Nomura Fixed Income Research

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Report from Arizona: Coverage of Selected Sessions of Strategic Research Institute's Eighth Annual Asset Securitization Symposium - 2001

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The following summaries reflect remarks of the panelists who participated in selected sessions at the recent Asset Securitization Symposium sponsored by Strategic Research Institute in Scottsdale Arizona. For the most part, the summaries have been drawn from notes taken during the sessions by Nomura employees. In addition, the summaries include a small amount of our commentary and interpretation, generally included in footnotes or placed in brackets to distinguish it from the other content. The summaries have not been reviewed or approved by the panelists. While we have tried to capture panelists' remarks accurately, we apologize in advance for any inaccuracies and omissions; readers should note the disclaimer at the bottom of the page. In addition, we wish to acknowledge the excellent work of Rita Karsadi and the rest of SRI's staff in organizing and hosting the conference.

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Monday, 12-Feb-2001

8:15 AM – The State of the Industry Address:
The Beginning of the New Millennium!

The early years of ABS, 1985-1994, involved branching out from mortgages to autos. The first deal was for Valley National. It was quickly followed by deals from the Big Three automakers. Credit cards came next followed by a selection of other assets. The dominant issuers in the early years included Citibank, Ford, Chrysler, GM, Household, and a few others. All the major issuers were large, well-known corporations.

The middle years, 1995-1997, were a period of extremely rapid growth for the ABS market. This period was when the home equity, manufactured housing, equipment leasing and student loan sectors fueled the rapid growth. But, this was also the time of gain-on-sale accounting. The population of issuers became more diverse, and the ranks of the dominant issuers included many smaller and financially weaker companies.

The mature years, 1998-2000, saw a moderate flattening of the growth rate of the ABS market and the resurgence of major corporations as the dominant issuers. Another feature of the mature years– especially in the past year– was the resurgence of subordinate class issuance.

The ABCP market has grown enormously since around 1995. It now has outstandings of around $650 billion.

A major investment bank projects that total issuance of public/144A ABS for 2001 will be $331 billion, including about $65 billion of CDOs (which may create some double counting because they could be backed by newly issued ABS). Thus, the firm's projected issuance ex-CDOs is $266 billion. Against that number, there will be $202 of ABS maturing in 2001, leaving net growth in ABS outstandings at about $64 billion.

The recent wave of consolidation leaves the population of issuers stronger. Major corporations now dominate. Separately, consolidation among ranks of the Wall Street firms has reduced the number of ABS trading desks by four (JP Morgan/Chase, CSFB/DLJ, UBS/PaineWebber, Pru).

On the rating agency front, the last three years have been the period of greatest downgrade activity for ABS. Even so, no credit card or auto ABS has been downgraded since 1993. Moreover, most of the downgrades in recent years were attributable to financial deterioration of companies that provided guarantees for some of their ABS (e.g., Conseco).

The economy is a key area of concern for the ABS market. Banks are tightening standards for commercial and industrial loans. This arguably presages a near-term tightening of consumer lending standards as well. This will help to buffer the impact of a potential recession on the ABS market. Similarly, the rise of the reported household debt burden is not really as ominous as it might seem at first blush: much of the high debt burden is concentrated among the very poorest households who are not the customers that subprime lenders are targeting.

Spreads on ABS are good now compared to historical norms and are very tight compared to corporates right now.

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Ford Financial Services is the broker-dealer for Ford. It handles the marketing of all short-term debt. Ford Credit's receivables grew by $24 billion last year. Ford did seven securitizations last year totaling about $22 billion. Each deal had two tranches, one of which was a short-term tranche. Ford plans to use securitization for about 40% of its funding in 2001 and beyond.

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Last year was an exceptional year for Sallie Mae. Sallie Mae made some significant acquisitions. Sallie Mae expects steady volume of its issuance in 2001 (but not at a level reflecting the acqui-

sitions it made in 2000), at a level somewhat below $11 billion. Sallie Mae expects to do quarterly deals. Defaults on student loans are driven by (1)the types of the schools that borrowers attend, (2)program changes from Washington, and (3)the condition of the economy.

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MBNA had a consistent presence in the market, globally, throughout 1999 and 2000. MBNA has been a consistent issuer is the US, Canada, Europe, and Asia. During 2000, MBNA achieved loan growth from $74 billion to $89 billion. The acquisition of the First Union portfolio was a positive because of the high quality of the acquired accounts: the cardholders on the accounts are somewhat more mature and have strong payment records. Seventy percent of the MBNA's funding is from securitization. Some of the rest of the company's funding comes from consumer bank deposits.

A key structural innovation that MBNA has embraced is the issuance of mezzanine and subordinate tranches from the master trust before the corresponding senior securities are sold. This allows the subordinate and mezzanine tranches to be larger, thus promoting liquidity.

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One of the investors targets "relative value" asset classes such as franchise loans, equipment leasing, and aircraft. It focuses on tranches carrying single-A ratings. The company has found that most of the problems that it has experienced have been attributable to servicer defaults rather than consumer defaults (i.e., poor performance on the underlying securitized assets because borrowers are unable to pay their bills).

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A money manager represented on the panel has about $15 billion invested in ABS, out of a portfolio of over $200 billion. Two-thirds of the $15 billion is in real estate-related ABS. The investor also has around $115 billion invested in mortgages [presumably agencies and jumbos]. Total ABS issuance for 2001 could be as high as $350 billion because companies now find it so much cheaper to issue ABS than to use unsecured borrowing. ABS spreads relative to corporates are very wide. ABS credit quality is going to deteriorate. Market participants make the mistake of simply extrapolating the performance of the last several years. If an investor really believes that ABS spreads will stay tight, the investor should sell its ABS and shift into corporates. The money manager, on the other hand, plans to shift moderately out of corporates in order to increase its ABS holdings.

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Key developments in 2000 included (1)the growing use of derivatives, (2)growth in Europe, (3)use of the web, (4)further announcements from the Basel Committee regarding international guidelines for bank risk-based capital standards, (5)some slippage of credit quality, and (6)CDOs. For 2001: "it's the economy, stupid." There will be a recession this year because too many people are losing their jobs. Alan Greenspan can accomplish a lot but he cannot hire all the unemployed people. The real story is that credit quality is becoming an issue for ABS. Not all triple-A's are created equal and some are more susceptible to being downgraded than others. The CDO market is reminiscent of the LBO market in the 1980s: now one hears phrases such as "make the numbers work" and "we can do any deal." CDOs are highly leveraged structures on built on very small capital bases.

Dis-intermediation is spreading through securitization in the sense that "whole business" securitization can be viewed as substitutes for the high yield market for the subject companies.

Credit risk in today's environment encompasses much more than the narrow notion of "pure credit risk." For practical purposes, credit risk must be viewed broadly; it is the risk you don't expect: Interest rate risk in the case of LTCM, political risk in the case of Japan, legal risk when someone goes to court and says "it's not what I really meant," liquidity risk, and information velocity risk when everyone gets the same information at the same time.

The wise issuer will not practice just-in-time funding. The wise investor will expect credit deterioration. The wise banker will look at all funding alternatives in all markets.

