key driver of the **D** to **C** transition. Loans with lower LTVs have a stronger propensity to cure, because the borrowers have an economic incentive to do so. However, loans with LTVs of exactly 80% have a low tendency to cure. That is because 80% LTV loans usually come from situations where an appraisal was sought to support a targeted loan amount corresponding to the 80% LTV. Also, declining home prices and illiquidity have made the overall cure rate (**D** to **C** transition) lower than it has been in the past. The lower cure rate is key feature of the current environment.

Putting it all together, ADCo forecasts a 60+ delinquency rate of 50% for the ABX 06-2 over the next two years. ADCo forecasts cumulative losses of around 20% for the ABX 06-2.

ADCo's model can generate loss estimates for each stratification category of a pool. For example, it projects losses of 15% for **C** loans, 33% for **D**, and 37% for **S**, for a certain sample pool.

The ADCo model projections can be used to generate cash flows that can be fed into Intex or the new Bloomberg credit functions. The cash flows also can feed into a credit OAS model for pricing securities.

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[1] The transition directly from **C** to **S** can occur if a borrower files for bankruptcy or renounces his intention to make further payments on the loan.

[2] Strictly speaking, FICO® scores only give an indirect indication of a borrower's ability to pay his debts. The calculation of a borrower's score does *not* include information about his income or his assets. Accordingly, FICO scores are primarily an indicator of a consumer's propensity or willingness to pay his debts rather than as an indicator of his ability to do so.

The ADCo model works better on first-lien loans than on second-lien loans. The origination channel (broker vs. retail) makes a very big difference in the performance of second-lien sub-prime loans.

2:00 pm – Consumer Credit Metrics and Evaluation

A FICO® score is a three digit number ranging from 300 to 850 which ranks a consumer according to risk. It is a summary of information in a consumer's credit file. The scores are designed to ***rank order*** risk. The scores are not designed to produce a fixed "odds-to-score" relationship over time.[3]

There are still many low-score consumers who pay their obligations (and a few high-score consumers who default). Because many low-score consumers actually pay, some lenders target the lower score range and charge higher interest rates to earn enough on the low-score consumers who pay to counterbalance losses on those who default.

FICO scores are based on trade lines, inquires, collections, and public records. The scores do not consider age, address, employment, income/DTI, gender, or collateral. The information that feeds into a score can be divided into five main categories that drive the score calculation to varying degrees: (1) payment history-35%, (2) outstanding debt–30%, (3) credit history length–15%, (4) pursuit of new credit–10%, and (5) credit mix–10%. In the payment history category, the score considers the recency, severity, and frequency of delinquencies. Recent delinquencies indicate much higher risk than delinquencies that are more than year old. In the outstanding debt category, the key measure is the percentage of available credit that a consumer has used. The outstanding debt category also considers the number of credit lines that a consumer keeps. Consumers that have high utilization ratios are much riskier than those who have low utilization ratios. The pursuit of new credit category lowers a consumer's score for new credit accounts and, to a lesser degree, for inquiries that indicate that a consumer is seeking new credit. The score considers only consumer-initiated inquiries within the last 12 months. The scoring system treats multiple inquiries close together in time as a single inquiry.

A recent performance test of FICO scores indicated that the scores have been reasonably successful at predicting defaults of both new and existing mortgages over a two-year performance window from 2005 to 2007. In each sample population, three quarters of defaults were among borrowers who scored below 620 (about 20% of the population). Fair Isaac is introducing a new version of the system (called FICO 08) that is designed to produce slightly better predictive power overall and substantially better predictive power for sub-prime borrowers.

FICO scores face challenges in a changing environment, like the present.

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[3] Despite the assertion that FICO scores measure risk only on a relative basis, Fair Isaac Corporation has often published "odds-to-score" tables. Those tables sometimes create the misconception that scores are measures of absolute risk.

FICO scores are not a complete solution for credit underwriting. Credit underwriting should cover the "three C's," **C**redit (willingness or propensity to pay), **C**apacity (ability to pay), and **C**ollateral. There is an indication that lenders got too lax in their credit underwriting practices in recent years.

FICO scores and their odds-to-score relationships move over time. As the economy shifts, consumers' FICO scores tend to drift lower in a recession and higher during periods of expansion. In addition, many macro economic factors can affect the odds-to-score relationship over time. The odds-to-score relationship often varies from one lender to another at any point in time.

Comparing two pools of loans based on their average FICO scores can be misleading. This is because risk does not change in direct proportion to the scores. Pools with wider dispersions of scores will tend to be riskier because the higher risk of low-score loans outweighs the reduction in risk for high-score loans (*i.e.*, risk increases exponentially as scores drop).

One of the ways consumers sometimes try to game the scoring system is by adding authorized users to their card accounts, which can bring the new authorized user's credit information into the subject consumer's file. The new FICO 08 scoring system will not use information from authorized users in generating a consumer's score.[4]

Monday, 4 February 2008

8:00 am – Welcome and Chair's Address

Securitization is an important market that is facing tough challenges. How industry participants respond to the challenges will affect whether the securitization industry can thrive in the future. Securitization has delivered substantial benefits to both consumers and businesses in the form of cheaper borrowing costs. Industry participants need to focus on the core principles and values that the securitization industry should embrace.

- All participants must take responsibility for their own actions. This includes lenders, issuers, rating agencies, and investors. Regulators should not stifle innovation. Borrowers should have access to a range of credit products but must accept responsibility for their obligations.

- Transparency must be improved. This does not necessarily mean more data, but rather improvements in standardization of data and access to data. An ASF committee is working toward the development of a standardized loan-level data format for residential mortgage loans.

[4] See also http://seasonedtrades.com/add-mortgage-tradelines.html http://seasonedtradelinesblog.blogspot.com/2007/12/fico-08-e-book.html

- The industry needs to work together to address deficiencies or shortcomings in how it is regulated. Industry participants need to work with regulators and not merely seek to thwart all attempts at regulation or oversight. The residential mortgage market is a national market and it should be regulated uniformly at the national level. Any regulation should preserve legal certainty. Accordingly, the industry should not push for modifications of loans to such a large degree that it would undermine certainty about the enforceability of residential mortgage debt.

8:20 am – Keynote Address by Federal Reserve Governor Randall Kroszner

The Federal Reserve is working on several initiatives for consumer protection. The mortgage market has long been a source of strength for the economy but there is tremendous stress in the sub-prime mortgage sector.

Twenty percent of sub-prime mortgage loans are delinquent by 90 days or more. The number of foreclosures has recently been growing. During 2007Q3, 170,000 loans entered foreclosure.[5] The problem with the sub-prime mortgage sector is evident from early payment defaults (EPDs). The poor performance has caused a virtual shutdown of the sub-prime mortgage market.

Effective consumer protection can reduce uncertainty about underwriting standards, which can help the sub-prime mortgage securitization market to recover.

About 1.5 million sub-prime ARMs are scheduled to reset in 2008 and another half million are scheduled to reset in 2009. Many borrowers will not be able to withstand the resets on their loans. Because foreclosures are so costly, servicers should try to work with borrowers who cannot pay to find alternatives to foreclosure. Industry participants should embrace fast-track loan modification policies.[6] Servicers must develop the capacity to deal with the anticipated wave of defaults and potential loan modifications.

The Fed has been working with consumer organizations to try to deal with the coming wave of loan resets and defaults.

The Fed has a proposal to modify its HOEPA regulations to protect consumers from excessive layering of risk.[7] The standards are intended not to be overly prescriptive, to preserve innovation and choice. The proposal is out for public comment until April 8. The proposal

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[5] For more information on recent foreclosure activity see RealtyTrac.com, *U.S. Foreclosure Activity Increases 75 Percent in 2007*, http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=3988&accnt=64847

[6] American Securitization Forum, *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans* (6 Dec 2007) http://www.americansecuritization.com/uploadedFiles/FinalASFStatementonStreamlinedServicingProcedures.pdf. I raised some concerns about the streamlined framework in our 12/10/07 report titled *ABS/MBS Investors Lose in Treasury Dept.-ASF Plan for Loan Modifications.*

[7] Federal Reserve System, *Truth in Lending, Proposed Rule*, 73 Fed. Reg. 1671 (9 Jan 2008).

provides for strict regulation of higher priced mortgage loans. The pricing threshold is intended to cover the whole sub-prime sector and part of the alt-A sector. The proposal would prohibit broker steering, appraisal coercion, and unwarranted fees.

The proposal has three key rules to assure that borrowers on high cost loans can afford their loans. First, a lender must consider the borrower's ability to repay. Second, the lender must verify a borrower's income and assets. Third, the lender must collect escrows for insurance and taxes in connection with high cost loans.

The proposals would prohibit lenders from engaging in a pattern or practice of making loans based on repayment sources other than income. Although the proposal requires a lender to consider a borrower's debt-to-income ratio, it does not set a specific DTI limit.

The regulations would apply to all mortgage lenders. They would be legally enforceable by both regulators and consumers. They would also provide for statutory damages. Allowing consumer actions and not having quantitative thresholds arguably reduces legal certainty but this is counter-balanced by the requirement of pattern or practice.

The proposal targets no-doc lending (*i.e.*, loans in which the lender does not verify the borrower's income or assets). It generally requires documentation of consumer income but allows for "non-standard" forms of documentation.

Requiring escrows for taxes and insurance addresses the fact that some sub-prime borrowers do not fully understand the financial burdens of homeownership. Consumers with high-priced loans would be allowed to opt out of that requirement after 12 months of payments.

The proposal would ban prepayment penalties where they are most likely to prevent a borrower from refinancing a loan that is particularly burdensome. The rule would restrict the form of prepayment penalties in other cases.

Broker steering is another area addressed in the Fed proposal. Yield spread premiums (YSPs) can create a conflict of interest that makes a broker pursue his own interest rather than a borrower's. The proposal would prohibit a lender from paying a broker more than an amount agreed to in writing ***and in advance*** by the consumer.

Effective consumer protection can restore confidence in the market and restore the flow of capital for non-conforming mortgages.

Q&A: One audience member asked whether the Fed is working on regulation of the rating agencies. He said the rating agencies have lots of blood on their hands. Governor Kroszner said that the SEC is the primary regulator of the rating agencies.

One of the key ways that the Fed can help to restore confidence is with improved loan underwriting standards.

A representative of the Hope Now alliance[8] notes that around one quarter of the 4,000 borrowers who contact the hotline daily should never have become homeowners. She asserts that short sales are often the best solutions for those borrowers because they can shed the responsibilities of homeownership and return to rental housing. Governor Kroszner states that that Fed supports all kinds of alternatives for alleviating homeowner distress. He notes that the recent change to the tax law excludes forgiveness of mortgage debt from income and is very beneficial to homeowners.[9]

9:05 am – 2008 Market Overview and the Future of Securitization

The session focuses on four main themes: diagnosis, context, prescription, and outlook.

Diagnosis: One panelist feels that several causes underlie the current problems. The first is fundamental factors, such as the housing bubble. Another is ABS CDOs (*i.e.*, CDOs backed by ABS), which produced overleveraging. There needs to be greater segmentation or differentiation between asset classes that are in trouble and those that are not.

Another panelist observes that the current problems started as a credit problem in the sub-prime mortgage ABS sector that then spread into the ABS CDO area and triggered massive speculation through CDS (credit default swaps). The ensuing volatility caused many investors to pull back from all areas of the securitization market. In particular, investors drastically pulled away from ABCP and from SIVs, producing a liquidity crisis (in contrast to a credit problem). The liquidity crunch is driving liquidations and pushing down security prices. That, in turn, is increasing counterparty risk and exacerbating the problems with the bond insurers.

A third panelist feels that some investors do not sufficiently analyze the risks of certain securitization activities and investments. The CDS market presents particular risks and challenges. For example, one issue on which market participants sometimes fail to focus is the types of instruments that are deliverable under a CDS. Also, as CDS valuations move, counterparty risk potentially increases.

A fourth panelist notes that sub-prime issues created the liquidity crunch that hit SIVs and ABCP. Right around the start of the sub-prime problems, four SIVs got into trouble right away because they held high concentrations of sub-prime mortgage exposure. Those four SIVs could not roll their paper and then the press started running stories implying that all SIVs were full of sub-prime mortgage exposure. SIV credit spreads widened from L+5 to the range of L+50 to L+100. A fifth panelist remarks that the market conditions three years ago prompted some SIVs to abandon diversification as they stretched for yield. A sixth panelist emphasizes that

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[8] The Hope Now alliance (http://www.hopenow.com) is organized under the auspices of the Financial Services Roundtable (http://www.fsround.org). Hope Now is the culmination of various FSR initiatives toward addressing the increase in residential foreclosures. Those initiatives started in 2006 with the creation of a hotline (888-995-HOPE) and a website (http://www.995hope.com). A national ad campaign promoting the hotline began in June 2007.

