EUROPEAN SECURITISATION

A RESOURCE GUIDE

European Securitisation Forum

European Securitisation Forum

The European Securitisation Forum was established to promote the continued growth and development of securitisation throughout Europe, and to advocate the interests and serve the needs of European securitisation markets and market participants. Membership in the Forum is open to a diverse range of organizations, including securities firms, banks and other financial institutions, originators and issuers, institutional investors and asset managers, law firms, rating agencies, financial guarantors and accounting firms, among others.

Additional information about the Forum may be obtained from its Internet Web site, located at *www.europeansecuritisation.com*.

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PREFACE

It is widely believed that securitisation offers tremendous opportunities, and significant benefits, throughout Europe — to issuers and investors, and, from a broader social and economic perspective, to the citizens and governments of individual European jurisdictions.

Yet despite this potential, and notwithstanding recent growth, securitisation remains at a relatively early stage of development, and is still evolving as a mainstream capital markets financing mechanism throughout Europe. The understanding, usage and acceptance of securitisation varies widely from one jurisdiction to the next. A basic reason for this may be the relative novelty of securitisation. It has only recently been introduced in much of Europe, and simply does not enjoy the same level of familiarity, comfort and recognition as other, more traditional forms of debt and equity financing, whether among issuers, investors, governmental policymakers or the general public.

This publication, developed by the European Securitisation Forum, is intended to help close this gap, and to advance the general level of knowledge and understanding of securitisation concepts, instruments and markets. It is designed to provide a basic description, and working definition, of securitisation. It describes the principal features and characteristics of securitised instruments, as well as the structural elements and mechanics that are common to most, if not all, securitisation transactions. It identifies key transaction participants, and explains their essential roles and functions. It provides an overview of important legal, regulatory and other considerations affecting securitisation transactions. Finally, it offers some elementary perspectives on the purposes and benefits of securitisation for various types of market participants, and its present and potential application to meet a growing range of financial market needs throughout Europe.

I. INTRODUCTION

Securitisation may broadly be defined as the process whereby loans, receivables and other financial assets are pooled together, with their cash flows or economic values redirected to support payments on related securities. These securities, which are generally referred to as "asset-backed securities" or "ABS," are issued and sold to investors — principally, institutions — in the public and private markets by or on behalf of issuers, who utilize securitisation to finance their business activities.

The financial assets that support payments on ABS include residential and commercial mortgage loans, as well as a wide variety of nonmortgage assets such as trade receivables, credit card balances, consumer loans, lease receivables, automobile loans, and other consumer and business receivables. Although these asset types are used in some of the more prevalent forms of ABS, the basic concept of securitisation may be applied to virtually any asset that has a reasonably ascertainable value, or that generates a reasonably predictable future stream of revenue. As a result, securitisation has been extended to a diverse array of less well known assets, such as insurance receivables, obligations of shippers to railways, commercial bank loans, health care receivables, obligations of purchasers to natural gas producers, and future rights to entertainment royalty payments, among many others.

II. SECURITISATION MECHANICS: TRANSACTION STRUCTURES AND PARTICIPANTS

A. OVERVIEW

Although the list of assets that may be securitised is potentially endless, the fundamentals of securitisation are relatively basic, and are common to nearly all types of transactions. As a result, the process of securitisation — including the underlying structures that are utilized and the roles and functions of key transaction participants — will be similar to a meaningful degree wherever the securitisation concept is applied. These similarities are present even in different countries, under different legal and regulatory structures.

At the most basic level, the intended goal and effect of virtually all securitisation transactions is to isolate the financial assets that support payments on the related ABS. This isolation ensures that payments on the ABS are derived exclusively from the performance of a segregated pool of financial assets (and any related credit or liquidity enhancements, as discussed below), rather than from the entity that originates or holds the assets. In this sense, securitisation may be distinguished from other, more traditional forms of debt and equity financing, in which returns to investors are generally derived from the claims-paying ability or profit-making potential of an ongoing business enterprise. Another basic feature of the ABS market that distinguishes it from the corporate debt and equity markets is the continuous (typically, monthly) return of principal exhibited by many types of ABS. This feature of ABS requires investors to assess the impact of alternative potential future cash flows (including prepayments) in making a meaningful evaluation of a security's yield.