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Consumers are going to react to seeing poor performance on their portfolios at the same time that they have to deal with capital gains from their mutual funds. This will have an effect after April 15 when consumer have to pay taxes on the capital gains for which they received no cash. Just the same, in spite of worsening consumer sentiment, unemployment and interest rates are both low and, therefore, the economy ought to have a soft landing.

The credit card industry is more concentrated today than it was just a few years ago. This is good because the surviving companies are the ones that actually have experience in dealing with economic slow-downs.

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Ford is in the fifth year of a major cost cutting process and expects to sell fewer cars in 2001 than in 2000. In addition, there is very little room for price increases on new cars. Consumers are demanding better quality and more options for the same price as before. Sales were down a bit in January but not by as much as had been expected. Ford is still expecting a fairly good year in 2001, partly because of the currently low level of interest rates and partly because of leases terminating in 2001.

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We are already having a hard landing. The declines in consumer and business confidence have very rapid, but we have not seen the worst yet. In spite of the Fed's recent rate cuts, conditions are deteriorating.

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It will take time for people to lose their jobs and get them back again. This year will be challenging for the economy, but this could be good for the ABS market in the long run.

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The market has overreacted to the problems with subprime credits.

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To work with subprime assets, an investor has to get comfortable with the amount of protection supporting his bonds. Also, there are important differences among issuers; quality of management is a factor for subordinate tranches.

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As long as there is a buyer for the double-B and triple-B classes, subprime securitization can survive.[1]

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Recent consolidation on Wall Street means that there are now fewer bids and, therefore, there is somewhat less secondary liquidity.

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The large issuers have more investment banks approaching them than they can use. One large issuer strives to have daily communication with the trading desks of the major firms that make a market in its ABS.

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Liquidity has evaporated from the ABS market. There is about the same level of liquidity as there was during the worst times of 1998. Based on this, spreads should be much wider than they are right now. A money management firm expects the Wall Street dealer community to suffer dis-intermediation as

[1] This comment is somewhat odd. The most subordinate tranche of subprime mortgage securitizations almost always attains a rating of triple-B. Most subprime auto securitizations use bond insurance. Thus, double-B rated tranches from subprime securitizations are rare.

investors look to ways to trade directly with each other (bypassing the Street) and reducing dependence on the Street trading desks.

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Four issues now confront the ABS market:

- Accounting: A new accounting standard called FAS 140, which goes into effect at the end of March, is still clouded by uncertainty about the kind of legal opinions that will be needed in order for an issuer to achieve "sale treatment" on its securitizations.[2]
- Bank Capital Guidelines: The 600-page Basel Committee proposal regarding bank risk based capital guidelines contains both positive and negative features.[3]
- Legal/Bankruptcy: LTV Corp. filed for bankruptcy on 29 December 2000 in Ohio. The company is arguing that two securitizations it did should be recharacterized as financings. The case is in the Ohio bankruptcy court and a decision is due in early March. If LTV convinces the bankruptcy court to recharacterize the securitizations as secured financings, the case could have a very damaging effect on securitization activity in general. A group of securitization issuers is filing an amicus brief arguing that LTV's deals should not be recharacterized.
- Bank Regulatory Accounting: The FFIEC[4] low-level-recourse proposal would increase capital requirements for subprime loans.

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Proposed privacy legislation could hurt securitization. One proposal would allow consumers to opt-out on information transfers within a single financial institution. Also, bankruptcy reform should happen in 2001.

9:30 AM – Traders' Roundtable Discussion: Exploiting Opportunities in Today's Highly Competitive Primary and Secondary Markets

The focus for the panel will be the economy.

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Triple-A, double-A, and single-A bonds are well insulated from the risks of a recession. With respect to prime autos, the panelist is comfortable down to the deeply subordinated classes. However, in subprime autos, subprime mortgages, and manufactured housing, he urges caution.

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The theme for the year will be remaining liquid in the short-term. In the prime sectors, ABS have become a safe-haven product amidst the turmoil in the agency sectors. Thus, the outlook for the prime quality auto and credit card sectors is very positive, even if one is very bearish on the economy. On the other hand, subprime and nonprime product offers some very cheap and enticing prices right now (but they do carry more risk).

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There has been too much negative hype and investors have become more conservative than conditions warrant. Credit enhancement levels on triple-A classes are excessive. The examples of some mezzanine and subordinate bonds "getting whacked" can be attributed to the rating agencies having been unfamiliar with the collateral (in other words, the rating agencies initially underestimated the riskiness of the collateral and specified too little enhancement for the mezzanine and subordinate classes).

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[1] For a general discussion of FAS 140 see the Deloitte & Touche report at:
http://www.dttus.com/pub/headsup/7-10/oct19-01.htm

[2] The regulatory panel included further discussion of the Basel Committee proposal. Mayer Brown & Platt has supplied a brief memo summarizing the new Basel proposal. The memo is available at:

http://www.securitization.net/knowledgebank/legal/Sec_basel.pdf

[4] The FFIEC, or Federal Financial Institution Examination Council, is the entity through which the four separate bank regulatory agencies and the National Credit Union Administration coordinate their rule-making activities.

How and when will the recession that is now hitting the corporate market hit the ABS market? The answer is that it will hit the subprime sectors. Separately, the consolidation among the Street Firms has not been entirely bad because the surviving firms have increased their commitments to ABS. One of the major investment banks now has seven ABS traders and four researchers.

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Consolidation among issuers is both positive and negative. The surviving issuers are stronger. However, the securities issued by companies that have disappeared lose liquidity and support from the Wall Street dealers.

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There has been a dramatic change in the secondary market over the past few months. Much of the outstanding bulk of ABS is now trading at a premium. Investors are worrying more about prepayment risk than they should be. Thus, some of the premium paper is now cheap relative to the similar par-coupon bonds.

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This speaker agrees with the previous speaker that some of the best opportunities right now are in the prime auto sector were the paper has priced at higher prepayment speeds than are actually likely to occur. Mortgage investors should look at NAS bonds; it is not worth it to give up the spread relative to sequentials.

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Premiums present good opportunities right now. Speeds should not pick up in the real estate ABS sector. Mezzanine and subordinate bonds are cheap right now because of less demand from the CBOs. In addition, the recent vintages of manufactured housing and home equity ABS are backed by loans of superior credit quality than the deals of a few years ago.

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There will be upside in non-California rate reduction bonds after the California situation clears up. New home equity ABS offer opportunity because so many of the loans have prepayment penalties. There is also opportunity in home equity ABS from certain of the failed issuers; investors can do their homework on the deals to project cumulative losses and then take advantage of the cheap prices.

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Changing the market's benchmark from Treasuries to swaps has caused the volatility of swap spreads to decline. It has also narrowed the bid-ask spread in some areas, such as credit cards. On the other hand, hedging costs have gone up slightly.

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The overall capital markets will be quite volatile through the first quarter of 2001 but the ABS sector should be less so. ABS issuers are very nimble and respond rapidly to market opportunities. This was evident in the large amount of recent floating rate issuance from the auto lenders.

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A sector that will become bigger is subordinate and mezzanine ABS and, especially, distressed mezzanine and subordinate ABS. Sometimes the distressed mezz and sub bonds trade without sponsorship and trade at very depressed prices. If the economy goes into a recession, there will be more rating downgrades and there will be opportunities to buy good bonds at cheap prices.