[9] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, 110th Cong., 1st Sess. (20 Dec 2007) (amending I.R.C. § 108(a)(1)).

securitization brings tremendous benefits. However, things got out of hand when market participants stopped applying the "three C's" and simply stretched for yield.

Respondents to the pre-conference survey[10] generally felt that poor lending and underwriting decisions by lenders were the key causes of the problems. Lack of investor discipline and overreliance on ratings were also popular answers. Long term credit availability is the key issue for regulatory initiatives. The key business threat is continued illiquidity. The biggest challenge for the RMBS area is illiquidity.

Context: One panelist asserts that the current situation is not merely a cyclical phenomenon. Rather, the current situation reflects deeper issues regarding the structure of the market. Around 1990 or 1991, deal structures had to move away from using letters of credit because of downgrades of the "LoC" banks. For much of the last five years, most market participants used a revenue-oriented strategy rather than one based on doing "solid" business.

Another speaker focuses on the SIV market. Originally, SIVs had committed liquidity facilities of 10% to 20%, and if that was not enough, they could sell their liquid securities. The recent problems with SIVs came from the fact that their holdings had become illiquid. The consequence is that investors are now requiring SIVs to maintain much higher levels of committed liquidity. In contrast, most ordinary ABCP programs have always had 100% committed liquidity.

The securitization market has had trouble before in other areas: manufactured housing (MH), aircraft, franchise loans, sub-prime auto loans. However, an important feature that distinguishes the current situation is the role of ABS CDOs as buyers of huge volumes of ABS. ABS CDOs will likely have a much smaller role (if any) in the future.

A third speaker notes that what is happening in the sub-prime mortgage sector is very similar to what happened in the past in the MH and sub-prime auto loan sectors. Aggressive lending practices migrate through different sectors over time. The market will adapt and solve the problems in the sub-prime sector.

A fourth speaker notes that the sub-prime mortgage sector is larger in the U.S. than it is in Europe. Also, banks dominate the issuance landscape in Europe but not in the U.S. Accordingly, the magnitude of the sub-prime problem is much larger in the U.S. SIV issuance likely will decline by 35% to 40% because of the spillover from sub-prime.

Survey response on context: Most respondents expected that the yield on the 10-year Treasury note would be in the range of 3.0% to 3.5% around the middle of 2008. Respondents had widely varying views about the likelihood of a recession in 2008. However, very few respondents believed that the odds of a 2008 recession are less than 25%. Many expect growth of securitization in China and Asia, but many also expect continued growth in the U.S.

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[10] Two weeks before the conference, the ASF conducted a survey of registered attendees to find out market participants' views on issues confronting the securitization industry. The survey garnered 714 responses. Most responses were from individuals associated with issuers or intermediaries.

Prescription: One panelist feels that confidence can be restored only when (1) real money is attracted back into the market, (2) bid-ask spreads narrow, and (3) the spread differential between new issues and secondary trading narrows. Transparency remains an issue. There is lots of data but it is not always readily available. There ought to be public posting of remittance data. There ought to be standardization of structures. Another key problem area is the valuation of assets. Valuation uncertainty produces the very wide spread between prices at which buyers are willing to buy and the prices at which sellers are willing to sell.

Another panelist notes that yield spreads are at historically wide levels and that some new money from hedge funds is starting to tip-toe into the market. Liquidity is starting to creep back slowly. There is a fair bid for the front-pay classes (*i.e.*, the tranches that receive the earliest distributions of principal from the underlying loans) of sub-prime mortgage ABS. Market participants need to get back to the "three C's" to motivate investors to return to the market. Once a flow of new deals resumes, it will alleviate some of the dysfunction in the price discovery process.

A third panelist notes that rating agencies, issuers, and arrangers need to rethink the way that they analyze and structure CDOs.

A fourth panelist addresses the issue of whether market mechanisms can correct the problems or whether a policy response is necessary. He feels that there is some role for policy action to restrain the behavior of mortgage brokers. The market, however, can address many problems itself. Investors' withdrawal from the market is evidence that the market mechanisms can work. Investors will return when issuers and arrangers bring good-quality product to the market.

A fifth panelist urges ABCP investors to do their credit homework. Investors should not rely blindly on the rating agencies. They should fully understand the workings of credit enhancement and liquidity facilities for the programs in which they invest.

A sixth panelist emphasizes the need for securitization professionals to fully understand the true nature of the assets that are the subject of their securitization deals. The market, rather than policymakers, should solve the current problems.

Survey respondents feel that the key steps needed for restoring confidence are improving disclosure and the rating process – things that lie within the industry's power, rather than the purview of policymakers.

Outlook: One panelist feels that 2008 will be a year of low volume and a flight to simplicity. Issuers will learn to accept the new spread environment. Investors may broaden their focus to non-U.S. deals. Beyond 2009, the market will start to bounce back. The outlook for CDOs is harder to predict. CDOs sponsored by banks have a better chance for coming back than others.

Another panelist expects non-mortgage ABS issuance to continue at a level of around $250 billion in 2008. The outlook for CDOs is weak, though CLOs may come back sooner. RMBS may bounce back later in the year. Many foreign investors are nervous about investing in U.S. deals.

A third panelist feels that 2008 will be the year in which executive management of organizations will start to understand securitization.

10:20 am – Transparency, Valuation and Rebuilding Investor Confidence

What is transparency? Is it more data? Better data? Data on pricing?

Nobody seems to know the size of the synthetic ABS CDO market. The fact that nobody knows indicates that there is a lack of transparency in that area.

How We Got to Where We Are: The transparency debate really started in the pension plan sector, with concern about hedge fund activities. Now transparency encompasses not only instruments and rating methodologies, but also financial institutions and their financial reporting practices. During an environment of declining yields, institutions stretched to achieve higher yields by investing in instruments that had lower transparency. Now, with investors' risk aversion rising, the poor transparency of some instruments has hurt their liquidity and the poor transparency of some financial institutions has hurt their ability to lend.

Another panelist notes that an IMF committee has offered recommendations for improving market conditions by boosting transparency.[11] One recommendation is to improve disclosure by making it more relevant and meaningful (as opposed to simply more data). Transparency could be improved by standard terminology, along the lines of what the European Securitization Forum is pursuing. Rating agency methodologies also should be made more transparent. Checks and validations of rating methodologies should be done in order to reestablish credibility in the rating process. Independent review and monitoring of rating agency models and independent stress testing would help as well. Disclosure about the valuation of Level 3 (illiquid) instruments should be improved.[12]

The first panelist adds that policymakers need to be careful not to cripple securitization as they attempt to improve it.

Historical Data: There is a continuing trend toward analyzing loan-by-loan data. However, the ability to use such data for making reliable forecasts has been called into question because of the rapidly changing environment. Market participants are reexamining the ways in which they use data. There is also increasing focus on data validation.

Transparency means different things to different people. "More" transparency may not be the issue and it is not fully clear what "more" refers to. More information? The accessibility of information? The ability to use the information consistently in a systematic way?

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[11] *See generally* International Monetary Fund, *Global Markets Face Protracted Adjustments*, IMF SURVEY, vol. 36, no. 12, at 184 (Oct 2007) http://www.imf.org/external/pubs/ft/survey/2007/101507.pdf.

[12] "Level 3" refers to estimation of an asset's value from unobservable inputs as opposed to market prices or other independently verifiable data. The term comes from FAS 157, the accounting standard about fair value measurements. Financial Accounting Standards Board [hereinafter "FASB], *Statement of Financial Accounting No. 157, Fair Value Measurements* ¶ 30 (Sep 2006) http://www.fasb.org/pdf/fas157.pdf.

The LoanPerformance database is an extensive database of loan-level performance data on securitized mortgage loans. The availability of data allows for superior analysis. Because of its merger with First American, the LoanPerformance database includes public record information that gives updates on the status of each loan, including the addition of new liens on the related properties and other developments, such as tax delinquencies. The system also can get updated AVMs[13] on properties to indicate what proportion of loans in a deal have had LTV improvement or LTV deterioration. A key aspect of the LoanPerformance database is the linkage of reported deal data with public record data.

Another panelist notes that investors bear the onus of valuing the assets on the balance sheets of banks, brokers, and bond insurers. Investors need to be mindful of the proportion of Level 3 assets on a firm's balance sheet. It is important to understand the structural aspects of assets and how structure affects the degree of "cliff risk" in an asset.[14] It is hard to gauge the reliability of forecasts that depend on a chain of consequences: home prices driving credit risk driving security prices, etc.

Another speaker remarks that traders occasionally need to suffer a "direct hit" in order to remind them about risk. Most of the securities that the speaker has recently examined have declined in value by 50% or more. The reason for the decline is a huge "spider web" of interlinked and highly correlated risks. Some risks related to originations, some to transparency, some to the flat yield curve, some to spread compression, some to the CDO bid (*i.e.*, the demand for ABS from CDOs), some to the invention of CDS, and some to the SIVs and ABCP that held highly levered exposures to sub-prime mortgage paper. As things became unglued, the inter-linkage of risk made everything worse and the consequences ultimately will fall on consumers.

Over the past 10 years, the securitization and capital markets captured much of the lending market share that used to reside in regional and community banks. If securitization and the capital markets cannot provide funds for lending, it is not clear how quickly the regional and community banks can get back into the game. There are securities rated triple-A trading at prices in the range of 50% to 60% of par, and there are securities rated double-A trading in the range of 20%. There is an even greater crisis in trading whole loans.

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[13] AVM stands for "automated valuation model." The term generally refers to automated appraisals of residential properties. AVMs typically rely on publicly available information. Consumers now have access to free AVM services such as www.zillow.com.

[14] "Cliff risk" refers to the potential for large changes in the performance of a security from small changes in the performance of its underlying collateral. For example, a subordinate tranche of a typical sub-prime mortgage ABS deal might receive a full payout of its entire principal if losses on the underlying loans remain below 8%. However, the tranche might be entirely wiped out if losses exceed 9.5%. The performance of the tranche deteriorates extremely quickly (*i.e.*, "falls off a cliff") once losses reach 8%. Likewise, an ABS CDO can embody significant cliff risk if most of its underlying collateral consists of ABS tranches that have such risk. The notion of "cliff risk" is embodied in "thickness" variable included in certain calculations under the Basel II risk-based capital guidelines. *See* Basel Committee for Banking Supervision, *International Convergence of Capital Standards and Capital Measures* [hereinafter "Basel II"], ¶¶ 623-632 (rev. June 2006) http://www.bis.org/publ/bcbs128.pdf. The concept also is embodied in the recently adopted U.S. regulations for implementing the Basel II guidelines. *See* Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, *Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II*, 72 Fed. Reg. 69287, 69424 (7 Dec 2007) (section 45 of the Common Appendix for all agencies).

The Most Important Steps: Panelists have differing views about what the most important steps would be for restoring confidence and helping the securitization market to recover:

- transparency regarding (i) assets included in deals and (ii) assets on firms' balance sheets
- resolution of the situation with the bond insurers
- clarity about the risk exposures of financial institutions
- on the security side, clarity about whether policy action will change the obligations under the contracts
- availability and sharing of information needs to become easier
- a return to fundamental analysis
- disclosure of leverage by financial institutions and bond insurers

There are great opportunities in distressed markets. Some securities are very cheap, but it is hard to re-trade them.

11:25 am – Housing Markets and the Consumer Economy

Panelist No. 1: "Greed" was a key cause of the current problems. Consumers were greedy thinking that homes would go up in value forever. Homebuilders, lenders, real estate brokers, mortgage brokers, and securitizers also were greedy.

Home prices have more room to fall. Housing is not yet affordable. Buyers are nervous and uncertain.

This downturn is national and it is one of the worst. Homebuilding has slowed down all across the country. The current downturn appears to mirror past homebuilding downturns. Prior downturns have lasted for several years and have witnessed declines in housing starts of 50% or more.

It takes time for a wave of overbuilding to work through the system. The pace of housing starts has to decline by another 25%. The normal level of housing demand might not return until 2012 or 2013. Demographics do not bode well for the next six or seven years. Many of the home sales in 2005 and 2006 came from pulling demand forward from future years.

There is still an enormous gap between home prices and household incomes. Based on historical averages, home prices would have to decline by another 20% to restore the long-term historical relationship.

