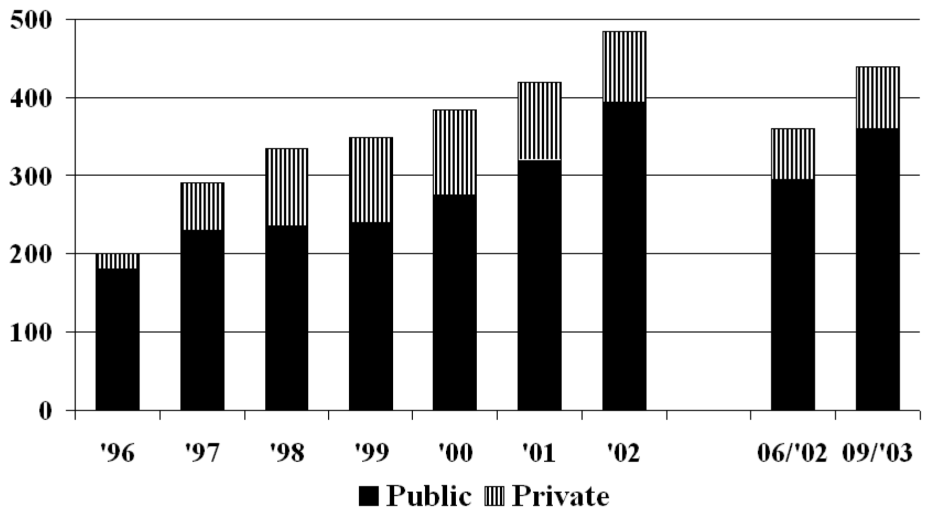
Asset-backed securities (ABS)

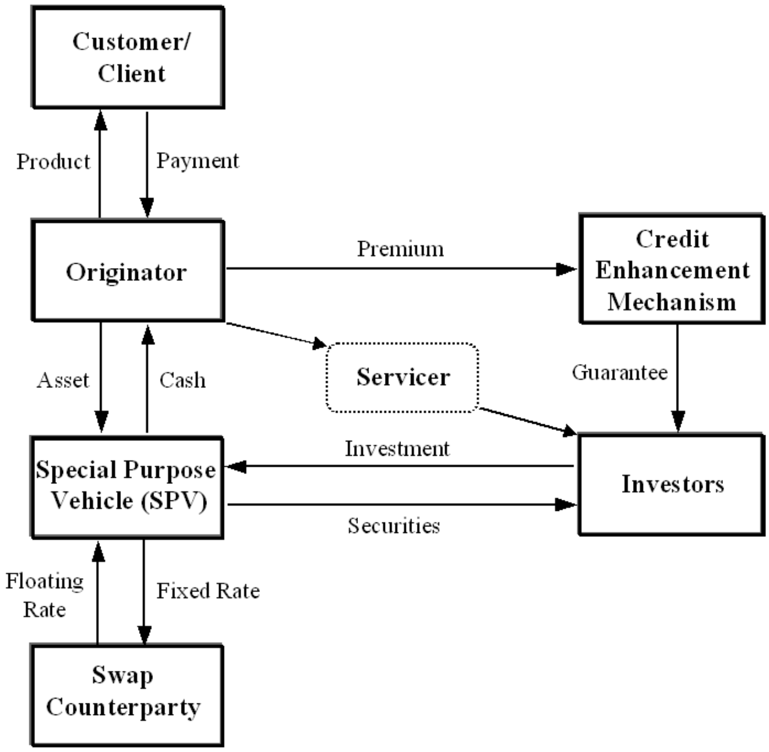
Asset-backed securities (ABS) are bonds or notes backed by financial assets. Classically these assets consist of receivables (other than mortgage loans) such as credit card receivables, auto loans, home equity or manufactured housing. Financial institutions that originate loans, i.e. banks, credit card providers, auto finance companies and consumer finance companies, turn their loans into marketable securities through a process known as securitization.

Asset-backed securities are first developed in the mid-1980s, and are the main form of securitization in the United States. As "new" form of financing, securitization strongly influenced the business of the banking industry since these financial transactions become frequently completed without the inclusion of banks (*disintermediation*). Also in Europe this trend seems to increase, driven by regulatory requirements and the impact of the BASEL COMMITTEE. According by the BOND MARKET ASSOCIATION, the total amount of asset-backed debt outstanding rose to about \$1.5 trillion in the third quarter of 2002 from \$316 billion in 1995. The issuance of asset-backed securities increased from \$268 billion in 1998 to about \$489.1 billion in 2002, and set a new record in 2003, totaling \$584.2 billion. Figure 1 gives an overview about the issuances of asset backed securities from 1996-2003.



