

Accounting vs. Reality: Can We Handle the Truth?

I. Introduction

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Accounting and economic reality sometimes conflict. This can make life difficult for a CFO, especially in the wake of Enron. A CFO faces a tough challenge in dealing with analysts, equity investors, and lenders if his company's financial statements paint a confusing or incomplete picture of its true economic condition.

A company that uses securitization can follow generally accepted accounting standards and still have financial statements that confuse or mislead market participants. In striving to establish standards of broad applicability, policymakers have created rules that undermine the fundamental purpose of accounting: to provide a fair and complete picture of a company's economic condition.

The root of the problem stems from difficulty in deciding what to include in a company's "assets" and "liabilities" on its balance sheet. Assets and liabilities are important because they are key elements in calculating the financial ratios used for comparing companies and for measuring their performance. In addition, for regulated financial institutions, assets are a key determinant of regulatory capital requirements.

Two types of scenarios create notable difficulty: The first is when a company holds the benefits and risks of owning assets but finances them in a transaction that removes them from the company's balance sheet. This happens in a variety of securitization transactions, including many for financing credit card receivables and home equity loans. The second difficult scenario arises when a company conducts operations through special purpose entities but does not include the related assets and liabilities on its financial statements. This happens, for example, when a bank uses an asset-backed commercial paper program for making loans to its customers. In either scenario, a CFO faces the difficulty of explaining key dynamics of his company's business that are not reflected on its financial statements.

II. Financing via Securitization Can Muddle Leverage-Ratios

Accounting for securitizations sometimes requires the seeming contradiction of removing the subject assets from a company's financial statements while the company continues holding the risks and benefits of owning them. Users of the company's financial statements may suffer confusion over the company's true leverage and the source of its earnings. During the late 1990s, certain home equity lenders were vivid examples of how such confusion can arise.

Some home equity lenders ("securitizers") use securitization as the primary means of financing the loans that they make to consumers. Others ("portfolio lenders") use traditional financing techniques, such as issuing corporate bonds or borrowing from commercial lenders. The financial statements of two otherwise-identical companies might look completely different if one is a securitizer and the other is a portfolio lender. This can happen even if both companies hold virtually identical economic risks and benefits associated with their assets. The difference in the two companies' financial statements can create confusion for equity investors, financial analysts, and other market participants. Moody's highlighted this issue in 1996:

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From a comparative standpoint, though, significantly different accounting practices for securitizers as compared to portfolio lenders has, in Moody's view, clouded the analysis of these differing business models.

This is a concern because the simple act of securitizing assets can affect the appearance of the income statement and balance sheet in a profound manner without, in many cases, significantly altering the underlying economics of the securitizer... Reported balance sheet leverage declines as securitized assets are treated as "sold" for accounting purposes, although there may be little, if any, risk transference...

With the explosion in the use of securitization, it has become increasingly necessary to be able to objectively distinguish between the accounting effect and the economic impact of securitization. Because of different accounting treatment, any direct comparison of results with financial services companies that do not securitize their assets becomes misleading.¹

A. (Mis-) Treating Assets as "Sold"

The source of confusion is that one type of financing may treat home equity loans as assets of a company while the other treats them as having been "sold." The effect of "sale treatment" is that a company's balance sheet shrinks and, therefore, its leverage ratio appears better. Consider the following example of two companies, each of which has \$50 million of capital and has originated \$500 million of home equity loans:

- The first company finances its loans the old-fashioned way; it borrows \$450 million by selling corporate bonds. The company's balance sheet will show \$500 million of assets and \$50 million of capital, corresponding to a leverage ratio of 10-to-1.
- The second company finances \$375 million of its \$500 million of home equity loans by means of securitization. The company transfers \$375 million of the loans to a trust, which issues high quality asset-backed securities (ABS). The company sells the ABS to fixed-income investors and retains a "residual interest" in the trust.² The company's balance sheet will include the \$125 million of loans *not* financed through the securitization as well as the estimated value of the residual interest. If the estimated value of the residual interest is \$25 million, the total assets reflected on the company's balance sheet would be \$150 million, corresponding to a leverage ratio of 3-to-1.