Although nominal home prices did not decline between the Great Depression and the current downturn, there have been real price declines during periods of rapid inflation.[15] Price declines

[15] For example, real home prices declined slightly in the late 1950s and sharply in both the early 1980s and the early 1990s. *See*, Marsh, B., *A History of Home Values*, NEW YORK TIMES, Week in Review (26 Aug 2006) http://www.nytimes.com/imagepages/2006/08/26/weekinreview/27leon_graph2.html (citing: Shiller, R.,

are likely to continue. Homeowners need to "find religion" with respect to what their homes are actually worth. Builders are pushing prices down right now because they need to sell homes quickly to raise cash. The inventory overhang is huge.

The average LTV for households that have mortgages is 84%. The LTV for the bottom quartile is much higher. Those households' mortgage loans can become underwater from relatively small declines in the value of their home.

Housing sales should bottom in 2009, return to normal in 2012-13, and regain their peak level several years later. Real housing prices should decline through 2010. Consumer discretionary purchases will track the pricing trends. Legislation for the FHA and the GSEs will help. The Fed rate cuts will not help much because 90% of borrowers use 30-year fixed rate mortgages. Consumer balance sheets remain weak and the Fed action will not fix them.

Home prices should decline though 2008 and reach a bottom in 2009.

Panelist No. 2: Just as the economy has not seen the full impact of the housing downturn, the housing downturn has not seen the full impact of the economy. The likelihood of a recession is more than 50%. The Fed interest rate cuts will not prevent the recession but they should make it shorter and milder than it otherwise would be. The recession could be made worse or longer if the job market softens.

The outlook for 2008 is very weak growth, with negative GDP growth in Q2 or Q3. Job growth is slowing. The key driver of consumer spending is wage and salary income. The growing job market during recent years was a key driver of growth in consumer spending. If wages and salaries stop growing, it will produce a decline in consumer spending in addition to the downward pressure on consumer spending caused by the wealth affect of declining home prices.

Consumer sentiment is down. Automobile sales are down. Although there is no good news, none of the news is so negative that it is the type associated with severe downturns. Mortgage equity withdrawal will be more difficult for the next several years, which also will place downward pressure on consumer spending. The high level of consumers' financial obligations suggests that consumers do not have much more borrowing capacity to fuel incremental consumer spending.

Manufacturing is slowing. Given that both home building and manufacturing are slowing, the odds of recession are higher than 50% for 2008.

The peak to trough decline in home prices likely will be in the range of 15% to 20%. However, the OFHEO home price index will reflect only about half that amount because it does not cover all homes.

IRRATIONAL EXUBERANCE, Princeton University Press (2d ed. 2005) (underlying real home price data series available on Prof. Shiller's website at http://www.irrationalexuberance.com/Fig2.1Shiller.xls)).

Panelist No. 3: The housing market is like the New England Patriots football team. Many peopled believed that neither the housing market nor the Patriots could lose.[16]

The current housing cycle was driven by different factors than past cycles and, therefore, past cycles are not good indicators of what to expect. It is not fully clear what should be viewed as "normal" housing market conditions or what the recovery will look like.

The new level of "normal" home sales might be lower than has been seen in recent years. There may be a shift from homebuyers viewing their homes as investments to viewing their homes as shelter. However, it does not appear likely that conditions will degenerate to resemble the weak economy of the 1980s. Slower home sales would likely mean lower mortgage origination volumes. Looking past the trough, the recovery will likely not have any "juice." That is, it will be slow and drawn-out.

In the previous five housing cycles of the post-WWII period, existing home sales, new home sales, and housing starts declined an average of 24%, 25%, and 27%, respectively. However, in this cycle the corresponding declines seem more severe at 22%, 41% and 38%, respectively. Meanwhile, in the past cycles, GDP dropped 1.0%, while it has grown by 2.5% in this one. The unemployment rate increased by 1.4 percentage points in prior cycles, but only by 0.5 percentage points in this one.

Comparison of Economic Performance Measures between Past Housing Cycles and the Current Cycle

	Average for Previous Five Housing Cycles of Post-WWII Period	This Cycle
Change in Existing Home Sales	-24%	-22%
Change in New Home Sales	-25%	-41%
Change in Housing Starts	-27%	-38%
GDP Growth	-1.0%	+2.5%
Change in Unemployment	+1.4 ppt.	+0.5 ppt.

The sub-prime crisis has caused the spread for jumbo loans to jump to 100bps. In past crises, the spread has jumped to 50bp. In calm times it is usually around 25bps. The GSEs provide an important and tangible benefit in a major segment of the mortgage market

Sub-prime mortgage lending is likely to continue as a source of funding for minority and immigrant home buyers. Sub-prime will co-exist with FHA programs. Sub-prime ARMs will likely be supplanted by sub-prime FRMs.

1:25 pm – CDO/CLO Market Update and Outlook

One panelist emphasizes that CLOs are different from ABS CDOs. The collateral for a CLO is primarily first-lien, senior secured corporate loans. In an ABS CDO, the underlying collateral

[16] The session was held the morning after the New York Giants beat the New England Patriots by a score of 17 to 14 in Super Bowl XLII. The Patriots had been unbeaten for the entire season prior to the game.

is primarily sub-prime mortgage ABS. In CLOs, the rating agencies rely on the default history of corporations since the 1920s. In ABS CDOs, the rating agencies rely on performance history over a period of about 10 years for sub-prime mortgage loans and ABS. CLOs benefit from skin in the game on the part of the lenders involved with the corporate loans.

ABS CDOs are effectively re-securitizations because an ABS CDO is a securitization of already securitized mortgage loans. A CLO is a first-tier securitization. CLOs have strong industry diversification, while ABS CDOs have concentrated exposure to housing and residential mortgage loans.

Relatively few CLO tranches have suffered downgrades. More than 6,000 CLO tranches have been issued. Only 98 tranches have suffered downgrades. Only 17 tranches were downgraded from CLOs that had exposure to high-yield bonds (as opposed to loans) of 15% or less.

A second panelist addresses the challenge of managing ABS CDOs. Although delinquencies are very high, losses have remained low. A manager must follow every item of collateral in his managed deal and he should sell whenever he perceives that he can get a price better than the projected recovery on the security. The manager must be willing to book a loss when a trade makes sense. There is hope that the Fed interest rate cuts can help reduce defaults, but the more realistic view is to accept the fact that losses will be severe.

A third panelist agrees with the need for an ABS CDO manager to be willing to sell collateral. There is limited liquidity for trading distressed ABS, but it is enough to get trades done. It is also necessary to be proactive with the documentation for the CDOs. The manager needs to stay ahead of the curve on the possible need for seeking amendments to documents.

The second panelist remarks that investors need to understand the sensitivity of ABS CDO tranches to the performance of the loans that back the underlying ABS. In analyzing the risk of the ABS CDOs, market participants placed too much emphasis on the historical credit performance of triple-B-rated ABS rather than on the credit performance of the *loans* backing the ABS. He feels that investors will come back to ABS CDOs only if they feel that they can really understand what they are buying.

The third panelist compares ABS CDOs to closed-end bond funds. He asserts that professionals misjudged correlation and mispriced risks.

A fourth panelist says that investors and other market participants must get back to credit fundamentals. They need to perform traditional credit analysis on the assets included in CDOs in addition to the mathematical simulation analysis.

There is a large overhang of syndicated loans and leveraged buy-outs that investment banks have committed to fund. It is about $150 billion in the U.S. and about €50 billion in Europe. The banks are being forced to sell some of the exposures at deep discounts.

Another panelist cautions against confusing diversification with low correlation. He asserts that there can be diversification and still high correlation. He notes that investors have learned that they really need to understand the collateral underlying a CDO and that they cannot simply

rely on the structure. Market participants need to guard against simply extrapolating from the most recent data point.

Another panelist re-emphasizes that a danger of the models is that they are based on the past, which might not be a good indicator of the future. He also re-emphasizes that investors can buy loans to strong companies (with good collateral coverage) for 90¢ on the dollar.

Given that securitization is "badly wounded," what do market participants need to do to help the market recover? One panelist returns to the subject of the current overhang of loans. He asserts that if a security is rated triple-A, investors should not need to know anything about the underlying assets. Another panelist says that structured products need more transparency in pricing, including data on trading prices. With such transparency, all market participants would be able to see where the securities are trading and to take views on whether they think the levels are right. There is no such thing in securitization, and CDO investors are left with scant guidance as to what their investments are worth. This has forced many to look at the ABX indices as indicators or proxies for valuation. In a similar vein, too many players have had to depend on unreliable monthly marks (*i.e.*, indications of price) from dealers. Another panelist observes that many financial institutions still do not really know the full extent of their exposure because their model-based valuations are unreliable.

Another panelist focuses on the issue of complexity. He asserts that there was too much complexity. Maybe the CDO sector should evolve to be a smaller, private market, in which investors perform in-depth analysis and get paid for doing so.

There is oversupply of both leveraged loans and residential real estate.

One panelist expects the vast majority ABS CDO tranches below the most senior level to "transition to equity status" (*i.e.*, have little prospect of principal recovery and receive interest payments only for a limited time).

2:30 pm – RMBS Ratings Methods and Criteria

At last year's conference (ASF 2007),[17] the tone was cautious but still generally positive. Upon returning from the conference, market participants could start to see rising delinquencies, especially on deals backed by second-lien mortgage loans. Today conditions are much worse. What a difference a year makes!

<u>Rating Transitions</u>: Each of the rating agencies shows very high rates of negative rating transitions for 2006- and 2007-vintage deals backed by sub-prime loans. Deals backed by alt-A loans displayed somewhat lower, but still very high, rates of negative transitions.

<u>Changes to S&P Methodology</u>: S&P has changed its surveillance assumptions for U.S. RMBS. With rising delinquencies, it has become apparent that there is not merely an EPD (early payment default) issue. This suggests that losses will be more back-weighted in the deals. S&P

[17] Our report on ASF 2007 is available at http://www.adelsonandjacob.com/pubs/ASF_2007_Notes.pdf.

expects losses of 19% for the 2006 vintage and has lowered its expectation of excess spread because of loan modifications.[18] It has also changed the methodology for new issues. It places less emphasis on FICO® scores and greater emphasis on CLTVs (*i.e.*, the cumulative loan-to-value ratio of all loans secured by a given property) as predictors of loan credit quality. Step-downs[19] are causing negative rating transitions in older deals. Accordingly, S&P has changed its criteria of for step-downs. S&P has published three articles on the potential impacts of loan modifications.[20] As the percentage of loan modifications increases the impact is increasingly detrimental to the cash flow to the senior tranche. S&P is re-invigorating its focus on data quality. It is placing particular emphasis on the steps that lenders take to prevent fraud.

<u>Changes to Fitch Methodology</u>: Fitch is focusing on the rapid increase in home prices before the bursting of the bubble. Accordingly, Fitch is now placing greater emphasis on its forecast of where home prices are going. Fitch wants to make sure that investment grade and high investment grade securities are well enhanced for all cases, but it is necessary to have an "expected" case that is actually expected. Fitch performed reviews on a sampling of loan files from defaulted loans and found that there was low data quality. Fitch plans to focus intensely on data quality.

<u>Restoring Confidence in Ratings</u>: One of the key issues is the integrity of the data upon which rating agencies base their ratings. Moody's proposed the creation of a system of third-party data verification. The industry has a stake in improving the quality of data to make securitizations more robust.

Investors need to understand what rating agencies do so that they can make informed decisions.

<u>DBRS</u>: DBRS makes its rating model available to market participants. It publishes a new issue report on each deal that can be retrieved by typing CN <go> from the Bloomberg DES screen for a security. DBRS estimated that the ASF's fast-track loan modification framework[21] would apply to between 15% and 30% of all loans and would produce a substantial reduction in excess spread. The reduction in excess spread could result in downgrades of one to three notches

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[18] "Excess spread" refers to the excess of interest payments on a pool of securitized loans over the interest payments on the related ABS. Sub-prime mortgage ABS ordinarily use excess spread as one of their sources of credit enhancement. Loan modifications that lower the interest rates on securitized loans would reduce the amount of excess spread available to protect the related ABS from credit losses.

[19] The term "step down" refers to a structural feature in most sub-prime mortgage ABS deals that can allow a substantial release of principal to subordinate tranches following a deal's third anniversary if certain performance tests are satisfied. The balance of the subordinate tranches declines significantly (*i.e.*, steps down) when the tranches receive large amounts of principal distributions within a short time.

[20] *See, e.g.*, Shaikh, W., et al., *Standard & Poor's Revises Assumptions For Analyzing U.S. RMBS Pools that Contain Modified Loans*, Standard & Poor's special report (9 Oct 2007); Perelmuter, M., W. Shaikh, and M. Stock, *Revised Guidelines For U.S. RMBS Loan Modification and Capitalization Reimbursement Amounts*, Standard & Poor's special report (11 Oct 2007).

