



ASSET-BACKED SECURITIES

*Investing for
attractive yield and
high credit quality.*



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WHAT ARE ASSET-BACKED SECURITIES?

Asset-backed securities, called ABS, are bonds or notes backed by financial assets. Typically these assets consist of receivables other than mortgage loans,¹ such as credit card receivables, auto loans, manufactured-housing contracts and home-equity loans. ABS differ from most other kinds of bonds in that their creditworthiness (which is at the triple-A level for more than 90% of outstanding issues) derives from sources other than the paying ability of the originator of the underlying assets.

Financial institutions that originate loans—including banks, credit card providers, auto finance companies and consumer finance companies—turn their loans into marketable securities through a process known as securitization. The loan originators are commonly referred to as the issuers of ABS, but in fact they are the sponsors, not the direct issuers, of these securities.

These financial institutions sell pools of loans to a special-purpose vehicle (SPV), whose sole function is to buy such assets in order to securitize them.² The SPV, which is usually a corporation, then sells them to a trust. The trust repackages the loans as interest-bearing securities and actually issues them. The “true sale” of the loans by the sponsor to the SPV provides “bankruptcy remoteness,” insulating the trust from the sponsor. The securities, which are sold to investors by the investment banks that underwrite them, are “credit-

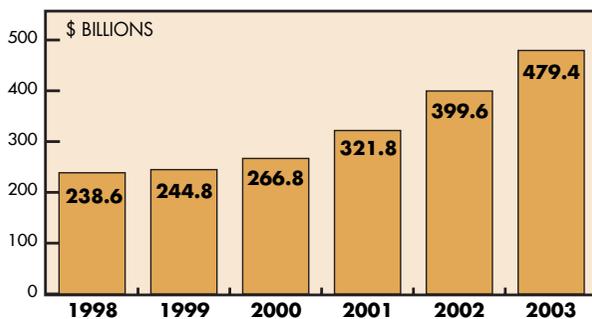
¹Securities backed by first mortgages, although the most common ABS, are considered a separate investment category and are therefore not included in this guide. They are discussed in detail in *The Bond Market Association's Investor's Guide to Mortgage Securities*.

²Certain types of financial institutions, such as banks, may sell their loans directly to a trust that issues ABS, since the intermediate sale to an SPV is not needed to achieve bankruptcy remoteness. (See “Special-Purpose Vehicle and the Rating,” on page 10.)

enhanced” with one or more forms of extra protection—whether internal, external or both. (See “Credit Enhancement,” on page 11.)

ABS constitute a relatively new but fast-growing segment of the debt market. The first ABS were issued in 1985; in that year, the market for publicly offered ABS issues was \$1.2 billion. In 2003, issuance totaled a new record of \$479.4 billion. This booklet primarily addresses publicly issued ABS, although the growing private-issue ABS market is briefly mentioned. It is estimated that a total of over \$2.6 trillion of ABS were issued from 1985 through 2003.

ISSUANCE OF PUBLIC ASSET-BACKED SECURITIES 1998-2003



Source: Thomson Financial Securities Data

BENEFITS OF INVESTING IN ABS

Investors buy ABS for a variety of reasons:

Attractive yields. Among triple-A rated assets, ABS offer higher yields than comparable-maturity U.S. Treasury securities and yields that are similar to corporate bonds and mortgage-backed securities (MBS) of comparable maturity and credit quality.



High credit quality. ABS are one of the most secure investment vehicles from a credit standpoint. Like other debt instruments, they are evaluated and assigned a rating based on their ability to pay interest and principal as scheduled. But unlike most corporate bonds, ABS are secured by collateral and credit-enhanced with internal structural features and/or external protections to further ensure that obligations are met. Most ABS receive the highest rating—triple-A—from the major credit rating agencies.

Diversity and Investment Diversification.