¹ Alternative Financial Ratios for the Effects of Securitization: Tools for Analysis, Moody's Special Report (Sep. 1997) (reprinted in Securitization and its Effect on the Credit Strength of Companies: Moody's Perspective 1987–2002, Moody's Special Comment at 47, 48 (Mar 2002)).

² In practical terms, the residual interest embodies virtually all the economic risks and benefits of owning the home equity loans. On the other hand, in a theoretical sense, the securitization transfers some risk to the investors who buy the ABS. For example if credit losses on the home equity loans are so severe that they wipe out the residual interest, the ABS investors would then suffer losses. However, as reflected by the high credit ratings of the ABS, the likelihood that they will suffer any loss is quite small.

In technical terms, the residual interest in a home equity loan securitization represents the right to receive "excess spread." Excess spread is the difference between the yield on an asset and the all-in cost of financing the asset. If the interest rate on the underlying pool of home equity loans is 11%, the interest rate on the securities is 7%, and other costs amount to 1%, the excess spread would be 3% (11%-7%-1%=3%). Prepayments and credit losses on the underlying pool of loans determine the actual amount of excess spread cash flow that the company receives over time.

Excess spread provides the securitization's first line of defense against credit losses. Excess spread absorbs credit losses in order to protect the ABS from experiencing a loss. If credit losses on the underlying loans are more severe than the company anticipates, the excess spread cash flow will be less than projected. Conversely, if credit losses on the loans are milder than anticipated, the excess spread cash flow will exceed the company's original projections.

Excess spread cash flow also depends on prepayments. If the borrowers on the underlying loans prepay their loans more quickly than expected, excess spread cash flow is reduced. On the other hand, if the borrowers on the underlying loans prepay their loans more slowly than expected, excess spread cash flow is increased.

Although the performance of the entire pool determines the amount of excess spread cash flow that the company receives, the company reports only the residual interest on its financial statements.

Based on the two companies' financial statements, the first company appears to have much more leverage than the second. This could make market participants mistakenly believe that the first company is much riskier and less credit-worthy than the second. In addition, the second company's CFO may face the prospect of explaining how his company's fortunes depend on the performance of \$375 million of mortgage loans that are not reflected on its financial statements.

B. "FAS 140" Ignores Economic Reality

It strains common sense that a company's choice of financing method can so drastically change the appearance of its financial statements. Nonetheless, generally accepted accounting principles mandate this result. The applicable authority is called FAS 140.³ FAS 140 specifies when assets financed through securitization should be treated as having been "sold." However, the specification is not dependent on whether the "seller" retains the economic risk and benefits of owning the assets. Thus, the standard disregards what is probably the most significant aspect of economic reality. In this respect FAS 140 is defective because it mandates financial reporting practices that promote (and arguably even encourage) illusory distinctions not based on economic reality.

FAS 140 is a relatively new accounting standard. The Financial Accounting Standards Board⁴ released FAS 140 in September 2000 and made it effective for transactions occurring after 31 March 2001. The previous standard was called FAS 125, which FASB issued in June 1996.⁵ FAS 125, in turn, replaced an earlier standard called FAS 77.⁶ Clearly, the FASB has been grappling with how to treat securitizations for a while.

FAS 77 focused slightly more on economic reality than either FAS 125 or FAS 140. For example, paragraph 5 of FAS 77 specified that securitized assets would be treated as sold only when the securitizer surrendered control of their future economic benefits. However, like the later standards, FAS 77 disregarded the retention of economic risk.

C. Financial Statement Footnotes

Although FAS 140 creates an illusory distinction between securitizers and portfolio lenders, a securitizer concerned about confusing or misleading market participants arguably can minimize the damage by making proper disclosures in the footnotes to its financial statements. In principle, this ought to be sufficient to avoid misleading or confusing the market. In practice, it is far from perfect.