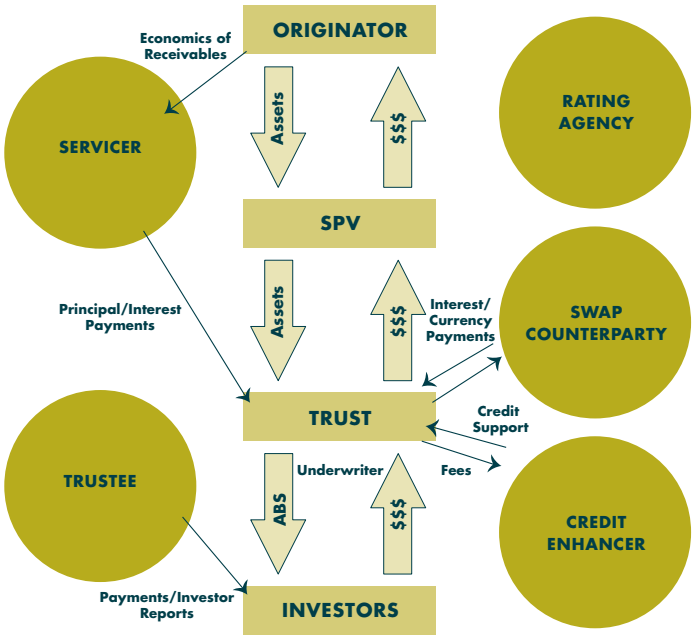
B. TRANSACTION STRUCTURES AND PARTICIPANTS

Although the transaction structures employed in securitisation transactions may at first glance appear to be complex, there are a number of common components.

Asset Origination and Servicing The assets that underlie securitisation transactions are first created when an entity — the "originator" — makes a loan or otherwise extends financing to a borrower — the "obligor" — to finance the obligor's purchase or use of that asset.

Once a financial asset is created, the originator usually continues to provide a collection and management function in connection with that asset, in accordance with its existing credit and collection procedures. These activities are generally referred to as "servicing," and when acting in this capacity, the originator (or other entity performing these functions) is referred to as the "servicer."

TRANSACTION PARTICIPANTS AND FUNCTIONS
Creation of an ABS Security



Asset Conveyance and "True Sale" To create asset-backed securities, the originator or other owner of financial assets conveys those assets to another entity which, for reasons discussed below, will usually be a bankruptcy-remote or insolvency-remote special purpose vehicle, or "SPV." The SPV (or another entity to whom the SPV conveys the assets, which is often organized in the form of a trust, whose beneficiaries are investors in the ABS) will issue debt securities in the capital markets (acting in this capacity as the "issuer"). These securities are usually purchased by institutional investors, including banks, insurance companies, pension plans and portfolio managers, among others. The proceeds from the issuance of these securities provide the funds needed by the SPV or other issuing entity to pay the purchase price of the assets.

The conveyance of assets from the originator to the SPV or other issuer generally needs to be conducted in a manner that results in a "true sale," and not, in substance, merely a secured financing. A true sale is necessary in order to remove the assets from the bankruptcy or insolvency estate of the originator or other seller of the assets — in other words, to effect the legal isolation of the assets described above. To the extent this legal isolation (i.e., a true sale) is accomplished, investors generally may look only to the assets themselves — and not to the originator or seller of the assets — for payment on the ABS. Equally important, to the extent that the originator or seller were to become bankrupt or insolvent, a trustee or receiver of the bankruptcy or insolvency estate would not be able to reach the transferred assets to satisfy claims of creditors of the originator or seller.

Credit Enhancement Depending upon the nature of the transaction and the assets involved, the asset pool may need to be supported by one or more types of credit and/or liquidity support ("credit enhancement" and "liquidity enhancement," respectively) in order to achieve the desired credit risk profile for the debt securities being issued. As discussed in greater detail below, such credit and liquidity enhancements may be supplied from internal sources (i.e., they may be generated from the assets themselves), or they may be supplied, for a fee, by a third party.

Interest Rate and Currency Swaps In European securitisation transactions, it is often the case that the assets underlying a floating-rate ABS issuance bear interest at a fixed rate. It is also relatively common for the underlying assets to be denominated in one or more currencies that differ from the currency in which the ABS bond payments are made. In order to hedge against potential mismatches, the sponsor of a securitisation transaction will typically arrange for the issuing entity to enter into interest rate swaps, currency swaps and other hedging and risk-management arrangements with another entity (a "swap counterparty") to protect against unfavorable interest rate and currency exchange rate movements.

Credit Ratings In most securitisations, and for virtually all ABS issued in the public markets, credit ratings from one or more major, internationally recognized rating organizations ("rating agencies") are customarily obtained at issuance. Investors and other ABS market participants have come to rely on independent rating agencies to perform the specialized and complicated analysis needed to assess the credit quality, structural integrity and other attributes of a particular ABS. Once issued, rating agencies usually (but not always) monitor the performance of the transaction throughout its life, and maintain and adjust their ratings accordingly.

