
Chapter 1

The Treatment of Structured Finance under the Investment Company Act

I. Introduction and Summary of Recommendations

Structured finance is a financing technique in which financial assets, in many cases illiquid, are pooled and converted into capital market instruments.¹ In a typical structured financing, a sponsor transfers a pool of assets to a limited purpose entity, which in turn issues non-redeemable debt obligations or equity securities with debt-like characteristics ("fixed income securities"). Payment on the securities depends primarily on the cash flows generated by the assets in the underlying pool. Typically, the securities are rated in one of the two highest categories by at least one nationally recognized statistical rating organization ("rating agency"). Issuers that have more assets or that expect to receive more income than needed to make full payment on the fixed income securities also may sell interests in the residual cash flow.

Structured finance differs from conventional financing techniques in that it involves the pooling of financial assets, which are then removed from the sponsor's balance sheet. The risks inherent in holding the financial assets are shifted away from the sponsor to investors that believe they are in a better position to accept these risks? As a result, the sponsor may be able to manage its balance sheet better, while gaining access to alternative funding sources.

¹Although "structured finance" is the term most commonly used to describe this financing technique, the terms "structured securitized credit," "asset-backed arrangement," "asset-backed financing," and "asset securitization" also are used. We use these terms interchangeably throughout this chapter.

²See JAMES A. ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 5, 9-11 (sponsored and produced by McKinsey & Company Securitization Project; 1988). The sponsor **may** still bear some risk, depending on whether it provides recourse or owns some of the securities issued in the financing. *Id.*

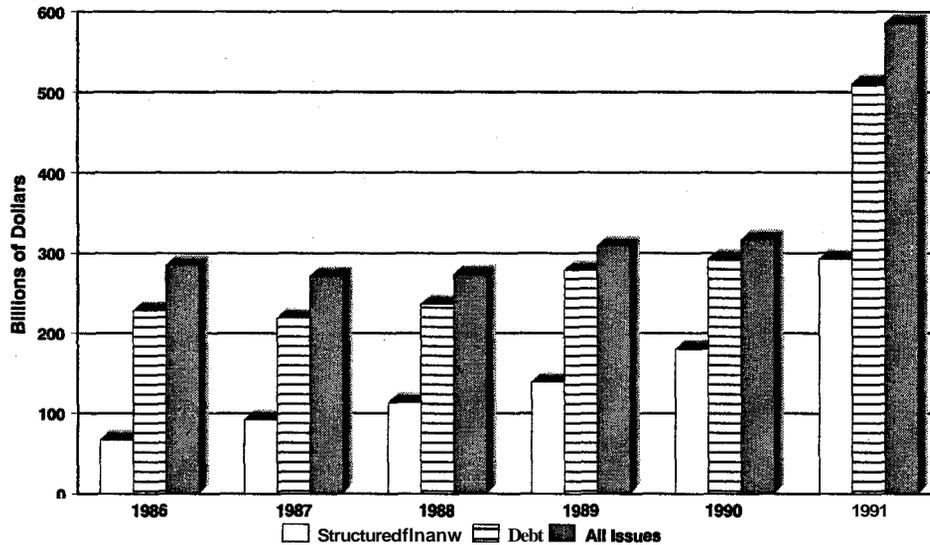
Since its inception in the 1970's, the structured finance market in the United States has grown rapidly? One observer has estimated that \$292.8 billion of structured financing securities were issued in the United States in 1991, compared with \$174.0 billion in 1990.⁴ The significance of the structured finance market is particularly apparent when its market share is compared to the market share of other types of offerings. In 1991, structured financings accounted for approximately fifty percent of total public securities issuances (debt and equity) in the United States, and approximately fifty-seven percent of total public debt securities issuances?

³Structured finance is a form of "securitization." Although observers define "Securitization" in somewhat differing ways, generally it is the process by which funding that traditionally was obtained from commercial lenders, such as banks and finance companies, is obtained instead through the use of securities. See, e.g., *id.* at 3; LOWELL L. BRYAN, BREAKING UP THE BANK: RETHINKING AN INDUSTRY UNDER SIEGE 66-70 (1988). In addition to structured finance, other forms of securitization include commercial paper, loan participations and high yield bonds. See, e.g., BRYAN, *supra*, at 66, 69; TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES, § 1.2, at 6 (1991).

⁴In 1991, approximately \$246.21 billion of mortgage-backed securities and \$46.60 billion of non-mortgage asset-backed securities were issued compared with reported issuance in 1990 of \$133.94 billion of mortgage-backed securities and \$40.10 billion of non-mortgage asset-backed securities. Michael Liebowitz, *Reversing Four-year Trend and Swooning Economy, Wall Street Explodes in 1991*, INV. DEALERS' DIG., Jan. 6, 1992, at 26-27 [hereinafter *IDD 1991 Figures*].

⁵In 1991, an estimated \$585.97 billion of total United States debt and equity securities were issued of which \$510.96 billion were debt securities. *Id.* at 24, 27, 30-31. In comparison, in 1990, an estimated \$312.11 billion of total United States debt and equity securities were issued of which \$288.36 billion were debt securities. *Id.* As the foregoing figures indicate, although total structured finance issuances grew 68% from 1990 to 1991 (mostly as a result of an 84% increase in the issuance of mortgage-backed securities), both total securities issuances and total debt securities issuances grew even faster between 1990 and 1991 (88% and 77% respectively). Thus, from 1990 to 1991, structured finance issuances declined six percent as a portion of total securities issued and three percent as a portion of total debt securities issued.

FIGURE 1-1
 Comparative Data Reflecting Growth of Structured Finance in the
 United States 1986-1991



Source: Investment Dealers' Digest

Despite this robust growth, the Investment Company Act⁶ has constricted the development and evolution of the structured finance market. Structured financings fall within the definition of investment company but cannot operate under the Act's requirements.⁷ Many financings have avoided regulation under the Act by relying on the exception to the definition of investment company in section 3(c)(5), which Congress included in 1940 for the commercial finance and mortgage banking industries? The Commission has granted exemptions with

⁶Investment Company Act of 1940, 15 U.S.C. § 80a.

⁷See generally *infra* Section IV.

⁸15 U.S.C. § 80a-3(c)(5).

Certain federally sponsored structured financings, such as those sponsored by the Federal National Mortgage Association ("FNMA"), also are exempted from the Act's provisions under section 2(b), which exempts, among other things, activities of United States Government instrumentalities or wholly-owned corporations of such instrumentalities. 15 U.S.C. § 80a-2(b). The Division did not re-examine the treatment of federally sponsored structured financings under the Act.

respect to other financings, primarily those involving mortgage-related assets.’’
Financings that are unable to rely on a statutory exception or obtain an exemptive
order must sell their securities either privately to no more than 100 investors in
reliance on the Act’s private investment company exception, or outside the United
States?’ Thus, the Investment Company Act distorts the structured finance
market, even driving some offerings offshore. The Act also causes much
unproductive discussion over whether particular offerings may rely on section
3(c)(5).

In light of these problems, the Division has re-examined the Investment
Company Act’s treatment of private sector structured financings.¹² We
recommend that the Commission adopt a rule exempting structured financings
from all provisions of the Investment Company Act, subject to conditions that
would address the investor protection concerns presented by structured
financings.¹³ The conditions generally would restrict "management" of exempt
financings; prohibit the issuance of redeemable securities; limit public securities
issuances to debt or debt-like securities that are rated in the top two investment

¹⁰See *infra* Section IV.A.2.

’’Investment Company Act § 3(c)(1), 15 U.S.C. § 3(c)(1).

¹²In the course of this examination, the Division met with representatives of entities associated
with the structured finance industry to discuss, among other things, how structured financings
work, the roles of the various participants, the status of the structured finance market, likely
developments, and investor protection concerns. In addition, the Division published a request for
comments on reform of the regulation of investment companies which included a request for
comments on the regulation of structured financing under the Act. Request for Comments on the
Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534,
§ III.C. (June 15, 1990), 55 FR 25322 [hereinafter Study Release]. The Division received many
responses to the Study Release addressing structured finance issues including letters from The
American Bankers Association; The 1940 Act Structured Finance Task Force of the American Bar
Association; Banca D’Italia; Bankers Trust Company; Chase Manhattan Bank; Chemical Bank;
Citicorp; Cleary, Gottlieb, Steen & Hamilton; Davis Polk & Wardwell; Dean Witter Reynolds Inc.;
The Equitable Life Assurance Society of the United States; Federated Investors; Financial Security
Assurance; Foley & Lardner on behalf of Smith Barney Asset Capital Corp.; Tamar Frankel;
Investment Company Institute; Mayer Brown & Platt; Mayer Brown & Platt on behalf of
Continental Bank N.A.; Merrill Lynch & Co., Inc.; New York Clearing House; Sears, Roebuck and
Co.; and Shearson Lehman Brothers.

¹³Of course, structured financings are also subject to various regulatory requirements under
the Securities Act of 1933 (15 U.S.C. §§ 77a-77aa), the Securities Exchange Act of 1934 (15 U.S.C.
§§ 78a-78ll), and the Trust Indenture Act of 1939 (15 U.S.C. §§ 77aaa-77bbbb), as well as other
federal laws and state laws. The Division examined only the Investment Company Act issues.

grades, the payment of which depend on the cash flows from the underlying assets; and require independent trustees.

Section II of this chapter provides an overview of structured finance, discussing the present status of the market and how it began, which institutions are securitizing their assets and why, who purchases these securities, and expectations for the future. Section III discusses the basic mechanics of structured financings, including the responsibilities of the various entities involved. Section IV describes the application of the Investment Company Act to structured financings and its effects. Section V discusses whether structured financings should be subject to the Act, examining whether structured financings present the potential for the type of abuses the Investment Company Act is designed to remedy and, if so, how structured financings could be regulated under the Act. Section V also analyzes possible reforms, including several of those suggested by commenters in response to the Division's request for comments on reform of the regulation of investment companies (the "Study Release"),¹⁴ and discusses the Division's proposed rule.

II. Overview of Structured Finance

A. The Structured Finance Market

1. The Mortgage Market

The modern structured finance market originated in the 1970's with the securitization of residential mortgages.¹⁵ Since then, securities backed by residential mortgages have dominated the structured finance market. As of September 30, 1991, the aggregate amount of securities backed by one- to four-family mortgages was reported to be \$1.2 trillion, representing forty-two percent of all mortgage debt.¹⁶ Total value of mortgage-backed securities issued in 1991

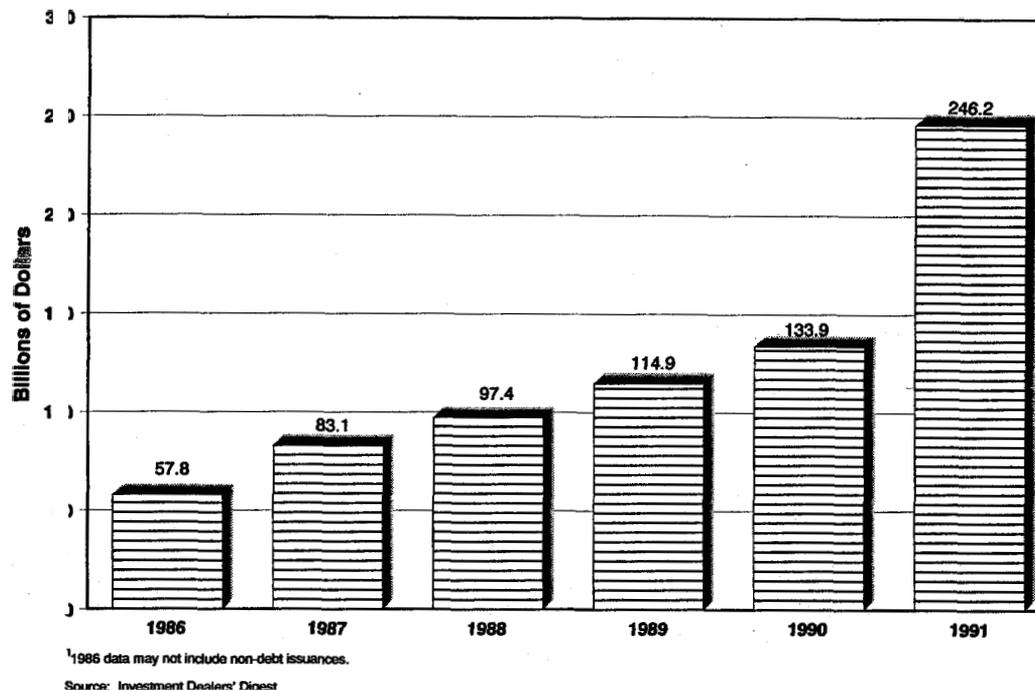
¹⁴Study Release, *supra* note 12.

