



### What Is A Securitization?

- A security or other investment
- Payable from the issuer's assets
- Structured to avoid sponsor's bankruptcy risk
- Investors can focus solely or primarily on specific risks
- Can be credit enhanced to achieve the appropriate level of creditworthiness

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### Introduction to Securitization

- What is a Securitization?
- Benefits of Securitization**
- Overview of the ABS Market
- Structure - The Essence of Securitization
- Features and Terms of Securitization Transactions
- New Developments

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### Benefits for Consumers and Businesses

- Traditional Benefits of Securitization:
  - Lowers cost of credit
  - Makes credit more available
  - Increases the variety of credit available to meet their needs
  - Increases competition among lenders in the marketplace
  - Contributes to a healthy economy by keeping rates low, and ensuring consumer and corporate access to credit.
- Are these benefits still available today?

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**Why do Investors invest in ABS?**

- Diversification
  - Non-Correlation?
- Liquidity
- Direct Exposure to Consumers

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**Audience Question:**

**Why Do Issuers Securitize?**

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**The Issuer's Motivations**

- Get the money
- Get it cheaply
- Accounting treatment/Regulatory Capital Relief
- Other motivations
- Match funding of assets
- Demonstrate balance sheet liquidity to rating agencies
- Originate/ service more receivables, leading to economies of scale
- Obtain financing in times of financial stress
- Many securitizers find they run a better business

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## Risks of Securitization

### Originators/ Issuers

- ▶ No Skin in the Game
- ▶ Originators and Issuers Not Owner of Risk



### Investors

- ▶ Reliance on Rating Agency Analysis
- ▶ Structural Complexities / Modeling
- ▶ Lack of Transparency / Leverage

### Consumers

- ▶ Access to credit they cannot afford

### Securitization Used Improperly:

- ▶ Creates incentive to make imprudent loans
- ▶ Over leverages the financial markets

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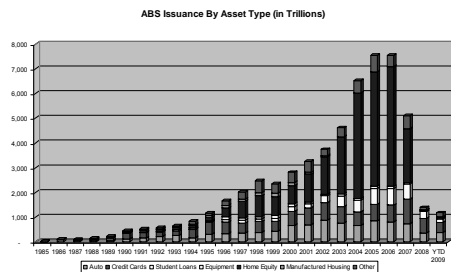
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## Growth of Securitization Market



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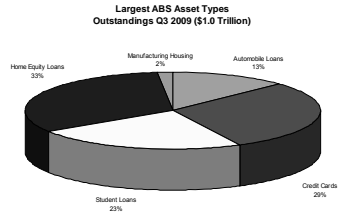
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### Outstanding ABS by Asset Type



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### Year-to-Date ABS Issuance (as of 2/18/10)

	2009 YTD (\$)	Percentage (%)	2010 YTD (\$)	Percentage (%)
Auto/Vehicle Loans	1,818.0	76.87	9,777.0	59.72
Equipment	-	0.00	289.7	1.73
Credit Cards	-	0.00	1,995.0	12.14
Student Loans	547.0	23.13	2,865.7	17.62
Other*	0.0	0.00	3,241.1	19.80
<b>Total ABS</b>	<b>2,365.0</b>	<b>100.00</b>	<b>16,372.5</b>	<b>100.00</b>

\* Source: Citigroup

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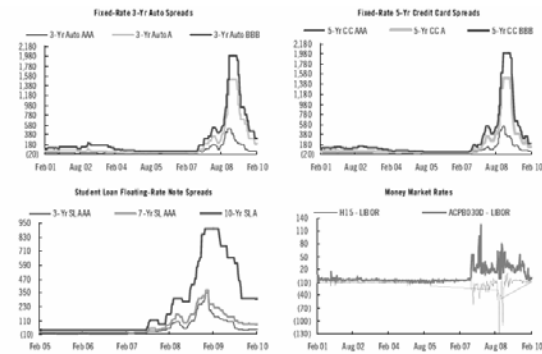
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### ABS Spreads




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## Structure – The Essence of Securitization

- Audience Question:
  
- What rating would you give:
  - \$100 million of notes secured by \$200 million of treasury securities