The ABS market is highly diverse in terms of structures, yields, maturities and collateral. The assets that back securities represent many sectors of business activity, from credit card receivables to auto, boat and recreational vehicle loans, and from equipment leases to home-equity and bank loans. In addition, the ABS sector offers investors the ability to diversify their fixed-income portfolios away from more traditional concentrations in government, money market and corporate debt securities.

Predictable cash flow. The certainty and predictability of cash flow for many types and classes of ABS are well established. Investors can buy these securities with considerable confidence that the timing of payments will occur as expected. (However, for some of the more recent mortgage-like ABS that are subject to greater prepayment uncertainty, investors should understand that the predictability of cash flow is less precise. This higher degree of uncertainty is normally reflected in a higher yield.)

Reduced event risk. Because ABS are secured by underlying assets, they offer significant protection against event-risk downgrades, particularly in contrast



to corporate bonds. A major concern investors have about unsecured corporate bonds, no matter how highly rated, is that the rating agencies will downgrade them because of some disruptive event affecting the issuer. Such events include mergers, takeovers, restructurings and recapitalizations, which are often undertaken by corporate managers trying to boost shareholder value.

TYPES OF ASSETS THAT BACK SECURITIES

Theoretically, any asset that has a revenue stream can be transformed into a marketable debt security. In practical terms, the vast majority of ABS are collateralized by loans and other financial assets.

The first four asset types listed below—home-equity loans, auto loans, credit cards and student loans—together constitute the largest segment of the ABS market. Historically, they have been securitized for the longest period and together account for over 80% of total public nonmortgage ABS issuance to date.

There are various ways to classify securitized assets, but perhaps the key distinction for investors is whether the assets are amortizing or nonamortizing, because this affects the cash flows investors receive. An **amortizing loan** is one that must be paid off over a specified period with regular payments of both principal and interest. A **nonamortizing**, or revolving, loan does not require principal payments on a schedule, so long as interest is paid regularly. Revolving credit card accounts are perhaps the leading example of nonamortizing loans.

Home-Equity Loans

These loans now constitute the largest sector of the ABS market. Forty-four percent of the ABS issued in 2003 were backed by closed-end home-equity loans (HELs) and open-end loans, which are also called home-equity lines of credit (HELOCs). Both types of loans enable homeowners to borrow against the non-mortgaged value of their homes, and often use these loans to consolidate all their debt into one monthly payment. The interest on HELs is generally tax deductible.

A closed-end loan may be a second mortgage on a property or, increasingly, a first mortgage. HELs have a fixed term, typically from 10 to 30 years. Generally, borrowers who take out HELs as their first mortgage are known as B or C borrowers; they are people with impaired credit. As mortgages, HELs are amortizing assets.

HELOCs, in contrast, provide a revolving credit line against which homeowners may borrow as they wish for a number of years. They are similar to credit card receivables and are generally considered nonamortizing assets (although some are partially amortizing because they require small, regular principal payments).

Auto Loans

The second largest, and the oldest, asset class in the ABS market is auto loans (16.1% of issuance in the first half of 2003). Most auto ABS are supported by prime loans—those made to borrowers with very strong credit histories. But some auto ABS are collateralized by loans to subprime (also called B, C and D) borrowers. Loans to individual car buyers are amortizing assets.

Credit Cards

Securities collateralized by credit card receivables are one of the oldest segments of the ABS market, representing 14.3% of ABS issuance in 2003. Holders of credit cards may borrow funds, generally on an unsecured basis up to an assigned limit, and pay the principal and interest as they wish, as long as they make a small required minimum payment on a regular basis—generally once a month. Consumers may also borrow more money while paying off the old debt, if they do not exceed the credit limit. Because cardholders do not have to pay off the principal on a schedule, credit card debt has no actual maturity and is therefore a classic example of a nonamortizing loan.

Student Loans

Student loan ABS represented 8.1% of ABS issuance in 2003. As a group, student borrowers have relatively high default rates, but this reality is largely neutralized by government guarantee programs that cover most student loans. However, a small but growing number of student loans do not benefit from government guarantee programs; lenders therefore bear the risk on such loans directly. Student loans are amortizing assets; that is, they must be paid off according to a predetermined schedule.

