TO: PROFESSOR WHITE, TERESA CARNELL

FROM: JOAQUIN SEQUEIRA

SUBJECT: ASSET-BACKED SECURITIES: HOW THEY WORK, ADVANTAGES TO ORIGINATORS, AND ADVANTAGES TO INVESTORS

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CC: TOM WERTHMAN, ABIGAIL BERTUMEN

The Securities and Exchange Commission defines Asset-backed Securities (ABS) as "a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases."[1] This means that ABS is a security that has underlying assets which are in the form of accounts receivable, which the debtors to the accounts receivable make regular payments on, and those regular payments are then passed through to the holders of the securities. The accounts receivable which are securitized can either be fixed or revolving which means that they can either be loans such as a mortgage or a car loan, which have a constant principal and interest payment, and a definite maturity date; or the accounts receivable can be revolving such as credit card debt which has a minimum monthly payment but has no definite date in which the entire receivable will be received because there is no maturity date. There are various reasons for why ABS have been created and why they are beneficial to both the party securitizing their accounts receivable and to investors in the securities – which will be discussed in this paper. Before being able to understand the advantages that ABS present it is important to have an understanding of how ABS works.

The securities involved in ABS look much like debt instruments – bonds – but they are then traditional bonds in that an investor in an ABS also has a sort of ownership of the trust used to create the ABS. The type of trust which is used to create ABS is a grantor trust. A grantor trust is a pass-through entity – much like a partnership – which means that the trust itself does not pay taxes – the grantor, or owner, of the trust is taxed on the income that is passed through to them. In the case of ABS the grantor is initially the issuer but then becomes the investors in the trust.

In all ABS transactions there are a common set of parties which make the transaction work: group of borrowers, an originator, an issuer, a servicer, trustee, rating agency and an investor.

An ABS transaction begins with a group of borrowers and an originator. An originator extends credit or makes loans to various borrowers or borrowing entities. The borrower then owes money to the originator. The originator then has on their balance sheet converted cash assets to accounts receivable assets. Having assets is a good thing for the originator but the accounts receivable which are on their balance sheet are not liquid – meaning they can not be readily converted to cash – so the originator is limited in its ability to create new business with these assets. All that the originator can do with these accounts receivable – other then collect their regular payments – is sell them to another party. So that is the next step in securitizing – the originator sells their accounts receivable to an issuer.

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[1] 17 CFR § 229.1101

The issuer is a Single Purpose Entity (SPE), which is only engaged in the business of buying and selling these assets. The SPE is usually a subsidiary of the originator and is created to make the appearance of a true sale of the assets instead of just the securitizing of a loan. This true sale is done to protect the assets from creditors of the originator. Once the SPE owns the assets the SPE along with the trustee and servicer create a grantor trust in which the SPE retains ownership of the trust via certificates and the servicer and trustee agree to perform specific functions for the trust. These certificates evidencing a beneficial ownership are later sold to investors. When the certificates are created they sometimes do not yield all of the interest which is paid by the borrowers – in which case the issuer may retain the spread between what is actually paid to the certificate holders and what is actually paid by the borrowers.

Once a pool of assets are defined and designated to be securitized – the issuer works with the rating agencies to rate and structure the security. The rating agencies look at the pool of assets and run various tests and scenarios on the assets to establish initial ratings for the certificates. The ratings establish a priority of payments to the certificate holders and let the certificate holders / possible investors know how much credit support they each have. The ratings go from AAA, AA, A all the way down to an unrated first loss position. A possible investor in a AAA rated certificate knows that they will have the credit support of the AA, A, and all other certificates beneath them before they will experience a loss. For example if an ABS transaction has a total underlying pool of assets worth $10 million and the AAA certificate (the highest rated certificate) is worth $1 million – there would have to be $9 million in losses on the ABS transaction prior to the AAA certificate holder realizes a loss on their investment. Once the ABS structure is completed the rating agencies continually re-evaluate the ABS transaction to evaluate their ratings of each class of certificates in the ABS transaction to possibly change them. If ratings are changed after the transaction is running it is mainly for the purposes of letting current investors and possible future investors how secure the rating agencies believe the certificates are.

