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Asset-Backed Securities Primer

A Charged and Highly Dynamic Fixed Income Market

by Wade Walters

Historical Development of Asset-Backed Securities

An asset-backed security (ABS) is any fixed income security whose interest and principal repayment is derived from a pool of physical or economic assets held by a bankruptcy-remote trust or special purpose vehicle (SPV). ABS are backed by a diverse and ever-expanding array of assets, including bank and finance company assets such as credit cards, auto loans, real estate, equipment leases and corporate loans, or corporate assets like trade receivables and real estate. Structural innovations are also growing to meet the needs of an expanding investor base.

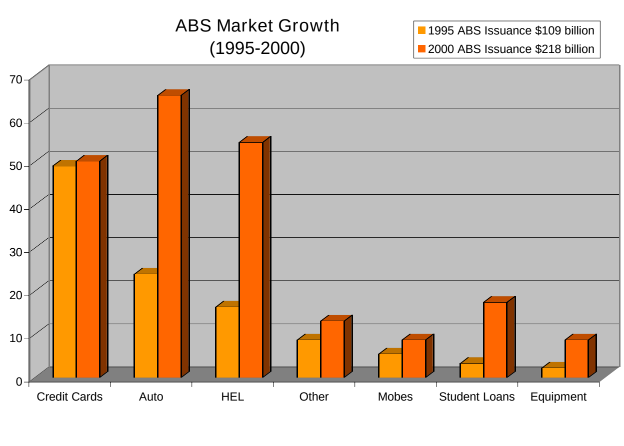
The ABS market grew out of the mortgage-backed securities (MBS) market in the mid-1980s. By this time, the MBS market had developed a mechanism for aggregating small residential mortgages into large homogenous pools of assets that could be financially engineered through securitization into bonds to meet the specific requirements of large institutional investors. Because these pools or collateralized mortgage obligations (CMO) contained thousands of individual residential mortgages guaranteed by government-sponsored agencies, the repayment of the underlying securities was reasonably certain.

In March 1985, Sperry issued the first non-mortgage ABS in a transaction backed by computer leases. Later that year, the first automobile loan-backed deal was issued. In the past 15 years, the ABS market has grown exponentially to include a diverse group of assets, issuers and investors. [1]

Originators, such as banks, savings and loans, finance companies and investment banks, saw asset-backed securities as an opportunity to attract a new group of long-term institutional investors to provide funding for their various businesses. In order to free-up scarce capital, these institutions pool groups of loans, leases or mortgage-related assets and sell or assign them to a bankruptcy-remote SPV that in turn issues asset-backed securities to investors. The capital raised through securitization enables originators to replenish their capital and originate more financial assets. They also earn fee income from continuing to service the assets sold to the trust or SPV.

Market Growth

In the past five years, the ABS market has doubled. Total issuance was approximately $109 billion in 1995 vs. $218 billion in 2000. Credit card receivables represent the largest asset class with 35% of all outstanding issuance, but have lagged behind home equity loan (HEL) issuance for each of the past two years. HELs represent 25% of all outstanding issuance followed by Autos with a 15% market share. Some of the more interesting developments in recent years have occurred in the "Other" category. "Other" is the 4th largest category and represents 11% of all outstanding issuance. The term "Other" is used to describe an extremely wide array of asset types, including utility rate reduction bonds, franchise loans, aircraft leases, medical receivables, tax liens and future flow transactions. [2]



Source: Merrill Lynch

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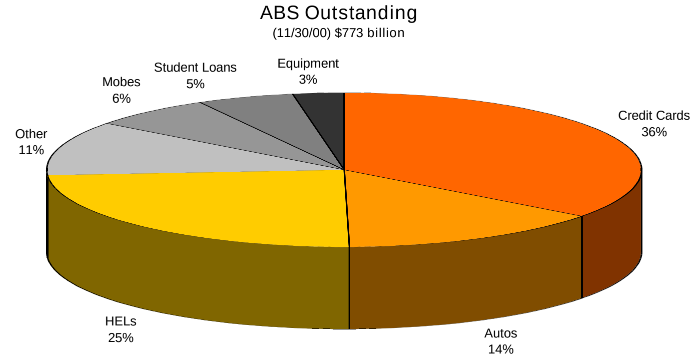

Source: Merrill Lynch

Investment Merits

Investors are attracted to ABS by the relatively stable prepayment characteristics, the customization allowed in tranching the maturities of the various bond classes and the stability of credit ratings relative to corporates. According to a CS First Boston study, ABS has historically exhibited greater rating stability than corporate bonds.