Under FAS 140, ratio comparisons between securitizers and portfolio lenders remain a problem, even for the most sophisticated users of financial statements. Moody's introduced the concept of "effective leverage" to address the difficulty of comparing the two types of companies. Moody's describes the effective leverage concept, in somewhat technical terms, as follows:

Clearly, if the seller retains the vast majority of the risk associated with its securitizations, then off-balance-sheet treatment of securitized assets and the recognition of gain-on-sale will cause the seller's balance sheet leverage to grossly overstate his capital sufficiency relative to the leverage ratio of a portfolio lender. In order to make comparisons between securitizers and balance sheet lenders more meaningful, Moody 's developed an alternative measure known as the "effective leverage ratio."

³ Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Sep 2000).

⁴ The Financial Accounting Standards Board (FASB) is the body responsible for defining generally accepted accounting principles (GAAP).

⁵ Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Jun 1996)

⁶ Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 77, Reporting By Transferors For Transfers of Receivables With Recourse* (Dec 1983)

The effective leverage ratio is a restatement of the traditional ratio of debt to tangible common equity to what it would be if securitizations were accounted for as financing transactions and not as sales. For companies that have no securitizations, the effective leverage ratio is the same as the ratio of debt to tangible common equity. For companies that do not record gain on sale for their securitizations, the effective leverage ratio is closely related to the ratio of equity to managed assets. For companies that do record gain on sale for their securitizations, the effective leverage ratio is a restated debt to tangible equity ratio, wherein "debt" includes securitization debt and "tangible equity" is net of the effects of gain-on-sale accounting.

This line of analysis revealed that many finance companies were operating with very thin capital bases. Our paper on alternative financial ratios demonstrated this for many independent finance companies which specialized in sub-prime lending and securitization.⁷

The need for specialized calculations such as Moody's "effective leverage ratio" clearly suggests that FAS 140's requirements are causing some harm in the form of confusion and misunderstanding. Even many experienced professionals may face difficulty in discovering a company's true economic condition from extensive footnote material. FAS 140 is a very complicated accounting standard and companies will sometimes make mistakes and omissions in trying to comply with its elaborate footnote requirements.⁸ Such mistakes and omissions will thwart the analytic efforts of even the most skilled and determined financial analysts.

Until GAAP is corrected to eliminate illusory distinctions between securitizers and portfolio lenders, CFOs of securitizers will continue to face the tough job of explaining their companies' true condition. Accounting distinctions between securitizers and portfolio lenders should be based only on economic substance and not the mere form of transactions.

III. Lending by Proxy: Asset-Backed Commercial Paper Programs

A second area of securitization where current accounting standards create an illusory distinction is in the treatment of asset-backed commercial paper (ABCP) programs. The issue is most pronounced in the banking sector. Banks that are otherwise identical may appear very different on their financial statements if one makes loans to its customers through an ABCP program while the other extends loans directly. The illusory distinction arises because loans made through an ABCP program do not appear on a bank's financial statements while loans made directly do. In other words, a bank does not "consolidate" its ABCP programs onto its financial statements.

A. How an ABCP Program Can Distort Leverage Ratios

Consider the following example. There are two banks, called Bank X and Bank Y. Each has \$8 billion of capital.

One, Bank X, has \$120 billion of assets consisting of commercial loans secured by the borrowers' trade receivables. In each loan, Bank X requires that the value of the collateral exceeds the loan amount by at least 10%. Bank X bears the risk that the borrowers will default on their loans, but having collateral mitigates the risk. Bank X's leverage ratio is 15-to-1.

⁷ *The Evolution of Moody's Views on Securitization*, Moody's Special Report (May 1999) (reprinted in *Securitization and its Effect on the Credit Strength of Companies: Moody's Perspective 1987-2002*, Moody's Special Comment at 5, 7 (Mar 2002); footnote omitted); see also *Substance, Not Form, of Securitizations Drives Standard & Poor's Leverage Analysis*, Standard & Poor's Research (11 Apr 2002); *Standard & Poor's Leverage Ratios for Credit Card Lenders*, Standard & Poor's Research (7 Mar 2000); FINANCIAL INSTITUTIONS CRITERIA, Standard & Poor's Criteria Book at 153, 156-159 (Jan 1999); compare *Capital Implications of Securitization and Effects of SFAS 125*, Fitch Research Special Report (16 Sep 1997); *Finance Company Capital Standards*, Fitch Research Special Report (16 Sep 1997).