Equipment Leases

Another comparatively small portion of the ABS market (1.5% of issuance in 2003) is represented by securitizations of leases for computers, telephone systems and other kinds of business equipment. Leases take two forms—closed end and open end, the difference being how the equipment (or its “residual value”) is paid for at the end of the lease. Both types of leases are amortizing assets. Equipment lessees are usually corporations, rather than individuals, and have good credit profiles.



Other Assets

There are several other emerging asset classes, including auto leases, small-business loans, short-term auto dealer inventory loans (or dealer floor-plan loans) and trade receivables (particularly hospital receivables). Beyond these are some even more embryonic asset classes. One new class that has made news is royalties payable to rock stars from a specified pool of their works.

Collateralized bond obligations (CBOs) and collateralized loan obligations (CLOs) are a fast growing new sector of the private asset-backed securities market. “CBO” or “CLO” generally refers to a debt obligation whose underlying collateral and source of payment consists of existing bank loans, emerging-market, high-yield or other forms of debt obligations.

Issuers and investment banks will continue to search for—and find—new types of assets to securitize to meet the growing investor demand for ABS.

INTEREST RATES AND YIELDS ON ABS

Yield. As with any fixed-income securities, the yield on ABS depends on the purchase price in relation to the interest rate (which may be fixed or floating) and the length of time the principal is outstanding. But with ABS (as with MBS), prepayment assumptions must be taken into account in determining the likely yield of a given issue. The more realistic the prepayment projections, the more accurate the yield estimates.



New issues of ABS carry higher estimated yields than U.S. Treasury securities and many corporate bonds of comparable maturity and credit quality. A key reason is that investors demand a higher interest rate to compensate for prepayment risk and resulting uncertainty in the average life of an ABS.

Once securities are trading in the secondary market, the spreads between ABS and Treasuries or comparable corporate bonds may widen or narrow depending on market conditions, including the direction of interest rates in the economy, the number of issues coming to market and factors specific to each type of ABS. For example, a rising level of personal bankruptcies may cause the perception of risk in credit card ABS to increase, requiring higher yields to entice investors.

Average Life. Also called the weighted average life, this is the time-weighted average maturity of a stream of principal cash flows. As noted above, it is the usual time dimension cited in the selling and trading of amortizing ABS. Average life can readily be estimated for a security that pays principal in a single payment. For an amortizing structure, the average life varies, depending on the prepayment assumptions. Based on the structure of a particular ABS and the type of underlying collateral used, ABS “tranches”—separate classes of securities—may be created with average lives that correspond to the maturity and duration requirements of a broad range of investors—from short-term money market tranches to long-term assets.

Total Return. This is the overall return on an investment, usually calculated on a one-year basis, when all interest, principal payments, reinvestment income and any capital gains or losses are factored in.

CREDIT QUALITY AND CREDIT ENHANCEMENT



CREDIT RATINGS

ABS are generally rated by one or more of the following rating agencies: Standard & Poor’s Rating Services, Moody’s Investors Service and Fitch Ratings. These agencies determine the amount of credit enhancement required to produce a credit quality comparable to that of a same-rated corporate bond. The vast majority of ABS are issued in one of the top two generic credit rating categories, either triple-A or double-A.

The agencies’ determination of the required credit enhancement is based on the characteristics of the collateral and its performance under severe stress—specifically, under hypothetical “depression” scenarios. Beyond the overall credit risks of the asset pool, the agencies look at risks specific to ABS. For example, they make sure the payment rate on the underlying loans is fast enough to make either controlled amortization payments as scheduled or a “bullet” payment. (See “How Are ABS Structured?” on page 13)

Special-Purpose Vehicle and the Rating. Use of an SPV is critical to the creation of ABS, because the SPV stands between the sponsor of the underlying loans and the issuer (the trust) of the securities. The key structural feature of an SPV, which enables it to insulate the trust from the sponsor, is bankruptcy remoteness. This is normally achieved by a “true sale” of the loans to the SPV by the sponsor. This means that the sponsor no longer has ownership rights to the loans, such that a trustee in bankruptcy of the sponsor would be unable to recover the loans or their proceeds. As a result, the ABS-issuing trust’s ability to pay inter-

est and principal should remain intact even if the sponsor were to fail.