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## Isolation is Important Because:

- Automatic stay
- A bankruptcy court can:
  - Say that you are oversecured and reduce the receivables that secure your debt
  - Substitute different kinds of collateral (e.g., an obsolete manufacturing plant)
  - Reject leases
  - Do lots of other bad things

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**Removing Assets From Seller's Bankruptcy Estate**

- The goal: to isolate assets from the bankruptcy risk of the originator
- How? a "true sale" to a "bankruptcy remote entity"

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**If You Want a Higher Rating than the Originator, You Must Have a "True Sale" to a "Bankruptcy Remote Entity"**

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**Recourse: The Biggest True Sale Issue**

- Bankruptcy court may find sale with recourse is, in substance, a secured loan
- Biggest Issue: Recourse

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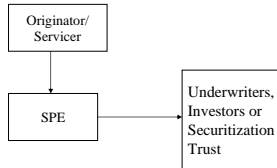
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### Typical Two-step Structure



- Step one: true sale to SPE
- Step two: either/or

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### Features / Terms of a Securitization

- Transaction Participants**
- Transaction Terms
- Servicing
- Credit Enhancement
- Designing the Securities
- Disclosure
- Process; Tips for Controlling the Process

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## Transaction Participants

- SPE / Issuing Entity
  - Limited purpose, bankruptcy remote entity
- Originator(s)
- Servicer(s)
  - Master Servicer
  - Primary Servicer
  - Back-up servicer
  - Special servicer
- Rating Agencies
- Credit enhancer
- Trustee
- Custodian
- Liquidity providers
- Investors
- Underwriters
- Lawyers
- Accountants

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## Important Transaction Terms

- Waterfall
  - Cash Going into Deal
  - Interest, fee and principal payments
  - Enhancement
- Assets Going Into Deal
- Eligibility criteria & Repurchase mechanics
- EoDs/Amortization Events/Funding Conditions/Servicer Defaults

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### Important Transaction Terms (cont.)

- Commitment; Funding mechanics for Conduit Deals
- Lockboxes (Conduits), requirements to deposit cash
- Amendments (particularly in term ABS deals)
- Hedging/Interest or Currency Swaps
- Cleanup call mechanics (typically in term ABS deals)

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### Servicing

- Audience Question:
  - What is a servicer, and why do we need a servicer?

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## Servicing

- Servicer collects payments, enforces the contracts
- Most deals are serviced by the originator/sponsor
- Servicer can be replaced upon certain events
  - Bankruptcy?

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## Servicing

- Three kinds of companies: Categories 1, 2 and 3
- Some deals have master or backup servicers
- “Hot” vs “cold” backups
- Control of cash vs commingling

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**Audience Question:**

- What are the principal risks in an ABS transaction?

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**Credit Enhancement**

- Primary risks in a typical securitization:
  - Obligor don't pay at all
  - If they pay, it's not on time
  - Payments are different from required payments on ABS
- Credit enhancement - nonpayment
- Liquidity - payment at wrong time

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**Credit Enhancement**

- Investors or rating agencies must evaluate creditworthiness of the assets
- Credit enhancement is sized for to achieve the appropriate level of creditworthiness

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### Primary Forms of Credit Enhancement

- Extra assets:
  - Overcollateralization/subordination
  - Excess spread
  - Reserve accounts
- Third party support
  - Bond insurance

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### Amount of Credit Enhancement

- Audience Question:
- What factors should cause the amount of enhancement to vary?

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### Amount of Credit Enhancement

- Depends on several factors:
  - Creditworthiness of assets
  - Creditworthiness of obligors
  - Obligor concentrations
  - Volatility of payment history
  - Trends in the business or portfolio
  - Experience of originator/servicer

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## Time Tranching

- Example: 10,000 sixty month loans @ \$100/month = \$1 million/mo.
  - Some Alternatives:
    - One \$60,000,000 security
    - Sixty \$1,000,000 securities
    - Five sequential \$12,000,000 securities
- Sequential: pay one before the next
  - Different investors buy different maturities
  - Shorter classes (< 13 mo.) can be sold to money market funds
- Prepayment risk may be greater for some securities