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Internet trading platforms have not yet had a significant impact on ABS trading. The web-based trading systems need to supply liquidity and they will only be able to do that if they can get sponsorship from individual dealers or the dealer community at large.

11:00 AM – Researcher's Focus Discussion: Did 2000 Meet Expectations and What Can We Expect for 2001 and Beyond?

One of the major investment banks does not have a very bearish outlook for the economy. Although consumer confidence will be down, unemployment will remain low or moderate and GDP growth will shrink but remain positive. There should be no problems with pools of loans to prime-quality borrowers but there could be problems with subprime pools. One economic statistic that is key for predicting performance of subprime pools is "average hours worked." That statistic reflects subprime borrowers' ability to make ends meet with money from overtime and second jobs.

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A second securities firm holds a similar outlook. From that perspective (i.e., neutral to positive), investors are somewhat overreacting to economic conditions. Much of the collateral being put into deals today is of higher quality than collateral backing deals from a few years ago.

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Household debt burdens are not very high compared to historical norms. The households at the weakest end of the economic spectrum disproportionately account for the higher overall average level of consumer debt. Those households are not highly represented in securitized pools. The recent pattern of consumer bankruptcy filings (an increase in 2000 followed by a modest decline) may be attributable to bankruptcy attorneys pushing consumers to file before the threatened enactment of bankruptcy reform.

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The subprime sector will experience a much greater negative impact that the prime sector in a recession.

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PeopleFirst is an internet lender that issued ABS wrapped by FSA. Over 90% of the borrowers used direct debits from their checking accounts to pay their PeopleFirst loans. Many of the borrowers have FICO scores in the high 700s.[5] The bonds traded at subprime spreads but they represent a good deal. Another trade that the speaker likes is buying credit card ABS from the Prime Credit Card Master Trust.[6]

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Liquidity is either present or absent with respect to particular ABS issues. Buying ABS from an unpopular name (beaten-up sector or name) is a bad trade. On the other hand, stepping down in credit is a good trade.

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The choice between liquidity and yield is one that each investor has to address for itself, based on the likelihood that it will have to liquidate a position. Investors should in higher quality, higher liquidity names. Recent consolidation among the Street firms has hurt liquidity.

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The downside risk of subprime assets outweighs the opportunity. The better trade for taking-on credit risk is to buy the lower-rated tranches from issuers of ABS backed by prime-quality assets.

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Investors can find opportunity in higher-rated mezzanine tranches from issuers that are out of favor. For example, double-A Conseco paper is a better opportunity than single-A Saxon paper. Likewise for Conseco double-A's compared to Vanderbilt single-A's. [This speaker's view seems exactly opposite to another speaker's.]

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[5] See generally, Alex Dill, PeopleFirst.com Vehicle Receivables Owner Trust 2000-2, Structured Finance New Issue Report, Moody's Investors Service (22 December 2000).

[6] See generally, Diana Weaver, Prime Credit Card Master Trust, Series 2000-1, Structured Finance New Issue Report, Moody's Investors Service (12 January 2001).

Compared to other fixed-income sectors, securitizations provide investors a much safer place to be invested during a recession than do corporate bonds. A second panelist disagrees, stating that most ABS do not offer very much upside right now and that investors will need to focus on coupon return rather than spread tightening for making money in the near future. A third speaker feels that spreads are likely to either remain stable or widen. A fourth panelist agrees with the second that there is not much tightening potential but there is material widening risk. The fourth panelist says there is a kind of negative convexity affecting mezzanine and subordinate ABS, and recommends that investors keep their powder dry and wait for opportunities when spreads do widen later in the year.

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Team Fleet is a distressed issuer of auto fleet-backed ABS. Those securities offer opportunity right now. A double-A bond from the 1998 deal is trading 100 over swaps. Holding the bond for just four months produces a win. Many of the cars are "program cars" (i.e., subject to repurchase contracts with Ford) and the remainder could be sold for very high losses before the bonds would be hurt.[7] Another opportunity: last year Conseco did a deal backed by non-performing truck loans. Even though the collateral is weak, the deal has lots of credit enhancement and a turbo feature to channel cash flows to the senior classes.[8]

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Twenty-three percent of the arbitrage CDOs done last year were ABS CDOs. These CDOs have had a very strong influence on the demand for mezzanine and subordinate ABS. However, investors in the CDOs need to remain mindful of the products going into the individual CDOs and on the managers' abilities. The CDO bid for mezzanine and subordinate ABS will continue to remain strong though the rest of the year and there will not be enough supply of subordinate and mezzanine ABS to support all the ABS CDOs in the pipeline.

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Demand from ABS CDOs will outstrip the supply of available mezzanine and subordinate ABS. Thus, the first ABS CDOs may be the best ones to have been done because they had the widest selection of sub and mezz ABS from which to choose.

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SIVs (securities investment vehicles) are in competition with the ABS CDOs and offer investors an alternative.

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Three panelists note that prepayments on autos are slower than had been expected, partly because of a high proportion of subvented loans. One of them says that home equity prepayments ought to be lower than people are expecting.

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Another panelist recommends a barbell portfolio having one portion concentrated in liquid, high-credit-quality securities such as ABS backed by credit cards and student loans. The other side of the barbell should be credit card triple-B's[9] and selected CDOs.

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[7] See generally, Shorie Afshar, Team Fleet Financing Corporation, Series 1999-4 Rental Car Asset Backed Notes, Structured Finance New Issue Report, Moody's Investors Service (30 July 1999).

[8] The panelist is apparently referring to Conseco Finance Vehicle Trust 2000-B. That deal was originally backed by roughly $506 million of fully current truck and trailer loans as well as roughly $24 million of delinquent loans.

[9] Credit card triple-B's are the "cash collateral amounts" or the "collateral invested amounts" that provide the first layer of credit enhancement in many credit card deals. The CCAs or CIAs in turn receive some protection through the excess spread generated by credit card receivables. The excess spread is often sufficient to allow the CCA or CIA to receive an investment grade rating.

Yet another panelist recommends staying in the card and auto sectors for triple-A ABS and he recommends single-A credit card ABS. He likes insured subprime auto ABS and triple-A home equity ABS because of good spreads. He also likes triple-A manufactured housing ABS.

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Another likes rate reduction bonds. He also likes credit card triple-As and single-As. He notes that floating rate credit card ABS are vulnerable to some spread widening because of the large inventory that will be offered this year (because of refunding). He likes the top-name home equity issuers down to the double-A tranches; otherwise, he favors sticking to the new issues in order to get some prepayment protection.[10] He likes equipment lease deals as a way to diversify away from consumer risk; and equipment deals are usually well enhanced. Timeshare receivables are buried under a bad perception but they are actually very good because of strong borrower quality.

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Another panelist echoes some of the remarks of the others. The core of an investor's portfolio should be cards and autos. This panelist recommends caution with respect to (1)tiering and (2)limited liquidity for deals from issuers whose names fall out of favor. The panelist likes California rate reduction bonds because of the opportunity for tightening.