Underwriting and Issuance An underwriter or placement agent (the "underwriter") generally serves as an intermediary between an issuer and investors in an ABS offering. The underwriter provides guidance on structuring the transaction in an efficient and cost-effective manner, which includes devising one or more classes, or "tranches," of ABS that are sold to investors in the public and private markets. In this fashion, the cash flows generated by underlying financial assets may be allocated to different tranches of debt securities, which may exhibit different credit, payment, coupon, maturity and other investment characteristics, to meet the needs and preferences of individual investors.

The choice of public versus private issuance of ABS depends on a number of factors, including the anticipated size of the offering, the breadth and depth of potential investor interest, and whether and to what extent there is a need or desire to facilitate broad and relatively frictionless secondary market trading of the bonds after issuance. As public offerings are generally more costly and time consuming (as a result of securities registration, listing, reporting, legal, accounting and other fees and expenses that are not present in private offerings), public ABS issuances are usually reserved for larger-scale Eurobond offerings for which a broad investor base is sought. In contrast, many European ABS (including certain tranches of otherwise public ABS offerings) are privately placed, with marketing efforts focusing on a more limited number of large institutional investors. Some of these private offerings are structured in a manner to comply with Rule 144A under the U.S. securities laws. Such 144A offerings may be useful because they allow for relatively unrestricted secondary market trading among very large "qualified insitutional buyers," or QIBs, which promotes greater secondary market liquidity among these issues.

Post-Issuance Reporting Once the ABS are issued, it is generally recognized as good market practice for issuers to provide for the ongoing collection and dissemination of performance data relating to each individual securitisation. This post-issuance transaction data, which is made available to investors and other market participants, details the performance of individual tranches of ABS and the financial assets that support them. This data is usually assembled and prepared for dissemination by servicers, who perform the ongoing servicing and collection functions with respect to the underlying assets, and is reported by the trustee or other administrative or payment agent on behalf of the issuer.

C. CREDIT ENHANCEMENT

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

1. Types of Internal Credit Enhancement

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

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

Overcollateralization In this case, the face amount of the financial asset pool is larger than the security it backs.

Yield Spread (Excess Servicing) Excess servicing, which is the first defense against losses, comprises the difference between the coupon on the underlying assets and the security coupon. In some ABS structures, excess servicing may be applied to outstanding classes as principal.

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

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

2. Types of External Credit Enhancement

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

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

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

Letters of Credit (LOCs) are issued by financial institutions, typically banks, that are paid a fee to stand by with cash to reimburse the trust for any losses actually incurred, up to the required credit enhancement amount.

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

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

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

III. PRINCIPAL OBJECTIVES AND BENEFITS OF SECURITISATION

As a capital markets financing mechanism, securitisation supports a number of objectives and may generate a wide range of benefits, whether viewed from the standpoint of an issuer or an investor, or from a broader social and economic perspective.

A. ISSUER BENEFITS

From an issuer's perspective, securitisation provides a vehicle for transforming relatively illiquid, individual financial assets into liquid and tradable capital market instruments. Through securitisation, an originator can replenish its sources of funds, which can then be used for additional origination activities.

Securitisation also provides issuers with what is frequently a more efficient, and lower cost source of financing in comparison with other bank and capital markets financing alternatives. The principal reason for this greater efficiency and lower cost of financing is the ability of an issuer, through securitisation, to issue securities that carry a higher rating (and thus a lower interest rate) than the long-term credit rating of the originating institution. This affords issuers cheaper financing than may be supported by their unsecured claims-paying ability. At the same time, by offering an alternative to more traditional forms of debt and equity financing, securitisation allows issuers to diversify their financing sources.

Another central objective and benefit of securitisation from an issuer's standpoint is that it facilitates the removal of assets from the organization's balance sheet. This outcome can help an issuer improve various financial ratios, utilize capital more efficiently and achieve compliance with risk-based capital standards. Financial institutions in most European jurisdictions are subject to the Basel Accords, which set forth an agreed framework for measuring the capital adequacy of certain commercial banks and the minimum standards that must be achieved. As many banks must either increase capital or dispose of financial assets to comply with these guidelines, and as increasing capital may be quite expensive, disposing of assets through a securitisation transaction has become an increasingly attractive means of assisting commercial banks in complying with the Basel framework.

A final set of issuer benefits associated with securitisation relate to the more flexible and adaptable nature of this form of financing in comparison with more traditional alternatives. For example, the ability of an issuer to subdivide and redirect cash flows from underlying financial assets often provides it with a better ability to manage its balance sheet,

and to achieve a more precise and efficient matching of the duration of its assets and liabilities. Similarly, many issuers have found that securitisation permits a greater degree of specialization and corresponding efficiency, by allowing a financial institution to segregate and unbundle its loan origination, funding and servicing functions in a manner that best responds to that institution's competitive advantages and desired strategic focus.