Investors in ABS, invest in ABS for various reasons. The advantages are discussed later in the paper. These investors can be banks, Real Estate Investment Trusts, or anyone who wants to invest in fixed income securities. When making an investment in an ABS an investor has various choices to make regarding their investment. The type of certificate, which an investor chooses to invest in, will also depend on how much of a return they want, amount of risk, and their level of involvement. An investor in an ABS must choose their level of involvement in an ABS – the level of involvement can be compared to that of a general partner and a silent partner in a partnership agreement. In an ABS the investors with the highest rated bonds have little rights to control how defaulted loans are corrected and how other actions regarding the assets are taken. The investor who is in the first loss position has the most rights regarding actions that are taken involving the underlying assets of the trust. The higher rated bonds will also provide a lesser return then the lower rated bonds, which is due to the level of risk associated with them.

Once the trust is created and the certificates are sold to investors the servicer and trustee keep the trust working for the borrowers and investors. The servicer is sometimes the same company as the originator. The essential job of the servicer is to interact with the borrowers on a regular basis just as a bank would – to collect payments, collect financial statements from the borrower, anticipate possible defaults, etc… Once payments are collected from the borrowers the servicer remits all of the payments it receives to the trustee. If a borrower is delinquent on making a payment then the servicer will advance payments on the borrowers behalf to the trust. This is done so that the investors in the trust do not experience a payment shortfall unless absolutely necessary. The servicer also works with borrowers to fix defaulted loans and if the defaulted loan can not be correct the servicer will take whatever actions they can to recover as much money for the trust as possible.

The main role the trustee has is the holder of the assets. In ABS this means that the trustee holds all of the documents which entitles the trust to receive the accounts receivables which were created by the originator. The other responsibilities of the trustee are to distribute payments to the certificate holders, to ensure that the rules of the securitization documents are being followed, and to provide regular reports to the certificate holders.

Prior to the development of securitization the process by which banks and borrowers made and paid back loans was much simpler. A borrower would go to a local bank and apply for a loan. The local bank would evaluate whether or not it was a good idea to give a loan to the borrower. If the loan was made then the borrower would make their monthly payments to their local bank until they repaid their entire debt. This seems like a much simpler process then the process that is used to create ABS. So why would a loan originator go through the burden of creating an ABS? And why would an investor want to invest in ABS? There are advantages to both parties.

The benefits for originators in creating ABS are that they can be tax advantageous, enable companies to avoid unnecessary risk and they create new business opportunities. There are other ways to create these benefits but they are not as advantageous.

One way a loan originator can accomplish the same things which an ABS transaction accomplishes is to create a separate corporation and sell the accounts receivables to them. The way a company would do this is to create a separate corporation whose sole assets are the accounts receivables and pay regular dividends to the shareholders of the corporation. Although this option would work, it is uneconomical for all the parties involved. A corporation requires there to be bylaws, a board of directors, and executives to run the corporation – all of which can cost money for the loan originator. For the investors, the biggest reason for this not being a better alternative to the ABS transaction is that a corporation is taxed at the entity level, which means there is less cash flow to the shareholders or beneficial owners of the assets.

The greatest advantage that a business trust provides in ABS transactions is the ability to eliminate credit risk. Prior to the use of ABS the loan originator would incur all of the risk associated with extending credit to a borrower. If a borrower defaulted then the loan originator would incur the entire loss. When using the ABS structure and the loan originator sells their accounts receivable the originator eliminates the risk they took in extending credit to a borrower and the originator makes a money in the process by charging origination fees, collecting some interest on the loans before selling them, and if the originator also takes on the role of being the servicer then the originator is able to collect fees for acting as the servicer.