[21] American Securitization Forum, *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans* (6 Dec 2007) http://www.americansecuritization.com/uploadedFiles/FinalASFStatementonStreamlinedServicingProcedures.pdf.

for tranches originally rated at the triple-B level, and downgrades of smaller amounts for tranches higher in the capital structures of the deals. The Fed's rate reduction will reduce the number of loans that would likely qualify for fast-track loan modification under the ASF's framework, because fewer loans will satisfy the criteria of having the monthly payment amount increase by more than 10%.

Loss Expectations for 2006 and 2007 Vintages: Fitch projects 21% cumulative losses for the 2006 vintage of sub-prime loans and around 26% for the 2007 vintage. Loans from late 2006 and early 2007 are ***entering*** foreclosure at a rate of 2.5% per month. At that rate, ultimate losses can be expected to be very high. Fitch publishes its expected losses for every deal that it rates, as well as its loss coverage number.

S&P expects loss severities to increase. Cheaper homes are depreciating the most. Loans secured by cheaper homes will suffer the highest loss severities. Moody's expects continuing deterioration. It expects cumulative losses for the 2006 sub-prime vintage to be in the range of 14% to 18%, with higher levels of losses in the loans from the later quarters of the year. DBRS expects 15% losses for the sub-prime market overall. S&P projects cumulative losses of 17% for the sub-prime 2007 vintage, compared to its projection of 19% for the 2006 vintage. S&P has a lower loss expectation for the 2007 vintage because (1) there is a higher proportion of fixed rate loans in the 2007 vintage and (2) home prices had already peaked in 2006.

Alt-A: DBRS recently projected that the loans backing a deal would have cumulative losses of 6%, although it had originally been structured (without a DBRS rating) based on a loss expectation of 1%. Fitch has been concerned about option ARMs for a long time. The proposal to increase the dollar limit for conforming loans might help to bail out some option ARMs.[22]

Q&A: A member of the audience accuses the rating agencies of having done bad analysis on MBS and of having fallen victim to conflicts of interest because they are paid by issuers. Panelists respond that the current environment is a very stressful one and one in which securities originally rated at the triple-B or single-A rating levels may reasonably be expected to suffer defaults. Panelists also note that the rating agencies are sensitive to the potential conflicts of interest and that such conflicts would be present even if they were paid by investors.

Panelists emphasize that although defaults may be common among securities initially rated in the triple-B and single-A categories, they should be rare or very rare among securities initially rated in the double-A and triple-A rating levels. The exception to that general observation is the small sub-sector of second-lien sub-prime loans. There will likely be a high prevalence of defaults among second-lien sub-prime mortgage ABS that initially carried double-A and triple-A ratings.

[22] Congress passed the Economic Stimulus Act of 2008 (H.R. 5140) on Thursday, 7 Feb 2008. If signed into law by the President, section 201 of the bill would temporarily raise the size limit for conforming loans to $729,750. In addition, section 202 of the bill provides a temporary increase in the size limit for FHA-insured loans in high cost areas.

3:45 pm – RMBS Research Roundtable

Expanding the *FHASecure* program may help to contain the sub-prime situation by enabling some borrowers to refinance who would otherwise not be able to do so.[23] However, the *FHASecure* program will not generally reduce the overall level of losses that investors and lenders will suffer on sub-prime mortgage loans. To reduce the level of losses, there would have to be a government program that would insure loans with LTVs substantially higher than 100% (*e.g.*, 125%).

A serious recession could prompt Congress to pursue a significant remedial strategy. The notion of a bail-out may gain momentum. Congress might act in the second half of the year. It might be a Katrina-like action. There may be increasing pressure to help the sub-prime borrowers. Lower short-term interest rates are not enough to bail out most of the sub-prime borrowers.

A key question is whether the government will eventually want to bail out individual homeowners or to leave the problems sitting on the books of financial institutions.

Pricing: It is extremely important for mutual fund managers to be able to accurately determine the NAVs (net asset values) of their funds so that investors can enter and leave the funds at fair prices. One fund manager refuses to trade with dealers who cannot provide daily marks (security valuations). Some dealers have relegated pricing to their back offices and the back office departments fail to attach a sense of urgency to the function. The fund manager talks to multiple dealers every day and recognizes that different dealers sometimes provide different prices. Because the ASF claims to represent investors as one of its constituencies, the ASF should take up the challenge of encouraging dealers to provide daily marks that mutual funds need. Notwithstanding the challenging nature of the current environment, dealers must be able to provide daily marks to mutual funds.

Analyzing the Constituents of ABX 07-1: One panelist feels that the expected cumulative losses on the securities included in the ABX 07-1 indices reveals the extent of weak underwriting. However, broad generalizations can be misleading. It is not correct to conclude that all issues from a particular shelf or issuer are uniformly good or bad. Part of the story is delinquencies and cumulative losses, but coverage levels are also important. OAS models[24] appear to be reasonably effective in pricing bonds of the highest and lowest quality. They are

[23] The *FHASecure* program is described in HUD Mortgagee Letter 2007-11 (5 Sep 2007) http://portal.hud.gov/fha/reference/ml2007/07-11ml.doc

[24] "OAS" stands for option-adjusted spread. OAS models are a class of quantitative methods for assessing the relative value of securities that contain embedded options. OAS analysis is often applied to residential MBS because of their embedded short option positions (*i.e.*, the borrowers' options to prepay their loans). OAS models attempt to estimate the value of securities by projecting future cash flows under a variety of interest rate scenarios. A typical OAS model uses an "interest rate process" to generate multiple hypothetical paths of future interest rates. For each such path, the OAS model uses a "prepayment model" to estimate the level of mortgage loan prepayments in each future month. The prepayment model produces a hypothetical cash flow corresponding to each scenario. The OAS model calculates the fixed spread over benchmark interest rates at which the discounted value of the modeled cash flows equals the actual market price of the security.

weaker with the bonds of intermediate quality. Sometimes the pricing of the index appears to be driven by the weakest constituents rather than by the overall quality.

Another panelist asserts that the five "best" constituent deals of the ABX 07-1 indices are:

- J.P. Morgan Mortgage Acquisition Trust 2006-CH2..................JPMAC 2006-CH2
- Morgan Stanley ABS Capital I Inc. Trust 2006-HE6.................MSAC 2006-HE6
- ABFC 2006-OPT2 Trust..ABFC 2006-OPT2
- Carrington Mortgage Loan Trust, Series 2006-NC4 ....CARR 2006-NC4
- C-BASS 2006-CB6 Trust ....CBASS 2006-CB6

He notes that derivative traders tend to look at the securities incorrectly, asserting that a given price level implies a certain default rate. However, they treat the defaults as starting immediately, while mortgage professionals understand the natural time distribution of loan defaults. Also, meaningful pricing must be based on considering a range of HPA (home price appreciation) assumptions, not just a single scenario.

Another panelist notes small changes in LIBOR can produce very significant changes in the implied fair price of the ABX. He acknowledges that sophisticated models provide an incomplete solution right now because conditions are unprecedented. Instead of fancy models, he is focusing on delinquency pipelines and on projecting future losses.

A fourth panelist observes that it is not enough to simply consider multiple scenarios; one must also ascribe meaningful probabilities to those scenarios. How one assigns probabilities to scenarios can drive pricing significantly. In addition, pricing the index depends on making a correlation assumption among the constituents.

What could go right?: Although there are severely distressed conditions in some important markets, there does not have to be nationwide real estate meltdown. In addition, it is possible that homeowners will not be entirely efficient in exercising the prepayment and default options in their mortgage loans.

4:50 pm – RMBS Traders Roundtable

Triple-A-rated bonds are trading at levels never seen before.

Liquidity: The bid-ask spread in the market went from 5 basis points to 5 or 10 full points. However, the real driving factor has been poor performance. That, combined with instability of the ratings, has had a much greater impact on prices. The CDO market has essentially shut down. SIVs have been taken out of the market. CDOs and SIVs were among the largest buyers of sub-prime mortgage ABS, and their withdrawal from the market has impacted liquidity and put downward pressure on prices. Bid-ask spreads will continue to expand and contract depending on the market's mood. Some days the bid-ask spread on the ABX indices is 4 points and other days it is half a point.

Another panelist observes that the bid-ask spreads are widest on bonds that have the greatest uncertainty of future performance. Front cash flow triple-A tranches have tight bid-ask spreads, as do tranches at the bottom of a deal's capital structure that have become credit IOs.[25]

A third panelist feels that the market cannot come back if bid-ask spreads stay in the range of five to ten full points.

Another panelist observes that BWICs/OWICs[26] are only one of several ways to sell a bond. Another way is to work quietly with a dealer. A third way is to wait to see if the bond or a similar bond appears on someone else's BWIC or OWIC. Front cash flow triple-A's seem tailor-made for BWICs. Bonds that have substantial performance uncertainty are probably better to handle quietly through a single dealer. Investors willing to sell protection (*i.e.*, through CDS) should be willing to bide their time because CDO liquidations are coming.

Another panelist counters that it is worthwhile disseminating BWICs periodically for the purpose of gathering information.

Dealers are bidding less and less frequently on investor BWIC lists. Sometimes the dealers just make low-ball bids. In the past, refusing to make a reasonable bid would damage a dealer's ability to place new issues with the investor. This is not a problem right now because there are no new deals. But, investors may be losing confidence in dealers' willingness to provide a secondary market.

<u>ABX</u>: One panelist feels that the ABX was theoretically a good thing but that it may have turned out to be damaging in practice. The ABX may have been misused or misapplied by various market participants. For example, accountants have been using the ABX as the basis for marking down CDOs, which may not really make sense. The panelist feels that, on balance, the ABX has been detrimental to the ABS market

A second panelist disagrees. He contends that the single-name CDS market improved the flow of cash deals. However, it did increase the volatility of prices. He feels that the ABX indices are not the real driver of price volatility for sub-prime mortgage ABS or for related areas such as ABS CDOs. Rather, the real driver is the poor performance of the underlying loans. The first panelist rebuts, saying that the ABX has amplified the impact of the poor performance of the underlying loans.

<u>Single Name CDS</u>: The market for single-name ABS CDS is not dead. Positions trade every day. Some hedge funds are unwinding their short positions (*i.e.*, contracts in which they

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[25] The term "credit IO" refers to a distressed security that is expected to make interest payments for some time but ultimately to suffer a 100% loss of principal. It is an "interest-only" security or an "IO" because of credit deterioration.

[26] The terms "BWIC" and "OWIC" mean, respectively, bids wanted in competition and offers wanted in competition. They refer to the use of a competitive bidding or offering process for the sale or purchase of securities. An investor seeking to sell a cash security would request BWICs on the security. An investor seeking to purchase a cash security would request OWICs. The terminology is often reversed in the context of synthetic securities (*i.e.*, credit default swaps)

purchased protection against defaults on the reference ABS). It remains to be seen whether there will be any ABS CDS activity after all the unwinding of shorts is done. However, the fact that ABS CDS are the only way to take a short position should keep the ABS CDS market alive for the long run. Another panelist notes that the volume of ABS CDS activity is unlikely to rise to 2005 or 2006 levels because CDOs are not likely to be active users of ABS CDS.

Risks: An ABS trader has to manage many risks. The landscape has many new risks that can cause multi-point swings in the pricing of the ABX indices. Legislative and regulatory proposals, Fed actions on interest rates, and events affecting the bond insurers can each cause prices to jump suddenly. Traders need to think about the cost of hedging those risks, which partly explains wide bid-ask spreads. There is counterparty risk on CDS.

Ratings: There has been massive rating instability. Many bonds have been downgraded by many notches. The rating process has lost credibility. Most dealers and the savvier investors use ratings only as one of several factors in their investment analysis. Despite their loss of credibility, ratings remain somewhat relevant.

Future Outlook: What could cause the market to rally? Could it be Fed interest rate cuts or other policy actions? One panelist notes that there are many policy initiatives in the works, including *FHASecure* program[27] and the Paulson/ASF plan for loan modifications.[28] On the whole, he does not expect any current policy initiatives to make a big difference for the market. However, he notes that if the government created a bail-out program like the RTC, such a program could have a substantial effect.

One panelist notes that several specialty funds are entering the ABS space in search of opportunities in distressed ABS. Some come from "event"-type funds and some from "macro"-type funds. Another panelist counters that the distressed players have not made much of a difference because they steer away from the bonds with the greatest performance uncertainty. At the moment, the market seems to feel that there are not great opportunities every day but that opportunities will possibly unfold as the year progresses.