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Another likes equipment deals for their incremental spread. He likes retail credit card deals, such as Sears, as opposed to Visa/MasterCard deals. He likes rate reduction bonds outside of California, and he likes premium auto ABS. For the subprime area, Castro recommends focusing on the top-tier names. He likes student loan ABS because the government is buying so much student loan collateral.

1:30 PM – The Impact of Regulatory Developments on the ABS Market

In January 2001, the Basel Committee issued its new, comprehensive proposal concerning bank capital guidelines.[11] As of 1999, the Basel Committee had already proposed to apply a sophisticated framework for treating securitization. Securitization risk weightings can be based on either third party ratings or an institution's own internal risk assessments. Triple-B securitizations held by a bank would be assigned to the 100% risk weight category. Double-A and triple-A securitizations held by a bank would be assigned to the 20% risk weighting. Single-As would receive a 50% risk weighting. Liquidity facilities for asset-backed commercial paper programs would be subjected to a 20% credit conversion factor and managed assets in a revolving securitization would receive either a 10% or 20% conversion factor.

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Unsecured corporate loans are treated more favorably than securitizations under the Basel proposal. In particular, securitizations are subjected to tougher loss severity assumptions than regular corporate loans. The panelist asks another why securitization got such harsh treatment from the Basel Committee. [The panelist is posturing here. His interpretation that securitizations are treated more harshly than regular bank loans is not entirely reasonable under a broader perspective]

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Different people worked on different parts of the Basel proposal. This explains part of why the treatment of securitizations and secured financings are different. In addition, because of leverage, loss severities on subordinate and mezzanine ABS can be very high.

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[10] New home equity ABS deals include a higher proportion of loans with prepayment penalties than older home equity ABS deals.

[11] The complete Basel proposal, including The New Basel Capital Accord and the supporting consultative document titled Asset Securitisation (sic), is available at http://www.bis.org/publ/bcbsca.htm.

New accounting standard FAS 140 addresses the issue of when a transfer of assets, such as in a securitization, will be treated as a sale for accounting purposes. One of the requirements for a securitization to receive sale treatment is that the transferor "surrender control" of the transferred assets. One aspect of surrendering control is the use of a "qualifying special purpose entity" or QSPE as the issuer of the end-product securities.

FAS 140 requires that 10 percent of the beneficial interests (i.e., equity) of a QSPE be held by an entity that is independent of the transferor. In addition, a QSPE must be brain dead; it must be on autopilot. The simple rule of thumb is that a "Q" cannot think. A Q can hold only passive financial assets. Swaps, caps, and floors are acceptable but some contracts that require the exercise of judgement or discretion are not. A Q cannot hold mortgage servicing rights but it can hold foreclosed assets temporarily.

A QSPE can sell assets but the circumstances must be defined in advance. This is significant for CDOs.

If a transferor sells assets to an SPE and the transferor or its agents can reclaim the assets, then the SPE will not be a QSPE. The issue is "agency."

Any kind of decision making that must occur in connection with disposing of an asset will be problem for a QSPE.

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There are three types of interesting new structures from a securities regulation perspective.

- Multi-tiered structures: These are deals in which securities created in one tier of a transaction become the subject assets for the next tier. These kinds of deals raise several issues: (1)which securities from which tiers have to be registered with the SEC, (2)in calculating the SEC's registration fees, should securities from multiple tiers be counted, and (3)whether it is appropriate to look through the tiers for purposes of determining whether a particular registration can qualify to use the expedited procedures allowed under certain registration forms (e.g., forms S-3 and S-11).
- Non-contemporaneous senior/sub structures: The key disclosure point is that there may be situations in which the subordinate securities mature before their corresponding senior securities thus leaving the seniors naked.
- Variable Payment Term Notes: VPTNs are a relatively new type of security, often associated with auto deals. Some such deals provide for adding loans after the sale of the securities. At first blush, this would appear to disqualify such a deal from using registration form S-3, which generally requires a fixed asset pool. The SEC is proposing to treat such an arrangement as satisfying the requirements for Form S-3 based on the notion that the pool is nearly fixed because of the tight limitations on the character of added accounts.

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The four US bank regulatory agencies are working toward issuing a new proposed capital rule. Even through a final Basel rule is scheduled to be issued by the end of the year, the US agencies may still issue their own rule because the Basel rule will provide for a three-year transition period.

There are two separate US proposals, the "securitization proposal"[12] and the "residual proposal."[13] The two main differences between the US proposal and the Basel proposal are: (1)the Basel proposal puts a 20% charge on liquidity facilities[14] and (2) the Basel proposal applies a minimum 10% conversion factor to managed assets[15] while the US proposal applies a 20% conversion factor.[16]

[12] Risk-Based Capital Standards; Recourse and Direct Credit Substitutes, 65 Fed. Reg. 12319 (8 Mar 2000) (available at http://www.fdic.gov/regulations/laws/federal/00riskb.pdf).

[13] Residual Interests in Asset Securitizations or Other Transfers of Financial Assets, 65 Fed. Reg. 57993 (27 Sep 2000) (available at http://www.fdic.gov/regulations/laws/federal/00cap.pdf).

[14] The New Basel Capital Accord, paragraph 535 (Jan 2001).

[15] The New Basel Capital Accord, paragraph 523 (Jan 2001).

[16] 65 Fed. Reg. at 12330-31 (8 Mar 2000).

The Basel proposal is very harsh in requiring deductions for retained interests. The industry can be expected to respond in the same way that it did to the earlier, corresponding US proposal.

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Deals or trusts that are required to supply new assets will be grandfathered for continuing treatment under FAS 125. Deals or trusts that permit new assets not to be added– such as ABCP programs– will be subject to new FAS 140 and will have to change their operations to acquire or retain QSPE status.

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The NAIC's Securities Valuation Office (SVO) has had to grapple with so-called "non-traditional ratings" that address only principal, or principal and only a portion of the interest on a security. The assignment of debt classifications to securities that provide for unrated cash-flow components is being reconsidered. The SVO has had to respond to "warning signs" such as:

- complaints from state insurance commissioners regarding highly-rated securities that trade at a tiny fraction of par
- rating agency statements that the principal cash-flow on a given security can receive a triple-A rating even though the full cash flow (i.e., principal and interest) would get a rating of triple-C
- investor complaints.

Therefore, it has become difficult to know what a triple-A rating means, at least with respect to ratings of certain securities. The SVO's response– for now– is to treat securities with certain non-debt characteristics as if they are a species of preferred equity.

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Back in December 1999 the banking agencies issued guidance on capital rules for securitization and hinted that there would be rules pertaining to residual interests. In part, the agencies were reacting to the fraud losses the occurred in the Keystone situation.[17] What the agencies should focus on is how to treat the residual holdings of banks that otherwise engage in questionable practices. In a larger context, the Office of the Comptroller of the Currency (OCC) views securitization as a good way for banks to manage risk. However, in a study of eight institutions during 2000, the OCC was disappointed to discover that the institutions had no basis for the assumptions behind their residual valuations.

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Securitization per se is being attacked in the LTV Corp. bankruptcy case.