¹⁵Mortgages were "securitized," in crude fashion, in the 1920's and 1930's. Typically, banks or mortgage insurers guaranteed the mortgages. Many of the mortgage pools experienced defaults and many of the guarantors failed, as a result of inadequate capital. Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497,500 (1989).

¹⁶Federal Home Loan Mortgage Corp., *Database, Securitized Mortgage Debt Outstanding, in THE SECONDARY MORTGAGE MARKETS Table 5 (Winter 1991/1992) [hereinafter Database.]* In contrast, as of the same date, only 10% of all outstanding multi-family mortgage debt had been securitized. *Id.*

was estimated to be \$246.2 billion, an eighty-four percent increase from the 1990 level of \$133.9 billion.¹⁷ Figure 1-2 illustrates the growth of the mortgage market.

FIGURE 1-2
Mortgage-Backed Securities Issued in the United States 1986-1991¹



The securitization of residential mortgages is a direct outgrowth of federal promotion of the secondary market in residential mortgages.¹⁸ The Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA"), and the Federal Home Loan Mortgage Corporation ("FHLMC") were formed to provide greater access to capital for residential

¹⁷*IDD 1991 Figures*, supra note 4, at 21. It is likely that only a small dollar amount of securitized commercial mortgages is included in this figure. For a discussion of securitization of commercial mortgages, see note 36 and accompanying text below.

¹⁸See, e.g., *BRYAN*, supra note 3, at 71.

mortgage financing through development of a secondary market for residential mortgages.¹⁹ FNMA and FHLMC promote the secondary mortgage market in part by purchasing mortgages and either holding the mortgages or selling them, in the latter case primarily by repackaging the mortgages into securities. GNMA primarily guarantees payment on the securities issued by mortgage pools that are created by financial institutions.

In 1970, GNMA created the first publicly traded mortgage-backed security? The security, known as a mortgage pass-through certificate, represented beneficial ownership of a fractional undivided interest in a fixed pool of residential mortgage loans. GNMA guaranteed timely payment of principal and interest on the certificates. Both FNMA and FHLMC subsequently issued mortgage-backed securities; and, like GNMA, embarked on mortgage-backed securities programs ("agency programs"). The FNMA and FHLMC programs differ from the GNMA program in two significant ways. First, both FNMA and FHLMC themselves issue securities, while GNMA guarantees securities issued by

¹⁹FNMA was created by Congress in 1938 as a wholly-owned government corporation for the purpose of providing a secondary mortgage market for Federal Housing Administration ("FHA") and later Veterans Administration ("VA") mortgage loans. In 1968, pursuant to Title VIII of the Housing and Urban Development Act of 1968 (Pub. L. No. 90-448, Title VIII, § 801, Aug. 1, 1968, 82 Stat. 536) (codified at 12 U.S.C. § 1716b), FNMA was divided into two separate entities. One continued to be called FNMA, but became a privately owned entity, subject to the regulatory authority of the Department of Housing and Urban Development ("HUD"). 12 U.S.C. § 1723(b). FNMA continues to provide a secondary market for FHA and VA mortgage loans, and, in 1970, was authorized to do the same for certain other mortgage loans. 12 U.S.C. § 1718. The other entity became GNMA, an instrumentality within HUD that generally services the portfolio of mortgages owned by the federal government. GNMA also guarantees securities issued by HUD-approved mortgagees that represent interests in pools of mortgages comprised solely of FHA, VA, and certain Farm Housing Administration loans. FHLMC was created in 1970, pursuant to Title III of the Emergency Home Finance Act of 1970 (12 U.S.C. §§ 1451-1459), to develop and maintain a nationwide secondary market for conventional residential mortgages issued by savings and loans, mortgage bankers, banks, and HUD-approved mortgagees. Under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), FHLMC became privately owned, subject to the regulatory authority of HUD. Pub. L. No. 101-73, Title VI, § 731(b)-(e), 103 Stat. 183, 429-435 (Aug. 9, 1989) (codified as amended at 12 U.S.C. §§ 1451-1459).

²⁰See KENNETH G. LORE, MORTGAGE-BACKED SECURITIES DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET 2-4 (1991-92 ed.). Mortgage-backed securities differ from mortgage-backed bonds, which were offered to the public as early as 1880. Mortgage-backed bonds are general obligations of an issuer that are secured by a pool of mortgage loans or mortgage securities. Payment of these bonds does not necessarily depend on the underlying cash stream from the mortgage pool; it may come from the issuer's general funds. See Pittman, *supra* note 15, at 500.

others. Second, unlike the GNMA program, securities issued by FNMA and FHLMC are not backed by the full faith and credit of the United States. Because of FNMA and FHLMC's close association with the federal government, however, securities issued by them are perceived by many to be virtually as safe as GNMA securities.²¹

The design of the agency programs, as well as the characteristics of the residential mortgages in each program's portfolio, greatly simplify the securitization of mortgages. The agencies generally purchase only a relatively homogenous class of these mortgages; accordingly, these mortgages meet similar credit criteria and have similar maturities. The large volume of loan originations and the relatively small principal amounts of the loans simplify securitization by facilitating credit and cash flow analysis, among other things. Finally, the perception of a federal guaranty backing the instruments, whether explicit or implicit, promotes investor acceptance.

The development by FHLMC, GNMA, and FNMA of mortgage-backed securities ("agency securities" or "agency certificates") promoted residential mortgage financing. By increasing the liquidity of the secondary residential mortgage market, the agency programs have reduced the cost of borrowing by lowering interest rates and origination fees.²² The agency programs also contributed to the innovation of new mortgage forms by creating a variety of new mortgage securities products.²³ For example, in 1983, FHLMC created the collateralized mortgage obligation ("CMO"). A CMO is a debt obligation whose structure allows the cash flows on the underlying mortgage pools to be carved up into separate classes of securities, called "tranches," each with a specified coupon

²¹See, e.g., LORE, *supra* note 20, at 1-8; Pittman, *supra* note 15, at 500. See also Peter V. Darrow, et al., *Rating Agency Requirements*, in 1 SECURITIZATION OF FINANCIAL ASSETS § 7.02[G], at 7-44 to 7-45 (Jason H.P. Kravitt ed. 1991).

²²Rosenthal and Ocampo reported (in 1989) that "[h]ome buyers are now paying approximately 100 basis points less in interest (versus U.S. Treasury yields) on fixed-rate mortgages than they were a decade ago when mortgage securitization was much less pervasive." ROSENTHAL & OCAMPO, *supra* note 2, at 12. See also LORE *supra* note 20, at 1-12 (FHLMC's annual report indicated that interest rates on mortgages that qualify for sale to FHLMC are about one-half of a percentage point lower than nonconforming mortgages). But see Pittman, *supra* note 15, at 542-543 (as of 1986, the Federal Reserve Board did not credit SMMEA with any decrease in interest rates available to homeowners nor did it anticipate that SMMEA would effect any significant reduction in the future); BRYAN, *supra* note 3, at 86 (in 1988, a reduction in mortgage rates had not yet occurred although the author viewed that result as inevitable, eventually).

²³WILLIAM W. BARTLETT, MORTGAGE-BACKED SECURITIES 12 (1989).

and stated maturity. Scheduled payments and prepayments from the mortgage pool are allocated to retire the classes in the order of stated maturities.²⁴

The three agency programs dominate the secondary residential mortgage market²⁵ but the private sector has also participated in issuing mortgage-backed securities. Mortgage-backed securities issued by the private sector have typically been backed by agency certificates and conventional mortgages that the sponsor either originates itself or purchases in the secondary market. Many of the conventional mortgages have balances exceeding the maximum loan limits permitted to be purchased by the agencies ("nonconforming loans").²⁶ These securities also lack the guaranty of the agency securities, a significant handicap to the private sector in the secondary residential mortgage market.²⁷

In an effort to expand the participation of the private sector in the secondary market, Congress enacted the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA").²⁸ Congress was concerned that the agencies would not be able to meet future demands for mortgage credit. SMMEA removed obstacles for privately sponsored mortgage-backed securities by, among

²⁴The CMO structure followed a prior unsuccessful attempt to devise a multiclass mortgage security. In 1983, Sears Mortgage Securities Corporation introduced a multiple class pass-through security, which was unsuccessful because it received unfavorable tax treatment by the Internal Revenue Service ("IRS"). *Pittman, supra* note 15, at 505-506. In 1986, Congress effectively overruled the IRS in this matter by enacting the Real Estate Mortgage Investment Conduit ("REMIC") provisions in the Tax Reform Act of 1986. Pub. L. No. 99-514, §§ 671-675, 100 Stat. 2085,2309-2320(1986), codified at 26 U.S.C. §§ 860A-860G. See *Pittman, supra* note 15, at 505,508. For more discussion of CMOs and REMICs, see *infra* notes 146-151 and accompanying text.

²⁵For example, in 1990, FHLMA, GNMA and FNMA together issued \$235 billion in pass-through securities out of a total pass-through issuance of \$249 billion, thus giving the agencies 94.2% of total pass-through issuances in 1990. *Database, supra* note 16, at Table 2, Part A. In addition, in 1990, FHLMA and FNMA combined issued \$97.5 billion in multiclass mortgage securities (CMOs and REMICs) out of a total multiclass issuance of \$118.6 billion, thus giving the agencies 82.2% of total multiclass issuances in 1990. *Id.* at Table 3. In the first three quarters of 1991, FNMA and FHLMC increased their market domination, issuing 94.2% of all multiclass mortgage-backed securities offered. *Id.*

²⁶LORE, *supra* note 20, at 1-14.

²⁷David Abelman, *The Secondary Mortgage Market Enhancement Act*, 14 REAL ESTATE L. J. 136, 145-147 (1985).

²⁸The Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (1984) (codified at scattered sections of 12 and 15 U.S.C.).

other things, pre-empting certain state investment laws so that state regulated institutions might purchase privately sponsored mortgage-backed securities to the same extent as agency securities, granting authority for certain depository institutions to invest in these securities, and requiring states to exempt privately sponsored mortgage-backed securities from state registration to the same extent as agency securities, unless the state specifically deemed otherwise?

Despite SMMEA, the private sector has not made significant inroads in the secondary residential mortgage market. Indeed, in 1989, the dominance of the agencies grew even greater as private issuance slowed in response to problems in the financial market, the loss in 1986 of tax incentives, and the savings and loan crisis.²⁹ Issuance of privately sponsored pass-through certificates dropped by more than forty percent between 1988 and 1989 causing a **6.4%** decline in market share.³¹ More dramatically, the market share of publicly offered multiclass securities (e.g., CMOs) issued by the private sector dropped almost fifty percent between 1988 and 1989.³² In 1990, the market share of privately sponsored pass-through certificates held steady,³³ while the market share of privately sponsored multiclass securities recovered slightly only to dip again in the first three quarters of 1991.³⁴

²⁹For more information on SMMEA, see Pittman, *supra* note 15; Abelman, *supra* note 27.

³⁰LORE, *supra* note 20, at 2-39.