B. INVESTOR BENEFITS

From the standpoint of investors, securitised instruments offer significant yield premiums over sovereign government issues of comparable maturities. The magnitude of this premium depends on a number of factors, but is most directly related to the credit quality of the particular ABS. Securitised instruments typically are traded on the basis of a spread above a benchmark rate — such as the London Interbank Offered Rate (LIBOR), in the case of floating rate instruments. As such, they can help meet investors' demands for alternative spread-based investment product, while simultaneously serving basic investment goals of diversification and the risk reduction that may result.

Investors pursue varying strategies involving the ABS sector. For example, a large percentage of LIBOR-based floating-rate product tends to be absorbed by commercial paper conduits or leveraged LIBOR funds. Utilizing this strategy, investors can take advantage of the spread between their low funding costs and the wider margins available in the ABS market. On the fixed-rate side, pension funds constitute a large investor segment for certain types of ABS due to their relatively high credit ratings and predictable cash flow. Given their constituency, pension funds tend to be conservative in their investment strategy, and ABS provide a wide variety of product choices at attractive spreads. On the other hand, insurance companies and money managers tend to focus on total return. The ABS market offers generous spreads in comparison to the corporate debt markets, allowing total return accounts to focus on incremental spread characteristics. Accordingly, the bulk of low investment-grade rated ABS products tend to be purchased by insurance company and money manager accounts.

The significant and virtually limitless variety and flexibility of credit, maturity and payment structures and terms made possible via securitisation techniques allows investment products to be tailored in a manner that responds to specific, and sometimes unique, investor needs. This variety and flexibility are the hallmarks of securitisation structures and instruments, and is a key investor consideration. And, as the secondary market for broad categories of European securitised instruments matures, and adds greater breadth and depth, investors are also likely to benefit from increasing levels of liquidity and a corresponding tightening of spreads.

C. SOCIAL AND ECONOMIC BENEFITS

In markets where securitisation has been employed on a broader scale, a number of public, social and economic benefits have been realized. For example, the existence of liquid and efficient secondary securitisation markets has had the effect of increasing the availability, and reducing the cost, of financing in the primary lending markets. The financing needs being serviced often relate to areas that are favored by social or governmental policy, such as increasing the supply of funds for home ownership. Similarly, liquid and efficient secondary securitisation markets can reduce geographical and regional disparities in the availability and cost of credit throughout a particular jurisdiction by linking local credit extension activities to national, and increasingly global, capital markets systems.

It has also been observed that robust securitisation markets facilitate and encourage the efficient allocation of capital by subjecting the credit-granting activities of individual financial institutions to the pricing and valuation discipline of the capital markets. In this

fashion, securitisation helps to promote the allocation of scarce societal capital to its most efficient uses. From a regulatory and financial markets supervisory perspective, securitisation offers a useful mechanism by which financial institutions may shift concentrated credit, interest rate and market risks associated with their portfolio activities to investors and the more broadly dispersed capital markets, thus reducing risks to individual institutions, and systemic risks within financial systems.

For all of these reasons, the widespread use and encouragement of securitisation as a matter of governmental policy can help to achieve desirable social and economic goals, such as stimulating the growth of affordable housing; increasing the availability and lowering the cost of consumer credit; promoting efficient market structures and institutions; facilitating the efficient use and rational allocation of capital; and facilitating the achievement of governmental fiscal, economic and regulatory policy goals.

IV. BASIC TYPES OF SECURITISED INSTRUMENTS

There are a number of methods of classifying financial assets and related ABS. Perhaps the key distinctions are (1) whether the ABS is supported by mortgage or nonmortgage financial assets, and (2) whether the underlying assets are amortizing or nonamortizing.

A. MORTGAGE-BACKED ABS

1. Pass-throughs

The most basic form of mortgage-backed security, known as a "pass-through" or "participation certificate," represents a direct ownership interest in a pool of mortgage loans or in a pool of mortgage-backed securities. As the name suggests, periodic payments of principal and interest from the pool of mortgages are collected by the servicer of the security, and are passed through to investors. Pass-throughs may be collateralized by level-pay, fixed- or floating-rate mortgage loans of various maturities.

2. Collateralized Mortgage Obligations

A collateralized mortgage obligation, or "CMO," is a multiclass security that is backed by a pool of pass-through mortgage loans or mortgage-backed securities. In structuring a CMO, an issuer distributes cash flow from the underlying mortgage collateral among various classes of debt securities, or tranches, which constitute the bond issue. Every CMO contains two or more such tranches, each having expected maturities and cash flow characteristics that are designed to meet specific investment objectives. For example, the average life expectancies of the different tranches in a four-part CMO transaction might be two, five, seven and 20 years.