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## Credit Tranching

- Senior/subordinated: Sub investors have greater credit risk
- Add swaps to change fixed/floating or currency
- Like a Puzzle - Investor Demand and Pricing Determine Tranches

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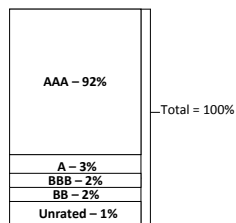
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## Credit Tranching



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### Magnifying the Leverage

- If I take 100 BB interests, how much AAA can I get?
- This is basically the concept of an ABS CDO
  
- If I then take 100 subordinated interests in CDOs, how much AAA can I get?
- This was the CDO-squared

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### Designing the Securities

- Most common: structure the securities to match the assets
  - Long term assets (e.g., HELs, autos) tend to have longer maturities
  - Short term assets (e.g., credit cards, trade receivables) tend to be revolving
  - Fixed rate assets tend to have fixed rate funding
- Mismatches create risks which require protection
  - Hedges
  - Enhancement
- Common mismatches
  - Fixed/Floating
  - Long term assets into ABCP conduits
- Tranching

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## Types of ABS Disclosure

- Transaction Parties and Terms
- Historical Losses
- Credit Scores of Obligor
- Loan level data, including:
  - LTV
  - Debt-to-income ratios
  - Payment-to-income ratios
- ABS disclosure really was not the problem
  - If investors read the prospectuses, they could see these were subprime or “no document” loans
  - Investors knew these were adjustable mortgages, and the amount that were adjusting in 2007
- If not disclosure, what was the problem?

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## **Process of Structuring and Closing a Deal**

- Collaborative Process
  - Need to accommodate issuer business objectives, investor requirements and accounting and tax constraints
- Role of Rating Agencies
  - Term ABS vs. Conduits – Prior vs. Post Review
- Structuring
- Negotiation and Drafting
- Launch and Pricing – Term ABS Deals
- Closing

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## **Tips on Controlling the Process**

- No more than three drafts of any agreement
  - Make sure everyone comments or signs off on the first draft
  - Negotiate everything before turning new drafts
- Get regulatory, tax and accounting signoff early
- If you've already done a deal, do repeats rather than entirely new structures and terms
- Prepare drafts of subsequent reports before you close
- Enforce your timeline

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- Legislative and Regulatory Developments

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## The Problem

- The market breakdown had many causes
- Securitization investors often relied entirely on ratings
- Rating agency models assumed worst case scenarios, BUT:
  - Models were based on the past data
  - Correlation not fully taken into account
- Home prices have never declined as badly in the US as 2007-08
- The past turned out not to be an adequate predictor of the future

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## Should Securitization Be Eliminated?

- Should fine wine be eliminated because of hangovers?
- Securitization is a technique
  - Allows bankruptcy-remote financing of assets
  - Allows investors to focus primarily on the risks and creditworthiness of particular assets
- BUT, investors must still focus on those assets

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## Securitization Legislation

- Financial Reform bill (H.R. 4173) passed by House on 12/11/09
- Securitization Portions Entitled "Credit Risk Retention Act of 2009"
- Senate bill currently in Senate Banking Committee and likely to vary significantly
  - Timing unclear but could be as late as May or June

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### Retention

- Requires regulations by the bank regulators and the SEC, not any substantive regulation.
- House bill applies not only to securitization but also to loan sales.
- Generally 5% risk retention
  - Appropriate agencies may create exemptions and exceptions, up or down, to this amount
- Credit risk retained “must be no less at risk for loss than the average of the credit risk so retained”
- No Hedging

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### Increased Disclosure and Reporting Requirements

- ABS no longer benefit from the exemption from Exchange Act filing requirements under Section 15(d) for securities held by fewer than 300 persons.
  - Reporting continues to apply after first year.
  - Unclear how rules will apply to issuers that have already suspended reporting
- SEC to adopt regulations requiring ABS issuers to disclose additional information

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### Representations and Warranties in ABS Offerings

- Credit rating agencies to include in reports accompanying ratings:
  - Description of representations, warranties and enforcement remedies available to investors
  - How they differ from similar offerings

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