Counterparty Risk: The risk that one or more of the bond insurers could fail is a huge counterparty risk for market participants. One speaker expects something to be done to save the bond insurers because too many entities are exposed to them as counterparties.

The market already has a good handle on the where the performance of the sub-prime sector is going. The alt-A sector is tougher, because the performance of the loans is very poor in some deals, but the credit support is much less than in sub-prime details. The prime mortgage sector should not deteriorate too severely because prime borrowers usually have substantial equity in their homes.

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[27] The *FHASecure* program is described in HUD Mortgagee Letter 2007-11 (5 Sep 2007) http://portal.hud.gov/fha/reference/ml2007/07-11ml.doc

[28] American Securitization Forum, *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans* (6 Dec 2007) http://www.americansecuritization.com/uploadedFiles/FinalASFStatementonStreamlinedServicingProcedures.pdf.

One panelist feels that there is room for the triple-A ABX sub-indices to fall further. It could happen from trouble with the bond insurers or from downgrades.

Many positions trade at prices that imply yields in the range of 15% to 20%. Investors should be willing to take some of that yield and apply it toward hedging.

Tuesday, 5 February 2008

9:00 am – Opening Remarks

Selected items from a "top 10" list of observations about the structured finance industry:

- Structured finance can make a difference for good or for bad. But it makes a difference.
- The demise of structured finance in the U.S. would damage securitization all around the world because the world looks to the U.S. as an example and as the leader in securitization.
- We have the resources and ability to put ourselves back together; do we have the will?
- The structured finance industry is smart, but we must not be dumb by putting selfish short-run interest over long-run self-interest.
- We make mistakes. It is a mistake for participants at any step of the securitization process to forget that all steps in the process have a stake in the entire process.
- We must make sacrifices if we want respect from policymakers.
- Structured finance is one of the wonders of the modern world. Let's make sure that we keep it that way.

9:15 am – Keynote Address by Treasury Under Secretary Robert Steel

Capital markets have evolved rapidly in recent years and the pace of evolution will likely continue to accelerate in the area of securitization. The pace of innovation accelerated dramatically in the 1990s and continues to accelerate.

The Treasury Department generally favors securitization as a financial tool. However, it notes that there has been misfeasance and malfeasance by some players. It favors regulation of mortgage brokers. There is focus on securitization, rating agencies, and mortgage originations.

Securitization can remain a strong market in the future, but market participants must take a measure of responsibility for what has happened and act on the lessons learned.

The bursting of the housing bubble had effects that rippled through many financial sectors and created turmoil in the credit markets because of the interconnectedness among financial sectors.

Apart from the considerations of the financial markets, the bursting of the housing bubble combined with recent aggressive lending practices will create pain and hardship for families and communities. A rising foreclosure rate during a housing downturn is to be expected. However, the current downturn is expected to be exceptionally severe. The Treasury Department encourages loan modification as a tool for mitigating the level of foreclosures by helping homeowners who can be helped through reasonable modifications.

The Hope Now alliance[29] includes 94% of the sub-prime servicers. On December 6, the President announced new guidelines for helping distressed borrowers with fast-track refinancing. The Hope Hotline receives roughly 4,000 calls a day. Servicers reimburse Hope Now counselors $100 for each counseling session. Hope Now members have mailed 430,000 letters to delinquent borrowers who had not responded to previous contact attempts by servicers. Around 77,000 responded to the letters from Hope Now. Servicers now contact borrowers 120 days before the reset dates on their loans. Around 75,000 families have refinanced through the *FHASecure* program[30] and around 100,000 more loans are in the pipeline. The passage of the Administration's mortgage forgiveness proposal relieves borrowers of tax burdens when servicers forgive some principal on their loans.[31]

The rate of sub-prime loan modifications tripled in 2007Q4 relative to 2007Q3. The Treasury Department wants servicers to apply the ASF framework for streamlined loan modifications.[32] The Treasury Department expects all servicers to report the results of their progress with streamlined foreclosures to Hope Now each month.

Q&A: An audience member asserts that Hope Now reaches too few distressed homeowners and that the ASF does not care about homeowners. Secretary Steel counters that homeowners are the key focus of the Administration's efforts and that the Administration is "trying to put its thumb on the scale" on behalf of homeowners.

Another audience member asserts that the key strategy to ameliorating the high frequency of foreclosures is personal contact with distressed borrowers. He asserts that sending letters is a deficient strategy. His organization reaches out to borrowers by knocking on doors and emphasizes face-to-face contact.

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[29] *See* note 8, *supra*, for general information about Hope Now.

[30] The *FHASecure* program is described in HUD Mortgagee Letter 2007-11 (5 Sep 2007) http://portal.hud.gov/fha/reference/ml2007/07-11ml.doc

[31] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, 110th Cong., 1st Sess. (20 Dec 2007) (amending I.R.C. § 108(a)(1)).

[32] American Securitization Forum, *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans* (6 Dec 2007) http://www.americansecuritization.com/uploadedFiles/FinalASFStatementonStreamlinedServicingProcedures.pdf.

10:05 am – Legislation, Regulation and Market Oversight – A Global Review

What has happened in the structured market?: One panelist feels that the fundamental problem is a failure of memory. It is the failure on the part of structured finance professionals to remember financial history and the long series of bubbles and busts. Every bubble is characterized by the rise of a favored asset class and the use of high leverage. Then there is always a bust followed by a contraction of liquidity. The market relearns the liquidity lesson with every bust. The natural sequence of events continues with the exposure of scandals, the uncovering of fraud, the search for the guilty, and finally, the political reaction.

The Cycle of Bubbles

rise of favored asset → use of high leverage → bubble valuations → bust/bursting of the bubble → contraction of liquidity → exposure of scandals → uncovering fraud → search for the guilty → political reaction…

A second panelist (a bank regulator) agrees that the current situation is not wholly dissimilar from previous cycles. However, there are some differences. One is that credit and liquidity risks have become more intertwined than they were in the past. Another difference is the number of market participants – there are more unregulated market participants than in the past. This creates a challenge for regulators in figuring out how to create standards that will apply across the entire industry. Large financial institutions generally seem well positioned to withstand the stresses of the current environment.

A third panelist notes that one of the "benefits" of securitization – dispersion of risk through numerous holders – may be a detrimental feature in the sense that it exposes a greater number of market participants to the stress.

A fourth panelist notes that most financial institutions did not include scenarios of general market illiquidity in their risk management process. The problem is that senior managements of financial institutions dismissed the "worst-case" scenarios in their analyses. That can be a fatal mistake; "black swan" events happen in finance. Instruments became too complex and leverage became excessive. Regulators need to be careful not to kill securitization as they seek a cure for the current situation.

What is the European View?: European financial institutions were overly confident. When the troubles fully surfaced in August, they were surprised by the magnitude of the problems that they faced.

The SEC's Perspective: There are two areas of concern in the Division of Trading and Markets. The Division is responsible for regulating broker-dealers and rating agencies. The securities firms sold the securities and sometimes originated the underlying assets that backed the securities. The rating agencies facilitated the process with their ratings. Some CDOs are so complicated that it is very hard to figure out their credit quality.

One proposal is to require an underwriter to disclose all of its positions including all the underlying assumptions. Another is that investors should be told to perform their own evaluations and not simply to rely blindly on credit ratings. Security valuations cannot simply be based on ratings. The valuations must be based on all relevant factors. Firms need to adopt concentration limits and to understand that hedges do not always work. Rating agencies need to review asset originators in order to have confidence in the reliability of data about the assets that go into deals.

Liquidity: Liquidity has been one of the SEC's key concerns for a long time and some of the securities firms have suffered serious losses from the liquidity contraction.

Another panelist notes that financial institutions may have understood the importance of liquidity but they made wrong assumptions about the how severely liquidity would contract during stressful conditions. He adds that mark-to-market (*i.e.*, fair value) accounting can create liquidity pressures, and that it has as many weaknesses as historical cost accounting.

Liquidity is the belief that assets can be sold easily. When a bubble is under way, it is extremely hard to get market participants to consider highly adverse scenarios. Dismissing adverse scenarios leads to excessive valuations and excessive leverage. The bust cannot be foreseen because everything seems to be going so well.

There may be some measures that could dampen the magnitude of future bubbles. One proposal is to require banks to guarantee all the mortgage loans that they originate. A key element of such a policy would be to have capital requirements for banks that mirror those for Fannie Mae and Freddie Mac. Another proposal would be to provide mortgage borrowers with meaningful, relevant, and concise disclosures about the risks of the types of loans that they are considering.

Regulatory Responses: One panelist observes that an important issue right now is bank support for their sponsored ABCP conduits. For some institutions, potential consolidation under FIN 46(R) is an issue.[33] Risk-based capital guidelines do not require consolidation of ABCP programs regardless of the consolidation treatment under GAAP. The regulators are rethinking whether the institutions have sufficient capital with respect to liquidity facilities for ABCP programs.

Do there need to be changes to the rating-based approach for the capital treatment of re-securitizations? In light of recent events, the policy many need to be revisited.

There are many issues with the treatment of securitizations held in a bank's trading book.[34] U.S. regulators do not allow banks to hold liquidity facilities in their trading books. There is work going on for incremental default risk with respect to trading books. Is the treatment of CDOs appropriate? Where does event risk end and default risk begin? Are there some positions

[33] FASB, *FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities* (Dec 2003) http://www.fasb.org/pdf/fin%2046R.pdf.

[34] *See, e.g.*, Basel II ¶¶ 683-708.

that have such fat tails (*i.e.*, high risk of severe default) that they simply should not be held in a bank's trading book?

Another panelist remarks that the regulators' risk management expectations have been adopted in varying forms at different firms. The proposal to have banks hold first loss exposure to mortgage loans would likely not work because derivatives allow institutions to hedge away virtually any kind of risk. Moreover, the current problems at some firms come from holding exposures at the *top* of the capital structure of securitizations.

A third panelist predicts that the examination process will likely be much more aggressive going forward. Examiners will be more aggressive at highlighting risks and requiring reserves. The OTS believes that there needs to be heavier regulation of mortgage banks.

Another panelist argues that securities firms and rating agencies should be responsible for policing mortgage loan originators, and for assuring that originators do not supply false data.

In the U.K., the FSA wants to preserve the benefits of securitization but also wants to make sure that institutions can control and manage risks. The FSA will soon release a discussion paper for the industry to respond to. The SIV experience was an eye-opening one for both the industry and the regulators. Investors often did not realize that they had bought notes from essentially "unregulated banks." CPPI (constant proportion portfolio insurance) strategies have lost credibility because of cliff risk.

Advice to the Regulators: The current situation cannot be entirely fixed by regulation. It is not possible to make borrowers or investors behave prudently. Much of the fix has to come from the industry. National lending standards would be a key improvement for the market. Also, rules have to be balanced, because if they are too strict they will close-off credit to many borrowers. The rules about assignee liability must have a safe harbor or lenders will stop making some types of loans.

Cautions: Be careful of falling in love with any accounting model (particularly mark-to-market accounting). The philosophy should not be to prevent people from taking risk, but rather to assure that people know the risks that they are taking. There should be less reliance on credit ratings; structured finance professionals should be more skeptical.

Legislation: The OCC supports having a national standard for mortgage lending. The OTS supports greater supervision of mortgage banks.

The industry has to focus on risk management. Skin in the game is a key concept. The last so-called crisis was Enron, which got market participants to focus on reputation risk. Reputation risk gives all market participants skin in the game.

11:20 am – Mortgage Servicing and Loss Mitigation

One legislative proposal would insulate servicers from private law suits based on loan modifications.[35] That proposal would somewhat undermine the "sanctity" of contracts, and would undermine confidence in the capital market going forward. Two panelists feel that such legislation would be detrimental in the long term and should not be pursued. Moreover, one panelist asserts that the contractual limitations on loan modifications in some deals (*e.g.*, 5%) are not material restrictions.

Several panelists note that a key step in helping many borrowers is contacting them several months before the interest rates on their loans reset. Early contact allows the lender and the borrower to discuss alternatives if the borrower is not able to pay the contractual rate on the loan following the reset.

One panelist feels that the recent Fed interest rate cuts are important because they will significantly reduce or eliminate interest rate shock for most sub-prime borrowers. Based on forward interest-rates, the market expects LIBOR to decline to a level at which monthly payments for many borrowers would not increase when their loans reset. The larger issue is the fact that many sub-prime borrowers have no equity in their homes.