Sequential-Pay, or "Plain Vanilla," Tranches

The most basic type of CMO is known as a sequential-pay, or "plain vanilla," bond. As the payments on the underlying mortgage loans (or other collateral) are collected, the CMO issuer first pays a specified coupon rate of interest to the bondholders of each tranche. All scheduled payments of principal from the mortgage collateral, plus all unscheduled principal prepayments, are directed to the investors in the first tranche until it is paid in full. Investors in subsequent tranches do not start receiving principal payments until the prior tranches are retired. This sequential paydown continues until the last tranche — the security having the longest maturity — is retired.

Planned Amortization Class (PAC) Tranches

PAC tranches of CMOs establish a principal sinking fund schedule that remains fixed as long as prepayments remain within a specified band. If prepayments are faster or slower than the specified band, principal is shifted to or from other tranches, called companion or support tranches (described below). Only if prepayments are faster or slower than the specified band will the PAC pay on a different principal schedule. Thus, the yield and average life of a PAC tranche estimated at the time of investment are more likely to remain stable over the life of the security.

PAC tranches are one of the most common types of CMO tranche, and constitute a large segment of the new-issue market. Because they offer a high degree of investor cash-flow certainty, PAC tranches usually offer yields that are lower than other similarly creditworthy, non-PAC mortgage securities having the same expected maturity.

Targeted Amortization Class (TAC) Tranches

TAC tranches also provide more cash-flow certainty than a sequential tranche by providing protection against early redemption, if prepayments increase up to a certain level. A TAC bond may have a longer maturity, however, if prepayment rates fall. The yields on TAC bonds are typically higher than yields on PAC tranches with similar average lives, but lower than yields on companion tranches.

Companion, or Support, Tranches

Every CMO containing PAC or TAC tranches will also have companion tranches (sometimes called support bonds), which absorb the prepayment variability that is removed from the PAC and TAC tranches. Once the principal is paid to the active PAC and TAC tranches according to a predetermined schedule, the remaining excess, or shortfall, is reflected in payments to the active companion tranches. The average life of a companion tranche may vary widely, increasing when interest rates rise and decreasing when rates fall. To compensate for this variability, companion tranches offer the potential for higher expected yields when prepayments remain close to the rate assumed at purchase.

Z-Tranches (also known as Accretion Bonds or Accrual Bonds)

Z-tranches are structured so that they pay no interest during a period in which specified conditions exist (a "lockout period"), usually while other tranches are active. During the lockout period, a Z-tranche is credited with accrued interest, and the face amount of the bond is increased at the stated coupon rate on each payment date. After the lockout period ends, Z-tranche holders start receiving cash payments that include both principal and interest. Typical Z-tranches are structured as the last tranche in a series of sequential, or PAC, and companion tranches and have average lives of approximately 20 years. However, Z-tranches can be structured with intermediate-term average lives as well.

3. Stripped Mortgage-Backed Securities

Principal-Only (PO) Securities

Some mortgage securities are created so that investors receive only principal payments generated by the underlying collateral. These Principal-Only (PO) securities may be created directly from mortgage pass-through securities, or they may be tranches in a CMO. In purchasing a PO security, investors pay a price that is deeply discounted from the face value and ultimately receive the entire face value through scheduled principal payments and prepayments. POs are extremely sensitive to prepayment rates. A companion tranche structured as a PO is called a Super PO.

Interest-Only (IO) Securities

Separating principal payments from pass-through securities to create PO mortgage securities necessarily involves the creation of Interest-Only (IO) securities. IOs can also be tranches of CMOs that are created by stripping coupon interest from other classes. IO securities are sold at a deep discount to their "notional" principal amount, namely, the principal balance used to calculate the amount of interest due. They have no face or par value. As the notional principal amortizes and prepays, the IO cash flow declines. IOs are one of only a few fixed-income products which may benefit from increases in market interest rates.

Residuals

CMOs also contain a "residual" tranche, which collects any cash flow remaining from the collateral after the obligations to the other tranches have been met. Residuals may be structured as sequential, PAC, floating-rate or inverse floating-rate tranches, and differ from regular tranches primarily in their tax characteristics and, in some cases, transfer restrictions.

Floating-Rate Tranches

Floating-rate CMO tranches carry interest rates that are tied in a fixed relationship to an interest rate index, such as the LIBOR, subject to an upper limit, or "cap," and sometimes to a lower limit, or "floor." Floating-rate securities can be structured using PAC, TAC, companion and sequential tranches.

The creation of a floating-rate security from fixed-rate collateral requires that an inverse-floating-rate security be present. Inverse floaters have coupons that move opposite to changes in interest rates — increasing in coupon as rates decline and decreasing in coupon as rates increase.