³¹In 1988, non-agency sponsors issued approximately **\$20.7** billion of pass-through securities representing **12.1%** of total issuance (**\$170.6** billion). *Database, supra* note 16, at Table 2, Part A. In 1989, non-agency sponsors issued only **\$12.2** billion of pass-throughs representing **5.7%** of total issuance (**\$212.6** billion). *Id.* Although the volume of non-agency sponsored pass-through securities increased to approximately **\$14.3** billion in 1990, total issuance also increased to **\$249.3** billion leaving the non-agency sponsors' market share the same as 1989. *Id.*

³²In 1988, non-agency sponsors issued **\$51.0** billion of multiclass securities out of a total volume of **\$76.8** billion for **66.4%** of the multiclass mortgage market. *Id.* at Table 3. In 1989, non-agency sponsors experienced a precipitous **49.8%** drop in multiclass market share (and a **67.3%** drop in volume) issuing **\$16.7** billion of multiclass securities out of a total volume of **\$100.5** billion or **16.6%** of the multiclass mortgage market. *Id.*

³³See *supra* note 31.

³⁴In 1990, non-agency sponsors issued **\$21.1** billion of multiclass securities out of a total volume of **\$118.6** billion for a slight market share increase to **17.8%** of the multiclass mortgage market. *Database, supra* note 16, at Table 3. In the first three quarters of 1991, however, non-agency sponsors issued only **\$10.5** billion of multiclass securities out of a total volume of **\$137.6** billion for a mere **7.6%** of the multiclass market, of which **\$2.5** billion or **1.8%** consisted of
(continued...)

The private sector has begun to securitize commercial mortgages and mortgage products. Sponsors have publicly offered securities backed by small commercial loans, large single mortgages on office buildings, and commercial mortgage loans in the form of tax-exempt industrial development bonds.³⁵ The development of these securities has been slowed, in part, by the lack of standardization in loan structure and documentation and soft real estate markets.³⁶

In addition to the public mortgage market, there have been a number of private placements of mortgage products. Private placement of securities backed by residential mortgages apparently is unusual. The opposite is true for commercial mortgages, with many, if not most, commercial mortgage-backed securities sold in private placements, perhaps because of the lack of standardization.³⁷

2. The Non-Mortgage Market

Since the mid-1980's the techniques pioneered in the secondary residential mortgage market have been used by the private sector to securitize other assets. As of year-end 1991, approximately \$158.34 billion of non-mortgage asset-backed

³⁴(...continued)

securities issued under the securitization program of the Resolution Trust Corporation (the "RTC"). Id. For further information about the RTC's securitization program, see *infra* notes 96 & 97 below and accompanying text.

³⁵PAVEL, *supra* note 43, at 77-78.

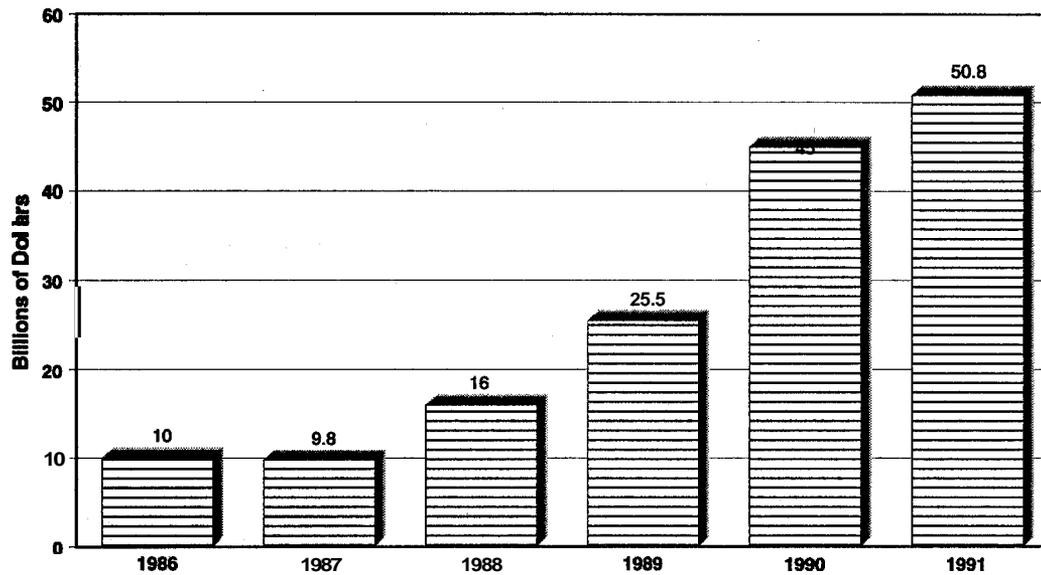
³⁶See LORE, *supra* note 20, at 1-3, 1-6, 2-41. See also Suzanne Wittebort, *Asset-Buck & Come of Age*, INSTITUTIONAL INVESTOR, Dec. 1991, at 80 ("[M]ortgages on commercial property tend to be more individualized and cash flows on a package of them can be lumpy.").

³⁷Wittebort, *supra* note 36, at 80 (reporting that most of the anticipated commercial mortgage-backed structured financings in 1991 would be issued in private placements). Standard & Poor's ("S&P") has estimated that 75% of the commercial mortgage-backed securities it has rated have been privately placed. See *Commercial Mortgage Securitization -- It's Time Has Come*, STANDARD & POORS CREDIT REVIEW COMMERCIAL MORTGAGE SECURITIES, Apr. 8, 1991, at 3. But see LORE, *supra* note 20, at 1-3, 2-42 (the earliest commercial mortgage-backed securities issuances took place in the private market but subsequently the market saw a series of public transactions involving pools of smaller commercial mortgages).



securities had been publicly issued.³⁸ One observer has estimated that the volume of non-mortgage asset-backed public issuances in 1991 totalled approximately \$50.8 billion, up from a \$10 billion total in 1986.³⁹

FIGURE 1-3
Non-Mortgage Asset-Backed Securities issued in the
United States 1986-1991



Source: Dean Witter Reynolds, Inc.
Asset-Backed Securities Reference Guide
Year Ended 1991

³⁸DEAN WITTER REYNOLDS, INC., ASSET-BACKED SECURITIES REFERENCE GUIDE A-22 (Year Ended 1991) [hereinafter DEAN WITTER]. This figure is still dwarfed by the aggregate amount of mortgages securitized, which was estimated as of September 30, 1991 to have amounted to \$1.2 trillion. See supra note 16 and accompanying text.

³⁹*Id.* at A-10. But see *IDD 1992 Figures*, supra note 4, at 22 (reporting \$46.6 billion of asset-backed securities issued in 1991).

Securities backed by automobile loans and credit card receivables represent approximately eighty percent of the public non-mortgage asset-backed market and also constitute by far the two largest segments of that market.⁴⁰ In 1991, securities backed by credit card accounts receivable represented approximately forty-three percent of the non-mortgage asset-backed securities issuances.⁴¹ Other assets presently being securitized publicly include home equity loans,⁴² boat loans, computer leases, airplane leases, mobile home and recreational vehicle loans, vacation timeshares, hospital accounts receivable, Small Business Administration loans,⁴³ and industrial development bonds backed by different types of assets, including equipment leases.⁴⁴

⁴⁰As of year-end 1991, securities backed by credit card receivables and automobile loans together amounted to \$129.4 billion out of \$158.3 billion total asset-backed securities original issuance. DEAN WITTER, *supra* note 38, at A-16. Financings backed by automobile loans were among the first non-mortgage structured financings publicly offered, and, until recently, represented the largest segment of the public market. *Id.* at A-17. By year-end 1991, financings backed by credit card receivables had surpassed automobile loan transactions in market share of outstanding securities. *Id.* at A-16.

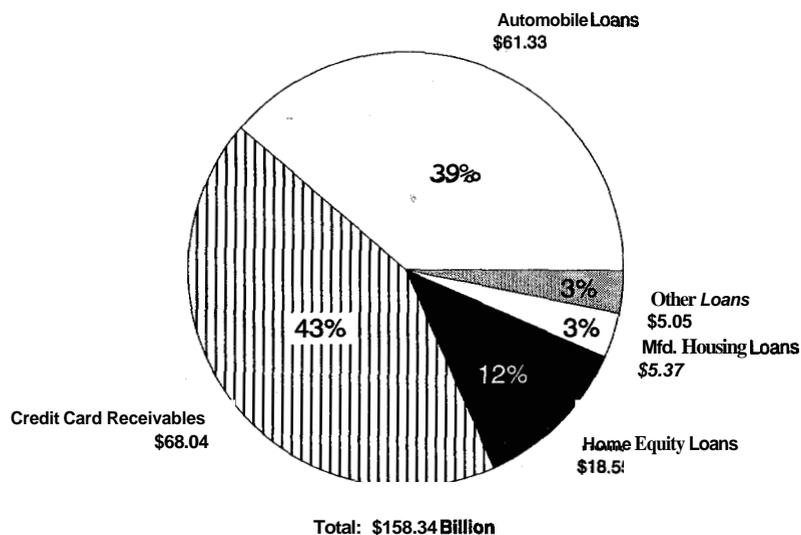
⁴¹*Id.* at A-16. In 1991, credit card receivables backed the issuance of \$21.6 billion out of a total issuance of \$50.8 billion in non-mortgage asset-backed securities. *Id.* at A-1.

⁴²Technically, home equity loans are mortgage products. Nevertheless, because home equity loans have many of the same characteristics as credit card receivables, structured financings backed by these loans are considered by many to be part of the non-mortgage asset-backed market.

⁴³The Small Business Secondary Market Improvements Act of 1984 (Pub. L. No. 98-352, 98 Stat. 329 (1984) (codified at 15 U.S.C. §§ 633-634, 639)), authorized the Small Business Administration ("SBA") to establish a program for securitizing SBA loans. SBA also acts as a guarantor of such securities packaged by the private sector. For a more detailed discussion of such securities, see CHRISTINE A. PAVEL, *SECURITIZATION* 152-155 (1989).

⁴⁴See DEAN WITTER, *supra* note 38, *passim*.

FIGURE 1-4
Total Issuance of Non-Mortgage Asset-Backed Securities by Collateral Type



Source: Dean Witter Reynolds, Inc.
 Asset-Backed Securities Reference Guide
 Year Ended 1991

Most of the assets that have been securitized have homogeneous characteristics, including similar terms, structures, and credit characteristics.⁴⁵ The assets tend to have payment streams with proven histories of performance, which in turn make future payments reasonably predictable. These characteristics facilitate analysis of the credit risks.

Other types of assets lack the homogeneity necessary for easy credit risk analysis and therefore are just beginning to be securitized. For example, non-performing loans, middle market loans, and other types of commercial loans are in the beginning stages of securitization.⁴⁶ The obstacles associated with

⁴⁵PAVEL, supra note 43, at 17-20.

⁴⁶*Id.* See also Christopher L. Snyder, Jr., Securitizing Middle Market *Loans* in THE ASSET SECURITIZATION HANDBOOK 440-476 (Phillip Zweig ed., 1989) [hereinafter THE ASSET SECURITIZATION HANDBOOK]. But see Jean-Louis LeLogeais and Don Kerr, Applying the Strategic View to Asset *Securitization* Decisions, AM. BANKER (Special Adv. Supp.), May 30, 1989, at 4A to 5A. (Securitization is prohibitively expensive for banks whose asset mix is concentrated in the middle market with its relatively higher spreads and returns; this is true because of the nonuniform nature of business risks and the inherent inability to pool loans effectively.)

securitizing these assets include the lack of reliable data on losses, uniform underwriting and collection standards, standardized documentation, and similar loan balances. In addition, the transaction must be structured so that credit risk analysis can be accomplished without loan-by-loan review.⁴⁷

A number of non-mortgage, asset-backed securities have been privately placed. Although some of these securities are similar to those sold publicly,⁴⁸ many private placements involve types of structured financings that have never been publicly offered in the United States, in part because of the Investment Company Act. For example, financings backed by high yield bonds ("collateralized bond obligations" or "CBOs"), installment loans, future royalties, and Medicare and Medicaid receivables have all been issued in private placements, but have never been sold publicly in the United States.