2:40 PM – The Private Placement and 144A Market: Evaluating Pricing from the Investor Perspective

Last year ABS remained a preferred investment because they displayed stability and strong performance amidst volatile conditions in other markets. Ninety-six percent of private placement ABS issuance last year was done as rule 144A offerings.

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One of the benefits of 144A deals relative to public deals is the ability to pick up a bit more spread. Relative to fully private deals, 144A deals can provide more liquidity. A disadvantage of 144A deals is the time compression (relative to full private placements) and the necessarily curtailed due diligence. Sometimes just getting the documents in a 144A deal– let alone negotiating them– is a problem.

[17] First National Bank of Keystone was a bank that engaged in subprime mortgage lending and so-called high LTV lending. The institution also committed fraud by reporting that it owned certain assets that it had actually sold. Keystone was shut-down by the OCC in September 1999. Keystone's failure will ultimate cost taxpayers nearly $800 million. About $500 million of the loss is attributable to Keystone's fraudulent reporting. The remainder of the loss will come from the residual interests that Keystone retained in its subprime mortgage and high LTV mortgage securitizations. Of $380 million of residuals carried on Keystone's books, the ultimate loss estimated by the FDIC will be in the range of $340 million to $370 million.

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When a given ABS is in high demand, the banker and the issuer resist supplying the documents and are not receptive to comments. But, if the security is not being well received in the market, the banker and the issuer will supply the documents and will accept comments. [An implication of these remarks is that market demand pushes the manner of execution to the lowest standard that will allow the bonds to clear the market].

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One large investor will accept public style execution on 144A deals from issuers that are rated investment grade. However, the investor insists on private-style execution for deals from speculative-grade issuers.

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Many deals that should have been done as full private placements– to allow for deeper due diligence– have been improperly pushed into the 144A market. Another large investor wants certain types of deals pushed back into the fully private arena: (1)deals form new issuers and (2)deals backed by very unusual assets.

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The market for the most liquid 144A ABS is sufficiently liquid that investors reasonably can obtain a bid close to the price levels that they use for marking securities to market. However, for other (i.e., most) 144A ABS, an investor is likely to receive an actual bid price much worse than the calculated price that he uses to mark his holdings to market.

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One of the large insurance companies looks at one or two CDOs each day. It is better for the CDOs to buy 144As than privates because (1) there is more information on the 144As and (2)the 144As have dual ratings. Another speaker agrees that having more underwriters, more disclosure, and more ratings help CDOs to gain investor acceptance.

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One of the large investors uses the Treasury curve more than the swap curve for internal purposes (performance measurement), but it necessarily uses the swap curve for bidding on deals. Panelists from two other large investors say that their companies work the same way. A fourth investor primarily uses the swap curve. Another one uses whatever curve is best for measuring value. The last one measures itself internally on the Treasury curve.

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Time compression in 144A deals is the main problem. Another panelists says that the ability to spend time with management is key. He focuses on whether management will continue to provide adequate reporting support for its deals. A third panelist is frustrated by bankers who advise issuers not to provide information to investors.

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During 2000, one of the speakers held a deal from an issuer that went bankrupt, but the Bankruptcy Court upheld the securitization trust. In another case, the speaker had to work through a transfer of servicing. The asset types involved were franchise loans and equipment leases.

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One of the panelists cites a fully private deal in which he had negotiated to have the right to transfer servicing if the seller/servicer was downgraded below a specified level. This turned out to be an important right.

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Rating downgrades have been concentrated in the home equity, manufactured housing, and franchise loan sectors. A second panelist agrees and notes that if the economy is headed into a recession there could be disproportionate pressure on the private and 144A areas. Extra pressure on those areas would arise because many subordinate and mezzanine bonds are sold privately or as 144A's, while the related senior bonds are sold in the public market. A third speaker is concerned that subprime assets will suffer a major deterioration in a weakening economy. A fourth urges the audience not to buy private or 144A deals of any asset class unless they have the ability to run their own stress tests on the deals. A fifth expresses the need for caution with respect to franchise loans and equipment leases.

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Two speakers explain that their companies generally refrain from buying wrapped deals. One says that his company wants to understand how deals work and to be paid for the understanding. The other says that the protection from bond insurance is incomplete; many ABS have call and extension risk that bond insurance does not cover. Those risks compel the second panelist's company to fully understand the subject deal regardless of the use of bond insurance. All the other panelists express a mix of views on their companies' willingness to buy insured securities, but all prefer to work on understanding deals, and to get paid for that work.

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New areas: jet engines, servicing advances, alternative student loans, and modular housing. There are pockets of value across all asset classes. Another panelist says that his company is not finding value in new asset classes right now. A third speaker says that his company found operating assets as a new [and appealing?] asset class last year, but it remains unclear whether any class has special value.

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Operating asset deals– like the pub deals in Europe– may not have much of a future in the US. Just the same, more and more companies are securitizing their receivables (just as they used to finance their receivables through traditional means).

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One of the large insurance companies got into alternative student loans for the first time last year. The panelist from that company explains that she also looked at a deal backed by a contract to deliver equipment to the government, but she could not get comfortable with it. Another panelist did not look at any new asset classes per se but she did look at some synthetic transactions.

4:10 PM – Analyzing the Growing Use of Derivatives and Synthetic Securities

Synthetics have grown in popularity because they can be easier to execute than traditional deals and because they are excellent tools for financial institution risk management. The recent difficulties experienced by some synthetic CBOs were triggered by credit problems at corporate credits such as Xerox. Going forward, there should be more structures featuring dynamic risk management and those involving currency risk and new asset types.

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Synthetic issuance accounted for about half of all CDO issuance in Europe over the past year. The driving forces continue to be regulatory capital relief and balance sheet risk management. The synthetic products allow institutions to achieve their objectives more easily than would "traditional" (i.e., non-synthetic) securitizations because the process of selling assets to an SPV is difficult or impractical in some jurisdictions. In 2000, the regulatory bodies provided approval for some of the structured being used by European financial institutions. Underlying asset classes include bonds and loans as well as unrated loans to small and mid-sized companies. Commercial and residential mortgages were also among the asset types underlying European synthetic securitizations during 2000.

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The CDO structure is very flexible and, therefore, should remain popular for executing deals for the foreseeable future. It can work with any asset type as long as there is a basis for projecting losses.

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Four developments in Europe over the past year:

- regulatory capital regimes differ in their definitions of "credit events" under credit default swaps
- evolving definition of "termination events" under credit default swaps
- blind pools and disclosed pools may receive different regulatory treatment and varying acceptance from investors
- synthetic deals are being done in which not all tranches carry ratings from both rating agencies

The US is developing differently than Europe in that some issuers are bringing deals to market with no ratings at all.

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Rating a synthetic deal is based on the notion that it is equivalent to a cash flow deal and that the definition of a "credit event" in the synthetic deal mirrors what would be a default in a cash deal. Although the data compiled by rating agencies focuses on payment defaults, synthetic securities can define "credit events" more broadly than payment defaults, provided that the differences are understood and their frequency can be predicted reliably.