B. NONMORTGAGE ABS

Nonmortgage asset-backed securities typically employ the same types of structures that are prevalent in the mortgage-backed ABS market — specifically, the pass-through or pay-through structure. However, there have been a number of innovations in the types of issuance structures that are used to warehouse or hold the pool of assets that generate interest and principal payments on such ABS. These may be generally described as non-amortizing, or revolving, structures, which are distinguishable from the amortizing structures typically employed in mortgage-backed ABS transactions. Following is a brief description of common types of assets and issuance structures currently being used in the nonmortgage ABS market:

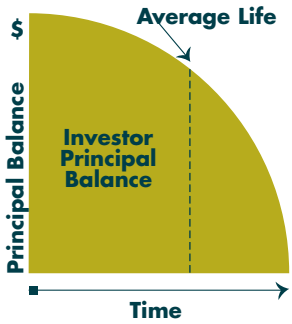
1. Amortizing and Nonamortizing Assets

An amortizing asset is one that must be paid off over a specified time period, with regular payments of both principal and interest. Residential mortgage loans are perhaps the leading example of the larger class of amortizing assets. A nonamortizing, or revolving, asset does not require scheduled repayments of principal, but generally does require regular payments of interest on the outstanding principal balance. Revolving credit card accounts are a primary example of nonamortizing assets.

2. Amortizing and Nonamortizing Issuance Structures

By extension, ABS that return principal to investors throughout the life of the security are said to be fully amortizing. They may be designed to match closely the repayment of underlying assets through scheduled and unscheduled interest and principal repayments, or their cash flows may be structured in a manner that provides greater certainty of maturity, and a greater (or lesser) degree of protection against prepayments on the underlying assets,

AMORTIZING ABS



- Amortizing structures pay principal to investors in monthly or quarterly installments as received from obligors.

  Interest at a fixed or floating rate is paid on the declining balance.

- Amortizing structures are priced and traded based on average life, which can be thought of as the time-weighted number of months (or years) that principal is outstanding.

- Average life incorporates assumptions regarding prepayments, since any prepaying principal (including losses) will accelerate the rate at which the investor balance is paid down.

- Residential and commercial mortgages, retail auto loans, home equity loans, manufactured-housing loans, equipment loans, and student loans are typically securitised using amortizing structures.

which would otherwise result in an early return of principal to an investor. As discussed below, prepayment risk is a key investment consideration associated with ABS, although the rate of prepayment may vary considerably by the type of underlying asset.

The most basic amortizing cash-flow structure is referred to as a "pass-through," in which investors in ABS receive their proportional allocation of principal payments on the underlying financial assets as they are received, together with required interest, until the security is retired. To the extent that there are multiple tranches of ABS, under the pass-through structure all such tranches simultaneously receive a pro rata allocation of principal payments (together with interest) during the life of the securities. In contrast, ABS may be issued in sequential pay structures. A wide variety of other cash-flow structuring techniques are used to allocate and prioritize payments among various tranches of securities, in order to produce desired cash-flow and maturity characteristics.

Interest on ABS may be paid at a fixed or floating rate. In recent years, a growing number of ABS — backed both by amortizing and nonamortizing assets — have been offered with floating, rather than fixed, rates of interest. This is particularly true of securitisations designed to meet the needs of European investors, who frequently are seeking assets possessing an interest rate that is indexed to a designated funding reference (such as LIBOR), plus a specified margin. When the underlying assets consist of fixed-rate obligations, a cash-flow mismatch may be inevitable. As discussed above, it is common for an issuer in these situations to arrange with a counterparty for an interest rate swap or a rate cap in order to offset the resulting basis risk to floating-rate investors.

Revolving assets (primarily credit card receivables, but also certain other types of consumer debt, trade receivables and leases) may be securitised using a controlled amortization structure. This is a method of providing investors with a relatively predictable repayment schedule, even though the underlying assets are nonamortizing. After a predetermined "revolving" period, during which only interest payments are made, these securities call for the return of principal to investors in a series of defined, periodic payments over a specified time frame, usually less than a year.

"Bullet" structures, which are also used with revolving assets, are designed to return principal to investors in a single payment. These ABS also feature two separate cash-flow management periods: the revolving period, during which any principal repaid is used to purchase more receivables, which are added to the asset pool, and the accumulation period (analogous to the amortization period in a controlled amortization structure), during which principal payments build up in a separate account to fund the bullet payment to investors. The most common bullet structure is the "soft" bullet, so labeled because the bullet payment is not guaranteed on the expected maturity date (although most such ABS do in fact return principal on this date). In contrast, a "hard" bullet structure ensures that principal is paid off on the scheduled maturity date. This is accomplished by providing for a longer accumulation period, a third-party guarantee, or both.