B. Sponsors of Structured Financings

With the exception of the federal government and federally sponsored entities, the most active sponsors of structured financings are commercial banks and savings and loans. In 1988, the last year the private sector was relatively active in the residential mortgage-backed securities market, the major issuers were savings and loans, responsible for half of private sector mortgage-backed issuances, and commercial banks, responsible for fourteen percent of such issuances in 1988.⁴⁹ Other active sponsors of residential mortgage-backed securities in 1988 included investment banks (twenty-four percent), insurance

⁴⁷See Peter Haidorfer, *Assessing Consumer Debt Risk is Vital for Credit Enhancers*, AM. BANKER (Special Adv. Supp.), May 30, 1989, at 10A to 11A.

⁴⁸Some of the first sales of assets now commonly securitized and sold publicly were initially sold in private placements. For example, the first structured financing backed by credit card receivables was placed privately in March 1986, with the first public transaction occurring in 1987. See PAVEL, *supra* note 43, at 109.

⁴⁹LORE, *supra* note 20, at 2-38 to 2-39.

companies (eight percent), and conduits⁵⁰ (four percent).⁵¹ Although these types of entities continue to sponsor mortgage-backed securities, since 1989 their volume and market share have dropped considerably **with** the increase in the strength of the agency programs.⁵²

In the non-mortgage market, as of year-end 1991, commercial banks had originated approximately 45.6% of total issuances.⁵³ Other sponsors included auto manufacturers (28.0%), retailers (7.1%), and savings and loans (5.5%).⁵⁴

From a sponsor's perspective, there are sound reasons to securitize assets.⁵⁵ The sponsor may be better able to manage its loan portfolio, and, in turn, its balance sheet: asset securitization permits a sponsor to convert financial assets into cash, which can be used to retire debt or acquire new receivables. Asset securitization can increase the liquidity of a loan portfolio, permitting a sponsor to select the financial assets it wishes to keep, and to sell the assets it does not want. Asset securitization also permits a sponsor to reduce its interest rate risk resulting from its funding fixed-rate, long-term assets with floating rate and/or short-term liabilities, a particularly attractive option in times of volatile interest rates.⁵⁶ Alternatively, by selling portions of portfolios concentrated in

⁵⁰A mortgage conduit is an organization that purchases mortgages, packages the mortgages into pools, and sells the mortgages through the capital markets. For information on the evolution of conduits, see BARTLETT, *supra* note 23, at 9-11.

⁵¹LORE, *supra* note 20, at 2-38 to 2-39.

⁵²See *supra* notes 30-36 and accompanying text. See also LORE, *supra* note 20, at 2-38.

⁵³DEAN WITTER, *supra* note 38, at A-26.

⁵⁴*Id.*

⁵⁵Originators that sell assets to a financial intermediary, such as a conduit, that in turn sponsors a structured financing backed by the assets, receive many of the same benefits as originators that sponsor a financing. Originators may choose to sell to these intermediaries if they do not hold enough assets to make sponsorship economical.

⁵⁶See, e.g., Thomas R. Boemio & Gerald A. Edwards, Jr., *Asset Securitization: A Supervising Perspective*, 75 FED. RES. BULL. 659,663 (1989); BRYAN, *supra* note 3, at 85; ROSENTHAL, *supra* note 2, at 10-13. Savings and loans, for example, securitized portions of their mortgage portfolios in part to address risks of rising interest rates. Mortgage loans traditionally had maturities of 30 years and had fixed interest rates. By contrast, 65% of a typical savings and loan's liabilities are time and savings deposits that mature in less than one year. See Pittman, *supra* note 15, at 501. In response to increasing competition from national residential mortgage originators, savings and (continued...)

a single industry or geographic area, for example, a sponsor may use structured financings to diversify its credit risk.⁵⁷

By being better able to manage its loan portfolio, a sponsor also can strengthen its financial condition. Removing certain assets from the balance sheet can boost the return on assets and on equity. If the transaction is considered to be a sale of assets, income recognition may be accelerated by permitting the sponsor to realize a gain (or loss) upon sale? Income may also be recognized from previously deferred loan fees.

Structured financings also allow sponsors to gain access to alternative funding sources.⁵⁹ Some sponsors, particularly those that enter the capital markets frequently, find it useful to be able to offer new instruments. In addition, structured financings allow sponsors to broaden their investor base.⁶⁰

Structured financings also provide sponsors with access to funding sources that, depending on the sponsor's credit rating, may be less expensive and more feasible than traditional sources.⁶¹ Because securitized assets usually are no longer assets of the sponsor, the structured financing may be rated independently of the sponsor's rating. Sponsors find structured financings particularly beneficial during economic downturns when there frequently is widespread downgrading of corporate credit, making the issuance of corporate debt or equity through the markets less attractive.⁶²

⁵⁶(...continued)

loans also have used structured financing to lower their costs of funding and to sell off assets with inadequate spreads. *Innovations in Thrift Financing: Opportunity and Risk*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Aug. 1987, at 3.

⁵⁷See, e.g., BRYAN, *supra* note 3, at 82-83; Boemio & Edwards, *supra* note 56, at 663; ROSENTHAL, *supra* note 2, at 9-10; Wittebort, *supra* note 36, at 78.

⁵⁸Boemio and Edwards, *supra* note 56, at 663.

⁵⁹See, e.g., BRYAN, *supra* note 3, at 84.

⁶⁰See, e.g., Wittebort, *supra* note 36, at 78.

⁶¹See, e.g., BRYAN, *supra* note 3, at 81-82, 124.

⁶²See Richard Benson, *Recession and Credit Crunch Will Spur Asset Securitization*, MORTGAGE-BACKED SEC. LETTER, Nov. 12, 1990, at 8.

Banks have been particularly active in using structured financings.⁶³ This activity can be traced in part to the severe financial pressures in the United States banking industry. Bank credit quality steadily declined throughout the 1980's, with a considerable acceleration of this decrease occurring within the last few years as a result of deterioration of real estate assets and loans to highly leveraged borrowers.⁶⁴ The deteriorating quality of bank assets has resulted in a significant number of downgrades of the credit ratings of United States banks.⁶⁵

In some cases, structured financings may provide regulatory benefits for banks, savings and loans, and other regulated entities, by enabling them to meet their reserve and capital requirements. For example, banking and thrift regulatory agencies have adopted "risk-based" capital requirements for depository institutions.⁶⁶ The risk-based capital requirements for banks assign assets and credit equivalent amounts of off-balance sheet items to risk categories, depending on each asset's level of credit risk.⁶⁷ The level of capital that a bank must maintain depends on the level of risk -- or "risk weight" -- assigned to that bank's assets. Many banks have had to increase their capital ratios to meet these requirements, but, because of market concerns about their creditworthiness, have

⁶³See, e.g., Boemio & Edwards, *supra* note 56, at 662.

⁶⁴Andrew Freeman, *Credit Downgrades on US Banks Predominate amid Asset Worries*, FIN. TIMES, Aug. 16, 1990, at 19. See also *Bank Profitability in the 1990's*, FITCH RESEARCH FINANCIAL INSTITUTIONS (Special Report), Dec. 20, 1991, at 2.

⁶⁵See *Pressures on U.S. Bank Ratings*, Presentation by Christopher T. Mahoney, Vice President/Associate Director, Financial Institutions Group, Moody's Investor's Service, to the American Bankers Association CFO Forum, New York, September 11, 1990 in MOODY'S STRUCTURED FINANCE RESEARCH AND COMMENTARY, Oct. 1990, at 9. See also *U.S. Money Center Banks*, MOODY'S INDUSTRY OUTLOOK, Aug. 1990, at 4.

⁶⁶Risk-based capital requirements are set forth at 12 C.F.R. pt. 3, App. A (for national banks); 12 C.F.R. pt. 208, App. A (for state member banks insured by the Federal Deposit Insurance Corporation ("FDIC")); 12 C.F.R. pt. 225, App. A (for bank holding companies); 12 C.F.R. pt. 325, App. A (for FDIC-insured state non-member banks); and 12 C.F.R. pt. 567 (for savings associations). For a general discussion of risk-based capital requirements, see, e.g., Michael G. Capatides, et al., *Bank and Savings and Loan Association Regulatory Considerations*, in 2 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 21, § 12.03 at 12-19 to 12-38; FRANKEL, *supra* note 3, § 7.14, at 224-234.

⁶⁷For example, most securities issued or unconditionally guaranteed by United States government agencies are assigned a zero percent risk weight. 12 C.F.R. pt. 3, App. A, § 3(a)(1)(iii) & (iv). An example of a high risk (100% risk weight) asset is stripped mortgage-backed securities (12 C.F.R. pt. 3, App. A, § 3(a)).

had difficulties raising the necessary capital! To meet their capital needs, many banks have sponsored structured financings, either by securitizing assets, such as credit-card receivables, or, less frequently, by setting up "bad banks" whereby non-performing loans are sold to newly created entities chartered as banks, whose primary function is to liquidate these assets. Structured financings have enabled banks to meet risk-based capital requirements by securitizing "higher risk-weighted assets" and either taking the sale proceeds and purchasing "lower risk-weighted risk assets" (which require less capital), or keeping the proceeds in cash or other liquid assets.

Even without higher capital requirements, structured financings may be very attractive for banks.⁶⁹ In addition to obtaining capital by selling their assets through structured financings, banks may also obtain funding by retaining the servicing rights to those assets and retaining a possibly economically valuable residual interest? Also, structured financings can benefit banks by increasing the liquidity of their loan portfolios.⁷¹

⁶⁸For a discussion of the use of securitization by banks and bank holding companies to manage their risk-based capital and capital adequacy requirements, see Boemio and Edwards, *supra* note 56, at 664-669.

⁶⁹It has been argued that even a bank with a AAA rating would benefit in terms of capital cost savings by securitizing those high-quality assets for which regulatory capital requirements overestimate actual expected credit losses. See BRYAN, *supra* note 3, at 83.

⁷⁰For a discussion of residual interests, see *infra* notes 143-145 and accompanying text. By retaining the servicing rights to the assets, banks may continue existing lending relationships with their customers even though the original loans are no longer on their balance sheets.

⁷¹The advantages of increased liquidity are discussed *supra* notes 55-56. Some observers believe that structured financings could lead to a more stable and less costly financial system. See ROSENTHAL & OCAMPO, *supra* note 2, at 13-17, 21. See also PAVEL, *supra* note 43, at 227-229 (suggesting a variety of scenarios in which securitization would help to make the banking system more efficient). Others have suggested that the technology of structured financing could be used to help restructure the banking industry. One observer has written that the technology of structured financing would enable the banking industry to separate the depositing and lending functions of a bank and permit banks to establish separate businesses around the functions that it is the most capable of delivering at the best price. This would address what the observer believes is one of the fundamental flaws of the present banking system, the cross-subsidy of deposits and loans, and promote a competitive banking environment, with only the depository institutions being protected by a federal guarantee. BRYAN, *supra* note 3, at vii-x, 92-98, and *passim*.

C. Purchasers of Structured Financings

1. Institutional Investors

Institutional investors, including banks, savings and loans, pension funds, insurance companies, and money managers have been the predominant purchasers of asset-backed issues.⁷² These investors find asset-backed securities attractive for several reasons. First, institutional investors generally consider most asset-backed securities to be relatively safe investments because such securities generally are highly rated by one or more rating agencies.⁷³ Also, in many instances, institutional investors conduct their own due diligence review prior to investing.⁷⁴ Second, the securities typically offer returns that are higher than those of United States Treasury securities with comparable maturities.⁷⁵ Third, some asset-backed securities, such as certain mortgage-backed securities, are relatively liquid, enabling the investors to resell the securities to meet changed portfolio objectives or new liquidity needs. Fourth, most agency securities and

⁷²ROSENTHAL & OCAMPO, *supra* note 2, at 13; LORE, *supra* note 20, at 2-48. See also Boemio and Edwards, *supra* note 56, at 663. Until recently, savings and loans were the largest holders of mortgage-backed securities. Their share of this market has **shrunk**, in part, because undercapitalized savings and loans must sell substantial amounts of assets. KENNETH G. LORE, MORTGAGE-BACKED SECURITIES: DEVELOPMENTS AND TRENDS IN THE SECONDARY MARKET 2-53 (1990-91 ed.). See also LORE, *supra* note 20, at 2-38. Banks and insurance companies have taken up some of the slack; one observer has reported that insurance companies presently hold approximately one-third of the mortgage-backed securities market. *IDD 1991 Figures*, *supra* note 4, at 22. See also Phil Roosevelt, *Banks Halt Their Binge in Mortgage Securities*, AM. BANKER, May 8, 1990, at 1; *Bank Profitability in the 1990's*, *supra* note 64, at 2/12. Banks and insurance companies also have been active in purchasing non-mortgage asset-backed securities. Although at first blush it may seem ironic that the sponsors of structured financings are among the most active purchasers, asset securitization may allow institutions to diversify their assets. Boemio and Edwards, *supra* note 56, at 663. For example, a Californian bank may find it desirable to securitize mortgages on properties on the West Coast and use the proceeds to buy CMOs backed by mortgages on East Coast properties.