Prior to ABS if a company extended credit to a borrower which repaid their entire loan over 30 years – the loan originator would make money but it would take 30 years to do so and in that time the originator will have to endure various risks because of possible changes in the market, changes in the borrower's credit, and possibly the opportunity cost of not being able to make loans to other borrowers. ABS allows an originator to make loans and within a few months regain all of the money that they have leant out and repeat the process again.

An advantage that is particular to Mortgage Backed Securities is that the federal government does not tax the earnings of the trust at the trust level if it is set up as a Real Estate Mortgage Investment Conduit (REMIC).[2] This is attractive to investors because it means there is more money left for them. Some of the same tax treatment was provided for, for another type of business trust called a Financial Asset Securitization Investment Trust, but the statutes that recognized these types of trusts were repealed in 2004. The repeal of these statutes had to do with a lack of popularity because of a one time tax that was charged to the issuers at the time of securitization and because it was a type business trust that was being abused and the abuse was highlighted when Enron collapsed.[3]

If an LLC or LLP were used taxes would not be an issue but it would make the creditor become a party to many companies' for each pool of assets it wants to sell to other investors, which may be burdensome. For a company that does business by extending credit it seems a simpler process to sell its accounts receivable to a business trust then it is to negotiate a contractual relationship with many different investors.

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[2] 26 USCS 860A
[3] 108 P.L. 357, see also 26 USCS 860H

ABS transactions allow for companies to create new business by replenishing the originators capital to allow them to make more loans with and allow the originators to continue its relationships with borrowers by allowing the originators to continue as a servicer to the trust. Although the originators are not making as much money off of the interest they would traditionally receive absent the ABS structure, the originators still make money off of various fees which allow the company to grow. These fees can be in the form of origination fees or servicing fees. The origination fees are fees that are paid for by the borrower at the time the loan is made. The servicing fees are paid by the trust to the servicer for the servicers services.

While the greatest advantage that ABS has for loan originators is that it decreases their exposure to risk and provides them a faster return on their investments. The advantages to investors of ABS is that an investor can choose how to protect themselves from some risks, it provides a less risky investment for bond investors, it creates the same opportunity for investors that originators have in making risk-free money at a rate much higher then the risk-free rate associated with government securities, it creates all of the same opportunities for an investor that an originator enjoys, and the investor can enjoy favorable tax treatment. The examples used below refer mostly to Mortgage Backed Securities but the same principals can be applied to any type of ABS.

The way ABS are structured is in a hierarchy in which the ABS is divided into different rated bonds with the higher rated bonds being more insulated from losses then the lower rated bonds. An investor is able to choose the level of risk they participate in by choosing which ratings of bonds they invest in. The higher rated bonds provide a higher credit support (the amount of losses which would have to occur before they experience a loss) and the lower rated bonds have a lower amount of credit support. An investor who buys the lowest rated bonds is the investor in the "first loss position" because they have no credit support. In order to protect their investment the first loss position holder is able to appoint a representative to evaluate different strategies to be taken on defaulted loans or act on their own when loans default. So whether an investor chooses to take high risks in their ABS investments or low risks – they can choose to protect their investments either by buying bonds with credit support or by appointing a knowledgeable person or company to advise the servicer on which actions to take regarding defaulted loans.

Another reason for ABS being a favorable investment vehicle is because an investor shelters themselves from the credit risk associated with investing in the credit of a single company or single type of borrower. When investing in traditional corporate bonds, an investor has a claim only to that one corporation which they have invested in. If the corporation goes bankrupt or is unable to meet its obligations then the investor will likely take a loss on their investment. The risk of investing in a single corporation's bonds is equivalent to investing in one type of borrower – whether it is a group of borrowers in a single part of the country which exposes the investor to risks of natural disasters like Hurricane Katrina, borrowers in a single type of industry which exposes an investor to the risks such as the decline in the hospitality industry after the 9/11 terrorist attacks. A pool of ABS normally represents many different borrowers with different credit ratings and many different types of borrowers which can represent different types of risks. By diversifying all the types of risks associated with a particular pool of assets the party securitizing the pool of assets makes it less likely that an investor will experience a large loss because it is less likely for all of the risk factors for the entire pool of assets to go bad at once.