Bankruptcy remoteness, along with certain other aspects of the SPV's and trust's structures and the extra support provided by credit enhancement, enable the ABS to receive their own credit rating, independent of that of their sponsor. This is important for investors, because the sponsor may well have a lower credit rating than the triple-A carried by most ABS.

CREDIT ENHANCEMENT

A distinctive feature of ABS is that they are credit-enhanced, unlike conventional corporate bonds, which are usually unsecured. Credit enhancement occurs when a security's credit quality is raised above that of the sponsor's unsecured debt or that of the underlying asset pool. A variety of internal and/or external credit supports are employed to increase the likelihood that investors will receive the cash flows to which they are entitled.

INTERNAL CREDIT ENHANCEMENT

Subordination: A popular type of internal credit support is the senior/subordinated (or A/B) structure, which is technically a form of "overcollateralization." It is characterized by a senior (or A) class of securities and one or more subordinated (B, C, etc.) classes that function as the protective layers for the A tranche. If a loan in the pool defaults, any loss thus incurred is absorbed by the subordinated securities. The A tranche is unaffected unless losses exceed the amount of the subordinated tranches.

The senior securities are the portion of the ABS issue that is typically rated triple-A, while the lower-quality (but presumably higher-yielding) subordinated classes receive a lower rating or are unrated.

Overcollateralization: In this case, the face amount of the loan portfolio is larger than the security it backs.

Yield Spread (Excess Servicing): Excess servicing, which is the first defense against losses, comprises the difference between the coupon on the underlying collateral and the security coupon.

Turboing: In this case, excess servicing is applied to outstanding classes as principal.

Excess Spread is the net amount of interest payments from the underlying assets after bondholders and expenses have been paid. The monthly excess spread is used to cover current-period losses and may be paid into a reserve fund to increase credit enhancement.

A **Reserve Fund** is created to reimburse the trust for losses up to the amount of the reserve. It is often used in combination with other types of enhancement.

EXTERNAL CREDIT ENHANCEMENT

In addition to internal credit supports, some ABS use external credit enhancement from a third party.

Surety Bonds: A surety bond is an insurance policy provided by a rated and regulated insurance company to reimburse the ABS for any losses incurred. Often the insurer provides its guarantees only to securities already of at least investment-grade quality (that is, BBB/Baa or equivalent). Usually this requires one or more levels of credit enhancement that will cover losses before the insurance policy. An insured ABS is rated equal to the claims-paying rating of the insurance company, typically triple-A, because the insurance company guarantees the timely payment of principal and interest on the security.

Third-Party or Parental Guarantees: A third party—e.g., a rated and regulated insurer, or the parent company of the seller/servicer—promises to reimburse a trust for losses up to a stated maximum dollar amount. They can also agree to advance principal and interest as necessary and buy back defaulted loans.

With a **Letter of Credit (LOC)**, a financial institution, typically a bank, is paid a fee to stand by with cash to reimburse the trust for any losses actually incurred, up to the required credit-enhancement amount.

These first three forms of external credit enhancement expose the investor to “third-party risk,” where the ABS rating will be dependent on the creditworthiness of the institution providing the enhancement. If the institution is downgraded, then the ABS may also be downgraded.

Cash Collateral Account (CCA): In this case, the issuer borrows the required credit-enhancement amount, usually from a commercial bank, and then invests that amount in the highest-rated short-term (one-month) commercial paper. Since this is an actual deposit of cash—unlike an LOC, which represents a pledge of cash—a downgrade of the CCA provider would not result in a downgrade of the transaction.

Collateral Invested Amount (CIA) is similar to a subordinated tranche and either purchased on a negotiated basis by a single third-party credit enhancer or securitized as 144A private placement and sold to several investors.