⁷³Boemio and Edwards, *supra* note 56, at 663; ROSENTHAL AND OCAMPO, *supra* note 2, at 13.

⁷⁴In some cases, particularly for private placements, institutional investors are involved in structuring the financing.

⁷⁵Wittebort, *supra* note 36, at 79 (according to Sears, "spreads over five-year Treasuries for credit card issues now run roughly 30 basis points below an index of single- and double-A corporate debt issues, versus about 40 basis points above the index in 1988. . ."). See also Boemio & Edwards, *supra* note 56, at 663.

CMOs backed by agency securities have low risk weightings under depository institution capital requirements.⁷⁶

In addition to the highly rated fixed income securities that are the predominant type of securities offered, many structured financings include other securities that are riskier such as stripped securities and residual interests. Some institutional investors find these securities attractive because they often have higher yields than the highly rated fixed income securities. In addition, institutional investors find that certain of these securities may be useful for hedging.⁷⁷

2. The Retail Market

Although institutional investors are the predominant purchasers of structured financings, there is also a retail market in these securities. Some residential mortgage market products have been specifically targeted to retail investors. For example, since 1985, many CMOs and other multiclass mortgage-backed securities have been structured to include classes that are designed for the retail investor, with minimum denominations as low as \$1000.⁷⁸

There are fewer retail transactions in the non-mortgage asset-backed market. In 1990, approximately \$1 billion of these securities were sold to individual investors, a seventy-six percent increase from 1989.⁷⁹ All were backed by credit card receivables originated by Sears Credit Account Trust or Standard Credit Card Trust.⁸⁰ Securities targeted for the retail market typically

⁷⁶See *supra* note 67.

⁷⁷In 1990, banks and savings and loans became less active in purchasing some of these securities, possibly in anticipation of regulatory changes. See *Banks Halt Their Binge in Mortgage Securities*, *supra* note 72; *IDD 1991 Figures*, *supu* note 4, at 22. For further discussion of these securities and the proposed regulatory changes, see *infra* notes 132-138 and accompanying text.

⁷⁸One observer has estimated that thus far, individual investors have accounted for approximately five percent of all REMIC sales. Richard Chang, *Promising Year for Mortgage Backeds*, *AM. BANKER*, Jan.6, 1992, at 20.

⁷⁹DEAN WITTER REYNOLDS, INC., ASSET-BACKED SECURITIES REFERENCE GUIDE A-1, (Jan.1991) [hereinafter DEAN WITTER].

⁸⁰See DEAN WITTER, *supra* note 38, at A-18.

have been rated **AAA** and sold in denominations as low as \$1000.⁸¹ In 1991, no non-mortgage offerings were specifically targeted for retail investors.⁸²

Retail investors find structured financing securities attractive because of their high ratings and because their yields are higher than those of comparable Treasuries⁸³ (although their yields usually are not as high as the yields on comparable structured financings sold on the institutional market).⁸⁴ Sponsors sell to retail investors to diversify and expand their investor base, as well as to ensure a liquid secondary market for their securities. Selling to the retail market is very labor intensive, however, and thus underwriting fees for structured financings directed to the retail market may be more expensive than for structured financings targeted for institutions.

3. The International Market

A significant number of structured financings sponsored by United States institutions are sold abroad. International issues have been structured both as unregistered Eurobonds in bearer form and as registered securities in the country or countries where the offering is sold. In addition, they have been sold overseas to both institutional and retail investors.

United States sponsors of structured financings have targeted the international market for a variety of reasons. Some have sold their issues overseas because their large portfolios need broad distribution. Others have gone overseas to avoid compliance with the Investment Company Act.

⁸¹For example, "through its Dean Witter Reynolds subsidiary, [Sears] has sold \$1 billion in asset-backed securities to the retail market in denominations as low as \$1,000." Wittebort, *supra* note 36, at 79.

⁸²DEAN WITTER, *supra* note 38, at A-18.

⁸³In addition, one investment columnist has suggested that investors who desire more yield than that available from the average money market fund or certificate of deposit should investigate asset-backed securities. See James E. Leberherz, Asset-Backed Securities Can Be *Higher-Yield* Investment, WASH. POST, June 30, 1991, at H9.

⁸⁴DEAN WITTER, *supra* note 38, at A-18. For example, spreads on credit card asset-backed securities issued on the institutional market from January 1, 1989 to December 30, 1991, averaged approximately 83 basis points, while the spreads on similar asset-backed securities sold to retail investors averaged 46 basis points. *Id.*

Although many offerings have been structured and sold directly in the international market, several sponsors have recently conducted "global" offerings, in which offerings are conducted simultaneously in the United States and abroad.⁸⁵ Global offerings provide a larger market for distribution and promote liquidity for sales on the secondary market.⁸⁶

International investors find asset-backed securities attractive investments for many of the same reasons that domestic investors find them attractive. International investors, like domestic investors, are attracted to these securities, typically high ratings and view them as an alternative to corporate debt securities, which, in uncertain economic times, are less desirable investments.⁸⁷ Many international investors consider asset-backed securities "cheap investments" because they have higher yields than other, similarly rated debt.⁸⁸

Notwithstanding the fact that a significant number of United States sponsors are selling structured finance offerings abroad, international offerings have not been entirely successful. For many global offerings, a majority of the securities are ultimately placed in the United States.⁸⁹ Because structured financings are still in their infancy abroad, international investors must be educated as to the merits of these securities, particularly in light of their unfamiliar structure. This is particularly true for global offerings which must be

⁸⁵For example, 17 issues of non-mortgage asset-backed securities were sold in global offerings in 1991, more than double the number offered in all of 1990. DEAN WITTER, *supra* note 38, at A-1; DEAN WITTER, *supra* note 79, at A-1.

⁸⁶In 1990, two Eurobond settlement agencies, Cedel S.A. and Euroclear System, began handling Citicorp-sponsored credit card structured financings, thereby linking international clearinghouse systems and permitting local clearance. See Michael R. Sesit, *Citicorp Forges "Global Bonds" with Credit-Card Link*, WALL ST. J., Aug. 30, 1990, at C1, C8.

⁸⁷See Tracy Corrigan, *Asset-Backed Securities Make Their Mark on Europe*, FIN. TIMES, June 25, 1990, at I24.

⁸⁸See Sesit, *supra* note 86, at C8.

⁸⁹See, e.g., Tracy Corrigan, *Europe Grows Cautious of Credit Card-Backed Issues*, FIN. TIMES, June 21, 1990, at 22 (dealers report stronger demand in United States than in international markets for latest issues of bonds backed by credit-card receivables); Corrigan, *supra* note 87 ("asset-backed securities market remains substantially US-based, in terms of both issuers and investors"); *Citicorp Deal Well Received but Retail Holders Want Out*, THOMSON'S GLOBAL ASSET BACKED MONITOR, Aug. 31, 1990, at 1, 2. Foreign investors bought 48% and 45% respectively of Citicorp's first two global credit card offerings. See Sesit, *supra* note 86, at C8.

structured to be attractive to both United States and foreign investors. For example, the limited European participation in one global offering was attributed in part to the fact that the payment schedule for the arrangement which, while typical for securities issued in the United States, was unfamiliar to European investors?'

D. Expectations for the Future

The future of structured financings is subject to some debate. Proponents have argued that this type of financing will become and remain in the long term as prevalent a financing technique as equity, conventional debt, or bank loans,⁹¹ but others disagree.⁹²

Most commenters, however, believe that, at least in the short term, structured financings will continue to have a large presence in the United States capital markets. One observer has predicted that 1992 will be a record-setting

⁹⁰The arrangement required coupons to be paid monthly, and the redemption of the principal to be spread out over the last year of the issue's life. See Tracy Corrigan, *MBNA America Bank in Asset-Backed Loan Debut*, FIN. TIMES, Nov. 2, 1990, at 130.

The difficulty in selling structured financings abroad is illustrated by the recent problems in the credit card backed securities market. Overseas issuances of financings backed by United States generated credit card receivables were virtually nonexistent in late 1990 and early 1991. This was due, in part to the rise in default rates on credit card receivables increasing the possibility of accelerated payments to investors, which caused anxiety among foreign investors that were unfamiliar with the concept of prepayment risk. As a result of this concern, sponsors have structured recent transactions to reduce the chance of prepayment. See *Sears Taps International Bond Markets with \$750M of Card-Backed Securities*, THOMSON'S GLOBAL ASSET BACKED MONITOR, Apr. 12, 1991, at 3; Patrick Harverson, *Back to Normal After Scares over Prepayment Risk*, FIN. TIMES; Jun. 19, 1991, at § III, p. III.

⁹¹See ROSENTHAL & OCAMPO, *supra* note 2, at 221-22; John B. Caovette, *As the Capital Markets Unbundle What Will the Future Bring?*, THOMSON'S GLOBAL ASSET BACKED MONITOR, Aug. 17, 1990, at 6; Wittebort, *supra* note 36, at 80. One observer has predicted that within the next 10 to 15 years, 60% to 80%, or more, of all new loans may be securitized. BRYAN, *supra* note 3, at 81.

⁹²See, e.g., LeLogeais & Kerr, *supra* note 46. These observers argue that the need to securitize may not necessarily be as important in the future as it is today. They also assert that not all assets can be securitized because of their lack of uniformity, an assertion echoed by Rosenthal and Ocampo. Rosenthal and Ocampo acknowledge that some commenters believe that the recent growth of structured financings is only a "temporary exploitation of certain regulatory loopholes," although they conclude that securitization is not simply regulatory arbitrage. ROSENTHAL & OCAMPO, *supra* note 2, at 5.

year for mortgage-backed securities, as low-interest rates prompt large increases in refinancings and initial loan originations.⁹³ The non-mortgage market also should remain strong to the extent that structured financings remain the best funding techniques for car companies and banks.⁹⁴

In addition, some observers believe that more sponsors -- both financial and non-financial institutions -- will become interested in asset securitization. Such sponsors could seek to issue securities backed by assets that are not presently among those commonly being securitized.⁹⁵

Finally, two federally sponsored entities have recently begun securitization programs. The Resolution Trust Company has begun to securitize more than seventy percent of the assets amassed from failed savings and loans.⁹⁶ Of the approximately \$67 billion in financial assets that will be used, \$57 billion are mortgage loans, \$3.2 billion are high yield bonds, and \$6.9 billion are consumer loans.⁹⁷

In addition, in mid-1991, the Federal Agricultural Mortgage Corporation ("Farmer Mac"), which administers the secondary market activities for agricultural real estate loans, began issuing securities backed by pools of loans guaranteed by the Farmers Home Administration. In the near future, Farmer Mac intends to offer guarantees for securities backed by agricultural mortgages that are issued by conventional lenders.

11. The Securitization Process

All structured financings share the same basic structure. We outline below the basic components of a typical structured financing and discuss how the

⁹³Chang, *supra* note 78.

⁹⁴IDD 1991 *Figures*, *supra* note 4, at 23.

⁹⁵For example, one observer predicted that financings backed by computer and other equipment leases would soon flourish. Wittebort, *supra* note 36, at 80.

⁹⁶Susan Schmidt, *Cleanup Agency to Back Bonds With Thrift Assets*, WASH. POST, Oct. 25, 1990, at E1.