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Synthetic asset-backed deals started with the structured note trusts of the early 1990s. Those deals had single assets that would be combined with derivative instruments to create synthetic cash flows. Some initial problems, such as late payments made during grace periods, were quickly spotted and solved. To solve the issue of swap termination payments, the rating agencies conceived solutions such as excluding termination payments from the affected deals by tendering the underlying assets to investors upon the termination of a swap. The rating agencies also addressed the issue of unintended terminations triggered by technical defaults. Similarly, rating agencies requested that a company's failure to pay its debts as they come due should not be a swap default or termination event for the swaps used in synthetic ABS.

Later synthetic deals expanded beyond simply mimicking the experience that an investor would have had from investing in an actual pool of assets. The newer breed of synthetic deals added the feature of leverage. Thus, investors could put up $50 million to get the experience on a pool of $300 million (these were like market value CDOs). A challenge for such a deal is marking assets to market on a regular basis. Another challenge for such a deal is the need to unwind the portfolio at the end of the deal; this takes time. To address the problem of swap providers insisting on termination payments in their swaps, deals can use subordinated termination payments (subordinated to the bond payments).

Another feature of synthetic deals that can be a surprise to swap counterparties is the requirement to post collateral if they are downgraded.

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One speaker asks another about the accounting (FAS 140) issue that arises because CDO issuers are not "brain dead" and, therefore, cannot qualify as QSPEs.

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The QSPE concept originated in FAS 125 and continues in FAS 140. However, it only applies to the transferor and its affiliates. According to old rules from the SEC, SPEs that do not qualify as Qs must still have three percent of real, outside equity (i.e., outside equity equal to at least 3% of assets). A few months ago, at the AICPA's conference in December, the SEC raised the issue of who is really the sponsor of an SPE and who should be excluded from counting as an outsider for the 3% test. In addition, the 3% outside equity must be equity "in legal form;" this is a hot-button for the SEC.

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Cash flow CDO structures have dominated the CDO market recently but synthetics have been important as well. Going forward, one of the panelists expects to see more synthetic transactions done by more kinds of issuers and investors.

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In the US, the same names are doing deals over and over again. This should prompt investors to focus on their growing exposure to specific underlying corporate names. Monitoring rating watchlists and using the KMV[18] credit risk modeling service are both steps that investors should take to protect themselves. An investor's exposure in synthetic CDOs can be a levered exposure and, therefore, the investor should protect itself through ongoing focus on the evolution of the exposures. Mark-to-market issues represent a tough area for synthetic CDOs.

5:15 PM – The Next Frontier of Securitization: CDOs of MBS and ABS

Last year, 23% of the ABS market went into CBOs. ABS CDOs are cheap for technical reasons rather than fundamental reasons. That means that they can be a good investment for accounts that do not need liquidity in their holdings. The experience and infrastructure of a CDO manager are important considerations in analyzing a potential CDO investment.

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The ABS CBO structure is primarily a cash flow CBO structure; cash flow on the underlying ABS supports the cash flow on the CBO. Although there are not daily mark-to-market tests, rating changes and credit losses on the underling ABS will affect the CBO's ability to meet its covenants. Compared to a high yield CBO, the manager of an ABS CBO has to manage the portfolio more frequently because of the short average lives of the underlying ABS. The manager of an ABS CBO continually is faced with having to reinvest cash flow from the underlying ABS.

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A triple-B home equity security trades at LIBOR+200, compared to a triple-B corporate, which might trade at LIBOR+70. This makes the triple-B home equity security an appealing investment for a CBO portfolio manager.

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In the case of certain ABS CBOs, a rating agency must factor in prepayments as well as defaults in order to create stress scenarios. One rating agency also tries to differentiate industry sectors. An important point of difference between ABS and high yield corporates in CBOs is the definitions of default, such as the treatment of PIK (payment-in-kind) assets.

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One insurance company is trying to broaden its investor base with a view towards increasing the level of assets under management. This is now allowed because of the removal of restrictions on the company's ability to do outside, fee-based business.

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One investor (an insurance company) prefers CBOs where the manager has more, rather than less, flexibility and CBOs where the manager has a deep bench of analytic talent. The investor also focuses on the investment process; both from a credit and monitoring perspective. A third factor is how a manager chooses that parties with which to do business; the investor has passed on certain deals because of the identity of the trustee. The investor prefers that a deal not be operating near its triggers at the time of issuance; it should have some room to maneuver. Finally, a CBO manager must know the documents for its deals.

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[18] KMV is a San Francisco-based company that engages in quantitative modeling of corporate credit default risk. Many banks subscribe to KMV's services.

Managing an ABS CBO requires having a team that possesses a wide array of abilities. The manager must know how to trade ABS in order to accumulate the underlying assets and it must know about running basic CBOs. The manager must be fully conversant with its own documents and the details of its default definitions and covenants.

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One investor (a money manager) feels that it is important for a manager to have a piece of the equity in its CBOs. This aligns the manager's interests with those of investors. On the other hand, an investor should be wary if an ABS CBO manager does not sell any of the equity. Having outside equity investors provides checks and balances, and proves that the equity is marketable.

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An insurance company that has issued a CBO retained all the equity.

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One speaker asserts that some of the best CBOs are ones where the manager did not retain any of the equity. Even in the absence of retaining any equity, a manager can still have "skin in the game" in terms of reputation and franchise value. The speaker differentiates CBOs where the manager manages for the debt from those in which the manager manages for the equity. He contends that deals in which the equity is sold compel the manager to manage for the equity rather than the debt [he implies that this is a bad thing].

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Investors in an ABS CBO should ask to see the equity pitch book for the deal. It will show the assumptions used for selling the equity. Most managers will acknowledge that if the equity returns are low or negative they will not be able to create new CBOs.

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A particular issuer does not rely on the trustee of its deals to monitor cash flows and compliance. It replicates all functions on its own systems in order to maintain full control of its deal. This will minimize the likelihood that the deal will run into the operational problems that other CBOs have experienced.

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ABS CBOs work because of the monthly discipline of testing the assets and the cash flows. The rating agencies are the parties primarily responsible for having imposed the necessary discipline.

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In connection with doing CBOs, one issuer hired two additional people to watch remittance reports and to stay ahead of the market on deteriorating credits. That issuer has managed to get out of deteriorating credits before the market realized what was happening; in one case it made 12 points on a such a trade the week before the market realized the problem with the credit.

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A rating agency has identified six sectors for purposes of the diversity analysis of ABS CBOs: consumer, CMBS, guaranteed deals, etc. The rating agency is reevaluating its approach in this area. Diversity scoring/correlation is one of the toughest issues for ABS CBOs. The issue ties into the assumed default frequencies and severities ascribed to the underlying assets.

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Diversity for its own sake is not necessarily a good thing if it impels a manager to invest outside its areas of expertise. An insurance company that invests in CBOs likes to directly examine the underlying portfolio of an ABS CBO and to very closely scrutinize any synthetic securities in which the manager invests.

An insurance company that issued an ABS CBO seeded the deal with assets from its own portfolio and structured the deal to have a rather long ramp-up period. This allows the deal to avoid the pitfalls of being squeezed in a tight market when lots of ABS CBOs are all scrambling for the same triple-B paper. Although the long ramp-up may hurt the equity return, the insurance company retains the equity and, therefore, it can manage the consequences.