⁸ See generally, Douglas Skipworth, *Statement 140 – A Study of Securitization Disclosures*, FASB Study (26 Dec 2001; available online at <http://accounting.rutgers.edu/raw/fasb/studyst140.pdf>).

The second bank, Bank Y, handles things differently. It extends \$80 billion of secured loans directly to its customers. Bank Y *indirectly* extends *another* \$40 billion of loans through one or more ABCP programs. The aggregate \$120 billion of loans is identical to Bank X's loan portfolio. Bank Y is directly exposed to risk on the first \$80 billion of loans and indirectly exposed to risk on the second \$40 billion.⁹ Only the first \$80 billion of loans appear on Bank Y's financial statements, producing a leverage ratio of 10-to-1.

At first glance, Bank X's leverage ratio appears 50% higher than Bank Y's. This makes Bank X appear riskier than Bank Y, even though the two banks face the same economic risks and benefits of \$120 billion of identical loans. By not using an ABCP program, Bank X has placed itself in the position of having to explain that it is not really riskier than Bank Y, even though Bank X's leverage ratio implies that it is. Conversely, Bank Y's CFO may face the challenge of explaining how his bank is exposed to risk on \$120 billion of loans while only \$80 billion appears on the company's financial statements.

The illusory distinction between the leverage ratios for Bank X and Bank Y needs to be fixed. Either both banks should count \$120 billion in loans on their financial statements or both banks should count the same fraction of that amount. One of the applicable accounting standards is called FAS 94. The FASB is now considering possible changes to FAS 94, but it seems unlikely that those changes will fix the problems described here.

B. Regulatory Capital

Beyond the impact on financial ratios, ABCP programs have a similar effect on banks' regulatory capital requirements. U.S. bank capital guidelines generally require banks to have capital amounting to at least 8% of their assets. In other words, a bank with \$8 billion of capital can have up to \$100 billion of assets. However, the regulations are complicated and specify special treatment for certain types of assets. Residential mortgage loans, for example, are counted at only half their actual amount. Thus, \$8 billion of capital could support up to \$200 billion of residential mortgage loans.

1. Bank X's Regulatory Capital Requirement

Returning to the example from before, the two banks could be subject to very different capital requirements because one uses an ABCP program and the other does not. Let's consider Bank X first. The bank has \$120 billion of commercial loans, which are counted at their full amount under the capital regulations. Therefore, the Bank X is supposed to have capital of at least 8% of \$120 billion, or \$9.6 billion. With actual capital of just \$8 billion, Bank X has a capital deficiency of \$1.6 billion. Regulators might insist that Bank X either increase its capital (*e.g.*, by selling stock) or shrink its assets.

2. Bank Y's Regulatory Capital Requirement

Turning to Bank Y's capital requirement is a bit more complicated. The capital regulations count the \$80 billion of loans made directly by Bank Y at their actual amount. In addition, if Bank Y's ABCP program is like most, the capital regulations will treat the bank's contractual obligations to the program as either a \$4 billion asset or an \$8 billion asset. Thus, Bank Y would have "regulatory assets" of either \$84 billion or \$88 billion. Bank Y's regulatory capital requirement would be either \$6.72 billion (*i.e.*, 8% of \$84 billion) or \$7.04 billion (8% of \$88 billion). Because Bank Y has actual capital of \$8 billion, it fully complies with its capital requirements. See the appendix for a more detailed description of how to figure Bank Y's capital requirement.

⁹ The ABCP program raises money for loans by issuing ABCP in the short-term money markets. Investors buy the ABCP because it is a low-risk investment. The bank supplies various support facilities – usually a "credit enhancement facility" and a separate "liquidity facility" – that give the ABCP its low risk character. Through the support facilities, the bank bears the risk of loans booked at the ABCP program.

3. The Illusory Distinction

The foregoing example is troubling. Two banks have the same amount of capital, make identical loans, and bear identical risk. Yet one bank meets its regulatory capital requirements and the other does not. Without regard to the *normative* question of what the right level of capital for \$120 billion of secured commercial loans *ought to be*, it is absurd that the requirement should be *different* for two banks such as Bank X and Bank Y. Based on their identical risk, the capital requirements for the two banks should be the same.