⁹⁷*Id.* For additional discussion of the RTC securitization program, see Paulette Thomas, *S&L Liquidators Get \$294.5 Million in Junk Bond Sale*, WALL ST. J., Oct. 2, 1991, at B12; Paulette Thomas, *Mortgage-Backed 'Ritzy Maes' Stroll Down the Street with RTC*, WALL ST. J., Jul. 12, 1991, at C1.

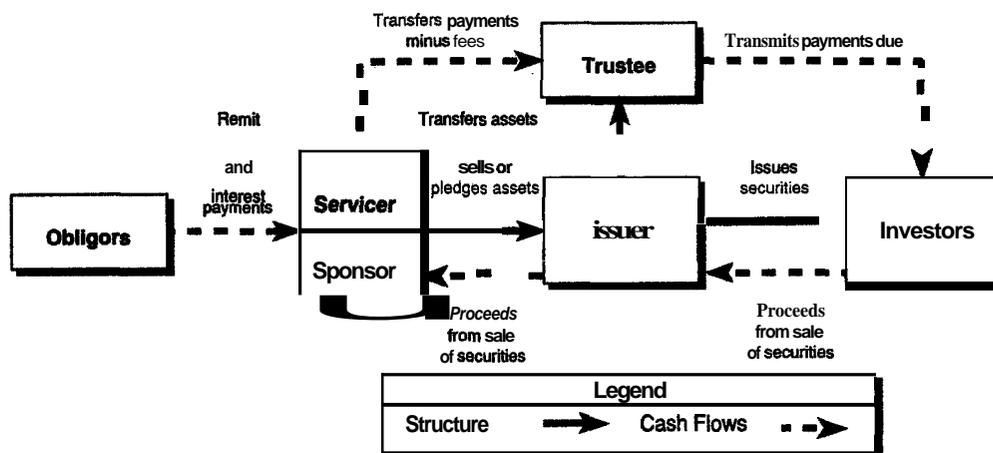
financing works. We also discuss investor protection issues, the role of the rating agencies, and the use of credit enhancement. Finally, we consider the differences between unrated and rated structured financings. Our discussion is necessarily general; there is a wide range of permutations used in practice.

A. The Components of a Structured Financing

1. The Participants

A typical structured financing has four primary participants: **the** sponsor, who often is the initial owner of the assets; the issuer, who obtains the assets and issues the securities; the servicer, who takes ultimate responsibility for servicing the assets in the pool; and the trustee, who is assigned and holds the assets through the life of the issue and monitors the activities of the servicer.⁹⁸ The basic components of a structured financing are shown in Figure 1-5 below.

FIGURE 1-5
Structured Financing Components



⁹⁸Credit enhancers and the rating agencies may also participate in structuring the transaction. Because not all structured financings are rated or contain external credit enhancement, the roles and responsibilities of these parties are discussed separately. For a discussion of credit enhancement see Section III.B.2 *infra*. For a discussion of rating agencies, see Section III.B *infra*. Of course, as in most securities issuances, underwriters and independent auditors are also participants.

A structured financing begins with a pooling and servicing agreement ("P&S agreement") among the sponsor, the trustee, and the servicer. The P&S agreement establishes the issuer and governs the transfer of the assets from the sponsor to the issuer (and ultimately to the trustee). It also sets forth the rights and responsibilities of the participants and typically contains a number of representations, warranties, and covenants about the characteristics of the assets. Finally, the agreement may require that periodic reports be sent to investors, the trustee, and other parties.

Typically, under the P&S agreement, the sponsor transfers a fixed pool of homogeneous assets, which it owns, to the issuer (either directly or through a subsidiary of the sponsor) in return for the proceeds from the sale of securities backed by these assets. In order for the sponsor to remove the assets from its balance sheet and therefore to obtain many of the benefits of asset securitization, the transfer must be a sale for accounting purposes? Whether the transaction

⁹⁹Under generally accepted accounting principles ("GAAP"), a sale occurs when both the risks and rewards of ownership have been transferred to the purchaser. Under GAAP, a sponsor may remove assets from its balance sheet if the sponsor sells the assets without recourse. For many sponsors, a transfer with recourse may still be a sale, provided that the transfer meets the conditions set forth in Statement of Financial Accounting Standards No. 77 ("FAS 77"). FAS 77 generally provides that a transfer of receivables with recourse shall be recognized as a sale if (i) the transferor surrenders control of future economic benefits of the sold receivables, (ii) the transferor cannot be required by the transferee or any other entity to repurchase the receivables except in accordance with the recourse provisions, and (iii) the transferor's recourse obligation can be reasonably estimated. FAS 77 is currently under review as part of a re-examination of financial instruments and off-balance sheet accounting.

Historically, banks and savings and loans have generally been subject to regulatory accounting principles ("RAP") RAP, like GAAP, has allowed a sponsor to remove assets from its balance sheet if the sponsor sells the assets without recourse. Unlike GAAP, however, RAP generally has required an asset sale with recourse to be treated as a borrowing. The seller must continue to hold the full amount of regulatory capital reserves against the proceeds from the transfer of the assets. There are two relevant exceptions. First, in regard to sales of participations in pools of residential mortgages, the bank may treat the transfer as a sale as long as the bank does not retain any "significant risk of loss," which generally has been viewed as being more than 10% recourse. The other exception pertains to the use of "spread accounts," which are also a type of credit enhancement, discussed *infra* note 232 and accompanying text. For more information about the accounting aspects of securitization, see Ernest L. Puschaver, *Accounting Issues, in 2 SECURITIZATION OF FINANCIAL ASSETS*, *supra* note 21, at §§ 18.01-18.04; ROSENTHAL & OCAMPO, *supra* note 2, at 65-73; PAVEL, *supra* note 43, at 163-181 (Chapter 7, "Accounting for Securitization: GAAP versus RAP").

Recently, section 121 of the Federal Deposit Insurance Corporation Improvement Act of 1991
(continued...)

between the sponsor and the issuer constitutes a sale also is relevant to determining whether the assets transferred and the cash flow therefrom could be used to pay the sponsor's creditors should the sponsor become insolvent. (What constitutes a sale for bankruptcy purposes may differ from what constitutes a sale for accounting purposes.)

The issuer is typically a special purpose entity whose only business activity is to acquire and hold the assets, and issue securities backed by the assets. Because the issuer has no significant facilities or employees, its duties are contracted out to other parties, primarily the servicer.¹⁰⁰

The form of organization of the issuer generally depends on tax considerations and the desired payment structure of the financing.¹⁰¹ There are two basic types of payment structures that are used: pass-through and pay-through.¹⁰² In a pass-through structure, the issuer typically is a grantor trust.¹⁰³ A grantor trust essentially is a trust that acts as a conduit for the

⁹⁹(...continued)

(Pub. L. 102-242, 105 Stat. 2236, 2250-51 (Dec. 19, 1991), codified at 12 U.S.C. § 1831n) amended the Federal Deposit Insurance Act to require that financial statements submitted to federal banking agencies be prepared in accordance with GAAP, unless an agency determines that a particular GAAP principle is inconsistent with certain stated objectives, in which case the agency may prescribe an accounting principle no less stringent than GAAP.

¹⁰⁰2 FRANKEL, *supra* note 3, § 14.1, at 80-81; *The Importance of the Role of the Servicer in Securitized Transactions*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Apr. 1990, at 12 [hereinafter *The Servicer in Securitized Transactions*].

¹⁰¹The form of organization of an issuer holding mortgage-related assets need not affect the payment structure of the financing if the issuer elects REMIC status. See *infra* note 149 and accompanying text.

¹⁰²For a general discussion of these structures and the attendant tax issues, see, e.g., William A. Schmalz et al., *Tax Issues*, in 1 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 21, §§ 9.01-9.06; Charles M. Adelman & Roger D. Lorence, *Tax Considerations*, THE ASSET SECURITIZATION HANDBOOK, *supra* note 46, at 298-334; ROSENTHAL & OCAMPO, *supra* note 2, at 48-63.

¹⁰³ROSENTHAL & OCAMPO, *supra* note 2, at 49. Although securitizations of credit card receivables use trusts that issue certificates and often are characterized as pass-through (see DEAN WITTER, *supra* note 38, at B-37 to B-43 (characterizing Sears Credit Card Account Trusts as pass-through)), the structure of this type of financing generally prevents the issuer from qualifying as a grantor trust for tax purposes. See Jason H.P. Kravitt, *A Brief Summary of Structures Utilized in the Securitization of Financial Assets*, in 1 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 21, § 4.03[C], at 4-39.

outright sale of assets to the investors. Investors purchase certificates representing a fractional undivided interest in the trust and are entitled to a pro rata share of the cash flows from the assets.¹⁰⁴ To be considered a grantor trust for tax purposes, the trust must be passive. Thus, this structure generally requires that the pool remain fixed, except for limited substitutions to replace "defective" assets, and does not allow for management of cash flows.¹⁰⁵

In a pay-through structure, the issuer typically is a special purpose corporation or an owner trust.¹⁰⁶ Most of the securities issued are structured as debt, permitting deduction of interest payments which offsets the income received on the assets. Issuers structured in this manner need not be subject to the constraints imposed by the grantor trust tax classification. Thus, payments to investors need not be tied to the incoming cash flows from the underlying assets, but rather may be structured to permit the creation of classes of securities with different payment schedules that are tailored to investor demand.¹⁰⁷

The servicer is the primary administrator of the financing. Often the sponsor or an affiliate of the sponsor is the servicer.¹⁰⁸ In other financings, the

¹⁰⁴The certificates are considered to be equity (1 FRANKEL, *supra* note 3, § 8.2, at 289), although in many respects they have debt-like characteristics. One drawback of these securities, from a marketing standpoint, is that investors are subject to greater prepayment risk. ROSENTHAL & OCAMPO, *supra* note 2, at 53. For a discussion of the characteristics of these securities, see *infra* note 128 and accompanying text.

¹⁰⁵The trust must be passive to avoid being classified as an association, which would be taxable as a corporation. Such a characterization could have adverse tax consequences because the interest income to the trust from the assets would be taxable while the payments from the trust to the investors would be nondeductible distributions. Consequently, the trust would have a substantial tax liability, and investors would receive yields substantially less than anticipated. ROSENTHAL & OCAMPO, *supra* note 2, at 51.

¹⁰⁶*Id.* at 54.

¹⁰⁷*Id.* at 55.

¹⁰⁸See *Credit Curd Deals Aren't Equal*, FITCH STRUCTURED FINANCE (Special Report), Apr. 10, 1990, at 5. If the sponsor is the servicer, the sponsor typically agrees that, in servicing the accounts, it will impose the same terms as those it imposes with respect to its own portfolio of accounts. In some mortgage transactions, where the sponsor is a conduit, each originator of the mortgages in the pool may act as a "servicer," and perform many of the functions that the servicer would perform, but only for the mortgages it originates. A "master servicer" is responsible for overseeing the subservicers and tracking the funds from subservicers to investors. See STANDARD & POOR'S CORPORATION, S&P'S STRUCTURED FINANCE CRITERIA 98 (1988) [hereinafter S&P'S STRUCTURED FINANCE CRITERIA].

servicing function is carried out by a third party that may not necessarily be in the business of generating the type of assets that it is servicing.

The servicer collects payments on the underlying assets when due and ensures that funds are available so that investors are paid in a timely manner.¹⁰⁹ The servicer's specific obligations depend on the transaction and the assets involved. Generally, the servicer is responsible for collecting on delinquent accounts.''' The servicer may commingle collections on the assets with its own funds until payment to investors, may remit the collections to the trustee, or maintain the funds in custodial accounts:'' The servicer may also reinvest idle cash in short-term investments when there is a timing mismatch between the collections and distributions to investors.¹¹²

In addition, the servicer oversees the substitution of assets as permitted by the P&S agreement. For example, the agreement may permit the substitution of assets that are determined not to meet specified eligibility criteria. A servicer also may monitor tax and insurance payments, maintain escrow accounts, advance funds to provide liquidity to cover loans in arrears, maintain all relevant documentation, and administer other day-to-day operations of the issuer.¹¹³

The trustee is appointed to monitor the issuer's obligation to investors. Generally, publicly issued structured financings that issue debt are subject to the Trust Indenture Act.¹¹⁴ The Trust Indenture Act sets forth requirements

¹⁰⁹See 2 FRANKEL, *supra* note 3, § 14.8, at 91.