HOW ARE ABS STRUCTURED?

Fully Amortizing

Securities that return principal to investors throughout the life of the security are said to be fully amortizing. They are designed to closely reflect the full repayment of the underlying loans through scheduled interest and principal payments. They are typically backed by HELs, auto loans, manufactured-housing contracts and other fully amortizing assets.

Prepayment risk is a key consideration with such ABS, although the rate of prepayment may vary considerably by the type of underlying asset.

Controlled Amortization

Revolving debt (primarily credit card receivables, but also HELOCs, trade receivables, dealer floor-plan loans and some leases) may be securitized using a controlled amortization structure. This is a method of providing investors with a relatively predictable repayment schedule, even though the underlying assets are nonamortizing. Controlled-amortization ABS resemble corporate bonds with a sinking fund. After a predetermined “revolving” period during which only interest payments are made, these securities attempt to return principal to investors in a series of defined periodic payments that usually occur over less than a year. A risk inherent in this kind of ABS is an early amortization event. (See “Early-Amortization Risk,” on page 20.)

Soft/Hard Bullet

“Bullet” structures, which are also used with revolving assets, are designed to return principal to investors in a single payment. These ABS also feature two separate cash-flow management periods: the revolving period,

during which any principal repaid is used to buy more receivables, and the accumulation period (analogous to the amortization period in a controlled-amortization structure), during which principal payments build up in an escrow account to fund the bullet payment to investors.

The most common bullet structure is the soft bullet, so labeled because the bullet payment is not guaranteed on the expected maturity date (although most such ABS *do* pay off on time). The potential for a shortfall exists during the accumulation period, in which case investors may receive the remaining principal payments over an additional period (usually one to three years) until what is known as the final maturity date.

In contrast, a hard-bullet structure ensures that the principal is paid on the expected maturity date and does this with a longer accumulation period, a third-party guarantee or both. In a hard bullet, rating agencies evaluate the timeliness of principal payments. Hard bullets are rare, because investors are comfortable with soft bullets and are unwilling to pay extra (in the form of a lower yield) for a guarantee. As with controlled-amortization structures, soft- or hard-bullet structures are also subject to early amortization risk.

Floaters

In recent years, a growing number of issues—backed both by amortizing assets (notably auto loans) and non-amortizing assets (credit cards)—have had a floating, rather than a fixed, interest rate. The rate adjusts periodically according to a designated index (such as LIBOR or, in some cases, U.S. Treasury bills) plus a fixed margin.

When the underlying collateral is itself made up of floating-rate loans—such as credit card debt indexed to

the prime rate—a floating-rate coupon on the ABS can help avoid a cash-flow mismatch between the borrowers and the investors. When the collateral consists of fixed-rate loans, a cash-flow mismatch is inevitable. Therefore, the issuing trust often arranges with a counterparty for an interest rate swap or with an outside provider for a rate cap to offset the resulting basis risk to investors.

Sequential Pay

Frequently, ABS are issued as sequential-pay securities. This means that the first tranche (the one with the shortest average life) receives all available principal payments until it is retired; only then does the second tranche begin to receive principal; and so on. (The alternative structure is pro rata pay, under which all tranches receive their proportionate shares of principal payments during the life of the securities. A combination of these is also very common: sequential deals that switch to pro rata at a certain date or pro rata deals that switch to sequential upon credit-related events.)

As stated above, one of the main ways ABS are credit-enhanced is with a senior/subordinated structure, in which a senior class of securities is supported by one or more tranches of subordinated securities. The order in which investors in the subordinated ABS are paid is determined by the payment rights and priorities that are established when the junior classes are issued.

PREPAYMENT MODELS

Investors in ABS are typically concerned about the likelihood and extent of prepayment. That is, they worry about receiving all or part of the principal of the underlying debt before it is due (in the case of amortizing

assets) or before it is expected (in the case of nonamortizing assets). Determining the most likely prepayment scenario is critical to making an investment decision with a reasonable expectation about a security's life—which, in turn, affects the likely yield.