IV. Conclusion

Accounting standards and capital regulations sometimes make illusory distinctions between institutions that use securitization techniques and those that do not. Those distinctions are inappropriate and need to be eliminated. Accounting standards and capital regulations need to focus on the real economic substance of financial transactions. However, until that happens, pity the CFO who must explain why there is a wide gulf between his company's financial statements and economic truth.

Appendix

Figuring the Capital Requirement Attributable to Bank Y's ABCP Program

Normally, a bank-sponsored ABCP program repays maturing ABCP by issuing new ABCP. However, to protect investors from the risk that the program might not be able to issue new paper (e.g., because of a downgrade of the program's rating or because of a disruption of the commercial paper market), the program has back-up lines of credit upon which it can draw. The back-up lines of credit are called "support facilities" because they support the ABCP program's ability to repay its maturing ABCP.

In practice, banks often create multiple ABCP programs in order to avoid problems with lending limit rules. For the sake of simplicity, Bank Y is treated as having one ABCP program for \$40 billion of loans. The results shown below would be the same for multiple (identical) programs amounting to \$40 billion in the aggregate.

A. The Credit Enhancement Facility

A typical bank-sponsored ABCP program has two support facilities. The first is called the "credit enhancement facility." The credit enhancement facility supplies funds unconditionally when the ABCP program needs money to repay maturing ABCP. However, the credit enhancement facility is small; usually amounting to 10% or less of the full amount of the program (i.e., a \$10 billion ABCP program usually has a credit enhancement facility of \$1 billion or less). Because funding under the credit enhancement facility is unconditional, that facility bears the credit risk of the assets financed in the ABCP program.

A bank that sponsors an ABCP program usually provides the credit enhancement facility for the program. Regulatory capital regulations impose a capital requirement for credit enhancement facilities. In the jargon of the regulations, the credit enhancement facility is a "direct credit substitute."¹⁰ According to recently issued guidelines, the capital requirement attributable to a credit enhancement facility depends on a bank's own assessment of its risk exposure through the facility.¹¹

- If the bank determines that its risk exposure through the credit enhancement facility is equivalent to or better than a "triple-B" level of risk, the facility is simply counted as if it were an asset. This translates into a capital requirement of 8% of the amount of the facility.
- If the bank determines that the risk is equivalent to a "double-B" level of risk, the facility is counted as if it were an asset twice the size of the facility. This translates into a capital requirement of 16% of the amount of the facility.
- If the bank concludes that its risk is worse than a "double-B" level of risk, the full amount of the ABCP program is counted as an asset, subject to the proviso that that capital requirement cannot be higher than the full amount of the credit enhancement facility.

Returning to the example, the credit enhancement facility for Bank Y's ABCP program is \$4 billion, or 10% of the \$40 billion program size. If Bank Y concludes that it faces triple-B or better risk under the credit enhancement facility, the facility would count as a \$4 billion asset and have an associated capital charge of \$320 million (i.e., 8% of \$4 billion). If the bank concludes that its risk is equivalent to double-B, the credit enhancement facility would count as a \$8 billion asset and have an associated capital charge of \$640 million. If Bank Y concludes that its risk exposure is worse than double-B, the

¹⁰ 12 C.F.R. Part 3 Appendix A Section 4(a)(4); 66 Fed. Reg. 59614, -32 (29 Nov 2001).

¹¹ 12 C.F.R. Part 3 Appendix A Section 4(g)(1); 66 Fed. Reg. 59614, -34 (29 Nov 2001).

full amount of the ABCP program would be counted as an asset and the capital requirement would be \$3.2 billion.

Clearly, a bank has an enormous incentive to conclude that its risk exposure under ABCP credit enhancement facilities is at least of double-B quality. In practice, it seems highly unlikely that bank sponsors of ABCP programs will ever conclude that their risk exposure is worse than double-B. Accordingly, the Bank Y example highlights the double-B and triple-B scenarios.