¹¹⁰*Id.*

¹¹¹If the credit quality of the servicer is low, some risk is created by the servicer commingling collections. The funds may become subject to claims of the servicer's creditors if the servicer becomes insolvent. See Darrow, et al., *supra* note 21, § 7.02[D][2], at 7-14.

¹¹²*Id.* at 7-13.

¹¹³See S&P'S STRUCTURED FINANCE CRITERIA, *supra* note 108, at 24.

¹¹⁴Congress amended the Trust Indenture Act in 1990. See Trust Indenture Reform Act of 1990, Pub. L. 101-550, 104 Stat. 2721 (1990), codified at 15 U.S.C. §§ 77ccc-77eee, 77iii-77rrr, and 77vvv (effective November 15, 1990). The 1990 legislation, among other things, removed the prohibition against an otherwise qualified trustee that has one of the statutorily specified relationships with the obligor on the indentured securities (formerly "conflicts of interest") from serving as trustee provided that there is no default. The legislation also expressly incorporated provisions previously required to be specifically placed in the trust indenture, and gave the Commission exemptive authority.

regarding, among other things, the eligibility and qualifications of trustees,¹¹⁵ the preferential collection of claims against the issuer, and reporting obligations. The Trust Indenture Act also addresses the duties of trustees when an issuer defaults.

The Trust Indenture Act applies only to financings that issue debt. Because pass-through certificates are regarded as equity, transactions issuing such securities are not subject to that Act. As a practical matter, however, the structures of many such transactions are similar to transactions that are subject to the Trust Indenture Act.¹¹⁶ Similarly, although private placements are exempt from the Trust Indenture Act, some of these transactions also are structured in a way that is consistent with that Act's requirements.

In a publicly offered structured financing, the trustee typically is a bank that is not affiliated with the sponsor or any other parties to the transaction.¹¹⁷ Only a few entities currently are in the business of acting as trustees in structured financings.

¹¹⁵Generally, the Trust Indenture Act requires the appointment of one or more trustees, at least one of which is a corporation organized under the laws of the United States or a state (or organized under the laws of a foreign government as permitted by the Commission), with a minimum combined capital and surplus of \$150,000. 15 U.S.C. § 77jjj (a) (1)& (2). The Trust Indenture Act prohibits an obligor or its affiliate from serving as trustee for indentured securities offered by the obligor. 15 U.S.C. § 77jjj(a)(5). Also, if a trustee has or becomes subject to a conflicting interest, the trustee must resign or remove the conflict. 15 U.S.C. § 77jjj(b). A conflicting interest generally arises if the indentured securities are in default and the trustee has one of the relationships with the obligor set forth in section 310(b) of the Trust Indenture Act. 15 U.S.C. § 77jjj(b).

¹¹⁶See LORE, *supra* note 20, at 4-49.

¹¹⁷Because the Trust Indenture Act prohibits the obligor or its affiliates from serving as trustee, neither a sponsor of a structured financing that falls within that Act, its affiliates, nor a credit enhancer (which meets the definition of obligor under Section 303(12) of that Act) may act as trustee. The Trust Indenture Reform Act of 1990, *supra* note 114, amended the Trust Indenture Act to provide that an underwriter may act as trustee so long as there is no default. See 15 U.S.C. § 77jjj(b)(2).

Generally, the trustee is assigned and holds the underlying assets (or documentation of interest in the assets) in accounts designated for each structured financing for the benefit of investors. The trustee also receives payments from the servicer and any credit enhancers, and remits them to investors.¹¹⁸ The trustee also may reinvest the funds on a short-term basis prior to payment.¹¹⁹ In addition, the trustee reviews the activities of the servicer, in part by receiving periodic reports from the servicer on payments and future projections. The trustee may be expected to calculate the payments and future cash flow projections if the servicer fails to perform this duty.¹²⁰ Similarly, if the servicer becomes insolvent or withdraws, the trustee may act as interim servicer until another servicer has been appointed. Finally, the trustee may act to represent the interests of investors if there is a default.¹²¹

2 The Securities Issued

Almost all issuers, whether using a pass-through or pay-through structure, offer fixed-income securities (*i.e.*, securities that are either debt obligations or that have debt-like characteristics).¹²² The securities typically entitle the holder or owner to a specified principal amount at maturity and bear interest based on the principal amount at a fixed rate, a floating rate determined periodically by reference to an index, or a rate determined through periodic auctions among investors or prospective investors, or through the periodic remarketing of the instrument.¹²³ The interest rate also may be determined by reference to

¹¹⁸Asset Finance Group, *The First Boston Corp., Overview of Assets and Structures*, in *THE ASSET SECURITIZATION HANDBOOK*, *supra* note 46, at 35-36.

¹¹⁹E. Kay Liederman, *The Role of the Trustee in Securitization*, *AM. BANKER* (Special Adv. Supp.), Dec. 17, 1991, at 13A.

¹²⁰See *S&P'S STRUCTURED FINANCE CRITERIA*, *supra* note 108, at 24.

¹²¹For a more detailed discussion of the role of the trustee, see Liederman, *supra* note 119.

¹²²The traditional distinction between debt and equity is somewhat blurred in the context of structured finance. For further discussion, see 1 *FRANKEL*, *supra* note 3, § 8.9 at 301.

¹²³A few issuers, mainly finance subsidiaries of thrift institutions and corporations, have offered asset-backed auction rate preferred stock. See *S&P'S STRUCTURED FINANCE CRITERIA*, *supra* note 108, at 51. See also 1 *FRANKEL*, *supra* note 3, § 8.6.

specified portions of the interest received on the underlying assets. The average life of most non-mortgage structured financings ranges from one to five years; mortgage-backed securities usually have a longer duration.¹²⁴ The securities are not redeemable at the option of the holder.

The payment of the security derives directly from the cash flow generated by the portfolio of assets.¹²⁵ The yields paid to investors obviously must be lower than the effective yield on the underlying assets. For example, securities backed by credit card receivables may yield only nine percent, even though the receivables themselves yield eighteen percent." Investors, in effect, give up a substantial portion of the yield spread because the transformation of these assets into securities enables investors to receive what they consider to be safer and more liquid investments than if they had purchased the assets without the financing being structured.¹²⁷

The structure of the security depends in part on whether the payment structure is pass-through or pay-through. In the case of a pass-through structure, with two exceptions discussed below, the issuer must issue a single class of securities. Each security represents a fractional interest in the trust. Investors are entitled to a pro rata share of the cash flows, net of fees. This structure requires that all payments, including prepayments, be passed through to investors almost immediately after receipt. Accordingly, the timing of payments and maturity of

"The average life of a debt security is the expected average time it will take to repay each dollar of principal. Most securities backed by automobile loans, for example, run from one to two years, while credit card-backed securities typically have a maturity of two to six years. DEAN WITTER, *supra* note 38, at A-28.

¹²⁵There are two other payment structures used in structured finance for which payment does not depend directly on the cash flow on the assets. "Market value transactions" are financings in which payment on the securities sold depends on the market value of the underlying assets. This structure has been used primarily in securitizing high yield bonds. See *infra* note 162. "Third party credit-supported debt" involves the issuance of securities the payment on which is derived primarily from third-party credit support. Darrow et al., *supra* note 21, § 7.02[B], at 7-9. Because the overwhelming majority of structured financings are cash flow transactions, these other payment structures generally are not discussed in this chapter.

¹²⁶The differential usually is used to pay fees for servicing and credit enhancement and to cover losses on the underlying assets. Any remaining spread may be allocated to the holder of the residual interest. See *infra* notes 143-145 and accompanying text.

¹²⁷See BRYAN, *supra* note 3, at 81-82.

a pass-through security is uncertain, and investors may receive payment of principal when reinvestment opportunities are relatively unattractive.¹²⁸

In contrast, the pay-through structure allows allocation of cash flow to permit the issuance of securities with maturities and payment schedules different from those of the underlying assets. Although structured financings using the pay-through structure may issue only one class of securities, many issue several classes. One common form of this structure, often called the "sequential-pay structure," permits the issuance of several classes of securities with differing maturities. Typically, interest is paid concurrently on most or all of the classes, but principal is allocated to one class until that class is retired. The other classes are retired sequentially in order of maturity date.¹²⁹ Yields and ratings may vary among the classes. In addition, the pay-through structure permits the use of different payment schedules. Thus, the pay-through structure permits securities to be structured with maturities and payment schedules that meet the needs of particular investors.¹³⁰

Both structures permit the issuance of stripped securities. Stripped securities are created by splitting the cash flow from an asset pool into separate components of interest and principal, so that investors of different classes receive unequal proportions of principal and interest. There are an infinite number of possible principal and interest combinations. In simplest form, strips are issued in interest only ("IO") and principal only ("PO") classes. IO certificates entitle the holder to a pro rata share of interest paid on the assets, without any preference or priority in the class. PO certificates entitle the holder to a pro rata share of principal payments made on the assets. Stripped securities were developed for and are used primarily in the mortgage market.¹³¹

¹²⁸See, e.g., ROSENTHAL & OCAMPO, *supra* note 2, at 52-54; CRAIG J. GOLDBERG, MERRILL LYNCH MORTGAGE CAPITAL INC., *INVESTING IN ASSET-BACKED SECURITIES* 9-10 (1988).

¹²⁹A multiclass structure may contain classes that issue more complicated types of securities, such as zero coupon and floating rate bonds and stripped securities. See, e.g., Pittman, *supra* note 15, at 506-507; *Rating Whole-Loan Backed Multiclass Securities*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Aug. 1989, at 12.

¹³⁰See GOLDBERG, *supra* note 128, at 9-10. See also *supra* text accompanying note 107.

¹³¹See, e.g., Pittman, *supra* note 15, at 511. When we refer to "stripped securities," we are excluding stripped Treasury Securities where principal and interest components of Treasury notes and bonds are separated.

IO and PO certificates are volatile securities. The investor in an IO or PO certificate is paying for an interest in a payment stream that is priced based upon an assumed prepayment pattern. Accordingly, changes in interest rates or other factors that alter prepayments on the assets greatly affect the timing and amount of payment on the securities and thus the value of the securities.¹³²

Despite this volatility, or because of it, many institutional investors have purchased stripped securities either as stand alone securities or for use as hedging devices.¹³³ Because of the risks inherent in investing in stripped securities and similar instruments, the Federal Financial Institutions Examination Council ("FFIEC")¹³⁴ has issued for comment a Supervisory Policy Statement concerning the selection of securities dealers by, and certain securities activities of, depository institutions.¹³⁵

¹³²*Id.* at 511-512. If the assets are prepaid faster than expected (*e.g.*, when interest rates decline), IO investors may suffer large losses. In the case of a sudden drop in interest rates, IO investors may lose most of their investment. PO investors would experience a gain in this situation since PO certificates are sold at discount and investors would recover their investment sooner than anticipated. Conversely, if the assets are prepaid more slowly than expected (*e.g.*, when interest rates are rising), IO investors benefit because maturities lengthen and more interest is collected. PO investors effectively would experience a loss because the yield to maturity on the certificates would be lower since the term to maturity of the assets is extended. *Id.*

¹³³The credit quality of stripped securities may be rated. The ratings, however, do not address prepayment risk. See *Stripped Mortgage Securities*, STANDARD & POORS CREDITREVIEW: COLLATERALIZED MORTGAGE OBLIGATIONS, Aug. 29, 1988, at 5.

¹³⁴The FFIEC consists of the Board of Governors of the Federal Reserve System, the FDIC, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration.