CLOs, CBOs and Other Structures

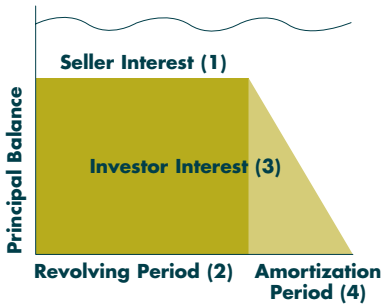
In addition to the basic mortgage-backed and nonmortgage asset-backed structures outlined above, other transaction structures have emerged that are typically included within the gener-

al category of "securitisation" transactions. The past several years have seen the dramatic growth of bank-sponsored collateralized loan obligation financings, or "CLOs." In its simplest form a CLO is a debt security that is collateralized by commercial bank loans. However, the term "CLO" has been used to refer to more complex securitisation transactions where multiple classes of debt (or in some cases, equity) securities are issued by a special-purpose entity whose assets consist principally of commercial bank loans. The cash flow from the underlying loans is used as the source of payment on the securities issued by the special-purpose entity.

Similar to other forms of securitisation, CLO structures enable banks to sell large portfolios of commercial loans directly into the international capital markets, while providing the means to achieve a number of financial and business objectives, including the reduction of regulatory capital requirements, off-balance sheet accounting treatment, reduced credit exposure and more efficient funding. To date, most CLOs have been large transactions undertaken by international banks, in which the related securities have been issued privately to large institutional investors.

In turn, a collateralized bond obligation, or "CBO," refers to a similar transaction in which the underlying collateral consists of corporate bonds or other debt securities. Many CLO/CBO structures are hybrid transactions, in which the collateral may be made up of a mixture of corporate bonds and other secured and unsecured commercial loan obligations. Some of these transactions include "credit-linked notes," which are notes with payment terms that reflect, but are not necessarily identical to, the payment terms of specific loans owned by the sponsoring bank but which are not included as collateral in the transaction.

REVOLVING TRUST STRUCTURE



- Revolving structures are used for assets that have a relatively high turnover rate (credit cards, dealer floor-plan, trade receivables). The benefit is the ability to create securities with long average lives backed by assets that are relatively short.
- A seller interest (1) ensures that there will be sufficient principal in the trust as outstanding balances grow and shrink from month to month.
- During the revolving period (2), principal collections are used to purchase new receivables. The investor interest (3) remains constant.
- During amortization (4), principal payments are applied to retire the investor balance in a series of equal installments (controlled amortization) or principal may be trapped in a separate account until the expected maturity date and then paid in a single lump sum to investors (soft bullet).

V. OVERVIEW OF SIGNIFICANT LEGAL, REGULATORY, TAX AND ACCOUNTING CONSIDERATIONS IN EUROPEAN SECURITISATIONS

Legal, regulatory, tax and accounting rules applicable to securitisation transactions differ widely among various European jurisdictions and are subject to ongoing modification and revision. In certain common law jurisdictions, such as the United Kingdom, different types of securitisation structures have been able to evolve relatively free of legal restrictions, as long as they are not expressly prohibited by existing statutes. In other jurisdictions characterized by civil legal codes (for example, France, Italy and Spain), specific laws must be adopted in order for the securitisation market to develop. As a consequence, it is beyond the scope and purpose of this resource guide to provide an exhaustive categorization and

current, detailed description of these legal and other constraints. Nevertheless, it is possible to offer some generalized guidance, in overview fashion, concerning some of the most significant legal, regulatory, tax, accounting and similar issues that need to be addressed when structuring and executing a securitisation transaction in Europe.

At the outset, it is necessary in structuring a securitisation transaction to deal with legal, regulatory and tax rules that may affect the sale, assignment or other conveyance of assets by originators to securitisation vehicles. These rules may address, for example, the basic legal framework for creating, transferring and perfecting ownership interests in the assets; restrictions on the types or terms of financial assets that may be transferred for purposes of securitisation; obligor notification or consent requirements and/or the need to obtain specific regulatory approval prior to transferring the assets; and taxation and gain-recognition events that may be triggered by the transfer of assets to a securitisation vehicle. In addition, it is generally important for there to exist various types of default, foreclosure and/or repossession remedies that may be exercised at the individual asset level by the servicer or other administrator of the securitisation transaction.

As discussed above, a central legal issue that must be addressed in virtually all securitisation transactions is the isolation of transferred assets from the financial fortunes of the related originator or any of its affiliates. This requires conforming the transfer to the bankruptcy or insolvency legal regime of the particular jurisdiction, generally by effecting the transfer as a "true sale," and building structural protections into the special-purpose entity to render it "bankruptcy remote."