What follows are explanations of the key prepayment conventions used by the ABS market. Investors should bear in mind that prepayment models do not predict actual prepayment behavior, but instead provide a common methodology for expressing prepayment activity. Moreover, since the ABS market has existed only since the mid-1980s, prepayment models, which are based on historical performance, are likely to evolve further.

Constant Prepayment Rate (CPR)

Also known as conditional prepayment rate, the CPR measures prepayments as a percentage of the *current outstanding loan balance*. It is always expressed as a compound annual rate—a 10% CPR means that 10% of the pool's current loan balance pool is likely to prepay over the next year. The CPR is commonly used to describe the prepayment experience of HELs and student-loan assets.

Monthly Payment Rate (MPR)

Technically, this is not a prepayment measure, because it is used with nonamortizing assets, such as credit card and dealer floor-plan receivables, which are not subject to prepayment. Rather, the MPR is a *repayment* measure and is calculated by dividing the sum of the interest and principal payments received in a month by the outstanding balance. The rating agencies require every nonamortizing ABS issue to establish a minimum MPR as an early-amortization trigger event; if repayments drop to that level, the security enters into early amortization. (See “Early-Amortization Risk,” on page 20.)

Absolute Prepayment Speed (ABS)

This abbreviation (which, confusingly, is the same as that used for asset-backed securities) is commonly applied to securities backed by auto loans, truck loans, RV loans and auto leases. Unlike CPR, which measures prepayments as a percentage of the *current outstanding loan balance*, the ABS calculates them as a monthly percentage of the *original loan balance*.

Home-Equity Prepayment Curve (HEP)

The HEP curve is a prepayment scale (ranging from 0% to 100%) for HELs that captures the more rapid plateau for home-equity prepayments vis-à-vis that of traditional mortgages. It is a 10-month seasoning ramp with even step-ups, terminating at the final HEP percentage in the 10th month. The standard HEP is 20%; it equals 2% CPR in the first month, 4% in the second month, 6% in the third month and so on until it levels off at 20% CPR in the 10th month.

Prospectus Prepayment Curve (PPC)

Sometimes called the pricing prepayment curve, the PPC is a relatively new convention, used mainly with HELs. It refers to the pricing speed of a transaction as defined in the prospectus and is always issue-specific. Issues are normally priced at 100% PPC, but comparisons among deals can be difficult because PPC may be defined differently in each security's prospectus.

Manufactured-Housing Prepayment Curve (MHP)

A prepayment scale with a 24-month seasoning ramp, MHP is often used in the manufactured-housing sector. Thus, 100% MHP equals a starting rate of 3.7% CPR in the first month, stepping up 0.1% per month until the 24th month, after which it remains constant at 6% CPR. Most securities have recently been priced at 150% to 200% MHP (that is, 5.6% CPR in the first month, rising to 9% CPR in the 24th month).

ASSET-BACKED VERSUS OTHER FIXED-INCOME SECURITIES

Amortizing ABS, like mortgage-backed securities, are generally sold and traded according to their “average life” rather than their stated maturity dates, as with corporate and government bonds. Average life, as described under “Interest Rates and Yields on ABS” (page 8), is the average length of time that each principal dollar in a pool is expected to be outstanding

Although ABS are less familiar to some investors, the cash-flow characteristics of these securities often mirror those of MBS—which is not surprising: Mortgages were the first assets to be securitized, and they have become very familiar to investors. Less commonly, ABS may have cash flows that resemble those of corporate bonds.

MARKET RISKS

Interest Rate Risk

As with all fixed-income securities, the prices of ABS fluctuate in response to changing interest rates in the general economy. When interest rates fall, prices rise, and vice versa. Prices of ABS with floating rates are, of course, much less affected, because the index against which the ABS rate adjusts reflects external interest-rate changes.