B. The Liquidity Facility

The second support facility for an ABCP program is called the "liquidity facility." Compared to the credit enhancement facility, the liquidity facility is very large. Typically, the size of the liquidity facility equals the difference between the size of the whole ABCP program and the size of the credit enhancement facility (*i.e.*, a \$10 billion ABCP program with a \$1 billion credit enhancement facility would have a liquidity facility of \$9 billion). In the example, Bank Y supplies a \$36 billion liquidity facility for its ABCP program.

Unlike the credit enhancement facility, the liquidity facility provides funds only on a *conditional* basis. The amount available from the liquidity facility is determined by the condition of the collateral for the program's loans. When the collateral is trade receivables, the test is whether they have become delinquent (*e.g.*, past due by more than 60 days). As long as the total amount of delinquent collateral is less than the amount of the credit enhancement facility, the ABCP program will have sufficient capacity under its support facilities to repay all of its maturing commercial paper. However, if the amount of delinquent receivables exceeds the amount of the credit enhancement facility, there could be a shortfall.

Under the present regulatory framework, there is no capital requirement associated with liquidity facilities. However, there have been reports that U.S. regulators are considering imposing a capital charge on liquidity facilities.¹² Two suggested approaches call for treating a liquidity facility as an asset of either 20% or 10% its actual size. If Bank Y provides a liquidity facility of \$36 billion for its ABCP program, the incremental capital charges would be either \$576 million (8% of 20% of \$36 billion) or \$288 million (8% of 10% of \$36 billion).

The tables on the following page summarize various scenarios for calculating Bank Y's regulatory capital requirement and show the difference between capital requirements for Bank X and Bank Y under each scenario:

¹² *US Won't Wait for Basel on Liquidity Rules, Asset-Backed Alert* (29 Mar 2002).

Summary of Regulatory Capital Calculations and Comparison of Bank X and Bank Y Capital Requirements under Various Scenarios				
Direct Loans (\$ millions)			Bank Y	Bank X
direct loans			\$80,000	\$120,000
capital charge	8%		\$6,400	\$9,600
ABCP Program			Bank Y	Bank Y
program size			\$40,000	\$0
credit support facility	10%		\$4,000	\$0
liquidity facility	90%		\$36,000	\$0
ABCP Credit Enhancement (Bank Y)				
risk		≥ BBB	BB	< BB
conversion factor		100%	200%	program size
regulatory asset (credit equivalent amount)		\$4,000	\$8,000	\$40,000
capital charge (8%)		\$320	\$640	\$3,200
Bank Y Combined Capital Charge for ABCP Credit Enhancement and Liquidity Facilities (\$ millions)				
Credit enhancement risk		≥ BBB	BB	< BB
Liquidity facility capital charge at 0% credit equivalent amount	\$0	\$320	\$640	\$3,200
Liquidity facility capital charge at 10% credit equivalent amount (8% × 10% × \$amount)	\$288	\$608	\$928	N.A.
Liquidity facility capital charge at 20% credit equivalent amount (8% × 20% × \$amount)	\$576	\$896	\$1,216	N.A.
Bank Y Capital Charge for Direct Loans PLUS Combined Capital Charge for ABCP Credit Enhancement and Liquidity Facilities (\$ millions)				
Credit enhancement risk		≥ BBB	BB	< BB
Liquidity facility capital charge at 0% credit equivalent amount	\$0	\$6,720	\$7,040	\$9,600
Liquidity facility capital charge at 10% credit equivalent amount (8% × 10% × \$amount)	\$288	\$7,008	\$7,328	N.A.
Liquidity facility capital charge at 20% credit equivalent amount (8% × 20% × \$amount)	\$576	\$7,296	\$7,616	N.A.
Difference between Bank X's Regulatory Capital Requirement and Bank Y's (\$ millions)				
Credit enhancement risk (Bank Y)		≥ BBB	BB	< BB
Liquidity facility capital charge at 0% credit equivalent amount	\$0	\$2,880	\$2,560	\$0
Liquidity facility capital charge at 10% credit equivalent amount (8% × 10% × \$amount)	\$288	\$2,592	\$2,272	N.A.
Liquidity facility capital charge at 20% credit equivalent amount (8% × 20% × \$amount)	\$576	\$2,304	\$1,984	N.A.

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