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There is widespread complaining to one of the rating agencies about recovery assumptions. That rating agency uses an 85% recovery assumption for triple-A-rated securities and successively lower recovery assumptions for lower rated securities. The rating agency does not really give "credit" for a manager's abilities but it has been unwilling to rate deals from some would-be managers.

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ABS CBOs are good investment because of the strong diversification of the underlying asset types. The diversification is better than can be achieved in a traditional high yield CBO.

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The levels of stress that ABS CBOs can withstand are many times more severe than stresses that would crush similarly rated corporate credits.

Tuesday, 13-Feb-2001

8:00 AM – State of the Japanese Securitization Market: Opportunities in the Far East

The Japanese CMBS and RMBS areas have experienced very rapid growth relative to other areas. The GHLC (Japan's mortgage GSE) is one of the main driving forces behind the growth in Japanese RMBS. The growth of CMBS has been accelerated by credit tightening at the banks and the impetus to move assets off balance sheets.

The drivers for further securitization growth in 2001 will be (1)the GHLC, (2)the sluggish economy, and (3)J-REITs possibly becoming CMBS investors. On the other hand, new rules that restrict issuers from holding retained interests larger than 5% will be a countervailing force that dampens CMBS issuance. Before 1999, all mortgage lending in Japan was done on a full recourse basis. The recent shift to non-recourse lending should promote commercial lending activity in the short-run and increased CMBS activity subsequently.

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New securitization laws were passed last year to address some shortcomings in the original law.

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Nevertheless, it is still often necessary to use an offshore SPE for a securitization.

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One way around having to use an offshore SPC is to use a Japanese "trust fund" structure for bankruptcy remoteness.

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In 1998 and 1999 some CDOs were motivated by the funding needs of double-B and triple-B companies because of a tight credit environment. Following relief to the banks (from the government of Japan), the motivation behind CDOs declined in 2000. There has been steady issuance of Japanese ABS over the past year. One new asset type in 2000 was trade receivables. Formerly, trade receivable securitization in Japan had been confined to ABCP programs. In 2000, there was increased diversification of the types of originators, including more local banks.

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Japanese investors [lenders?] seem reluctant to hold credit risk exposure on consumer receivables. Only a small number of financially strong (investment grade) players are comfortable holding consumer credit risk exposure.

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Consumer finance companies in Japan offer a basic revolving credit product with similar functionality to a credit card, although there is no ability use it for purchases. A typical balance is in the range of US$4000 and the line can be accessed through ATMs. The typical borrower is of subprime credit quality and, until this year, the interest rate was 40%. During the past year, the maximum legal rate was lowered to 29%.
In a recent Japanese consumer loan securitization, the receivables started out being pooled in a master trust similar to a US credit card deal; the deal used the first master trust in Japan. The master trust issued senior and subordinated certificates and a variable funding certificate. The senior and subordinate certificates were placed in an SPC, which then issued notes.

The two goals of the structure were (1)bankruptcy remoteness and (2)avoiding administrative paperwork on the underlying loans. Achieving bankruptcy remoteness was relatively straightforward. Avoiding administrative paperwork is more complicated. Japanese law imposes restrictions and notice/filing requirements upon the transfer of ownership of the loans. The "entrustment" mechanism used in the deal is viewed as a transfer sufficient to achieve bankruptcy remoteness but not as a transfer that triggers paperwork. Thus, the entrustment is a transfer for some purposes and not for others. In addition, the deal used a "double Cayman SPC" structure as a way to address withholding tax problems that would otherwise have affected certificate cash flow before the funds reached the notes. In addition, using notes as the ultimate securities expanded the universe of potential investors in the US.

The maximum legal consumer interest rate of 29% is the highest rate that can ever be charged. In some situations, the maximum rate can be as low as 20%. The increment of interest between 20% and 29% is sometimes called "gray interest," and its enforceability is sometimes called into question. On the other hand, consumer challenges to the interest rates charged are rare and there have been no class action challenges (class action lawsuits do not exist in Japan). The actual incidence of challenges to the rates is under 0.01%. Last year, two finance companies were hit by claims from about 100 customers. This is an insignificant number is absolute terms, but it raises the threat of bad publicity for the affected companies.

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At least one of the US-based rating agencies is comfortable rating the senior securities from the consumer finance deals, in spite of uncertainty about the collectability of the gray interest. However, the issue is significant at the very highest rating levels.

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Some of the Japanese insurance companies are nearly bankrupt. Nevertheless, the rating agencies continue to maintain good ratings on their claims paying. However, the insurance companies do have sufficient liquidity to meet their current cash needs. Overall, the system seems to be lacking discipline.

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An impediment to the development of the Japanese market has been week information disclosure compared to the US. Another impediments is the occurrence of a tax recognition event when a company contributes an asset to a J-REIT.

9:20 AM – State of the CDO Market: New Trends and Issues

A difficulty now affecting some CBOs is that the equity investors are losing money while the manager is getting its full fee. This is prompting some to propose partially subordinating the management to the equity. The desire to do this is amplified by the rise of ABS CBOs which are more highly leveraged than traditional high yield CBO and which, therefore, have displayed greater volatility of equity returns. One

technique for expanding the universe of potential equity investors is to bundle the equity with a Treasury strip to great a ratable debt instrument.[19]

As a general matter, a CBO manager's interests are aligned with the interests of the equity holders to a greater degree than with the interests of the senior debt holders. On the other hand, when the equity experiences good performance, the debt should as well. But, the weak alignment of the manager's interest with the bondholders' could break down if (1)the CBO is operating right at the edge of its covenants, (2)the manager holds a substantial portion of the equity, and (3)the equity has been hit. In that case, the manager may have the incentive to take more risk in attempting to restore the value of the equity, even though doing so would put the senior bondholders at unnecessary risk.
Mezzanine tranches from CBOs are relatively illiquid. The natural purchasers of those securities are buy-and-hold investors. When investors have sought bids on their holdings of CBO mezzanine and subordinate tranches they have received disappointing price levels. When an investor seeks a bid, it may take the banker a week to model the deal and then respond. Several panelists caution the audience against buying mezzanine and subordinated tranches of CBOs unless they have the capacity to model the deals themselves.

Over the past few years, the market has come to view the role of CBO managers as more important. This is especially true in the case of market value CBOs, but also true for cash flow CBOs as well. One panelist says that she looks for CBO managers who are not simply high-yield bond managers, but who also have expertise across a wider array of financial products. A panelist from a rating agency observes that starting in 1998 investors heightened their focus on experience and infrastructure but not necessarily on the quality of a manager's experience. Now investors are starting to focus more on the quality and success of a manager's experience. Managers who have done several CBOs do not necessarily have better infrastructure than new CBO managers. The older managers may have done their first deals when the market's standards were lower.

Two panelists express concern about managers who have rapidly increased their assets under management and about those who are hedge fund managers.

Management agreements for older CBOs are very different from the ones used today. Some investors in the older CBOs have experienced frustration at not being able to remove an asset manager who is performing poorly.

The definition of "defaulted securities" varies a lot from deal to deal and it is a very important issue. In the early deals, the definition was very narrow and included only securities that were actually in default of payment. More recently, based on pressure from the rating agencies, deals have used broader definitions of "defaulted securities" to include securities with respect to which there has been a technical default.