Some ABS are subject to another type of interest rate risk—the risk that a change in rates may influence the pace of prepayments of the underlying loans, which, in turn, affects yields. As a general rule, nonmortgage consumer assets, including credit card receivables,

auto loans, student loans and so on, are not highly sensitive to fluctuations in interest rates. Thus, ABS backed by such assets are not usually subject to prepayment acceleration due to declines in interest rates.

However, mortgagelike assets do face some interest-rate-based risk of prepayment. Fixed-rate HELs (most of which are first mortgages) are the most interest-rate-sensitive type of collateral for ABS. Such borrowers are more likely to refinance when prevailing interest rates fall than are, for example, floating-rate HEL borrowers, HELOC borrowers (whose lines of credit usually have adjustable interest rates) or even manufactured-housing borrowers. Manufactured-housing contracts, which are used to finance the purchase of manufactured houses, also exhibit prepayment sensitivity in response to changes in interest rates, despite the fact that the average balance of such contracts (usually \$30,000 to \$35,000) is much less than that of typical mortgage loans.

Early-Amortization Risk

Most revolving ABS are subject to early-amortization events—also known as payout events or early calls. A variety of developments, such as the following, may cause an early-amortization event: insufficient payments by the underlying borrowers; insufficient excess spread; a rise in the default rate on the underlying loans above a specified level; a drop in available credit enhancements below a specified level; and bankruptcy on the part of the sponsor or the servicer.

When an early-amortization event is triggered, the revolving period is terminated, as is the controlled-amortization period or the accumulation period, if applicable. Under early amortization, all principal and interest payments on the underlying assets are used to pay the investors, typically on a monthly basis, regard-

less of the expected schedule for return of principal. Once early amortization has been triggered, it cannot be rescinded or reversed. The accelerated repayment serves as a further protection for investors and, indeed, is required by the rating agencies.

Default Risk

The risk of default is most often thought of as a borrower's failure to make timely interest and principal payments when due, but default may result from a borrower's failure to meet other obligations as well. One such obligation critical in the ABS market is the maintenance of collateral as specified in the prospectus.

As discussed above under "Credit Ratings" (page 9), an investor's most reliable indicator of the likelihood of a security's default is its credit rating. Because of the credit enhancements required for ABS by the rating agencies, the senior classes of most issues receive a triple-A, the highest rating available. The likelihood of failure to receive principal and interest payments for such securities is remote. The ABS sector has, in fact, performed remarkably well from a credit perspective.

The B, C and any lower classes of an ABS issue are lower-rated or unrated and, indeed, are designed to absorb any losses before the senior tranche. Prospective buyers of these pieces of an issue must decide if the increased risk of default is balanced by the higher returns these classes pay.

TAX STATUS OF ABS

Generally, only the interest portion of payments to ABS investors is subject to income tax—state and local (if applicable), as well as federal. The portion of the payments that represents return of principal or original cost is not taxable.



However, if the securities were purchased at an original-issue discount or a market discount, different rules apply. In the first case, if an investor buys an asset-backed security when it is issued for a price that represents a discount from its face value, the investor may be taxed on the discount that accrues on the security before the investor actually receives it. In the second case, if the security was purchased at a discount in the secondary market, the investor may be subject to a tax on the accrued market discount as principal payments are received on the security, as well as on the interest payments.

Foreign Withholding

Generally, an individual who is not subject to U.S. taxation who purchases an ABS issued by a U.S. issuer would not be subject to U.S. withholding tax to the extent that the security qualifies for the portfolio interest exemption and also qualifies as a debt security for U.S. tax purposes. (Some ABS are, for certain technical reasons, deemed by the Internal Revenue Service to be equity securities rather than debt securities.) Payments on securities that are not treated as debt for tax purposes would likely be subject to U.S. withholding taxes.

In this, as in all other tax-related matters, investors should consult a tax professional for advice about their specific situations.