¹³⁵In January 1991, the FFIEC published for comment Supervisory Policy Statement Concerning Selection of Securities Dealers, Securities Portfolio Policies and Strategies and Unsuitable Investment Practices, and Stripped Mortgage-Backed Securities, Certain CMO Tranches, Residuals, and Zero-Coupon Bonds, 56 FR 263 (Jan. 3, 1991). In response to comments, in August, 1991, the FFIEC published for comment a revised portion of the Supervisory Policy Statement that pertained to the acquisition of stripped mortgage-backed securities, certain CMO tranches, residual interests, and zero coupon bonds. Supervisory Policy Statement on Securities Activities, 56 FR 37095 (Aug. 2, 1991) [hereinafter Supervisory Policy Statement].

Under the proposal, stripped securities and certain other securities that the FFIEC considers to be "high-risk mortgage securities"¹³⁶ are deemed to be "[un]suitable investments for depository institutions" because of their volatility. Accordingly, the proposal would prohibit most depository institutions from investing in such securities unless they are purchased for the purpose of reducing the institution's overall interest rate risk.¹³⁷ Depository institutions wanting to purchase these securities must have the internal ability to determine both prior and subsequent to purchase that the securities would actually reduce interest rate risk. Depository institutions would be required to dispose of high-risk mortgage securities that do not reduce interest rate risk in an orderly fashion.¹³⁸

In addition, both pass-through and pay-through structures permit the issuance of classes of senior and subordinate securities. The senior/subordinate structure splits the cash flow into at least two classes. The senior class has first claim on the cash flow from the pool; the subordinate class absorbs credit losses before the senior class.¹³⁹

The senior class usually is offered publicly and is considered to be insulated from credit risk in part because of the presence of the subordinated class. Performance of the classes depends on the specific senior/subordinate structure adopted and on the actual level of defaults on the assets. The

¹³⁶In general, the FFIEC considers any mortgage derivative product that possesses average price volatility or average life greater than a standard, fixed-rate 30-year mortgage-backed pass-through security to be "high risk." Thus, the policy also applies to certain CMOs, certain REMICs, and CMO and REMIC residuals. Supervisory Policy Statement, *supra* note 135, at 37096-98. In addition, the policy applies to residuals issued in non-mortgage structured financings. *Id.* at 37097. For a discussion of residuals, see *infra* notes 143-145 and accompanying text. The National Association of Insurance Commissioners is drafting a proposal limiting insurance company purchases of these securities. See *IDD 1991 Figures*, *supra* note 4, at 22.

¹³⁷Depository institutions with "strong capital and earnings and adequate liquidity" and with "closely supervised trading department[s]" would be permitted to purchase high-risk mortgage securities for trading purposes. See Supervisory Policy Statement, *supra* note 135, at 37096 n.1.

¹³⁸*Id.* at 37098. The proposal would also require that the depository institutions develop written portfolio policies, approved by their boards, regarding the purchase of these types of securities. *Id.*

¹³⁹Some senior/subordinate structures split the cash flows into several senior sequential-pay classes. Similarly, some structured financings have more than one subordinated class. See *Rating Whole-Loan Bucked Multiclass Securities*, *supra* note 129, at 11-12.

subordinate class may be privately placed, publicly offered,¹⁴⁰ with yields higher than those of the senior class certificates,¹⁴¹ or held by the sponsor.¹⁴²

Finally, most structured financings include residual interests, which are equity interests backed by cash flow not needed to pay the holders of the fixed-income securities or to pay administrative expenses. This cash flow may be derived from income generated by the reinvestment of collections on the assets prior to disbursement to investors, by overcollateralization, or by the spread between the interest rate on the assets and the interest rate on the fixed-income securities.¹⁴³

Residuals may have a high return, but they are volatile, unpredictable securities. Predicting the ultimate return on residual interests is highly complicated, and requires a high degree of sophistication, given the variety of sources of cash flows and the effects of changes in prepayments and interest rates on the cash flow. The risks vary from transaction to transaction, depending on the transaction's structure and assets. The interdependency of these factors "leads to myriad analyses and predictions for residual interest investors."¹⁴⁴

¹⁴⁰The market for subordinate securities has grown tremendously in the last two years, with estimated issuance for 1991 totaling over \$2 billion. Wesley W. Sparks, *The Consumer Asset-Backed Market: A Trader's Perspective*, AM. BANKER (Special Adv. Supp), Dec. 17, 1991, at 1A, 6A.

¹⁴¹The subordinate class may or may not be rated. GOLDBERG, *supra* note 128, at 12. If the subordinate class is rated, it usually has a rating lower than the senior piece. In many cases, the subordinate class has an external credit enhancement and is thereby protected to some degree against default losses. The amount of credit enhancement needed to achieve an investment grade rating is relatively high due to the greater risk of default. See *Credit Card Deals Aren't Equal*, *supra* note 108, at 13.

¹⁴²The sponsor's retention of the subordinated class is considered by some to be a form of recourse, and therefore the transfer of the receivables to the pool may not be considered a true sale for bankruptcy concerns. For example, following a downgrade of the rating of Sears' senior debt, Fitch downgraded from AAA to AA certain structured financings where Sears retained the subordinate class. See *Sears' Debt, Asset-Backed Ratings Cut*, FITCH INSIGHTS, Apr. 16, 1990, at 4.

¹⁴³See, e.g., Pittman, *supra* note 15, at 509-510; Boemio & Edwards, Jr., *supra* note 56, at 662.

¹⁴⁴*CMO Residuals*, STANDARD & POOR'S CREDITREVIEW: COLLATERALIZED MORTGAGE OBLIGATIONS, Aug. 29, 1988, at 4. Residuals structured as equity are not rated. Some residuals are structured as debt, having stated principal amounts (which often are extremely small) and bearing interest at a minimum stated rate. These securities can be rated. As with other debt-like obligations, the rating does not address prepayment and interest rate risk, which can be extreme for residuals.

Initially, residual interests usually were retained by the sponsor. In the last several years, residual interests increasingly have been sold to institutional investors, which usually purchase them for hedging purposes.¹⁴⁵

3. Types of Structured Financings

Many structured financings, regardless of their underlying assets, are structured and operate generally in the manner set forth in the previous two subsections. Some structured financings, however, possess different attributes than other types of structured financings, in part because of the nature of their assets. This section briefly describes some of these differences.

a. CMOs and REMICS

CMOs are multiclass, sequential pay, debt obligations backed by various types of mortgage loans or by mortgage-backed securities.¹⁴⁶ Most CMOs issue at least four tranches, with each tranche typically having a different maturity, interest rate, and prepayment risk. Like most sequential pay securities, the first tranche on which principal is paid typically is the class with the shortest maturity.

That class generally bears the highest prepayment risk, while classes with longer maturities bear less of a prepayment risk. To reduce prepayment risk, CMOs may contain tranches that issue "planned amortization class" bonds ("PACs"). Investors in PACs receive principal and interest payments that are made in accordance with a fixed amortization schedule that does not depend on the rate of prepayments of the underlying mortgages, thereby providing a high degree of predictability regarding final maturity and expected average life. Prepayment risk is shifted to other tranches in the CMO, which consist of "companion" bonds that are subordinate to PACs and which have more volatile prices and expected average lives. Some CMOs also include tranches that issue stripped securities, zero coupon bonds, floating rate bonds, and debt-like residual securities.

¹⁴⁵See 1 FRANKEL, *supra* note 3, § 8.3.2.

¹⁴⁶Of the approximately \$118.6 billion in CMOs and other multiclass mortgage securities offered in 1990, approximately \$112.8 billion or ninety-five percent held pass-through securities as collateral. *Database, supra* note 16, at Table 3. Of the approximately \$138.0 billion in CMOs and other multiclass mortgage-backed securities offered in the first three quarters of 1991, approximately \$134.8 billion or 97.7%, held pass-through securities as collateral. *Id.*

Many issuers elect to be treated as "real estate mortgage investment conduits" ("REMICs"), which were created by the Tax Reform Act of 1986.¹⁴⁷ The election of REMIC status permits the issuance of multiple classes of securities without tax constraints.¹⁴⁸ REMIC status affects only the taxation of the issuer and the investors -- the securities law and accounting requirements remain the same.

Under the REMIC provisions, the issuer's form of organization does not affect the payment structure. The issuer may be a grantor trust, corporation, partnership, or even a designated pool of mortgages that is not a separate legal entity. The securities issued may be pass-through securities, debt, stock, or partnership interests. Only issuers of securitized mortgage products can elect REMIC status.¹⁴⁹

In practice, REMICs are very similar to CMOs (and are considered by some to be a subset of CMOs), with the exception of their tax treatment. A REMIC must issue at least two types of securities: regular interests and residual interests. A REMIC may have multiple classes of regular interests, each with varying maturities, but only one class of residual interests.¹⁵⁰ Although REMIC status is elective, as of January 1, 1992, it is generally the only means for issuing

¹⁴⁷Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2309, Title VI, § 671(a) (Oct. 22, 1986), codified and amended as 26 U.S.C. §§ 860A-860G.

¹⁴⁸For example, non-REMIC multiclass securities generally must be issued as debt obligations to avoid dual taxation. See *supu* notes 106-107 and accompanying text.

¹⁴⁹See Kravitt, *supu* note 103, § 4.02[c], at 4-16. Substantially all of the assets of a REMIC must consist of "qualified mortgages" or "permitted investments." I.R.C. § 860D(a)(4). The term "qualified mortgage" includes "any obligation (including any participation or certificate of beneficial ownership therein) which is principally secured by an interest in real property," among other things (I.R.C. § 860G(a)(3)), such as residential and commercial mortgages and mortgage-backed securities. The term "permitted investment" includes any cash flow investment, qualified reserve asset, or foreclosure property. I.R.C. § 860G(a)(5).

¹⁵⁰For tax purposes, regular interests are considered debt, notwithstanding the actual form of ownership interest, while residual interest holders are treated much like partners in a partnership. Residual interest holders do not, however, have the disadvantages associated with owning a partnership interest, *i.e.*, the limited ability to transfer the interest, and personal liability. See ROSENTHAL & OCAMPO, *supra* note 2, at 60-62; Pittman, *supra* note 15, at 508-09.

multiclass mortgage-backed securities without certain adverse tax consequences.¹⁵¹

b. Revolving Accounts Receivable

Many of the assets being securitized are fixed payment obligations; that is, they are loans for a fixed amount of credit, amortized according to a fixed schedule of payments. Such assets include fixed rate residential mortgages, consumer automobile loans, boat loans, and manufactured housing loans.

Revolving accounts receivable also are being securitized, however. A revolving account generally allows a borrower to draw on a line of credit up to a certain limit and repay only a minimum amount on a monthly basis. A borrower may pay more than the minimum monthly amount or repay the entire outstanding balance when billed. Thus, unlike a fixed payment obligation, the outstanding balance in a revolving account is unpredictable and may vary significantly every month. The type of revolving account most commonly securitized is the credit card account receivable.¹⁵²

The structure of a financing backed by credit card accounts receivable reflects the characteristics of the asset. Typically, the sponsor pools and transfers to a trust current and future receivables generated by specified credit card accounts. The accounts themselves do not become the property of the trust. Although the portfolio of the accounts from which the receivables are generated is fixed at the time the securities are issued, the balance of the pooled assets will fluctuate as new receivables are generated and existing amounts are paid or charged off as a default. Although credit card balances fluctuate, the balance of a large pool of credit card receivables is generally predictable over time, which permits credit card receivables to be securitized.¹⁵³ In the event that the

¹⁵¹See Kravitt, *supra* note 103, § 4.02[C], at 4-16, and Robert E. Gordon, et al., *Real Estate, in 2 SECURITIZATION OF FINANCIAL ASSETS*, *supra* note 21, § 15.02[E][2], at 15-39 to 15-40.

¹⁵²Revolving home equity lines of credit and revolving wholesale automobile loans also are beginning to be securitized. For a discussion of the securitization of home equity loans, see *Securitizing a New Industry*, STANDARD & POOR'S CREDIT REVIEW: ASSET-BACKED SECURITIZATION, Mar. 27, 1989, at 49-54.

¹⁵³See *Credit Card Deals Aren't Equal*, *supra* note 108, at 7.