FHASecure: So far, the *FHASecure* program has been a failure.[36] Only about a thousand loans with negative equity or with delinquent status have been refinanced. [The statement seems to contradict the earlier remarks by Treasury Under Secretary Steel. *See* p. 26.] One of the problems is that lenders are afraid that they will not be able to sell the loans because they do not qualify for inclusion in Ginnie Mae TBA pools. Another problem is that the criteria for the *FHASecure* program are too strict. For example, one of the requirements of the program is that a borrower has been current for the six months immediately preceding the reset date of his loan.

Another speaker argues for expanding *FHASecure* to allow refinancing by borrowers who are in default for any reason (not just those who are forced into default because of the reset on their loans) and to allow for "short" refinancing. A short refinancing is where the original lender would take a loss and the new FHA loan would finance to an LTV of 100%. For a securitized loan, the trust would take an immediate loss on the short refi.

Servicers are under pressure to comply with their reporting obligations while simultaneously wrestling with unprecedented numbers of delinquencies and loan modifications. Reporting for loan modifications is not standardized. Servicers have lots of data about the loans that they modify, but they have difficulty in sharing it with the capital markets in the form that meets the market's needs.

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[35] Emergency Mortgage Loan Modification Act of 2007, H.R. 4178, 110th Cong., 1st Sess. (2007).

[36] HUD estimates that the *FHASecure* program can help 240,000 families. The program is described in HUD Mortgagee Letter 2007-11 (5 Sep 2007) http://portal.hud.gov/fha/reference/ml2007/07-11ml.doc

On panelist proposes creating a for-profit entity that would have a public mission of dealing with the wave of foreclosures. The entity would buy defaulted loans and have infinite flexibility to resolve distressed loans.

One audience member focuses on investor properties and argues that loan servicers should seek deficiency judgments from investor-borrowers who default. A panelist from a servicing company says that his firm treats investor properties the same way as owner-occupied homes. Another panelist argues strongly that the "system" should pursue investor-borrowers who have the resources to pay. In California a lender can pursue a deficiency against a borrower who does not use the mortgaged property as his primary residence.

1:25 pm – Accounting Standards Developments

ASF Framework for Loan Modifications: Some servicers had been reluctant to implement the ASF framework because of concern about accounting issues. The problem related to the exercise of discretion by a servicer, which could have undermined the status of a securitization vehicle as a QSPE.[37] The standard allows taking action once the default of a loan becomes reasonably foreseeable. The SEC solved the problem by issuing a letter stating that companies following the ASF framework would not disqualify the "Q" status of their QSPE securitization vehicles.[38] However, the SEC also said that companies should make additional disclosures about the impact of loan modifications on their retained securitization interests and on third parties. There is a question about whether the expanded disclosure applies only to a servicer that modifies loans or to all companies that have exposure to modified loans.

The SEC has asked Fannie Mae to greatly increase the amount of disclosure about loan modifications in its annual filing for 2007.

FAS 140: The SEC has given FASB a deadline of fixing FAS 140 by the end of the year. FASB is leaning toward the solution of eliminating QSPEs. FASB is considering two ways of doing so. One is to preserve the general components approach currently embodied in FAS 140. FIN 46(R) would be modified to use an "economic risks and rewards" approach for determining whether a company would be required to consolidate a securitization vehicle onto its financial statements. Another approach would be to look for continuing involvement. That approach would result in fewer transactions receiving sale treatment. The former approach is likely to be the one that FASB selects.

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[37] QSPE stands for "qualifying special purpose entity." QSPEs are a central feature of the accounting rules that govern whether a securitization will be treated as a "sale" or as a "financing" in the financial statements of companies that follow generally accepted accounting principles (GAAP) in the U.S. *See* FASB, *Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (a replacement of FASB Statement No. 125)* ¶¶ 9, 35-46 (Sep 2000) http://www.fasb.org/pdf/fas140.pdf.

[38] Letter from SEC Chief Accountant Conrad Hewitt to Arnold Hanish, Chairman, Committee on Corporate Reporting, Financial Executives International and Sam Ranzilla, Chairman, Professional Practice Executive Committee, The Center for Audit Quality, American Institute of Certified Public Accountants (8 Jan 2008) http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf.

FASB is considering the use of linked presentation (asset and related liability on the asset side of the balance sheet) for some transactions that do not qualify as sales. It is not clear, however, whether the linked presentation approach should apply for (1) "failed derecognition" under FAS 140's legal isolation criteria, or (2) primary beneficiary status under FIN 46(R).[39]

Another issue is the "measurement attributes" of assets and liabilities (*e.g.*, fair value vs. amortized cost). Assets and liabilities in a linked presentation should have a fair value attribute. In such a system, both the asset and its linked liabilities would be marked to market.

Although the SEC has insisted that FAS 140 be revised by the end of 2008, the panelist from the FASB staff feels that the project cannot be completed so soon. The FASB staff will tackle the issues of effective date and transition procedures after the final proposal takes form.

The accounting profession has been struggling with derocognition issues for decades. One of the challenges of assessing primary beneficiary status under FIN 46(R) is the need for historical data about the performance of the underlying assets. Such data is not often available. Another issue is modeling. FIN 46(R) sometimes requires too much modeling to determine primary beneficiary status. Also, it is no longer possible to simply assume that triple-A-rated securities can never default.

<u>FIN 46(R)</u>: Voluntary support for a vehicle can create an implied variable interest and influence the determination of primary beneficiary status. [This is an issue for sponsors of ABCP programs and SIVs if the sponsors have provided significant voluntary support.]

Preparers of financial statements need to warn FASB about proposed standards that may be impractical.

As part of the elimination of QSPEs, FASB is considering related changes to FIN 46(R). Right now, the staff feels that a "risks and rewards" model is the right approach for addressing consolidation. However, one open issue is whether accountants need to reconsider their consolidation determinations when economic risks and rewards change because of (1) changes in the underlying assets, (2) modifications to contractual terms, or (3) important market events. The SEC should provide guidance on how it wants implicit guarantees treated.

<u>FAS 157 – Fair Value Accounting</u>: One of the challenges to implementing fair value accounting policies under FAS 157 is the limited reliability of pricing information from third-party vendors. For example, the source or basis of vendor-supplied prices is often unclear, creating uncertainty about whether the prices should be categorized in Level 2 or Level 3.[40] In

[39] Failed derecognition refers to a transaction that is classified as a financing rather than as a sale because it fails to satisfy the requirements of FAS 140. Under FIN 46(R) ¶¶ 14-15, a reporting company that is the primary beneficiary of a variable interest entity must consolidate the variable interest entity on its financial statements.

[40] FAS 157 establishes a hierarchy of inputs for measuring the fair value of assets and liabilities. Level 1 inputs are quoted prices in active markets for identical assets or liabilities. Level 2 inputs include (a) quoted prices for similar, but not identical, assets or liabilities in active markets, (b) quoted prices for similar or identical assets or liabilities in inactive markets, and (c) readily observable inputs other than quoted prices (*e.g.*, interest rates, prepayment speeds, etc.). Level 3 inputs are unobservable inputs. *See* FAS 157 ¶¶ 21-31, http://www.fasb.org/pdf/fas157.pdf.

addition, assets can move between the Level 2 and Level 3 categories as market conditions change.

Although FAS 157 sounds like it should be easy to implement, it is not. About a third of ABS and MBS products carried on the books of reporting companies at the end of 2007 were categorized in Level 3. Level 3 assets require substantial modeling efforts and burdensome disclosures. Getting just one broker quote probably is not enough to move an asset from Level 3 to Level 2.

There are some easy Level 2 assets. However, complex instruments and securities with low credit ratings rarely have market-observable data that would allow them to qualify for Level 2.

A company can elect to mark its own debt to fair value. However, if it does so, it must mark the value of its own liabilities up or down as its creditworthiness changes. When the company's credit improves it must recognize a loss (because the fair value of its debt rises) and when its credit deteriorates it recognizes a gain (because the fair value of its debt falls).

Entry price equals exit price for Level 1 assets. In theory, the same principal should apply for Level 2 and Level 3.

The Fair Value Election Option: There is a danger that some companies will move impaired assets to fair value accounting because the initial drop in value will bypass their income statements and flow directly to retained earnings on their balance sheets.

2:30 pm – U.S. Regulatory Developments

The past year brought many important regulatory developments. Following on the heels of their guidance on "non-traditional mortgage products" of October 2006,[41] the U.S. bank regulators released final guidance on sub-prime mortgage loans in July 2007.[42] The SEC issued its rules for regulating credit rating agencies.[43] Around the end of the year, the bank regulators released the final rules for implementing the Basel II advanced framework in the U.S.[44] Most recently, the Fed proposed important changes to Regulation Z.[45] [Interestingly, panelists did not include the *FHASecure* program among the enumeration of regulatory initiatives.]

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[41] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Office Of Thrift Supervision, National Credit Union Administration, *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 Fed. Reg. 58609 (4 Oct 2006).

[42] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Office Of Thrift Supervision, National Credit Union Administration, *Statement on Subprime Mortgage Lending*, 72 Fed. Reg. 37569 (10 Jul 2007).

[43] Securities and Exchange Commission, Release No. 34-55857, *Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations; Final Rule*, 72 Fed. Reg. 33573 (18 Jun 2007).

[44] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, *Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II*, 72 Fed. Reg. 69287, 69424 (7 Dec 2007).

[45] Federal Reserve System, *Truth in Lending, Proposed Rule*, 73 Fed. Reg. 1671 (9 Jan 2008).

On the legislative front, key changes include the Mortgage Forgiveness Debt Relief Act of 2007 and the Economic Stimulus Act of 2008 (which raised GSE and FHA loan limits).[46] Important legislative proposals now under consideration include H.R. 3915, H.R. 4178, and S. 2452.[47]

Beyond the purely regulatory and legislative initiatives, there have been industry (ASF and SIFMA) initiatives in response to the sub-prime situation and its effects in the broader capital markets.

State Regulation: The Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) developed the Nationwide Mortgage Licensing System (NMLS) to fight fraud and predatory lending by the mortgage industry. CSBS contracted with FINRA[48] to develop the back office system. NMLS creates a single record for every state-licensed mortgage company, branch, and individual that is subject to licensing in any state. The single record allows companies and individuals to be tracked across state lines and over any period of time. It creates a single repository for all enforcement actions.

NMLS became operational with seven states in January. Roughly 40 states have committed to participate in the system. NMLS covers mortgage banks and mortgage brokers that are not otherwise regulated.

CSBS and AARMR started working with the federal banking regulators to create parallel guidance to the non-traditional guidance[49] and the subprime guidance.[50] AARMR-CSBS issued model examination guidance on 7/31/07.[51] In December AARMR-CSBS adopted an agreement for a cooperative protocol for mortgage supervision of state-regulated entities.

H.R. 3915 encourages states to establish a nationwide system across all states and would require registration of both individual mortgage brokers and bank employees who originate mortgage loans. The measures contemplated by federal legislative proposals are so broad that

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[46] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, 110th Cong., 1st Sess. (20 Dec 2007) (amending I.R.C. § 108(a)(1)); Economic Stimulus Act of 2008, H.R. 5140, 110th Cong., 2nd Sess. (cleared for White House on 7 Feb 2008).

[47] Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. 3915, 110th Cong., 1st Sess. (3 Dec 2007); Emergency Mortgage Loan Modification Act of 2007, H.R. 4178, 110th Cong., 1st Sess. (14 Nov 2007); Home Ownership Preservation and Protection Act of 2007, S. 2452, 110th Cong., 1st Sess. (12 Dec 2007).

[48] FINRA stands for Financial Industry Regulatory Authority. It was created in July 2007 from the combination of the former regulatory functions of the NASD and the NYSE.

[49] Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators, *Guidance on Nontraditional Mortgage Product Risks* (26 Oct 2006) http://www.aarmr.org/pdf/CSBS-AARMR%20FINAL%20GUIDANCE.pdf.

[50] Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators, *Statement on Sub-prime Mortgage Lending* (12 Jul 2007) http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/Final_CSBS-AARMR-NACCA_StatementonSubprimeLending.pdf.

[51] http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/MEGs_HOME1.htm.

every state would have to expand its regulatory framework. It is important for there to be close coordination of federal and state regulation of the mortgage industry because individuals move frequently between state- and federally regulated lenders.

The federal statement on sub-prime lending (7/10/2007) addresses particular practices in the sub-prime mortgage market and represents a "back to basics" approach to mortgage underwriting. The statement emphasizes the danger of risk layering. In addition to certain specifics, the statement highlights the problem of incomplete consumer understanding of product features. It notes that there are not adequate mechanisms for monitoring the performance of third-party originations.