All of the advantages that are enjoyed by the originators can also be enjoyed by the investors. A loan originator is essentially an investor who invests in the credit of borrowers. An investor in an ABS transaction is essentially making a loan to the trust with the hopes of being repaid in full at the maturity of their bonds. One differnce is that a loan originator is unable to make their loans at a discount the way a bond purchaser is able to purchase a bond at a discount. An investor who purchases only low grade certificates will always buy their bonds at a discounted rate because of the increased risk associated with them. This discount means that if none of their certificates experience a loss they will make a large gain and if the investor wishes to securitize their investments into a new ABS – essentially making risk-free money at a rate higher then the risk-free rate.

Bankruptcy remoteness is another reason that ABS is favorable to investors. Prior to ABS one of the ways a loan originator could fund new business is by creating their own bonds backed by their own credit. The problem that this presents is that an investor in that company might have to compete with creditors of the invested in company if that company ever went bankrupt. In an ABS situation the originator no longer owns the assets of the trust because the originator makes a true sale to the issuer and the issuer places the assets in a trust – making the trust the owners of the assets. And since the investors own the trust there is no party – other then the investors – who have a claim to the assets of the trust. So even if the originator files bankruptcy – it will have no effect on the trust or the investors.

Making risk-free money is possible due to the diverse pool of assets and the way bonds are sold. An investor who purchases lower grades of bonds is exposed to a higher risk of default because they are in the "first loss position" – meaning they will be the first to realize a loss. In order to offset this risk the trusts sell the lower grades of bonds at a discount. For example, if an investor invests $500,000 into 50 low grade bonds which have a cumulative face value of $1,000,000 – then that investor could re-securitize their investments making a new ABS backed by their previous investments in other ABS. When re-securitizing their previous investments the original investor will be able to sell the new series of bonds for a minimum of $500,000 and could structure the new ABS in such a way that they will recover their original investment and retain the lowest grade of bonds in the new ABS. This can be done because the original investors are securitizing a diversified pool of assets which are each backed by another set of diversified assets – so even if all the original investments are first loss investments – the re-securitized ABS has become so diverse that the likelihood for all the risk factors for the entire pool of assets becomes even less.

Taxes are always a motivating factor when doing business – whether it is an originator trying to structure an ABS or an investor looking to make an investment. ABS are pass-through entities just like a partnership or an LLC is. This means that the originator will have an easier time to attract investors and investors will be more likely to invest in an ABS then corporate stocks. This is because a pass through entity has no entity level taxes.[4] No entity level taxes means that there is more cash flow for the investors.

An investor, which invests solely in Real Estate Mortgage Investment Conduits (a type of ABS), can take advantage of more favorable tax treatment if the investor creates a company that is structured as a Real Estate Investment Trust (REIT). A REIT is another type a business entity that invests in real estate and is given favorable tax treatment if it distributes 90% of its profits as dividends on a regular basis.[5] A Mortgage REIT is a REIT that invests in real estate indirectly through mortgages. This favorable tax treatment is not only good for the Mortgage REIT – because it pays less in taxes then a normal corporation would – but also for the stockholders of the Mortgage REIT because they can expect regular dividends to be paid and since the REIT does not pay as much in taxes as a normal corporation does, the stockholders receive a larger portion of the pre-tax earnings of the REIT.

Prior to the use of ABS many of the advantages which are discussed in this paper were not realizable. Some of them could have been achieved by other means but the ABS structure has proved a favored financing technique and has become a huge industry for investors with over $6 trillion in tradable securities.[6]

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[4] The Universal Language of Cross Border Finance, Steven L. Schwarz, 8 Duke J. of Comp. & Int'l L. 235.
[5] 26 USCS 857
[6] An Overview of Credit Card Asset Backed Securities, Mark Furletti, www.phil.frb.org/pcc/workshops/workshop11.pdf (December 2002).