LEGAL INVESTMENT STATUS

The Employee Retirement Income Security Act of 1974 (ERISA) imposes certain restrictions on the ability of private pension plans to invest in ABS and on persons who are fiduciaries with respect to such plans. Although exemptions have been granted that permit ERISA plans to invest in a relatively broad range of



ABS, plan fiduciaries should consult their own counsel regarding any proposed ABS investment.

A number of federal and state statutes and regulations may affect the ability of certain types of investors to purchase ABS. For example, most states have laws and regulations governing the qualification and registration of securities that may be sold within their jurisdiction (so-called Blue Sky laws). Many of these states have exempted transactions with certain categories of institutional investors from these requirements; however, investors should consult their own counsel regarding the legality of an ABS investment under applicable state and federal laws and regulations.

MINIMUM INVESTMENTS, TRANSACTION COSTS AND MARKETABILITY

The minimum denomination for an investment in an ABS is typically \$1,000, although some classes have higher minimum denominations. There are some retail investors who buy small volumes of ABS, but this is still mainly an institutional market. As a practical matter, most institutions do not make ABS investments of less than \$1 million.

A national network of ABS dealers sell, trade and make markets in ABS. These transactions are executed over-the-counter, directly from dealer to dealer rather than through an exchange.

How quickly and easily a given ABS can be sold determines its marketability. In general, for an ABS to enjoy high marketability, there must be a significant trading volume and a large number of dealers in the security.

As the market has grown, all ABS, including HELs and manufactured-housing contracts, have become increasingly liquid and marketable. The two most mature sectors of the ABS market—publicly offered, investment-grade ABS backed by credit cards and auto loans—have liquidity generally greater than that of corporate bonds and approaching that of the U.S. Treasury market.

The liquidity and marketability of newer varieties of ABS vary widely, with the newest and less frequently traded types, of course, being the least liquid.

Investors should keep in mind that if they sell any ABS early—that is, before the final principal payment is made—the securities may be worth more or less than their purchase price.

GLOSSARY

Excess spread. The net amount of interest payments from the underlying assets after bondholders and expenses are paid and after all losses are covered. Excess spread may be paid into a reserve account and used as a partial credit enhancement or it may be released to the seller or the originator of the assets.

Expected maturity date. The date on which principal is projected to be paid to investors. It is based on assumptions about collateral performance.

Final maturity date. The date on which the principal must be paid to investors, which is later than the expected maturity date. Also called legal maturity date.

Grantor trust. A legal structure under which most pass-throughs are issued. It allows passive pass-through of cash flows without taxation at the pool level.

Overcollateralization. A type of credit enhancement in which the principal amount of collateral used to secure a given transaction exceeds the principal of the securities issued.

Owner trust. An amortizing structure that permits significant cash-flow engineering, which is generally prohibited with grantor trusts. Owner trusts are often used with auto loans, equipment leases and student loans.

Ramp. A concept often used with HELs and manufactured-housing transactions to describe a series of increasing monthly prepayment speeds, prior to a plateau, on which the expected average life of a security is based.

Revolving trust. A securitization structure frequently used for assets with high turnover rates, such as

credit card, trade and dealer floor-plan receivables. It is characterized by having a revolving period and an accumulation (or controlled-amortization) period.

Seasoning. The age of accounts. In the ABS market, this term refers to the fact that various asset types have different seasoning patterns, which are characterized by periods of rising and then declining losses.

Special-purpose vehicle (SPV). A bankruptcy-remote entity set up to insulate the issuer of ABS (the trust) from the sponsor, or originator, of the assets. Also called special-purpose corporation (SPC).

Surety bond. A bond that backs the performance of another. In the ABS market, a surety bond is an insurance policy typically provided by a rated and regulated monoline insurance company to guarantee securities holders against default.

Tranche. One class of a securities issue which shares the same characteristics. *Tranche* is the French word for "slice."

True sale. An actual sale, as distinct from a secured borrowing, which means that assets transferred to an SPV are not expected to be consolidated with those of the sponsor in the event of the sponsor's bankruptcy. Rating agencies usually require what is called a true-sale opinion from a law firm before the securities can receive a rating higher than that of the sponsor.



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