ARM resets are concentrated in the subprime market. High delinquencies are present in both the sub-prime and alt-A sectors.

Loan Modifications and Loss Mitigation: Servicers are being called on to deal with rising numbers of delinquent loans. Loan modifications are one alternative for mitigating losses on defaulted loans. The ASF loan modification framework[52] was partly a response to media reports that loans could not be modified because of impediments built into securitizations. The framework calls for fast-track modifications for borrowers who cannot successfully refinance but who have paid their loans prior to the reset. Then, if the loan meets other criteria relating to whether the borrower might not be able to afford the contractual payment on the loan, the framework calls for allowing modification of the loan without an explicit determination that the modification is beneficial to investors. The industry estimates that 5% to 6% of loan modification candidates would qualify for the fast-track treatment.

3:45 pm – CDO Ratings Methods and Criteria

ABS CDOs – What went wrong: One panelist feels that the problems started in the sub-prime market. Performance there has deteriorated at an unprecedented pace. Conditions are changing very fast, which has created difficulties. Home price declines and borrower fraud are the key underlying causes. The "shutdown" of the mortgage market has accelerated the decline of home prices. Declining home values and the overhang of unsold inventory are producing very high loss severities on defaulted loans.

Bonifacius CDO (closed July 2007): Within several months of closing, the underlying assets of the Bonifacius CDO had suffered substantial deterioration. When Fitch re-evaluated the deal, it applied very adverse assumptions with the objective of front running the ratings of the rating agency's own RMBS department. On November 2, Fitch downgraded 159 ABS CDO tranches. Only the top two Bonifacius tranches remained investment grade. The A4 class moved to a rating of CC. Most of the deal's underlying collateral had originally been rated triple-A or double-A (*i.e.*, Bonifacius was a "high grade" ABS CDO). There has been an EOD (event of

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[52] American Securitization Forum, *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans* (6 Dec 2007) http://www.americansecuritization.com/uploadedFiles/FinalASFStatementonStreamlinedServicingProcedures.pdf.

default) on the transactions and 8% of the underlying portfolio has migrated to double-C or lower by at least one of the rating agencies.

Moody's originally had assigned a rating of Aa1 to Bonafacious class A4. Later it downgraded the tranche in a series of rating actions ultimately ending at a level of Ca. At Moody's, the CDO department works closely with the RMBS department. History failed to provide a reliable prediction of what actually happened.

S&P's recent rating actions in the RMBS area[53] are going to flow through to its ratings of ABS CDOs. That rating agency's CDO department did not take the approach of front-running the company's RMBS ratings. Also, the rating agency has just announced changes to its correlation assumptions for ABS CDOs.[54]

A third panelist remarks that the trouble with CDOs came from sub-prime mortgage performance that was much worse than expected.

One speaker notes that all the other participants in the CDO sector held essentially the same views as the rating agencies.

Timeliness of Downgrades: One view is that professionals who complain about the timeliness of ABS CDO downgrades do not appreciate that surveillance of ABS CDOs should follow surveillance of the underlying sub-prime mortgage ABS deals. If CDO surveillance does not rely on ABS/MBS surveillance, it is unclear what can supply a reliable basis for adjusting the ratings of the ABS CDOs. Participants in the CDO area need to appreciate that not all ABS/MBS deals have equal performance. Some deals are performing much better than others.

The contrary view is that a rating agency can make broad assumptions about the general level of downgrades that will likely occur on the ABS/MBS side, and apply those assumptions for the purpose of downgrading ABS CDOs. The problem with that approach is that it sacrifices precision for quick action.

Fitch temporarily stopped rating CDOs in November, and only today released a new methodology for corporate CDOs.[55] Fitch has installed credit officers in the different product areas. The company has installed a new head of CDOs from the corporate rating area. In addition, the company has created greater separation between analytic and commercial functions.

S&P has already taken many of the steps that Fitch is pursuing now. Moody's also applies many of the same safeguards as Fitch and S&P.

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[53] Warner, E., et al., *S&P Takes Action on 6,389 U.S. Sub-prime RMBS Ratings and 1,953 CDO Ratings*, Standard & Poor's press release (30 Jan 2008) http://www2.standardandpoors.com/spf/pdf/media/subprime_action_rmbs_cdo.pdf.

[54] Jordan, P., *Correlation and Recovery Assumptions Revised for CDOs of ABS Backed by RMBS*, Standard & Poor's press release (4 Feb 2008) http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/4,5,5,1,1148451181197.html.

[55] Neugebauer, M., J. Carter, and K. Gill, *Proposed Rating Methodology for Corporate CDOs*, FitchRatings criteria report (4 Feb 2008).

S&P struck a different balance than Fitch with respect to the quickness vs. precision of ABS CDO ratings.

Panelists address the issue of potential conflicts of interest that come from having issuers pay for ratings. The panelists note that potential conflicts of interest would be present regardless of who pays for the ratings. If investors paid, some might want ratings to be monitored more quickly or more slowly, or for ratings to move higher or lower based on whether they have a long or short position in a security.

<u>CLOs</u>: The CLO market is in much better shape than the ABS CDO market, but there are almost no new deals. Bankers are holding large inventories of loans waiting to be securitized in CLOs. One of the impediments to executing deals is the high volatility of yield spreads. Both buyers and sellers don't want to execute if they feel that they might achieve more favorable pricing by waiting two weeks. Moody's is receiving a moderate level of inquiries for new CLOs. An unusually high proportion of the inquiries are for middle-market CLOs.

Fitch has some concerns about the CLO market. In particular, some loans have weaker terms and lighter covenants. However, because of the subprime troubles, investors have started to push back on lenders with respect to loans with weak covenants. The problem with weak covenants is that lenders have less ability to steer the outcome of a loan once problems have developed.

CLOs should not suffer the same problem as ABS CDOs because of key differences in how the loans are originated. The sub-prime mortgage loans backing an ABS are originated "in the dark." Information about the loans is carried through representations and warranties, but investors do not have direct access to loan files and borrower information. In contrast, in CLOs, key participants in the process have direct access to the borrower's financial statements and many of them retain risk exposure to the loan or the borrower.

4:50 pm – SIVs,[56] Market Value and Alternative Liquidity

This may be the last time that there is a panel on SIVs at a major securitization conference. SIVs became an attractive way for banks to support long-term investments with short-term funding. Banks could use SIVs without having to provide full liquidity backstop facilities.

Similarly, extendible commercial paper, which started with Citibank's Dakota program for credit card receivables, grew to be widely accepted.

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[56] SIV stands for "structured investment vehicle." A SIV is a special type of asset-backed commercial paper program. A SIV invests in a portfolio of highly rated securities and funds those investments by issuing securities of its own, usually a combination of ABCP and medium-term notes. In general, a SIV tries to generate a positive spread between the return on its investments and its funding costs by keeping the weighted-average life of its assets longer than the weighted-average life of its liabilities in a rising yield curve environment. See generally, Hewitt, R., *An Introduction to Structured Investment Vehicles*, Moody's special report (25 Jan 2002); Maurice, D., H. Tabe, and S. Pilcer, *Comparing and Contrasting Credit Arbitrage ABCP Programs and Structured Investment Vehicles*, Moody's special report (25 Jan 2005).

However, the recent liquidity crunch has virtually eliminated both SIVs and extendible commercial paper

Is the SIV as we know it dead?: One panelist says yes. SIVs will no longer be a viable way for funding positions in securities. However, there is a larger question: whether the absence of SIVs as investors for ABS and MBS will have a detrimental impact on the ABS and MBS markets. Another panelist agrees that the SIV market is dead. The two fundamental drivers of the business were stable asset values and the availability of short-term funding through the ABCP market. Both of those factors have disappeared. A third panelist also agrees. He notes that there has been so much bad news that it is impossible for any potential SIV to differentiate itself from the others. He notes that SIVs perform "maturity transformation" of high quality assets (*i.e.*, funding long-term assets with short-term liabilities), which is essentially banking.

Evolution of the Liquidity Crisis: The problem first moved into the Canadian ABCP market, where there was concern about exposure to U.S. sub-prime residential mortgage loans. That got the short-term markets focused on the sub-prime risks. Then it surfaced that some SIV lites[57] had sub-prime exposure, and later it was revealed that some regular SIVs had sub-prime exposure. Then concerns about bond insurers and banks, sectors where many SIVs have exposure, accelerated the trend of risk aversion and investors generally turned away from SIV paper.

Responses: HSBC recognized the problem and wanted to avoid holding a fire sale of the underlying portfolios of its SIVs. The bank felt that the assets were of very high quality. It had funded much of the portfolio with one-year MTNs and long-term repos. Senior management concluded that the disruption was not merely temporary, so it announced that it would provide 100% liquidity for its sponsored SIVs.[58] The bank is going to fund some of the assets though one of its ABCP programs, and the remaining portion through repos.

MBIA asset management funded its SIV primarily with commercial paper. It put a repo facility in place in August as liquidity was drying-up.

Another SIV manager was able to satisfy its covenants and was able to get its 25% liquidity facility expanded to 100%. The portfolio was very homogeneous and clean and, therefore, the manager was able to get a bank to take the risk. The restructuring costs were borne by the capital notes (*i.e.*, the most subordinate securities in the SIV capital structure). The CP got repaid in full. The mezzanine notes got a reduced coupon and then were fully repaid. The capital notes recovered about 50¢ on the dollar.

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[57] A SIV lite is a hybrid of SIV and CDO technology. A typical SIV lite had a thin equity tranche and issued highly rated CP. Before the current crisis, a typical SIV lite has funding costs that were slightly higher than a traditional SIV but lower than a CDO. SIV lites achieved leverage of 40 to 70 times, which was much higher than leverage in SIVs. Also, SIV lites invested in higher yielding assets, such as sub-prime mortgage ABS and alt-A MBS. However, running a SIV lite could be more complicated than running a traditional SIV. Most SIV lites were smaller in size than traditional SIVs and the investor base was smaller. *See generally* Mitchell, D., *SIV Market Grows, So Do SIV-Lites'*, Asset Securitization Report (21 Aug 2006).

[58] *HSBC Plans to Restructure Its Two SIVS*, HSBC press release (26 Nov 2007) http://www.hsbc.com/1/PA_1_1_S5/content/assets/investor_relations/sea/2007/sea_071126_sivs.pdf.

The SIV market was always opaque. The opacity is part of why the market came to its end. Interestingly, ABS CDOs provided investors with line item detail of their portfolios. SIVs never did any such thing. Part of why investors pulled away from SIVs was their black box character. HSBC was willing to share line item detail with capital note and mezzanine investors. HSBC realized that even though the SIV assets had very high quality, they might not be liquid during stressful conditions. Money fund managers who had invested in the SIVs realized that and pulled back.

Rating Agencies: One panelist remarks that rating agencies are fairly good at rating cash flow structures and they have some role in market value structures, but it is harder to assign stable ratings to market value structures. Rating agencies were "behind" on pricing because they would rely on pricing information from the SIVs, which in turn relied on pricing information from investment banks. It became very difficult to get reliable pricing information.

Traditional SIV managers did not generally push the leverage or the asset quality in the vehicles to the ultimate limits allowed by the rating agency capital models. However, managers of newer SIV pushed the limits. They followed the example of other structures, in which professionals work to optimize a structure to achieve maximum efficiency and the best execution.

Investors: Only a small portion of money market funds invested in extendible ABCP. At the end of August, around 110 funds had invested $86 billion in SIVs. The funds stopped buying new SIV paper. By the end of December the exposure was down to around $40 billion, and it is scheduled to be down to around $25 billion by the end of March. None of the funds broke the buck (*i.e.*, reported a net asset value below $1.00 per share). Those that might have were rescued by their managers. S&P has not downgraded any money market funds but it has taken action on a few "enhanced cash funds."

Replacement for SIVs: One panelist asserts that banks are a substitute for SIVs. He asserts that the low default risk of some assets relative to their required risk-based capital was a key motivation for creating SIVs. With the lower capital requirements for high quality assets under Basel II, banks will be the optimal vehicles for "maturity transformation" of high quality assets. Highly-rated, retail-oriented banks will have a competitive advantage in funding high quality assets on their balance sheets.

Lasting Damage to Structured Finance: The securitization industry has to restore investor confidence. It has to bring investors back to the market. Investors are re-pricing risk and issuers will have to come to grips with the re-pricing. Bank sponsors of ABCP programs may be liquidity constrained.

Sigma, K2, and the SIVs sponsored by the Bank of Montreal are the only ones left. There may be some asset sales from those vehicles. The market is wrestling with uncertainty about when they will sell assets. However, the issue of when banks sell assets from already defunct SIVs is a bigger question.