1997-1999 Rating Migration

	Corporates	All ABS
Aaa	8.51%	0.10%
Aa	6.32%	1.05%
A	6.18%	0.94%
Baa	6.04%	4.50%

One-year downgrade/default probability, 1997-1999.
Source: Moody's, CSFB.

Investors can achieve greater diversity by introducing new asset classes to their fixed income portfolios.

Additionally, ABS are defensive in nature because of the bonds' shorter maturities, due to the shorter terms typically associated with the types of the loan collateral supporting the bonds. Wider spreads are still available on certain ABS asset classes relative to corporate bond alternatives with similar ratings.

Aside from the advantages individual asset-backed securities provide to investors, they also provide a significant number of advantages to both broad and narrow fixed income portfolios:

- Within an aggregate portfolio, investments in asset-backed securities can create greater diversification and enhance the return provided by the shorter assets of the portfolio.
- They allow the portfolio manager to decrease a portion of the unsystematic risk inherent in a portfolio of corporate bonds by providing exposure to consumer-based assets.
- Held in bankruptcy-remote SPVs, asset-backed securities are not impacted by the acquisition and leveraged expansion strategies of management that at times adversely impact corporate bondholders. The legal separation of the collateral supporting the asset-backed securities from the assets of the issuer prevents the collateral supporting the asset-backed securities from being included in the bankruptcy estate should the issuer ever file for bankruptcy.
- ABS provide a large and ready supply of AAA rated securities, which at times may be difficult to locate in the corporate market and which may be used to increase the overall credit rating of the entire portfolio.
- ABS make up a relatively small component of the most popular aggregate indexes. The ABS component of the Lehman Aggregate is approximately 1.8%. Therefore, it is relatively easy to overweight ABS in a broad portfolio without making a large commitment to the ABS sector.

The unique structures available in ABS also provide significant benefits. For example, short money market eligible classes are often created as the front-end cash flow or tranche in ABS transactions. Floating rate securities may be created from a pool of fixed rate loans. These structural innovations have enabled money managers to create very specific short duration portfolios that invest in floating rate and fixed rate money market asset-backs while providing both liquidity and a significant yield advantage to LIBOR or other money market benchmarks.

Conclusion:
An Attractive Addition to a Portfolio

Asset-backed securities offer fixed income investors a unique opportunity to increase the yield and credit characteristics of a portfolio. With ABS issuance volume increasing by an average of approximately 20% a year for each the past five years and a total outstanding supply of $773 billion, liquidity has also increased. As supply has increased, the number of participants has expanded to include non-traditional ABS investors, including insurance companies, asset-backed commercial paper conduits and collateralized debt obligation (CDO) issuers. The development and proliferation of CDOs has further increasing the liquidity of the market at the subordinate level.

With a near record level of corporate downgrades expected in 2001, more corporate treasurers may find that the ABS market offers a cost-effective source of capital to fund their financing needs. For example, some airlines have chosen to utilize Enhanced Equipment Trust Certificates (EETC) to finance the purchase of new jetliners, using a first lien on the aircraft as security for the debt.

On November 13, 2000, the Department of Labor formally adopted changes to ERISA "underwriting exemptions". [3] By allowing ERISA accounts to purchase all investment grade securities, including the BBB- tranches of certain ABS/MBS/CMBS transactions, pension plans have a viable alternative to Ba and Baa corporates. Previously ERISA accounts could only purchase the AAA rated tranches of asset-backed transactions.

The ABS market is the most dynamic of the major fixed income markets. Structural and collateral innovations will guarantee that the ABS market will continue to evolve to meet the requirements of both issuers and investors. Therefore, employing an advisor that has the expertise to properly assess the relative merits, conduct due diligence reviews and monitor performance of each transaction is critical. Independence has developed an experienced team of professionals dedicated to the various aspects of the ABS market.

1[1] Anand K. Bhattacharya and Frank J. Fabozzi (eds.), Asset-Backed Securities, p. 4 (New Hope, PA: Frank Fabozzi Associates, 1996).
2[2] Merrill Lynch, "An Analysis of the ABS Market in the Year Ahead" ABS Market Outlook, p. 6 (December 22, 2000).
3[3] Id. at 41.

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