Another tricky issue is balancing restrictions on a manager's discretion against the benefit from giving the manager broad discretion to deal with problem situations. One panelist says that the solution is to use the rating agencies as watchdogs on a manager's exercise of discretion. The panelist from a rating agency responds that the rating agencies are not well situated for being watchdogs over the managers.

Before the fall of 1998, market value CBOs had been on the rise. More recently, the growth rate of such deals has declined. One panelist attributes this to the greater ease of modeling cash flow CBOs and the greater risk that investors must accept in a market value CBO (regarding the manager's ability to liquidate the assets at the end of the deal). One panelist takes the contrary view. He asserts that a market value deal is easier to model and that both the manager and the investors know exactly what the collateral is worth every week (based on the marks to market). On the other hand, there have been two bad years a row for the high-yield bond market and this has resulted in very poor performance for the equity in market value CBOs. In fact, one market value CBO has defaulted and the equity was wiped out. Thus, recent experience has cooled investors' appetite for equity in market value CBOs, and this has suppressed issuance of new market value CBOs.

[19] In the panel discussion on regulatory issues, one of the speakers attacked the ratings of securities structured in such a manner.

10:50 AM – The Risks and Rewards of ABS Subordinate Tranches

The key to one rating agency's analysis is its cash flow model. The rating agency customizes its cash flow model to suit particular deals. The basis for rating a subordinate tranche is the multiple of expected losses that the bond can withstand without defaulting. In the case of certain asset types, the rating agency has to make assumptions about the timing of prepayments and losses. The assumptions are necessary for assessing how much benefit comes from excess spread.

In the auto sector, there are rarely (if ever) downgrades of the subordinate tranches. The rating agency considers the 1990-91 recession as a triple-B scenario.

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An investor does not use ratings as the primary driver for buying mezzanine and subordinate securities. The best way to buy such securities is through extensive on-site due diligence. Most of the problems that the investor has encountered have stemmed from management problems at the issuers rather than from fundamental problems with the securitized assets. Similarly, the investor has observed a steady relation between deals that have had problems and lousy disclosure at the inception of the deals. Warning to investors: If you do not understand what is in a pool, do not invest in the related mezzanine or subordinate securities.

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There are three instances when the risks of investing in a deal's subordinated securities outweigh the possible rewards. The first is when the business model or viability of the sponsor/servicer is so weak that it cannot reasonably be expected to survive for the life of the deal. Servicing transfers are very disruptive and cause delinquencies and losses to rise. The second situation is when the subordinate security involves a concentration of non-credit risks such as interest rate risk (or market risk). The third situation is when the issuer is allowed to change the transaction in "midstream" without the consent of the bondholders. Even if a deal provides for having a rating agency police any amendments, one panelist does not want to touch it. The panelist is not comfortable ceding discretion over amendments to the rating agencies.

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From a tax perspective, the fact that subordinate ABS are issued at a discount creates the accretion (recognition) of taxable income before the receipt of cash. In addition, many trustees are not providing sufficient information to allow investors to properly calculate the accretions for tax purposes.

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One of the investors is bearish on the economy and interprets high consumer debt levels as a clear warning sign for subprime ABS, and especially for subordinate and mezzanine tranches of subprime ABS. The investor buys ABS rated as low as triple-B but focuses primarily on staying at single-A and above. Pools that experience a transfer of servicing have tended to perform worse because they become "orphaned." A replacement servicer cannot be expected to expend more effort than can be justified by the servicing fee. There have been problems in the home equity and manufactured hosing sectors. It is hard to rally the holders of the senior tranches to exert pressure on servicers to service aggressively; the senior holders become complacent because they have so much protection from subordination.

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A tough issue in structuring any ABS is how much control to give holders of subordinate tranches over the amendment process.

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A rating agency does not want to be in the position of approving or disapproving amendments. It would rather just deal with confirming a security's rating at the time of an amendment.

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In looking at a potential investment in ABS rated below triple-B, an investor should consider at the financial strength of the issuer. An investor should seek highly rated issuers who will be likely to support their deals. A recent example of such support is the cash that Toyota supplied to shore up its auto lease deal. An investor should also look for deals that supply increasing credit enhancement over their lives. One of the investors likes deals backed by hard assets; as the rate of asset depreciation slows, the collateral coverage on the individual underlying loans gets stronger and stronger.

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Another investor prefers to invest in privately placed subordinate ABS because it can get better access to management and information.

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One rating agency looks at NIM (net interest margin) deals by stressing the underlying transactions to the target rating level and then gauging whether there would be sufficient residual cash flow to support the NIM securities. [This approach de-emphasizes the fact that the credit performance of a NIM security may be much more volatile than that of a comparably rated subordinate tranche because it of higher sensitivity to prepayments.]

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At an earlier panel, some speakers observed that a NIM deal is equivalent to an issuer selling the equity in its previously-issued ABS and this should cause investors to question the issuer's ongoing commitment to its original deals.

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There is enormous variation among triple-B-rated subordinated ABS. One investor likes to focus on the amount of enhancement directly protecting the security in question. The point that investors need to focus on is how much of a cushion they have against losses exceeding their base case [expected?] levels. Separately, the recent drop in rates may create opportunities for investing in subordinate ABS because prepayments may rise and allow investors to recover market discount more rapidly than just a short while ago.

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One investor has not experienced any actual defaults on any subordinate ABS, but it has had to handle some that have become distressed. In some cases, servicers have gone into bankruptcy. In other deals, delinquencies have recently started to rise because of consumer layoffs, but the losses that will follow from such delinquencies have not yet occurred.

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The Effect of the Real Estate Cycle on Commercial Mortgage and CMBS Spreads. David P. Jacob and Ted Hong. December 15, 2000.

The Efficient Frontier for CMBS & Commercial Mortgages Using a Risk-Return Framework. David P. Jacob and Jignesh Patel. December 15, 2000.

Special Report: ERISA Reform. Arthur Q. Frank. November 17, 2000.

Product Note- ASC 1996-D2. Joshua Phillips. November 2, 2000.

Regulatory Special Report: ERISA Reform Proposal May Buoy Subordinate ABS, MBS, & CMBS Market By Year End. Arthur Q. Frank. August29, 2000.

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The Canadian Real Estate Market, “A Time to Lend”, Patrick Corcoran. April 1997. Nomura Commercial Real Estate Quarterly.

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Understanding and Managing the Balloon Risk of Commercial Mortgages and CMBS. David P. Jacob and Peter Fastovsky. January 1997.

Prepayment Protection and Provisions for Commercial Mortgages and CMBS. David P. Jacob and Peter Fastovsky. October 1996.

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How Have Prepayment Protection Provisions and Due-On-Sale Clauses Been Enforced by the Courts? David P. Jacob and Galia Gichon. April 1996. Nomura Commercial Real Estate Quarterly.

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Value and Risk of Commercial Mortgages and CMBS: An Options Approach. David P. Jacob, Ted Hong and Laurence Lee. January 1996.

A Comparative Analysis of CMBS Conduit Deals. David P. Jacob and Galia Gichon. October 1995. Nomura Commercial Real Estate Quarterly.

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