Wednesday, 6 February 2008

9:00 am – Esoteric and Emerging Asset Classes

Whole businesses securitizations, tobacco settlement receivables, video game future royalties, music royalties, insurance securitizations, and film royalties are examples of securitizations of esoteric and emerging assets.

Market Conditions: Certain types of deals are difficult or impossible in the current market. One panelist asserts that corporate (whole business) securitization was not hurt badly by the credit crunch. Nonetheless, there were a number of such deals that failed to close because of investor apprehension. There was a surge of activity in the second half of 2007, driven by a pull-back in the bank market. However, corporate securitizations often use bond insurance, and pressure on the bond insurers likely will be a significant factor in 2008. Accordingly, many issuers need to have a "plan B" in case they cannot execute transactions using bond insurance.

Another panelist observes that many "esoteric" asset classes have been around for 10 years or more. Many of those asset classes have performed as expected. For truly new asset classes, bond insurance is the optimal mode of execution. However, there is likely to be pressure on that approach in 2008. Distribution strategies for deals backed by new asset classes will likely target insurance company investors for risk at the NAIC-1 level, and bank loan investors for tranches of higher risk.

Deal structures tend to be relatively simple for securitizations of esoteric and emerging assets. The complexity is in the assets.

New Asset Classes: The composition of the new asset market in 2008 will resemble the composition in 2007. There will likely be deals backed by cell phone towers, franchise loans, and various forms of intellectual property. There is a possibility for innovation in the area of whole business securitization, which has been dominated by the restaurant sector. Companies in other industries may start to use whole business securitizations if they have stable cash flows and solid market presence. Ski resorts have used securitization, essentially as CMBS deals rather than ABS deals.

Another panelist highlights continuing innovation in intellectual property and insurance-linked securitizations. Mortality cap lines are the newest variant. There has been good reception of the insurance-linked deals among investors.

Europe vs. U.S.: A key difference between Europe and the U.S. is the legal framework. There are different ways to protect and isolate the assets in each jurisdiction. The legal environment in the U.K. was very conducive to whole business securitization, which allowed pub companies and water utilities to gain leverage. The European market might not have been receptive to the kind of franchise deals done in the U.S. because the underlying companies are not as strong. The U.S. market has favored deals with shorter maturities, while the European market has had deals with much longer maturities, sometimes as long as 50 years.

Rating Esoteric Deals: It is difficult to get an esoteric deal done in any environment. Current conditions just make things tougher. Some deals start and stop over a period of years, before actually closing or being abandoned. The basic rating approach for esoteric deals has not changed in recent months. However, one important recent change relates to the bond insurers. The bond insurers have brought value to esoteric securitizations by supplying continuous monitoring, oversight, and solutions when deals get into trouble. They have been particularly important in the area of whole business securitization. Now that the bond insurers are under stress, market participants are looking for other alternatives for providing monitoring and oversight and, eventually, substitute management for troubled companies.

Bond Insurer Outlook: Will the bond insurers have enough capital to keep insuring deals backed by esoteric assets? Will the deals start to use multiple bond insurers? Will new bond insurers enter the sector? One panelist from a bond insurer notes that the bond insurers have ample capacity to do new deals, though their capacity is less than it was before. Club deals (*i.e.*, deals involving multiple bond insurers) may become more common.

Another panelist notes that bond insurer capacity to take large single-name exposures is somewhat constrained. A greater proportion of deals may include subordinate, uninsured tranches. However, investors are very wary of taking risk at the triple-B level, so subordinate tranches would have to be structured to achieve a higher level of credit quality. There is a lot more depth in the market for single-A risk than for triple-B risk.

A third panelist observes that often it is not possible to structure a whole business securitization to the single-A risk level.

Film Securitization: Deals have moved toward production financing as studios seek to push financing onto established producers who can finance themselves. In addition, studios continue to use slate financing (*i.e.*, financing a portfolio of films planned for production in the future). Studio deals will likely use relatively simple, two-tier capital structures. Deals involving independent producers will have more complex, multi-layered capital structures.

Another panelist focuses on one of last year's deals, Relativity Media Holdings. It had an Ambac insurance policy and had been structured to achieve an investment grade risk to Ambac. Relativity would take films produced by Sony (thus little or no completion risk) and would receive box office proceeds and other royalties for five years. The deal was essentially a future flow deal and Sony's participation was a key feature in the ability to achieve investment grade status.

Another panelist expects film securitizations to start happening in Australia, Asia, and Europe. In particular, some non-U.S. companies should be able to securitize the future cash flow on their film libraries.

Technology Issues: Although revenue from DVD sales is declining in the U.S., it is being replaced by revenue from VOD (video on demand). It is important for a deal not to depend on any particular mode of distribution (just as a deal benefits from have a diversified pool of films).

Collateralized Fund Obligations (CFOs): Moody's rated one securitization of private equity interests a few years ago. It does not expect to see a significant number of such transactions.

Non-traditional IP: There have been a handful of securitizations of fashion brands. Those are quasi corporate deals and depend on the projected long-term viability of the brand.

10:05 am – Basel II Implementation[59]

Implementation: The Basel Accord calls for parallel running of Basel I and Basel II in 2007, followed by two years of phase-in transition floors. This means that the first year of full implementation would be 2010. In the U.S., the approach calls for one year of parallel runs (2008) followed by three years of transitional floors (2009-2011), after which a bank can fully implement the advanced approaches without floors.

Each bank must adopt an implementation plan in order apply the advanced approaches. A bank must have an implementation plan by 10/15/2008 and must start its parallel run within 36 months of 4/1/2008. Some banks will move toward the advanced approaches more quickly than others. There is a high hurdle that a bank has to meet in order to move toward the advanced approaches and to start its parallel run. If a bank chooses to use certain advanced optional processes, it will have to get written permission to do so. If a bank chooses to adopt such optional approaches later, after it has qualified generally to apply advanced approaches, it will still need to get specific regulatory permission.

Outside the U.S., the implementation rules are more rigid. Parallel runs started in 2007, but banks had the option of starting their parallel run in 2008 ["2008" probably should be 2006]. Electing to use the internal assessment approach triggered heightened regulatory scrutiny for some banks.

Impact on Various Asset Classes: Basel II is affecting banks in various capacities: as originators, investors, ABCP sponsors, and support providers for ABCP conduits. Basel II is much more sophisticated, layered, and nuanced than the Basel I standard that it replaced. The Basel II framework reduces the opportunities for achieving regulatory capital arbitrage. Because of higher capital charges for risky assets, the Basel II framework will motivate banks to sell high risk assets and to retain low risk assets.

Specifically as applied to securitization investments, it will be very costly for banks to hold unrated residuals or deeply subordinated residuals. Basel II imposes operational requirements. Sale treatment under Basel II depends on sale treatment under U.S. GAAP.

In the ABCP area, the Basel II framework has major impact in two ways. One relates to the capital arbitrage that had been available through the use of liquidity facilities to support ABCP programs. The U.S. final rules have eliminated the 0% credit conversion factor for liquidity facilities. For the standard approach, the credit conversion factor will be 100%. However, the actual capital charge will be 100% times the applicable capital charge for the underlying assets. A bank that uses the internal assessment approach (IAA) can reduce the capital burden of

[59] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, *Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II*, 72 Fed. Reg. 69287, 69424 (7 Dec 2007).

holding unrated ABS residuals by placing them in an ABCP program. In the ABCP program the bank can apply its internal assessment of the risk of the unrated ABS and apply a capital charge based on that assessment. In contrast, if the bank held the unrated ABS on its balance sheet it would incur a dollar for dollar capital charge. Using the supervisory formula approach (SFA) for unrated residuals would generally be impractical.

Another panelist notes that capital charges for holding residential mortgage loans will be quite low under Basel II, which may reduce the motivation to securitize mortgage loans. In contrast, the capital charge for credit card receivables will be higher, producing a greater incentive for securitization. In the ABCP area, the sub-prime crisis may be a greater factor than the change in requirements specified by Basel II.

Another speaker emphasizes that a key objective of Basel II was to reduce opportunities for regulatory arbitrage. Banks will continue to have an incentive to securitize assets if their required capital under the leverage ratio requirement is higher than under the risk based capital requirement.

Another speaker notes that the lower risk-based capital requirements for high quality assets under Basel II may reduce banks' motivation to execute synthetic securitizations of their high quality assets.

Coverage of Basel II: There will only be 11 or 12 U.S. banks that adopt the Basel II advanced approaches. The "standardized approach" (Basel II ¶¶ 566-605) has not yet been implemented in the U.S., but it will be. The "advanced IRB" approach under the Basel II framework will not be adopted in the U.S.

Basel II requires a transfer of significant credit risk to third-parties as a requirement for sale treatment. The U.S. version does not require that, but instead requires sale treatment under U.S. GAAP.

New Issues from the Recent Crisis: Most of the issues are not really new, but they were not in the headlines. Transparency has been an issue for a long time. Different market participants define transparency differently. Just throwing data into the market is not helpful. Without proper understanding of structures, data can be mere noise. Liquidity is another top issue. It has been an issue in prior cycles. Models are another issue and will continue to be so. Models have never provided accurate forecasts, but if you use them long enough you will eventually get lucky and hit an accurate prediction. Models will always depend on the people who put the scenarios into them. Rating agencies are a key issue. Ratings are not a substitute for due diligence. The standardized approach under Basel II will rely heavily on ratings. Reputational risk is an issue as illustrated by the fact that many banks bailed out their SIVs even though they had no contractual obligation to do so.

Another speaker notes that some banks have been taking credit losses through their ABCP liquidity facilities. This calls into question the treatment of liquidity facilities. Also, there is concern about the meaning of ratings on re-securitizations (e.g., CDOs^2) compared to regular securitizations.

Most panelists feel that even if the Basel II framework been adopted several years ago it would not have prevented the current crisis. Indeed, it might have made problems worse by allowing bank capital levels to decline. Another issue is that the market did not have data from which it could have reasonably anticipated what happened to sub-prime mortgages. One panelist feels that Basel II might have helped by requiring capital for liquidity facilities, but that would not have been a major factor. U.S. banks have long been required to conduct risk management, so the focus on that area of the Basel II framework would not have made a big difference for U.S. banks.

Q&A: Recent dissatisfaction with the rating agency ratings may prompt regulators to reconsider aspects of the ratings-based approaches within Basel II. Another panelist counters that the Basel II framework already applies different capital levels to different types of instruments even when they have the same rating.

The use of a single model under Basel II increases systemic risk because all banks will be using the same model and behaving the same way. On the other hand, banks have different data, and their internal ratings vary, which partly mitigates the impact of a single regulatory model.

11:10 am – Commercial ABS Sector Review

The construction sector is being hit harder than the agricultural sector. The equipment manufacturers are responding accordingly.

The environment feels like a recession. Nonetheless, operating assets such as aircraft, railcars, and shipping containers appear to be performing well. Some issuers in the area of small ticket leasing have been tightening credit standards. Aircraft lessors have done a good job of getting ready for the next cycle in their market. Aviation came out of a major downturn several years ago. Although aviation has been one of the better performing asset classes over the past few months, it has been highlighted as the poor performer at many industry conferences over the past several years. Notably, aircraft sales are very strong right now and global demand for aircraft is very strong. Airline credit quality has stabilized.

A panelist from a major finance company notes that his company generally has used many funding sources, of which securitization is just one. In the current environment, syndicated bank facilities with short terms offer the best alternative. Lenders demand "bullet proof" structure and credit quality.

Investors take comfort from the fact that the collateral backing commercial ABS consists of income producing assets. It is not merely "somebody's vacation in Puerto Rico." However, portfolio managers face pressure from their senior managements with respect to their securitization holdings. They are being required to explain and justify all securitization positions on their books.

Commercial ABS represent a beneficial diversification away from consumer risk. Spreads probably will not contract to their previous tight levels during 2008.

One panelist feels that secondary trading prices are too cheap, and that buyers can find great opportunities.

New deals are being done as syndicated bank loans. Lenders are appropriately focused on the structure of syndicated loans.

Lenders are able to pass along much of their increased funding cost to their customers. It is somewhat more difficult for equipment lessors to do so.

The biggest sectors of the commercial ABS space are aircraft leasing, rental fleets, shipping containers, and equipment finance for small- and medium ticket items. The biggest users of bond insurance are the aircraft, railcar, shipping container, and small ticket equipment lease areas.

Investors who can competently assess asset risk are the ones who will be able to find value in the market. The aircraft sector started using bond insurance after 9/11, but there should be a resurgence of uninsured aircraft deals in the future.

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