Another important set of issues relates to the legal framework governing the creation, maintenance and operation of special-purpose entities employed in securitisation transactions. The most basic prerequisite is for the governing legal framework to permit the issuance by special-purpose entities of securities evidencing ownership or beneficial interests in pooled financial assets, rather than a general claim against the entity itself. Different European jurisdictions may have different securities, tax and other laws that limit an issuer's flexibility in this regard. In addition, it is generally desirable or necessary to prevent or limit taxes on the income of the special-purpose entities; to avoid burdensome licensing or other regulatory requirements that might otherwise apply to such entities; to comply with various securities or investment laws that apply to the securities issued by various types of special-purpose entities to finance their purchase of the underlying assets; and to comply with bank and other financial institution regulatory restrictions that arise in connection with transfers of assets for purposes of securitisation.

Relevant securities, banking and other laws also need to be consulted in order to determine whether and under what circumstances it is possible for securitisation vehicles to issue multiple tranches of debt with varying payment priorities, maturities and other characteristics. On the investment side, legal investment laws applicable to pension funds, insurance companies, banks and financial institutions, and other institutional investors may restrict their participation in the ABS markets. Such restrictions may deal with the levels of permissible foreign currency exposure, requirements for currency matching, limitations on the type of assets in which investments may be made or limits on the amount or concentrations of those investments.

Finally, depending upon the originator's objectives, the balance sheet effects and accounting treatment and consequences of a particular securitisation will require in-depth investigation, and will frequently influence the ultimate structure of the transaction. As with legal, regulatory and tax systems, there is tremendous diversity among the accounting rules of different European jurisdictions. The most important issues to be confronted in

this regard include structuring asset sales in a manner that achieves non-recourse sale treatment, and asset derecognition for balance sheet purposes.

The foregoing overview is not meant to be exhaustive, and competent legal, regulatory, tax and accounting advisors should be consulted for more detailed information and guidance.

VI. IMPORTANT INVESTMENT CHARACTERISTICS AND RISKS OF SECURITISED INSTRUMENTS

Prepayment Risk

Investors in ABS are typically concerned about the likelihood and extent of prepayment on the financial assets underlying the ABS. Prepayment risk describes the risk of receiving all or part of the principal of the underlying debt before it is due (in the case of amortizing assets) or before it is expected (in the case of nonamortizing assets). Determining the most likely prepayment scenario is critical to making an investment decision with a reasonable expectation about a security's life — which, in turn, affects the likely yield. For certain asset types, such as residential mortgages, increasing prepayment activity is linked to corresponding declines in market interest rates. This means that more principal may be returned, and must be reinvested, at rates of interest that are lower than those in existence at the time of the original ABS investment. This aspect of prepayment risk is sometimes referred to as "reinvestment risk."

Interest Rate Risk

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

Some ABS are subject to another type of interest rate risk — the risk that a change in rates may influence the pace of prepayments of the underlying loans, which, in turn, affects yields. As a general rule, nonmortgage consumer assets, including credit card receivables, auto loans, student loans and so on, are not highly sensitive to fluctuations in interest rates. Thus, ABS backed by such assets are not particularly subject to prepayment acceleration due to declines in interest rates. On the other hand, as noted above, residential mortgage loans may exhibit a high correlation between prepayment activity and interest rate movements.

Early-Amortization Risk

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

When an early-amortization event is triggered, the revolving period is terminated, as is the controlled-amortization period, or the accumulation period, if applicable. Under early amortization, all principal and interest payments on the underling assets are used to pay the investors, typically on a monthly basis, regardless of the expected schedule for return of principal. Once early amortization has been triggered, it cannot be rescinded or reversed.

The accelerated repayment serves as a further protection for investors and, indeed, is required by the rating agencies.

Default Risk

The risk of default is most often thought of as a borrower's failure to make timely interest and principal payments when due, but default may result from a borrower's failure to meet other obligations as well. One such obligation critical in the ABS market is the maintenance of a required amount or quality of financial assets as specified in the governing documents for a transaction.

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

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

Liquidity Risk

Liquidity risk involves the relative ease with which a particular ABS can be traded and sold at any point in time at a price that reasonably approximates its intrinsic value. The level of liquidity for any given ABS depends on a variety of factors, including its perceived supply and demand characteristics and the broader market and interest rate environment. One of the main measures of liquidity is the size of the spread between the bid price and the offer price quoted by a dealer for the ABS — the greater this spread, the greater the liquidity risk. For investors who plan to hold an ABS until maturity, liquidity risk is less important.

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