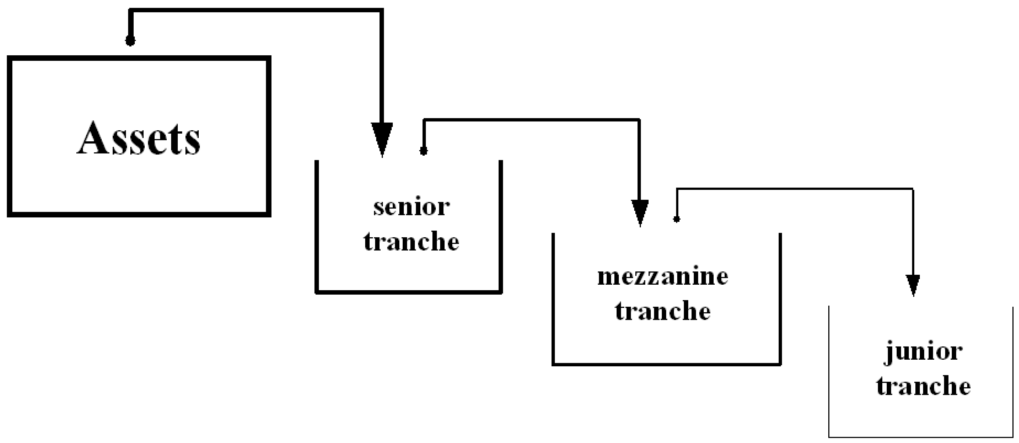
Source: Thomson Financial Securities Data

The loan originators are the sponsors of these ABS-securities. These financial institutions sell pools of loans to a so-called *special-purpose vehicle (SPV)*, whose sole function is to buy such assets in order to securitize them. The SPV, which is usually a corporation, then sells them to a trust. The trust repackages the loans as interest-bearing securities and actually issues them. The true sale of the loans by the sponsor to the SPV provides *bankruptcy remoteness* by insulating the trust from the sponsor. The securities, which are sold to investors by the investment banks that underwrite them, are *credit-enhanced* with one or more forms of extra protection - whether internal, external or both. The structure of an ABS-transaction is shown in diagram 2:



The SPV is not only used to insulate investors from sponsor's credit risk, additionally to provide transparent servicing of asset/liability and to structure tranches of debt to appeal to different classes of investors. Through the synthetic ABS-structure via SPV, the firm provides tax and accounting benefits to the sponsor.

The sponsor sells risk to investors by an asset backed security for several reasons. One reason could be to reduce regulatory capital. Under the capital adequacy framework from 1988 (Basel I), a bank has to hold capital against its credit risk which depends only on the credit exposure but not on the credit risk. Selling good credit risks is a way to reduce capital requirements under the Basel I accord. Another motivation for the sponsor could be to reduce a potential concentration risk in his credit portfolio by selling parts of it through an asset backed security. By creating several tranches of different riskiness, the sponsor is able to attract different groups of investors. Figure 3 shows a sequence of tranches; the sections are distinguished in senior, mezzanine and junior tranches which reflect varying exposure, respectively different levels of interest and repayments.



Generally, only the interest part of payments to ABS investors is subject to income tax - state and local (if applicable), as well as federal. The portion of the payments that represents return of principal or original cost is not taxable. However, if the securities were purchased at an original- issue discount or a market discount, different rules apply. In the first case, if an investor buys an asset-backed security when it is issued for a price that represents a discount from its face value, the investor may be taxed on the discount that accrues on the security before the investor actually receives it. In the case the security was purchased at a discount in the secondary market, the investor may be subject to a tax on the accrued market discount as principal payments are received on the security, as well as on the interest payments.

In practice, the demand had created new risk transfer products due to differences in supervisory, accounting and tax rules. A relatively new development can be seen in the use of corresponding regulation advantages across countries with financial risk reinsurance. Additional risk financing solutions through capital markets my means of risk securitization and other financial and finite reinsurance contracts underline the present convergence of banking and insurance markets.

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See also: ASSET SWAPS; CREDIT DERIVATIVES; CREDIT RISK ENHANCEMENT; DEFAULT RISK; ENHANCEMENT STRATEGIES; MORTGAGE DERIVATIVES; MORTGAGE-BACKED SECURITIES (MBS) AND DERIVATIVES; RISK POOLING; SECURITIZATION; SYNTHETIC ASSETS/SECURITIES; TAX-BASED FINANCIAL ENGINEERING TECHNIQUES.